Online Appendix

Accounting Regulation in the European Union

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This online appendix briefly discusses accounting regulation in the EU single market. First, we provide a brief history of accounting regulation in the EU. Second, we highlight the IFRS endorsement process. And third, we describe how the EU significantly shaped the securities markets across the Member States.

EU legislation – Accounting regulation and the EU single market

A brief history of accounting regulation in the EU

The EU single market established a common framework and legal basis for financial reporting and disclosure requirements, fostering transparency and simplification of cross-border transactions. The European Parliament and Commission passed multiple Directives and Regulations that affected company reporting and auditing, company law, and security markets; we highlight a few below. EU Regulations have immediate binding legal force throughout all Member States, while EU Directives include certain goals that all Member States must reach. For EU Directives, Member States are responsible for transposing these goals into national laws and can exert some decision-authority in how and when to implement such transposition, allowing for consideration of their specific institutional differences.[1] Member States often also issue national legislation to transpose EU Regulations, defining the local enforcement agencies, inspection and sanctions on the topic. Overall, enforcement of EU Directives and Regulations is mostly left to the Member States, resulting in important variation (see below).

In the early years of the EU, all Member States had their own local GAAP. The first major step towards harmonization was the 4th Company Law Directive 78/660 (Council of the European Union, 1978) which introduced the requirement to prepare unconsolidated (individual) financial statements in 1978. From 1983 onwards, the 7th Company Law Directive 83/349 (Council of the European Union, 1983) also introduced the requirement to prepare consolidated financial statements for companies (parents) that control another entity (subsidiary). Therefore, all limited liability companies in the EU must prepare financial statements, independent of their listing status. One of the most notable, and widely studied, regulations that shaped company reporting is the International Financial Reporting Standards (IFRS) Regulation (1606/2002), which adopted IFRS for the preparation of consolidated financial statements by firms listed on EU-regulated public markets in 2005 (European Parliament, 2002). The current accounting rules are laid down in the Accounting Directive 2013/34 (European Parliament, 2013), which increased the comparability of local GAAPs within the EU (European Parliament, 2013).

On the auditing side, the Statutory Audit Directive 2006/43 sets minimum requirements for statutory audits, such as the engagement of approved auditors and disclosure of the responsible auditor's identity (European Parliament, 2006). The Statutory Audit Directive has been amended by the Audit Directive 2014/56, which established uniformity in the rules concerning the independence and professional ethics of auditors, and in conjunction with the

[1] Reaching consensus on EU Directives is often easier for Member States, as they tend to be less detailed compared to EU Regulations. If a Member State does not transpose, the EU Commission can launch a formal infringement procedure and may bring proceedings against the Member State before the Court of Justice of the EU (European Parliament, 2024).

Accounting Directive 2013/34 laid down the current requirement to publish *audited* financial statements. Almost simultaneously, Audit Regulation 537/2014 improved the statutory audits of public-interest entities, enhancing transparency in the audit market.[2] It introduced mandatory audit firm rotation, the publication of significant risks (key audit matters), and the separation of audit and non-audit services (European Parliament, 2014). The Statutory Audit Directive 2006/43 also states that statutory audits should comply with the International Standards on Auditing (ISA) as developed by the International Auditing and Assurance Standards Board (IAASB), an independent standard setter. Additionally, both the Statutory Audit Directive 2006/43 and the Audit Directive 2014/56 state that the European Commission (EC) should adopt the ISA, but to date, the EC has not formally endorsed them. Therefore, there is no requirement to use the IAS across the entire EU. Almost all Member States, however, have voluntarily adopted the ISA. According to the International Federation of Accountants, France and Greece have only partially adopted the ISA.[3]

While taxation is regulated mostly at Member State level, two examples of EU-level tax regulation are the Value Added Tax (VAT) Directive (Council of the European Union, 2006) and the parent-subsidiary Directive (Council of the European Union, 2011). The VAT Directive harmonized the VAT system across the EU, while the parent-subsidiary Directive aimed to exempt dividends and other profit distributions paid by subsidiary companies to their parent company from withholding taxes, eliminating the double taxation of such income at the level of the parent company. Other examples are the Anti-Tax Avoidance Directive 2016/1164 (Council of the European Union, 2016), which defines anti-tax-abuse measures, and more recent regulations such as country-by-country reporting (Directive 2021/2101, European

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[2] The Audit Directive 2014/56 and Audit Regulation 537/2014 are often jointly labelled as 'EU Audit Legislation'.

[3] The information is based on the country profiles of www.ifac.org/who-we-are/membership (accessed Nov. 15, 2024).

Parliament (2021)) and Directive 2022/2523, which introduced the global minimum tax (Council of the European Union, 2022).

As a result of this layered regulatory framework, companies often effectively report under a three-book system: First, firms listed on EU-regulated markets prepare their consolidated statements in line with IFRS. Second, in most countries, the unconsolidated statements of the parent and all its subsidiaries must be prepared in line with local GAAP. Third, with tax mostly regulated at Member State level, firms must file tax returns that differ from IFRS and local GAAP.

IFRS endorsement process

After replacing in 2001 the *International Accounting Standards Committee* that had issued International Accounting Standards since 1973, the *International Accounting Standards Board* (IASB), a part of the IFRS Foundation, started developing IFRS. For an overview of the due process that the IASB exerts in the development of these standards, and the various parties involved, we refer to Deloitte (2023). After the IASB publishes a final draft of a new standard or a revision of an existing standard, the EU needs to endorse it before it comes into force. The *European Financial Reporting Advisory Group* (EFRAG), a non-profit organization operating under Belgian law, steps in to evaluate the standards. EFRAG assesses whether the standards meet the criteria for endorsement, as outlined in Article 3(2) of Regulation 1606/2002. For example, IFRS can only be adopted if "they meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management" (Article 3(2) 1606/2002). Upon receiving the advice from EFRAG, the EC prepares a draft endorsement of the IFRS standards. This draft is voted on by the *Accounting Regulatory Committee* (ARC) as defined in Article 6 of Regulation 1606/2002. If accepted, the EU Parliament and the Council of the European Union are granted a three-month period to review and potentially oppose the Commission's draft endorsement. If no objections are raised, the Commission's draft is published in the 'Official Journal', making them applicable and legally binding within the EU Member States.

The endorsed ‘EU-IFRS’ are not necessarily the same as the IFRS issued by the IASB. First, there is a timing difference between the IASB publication and the EU endorsement. Second, the EU can reject or only partially adopt IFRS and leave out certain aspects (‘carve-outs’). For example, the EU adopted IAS 39 (Financial Instruments: Recognition and Measurement) except for certain provisions on the use of the full fair value option and on hedge accounting (EY, 2022). Conversely, Dobler (2020) describes that the ‘top-up’ that "extends the scope of an optional temporary exemption from IFRS 9 from predominate insurers to the insurance sectors of EU-based financial conglomerates” in the endorsement of ‘Amendments to IFRS 4’ is effectively an unprecedented ‘carve-in’.

Security markets regulations

The EU also significantly shaped the securities markets across the Member States. The groundwork was laid in the Financial Service Action Plan (1999 – 2004), which included over 40 regulatory changes to create a single market for financial services (Byard et al., 2021). The four so-called Lamfalussy Directives, named after the former chair of the EU Advisory Committee Alexandre Lamfalussy, constitute the core of the action plan: The Market Abuse Directive 2003/6 aims to prevent insider trading and market manipulation (European Parliament, 2003a), the Prospectus Directive 2003/71 increased IPO prospectus disclosure (European Parliament, 2003b), the Markets in Financial Instruments Directive (MiFID I) 2004/39 was the culmination of the “passporting” efforts discussed above in that it created a single European financial service market (European Parliament, 2004a), and the Transparency Directive 2004/109 harmonized transparency requirements for firms listed on EU-regulated markets, and included the introduction of mandatory quarterly reporting for publicly listed firms (European Parliament, 2004b). The *European Securities and Markets Authority* (ESMA) monitors Member State enforcement activities and collects data on the number of examinations performed and the number of actions taken by local enforcers, but there exists no EU-wide enforcement body.

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