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Accounting Controls;

THE EUROPEAN EXPERIENCE

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Should the accounting process be administered in the public sector or the private sector? This question has been discussed within the profession and the business community for some time.

Recent attention focused on the issue by the U.S. Congress has prompted me to evaluate how the profession abroad has been affected by the type of control that has been placed over it. Recently I moved to Washington, D.C., after more than ten years in Europe. Thus, it is appropriate for me to contrast the relationship between government and the public accounting profession as it exists in European nations to that which exists in the United States. Since this relationship differs in each country of Europe, I will consider here its role in only three: the United Kingdom, the Netherlands, and the Federal Republic of Germany. All are industrially developed countries with mature public accounting professions.

The Origins of Accounting

The United Kingdom is considered by many to be the birthplace of accountancy. The role of professional accountants can be traced back to the early eighteenth century, when they helped to administer insolvent estates. The actual practice of the profession as we know it today, however, began in the nineteenth century—when business enterprises became larger, organized themselves as limited companies, and expanded abroad. The result was quick recognition of the need to improve accounting systems in order to control remote operations.

During the latter half of the nineteenth century, UK companies began to raise capital from the public. To bridge the credibility gap between the enterprise and the investor, a need for an objective assessment was recognized. Thus came into being audited financial statements.

The Companies Act of 1900 required that all limited companies appoint auditors. Anticipating this requirement, the public accounting profession pressed to gain legal status, and in 1880 the Institute of Chartered Accountants in England and Wales was incorporated by Royal

Charter. Shortly thereafter, institutes were chartered in Scotland and Ireland as well.

In response to similar pressures and opportunities, the public accounting profession in the Netherlands was formalized in 1895 under the Netherlands Institute of Accountants. As in the United Kingdom, the Dutch developed the accounting profession primarily in response to the needs of business. However, in the Netherlands, the academic community had a unique influence on the development of accounting rules. A number of accounting and economics professors in the early 1900s were particularly outspoken in conveying their “academic” interest in the development of the profession.

The German public accounting profession is nearly as old as its counterparts in the United Kingdom and the Netherlands, dating back to the beginning of the twentieth century. An important difference, however, lies in the motive for its origin. The German profession has grown out of the particular interests and needs of the very strong German banking industry. German companies have traditionally relied more heavily on debt financing than do companies in other countries. The strength and dominance of German banking institutions made this quite reasonable. In the late nineteenth century, large German banks began to establish auditing groups, either in separate auditing companies or as departments, to carry out auditing and other investigative assignments in connection with their loans and trade financing. Many of today’s largest German public accounting firms were started in this way, and leading elements of the profession were captives of the banking industry for many years. A few major German public accounting companies still have bank shareholders, and thus banking ties continue to be of prime importance.

Setting Auditing Standards

In the United Kingdom, the chartered accountant is not licensed or regulated by the government. Under the Royal Charters, the Institutes are responsible for establishing and

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strictly enforcing rules of professional conduct as a condition of membership. Under the charters also, those who violate the rules will be disciplined. The institutes themselves issue statements on ethics and professional conduct which expand on the broad rules in the charter.

The UK Companies Acts of 1948 and 1967 are the main pieces of legislation affecting businesses. They require that financial statements be audited, but they do not set auditing standards. Under this legislation, the auditor's report must state that in his opinion the financial statements comply with the Companies Acts and that they give a true and fair view of the business' state of affairs and its profit and loss. The auditor must satisfy himself that proper books have been maintained, that the financial statements are in agreement with the books, and that he has received all the information and explanations required from the company. The setting itself of auditing standards in the United Kingdom is the responsibility of the institutes.

In the Netherlands as well, auditing standards and the rules relating to professional conduct are the responsibility of the profession. The company law provides only that the financial statements of certain companies be audited and that required audits must be carried out by registered accountants.

The Registered Accountants Act of 1967 established the Netherlands Institute of Registered Accountants. The new organization drew together several previous groups. Under the act, the institute is responsible for the regulation of its members, the establishment of educational standards, the administration of examinations, and so on. The act, however, did not significantly change the practice of public accounting in the Netherlands. Nor were the rules of professional conduct, issued by its predecessor Institute of Accountants in 1910, substantially changed when they were expanded and clarified in 1973.

Since Dutch law does not require a specific form of auditor's opinion, the institute has stepped in to recommend a standard form. And although auditing standards have not been codified by the institute, there is an understanding of what constitutes good professional practice. This, combined with the institute's rules on professional conduct, results in well-developed auditing standards.

The enforcement of professional rules is the responsibility of the institute. Its disciplinary board hears complaints against members. If it finds a member guilty, it may either warn, suspend, or expel the member.

In Germany, there is more legislation and more government involvement concerning commercial and professional activities. Yet the regulation of the public accounting profession is limited. The Federal Accountancy Law gives

the Chamber of Auditors the authority to supervise professional activities. All "wirtschaftspruefer" are required to be members of this chamber. Most of them also belong to the Institute of Auditors, a voluntary organization which deals with ethical and technical questions in accounting and auditing. (It issues auditing guidelines which members are required to follow.) Both of these professional organizations are under the control of their members.

The AG (Stock Corporation) Law requires the auditor to meet certain responsibilities. Among other things it specifies the type of opinion and the type of report which is to be prepared. Legally, these rules apply only to audits of AG corporations, but wirtschaftspruefer generally apply the same rules—along with the auditing standards and guidelines issued by the institute—when auditing other types of business enterprises.

A unique characteristic of German law is that the professional liability of a wirtschaftspruefer is limited by the AG Law to DM 500,000 (\$200,000) and that he has virtually no professional liability to third parties. One might assume that, given this limitation, the German auditor might take less care in establishing professional standards and in carrying out his professional responsibilities. In fact, just the opposite is true. In my years in Europe, I have heard German auditors criticized for taking their professional rules too seriously, but never for being less professional than their counterparts in other countries.

In all three countries, professional accounting firms provide audit, tax, and management consulting services. In some countries, these firms also offer share evaluations, act as liquidator, receiver, or trustee, and provide commercial law, transfer agent, and company secretarial services. Moreover, government agencies in the three countries employ accounting firms as consultants, and government corporations are audited by public accountants. But no independence questions have been raised as a result of these management consulting activities or the work for government agencies. The professions in all three countries have well established independence rules.

While the national laws in each country do establish auditors' responsibilities, the parliaments of the three countries have clearly decided that establishing and enforcing rules and auditing standards is the province of the professional accountants themselves. All have passed accountancy laws prescribing just that.

The professions in these countries have developed to a high level of professional stature—as high, in my opinion, as in any other country, including the United States. Moreover, the reputation of accountants is excellent among business and government leaders in these countries.

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Accounting Principles

In the United Kingdom, accounting principles and disclosure requirements have been established both through legislation and through standards set by the public accounting profession. The Companies Acts of 1948 and 1967 provide the framework. Their provisions cover various requirements: bookkeeping, the filing of annual financial statements, and the auditing of annual financial statements. They also cover requirements designed to make financial statements "give a true and fair view of the state of affairs of the company and of its profit and loss of the year."

Parliament has left to the accounting profession the responsibility for establishing accounting principles and practices. In response, the three chartered institutes, along with a couple of other accountants' organizations, have agreed on "Statements of Standard Accounting Practice." Members consider these statements to be authoritative. The institutes also issue "Recommendations on Accounting Principles," which are generally persuasive but do not have the same force with members as do the statements.

The London Stock Exchange also has a certain influence on accounting principles and financial reporting. The requirements concerning listing applications and reports by listed companies go beyond the information that is normally called for under the Companies Acts. Of particular interest is one requirement. When a prospectus contains forecast information, the underlying assumptions must be disclosed and the accounting assumptions and calculations reported by the auditor.

Income tax legislation does not directly affect accounting or reporting in the United Kingdom. If tax regulations should provide for an accounting treatment that differs from generally accepted accounting practices, the tax effect of such differences is deferred in the company's financial statements.

Within the broad framework of the Companies Acts—that financial statements "give a true and fair view"—accounting principles have been developed over the years in response to the needs of the users of financial statements. Moreover, the institutes have been timely in issuing standards whenever matters require attention.

In the Netherlands, accounting practices and disclosure rules were most recently revised by the 1971 Act of the Annual Accounts of Enterprises. This act contains specific requirements on disclosure and on the classification of information in the financial statements. However, it provides little guidance in accounting principles. It suggests merely that in evaluating assets and determining liabilities, the accountant complies with standards that are acceptable in economic and business life. It does say, however, that the

accounting principles that are used must be disclosed in the financial statements and that the principles chosen must be applied consistently; otherwise, any changes in accounting principles and their effects must be disclosed.

The Netherlands' Stock Exchange Board has established no further accounting rules or disclosure requirements. Nor, as in the United Kingdom, do tax laws and regulations directly affect accounting or reporting standards.

While accounting principles are highly developed in the Netherlands, this is not the result of legislation, but rather of the influence of the academic community, the institute, and, in particular, business organizations who recognize a need for meaningful accounting rules. In fact, the Dutch government recently requested the Institute of Registered Accountants, along with representatives of the Dutch employers organizations and the Dutch trade unions, to determine what accounting standards can be considered acceptable in economic and social life. The accounting practices that result will enable the financial statements of Dutch companies to conform to the objectives of the 1971 Act on the Annual Accounts of Enterprises. Obviously this process will require compromise among the academic community, professional accountants, and representatives of the labor unions and the employers' associations. This pragmatic approach, however, should produce accounting principles which reflect a high degree of uniformity, as well as financial statements which provide the information needed by their users.

In Germany, on the other hand, accounting, reporting, and disclosure standards are the result of legislation, including a very strong tax law. The stock exchanges have virtually no role in developing accounting and reporting standards, and that of the public accounting profession is minor.

The most popular of the large business entities are called the AG (stock corporation) and the GmbH (limited liability company.) The AG Law of 1965 sets out reporting, disclosure, and accounting rules for AGs. It details the proper form for financial statements and disclosure rules, and to a lesser extent for valuation rules. While the 1965 law has tightened up the valuation alternatives, a range of judgment is still available.

The GmbH and other business entities are not bound by the AG Law, although they do consider it good practice to follow the law. They do so because the law that pertains to GmbH companies dates back to 1898. Of course, if it wants, a GmbH can also choose to base its accounting and reporting on this outdated law, incorporating current commercial and tax law rules. (The German Parliament has been working on a new GmbH law for almost ten years.)

In addition, there is a commercial code, applying to all business entities, which deals with bookkeeping and other commercial rules.

Tax law has a significant effect on German accounting and reporting practices. Contrary to the practice in the other countries, German law states that if a company utilizes such provisions as accelerated depreciation, which result in understatement of assets or overstatement of liabilities, these values must also be used in the company's published financial statements. As a result, almost all tax incentives affect a company's financial reports, and the effect does not improve the quality of the financial information.

Although there is no legal basis for the private sector to be involved in accounting rule-making, the Institute of Auditors does issue opinions on accounting and reporting requirements. These technical opinions are neither numerous nor legally binding, but a member must have valid reasons for not following them. More important perhaps is the institute's monthly journal, whose articles and papers on technical questions are an important source of information for the profession.

Because the rules of accounting, reporting, and disclosure are largely regulated by law, including the tax law, the ability to respond to change is limited in Germany. The Institute of Auditors has made some progress in recent years in issuing interpretations and pronouncements on accounting matters. However, the legislative process is slow, for accounting rules are not binding in Germany until they are legislated.

Three Contrasts in Rule-Making

In these three countries, we see three different ways in which government and private enterprise are involved in making accounting rules. In the UK, the government has established a framework for accounting and financial reporting through the Companies Acts. The substance is developed by practice and by the pronouncements of the Institutes of Chartered Accountants.

In the Netherlands a similar framework exists, but the government has established an accounting rule-making committee, which includes labor and business as well as registered accountants. In Germany, legislation is the only recognized source of accounting and financial reporting rules. As a result, even though the German profession has been increasingly active in issuing technical and interpretative papers, these do not have the authoritative stature as have, for example, pronouncements that are made by the UK institutes.

The UK accounting rule-making process is the most

responsive to changing economic and business conditions. In my opinion, the results are of high quality, and are responsive to more than the interests of industry. The process in the Netherlands is slower, and the result there reflects compromise among the various groups involved. The quality of the output, however, is high and is responsive. In Germany, the legislative process is less responsive to changing conditions—as evidenced by the 80-year-old GmbH law being on the parliamentary agenda for almost ten years. When there is legislative output, the quality, in my view, is much lower than the quality of accounting rules in other countries. To cite an example, financial statements in Germany are distorted by the legal requirement that the provisions of the tax law be utilized in official financial statements.

Personal Conclusions

I consider the quality of financial reporting—and of public disclosure—to be much higher in the UK and the Netherlands than in Germany. The reporting requirements under the German AG Corporation Law deal to a greater extent with form than with substance, and there is no practical vehicle for responding to the changing conditions that might occur.

Other factors, such as the traditional source of capital and the banking system, contribute to this situation. But a principal reason is that responsibility for accounting and reporting rule-making lies with the German parliament and government.

Accounting as an art has developed over many years. Accounting rules are best made by those skilled in the art. That they do not lend themselves to legislation, seems to be confirmed by the foregoing.

On considering the development of the public accounting profession in the U.S. in the past twenty years, one must conclude that there has been much positive change. The same is true in the three European countries. Such change occurs when the profession responds to a changing environment. By this is meant the changing role of government in business, but not legislation or government regulation of the profession.

Even though the German public accounting profession is one of the most highly regarded in the world, the development of accounting standards has been much slower there than in the other countries. This is due largely to the lack of both speed and quality in the legislative process. Of course, progress is even slower in a number of other countries where accounting standards are determined by parliament or the government. Nowhere, experience seems to say, do politics and accounting mix. ▲