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**DISCUSSION PAPER  
ON MODERNISATION OF  
THE ACCOUNTING DIRECTIVES**

**April 2001**

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## INTRODUCTION

*The Commission in June 2000 published its Communication “EU Financial Reporting Strategy: the way forward” with as main elements a requirement for listed EU companies to use IAS in their consolidated accounts from at the latest the financial year 2005 onwards and the introduction of a two-level endorsement mechanism. The endorsement mechanism is intended to give IAS the necessary legal backing.*

*The Commission Communication cannot be seen separately from the Commission initiative to modernise the Accounting Directives. The Communication states that the EU Accounting Directives should remain the basis of the EU’s accounting rules for limited liability companies including listed companies. The Communication will be implemented by a proposal for a Regulation, published on 13 February 2001. Although not in the text of the Articles of the Regulation, the explanatory remarks indicate clearly in para 3.2 Role of the Accounting Directives “The requirement for listed companies to apply IAS will be additional to the Directives’ requirements. The Directives will remain applicable to maintain a base level of comparability for all limited liability companies across the EU. This will also help unlisted companies that do not use IAS to be encouraged to move from the minimum requirements of the Accounting Directives to more sophisticated financial reporting such as IAS. Conformity with the Directives will be required for all listed companies, the application of IAS will be a supplementary requirement for listed companies.” In addition it is announced in the Communication (para 32): “The Commission will introduce proposals to modernize the EU Accounting Directives before the end of 2001 which will continue to be the basis for financial reporting by all limited liability companies in the EU. Modernization of the Accounting Directives should reduce potential conflicts with IAS and bring the Directives into line with modern accounting developments. This is particularly true where new technological developments call for an adaptation of traditional accounting methods, such as the recognition and measurement of intangible assets.” A similar statement is included in the press release on the proposed Regulation. “It will be accompanied by other initiatives notably the modernising in the course of 2001-2002 of existing Accounting Directives.”*

*The need for modernising the Accounting Directives is well acknowledged by all parties concerned. There are both strategic issues at stake as well as technical issues to be addressed. An example of the strategic issues is how to change the Directives without the need to change the structure of company law. Under the Fourth Directive, individual financial statements have both a legal function (as spelled out in the preamble to the Fourth Directive: protection of members and third parties) and an information function. Under IAS the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. The same applies to the consolidated financial statements under the Seventh Directive. The combination of the legal function and the information function of individual financial statements is at the heart of the issues to be resolved in the modernisation of the Accounting Directives.*

*At present the Commission and the Contact Committee are reflecting on how such a modernisation can be made. Also within FEE, debate and discussions have continued on the modernisation of the Directives. On 5 December 2000 FEE submitted its preliminary thoughts on the subject to the Commission. FEE believes however that all the key players should be involved in the discussion on the modernisation of the Directives. FEE therefore decided to prepare a discussion paper in order to stimulate the debate in Europe. In this FEE has expressed views on a number of issues based on the debate that has taken place within FEE so far. It is hoped that the paper provides a useful contribution to the debate on the modernisation of the Accounting Directives.*

## 1. EXECUTIVE SUMMARY AND CONCLUSIONS

This discussion paper addresses the problems with applying IAS in Europe under the current framework provided by the Accounting Directives. These problems should, to the extent possible, be solved by the forthcoming modernisation of the Accounting Directives within the timeframe set by the June Communication on the EU Financial Reporting Strategy and the proposed Regulation. Listed EU companies will be required to use IAS in their consolidated accounts from the year 2005 at the latest. However, taking into account that comparative figures would need to be restated, this would mean that companies need to be able to apply IAS at the latest from 2003 onwards.

A major issue to be dealt with in the modernisation of the Accounting Directives is whether and to what extent the Accounting Directives need to be changed. Amending the Accounting Directives cannot be avoided if compliance with the Accounting Directives will continue to be required also for companies using IAS. However, even if companies using IAS are scoped out from the Accounting Directives some modernisation would be desirable, at least to allow national GAAP to converge to IAS.

FEE believes that the ultimate aim of the modernisation process should be having the same financial reporting rules for individual and consolidated accounts. European Directives should not form an obstacle to use IAS. The priority of modernisation of the Accounting Directives is to reach full comparability and harmonisation of financial statements of at least listed companies across Europe and around the world and to avoid extra work and cost burdens for European companies. This approach is based on the assumption that IAS will be accepted worldwide for listing purposes.

However, in this context the different roles of individual financial statements under the Directives

- to provide information useful for economic decisions in capital markets, and
- as a legal document affecting creditor protection, capital maintenance (restrictions on dividends) and (in some countries) as the basis of taxation

have to be recognised being at the heart of some of the problems raised by the modernisation of the Accounting Directives. Modernisation of the Fourth Directive in order to align with the information function of IAS will also have implications for the legal role of individual financial statements. To solve the capital maintenance implications of the changes to the accounting rules, FEE proposes to introduce tests of adequate solvency in determining dividends. This would replace the present link between recognition of gains/losses in annual accounts and the restriction on distributions to shareholders. However, because of the implications of changes for both the Member States and the companies, and to give Member States the opportunity to avoid the taxation problems, a Member State option should be introduced for a certain transitional period to allow or to require companies to use the traditional rules of the "old" Fourth Directive in individual accounts instead of any modernised IAS-based Directive.

Several studies comparing the Accounting Directives and IAS have shown some more or less important incompatibilities between the two. The most important incompatibilities result from the different concepts of realisation and prudence and of fair value accounting versus historical cost accounting. These issues are clearly linked with the different role of (individual) financial statements under the Accounting Directives and under IAS. To remove these incompatibilities the question needs to be addressed whether Art. 31 of the Fourth Directive containing the main valuation principles should be changed to bring Art. 31 in line with IASC Framework and IAS 1 and whether the fair value based financial reporting of IAS should be introduced as an alternative, on equal footing, to historical cost accounting or whether historical cost accounting should remain the main accounting principle.

Furthermore, it has to be kept in mind, in those cases where compliance with the Directives would continue to be required, that IAS will continue to develop and to change and that, therefore, modernisation of the Directives should not only take care of present incompatibilities with IAS, but should be sufficiently general and flexible to avoid future incompatibilities. For example the formats prescribed by the Fourth Directive may need to be changed in order to allow for a single performance statement which might be introduced by IASB.

To modernise the Accounting Directives various alternative approaches are discussed:

- scoping out companies applying IAS from the Accounting Directives and transferring them to a capital market regime
- a high level version of the Accounting Directives for companies applying IAS including only issues that are not dealt with in IAS
- minimum changes required to remove present incompatibilities and to allow national GAAP to converge to IAS
- full modernisation of the Accounting Directives.

In considering the merits of these alternative approaches on the grounds of

- effectiveness in eliminating incompatibilities between Directives and IAS
- likelihood of being able to be in place by 2003 for listed companies
- costs to European business
- maintaining comparability of financial information on EU companies.

FEE continues to hold the view that the preferred solution would be to exempt listed and other companies applying IAS from the Accounting Directives and to transfer them to a separate capital market regime. However, if such an approach to scope out companies applying IAS from the Directives, e.g. for legal reasons, were not possible, FEE's preferred way to modernise the Accounting Directives would be the introduction of a "high level" version of the existing Directives which would only cover issues that are not dealt with in IAS. As a second step, a limited revision of the Directives could be envisaged with the aim of allowing national GAAP to converge to IAS. FEE would not be in favour at this stage of a fundamental review of the Accounting Directives, although this might be needed in the longer term, but not as a substitute for the other steps. However, in any case such a full modernisation instead of setting up detailed rules, should reinforce the framework character of the Directives.

## 2. MODERNISATION OF THE ACCOUNTING DIRECTIVES – STRATEGIC ISSUES

### 2.1. *Need for changing the Accounting Directives*

The June 2000 Commission Communication suggests that the Accounting Directives should remain the basis for financial reporting for all limited liability companies in EU. The Communication was given political support by the ECOFIN Council of Ministers in July 2000. The proposal for a Regulation on the application of international accounting standards, published in February 2001, reaffirms that the existing Accounting Directives (namely the 4th Company Law Directive (78/660/EEC) and the 7th Directive on consolidated accounts (83/349/EEC) will remain the basis for financial reporting for all limited liability companies. They are to be modernised in the course of 2001-2002, thus keeping pace with the deadline in the Regulation that at the latest by 31 December 2002, the endorsement process should have considered those IAS that currently exist.

If compliance with the EU Directives is required for companies applying IAS, the Directives will need to keep pace with international developments. This is a cumbersome process since it means not only that the Accounting Directives need to be brought in line with IAS to facilitate the use of these standards, but also that amending of the Directives should take place on a timely basis in order to avoid to the extent possible temporary differences. In February 2000, the Commission adopted a legislative proposal to amend the Fourth and Seventh Directives so as to permit the valuation at fair value of certain financial assets and liabilities. This proposal, when finally adopted, will contribute to reducing the risk of potential conflicts between current IAS (including IAS 39 on the recognition and measurement of financial instruments) and the Accounting Directives. However the fair value proposals to amend the Accounting Directives have shown also how cumbersome making amendments can be. A piecemeal introduction of further amendments will make the Directives even harder to read and they may become meaningless since they will be full of options and without any guarantee that the Member States will implement the “right” options to enable full IAS compliance.

It can also be questioned if it is right in principle for EU legislation to require listed companies to comply with two overlapping sets of rules for their consolidated accounts. It could therefore be envisaged that companies using IAS should either be scoped out from the Accounting Directives or that the Directives for these companies would be restricted to those matters not covered in IAS.

Amending the Directives cannot be avoided if compliance with the Directives will continue to be required even for companies using IAS. The expected future subjects to be treated by IASB will make regular updating of the Directives necessary, if Directives are still setting out the main accounting rules. The Directives would need to be modified to be flexible and have the capacity to adapt and respond to future needs and developments. However, even if the Accounting Directives have not to keep pace with IASs, some modernisation would be needed – and is planned for in the Financial Services Action Plan – to result in meaningful financial reporting by non-listed companies, because the Accounting Directives have not been amended for over 20 years.

### 2.2. *Aim of modernisation of the Directives*

With the completion of the internal market in the EU and the introduction of the euro the ultimate aim would be one set of financial reporting rules to obtain full comparability and harmonisation of financial statements in the EU.

To reach full comparability and harmonisation of financial statements, extending the requirement for listed companies to apply IAS in consolidated accounts to all companies should be considered. The present proposed Regulation gives Member States the option to do so, which is no guarantee for the

required harmonisation. A requirement limited to the consolidated accounts would enhance the comparability of financial reporting in consolidated accounts. Focusing on the consolidated accounts only would give a level playing field with the US.

A clear disadvantage of having separate rules for listed and non-listed companies is the reduced comparability of financial statements between listed and non-listed companies since two separate accounting systems will result. Another disadvantage in the case of public offerings (IPOs) is that figures normally have to be restated for three years. This is a lot of extra work if the company before quotation was on a different accounting system than IAS. There might also be implications for consumer and creditor protection in that in the Directives capital maintenance requirements have a greater influence than in the case of internationally accepted accounting standards.

Consolidated financial statements are the most important accounting instruments for information of the users of financial statements. Individual financial statements have limited possibilities to show the performance of economic entities which are legally structured in different single companies. Moreover, individual financial statements are in most Member States linked with national company law and with taxation. A development concentrated on consolidated accounts would not interfere with this existing mechanism. Focusing on the consolidated financial statements would not preclude a Member State's entitlement to impose in national company law additional disclosure requirements, distribution rules, capital maintenance requirements and similar obligations. The nature of any further national obligations established in company law should not be such as would inhibit compliance with IASs.

However companies may be interested in applying the same set of accounting rules in consolidated and individual financial statements. Therefore, in the long run the function and purpose of consolidated and individual accounts might move together and the differences between both sets of accounts would probably reduce. Ultimately, there should be the same financial reporting rules for individual and consolidated accounts. This would require a full modernisation of the Accounting Directives including elimination of options and consistent interpretations. To give Member States the opportunity to avoid the taxation and capital maintenance problems at national level, the introduction should be considered – at least for a certain period of time – of a Member State option to allow or to require the use of the traditional rules of the “old” Fourth Directive in individual accounts instead of the modernised IAS-based Directive.

### ***2.3. The role of financial statements***

Several functions and objectives of financial statements can be distinguished. The difference in objective between IAS financial statements and financial statements of the Directives is at the heart of the problem of modernisation of the Accounting Directives. IAS financial statements have only an information function and no legal function. The same applies to consolidated financial statements drawn up under the Seventh Directive. Whereas financial statements as envisaged in the Fourth Directive are legal documents which serve also, and even primarily, capital maintenance and distribution purposes and in addition are used for taxation purposes in a number of Member States. These different functions are difficult to reconcile, especially for amendments in relation to valuation that touch equity with immediate implications for capital maintenance and distribution purposes.

In this context, it needs to be considered whether the present linkage of company law with the Accounting Directives should be maintained, or whether separate rules can be established for consolidated accounts and individual accounts with a more direct link to company law.

### ***2.3.1. Information function of financial statements***

The information objective in particular is important for the functioning of capital markets in Europe, to allow users of financial statements to make economic decisions. The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it.

The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. The financial position of an enterprise is affected by the economic resources it controls, its financial structure, its liquidity and solvency and its capacity to adapt to changes in the environment in which it operates. Information about the performance of an enterprise, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in future. Information concerning changes in the financial position of an enterprise is useful in order to assess its investing, financing and operating activities during the reporting period.

Also the explanatory remarks of the proposal for a regulation on the application of international accounting standards underlines the information function in the introduction: “EU accounting legislation, adopted in the 1970s, provided a base level for harmonisation, as regards reporting requirements for limited liability companies. However, it has not been able to deliver sufficient comparability for publicly traded companies. A new approach is necessary to meet the current needs of a fully integrated European capital and financial services market, which the Lisbon European Council aspired to. Furthermore, these companies are subject to more demanding disclosure requirements from investors and need a financial reporting system that offers a much higher level of transparency and comparability of company performance”. Under an internal market approach it is further indicated: “By complying with IAS, the quality of financial statements will be dramatically improved and there will be an increasing degree of comparability. The credibility and consequently the usefulness of financial statements will be enhanced throughout the EU capital markets. Investors must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance and also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position and performance”.

Financial statements, and especially the individual accounts, also have a function as a legal document. For example, the amount of dividend that can be distributed is derived from those statements in order to ensure capital maintenance and thereby to safeguard creditor protection. In some Member States there is a linkage between the profit shown and taxable amounts accordance to the country’s tax laws. Each change in the Directives to bring the financial statements closer to the information objective, is likely to affect measurement and thereby the issue of what is considered profit for other functions like tax and dividend distribution.

In principle, there would be no problem to limit the Seventh Directive to the information objective, since consolidated accounts in Europe are not used for legal purposes. Companies have however a legitimate need for one set of financial reporting rules for both individual and consolidated accounts but also for legal and information purposes. Modernisation of the Accounting Directives should not force companies to have two or more different systems of financial reporting, with the related cost burden.



### ***2.3.2. Capital maintenance and creditor protection***

One of the purposes of individual financial statements identified in the first preamble to the Fourth Directive is the protection of members and third parties not only by providing them with information but also by ensuring capital maintenance: “whereas the coordination of national provisions concerning the presentation and content of annual accounts and annual reports, the valuation methods used therein and their publication in respect of certain companies with limited liability is of special importance for the protection of members and third parties”. Furthermore, Article 15.1 (c) of the Second Directive states that “the amount of a distribution to shareholders may not exceed the amount of the profits at the end of the year...”. The Second Directive does not include any special rule on how to calculate these profits. Instead the measures for calculating these profits are laid down in the Fourth Directive. Consequently, applying valuation rules different from the current Fourth Directive will have an impact on the amount which can be distributed to shareholders and thereby on creditor protection. An example of the implications for capital maintenance and dividend distribution is split accounting under IAS 32. Perpetual loans without interest should, under IAS 39, be classified as equity and could accordingly be distributed. This cannot have been the intention of the provider of the loan from a capital maintenance purpose.

There are two alternatives to deal with the distribution of dividends problem: either to amend the Second Directive or to amend the Fourth Directive.

It should also be realised that there are other ways than the capital maintenance concept to safeguard creditor protection, such as direct information provision, covenants and other forms of guarantees. Moreover, one could argue that liquidity and the expectation of future cash flows are more relevant for creditor protection than capital distribution and therefore the information purpose of individual financial statements must be emphasized. Under this approach one possibility would be to distinguish between non-distributable and distributable equity and for “unrealised” fair value changes to be included in a fair value reserve which would only be allowed to be distributed if gains were actually realised. In that way, the legal is distinguished from the information part. Another way out would be to address distribution of dividends by an amendment of the Second Directive by introducing a general solvency test – which may refer to liquidity, solvency and going concern of the company – as the basis for profit/reserves distribution.

These issues should be considered, in particular in the discussion of changing recognition and measurement rules of the Fourth Directive to solve existing and potential conflicts between the Directives and IAS, where the valuation rules in the Directives are an obstacle. In this context, one of the issues to be addressed is to what extent the Fourth and Seventh Directives should be changed. Valuation principles are currently part of the Fourth Directive. Therefore it could be argued that these changes need to take place in the Fourth Directive.

This would however create creditor protection problems. Therefore another alternative would be to bring the new valuation principles into the Seventh Directive. A Member State option might then be introduced into the Fourth Directive to use these principles for individual accounts, or to continue to use the traditional accounting rules of the current Directive. If such an option were to be introduced, different routes would have to be developed for these alternatives to solve the problem of creditor protection.

The question can be raised whether it is possible to modernise the Fourth and Seventh Directives without modernising the other company law directives. Any modernisation may have a direct impact on the other Directives notably when the problem of unrealised gains is touched on in the Fourth Directive. At present many discussions take place on the realisation of profits and performance reporting. On the other hand the interpretation of “realised” profits differs nowadays widely from

country to country and therefore the Second Company Law Directive – dealing amongst other with distribution of profit – has different implications in different countries.

FEE's preference would however be to address distribution of dividends by an amendment of the Second Directive by introducing a general solvency test as the basis for profit/reserves distribution. Under this approach it would be possible to give more emphasis to the information function of individual financial statements.

### ***2.3.3. Taxation***

Some Member States use the valuation rules in the Fourth Directive also for tax purposes. A change in valuation rules may therefore raise a problem. Such a problem could be solved by giving Member States (for a certain period of time) the possibility to continue to use traditional accounting rules for the individual accounts as discussed above. Consequently, some of the proposals to modernise the Directives (issues with impact on recognition and measurement) may need to be formulated as Member State options.

In the long run when the function and purpose of consolidated and individual accounts move together the differences between the two sets of accounts will reduce. The Discussion Paper does not exclude developments in the future which would allow some divergence between accounting, tax and company law.

Focusing on the consolidated financial statements as a first step would not preclude a Member State's entitlement to impose in national company law additional disclosure requirements, distribution rules, capital maintenance requirements and similar obligations. However, the nature of any further national obligations established in company law should not be such as would inhibit compliance with IASs.

## ***2.4 Adapting to future developments in accounting***

Global capital markets and the power of new technology are forces behind a revolution in corporate reporting. Accounting is no longer an area that remains unchanged for decades. A look at the agenda of the standard setters around the world shows that there are many areas where we can expect changes in future. In contemplation of the hand-over of its function to the IASB, the old board of IASC issued a statement<sup>1</sup> mentioning the need for future developments in a number of areas.

Modernisation of the Directives should therefore not only take care of present incompatibilities with IAS, but should be sufficiently general and flexible to avoid future incompatibilities. A system needs to be found so that the Directives can keep pace with IAS.

One could in principle envisage two methods to accomplish this. A first one would be to allow developments in IAS to be followed more closely by means of a more flexible relation between the Directives and IAS. Some of the suggestions in Chapter 4 are built on that principle.

An alternative would be that the process to amend the Directives is sufficiently flexible to allow for timely changes. The proposal for the Regulation on the application of IAS includes an Accounting Regulatory Committee that is proposed to work under so called "comitology procedures". Under such procedures, implementing powers are delegated to the Commission by a directive or regulation. The advantage of comitology is that measures can be taken more rapidly without having to go through the full consultation process with the Council of Ministers and the European Parliament. According to the

<sup>1</sup> Statement by the Board of the International Accounting Standards Committee, December 2000.

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EU Directive on comitology procedures from 28 June 1999 comitology procedure can only be used to:

- apply essential provisions of basic instruments, and
- adapt or update non-essential provisions of basic instruments.

Using comitology for the amendment/adaptation of European Directives requires therefore a distinction between essential and non-essential provisions in the Directives. As far as the Accounting Directives are concerned, presentation/lay-out and disclosure issues might be regarded as not being essential provisions but only technical issues. Measurement and recognition issues are more than technical in nature and it might therefore be questioned whether changes to the articles on measurement could be subject to comitology.

Therefore it is necessary to have a discussion on the advantages and disadvantages of a comitology procedure and whether this route could be taken in order to create flexibility and timeliness for the adaptation to future developments in accounting. In such discussion, the important question to be addressed is which articles of the Accounting Directives could be subject to comitology procedures.

### 3. MODERNISATION OF THE DIRECTIVES - TECHNICAL ISSUES

There are also a number of issues which are technical in nature and are partly caused by the fact that the Accounting Directives at present are based on historical cost accounting principles. Both the Commission and FEE have carried out studies comparing the Accounting Directives with IAS. Also at Member State level comparison studies have been undertaken.

In April 1999 FEE published its study “Comparison of the EC Accounting Directives and IASs – a contribution to international accounting developments”. The study has taken into account the Directives and related Commission (and Contact Committee) communications and other papers, but also the different understandings and interpretations of the text of the Directives in different Member States. The study provides guidance in that it assesses the differences between the Directives and IAS after having examined their national context in case special issues arise. The study covers all extant IAS published up to 31 December 1998 including all SIC interpretations issued at that date. IAS 39 was not included in the review because of the forthcoming Directive to allow for fair valuation of financial instruments. The study only covers consolidated accounts. The majority of the member bodies of FEE were of the opinion that there were no major problems between IAS and the Accounting Directives, even if there were some issues where clarification was needed. It was however noted that individual countries may in practice have more problems, due to the differences in the way in which options available in the Directives have been implemented in national law. It also concluded that future projects of IASB may give problems and the Commission needs to find a proper mechanism to handle these in order to continue to enable the use of IAS.

In July 2000 FEE published its study on “To what extent can options in IAS be used for consolidated accounts under the EC Accounting Directives?”. The study provides a comprehensive analysis of all options included in IAS for consolidated accounts and investigates which options are not open to companies which have to comply with the Accounting Directives. The study covers all extant IAS published or revised up to 30 April 2000 (up to IAS 40) including all SIC interpretations issued at that date. It includes all recognition, measurement and presentation options applicable to the consolidated financial statements. The study does not cover the options in disclosure because the disclosure requirements of the IAS do not conflict with the Directives since the Directives set only minimum disclosure requirements. The study does also not address options in IAS 7 on cash flow statements since cash flow statements are not addressed by the Directives and therefore allowed by the Directives.

All options in IAS that can be used by companies on a global level should also be available to companies in the EU. National GAAP should have the possibility to allow for these options.

The main issues identified in the abovementioned studies for the consolidated financial statements are described below (see chapter 3.3 to 3.7). Furthermore, the general problem of the different concepts of realisation and prudence and of fair value-accounting versus historical cost accounting have to be addressed.

#### *3.1 The concepts of prudence and realisation*

As indicated earlier in this paper one of the purposes of financial statements clearly identified in the Fourth Directive is the protection of creditors and other parties. In order to satisfy this objective, the prudence (including the realisation principle) principle is one of the main principles included in the Fourth Directive. Under IAS the prudence principle is one of the qualitative characteristics of financial statements explaining reliability, on the same level as the other characteristics of reliability: faithful presentation, substance over form, neutrality and completeness. According to the IAS

Framework prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.

According to the realisation principle of Art. 31 of the Fourth Directive, only “profits made” at the balance sheet date may be included. The debatable question is when a profit is made and, as a result, when it can be recognised in the profit and loss account. It seems difficult to find an overall interpretation of the term “profits made”. Due to the role and importance of financial statements within capital law (such as capital maintenance and profit distribution in certain Member States) and the risk to credibility of accounting information, differences in interpretation can only be resolved with one conceptual accounting framework being accepted throughout Europe. The IASC Framework would fulfil this role.

It should be considered whether Art. 31 of the Fourth Directive containing the main valuation principles should be changed to bring Art. 31 in line with IASC Framework for the Preparation and Presentation of Financial Statements as well as IAS 1 on the presentation of financial statements. Art. 31, part 1.c (aa) “only profits made at the balance sheet date may be included” would need to be changed since there are at present already severe problems with IAS when valuation gains can not be recognised under the Directives (IAS 39, IAS 40 and IAS 41). Also the move towards comprehensive income cannot be accommodated under the Directives without a change to Art. 31.1.c (aa). This may also imply a need to change the format for the profit and loss account (see section 3.6).

Appendix 1 includes a suggestion for a possible redraft of Art. 31. This redraft intends to bring Art. 31 in line with the IASC Framework for the Preparation and Presentation of Financial Statements as well as IAS 1 on the Presentation of Financial Statements. The prominent role of the prudence principle in the Directives needs to be reconsidered. It could be considered to add the qualitative characteristics of understandability, relevance, materiality, reliability and substance over form as well as a differentiation in main underlying assumptions (accrual basis and going concern) and the lower level qualitative characteristics.

Changing Art. 31 would create the taxation and distribution problems as discussed above in a number of countries. Therefore, it should be discussed whether there should or could be different accounting principles for the consolidated and individual accounts. However, if these revised principles, through a Member State option for a certain period of time, would not need to apply to individual accounts, what accounting principles should then be applied for the individual accounts: the old Art. 31? Would it be better to include the modernised principles in the Seventh Directive?

### ***3.2 Fair value accounting (versus historical cost)***

There is a clear tendency to move towards fair value accounting in many areas in IAS, which can be seen from the recently published standards IAS 39, IAS 40 and IAS 41. The fair value amendments that are currently under discussion<sup>2</sup> in the EU only address financial instruments and would not relate to investment properties or agricultural inventories. Furthermore, at present the allowed alternative treatment in IAS 38 to carry intangible assets at revalued amounts is not allowed under the Fourth Directive. Further changes in relation to fair value would therefore be needed to solve and avoid incompatibilities between the Directives and IAS now and in the future.

<sup>2</sup> COM(2000) 80 final, Proposal for a Directive of the European Parliament and of the Council amending Directives 78/660/EEC and 83/349/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies.

It needs to be addressed whether the fair value based financial reporting of IAS should be introduced as an alternative, on an equal footing, to historical cost accounting or whether historical cost accounting should remain the main accounting principle and fair value accounting should be introduced as an option in addition to replacement value, inflation accounting and revaluation. FEE would propose to introduce fair value based accounting as a further option.

It remains to be decided if the general fair value option should be included in Art 32 or Art 33. If Art 33 were amended, the main principle in the Fourth Directive would remain historical cost accounting and this would facilitate the implementation in those Member States where the creditor protection and/or taxation problems form an obstacle. Art 32 could remain unchanged. In Art 33.1 a fourth possibility should be added to introduce fair value accounting for non-financial instruments, including investment property and agriculture products. Consequently, Art 33.2 should be amended to allow inclusion of fair value adjustments in the profit and loss account. An alternative may be to extend the proposed new section on fair valuing of financial instruments to non-financial instruments as well. If Art 33.1 were to be amended Art 35 and Art 39 would also need to be amended in a similar way.

The purpose of the option would be to enable the use of IAS at present (IAS 39, 40 and 41) but also to accommodate fair value accounting for the other possibilities foreseen by IASB. FEE at present does not take position to extend fair value accounting beyond the possibilities foreseen by IAS and is not binding itself yet in the fair value debate.

### ***3.3 Reverse acquisitions***

Occasionally an enterprise obtains ownership of the shares of another enterprise but as part of the exchange transaction issues enough voting shares, as consideration, such that control of the combined enterprise passes to the owners of the enterprise whose shares have been acquired. This situation is described as a reverse acquisition. Although legally the enterprise issuing the shares may be regarded as the parent or continuing enterprise, the enterprise whose shareholders now control the combined enterprise is the acquirer. The IAS treatment of a reversed acquisition is that the acquiree is deemed to be the acquirer and thus applies the purchase method to the assets and liabilities of the enterprise that originally issued the shares.

Art. 19.1 (a) of the Seventh Directive however requires the purchase method to be applied by the legal acquirer of the acquired company, irrespective of which company is in substance the acquirer.

### ***3.4 Scope of consolidation - Exclusion from consolidation due to dissimilar activities***

The issue is that subsidiaries with incompatible activities should be excluded from the consolidated accounts under the Seventh Directive when inclusion would be incompatible with the requirement to show a true and fair view, whereas IAS 27 does not allow for any exclusion on the ground of different activities. This would require deletion of Art. 14 of the Seventh Directive since there is a conflict with IAS 27.

### ***3.5 Special purpose entity (SPE)***

SIC 12 requires that an SPE should be consolidated when the substance of the relationship between an enterprise and the SPE indicates that the SPE is controlled by that enterprise. In the context of an SPE, control may arise through the predetermination of the activities of the SPE or otherwise. Control may exist even in cases where an enterprise owns little or none of the SPE's equity. This is in contradiction

with Art. 1.1.(b) of the Seventh Directive which requires consolidation when the undertaking "... is at the same time a shareholder in or member of that undertaking".

### ***3.6 Certain aspects of the optional corridor approach in IAS 19***

The corridor procedure and the spreading of past service cost, as permitted by IAS 19, might result in deferred charges or a net amount of the pension obligation being shown at less than its full amount. This would not be in compliance with Article 31.1 (c) (bb) of the Fourth Directive, which states that account must be taken of all foreseeable liabilities. However, Article 43.7 of the Directive is widely interpreted as allowing no or partial recognition of pension obligations, the unrecognised obligation being disclosed in the notes. FEE is of the opinion that this interpretation is acceptable under Art 43.1 (7) of the Fourth Directive.

However, according to FEE, there is an incompatibility between the Directives and IAS 19 as regards actuarial gains. FEE considers that deferring actuarial gains would not be in compliance with Art 42 of the Fourth Directive which states that provisions may not exceed in amount the sums which are necessary. Since the corridor procedure is optional, companies do not need to use the corridor procedure. In this way, they could comply both with IAS 19 and the Fourth Directive. However, companies may wish to use the corridor approach to align with international practice whereas the Directive would not allow them to do so.

### ***3.7 Format issues***

#### *Classification in the balance sheet*

IAS 1 offers a presentation option whether or not to present current and non-current assets and current and non-current liabilities as separate classification on the face of the balance sheet. This classification into current/non-current is not always compatible with the Fourth Directive balance sheet format distinction for assets of fixed/current. There is a conflict between IAS 1 para 53 and Art. 15 of the Fourth Directive.

#### *Classification in the profit and loss account*

It might be difficult to comply with the format of the profit and loss account if a single performance statement were to be introduced by IASB. The line items included in the format would need to be changed to allow for the presentation of "comprehensive income".

#### 4. ALTERNATIVE APPROACHES FOR THE MODERNISATION PROCESS

In this section, various alternative approaches for the modernisation process are given and their advantages and disadvantages are spelled out. This section is not comprehensive but it is hoped that the main different approaches have been addressed. Also combinations of approaches are possible and envisaged. The following four alternatives are discussed:

- scoping out and transferring to a capital market regime
- high level version of the existing Accounting Directives
- minimum changes required to allow national GAAP to converge to IAS
- full modernisation of the Accounting Directives.

##### *4.1 Scoping out companies applying IAS and transferring to a different regime*

In December 1997, FEE wrote to the Commission on the subject of amending the Accounting Directives. FEE welcomed the preparedness of the Commission to change the Directives in order to allow companies also in the future to comply with both IAS and the Accounting Directives. However, since the amendment process takes considerable time and further differences may occur, FEE recommended that listed companies be allowed to apply internationally accepted accounting standards even if this would mean being for the moment in contradiction with the Accounting Directives. FEE recommended a rapid – temporary – solution consisting of excluding certain types of companies (companies that have listings abroad or which have significant financial statement users abroad) on a time limited basis from the scope of the Seventh Directive, by introducing a Member State option. In its “Discussion Paper on a Financial Reporting Strategy within Europe” from October 1998 FEE recommended exempting listed companies applying IAS from the Accounting Directives and transferring them to another, capital market, regime.

FEE holds the view that companies applying IAS whether in the individual or consolidated financial statements should be exempted from the Accounting Directives and transferred to a separate capital market regime with a Directive or Regulation that requires the full use of IAS. Scoping out should apply not only to listed companies which will be required to use IAS according to the draft regulation but also to other companies using IAS on a voluntary basis or according to national law.

##### *Advantages and disadvantages of “scoping out”*

The scoping out approach has the following advantages:

- no need to keep pace with the development of IAS;
- a “quick” solution, it would be possible to meet the time constraint set by the Commission Communication and proposed Regulation;
- for the time being, lengthy discussions on complex issues can be avoided, since only one article needs to be introduced;
- cost benefit analysis: this approach would minimise the costs of change for companies not using IAS;



and the following disadvantages:

- if scoping out would also apply for the individual accounts, the legal company law aspects would need to be arranged in a different way;
- it would lead to different accounting systems, and it may be difficult for companies not using IAS to switch to the other systems (for instance in case of a public offering), especially if national law does not converge to IAS.
- it may be considered as a short term solution since the ultimate aim would be to have one set of rules for all companies in individual and consolidated financial statements.
- it would not allow national GAAP to converge to IAS in those areas where the Directives form an obstacle, unless the Directives are changed.

It is doubtful whether it is sustainable in the longer run to have different measurement rules for different types of companies. Only differences in disclosure requirements are feasible and any differences in recognition and measurement recognition and requirements would need to be removed. Therefore in any case a procedure to eliminate inconsistencies between the two systems would be needed.

#### **4.2 High level approach**

A high level version of the Fourth and Seventh Directives would only include articles that cover issues that are not dealt with in IAS. This would include especially those articles requiring disclosures that are legal in background, and not serving the information objective. The high level version of the Accounting Directives would be introduced for companies using IAS whether in individual or consolidated accounts in accordance with the proposed Regulation or national law. Such a “high level” approach would be implemented by including a new Article in the Fourth and Seventh Directives, stating that companies applying IAS only have to apply the following articles:

##### Fourth Directive:

- Article 43 (9): disclosure of average number of employees (legal disclosure beyond financial reporting)
- Article 43 (12): disclosure of emoluments (legal disclosure beyond financial reporting)
- Article 43 (13): disclosure of advances and credits (legal disclosure beyond financial reporting)
- Article 46: annual report
- Article 47.1: publication
- Article 48: disclosure of full text of audit report
- Article 49: when annual accounts are not published in full
- Article 50: publication of the proposed appropriation of profit
- Article 51: auditing

##### Seventh Directive:

- Article 34 (9): disclosure of average number of employees (legal disclosure beyond financial reporting)
- Article 34 (12): disclosure of emoluments (legal disclosure beyond financial reporting)
- Article 34 (13): disclosure of advances and credits (legal disclosure beyond financial reporting)
- Article 36: consolidated annual report (directors’ report)

Article 37: auditing  
 Article 38: publication

*Advantages and disadvantages of “high level” version*

The “high level” approach has the following advantages:

- under the “high level” approach the danger of implementing articles in the Directives, that - consciously or not - are in conflict with IAS can be avoided, which is a necessary condition for having financial statements of European companies fully in line with IAS;
- Directives without precise accounting rules would confirm the framework character of the Directives and facilitate the pro-active role of the endorsement mechanism and the endorsement of IAS.
- since the Commission suggests in its June Communication that listed companies should apply IAS at latest for the financial year 2005, the modernisation of the Accounting Directives needs to be in place by 2003 at the latest because of the comparative figures to be presented in the financial statements. This means that there are effectively only three years to change the Accounting Directives. With the “high level” version it could be possible to meet this time constraint;
- if only a few articles are involved, lengthy discussions on complex issues can be avoided;
- full modernisation of the Accounting Directives in detail would make it necessary to introduce further options to solve complex issues within an adequate timeframe (similar to the fair value amendments at present). Proliferation of options may destroy the harmonisation and comparability objectives of the Directives;
- it leaves the articles with a legal background in place;
- cost-benefit analysis: a full modernisation of the Accounting Directives would be a major cost implication for the European economy;
- smaller companies not applying IAS may attach less importance to financial reporting and might be reluctant to accept changes;

and the following disadvantages:

- it may be considered to be only a short term solution since the ultimate aim would be to have one set of rules for all companies;
- it would not allow national GAAP to converge to IAS in those areas where the Directives form an obstacle. However, if Member States decide to allow companies to apply IAS in total, they can use the member state option of the forthcoming regulation to allow or require companies to apply IAS. In this case the “high level” approach will apply.

A variant of the high level approach could be to include in addition some further articles to provide a minimum basis of financial reporting (definition of the scope of the Directive, definition of annual

accounts, concept of true and fair view) in addition to those articles mentioned in the “high level approach” above.

Under the “high level approach” (as well as under the approach of scoping out, see section 4.1) a solution has to be found for the other companies not using IAS. It is questionable whether comparability would be achieved if the accounting standards to be used instead of IAS are to be developed by the national standard setters. One could therefore argue that there should be a full modernisation of the Directives anyhow. The companies most likely to be affected would be SMEs.

It could be considered to introduce an allowed alternative for SMEs using IAS but with less disclosures in the notes than required by IAS. However, IASB has not yet developed a SME financial reporting standard which means that a reference to IAS is not possible.

If IASB introduced a special reduced disclosure regime for SMEs this would automatically be fed into the Accounting Directives for companies using IAS. In the absence of a special IAS for SMEs, Member States should be permitted to allow SMEs to use the recognition and measurement requirements of IAS, but to disclose less information in the notes than required by IAS.

#### ***4.3 Minimum requirements to allow national GAAP to converge to IAS***

The question needs to be addressed whether under a “high level” version of the Accounting Directives, or under the approach of scoping out, any further amendments would be needed for the non-IAS using companies. The various advantages of introducing a “high level” version of the Directives for companies using IAS and scoping out are discussed, including keeping the necessary changes to the Directives to a bare minimum. However one of the disadvantages of not making any further amendments would be that obstacles in the Directives that hinder National GAAP from converging towards IAS are not necessarily removed and the convergence process can therefore either not take place or is substantially slowed down.

The minimum changes to be made are presented below. The list may appear fairly short but the issues involved are complex in nature, and even if introduced in the form of Member State options, will require a substantial effort in each of the Member States.

##### *Minimum changes to be made*

In order to keep the changes to the Fourth and Seventh Directives to a minimum at least the following changes should be made to allow National GAAP to converge to IAS:

- Minimum revision of Art 31 of the Fourth Directive

Art. 31, part 1.c (aa) “only profits made at the balance sheet date may be included” would need to be changed since there are at present already severe problems with IAS when valuation gains can not be recognised under the Directives (IAS 39 and its replacement, IAS 40 and IAS 41). Also the move towards comprehensive income cannot be accommodated under the Directives without a change to Art. 31.1.c (aa).

- Introduction of fair value accounting for items which are not covered by the fair value proposals of the Commission and treatment of changes in fair value (see also section 3.2)

- Introduction of the possibility to use a single performance statement (instead of the profit and loss account)

It is doubtful whether in Article 2.1 and 2.3 of the Fourth Directive (and Articles 16.1 and 16.3 of the Seventh Directive) the wording of profit and loss account would accommodate a possible future replacement of the profit and loss account by a single performance statement. Therefore it may be necessary to amend the term “profit and loss account” to “a statement of the company’s performance”. In addition (see section 3.6), it would be necessary to change the format and individual line items to allow for the presentation of “comprehensive income”.

- Removing apparent conflicts with IAS

Our study “Comparison of the EC Accounting Directives and IASs” of April 1999 showed only two incompatibilities between the Directives and IAS which do not allow the application of IAS under the Directives as discussed before:

- reverse acquisitions (see chapter 3.3)
- scope of consolidation – exclusion from consolidation due to dissimilar activities (see chapter 3.4)

- Eliminating the block on use of certain options in IAS

All options in IAS that can be used by companies on a global level should also be available to companies in the EU. National GAAP should have the possibility to allow for these options. The FEE study “To what extent can options in IAS be used for consolidated accounts under the EC Accounting Directives?” of July 2000 as discussed before identified the measurement issues and the presentation issue below:

- corridor approach (see chapter 3.5)
- fair valuing intangible assets (see chapter 3.2)
- fair valuing investment property with inclusion of gains and losses directly in the profit and loss account (see chapter 3.2)
- classification in the balance sheet in current/non-current (simplification of lay-out) (see chapter 3.6)

The following of the proposed amendments could at least for a certain time be introduced as Member State options in order to avoid the possible tax and capital maintenance consequences as discussed in section 2.3.2 and 2.3.3:

- amendment of prudence principle in Art. 31.1.c (aa)
- fair value accounting for items not covered by the fair value proposals of the Commission
- fair valuing intangible assets
- fair valuing investment property.

However, the introduction of Member State options may cause countries to deviate even further in their practices. Therefore within the time frame given by the option, Member States will have to amend their legislation to select the proper options in the Directives to facilitate IASs.

The above list only covers the main issues. The list may appear short but the issue involved are very complex. At least for a certain time, further European differences will occur since Member States will select different options. Moreover different interpretations will appear. The level playing field for

companies using IAS will only be achieved if also the “high level” modernisation or the scoping out approach is introduced.

This approach could also be seen in combination with the high level or the scoping out approach to solve problems for companies not using IAS and to modernise their financial reporting system.

#### *Advantages and disadvantages of the minimum requirements approach*

The “minimum requirements approach” has the following advantages:

- the approach is much less than a full modernisation so that it could be envisaged within a shorter timeframe;
- it allows national GAAP to converge to IAS since all obstacles are removed;
- in case this approach is not combined with the high-level or scoping out approach; it provides one set of accounting requirements for all companies).
- it leaves all legal articles in place;

and the following disadvantages:

- complexity of issues to be discussed, even if introduced in the form of Member States options;
- risks to be time consuming, may be difficult to respect the deadline of 2005 (in practice 2003)
- would still leave many subjects not addressed: which rules should apply in that case: IAS, national GAAP ?
- there would continue to be potential problems of non-compliance with IAS in the future;
- any modernisation is costly since it will require that all companies covered by the Accounting Directives change their financial reporting system.

#### **4.4 Full modernisation**

Full modernisation would include a fundamental review of the Accounting Directives. Such an amendment process could be based on the following assumptions:

- modernisation should reinforce the framework character of the Directives (proper balance between principles and details);
- modernisation of the Accounting Directives should reduce as much as possible potential conflicts with IAS;
- all options in IAS that can be used by companies on a global level should also be available to companies in the EU;
- the Directives are the basic EU legal rules on financial reporting for all EU limited liability companies;
- the Directives should make it viable for Member States to allow companies to have the same set of rules in both annual and consolidated accounts.

Initial suggestions for a total review of the Accounting Directives, based on the present structure of the Directives are included in the Appendices 1 and 2 for respectively the Fourth and Seventh Directives as attached. With detailed legislation, consequential changes may be needed in other articles. To reinforce the framework character in the Directives, i.e. to reach a proper balance between principles and detail, undue detail could be removed and the provisions in the Directives could be restricted to key accounting principles. Instead of having detailed rules within the Directives the details should be provided by the standard setters themselves, which in case of IAS is the IASB and SIC.

Also a proper balance should be achieved that allows companies to follow all available options in order to follow IAS and – at least for a certain time - Member States to use the options where they do or do not yet allow companies to apply IAS in individual accounts, because of the fact that necessary changes in taxation or other laws are not yet in place. Transition rules should be developed in such a way that all companies could at some point in time use IAS in order to achieve comparable financial reporting within the European market.

Full modernisation would be possible in various forms, for example the German Accounting Standards Board (DRSC<sup>3</sup>) has provided detailed suggestions to amend the Fourth and Seventh Directives. It is based on the view that the Accounting Directives should contain a framework of accounting rules and leave the detailed embodiment to accounting standards.

*Advantages and disadvantages of full modernisation*

The full modernisation approach has the following advantages:

- the Directives will be fully adapted to IAS and at present there will be no incompatibilities;
- the Directives provide one set of financial reporting rules for all limited liability companies;
- companies, other than listed companies, can use IAS – if allowed by national law – without being in conflict with the Directives;
- also smaller companies are required to follow a modern set of recognition and measurement rules (based on IAS) but not including all details of IAS;
- it would allow/require national GAAP to converge to IAS;
- it leaves all legal articles in place

and the following disadvantages:

- full modernisation requires a fundamental review of the Directives, would involve many complex and political issues and would be time consuming. It can be doubted if a full modernisation could be in place by 2005 (let alone by 2003);
- full modernisation may make it necessary to introduce further options to solve complex issues. Proliferation of options may destroy the harmonisation and comparability objectives of the Directives;

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<sup>3</sup> German Accounting Standards Board – Proposal for the Reform of the 4<sup>th</sup> EC Directive (7 December 2000); Proposal for the Reform of the 7<sup>th</sup> EC Directive (24 July 2000)

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- if full modernisation is not achieved in a flexible manner and if a flexible solution is not found for future changes or if the requirements are too detailed it is difficult to see how future amendments of the Directives can keep pace with IAS;
  - there would continue to be potential problems of non-compliance with IAS in the future;
  - full modernisation is costly since it will require that all companies covered by the Accounting Directives change their financial reporting system.

## APPENDIX 1 – FULL MODERNISATION – PROPOSED AMENDMENTS FOURTH DIRECTIVE

Art 2: para 1 and 3 will need to be combined into one paragraph and would need to include a reference to the performance of the company. The paragraph could read: “2.1 The annual accounts shall give a true and fair view of the company’s assets, liabilities, financial position and performance of the company”.

The paragraph should not indicate the composition of the annual accounts since this is subject to change (performance statement may replace the profit and loss account) and may include additional items (cash flow statements).

Art 4 and 5: could be deleted, only Art 4.4 should be kept since it describes the comparability of financial statements. Alternatively Art 4.4 could be included in Art 31 in its revised form as suggested below.

The formats provided by the Directives for the balance sheet and profit and loss account are very rigid despite the fact that captions can be added. The formats stem from over 25 years ago and do not fit modern accounting and recent accounting developments. The formats need a total revision or be left free. In this respect, it is notable that the proposed directive to amend the Accounting Directives to introduce fair value accounting for certain financial instruments does not indicate under which balance sheet item derivatives should be recorded and where fair value changes both in the balance sheet and in the profit and loss account should be recorded. Companies for competitive reasons wish to follow the internationally used formats, which are different from the current directive formats.

We suggest to provide only the minimum requirements for lay-out of the balance sheet and profit and loss account (IAS 1 para 66 and 75). Further details could be disclosed in the notes to the accounts.

Art 7: We suggest that Art 31.1 (e) should be combined with Art 7 into a new Art 7: “An asset and a liability item may only be offset when a company has a legally enforceable right to set off the recognised amounts.”

Art 8 to 10: see Art 4 and 5, be kept to minimum contents as required by IAS 1.

Art 11: to be kept, but amended to reflect the minimum contents.

Art 13: para 1: no change, para 2: to be deleted since not in line with the minimum requirements for layout. IAS does not allow accounting as an asset, but only as a deduction from equity.

Art 15: para 1: to be replaced by IAS 1 para 53: classification could either be current / non-current or in order of liquidity.

para 2: to be replaced by IAS 1 para 57 definition of current assets and para 60 definition of current liabilities.

para 4: to be deleted, since it is not possible to account for formation expenses as an asset under IAS 38 para 57. They should be treated as an expense.

Art 16: to be deleted, as a consequence of changing the formats.



- Art 17: to be deleted, as a consequence of changing the formats.
- Art 18: to be deleted, since this is too detailed a requirement when formats are only based on minimum requirements.
- Art 19: to be indicated that value adjustments can relate to impairment and normal depreciation. The article should be maintained with this clarification.
- Art 20: para 2: to be deleted since not in line with IAS 37.
- Art 21: to be deleted, since this is too detailed a requirement when formats are only based on minimum requirements.
- Art 22: to be replaced by the minimum requirements of IAS 1, see discussion before.
- Art 23 to 26: to be replaced by the IASC minimum requirements of IAS 1, see discussion before.
- Art 27: to be kept, but to be amended for above changes.
- Art 30: to be deleted, related to tax issues and the IASC minimum contents requirements are clear in this respect: heading IAS 1.75 (e) tax expense.
- Art 31: The main article that needs to be changed is Art 31, which needs to be brought in line with the IASC Framework for the Preparation and Presentation of Financial Statements as well as IAS 1 on the Presentation of Financial Statements. The differentiation in main underlying assumptions (accrual basis and going concern) and the lower level qualitative characteristics would also be useful. The qualitative characteristics of understandability, relevance, materiality, reliability and substance over form need to be added. In particular the prominent role of the prudence principle in the Directives needs to be reconsidered.

We suggest a redraft along the following lines:

"Article 31

1. The Members States shall ensure that the items shown in the annual accounts are valued in accordance with the following general principles:
  - a) a going concern basis should be used unless management either intends to liquidate the company or to cease trading, or has no realistic alternative but to do so (GOING CONCERN);
  - b) account must be taken of income and charges relating to the financial year, irrespective of date of receipt or payment of such income or charges. However, the application of this principle should not result in the recognition of items in the balance sheet which are not assets or liabilities (ACCRUAL BASIS);
  - c) the methods of valuation must be applied consistently from one financial year to another as well as the presentation and classification of items in the annual accounts (CONSISTENCY AND COMPARABILITY);
  - d) each material item should be presented separately in the financial statements. Immaterial amounts should be aggregated with amounts of a similar nature or function and need not to be presented separately (MATERIALITY);
  - e) information in financial statements must be complete within the bounds of materiality and cost (COMPLETENESS);
  - f) items in the annual accounts should be accounted for and presented in accordance with their substance and economic reality and not merely their legal form (SUBSTANCE OVER FORM);

- g) annual accounts must be readily understandable for users. The information included in the annual accounts must be relevant to the decision making needs. The information must also be reliable; i.e. free from materiality error and bias (UNDERSTANDABILITY, RELEVANCE AND RELIABILITY).
2. Valuation must be made on a prudent basis within the overall need to be free from bias. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.
  3. In case the opening balance sheet for a financial year does not correspond to the closing balance sheet for the preceding financial year, this fact and the reason for it have to be disclosed."
  4. Departures from these general principles shall be permitted in exceptional cases. Any such departures must be disclosed in the notes on the accounts and the reasons for them given together with an assessment of their effect on the assets, liabilities, financial position and profit or loss.

Art 33: a fourth possibility should be added to introduce fair value accounting for non-financial instruments, including investment property, and agriculture products. Consequently, Art 33.2 should be amended to allow inclusion of fair value adjustments in the profit and loss account. An alternative may be to extend the proposed new section on fair valuing of financial instruments to non-financial instruments.

Art 34: to be deleted, since it is not allowed under IAS 38.

Art 35: para 1: to be updated for decommissioning costs in that these costs can be included in production costs.

para 1 (d): to be deleted since it refers to tax specific circumstances.

Art 36: to be deleted, since potentially a conflict with IAS 39 and not in line with formats that are only based on minimum requirements.

Art 37: to be deleted, since not in line with IAS 38.

Art 38: to be deleted, since when these items are of secondary importance they are not material and there is no need to cover them specifically. If these items are material there is a conflict with IAS therefore Art 38 needs to be deleted.

Art 39: para 1(e) to be deleted since it refers to tax specific circumstances.

No further change apart from reference to fair value as discussed before.

Art 41: to be deleted, since the option of showing the difference as an asset would not be allowed under IAS 32.

Art 43: para 1.6: should be brought in line with IAS 32 to include also the period between 1 to 5 years.

para 1.11: the wording needs to be modernised.

para 2: no longer needed, can be deleted. A new disclosure on stock options should be added. We suggest at this moment only to include an additional disclosure and not the introduction of the accounting for stock options since charging to the profit and loss account is still the subject of debate.

Art 44: to be kept, consequential changes to be made in relation to minimum requirements.

Art 46: needs to be amended to reflect the modern views on a MD&A. Useful information could be obtained from the E5+2 position paper on a management analysis.

Art 47: to be kept, consequential changes to be made in relation to minimum requirements.

Final provisions Art 52 to 61 need to be adapted to reflect the current situation. Most of the articles can be omitted.

## APPENDIX 2 – FULL MODERNISATION – PROPOSED AMENDMENTS SEVENTH DIRECTIVE

Art 1: this article can be modernised by using the definitions and concepts of para 6, 7, 8 and 12 of IAS 27 (Consolidated Financial Statements and Accounting for Investments in Subsidiaries), with the emphasis on control rather than on voting rights. It may need to be considered to add some wording for special purpose companies (SIC 12).

Art 5: to be deleted, since the option for exemption is not in line with IAS 27 and 28.

Art 6: should be kept, apart from para 5 which is now out of date.

Art 7: para 1: phrasing of this paragraph is considered too complex, the reference to Member States should be deleted, with direct reference to the parent undertaking. This would make para 3 also easier to read.

para 1 (b): the second sentence can be deleted since it is out of date.

Art 13: para 3 needs to be brought in line with IAS 27 para 13 which indicates when a subsidiary should be excluded from consolidation.

Art 14: to be deleted, since there is a clear conflict, identified in earlier studies and the article is out of date given the existence of financial conglomerates.

Art 15: to be deleted, since under IAS 27 all companies need to be consolidated.

Art 16: to be amended in a way similar as proposed for the Fourth Directive (Art. 2)

Art 17: needs to be amended with reference to the minimum requirements of IAS 1, as earlier discussed for the Fourth Directive.

Art 19: para 1: needs to be amended and brought in line with IAS 22 para 32 and 34 (on business combinations: allocation of the cost of acquisition).

para 2: needs to be amended in line with the earlier proposed amendments for the Fourth Directive, in that the last sentence needs to be deleted.

Art 20: to be amended and brought in line with IAS 22 para 61 to 67.

Art 26: in para 1 a reference to cash flow statement and performance statement needs to be included as discussed earlier.

para 2: to be deleted, since not in line with IAS 27.18.

Art 28: second sentence to be deleted because not in line with IAS.

Art 29: para 2 (a) needs to be changed in that Member States are required to permit all companies the use in the consolidated accounts of all valuation methods available under the Fourth Directive. In this way all companies will be able to apply IAS without being in conflict with the Directives. (This is the case if the fair value option is included in the Fourth Directive rather than in the Seventh Directive (see before).)

para 5: to be deleted, since it deals with taxation which is regarded as a national problem.

Art 30: para 1: to be replaced by IAS 22 para 41, 43 and 44 on goodwill arising on acquisitions and related amortisation.

para 2: to be deleted, since this option is no longer allowed under IAS.

Art 31: to be replaced by IAS 22 para 59, 61 and 62 on negative goodwill arising on acquisitions.

Art 33: text needs to be brought in line with IAS 28, accounting for associates in investments, although most of the text can be kept. A streamlining and modernisation of the text is needed.

Art 34: we suggest as an additional disclosure: Earnings per share (EPS) basic and diluted. In addition para 1.6 should be brought in line with IAS 32 and the wording of 1.11 needs to be modernised as observed before for Art 43 of the Fourth Directive.

Art 36: needs to be amended, see our remarks on Art 46 of the Fourth Directive.

Section 6 Art 39 to 51: need to be reviewed since most of the Articles can be deleted as they are out of date, or need to be adjusted following the adjustments in the previous sections and articles.