

# IAS, IFRS, Comitology or the Law-Making Power of Institutions Governed by Private Law

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## 1. The Problem as such

When Regulation 1606/2002/EC of 19<sup>th</sup> July 2002<sup>1</sup> was passed in a co-decision procedure, a decision was taken under Art. 251 EC to incorporate the rules of the International Accounting Standards<sup>2</sup> into Community Law.

The above-named regulation provides that the International Accounting Standards Board (IASB) is to draw up these accounting principles and that the latter are to be adopted by means of a comitology procedure<sup>3</sup> through a regulation passed by the Commission.

The following article is designed to investigate as to whether a regulation, which – when it was passed – deviated the European Parliament's joint decision-making power under Art. 251 EC, can be effective.

## 2. International Accounting Standards Board and Endorsement Procedure

A brief overview is herewith given of the history and structure of the regulatory institutions. The IASB's predecessor, the International Accounting Standards Committee (IASC), was established on 29<sup>th</sup> June 1973 by professional bodies of the accountancy profession (mostly those representing auditors) from nine countries, *inter alia* Germany. London was to be its head office. In April 2001, the International Accounting Standards Board (IASB) with its registered office also in London took over from the IASC the task of trying to achieve a worldwide convergence of international financial reporting. For this purpose, a foundation (IASCF) with its head office in Delaware, U.S.A. was founded as a central institution that is financed through deposits made by leading audit companies, private financial institutions and industrial enterprises from all over the world, central and development banks and other international organizations. The IASC/IASB's underlying structure is nowadays made up of three bodies: the IASC trustees, the IASB and the IFRIC. The 22 trustees, *inter alia* auditors, analysts, professors and officers preparing accounts, nominate and monitor the IASB. The trustees hold unsalaried positions and, once an initial selection has been made, appoint through a nomination committee new members by way of cooptation. The Board is predominantly made up of full-time members, receives reports on the interpretations of individual IFRS/IAS from the International Financial Reporting Interpretations Committee (IFRIC, formerly SIC), but decides by itself on the IFRIC's publication and hence its coming into force. The Board also decides on the publication and the coming into force of the standards<sup>4</sup>. It thus constitutes an institution organized under private law that has no democratic legitimacy at all.

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<sup>1</sup> Regulation 1606/2002/EC of 19/07/2002, Off. Journal L 243 of 11/09/2002, 1

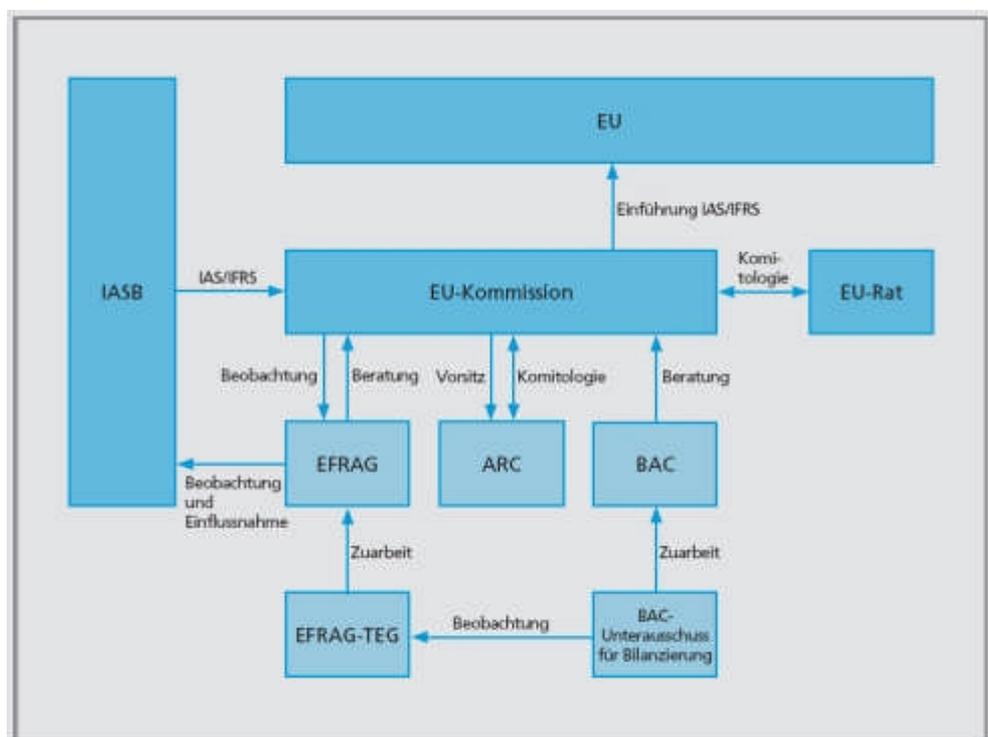
<sup>2</sup> 'International Accounting Standards' (IAS) und 'International Financial Reporting Standards' (IFRS) as well as the interpretations associated therewith (SIC/IFRIC interpretations).

<sup>3</sup> see paragraph 3 below

<sup>4</sup> Lüdenbach, IAS/IFRS, 3<sup>rd</sup> ed., 2004; cf. www.ias.org.

The legal bindingness of the IFRS/IAS is to be achieved through endorsement by the Commission. During this process, the endorsement procedure of the International Accounting Standards (IAS) and of the International Financial Reporting Standards (IFRS), both of which are designed by the International Accounting Standards Board (IASB), should take into account that the further development of these standards is an ongoing process. The endorsement of the IAS/IFRS on behalf of the EC takes place through comitology. A basic instrument empowers the Commission to pass in a simplified procedure implementing provisions for the purpose of this legal act. Equipped with this authority, the Commission will submit its proposal for the endorsement (or refusal, for that matter) of an IAS/IFRS to an Accounting Regulatory Committee (ARC). This committee consists of member-state representatives and is chaired by the Commission. If the committee agrees to the Commission's endorsement proposal, then the Commission takes steps for the application of the relevant accounting principle within the EC. Should the ARC fail to agree with the Commission's proposal, then the Commission must bring the matter of its proposal to the Council's attention in the course of the comitology procedure. The Council can approve of the Commission's proposal or dismiss it with a qualified majority. A technical committee (EFRAG – European Financial Reporting Advisory Group), which is made up of experts from the member states, together with its Technical Expert Group (EFRAG-TEG) is tasked with providing advice to the Commission for the application of the IAS/IFRS in the EU. The Commission merely acts as an observer in the EFRAG. The EFRAG is to be in contact with the IASB in order to include the Community's interests as early as during the preparation of a new IAS/IFRS or the modification of an existing IAS/IFRS.

The sub-committee on financial reporting of the EC's Banking Advisory Committee (BAC), which provides advice to the Commission in all issues relating to banking and banking supervision, was awarded an observer status with the EFRAG-TEG in order to ensure that all bank-related and banking regulatory aspects can be observed.



<sup>5</sup> Source: Deutsche Bundesbank – Monthly Report June 2002.

### **3. Comitology**

#### **3.1. The Underlying Principle**

In terms of Community Law, the consultation procedure described above is referred to as a comitology procedure. This is a process whereby the Council assigns under Art. 202, 3<sup>rd</sup> indent EC (formerly Art. 145) the law-making power to the Commission. The comitology procedure was already practiced prior to the relevant codification in the EC Treaty<sup>6</sup>. This transfer of the implementing power implies that the above-mentioned modalities must satisfy the underlying principles and rules that have been unanimously established by the Council following a relevant proposal made by the Commission and an opinion expressed by the European Parliament. It is necessary for underlying principles and rules to be established in the legal instrument, which then assigns the implementing powers to the Commission. Thus far, Art. 202 EC has remained unchanged in its version that was valid when the co-decision procedure under Art. 251 EC had not yet been introduced.

#### **3.2. How the European Parliament's Participation in the Law-Making Procedure came about**

It would be useful to explain in some detail how the European Parliament's involvement in the law-making process evolved. It was initially the Council that was the sole law-making body. The Parliament merely needed to be consulted, but its opinion was not binding on the Council. This consultation procedure continues to be effective in some areas<sup>7</sup>. Thereafter, the procedure of co-operation between the Council and the European Parliament was introduced by virtue of the Single European Act of 1986<sup>8</sup>, as a result of which the Parliament, bolstered by an absolute majority of MEPs, could force the Council to adopt a unanimous resolution when the Council wanted to enforce the legal act against the Parliament's will. This has by now been enshrined in Art. 252 EC.

The most recent event has been by virtue of the Maastricht Treaty<sup>9</sup> the introduction of the co-decision procedure that is now enshrined in Art. 251 EC. This gives the Parliament the power to thwart a legal act with an absolute majority. This is juxtaposed by Art. 202, 3<sup>rd</sup> indent EC the wording of which suggests that the sole law-making power was in the Council's hands. Art. 202 EC does not provide for any rules for the eventuality that any co-decision on the part of the Parliament under Art. 251 EC is affected.

#### **3.3. Comitology Decision**

It was for this reason that modalities for the exercise of the implementing powers assigned to the Commission were established with the Council's so-called comitology decision of 28<sup>th</sup> June 1999<sup>10</sup>.

The modalities were established, once the European Parliament had expressed its opinion. The opinion recommended several procedures. The decision as such was taken following a parliamentary hearing, but the Parliament did not act as a co-decision maker.

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<sup>6</sup> On the development cf. Hummer/Obwexer in Streinz TEU/TEC, 2003, Art. 202 Margin No. 25 ff.

<sup>7</sup> cf. Gellermann in Streinz TEU/TEC, 2003, prior to Art. 250 Margin No.8 ff.

<sup>8</sup> Off. Journal 1987 L 169 of 29/06/1987.

<sup>9</sup> Off. Journal 1992 C 224 of 31/08/1992.

<sup>10</sup> 1999/468/EC, Off. Journal L 184 of 17/07/1999, 23; decision modified by the Council's decision 2006/512/EC, Off. Journal L 200 of 22/07/2006, 11.

In Art. 3, the decision provides for a consultation procedure. It spells out that when the legal act is passed by the Commission under Art. 202, 3<sup>rd</sup> indent, an advisory committee consisting of representatives from the member states will be consulted beforehand. In an administrative procedure in accordance with Art. 4, an administrative committee, which is made up of representatives from the member states and tasked with expressing its opinion, will be set up. The committee will vote in accordance with the modalities stipulated by Art. 205(2)(4) EC. If the committee cannot agree in its opinion with the measures suggested by the Commission, the Commission will inform the Council and can adjourn the implementation by up to three months. In such case, the Council can take a different decision with a qualified majority.

Art. 5 sets out the regulatory procedure. It envisages that another committee (regulatory committee) is established that consists of representatives of the member states. The remainder of the procedure is identical with the administrative procedure. However, an opinion of refusal on the part of the regulatory committee has the effect that the Commission is unable to decide on the implementing measure<sup>11</sup>.

Art. 5 also provides for a regulatory procedure with control. In this context, further co-operation on the part of the European Parliament is envisaged.

The comitology decision has come under fire particularly because of the insufficient opportunity for the European Parliament to get involved<sup>12</sup>.

### 3.4. Regulatory Procedure

The implementation of the International Accounting Standards took place following a reference in Art. 6 of Regulation 1606/2002/EC under Art. 5 of the comitology decision that has the following wording:

(1) *The Commission shall be assisted by a regulatory committee composed of representatives of the member states and chaired by the representative of the Commission.*

(2) *The representative of the Commission shall submit to the committee a draft of the measures to be taken. The committee shall deliver its opinion on the draft within a time limit which the chairman may lay down according to the urgency of the matter. The opinion shall be delivered by the majority laid down in Article 205(2) of the Treaty in the case of decisions which the Council is required to adopt on a proposal from the Commission. The votes of the representatives of the Member States within the committee shall be weighted in the manner set out in that Article. The chairman shall not vote.*

(3) *The Commission shall, without prejudice to Article 8, adopt the measures envisaged if they are in accordance with the opinion of the committee.*

(4) *If the measures envisaged are not in accordance with the opinion of the committee, or if no opinion is delivered, the Commission shall, without delay, submit to the Council a proposal relating to the measures to be taken and shall inform the European Parliament.*

(5) *If the European Parliament considers that a proposal submitted by the Commission pursuant to a basic instrument adopted in accordance with the procedure laid down in Article 251 of the Treaty exceeds the implementing powers provided for in that basic instrument, it shall inform the Council of its position.*

(6) *The Council may, where appropriate in view of any such position, act by qualified majority on the proposal, within a period to be laid down in each basic instrument but which*

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<sup>11</sup> For more details see paragraph 3.4 below.

<sup>12</sup> Mensching, EuZW 2000, 268; Hummer/Obwexer in Streinz TEU/TEC, 2003, Art. 202 Margin No. 40 ff; an early claim filed by the Parliament failed for reasons of inadmissibility; Case No. 302/87 EP/Council (1988, 5615).

*shall in no case exceed three months from the date of referral to the Council.*

*If within that period the Council has indicated by qualified majority that it opposes the proposal, the Commission shall re-examine it. It may submit an amended proposal to the Council, re-submit its proposal or present a proposal for a legal instrument on the basis of the Treaty.*

*If on the expiry of that period the Council has neither adopted the proposed implementing act nor indicated its opposition to the proposal for implementing measures, the proposed implementing act shall be adopted by the Commission.“*

According to a judgement passed by the European Court of Justice, the comitology decision does not constitute a legal norm, but merely a code of conduct from which the Council cannot depart without having stated any reasons<sup>13</sup>. What remains unresolved is the question as to whether the underlying principles of Art. 251 EC can be undermined by the regulatory procedure under Art. 5 of Decision 1999/468/EC. For the Parliament is not in the position as a result of the regulatory procedure to thwart a regulation, nor has the Economic and Social Committee been heard in this matter.

### **3.5. Establishing Essential Features and Extent of Certainty**

The essential features of the matters to be regulated must be established in the basic instrument<sup>14</sup>. What is important in this context are those provisions that help to implement the fundamental guidelines of Community policy<sup>15</sup>.

The enabling provision also has to be established so that the boundaries of the conferred power are to be clearly set out<sup>16</sup>. Even if one interprets judicature in a way that the degree of specificity is variable<sup>17</sup>, the Council is still subject to a commitment under Art. 1 of the comitology decision in that the main features of the delegated powers are to be established in the basic instrument.

### **3.6. Underlying Principles and Rules of Regulation 1606/2002/EC**

The general regulation, on the basis of which any further implementing regulations are passed by the Commission, provides the following in Art. 3(2):

*(2) The International Accounting Standards can only be adopted if:*

- they are not contrary to the principle set out in Article 2(3) of Directive 78/660/EEC and in Article 16(3) of Directive 83/349/EEC and are conducive to the European public good and*
- they meet the criteria of understandability, relevance, reliability and comparability required of financial information needed for making economic decisions and assessing the stewardship of management.*

Article 2(3) of the fourth Company Law Directive 78/660/EEC has the following wording:

*‘The annual accounts shall give a true and fair view of the assets, liabilities, financial position and profit or loss of the company.’*

Article 16(3) of the seventh Company Law Directive 83/349/EEC has the following wording:

*‘The consolidated accounts shall give a true and fair view of the assets, liabilities, financial position and profit or loss of the undertakings included therein taken as a whole.’*

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<sup>13</sup> ECJ Judgement C-378/00, Commission/Parliament and Council (Life) (2003, I-00937).

<sup>14</sup> ECJ Judgement 23/75, Rey Soda, (1975, 1302) Margin No. 10, 14.

<sup>15</sup> ECJ Judgement C-240/90, Germany/Commission (1992, I-5383) Margin No. 37.

<sup>16</sup> ECJ Judgement 291/86, Central-Import Münster (1988, 3679) Margin No.13.

<sup>17</sup> Hummer/Obwexer in Streinz TEU/TEC, 2003, Art. 202 Margin No. 35.

These are only very general principles that at the end of the day undermine the passed company law directives in a simplified regulatory procedure.

What would have to happen in this case is that the directives should be re-evaluated in a co-decision procedure under Art. 251 EC. The fact is however that these directives are weakened in the simplified procedure. That means to say that standards, which have been formally decided and have led to the enactment of the directives in a complicated and well-balanced procedure, are now replaced by a general and not very concrete principle that cannot be grasped easily in Art. 3(2) of Regulation 1606/2002/EC. The compromise made at the time between the Anglo-Saxon view on financial reporting and the financial reporting practiced in Continental Europe is being undermined at the expense of the latter. At the time, the company law directives stood out for the comprehensive deliberations and the above-mentioned compromise.

Any one-way shift of the financial reporting as part of Company Law towards the practice of Anglo-Saxon legislation without any adjustment of Company Law is objectionable. It is a known fact that the incorporation of the IFRS into German law creates considerable difficulties with the existing financial reporting practice, in particular as regards the term *Eigenkapital*, a concept that is alien to Anglo-Saxons in this variety. In Anglo-Saxon territories, this term is paraphrased with 'equity', which seems to be an easy solution. But the concepts of equity and *Eigenkapital* originate from different legal contexts and will continue to be incompatible for as long as the Company Law of the member states has not been harmonized.

If the original accounting principles are to be abandoned and the accounting principles set out in the directives are to be relinquished, then such a step would require a democratic legitimacy that has to go beyond the ambivalent and diffuse definition in Art. 3(2) of Regulation 1606/2002/EC. It would be out of place to claim that Art. 3(2) of Regulation 1606/2002/EC establishes 'underlying principles and rules', as a result of which the modalities merely have to be established by the Commission under Art. 202 3<sup>rd</sup> indent EC. The extent of legal certainty, which is asked of the jurisdiction, namely that the powers are sufficiently specified, has not been achieved. The main elements of the delegated powers are not established in the basic instrument. The essential features of the matters to be regulated feature even less prominently. How is one supposed to be able to deduce from the clause of one article the essential features for a set of rules comprising several hundreds of pages? It appears to be exceedingly alarming if a private institute drafts accounting principles that are passed through a simplified procedure following circumvention of Art. 251 EC and without involvement of the European Parliament and the Economic and Social Committee as prescribed therein. In Community Law terms, this amounts to an inadmissible assignment of responsibilities to third parties outside the Treaty<sup>18</sup>. Hence the application of the accounting standards to Community Law is to be regarded as invalid, as such application is in blatant breach of the institutional balance.

#### **4. Effect on Sanctions**

If the implementation of the accounting standards is to be considered to be invalid on the grounds set out above, then all sanctions imposed for any breach of these standards would be inapplicable. This would also apply to any measures taken against auditors under the

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<sup>18</sup> ECJ, Case Nos. 9/56 and 10/56, Meroni/High Authority (1957/58, 133). In constitutional law terms, the same conflict arises due to the reservation of statutory powers, if institutions organized under private law avail themselves of virtually standard-setting responsibilities, e.g. IDW e.V. and Deutsches Rechnungslegungs Standards Committee e.V., when one considers the ambitious yardstick as envisaged by Art. 80 GG [German Civil Code] for statutory regulations.

professional code of conduct. In this respect, the decision made by the European Court of Justice would have to be clarified, if need be in the course of a referral procedure.

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## **6. Résumé**

The implementation of the International Accounting Standards by the EC Commission through comitology is marred by substantial Community Law concerns. This is not without consequences on possible sanctions imposed for breaches of the reporting requirements, which would have to be resolved by the European Court of Justice.