האוניברסיטה העברית בירושלים
THE HEBREW UNIVERSITY OF JERUSALEM

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International Accounting Standards (IFRS) and National Accounting Sovereignty: A Case Study of Germany and Israel

Israel Klein

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"I feel we have the chance, between now and the middle of the next decade, to have one standard around the world and that standard will be IFRS."

(Samuel A. DiPiazza, Jr., CEO of PricewaterhouseCoopers)[1]

[1] *Business Today*, 23 March 2008 (http://businesstoday.intoday.in/story/a-single-set-of-accounting-standards-is-inevitable--samuel-a.-dipiazza-jr/1/1704.html).

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A. Introduction[2]

Many social arrangements in modern society are based on financial parameters. For example, social welfare is given to a member of society based on his or her financial status; in a similar way, a member of society is required to participate in funding the needs of society through the payment of tax according to his or her financial income or wealth.

Everywhere we look, financial parameters play a major role in the modern social order. Naturally, the use of financial parameters is not limited to social systems with welfare characteristics. For example, financial credit is a social arrangement which is created *inter alia* between banks and borrowers based on the banks' capital availability and the borrower's financial stability and its ability to repay the debt – all of which are financial parameters.

In some circumstances the financial parameters are defined and measured within the social arrangement which uses them; while in other circumstances these parameters are defined and measured "outside" of that arrangement.

An important external source of financial parameters used by many social arrangements is financial accounting. To some extent, financial accounting becomes part of those social arrangements which use it.

One social arrangement which uses financial parameters is the law. An extensive part of legislation is dependent for its normative action on financial parameters which are provided by financial accounting. For example, in order to levy tax on corporations, the tax code uses financial accounting as a means to determine the taxable income of the corporation. This dependency of the law on financial accounting places it under a special normative status.

Although financial accounting plays a substantive role in providing the financial parameters which are used by many social arrangements, the idea of national accounting sovereignty has seen better days. During the previous decade, when international harmonization of financial accounting standards occurred, the

[2] Israel Klein is a research fellow at the Hebrew University of Jerusalem, Faculty of Law. The research for this paper was made possible by a research grant awarded by the Center for German Studies at the European Forum at the Hebrew University of Jerusalem. I would like to thank Prof. David Gliksberg of the Hebrew University and Dr. Hadar Jabotinsky for reading and commenting on earlier drafts of this paper. Any mistakes or omissions are, of course, my own.

local financial accounting rules and principles of more than one hundred countries were rapidly replaced by a united global standard of financial accounting: the International Financial Reporting Standard (IFRS).

The rapid spread of a uniform set of financial accounting standards raises the question of whether there is still a place for national accounting sovereignty in the era of the IFRS.

One way to approach this question would be to examine whether accounting standards in the era of the IFRS represent national preferences and needs, such as accomplishing distributive justice. An alternative explanation could be that accounting in the IFRS era has become a natural measuring technique. Following the answer to this question, another question has to be asked: in light of its national preferences, such as its influence on distributive justice, should financial accounting be set in a similar manner to other systems which have this type of influence, i.e. by a national body, or can it be set by a foreign body, like many other international measuring techniques?

This paper takes a different approach. Using Germany and Israel as a case study for two countries which adopted the IFRS, this paper argues that even in the era of the IFRS, accounting sovereignty still matters. According to this paper's findings this statement is true at least for some social arrangements such as taxation.

The factual findings this paper presents, concerning the maintaining of accounting sovereignty over taxation in Germany and in Israel, raise a number of normative questions about the concept of national accounting sovereignty. Among these is the question of which sovereign entity should set the accounting standards. Should it be the state, or can it be left in the hands of the local market force? A normative analysis of this question will be performed in the future, based on the factual findings this paper presents.

This paper proceeds as follows: the next part of the paper discusses the concept of national accounting sovereignty, and explains why Germany and Israel were chosen as a case study. The third part examines some developments of the past decade in the German accounting system, including the adoption of the IFRS. This examination shows that although Germany had surrendered some of its accounting sovereignty in exchange for international standards, accounting sovereignty over taxation was left intact. The fourth part provides a brief historical review of the development of the Israeli accounting system with an emphasis on the integration process of international accounting standards into the local Israeli accounting system, a process which climaxed with the adoption of the IFRS, and culminated in the loss of national accounting sovereignty over almost all of the accounting systems except for taxation. The fifth part discusses the different ways in which Germany and Israel maintained accounting sovereignty over taxation, and argues that at least two models exist for the maintaining of national accounting sovereignty over taxation. The last part of the paper concludes the discussion.

B. National Accounting Sovereignty

Unlike other national sovereignty concepts, such as state sovereignty over its geographical borders or the state's right to collect taxes from its citizens, national accounting sovereignty is not an associative concept. A proper definition of the term must begin with a discussion of the nature of financial accounting and its role in the modern state.

Financial Accounting

Financial accounting can be abstractly defined as a monetary measuring technique which describes activities and behaviors of an entity in financial terms. It can be seen as a financial language used by entities, such as companies, to describe some of their aspects in financial terms (Klein 2014).

For example, when a company possesses manufactured goods which are planned to be sold for profit, the goods will be expressed in the company's financial statement prepared according to accounting standards, as an inventory worth the monetary amount which was spent in the manufacturing process of these goods.

Like most languages, financial accounting is made of an accounting vocabulary which contains accounting terms, such as profit and loss, revenue and expense; and of grammar rules which regulate the use of the accounting terms. The accounting vocabulary and grammar rules are presented in the accounting standards.

As mentioned in the introduction, the expression of activities and behaviors in financial terms has become very important in modern society. More and more parts of the social order are affected or determined by financial parameters, and hence by financial accounting.

In many instances the state's formal regulation of its internal affairs is based on financial parameters which are determined by accounting standards. For example, state regulation which requires companies with revenues that exceed a certain amount to employ workers with disabilities is in fact dependent on the financial recognition of income and revenue. These financial parameters, and most importantly their recognition terms, are defined by accounting standards.

In this respect, accounting standards act as an invisible regulatory layer of rules upon which stand the formal laws of the state. Because of the substantial role of accounting standards in the broad social regulatory framework, a state which aspires to possess full sovereignty over its internal affairs must also possess sovereignty over the determination of at least some of the financial parameters and their measurement as determined by financial accounting.

In contrast to the national state's interest, accounting itself derives great benefits from being an international system which is not subordinated to any national authority. From a practical perspective, its development as a measuring technique is enhanced by its international usage. From a conceptual perspective, the ability of accounting to function properly as a system which expresses economic meanings is dependent on the ability of its users to compare and understand different accounting expressions made by different accounting entities in different parts of the world (Klein 2014). Without an international standard, differences exist between different national sets of accounting standards. Therefore the accounting expression produced by one national set of accounting standards of a specific jurisdiction is incomparable to another expression produced by a different national set of a different jurisdiction.

The lack of international comparability prevents accounting from being able to express financial meanings between sides which have a different domicile. In the pre-globalization era, it is possible that this mismatch did not constitute a problem. However, globalization, and all that comes with it, has produced a crucial need for international comparability and uniformity of financial results.

National Sovereignty versus International Comparability

A perpetual tension exists between the state's ambitions for full sovereignty over its internal affairs, hence its need to possess national sovereignty over accounting standards, and the need for international comparability of accounting standards along with accounting's desire for international uniformity.

The worldwide adoption of the IFRS over the past decade indicates strong international preferences for comparability over national sovereignty. Does this imply that the era of national sovereignty over accounting is over? This paper presents findings which show that there is at least one social arrangement in which a tendency to prefer national accounting sovereignty over international comparability still remains: taxation.

Maintaining national accounting sovereignty over taxation means that the state fully controls the determination and computation of the tax liability of its citizens. In addition, in cases where the determination or computation of the tax liability is dependent on financial accounting, the state also controls all the aspects of financial accounting which are relevant to taxation.

National sovereignty over financial accounting, like national sovereignty over other social arrangements, may take several forms (Hinsley 1986; Camilleri & Falk 1992: 15-24). For example, the national legislature may be the formal accounting standards setter for the state. Alternatively, accounting standards may be set by a local professional body, such as the national accountants association. Accounting standards may also derive their normative power from local social norms. All of these forms represent national sovereignty over accounting in the sense that financial accounting is controlled by the people who are affected by it. The identity of the specific social organ which is formally in charge of setting accounting standards may differ according to local preferences (it may be the legislature, the accountants, or other parts of the society); nevertheless that organ shares the same nationality as the society which is affected by its action.

Next to be examined are the IFRS adoption processes which have occurred in Germany and in Israel. Both these states harmonized national accounting standards but nevertheless maintained national accounting sovereignty over taxation. The finding that both countries have maintained national sovereignty over taxation indicates that some national accounting sovereignty still exists even in the era of the IFRS.

Germany and Israel also present an interesting case study concerning the forms of accounting sovereignty in different countries. Whereas in Germany accounting standards are set by the legislature and are part of the official law (Leuz & Wüstemann 2003: 460), in Israel no official body has been recognized as having the authority to set accounting standards. Instead, as will be elaborated hereafter, accounting standards in Israel derive their normative power from social norms rather than formal regulation.[3] It is interesting to note that although national accounting sovereignty takes different forms in the two countries, when it comes to taxation both countries manifest the same principal finding of maintaining national accounting sovereignty.

[3] Apart from accounting principles which are used by public companies (see hereafter).

C. Germany's Accounting Sovereignty

This section will discuss how the global trend of adoption of the IFRS affected Germany's accounting sovereignty. As will be discussed hereafter, similar to Israel, the adoption process of the IFRS in Germany did not lead to the surrendering of accounting sovereignty over taxation. In fact, The German mechanism[4] allowed a priori maintaining of national accounting sovereignty over taxation (as well as over some other social arrangements which use accounting) without any need for amendments to be made in the legal tax system due to the adoption of the IFRS.[5]

In order to fully understand how Germany maintained accounting sovereignty over taxation, an introductory observation must be made about the differences between solo financial reports and consolidated financial reports.

Solo Financial Reports and Consolidated Financial Reports

The financial results of an entity, such as a company, which controls other entities, such as subsidiaries, can be described in terms of two accounting perspectives.

One accounting perspective focuses purely on the legal nature of the entity and describes only the performance results of the legal entities in the entity's financial reports. Another perspective focuses on the economic nature of the entity; therefore, in case the entity holds other legal entities which have an economic effect on the results of the parent entity, their financial results will be consolidated together with the results of the parent entity. These two different "focal points" reflect the difference between solo reports and consolidated reports.

In fact, the preparation of a consolidated report for a group of legal entities is based on the entities' separate results, taken from the solo reports. The results from the solo report of the parent company and the results from the solo reports of its subsidiaries are combined "line by line," adding together items like assets,

[4] The German adoption process of the IFRS shares similar properties with some other EU countries' adoption process, e.g. France.

[5] The Israeli case will be discussed later in this article.

liabilities, equity, income, and expenses. Hence a consolidated report presents financial information about the group as a single economic unit.

The financial results of a solo report of a company versus that of a consolidated report will usually differ dramatically. One of the factors that create this difference is the accounting cancellation of inter-companies transactions in a consolidated report: since all the legal entities are presented in the consolidated report as one economic unit, transactions between different legal entities are actually transactions between the economic unit and itself and therefore should not be presented as transactions which bear financial consequences.

The difference between solo reports and consolidated ones is important for understanding the European regulation which led Germany (and other European countries) to adopt the IFRS.

The IAS Regulation

EU Regulation No. 1606/2002 of 19 July 2002, also known as the “IAS Regulation” (European Parliament and Council 2002), mandates, as of 1 January 2005, the preparation of IFRS consolidated financial statements by European companies which are capital-markets-oriented. The IAS Regulation marks the culmination of the European Union’s effort to harmonize accounting standards among member states (Haller & Eierle 2004).

The harmonization of accounting standards is seen as a necessary measurement to enable comparability of financial statements prepared by different European companies. Because the comparability of financial statements promotes the completion of the internal European market and enhances capital allocation among the European states, it promotes overall market efficiency and reduces the cost of capital for companies within Europe (IAS Regulation 2002).

In order to accomplish the comparability of financial statements, the regulation requires publicly traded companies to apply a single set of high-quality international accounting standards for the preparation of their consolidated financial statements (IAS Regulation 2002, section 2).

With regard to the aforementioned international accounting standards, the IAS Regulation stipulates as follows:

> “International Accounting Standards (IASs) are developed by the International Accounting Standards Committee (IASC), whose purpose is to develop a single set of global accounting standards. Further to the restructuring of the IASC, the new Board on 1 April 2001, as one of its first decisions, renamed the IASC as the International Accounting Standards Board (IASB) and, as far as future international accounting standards are concerned, renamed IAS as International Financial Reporting Standards (IFRS). These standards should, wherever possible and provided that they ensure a high degree of transparency and comparability for financial reporting in the Community, be made obligatory for use by all publicly traded Community companies.” (IAS Regulation 2002, section 7)

Nevertheless, the implementation of the IAS Regulation is limited to two aspects. First, the requirement is to implement international accounting standards only in the reports of public companies. Second, the requirement applies only to the consolidated reports of the aforementioned companies. There is no mandatory requirement to implement international accounting standards in solo reports of public companies. Nor is there such an obligation with regard to solo or consolidated reports of private companies (IAS Regulation 2002, article 4).

Instead, the decision to implement the IFRS in solo reports was left to the discretion of each member state. Hence, member states have the option to permit or require nonpublic companies to implement international accounting standards in consolidated reports; and to permit or require public and nonpublic companies to implement international accounting standards in solo reports (IAS Regulation 2002, article 5).

The IAS Regulation requirements concerning the implementation of the IFRS are summarized in the following table:

IAS Regulation 2002, articles 4 and 5		
	Consolidated	**Non-consolidated**
Public companies	Mandatory, required by IAS Regulation	Under the discretion of each member state
Nonpublic companies	Under the discretion of each member state	Under the discretion of each member state

The Adoption of IFRS Standards in Germany

To some extent, the voluntary adoption of international accounting standards began in Germany as early as the 1990s (Barbara et al. 2004; Haller & Eierle 2004: 32; Haller 2012: 160-164). Nevertheless, a formal mandatory adoption of the international accounting standards began only with the local German implementation of the IAS Regulation.

As discussed above, the European IAS Regulation required member states to oblige local companies which are capital-markets-oriented companies to implement the IFRS (as adopted by the European Commission, see hereafter) in their consolidated financial statements; the IAS Regulation did not, however, require the implementation of the IFRS in solo reports.

Corresponding with the IAS Regulation obligations, the transformation of the IAS Regulation into the German commercial code (HGB) was done while maintaining the demand, from all German companies, capital-markets-oriented and non-capital-markets-oriented, to prepare solo reports under the German GAAP.[6]

The reluctance of the German legislature to allow, let alone oblige, the implementation of the IFRS in solo reports preserved German accounting sovereignty over the preparation of these reports.

[6] To be precise, though German companies have the option to implement IFRS in their solo reports, this implementation has to be accompanied by the preparation of HGB statements for tax purposes and dividend-distribution calculation (§ 325 sect. 2 a HGB; Nobes and & Parker 2008, 321).

This preservation of accounting sovereignty over the preparation of solo reports is fully explainable in light of the important role that these solo reports play in the calculation of income for tax purposes and dividend distributions (Pfaff & Schröer 1996; Haller & Eierle 2004).

The implementation of the IAS Regulation in a limited scope which did not affect the preparation of the solo reports or their content, nor the obligation of German companies to prepare them, preserved German national accounting sovereignty over all legal fields that use solo reports, first and foremost the German tax system.

The discussion of Germany's sovereignty over accounting cannot be completed without discussing the IAS Regulation adoption mechanism. Even for the accounting systems for which accounting sovereignty was surrendered, it was not to a completely foreign party but rather to a European organization

The Adoption Mechanism of the IAS Regulation

The adoption mechanism included within the IAS Regulation leaves some prerogative over the adoption of the IFRS by the European Commission. Because the international accounting standards are not adopted automatically into European law, the accounting standard setting authority is not completely delegated to the IASB; instead the IAS Regulation requires particular adoption actions from the European Commission for every new international accounting standard published by the IASB. It is important to understand that the Commission's adoption is not guaranteed for all new standards. The IAS Regulation outlines key criteria which the new accounting standard must meet in order for it to be adopted by the European Commission; among those criteria is the requirement that adopted standards will be "conducive to the European public good" (IAS Regulation 2002, article 3(2)).

The adoption of new IASB standards by the European Commission is assisted by an accounting regulatory committee (ARC). The ARC is composed of representatives from different member states, among them Germany, and is chaired by the Commission. The main role of the ARC is to provide support and expertise to the Commission in the assessment of international accounting standards. The ARC also votes on the Commission's proposal for the new standard's endorsement. If the European Parliament or the Council of the European Union does not oppose the endorsement (which is recommended by the ARC according to the vote) within three months, or gives an earlier favorable opinion on the endorsement, the new standard is then adopted.

The adopted international accounting standards are then fully published in each of the official languages of the EU Community, as a Commission Regulation, in the *Official Journal of the European Communities* (IAS Regulation 2002, article 3(4)), and become legally binding in the different EU member states.

When Germany adopted the IFRS the same mechanism applied. Therefore, even the limited surrender of Germany's national accounting sovereignty was done not in favor of a private international body located in the United Kingdom, but in favor of the decisions of the European Commission and the ARC in which Germany plays an important role.

D. Israel’s Accounting Sovereignty

This section discusses recent developments in the Israeli accounting environment with an emphasis on the process of adoption of international accounting standards in general and the IFRS in particular. The Israeli accounting environment has undergone a slow but constant process of surrendering national accounting sovereignty. This process culminated in Israel’s adoption of the IFRS, which entailed surrendering accounting sovereignty over almost all accounting matters apart from taxation.

The Development of Accounting Standards in Israel

In order to clarify the recent developments in the accounting environment in Israel, and in light of the fact that, as far as is known to the author, a systematic description of the development of accounting standards in Israel is missing from the existing literature, this section begins by describing how the Israeli accounting environment had developed up to its current stage.

Since 1997 the body that de-facto sets accounting standards in Israel is the Israel Accounting Standards Board (IASB). Previously the body which had set accounting standards in Israel was the Institute of Certificated Public Accountants in Israel (ICPAS).

The ICPAS Era

The ICPAS was established in 1931, and started issuing professional publications in December 1939 (Levin 2011). Among its publications were audit standards and accounting standards. In July 1948, a few weeks after the independence declaration of the state of Israel, the ICPAS was officially recognized by state authorities as the representative of accounting professionals (Levin 2011, 7).

In 1973 the CPA Audit Regulation (CPA Regulation (Rules for proper conduct of Auditors) 1973) was enacted. Among its ordinances was the requirement that CPAs perform the audit according to “the regulations and generally accepted auditing standards” (CPA Regulation (Rules for proper conduct of Auditors) 1973, section 11(b) (1)). Concerning the identity of the generally accepted auditing standards, the CPA Audit Regulation thereby gave a special legal status to audit standards which were set by the ICPAS: the regulation explicitly stipulates that with regard to auditing, “a CPA who has acted according to standards, rules, or guidelines of the ICAPS will be viewed as though he has acted according to generally accepted auditing principles”. Hence, such an auditor will be exempt from accusation of negligence.

The fact that the CPA Audit Regulation did not give a similar legal status to accounting standards published by the ICPAS (nor did any other legal source at that time) represents the tension around the above mentioned normative question: What form should national accounting sovereignty take? Should accounting standards be set by a national private organization, such as the ICPAS, which is supposedly the most qualified and professional organization; or perhaps – because of the direct influence of accounting standards on a broad range of social arrangements (such as taxation) – a national organ of the state would be better suited for accounting standards setting? As will be shown in this subsection, the fact that the tension surrounding this question was not resolved in Israel during the 1970s led to the result that the setting of accounting standards in Israel was left to social norms and market forces.

The lack of a legal status for its accounting standards did not take the wind out of the ICPAS’ sails; it continued to publish its accounting standards. One reason may be that the ICPAS’ members were obliged anyway to implement accounting standards set by the ICPAS as part of their general obligation as ICPAS members to act according to professional publications issued by the professional committees of the ICPAS (ICPAS By-Laws 1970, section 57I). This status, where the ICPAS sets audit standards and accounting standards, lasted until 1997 when the IASB was established.

The IASB Era

One might think that the repeal of the ICPAS’ power to set accounting standards resulted from reconsideration of the question of who should hold national accounting sovereignty. However, the real reason for this repeal was the dissatisfaction with the ICPAS’ work. Common problems concerned the pace of setting new accounting standards and the adjustment of existing standards to the needs of the financial market and the regulator (Haggin Report 1994; ISA 2001).

In 1997, the Israeli Security Authority (ISA) and the ICPAS came to a final agreement that a new body for standard setting would be established in Israel, the IASB. Initially the IASB was established as a separate division within the ISA, and its workers were ISA workers (ISA 2001: 11). By the end of 1998, however, the IASB incorporated itself as a nonprofit limited-liability corporation with the ISA and the ICPAS as its sole shareholders. Israeli de-facto national accounting sovereignty was transferred from a governmental authority (ISA) to the hands of a private corporation.

Because of legal proceedings in which the IASB was involved early in the previous decade (Israel Electric Corporation v. Israel Accounting Standards Board 2001, 2001a), the attorney-general decided that the legal form of the IASB had to be set in legislation. It was decided that until the legislation process was completed the incorporation of the IASB had to be nullified. This decision reflected the attorney-general's discomfort with the fact that national accounting sovereignty was in private hands.

In accordance with the attorney-general's decision, in March 2003 the ISA transferred its shareholding rights to the General Accounting Office, which has been acting as its trustee since then. No other changes were made regarding the legal form of the IASB (ISA 2010:28-29).

In 2006 a draft bill[7] was published establishing a formal governmental authority under the provision of the justice and finance ministers (the "IASB Bill"). The new authority was planned to be in charge of all issues relating to the work of CPAs in Israel, including the setting of accounting standards (Memorandum of Law of Certified Public Accountants (The institution of accountancy and other provisions) 2006).

Although the draft was published as early as 2006, to this day the bill has not been passed. Currently[8] the IASB remains in the form of an independent nonprofit limited-liability company which is financed mainly by the IAS (ISA 2013a).

[7] "Tazkir Hatsa'at Hok."
[8] October 2014.

The Adoption of the IFRS in Israel and the Surrendering of National Accounting Sovereignty

The surrendering of national accounting sovereignty in Israel was part of a general integration of international accounting standards into the Israeli accounting environment. This integration process was done in a few stages over three decades. Although major progress occurred in the last decade with the comprehensive adoption of the IFRS, the seeds of the international integration were already planted during the mid-1970s when the ICPAS joined the International Accounting Standards Committee (IASC).

The IASC was established in 1973 as a joint venture of leading accounting bodies from nine countries: Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom, and the United States. It was created to promote the harmonization of accounting standards among its members. In the following years many other accounting bodies from different countries joined the organization; among them was the ICPAS, which joined on 9 April 1974 (ICPAS Opinion no. 23, 1981).

As a member of the IASC, the ICPAS committed itself to support the accounting standards published by the IASC and to make its best efforts to achieve their implementation in the financial reports of local entities.

Similar to other countries which were members of the IASC and did not modify their own existing local standards to reflect the content of the IASC standards (Zeff 2012: 813), the ICPAS published an accounting opinion, ICPAS Opinion no. 23, which adopted the IASC standards only for issues which were not covered by existing ICPAS standards or by accepted accounting principles (common practice) (ICPAS Opinion no. 23 1981, section 6I). In issues for which the IASC standards were adopted, the adoption was verbatim; this meant that the obligating standards were the original standards which were published by the IASC in English. The choice of the verbatim adoption was justified by the ICPAS on the ground of its lack of resources for publishing local standards which would implement the IASC standards (ICPAS Opinion no. 23 1981, section 3).

The process of integrating international accounting standards into the Israeli accounting environment did not stop with the verbatim adoption of the IASC standards. At the beginning of the current millennium, a decision was made by the IASB (which meanwhile, as described above, has overtaken the ICPAS' role in setting accounting standards in Israel) to further adjust the existing Israeli accounting standards to the international ones (ISA 2001:10).

As a result, from 2001 to 2007 the IASB has published more than thirty local accounting standards based on the international ones. These IASB standards were local accounting standards which included translated sections from the international accounting standards published by the IASC and the International Accounting Standards Board.[9] The majority of these standards included only minor changes as compared to the international standards published by the IASC and the International Accounting Standards Board (ICPAS 2008, 29); although their content was almost identical to the international accounting standards, these standards were set by an Israeli accounting standards setter.

The pace of local standards publications dropped dramatically in 2006. In that year the IASB published a "game changer" for the accounting environment in Israel: the IASB Accounting Standard no. 29. The publication of this standard represents the greatest challenge for Israeli national sovereignty over accounting.

IASB Accounting Standard No. 29

Until the publication of IASB Accounting Standard no. 29, "International Accounting Standards (IFRS) Adoption," Israeli entities implemented local Israeli standards in financial reports. As discussed before, these standards were first set by the ICPAS and then by the IASB. Since both organizations were committed to the harmonization idea, the content of the local Israeli standards was heavily based on international standards; nevertheless, the final standards were the product of a national Israeli organization.

All of this has changed with the adoption of IASB Accounting Standard no. 29, which requires entities to prepare financial statements according to the "international standards as published by the foreign body that sets the international accounting standards". As mentioned above, from 2001 that body is the International Accounting Standards Board, and the accounting standards which it publishes are the IFRS.

[9] The International Accounting Standards Board became the successor of the IASC in 2001.

The requirement made in IASB Accounting Standard no. 29 to implement the IFRS as published by the International Accounting Standards Board means that Israel has formally subordinated the preparation of financial statements by Israeli entities to the International Accounting Standards Board, thereby relinquishing Israeli sovereignty and handing it over to a foreign organization which is domiciled in the United Kingdom.

IASB Accounting Standard no. 29 adopted the international standards *verbatim*, and on an *ongoing basis*. In contrast, under the then-existing status international standards had been adopted ad-hoc and with some adjustments to the local published IASB standards. In fact, by including an *ongoing* adoption in IASB Accounting Standard no. 29's comprehensive adoption mechanism, the IASB has "delegated" its role as the de-facto setter of accounting standards to the International Accounting Standards Board; hence the body which was granted de-facto the role of accounting standards setting in the Israeli accounting system was no longer Israeli. National accounting sovereignty had been surrendered.[10]

IASB Accounting Standard no. 29 dramatically transforms the Israeli accounting system[11] from one based on local accounting standards to one based on international standards.

IASB Accounting Standard no. 29 was not the final step in the adoption of the IFRS in Israel. Another step in the process of giving up Israeli sovereignty has occurred with the general reform made in the disclosure regulations. However, before discussing this reform, the authoritativeness status of accounting standards in Israel needs a brief clarification.

Accounting Standards' Authoritativeness Status

The Israel Companies Act (Companies Act 1999) requires private companies to maintain books according to the Act's orders, while public companies (in general,

[10] Although IASB Accounting Standard no. 29 distinguishes between public companies (which are governed by the Securities Act (hereinafter "the Act") and private companies (which are not subordinated to the Act), where the former (as opposed to the latter) are obliged by the standard to implement the IFRS, private companies can still opt to implement the IFRS and not the local IASB standards, and hence can remove themselves from local accounting sovereignty.

[11] From a formal perspective, IASB Accounting Standard no. 29 did not abolish the existing IASB standards but, instead, became part of them, and hence part of the generally accepted accounting principles in Israel. Therefore, the implementation of the IFRS is included under the legal requirement to implement generally accepted accounting principles.

corporations whose securities are traded on the stock market) are required to maintain books according to the stipulations of the Securities Act (Companies Act 1999, section 171).

The Companies Act 1999, section 171	
Private company	Maintains books according to the Companies Act
Public company	Maintains books according to the Securities Act

According to the stipulations of the Companies Act, a company is required to "edit its financial statements according to generally accepted accounting principles in a way which will give a true and fair view that ought to be represented according to the accounting principles" (Companies Act 1999, section 171(d)).

The stipulations of the Securities Act (Securities Act 1968) do not include editing requirements for the financial statements of public companies. Instead they delegate the authority to set disclosure requirements, among them statement editing rules, to the finance minister. When using his power to legislate disclosure regulations, the finance minister has to advise the ISA and obtain the approval of the Financial Subcommittee of the Knesset (Securities Act 1968, section 36(b)).

Using his delegated power, a short time after the passing of the Securities Act in 1968, the finance minister published regulations dealing with general disclosure requirements for public companies. Those regulations included the requirement from public companies to edit financial books according to "accepted accounting and reporting principles" (Securities Act Regulation (Preparation of Financial Statements) 1969, section 3).

As shown above, both the Companies Act and the Securities Act required the implication of *generally accepted accounting principles* in companies' financial statements. As will be explained hereafter, this requirement was about to change in the years to come.

Meanwhile, neither the rules nor the regulations provided a definition of which organization could produce rules which would be seen as *generally accepted accounting principles*. This lack of determination of who is the generally accepted accounting principles setter is conspicuous in light of the fact that, as mentioned previously, the CPA Audit Regulation did stipulate the ICPAS as the body which can produce generally accepted auditing principles.

It can be argued that upon the enactment of the Securities Act (Preparation of Financial Statements) regulation in 1969, and its avoidance of defining a normative source for the term *generally accepted accounting principles*, the authority to set accounting principles was deliberately left to market forces. It seems that this question was left to be answered by the situation on the ground rather than by a deliberate normative choice.

The legal ambiguity regarding the standards setting authority was about to be resolved with the enactment of the IASB Bill. Based on the legal requirement to implement generally accepted accounting principles in financial statements, which, as discussed above, applied at that time to both private and public companies, the IASB Bill included an explicit and revolutionary stipulation that accounting standards should be set by a new authority, which was to be established according to the bill. It further stated that rules which were produced by that authority would be considered as generally accepted accounting principles for legal purposes ((The institution of accountancy and other provisions) Law 2006), section 45(a)). This could have been an important breakthrough for Israeli accounting standards setting. However, as noted above, the legislation process for the IASB Bill was never completed. Hence ambiguity about the identity of the Israeli accounting standards setter still exists, at least theoretically.

The lack of legal authoritativeness or status did not prevent the IASB standards from being broadly accepted as the mandatory accounting standards in Israel (IAS 2001: 12; Adini 2004: 160). IASB standards enjoy a broad consensus among all parties involved: the implementing companies; the CPA firms which audit the financial statements; and the Israeli regulators (IAS 2001:13-4). The consensus about the IASB standards that pertain to the CPA is especially interesting since the ICPAS, as known to the author, did not issue an official publication which endows the IASB with the authority to oblige ICPAS members to accept its standards.

Disclosure Regulation Reform

The original requirement of public companies to prepare financial statements according to generally accepted accounting principles dates back to the year 1969. This obligation changed in 2010. In that year, as part of a general reform of the disclosure regulations, the requirement to prepare financial statements according to *generally accepted accounting principles* was rephrased by the legislature as the requirement to prepare financial statements according to the *international reporting standards*.

Although the formal change of the legal requirement from *generally accepted accounting principles* to *international reporting standards* had no real influence on public companies, since IASB Accounting Standard no. 29 already required public companies to implement international reporting standards (IFRS), it did accelerate the process of surrendering national accounting sovereignty to international forces.

As mentioned above, it can be argued that under the legal requirement to implement *generally accepted accounting principles*, the normative source of accounting standards was their factual acceptance by the local society in Israel. This factual acceptance of the accounting standard by the local society made them part of the generally accepted accounting principles. Although, de facto, the accounting standards were published by the IASB, it was the local society that endowed them with normative power.

Under the new legal requirement to implement *international reporting standards*, the normative source of accounting standards has been changed. The legal reference to *generally accepted accounting principles*, which empowered the citizens to create binding accounting standards, was replaced with a reference to specific, identifiable international reporting standards. That reference gave the foreign body which publishes these standards the normative power to make accounting standards binding.[12]

[12] The authority to set accounting principles for public companies was delegated to the finance minister in the Israeli Security Law. That authority was then delegated by him, in the disclosure regulation, to the IASB. The question of whether such a delegation is constitutionally sound is left for future research.

The above description of the development of the accounting environment in Israel shows that the authority to set accounting standards was officially delegated to an international body in 2010. However, even before that time, the Israeli local accounting standards setting board (the IASB) had delegated this power to the UK-based accounting standards setter through the publication of IAS accounting standard no. 29.

All in all, it can generally be stated that the surrendering of accounting sovereignty in Israel is complete – except for the tax system.

Accounting Sovereignty and the Israeli Tax System

The adoption of international accounting standards in Israel has brought with it some challenges for legal systems which use accounting as the basis of their normative actions. Among those systems is the Israeli tax system, which uses accounting inter alia for the measurement of corporate tax liability.

As explained above, before IASB Standard no. 29 was published, local accounting standards in Israel were the result of a local process. The Israeli Tax Authority (ITA), among other relevant parties such as the banking commissioner, had a representative on the IASB management board which was authorized to prevent the publication of an accounting standard. After the comprehensive adoption of international standards through Standard no. 29, the ITA (as well as all other Israeli authorities which were members of the IASB management board) had no more influence on the setting of Israeli accounting standards.[13]

How did the ITA react to these developments in the Israeli accounting environment? Although international accounting standards have been influencing the Israeli accounting environment since the previous century, the straw that broke the camel’s back was the publication of IASB Accounting Standard no. 29.

On a general level, and as a direct result of the publication of IASB Accounting Standard no. 29, the ITA initiated a temporary directive in the Income

[13] After the publication of IASB Accounting Standard no. 29, the only way available to exercise influence on local accounting was by publishing a new IASB accounting standard that would override IASB Accounting Standard no. 29 and create an exception to the comprehensive adoption of the IFRS. Since 2010, with regard to public companies, this option became void because the source for implementation of the IFRS was no longer IASB Accounting Standard no. 29 but the legal requirement in the disclosure regulation.

Order (Income Tax Order 1961) which removed the link between the international accounting standards adopted into the generally accepted accounting standards in Israel (via IASB Accounting Standard no. 29) and the calculation of taxable income. As a result, taxable income could be calculated only according to "authentic" IASB standards.[14] Accounting sovereignty was restored with regard to tax accounting.

Why did this happen? What caused the ITA to regain accounting sovereignty? The reason concerns the role of the financial parameters which are included in the financial statements. When the accounting standards which are implemented in the financial statements change, the parameters which are included in the financial statements change as well. These changes necessitate changing the normative legal tax regime so that it will not be affected by the per-se changes in the accounting environment. The ITA regained accounting sovereignty so as to compete with the practical changes made in the financial parameters by the IFRS. Therefore, the considerations were practical and were not driven by a classic national argument.[15] However, in reality it is difficult to distinguish between practical considerations and national aspirations.

As was described earlier, the adoption of international accounting standards in Israel has culminated in the surrendering of national accounting sovereignty. The formal accounting standard setter for public companies in Israel has become a

[14] It is worth noting that the temporary directive stipulates that in the calculation of taxable income for the years 2007 and 2008, ISAB Accounting Standard no. 29 will not apply. 2007 was the first year in which it was possible to implement international accounting standards according to IASB Accounting Standard no. 29. The temporary directive was then extended to apply also to the calculation of taxable income for 2009 through 2011; where the Tax Authority promulgated an extension for 2012 and 2013 (the Law for a Change of National Priorities 2013, section 40(37))The temporary directive canceled the effect of international accounting standards that were adopted by IASB Accounting Standard no. 29, but not of other international accounting standards that were adopted during the first part of the IASB era as local IASB standards. As explained earlier, at the beginning of the IASB era extensive parts of the international standards were published by the IASB as local standards and therefore became part of the generally accepted accounting principles in Israel. In addition, the temporary directive neither canceled the possibility (or the mandatory requirement of ICPAS members) to implement international accounting standards for cases where no local accounting treatment exists through ICPAS Opinion no. 23, nor IFRS implementation due to the legal demand which exists in the disclosure regulations.

[15] It should be noted that the ITA has viewed disconnecting the link between the tax system and accounting as a temporary action, which was performed in order to give the ITA time to learn the effects of the international accounting standards. Although, after studying the subject, the ITA did initiate a proposal for specific ad hoc amendments to the tax code, required so as to mitigate the influence of international accounting standards (Memorandum of Law of Income Tax Ordinance 2011), these amendments have not yet been enacted (October 2014), and the temporary order was extended for two more tax years, 2012 and 2013 (30/7/2014 – apply retroactively).

foreign international body. Nevertheless, one cluster of the accounting environment in Israel has remained intact, the cluster of tax accounting.

The next section compares the Israeli and the German adoption process of the IFRS and the implications for the tax system. This discussion shows that each country maintained accounting sovereignty over the tax system differently, and that at least two models exist for maintaining national accounting sovereignty over taxation.

E. Discussion

While harmonizing their accounting systems, both Israel and Germany maintained a tax system heavily linked to financial accounting. Both countries' tax systems used corporations' financial statements in order to compute corporate tax liability.

Setting aside the international harmonization of accounting standards, the principal use of accounting standards, either national or international, for the purpose of determining taxable income is not free from legal and practical difficulties. From a legal perspective, accounting records are produced according to accounting principles. Those principles can be formulated by private organizations, such as the accountants association. In these cases, the legislature or other delegated authorities of the legislature are usually not involved in the process of creating accounting standards. This privatization of the tax system occurs when a significant part of the tax regime, such as the measurement of taxable income, is determined according to rules which are not decided by the legislature or by a delegated body. This privatization contradicts the legal principle that the imposition of tax must be performed by the legislature itself, among other reasons because of the infringement of property rights (Schön 2004: 428). From a practical perspective, in many cases accounting income measurements are not identical to the income that the tax systems want to tax. This is because accounting has its own objectives, some of which are very different from the objectives of the tax system (Schön 2004a). The different objectives produce different measuring principles: for example, one of the measurement principles of financial accounting is conservatism, which creates a bias in favor of a rapid recognition of expenses and a delayed recognition of income. In contrast, tax systems usually seek the opposite: to recognize income as soon as it is reasonable to expect the taxpayer to pay the tax, but to recognize expenses only to the extent that they can be matched to the recognized income (Ault & Arnold 2010).

Nevertheless, by mitigating some of these difficulties, both Israel and Germany have based their tax systems on financial accounting to a great extent. A classic example of the link between the German tax system and financial accounting is the "authoritativeness principle" (*Maßgeblichkeitsprinzip*) which prevails in the German tax system (Pfaff & Schröer 1996). According to this principle, the determination of taxable income follows the financial measurement made in the financial statements. Discrepancies between financial income and taxable income can only result from explicit and exceptional deviation commanded by the tax code. Therefore, the determination of taxable income is performed de-facto according to the accounting standards.

It is worth noting that until 2009, a reverse authoritativeness principle (*umgekehrtes Maßgeblichkeitsprinzip*) also existed in the German tax system. According to this principle, some financial accounting measurements were dictated by the German tax code: for example, tax options such as accelerated depreciation had to be expressed according to their tax results in the financial reports in order for them to be in force for tax calculations. The distortions that the reverse authoritativeness principle created in financial accounting's aspiration to a "true and fair view" of the financial position of the entity, is one of the main reasons it was cancelled with the enactment of the *Bilanzrechtsmodernisierungsgesetz* (Act to Modernize Accounting Law, also known as "BilMoG") (Hellmann, Perera, & Patel 2013: 127).

In a similar way to Germany, the Israeli tax system is also heavily linked to financial accounting. Much like the German one, the Israeli system contains an authoritativeness principle constructed by a court (Hashomrim Group v. Assessment Officer 1992). The Israeli version of the authoritativeness principle deals with situations in which the tax code does not stipulate the tax treatment. In these cases, according to the existing court ruling, the tax calculation has to follow financial accounting which was implemented in the books.

Because of the strong link between financial accounting and the tax system, when the international harmonization of financial accounting standards led to the adoption of the IFRS and the delegation of national accounting sovereignty over tax calculation, both countries faced a substantial threat to sovereignty over the determination of tax liability. As seen in previous sections of this paper, both countries dealt with this threat successfully, but they maintained accounting sovereignty over taxation in different ways. The rest of this discussion will argue that the different ways in which each country chose to maintain its national accounting sovereignty over taxation each represent a distinct model for doing so.

Hence at least two models exist for the protection of national accounting sovereignty over taxation in the era of international accounting harmonization.

Two Models for Maintaining National Accounting Sovereignty

The Israeli and the German way of maintaining national accounting sovereignty over taxation represent two distinct models for achieving accounting sovereignty over taxation. For the purpose of this discussion one model will be called the Isolation model and the other will be called the Limitation model. As will be discussed further on, each of those models can be used in order to maintain accounting sovereignty over taxation, and over other social arrangements which use accounting in the era of international accounting harmonization.

1. THE ISOLATION MODEL

As explained above, the international harmonization of accounting standards terminates national sovereignty over financial accounting systems. That, in turn, leads to the loss of national sovereignty over the tax system, which uses financial accounting in order to compute and determine tax liability. One way to compete with the final result of this sequence, i.e. the loss of national sovereignty over the computation of tax liability, is to isolate the tax system from the changes implemented in the financial accounting system due to the international harmonization of accounting standards.

This can be achieved by replacing the financial parameters which are used by the tax system, and which are computed by the non-subordinated financial accounting system, with new financial parameters which are calculated by a new subordinated "tax accounting system". The new tax accounting system will be based on the financial accounting system which prevailed until the adoption of the international accounting standards.

This model was implemented by Israel when it competed with the comprehensive adoption of the IFRS. The tax authorities initiated a legislative action which disconnected the tax code from the accounting standard which adopted the IFRS and hence created a separate new tax accounting, which is composed of the old local financial accounting standards which prevailed until the adoption of the IFRS.

2. THE LIMITATION MODEL

Whereas the isolation model maintains national accounting sovereignty over taxation by creating a new local tax accounting system, the limitation model competes with international harmonization by initially limiting the scope of the international harmonization process. Certain parts of the local financial accounting system thereby remain intact and are not affected by the international harmonization of accounting standards. These non-affected parts create accounting “safe harbors” which are then used by the tax system (or other social arrangements which require “native” accounting standards).

The tax system tends to use the financial parameters which are related to the legal entity rather than those which are related to the economic entity. Hence keeping the financial parameters of the legal entity (for example, its income calculation) unaffected by international accounting harmonization can maintain national accounting sovereignty over taxation. This can be achieved through limitations to the adoption process of the IFRS. For example, it can be decided that the IFRS should apply only to consolidated reports and not to solo reports. This method was implemented by Germany, where the IFRS was adopted only for consolidated reports. The requirement to prepare solo reports according to local accounting standards remained intact and was not canceled because of the harmonization process.

Both the isolation model and the limitation model can maintain national accounting sovereignty over taxation. Furthermore, both models can be used in order to protect social arrangements which use accounting, such as dividend distribution rules, from changes being made in the financial accounting system when such changes might distort their functioning.[16]

Under the isolation model, each social arrangement creates a unique accounting system for itself which is similar to the financial accounting system but excludes the unwanted changes. Under the limitation model, the unwanted changes are not implemented in the limited areas which are used by the specific social arrangement.

[16] In Germany, for example, the tax system is not the only legal system which relies on solo reports. As mentioned above, the distribution of dividends, for example, also depends on calculations that are based on solo reports.

F. Conclusion

Over the past five hundred years countries have been struggling to maintain sovereignty over internal affairs. Many justifications exist for this struggle for autonomy.

Some of the leading justifications concern the role of the legal system and the accountability principle of the accounting regulators. According to the rule of law principle and the basic democratic order, it is important that the citizens are involved in creating the norms of their country. A more earthly justification concerns the principle of accountability, according to which the regulator of the accounting rules should be accountable to the people who are affected by his regulations (Rabkin 1998).

Although many considerations support the maintaining of state sovereignty over accounting standards setting, the worldwide adoption of the IFRS shows that countries tend to give up national accounting sovereignty. This tendency correlates with other changes which are attributed to globalization and the loss of states' power (Friedman 2007; Bethlehem 2014)

By presenting findings from Germany and Israel, this paper shows that the national sovereignty over at least one cluster of the accounting system – namely, tax accounting – did not surrender to the trend of international adoption of the IFRS.

The findings presented in the paper also reveal two distinct models for maintaining national accounting sovereignty over taxation. These models can be used by other countries that wish to maintain national accounting sovereignty over taxation, or for the purpose of maintaining national accounting sovereignty over other national systems which use financial accounting.

The factual findings, especially regarding the different forms that national accounting sovereignty takes in Germany and in Israel, indicate the need for further normative research on which form of national accounting sovereignty is preferable.

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