FEE STUDY

Comparison of the EC Accounting Directives and IASs

A contribution to international accounting developments

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A. INTRODUCTION

1. BACKGROUND AND HISTORY

Background

European accounting is faced with changes due to continuing international developments which include:

- The results of the IASC/IOSCO agreement.
- The amendments to the Fourth Directive announced by the European Commission in order to facilitate the use of IASs.
- Several European countries have reacted to the needs of their listed companies by adopting new legislation that moves towards internationally accepted accounting regulations.
- The introduction of the euro encourages further transparency in accounting requiring a single accounting framework.

The euro competes with the dollar, and the European capital and financial markets are expected to grow in importance so that European multinationals become less dependent for their financing from the US capital market. Ensuring deep and liquid European capital markets requires the removal of barriers to cross-border provision of financial services. Not least amongst these barriers is the accounting diversity which prevents adequate reliance bring placed on financial statements across borders. The Commission has recognised this need and set out its proposed policy orientations for the regulation of Europe's capital and financial markets post-euro in the "Financial Services: Building a Framework for Action" Communication of October 1998. The Framework Communication indicates that the Commission will review whether listed companies should be required to prepare their financial statements in conformity with a more harmonised model such as that of IASC. IASs are therefore likely to play a more important role in Europe.

Moreover, already since 1995 the Commission together with the Member States – through their representatives in the Contact Committee and its Technical Subcommittee – has worked towards facilitating the use of IASs, (particularly for listed companies in their consolidated accounts). It has tried to avoid or minimise the (potential) differences between the Fourth and Seventh Directives and IASs. FEE supports the strategy of the Commission to facilitate the use of IASs. FEE is now reflecting on the contribution it could make to establishing a financial reporting strategy for Europe. It is, however, evident that under any of the various scenarios IASs will play a more profound role.

The accountancy profession and in particular listed companies will intensify their use of internationally accepted standards and need to have an in depth knowledge of these standards (as indicated under 2. Scope, this Study focuses on IASs only). Subject to future developments in Europe, companies have to operate within the framework set by the Accounting Directives and therefore it is important for them to know if there are any obstacles to complying both with the Directives and IASs.

Since the Accounting Directives contain many Member State options, their implementation into national law varies from country to country. The individual Member States have the possibility to amend their national legislation by using options different from the ones previously selected to bring their legislation closer to IASs. Moreover, there exist different understandings and interpretations of the text of the Directives – besides the fact that the different language versions of the Directives do not use exactly the same wording – due to cultural differences, different understandings and prioritising of basic principles, and differences in legal background (1997 FEE Comparative Study on Conceptual Accounting Frameworks in Europe). Although in the recent past, companies and accountants had to operate only within the framework provided by the national law and there was no need for specific knowledge of the Fourth and Seventh Directives, this situation has changed, now more and more countries allow the use of internationally accepted accounting standards in the consolidated accounts of mainly listed companies under the conditions of compliance with the Accounting Directives. These companies no longer have to operate within their national framework since they are exempted from national law, but within the framework set by the Accounting Directives. This means that all the options included in these Directives are available to them and not only those selected for implementation into national law.

Certain Member States that incorporated the Directives verbatim into their national law have problems with interpretations of the Directives by the Commission that contradict their common national understanding of the Directives and their national legislation. This common understanding may be laid down in commentaries, academic papers, etc. These countries have difficulties in explaining to their users and preparers and the accountancy profession that exactly the same text now may have a wider meaning or even a different meaning.

FEE has therefore decided to undertake a comparison between the Accounting Directives and IASs. It has not only 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 those countries where these are materially different from the Commission's and Contact Committee's interpretation of the Directives. A company needs to apply the IASs within the national context – be it national law, or the understanding of the Accounting Directives in that country. This study provides guidance in that it assesses the differences between the Directives and IASs, after having examined their national context in case special issues arise.

Movement towards different accounting practice will need time and will need to be stimulated by creating an understanding of developments in the international accounting field and interpretations in other European countries and in other parts of the world. This document hopes to contribute to this understanding.

History

In November 1995, the European Commission issued a communication "Accounting Harmonisation: a new strategy vis-à-vis international harmonisation". This document initiated the process of reviewing European accounting regulations and finding European companies a solution for their needs when seeking capital on international capital markets. As the Commission itself explained, the most urgent problem relates to European companies with an international exposure - the so called "global players" (European Commission, 1995, paragraph. 3.3). The new strategy deals comprehensively with the issues, acknowledges what has already been done, identifies the options facing the EU and sets out reasoned conclusions. FEE expressed its support for the initiatives of the Commission to give European companies the possibility to use IASs within the framework of the Directives. The strategy also encompasses a stronger influence of Europe within the IASC.

Companies with limited liability in the European Union must operate within the framework provided by the Fourth and the Seventh Directives and in most cases comply with the implementation of the Directives in the national law of their Member State. Banks, insurance undertakings and other financial undertakings are also influenced by these Directives since the Bank Accounts Directive and Insurance Accounts Directive refer to certain articles of the Fourth and Seventh Directives. Changes to the Fourth and Seventh Directives may have implications for those Directives. Any direct application of IASs is at present only possible within the framework provided by the Accounting Directives. However, in a growing number of countries, the national law need no longer be complied with for the consolidated accounts of listed companies, providing that certain conditions are met.

The recent French legislation states that listed companies will be allowed to prepare and publish their consolidated accounts according to international standards, providing they also comply with the Directives (Art 6. adding article 357-8-1 to the company law of 24 July 1966 which contains the accounting rules on consolidation). This means that Member State options could be ignored as long as the options provided in the Directives are respected by the companies. In the absence of the IASC/IOSCO agreement, and until 31 December 2002, companies are allowed to use US GAAP within the framework provided by the Directives. However, this "option" requires approval of the rules by the CRC and that the rules be translated into French, which is currently not the case for US GAAP, so effectively only an opening is made for IASs, which have been translated.

The German approach as formulated in the "Kapitalaufnahmeerleichterungsgesetz" also permits listed companies to prepare their group accounts according to internationally accepted accounting standards (i.e. IASs or US-GAAP). The group accounts according to internationally accepted accounting standards must be prepared in line with the Seventh Directive and the informative value of these accounts must be equivalent to group accounts under the German Commercial Code. In such cases quoted companies are exempted from preparing group accounts following the German Commercial Code. The application of the new law is limited to group accounts covering accounting periods ending before 31.12.2004. During this period the legislator intends to adjust the accounting rules to internationally accepted standards in particular for quoted companies. The statutory auditor has to confirm in his audit report that the conditions for being exempt from the requirement to prepare consolidated accounts according to national law have been met by the reporting company.

Similar developments have taken place in Austria, Belgium, Italy and Spain in that listed companies are allowed to use IASs in the consolidated accounts under the condition of compliance with the Accounting Directives and are exempted from the national rules. In some of these countries, this possibility is subject to additional conditions. In Austria not only listed companies are allowed to use IASs, but all companies are allowed to do so, in their consolidated accounts.

In Denmark, a task force has been set up by the "Erhvervsministeriet" (Ministry of Business and Industry) to evaluate and report on the structure and content of a new accounting act for companies also taking into consideration the aspects of IASs and internationally accepted accounting standards. It is planned to issue a proposal for a new revised companies accounting act in 1999. Although the companies accounting act has not been changed recently it has been accepted that it is not in conflict with companies preparing and publishing annual accounts complying with IASs.

In Hungary as part of the revision of the accounting regulations to prepare for joining the EU, aspects of IASs will be incorporated in the Hungarian Accounting Act during the coming two years.

In all these cases, within the EU and the European Economic Area, application of IASs is only possible under the condition of compliance with the Accounting Directives at the same time. This attaches importance to the process of solving any existing and potential conflicts between IASs and the Accounting Directives.

In 1996, the Contact Committee on the Accounting Directives examined the conformity of the IASC Framework and IASs published as at 31 December 1995 (excluding IAS 32 - Financial Instruments: Disclosures and Presentation) with the Accounting Directives. The objective of the analysis reported in the document ("An examination of the conformity between the international accounting standards and the European accounting directives") published in 1996 was to determine whether and to what extent conflicts between IASs and the Accounting Directives existed and would need to be resolved, so that European companies willing to apply IASs in their consolidated accounts could do so without being in conflict with European legislation.

However, as stated in the 1996 Contact Committee document, there were some restrictions to the examination as, for example, the number and complexity of the disclosures required under IASs go well beyond that provided for by the Accounting Directives. Issues not being treated in the Directives have not been considered as a potential conflict. Some IASs (IAS 7, 10, 14, 15, 17, 18, 19, 20, 24, 26 and 29) were excluded from the scope of the analysis as a preliminary examination had shown that the issues dealt with in these IASs did not raise any particular concerns as regards the general principles incorporated in the Accounting Directives. Equally, the 1996 paper did not refer to IAS 1, 4, 5, 12 and 13, because these standards were under review at the time of the analysis.

The 1996 Contact Committee document did not examine the following standards since they did not exist or were under review as at 31 December 1995: IAS 33, 34, 35, 36, 37, 38, 39 and IAS 1 (revised 1997); 12

(revised 1996); 14 (revised 1997); 17 (revised 1997); 19 (revised 1998) and 22 (revised 1998). These standards have been (re) issued since 31 December 1995. In addition the interpretations of the IASC from its Standing Interpretations Committee (SIC) were not taken into account since the SIC was only created in 1997. IAS 32 "Financial Instruments: Disclosures and Presentation" was also not covered as it was then being examined by a Joint Working Group on accounting and disclosures of financial instruments, composed of representatives from the Contact Committee and the Banking Advisory Committee.

The Contact Committee at that time identified two requirements of the IAS which raise problems of compatibility with the Accounting Directives, even if a hypothetical European company preparing its accounts in accordance with the Directives uses all options available under the Accounting Directives necessary to comply with IASs. The first incompatibility refers to the treatment of negative goodwill, the second to the scope of consolidation. Further differences may, however, occur at Member State level depending on the way in which Member States have interpreted the Directives and to what extent Member States have implemented the options into their national legislation.

In addition the Commission published in 1997 "Examination of the conformity between IAS 12 and the European Accounting Directives" (XV/7012/97) based on an examination carried out by the Contact Committee on the Accounting Directives. It lists a number of issues to be considered in deciding whether, and to what extent, to apply IAS 12 in European jurisdictions.

The Commission published in January 1998 an "Interpretative Communication Concerning Certain Articles of the Fourth and Seventh Council Directives on Accounting", (XV/7009/97) which aims to give guidance to bodies responsible for setting accounting standards in the Member States, to accounting professionals and to investors and other users of company accounts. The communication "comments on topics where authoritative clarification appears to be required". The topics have been chosen taking into account discussions in the Contact Committee on the Accounting Directives as well as discussions at the Accounting Advisory Forum, but do not necessarily represent the view of the Member States. The views expressed cannot - in themselves - impose any obligation. They do not constrain the interpretation that the Court of Justice, as the ultimate interpreter of the Treaty and secondary legislation, might place on matters. In a national law case concerning accounting issues reference can be made to the Directives and the judge, in case of doubt, can ask for a preliminary decision by the European Court of Justice. Only a decision from the highest court would give final legal certainty. However, the procedure of filing an appeal with and obtaining a decision from the European Court of Justice would at least take some years. The Commission's interpretations serve as an important source of information arising from the fact that the Commission is one of the parties involved in the Directives' legislative process.

The “dynamic” interpretation of the Directives intends to give the outer limits of the way in which certain articles within the Directives can be interpreted, but will not always be sufficient to solve all issues perceived as problems in certain Member States. It should be mentioned that defining outer limits by a “dynamic interpretation” also bears the risk that more options of different treatments will be allowed with negative consequences for the comparability of financial statements. As far as “hidden options” are concerned which are included in the Directive by using undefined legal expressions (such as “asset”, “realised”), an interpretation may not restrict different understandings of these expressions.

In 1998 the Commission published furthermore "Examination of the conformity between IAS 1 (revised 1997) and the Accounting Directives" based on an examination carried out by the Contact Committee on the Accounting Directives.

At the time this FEE Study was being finalised, the Commission was about to publish some further papers of the Contact Committee, and kindly made the text available to enable FEE to provide a complete and up-to-date picture in its analysis of the differences between IASs and the Accounting Directives.

The first paper the Commission will publish (around the same time as this FEE Study is published) is "Examination of the Conformity between International Accounting Standards and the European Directives" giving guidance for 1998 financial reports. This examination covers all IASs and SIC interpretations in issue and applicable to accounting periods beginning before 1 July 1998. The examination does not include the requirements of IAS 32 and of the following revised standards IAS 1 (revised 1997), IAS 14 (revised 1997), IAS 17 (revised 1997), IAS 19 (revised 1998) and the new standards IAS 35, 36, 37, 38, and 39 as well as the amendments to IASs 16, 22, 28 and 31 which were consequential to the adoption of IASs 37 and 38. The examination covers SIC 2, 3, 5, 6, 7 and 8. The paper indicates that its objective is to determine whether, and, if so, to what extent conflicts between IASs and Accounting Directives exist so that European companies wishing to apply IASs in their consolidated accounts can do so without conflicting with European legislation.

The examination concludes that there are no significant conflicts between the Directives and those IASs and SIC interpretations that are in issue and applicable to accounting periods beginning before 1 July 1998 with the exception of the incompatibility on the scope of consolidation already referred to in the 1996 Contact Committee document. The other incompatibility on negative goodwill no longer exists due to the revisions to IAS 22. In the paper the Commission announced the publication of conformity examinations of the IASs that have been finalised and published but are not yet in force.

The text of the further examinations was also made available to FEE and covers IAS 35, IAS 36, IAS 37, IAS 38, IAS 22 (revised 1998), IAS 16 (revised 1998), IAS 28 (revised 1998) and IAS 31 (revised 1998). These examinations are referred to, where appropriate, in part C of this Study. Furthermore, the Contact Committee will publish a conformity examination on IAS 19 (revised 1998), IAS 32 and SIC 16 on treasury shares later in 1999. The draft text on the conformity examination of IAS 19 (revised 1998) was already made available to FEE, but is still subject to revision. At present, a detailed paper on SIC 16 is under discussion by the Contact Committee.

The Directives set out broadly accepted minimum rules for companies, both for global players and for SMEs. Given the developments in company legislation and practice, it will be necessary to change the Directives in certain areas in order to enable a company to apply IASs and at the same time to be in compliance with the Directives. Commercial and accounting practices develop over time and the Directives may need detailed changes to reflect these developments (especially bearing in mind that the Fourth Directive was issued over 20 years ago). The route announced by Commissioner Mario Monti in April 1997 to amend the Directives in order to overcome insoluble conflicts between international rules and the Accounting Directives is welcomed by FEE.

The Communication from the Commission (October 1998): "Financial services building a framework for action" (the Framework Communication) recognises the need for speedier adjustment of legislation and for a streamlined approach to drafting regulation: "Delays in modernising EU rules to comply with internationally accepted best practice handicaps regulators and supervisors in maintaining the stability of the financial system." In addition, explicit support is expressed for IASs by indicating (page 8): "The Commission will consider whether any of the options provided for by our Accounting Directives are no longer necessary or appropriate. In addition the Commission will review whether listed companies should be required to prepare their financial statements in conformity with a more harmonised framework, such as IAS". FEE welcomes the approach in relation to financial reporting matters as set out in the Framework Communication.

The Contact Committee has discussed amending the Fourth Directive in order to allow for fair value accounting of financial instruments. A proposal for a Directive to amend the Fourth Directive is expected during 1999.

2. SCOPE

In some countries it is already possible to draw up financial statements in compliance with IASs, assuming compliance with the Directives. In others, this possibility has recently been created by amending legislation, with those financial statements still required to be in compliance with the Accounting Directives. Several European countries such as Austria, Belgium, France, Germany, Italy and Spain allow or will allow the use of internationally accepted accounting standards in the consolidated accounts of mainly listed companies. In those countries, under certain conditions, not only the use of IASs is allowed but also the use of US GAAP. This study is, however, limited to a comparison between IASs and the Accounting Directives. The study does not address US GAAP.

The study focuses on the possible obstacles in the Accounting Directives both in a general and national context which hinder or complicate the use of IASs. With regard to consolidated accounts, it refers to problems arising when preparing consolidated accounts according to the Directives and IASs[1]. FEE has issued in 1997 a "Comparative Study on Conceptual Accounting Frameworks in Europe" which focuses on the underlying issues in order to explain differences in national accounting treatments and national interpretations of the Accounting Directives. IASs or SIC interpretations are referred to only where debate within FEE has shown that there are differences, in understanding or interpretation, with the Directives or where the debate finally concluded that no problem occurs but the nature of the debate had shown that the issue merits discussion in order to clarify the situation. Cases where companies could avoid an incompatibility with the Directives by choosing the "right" option are in some instances also discussed when the other option – not available because of compliance with the Directives – would be preferred by most companies.

The study deals only with the Fourth and Seventh Directives and does not address the Bank Accounts Directive (BAD) or the Insurance Accounts Directive (IAD), although some of the issues raised may also apply to the BAD and IAD through their linkage with the Fourth and Seventh Directives.

This Study aims to identify an overall point of view, taking into account the documents issued by the Commission and the Contact Committee on the Accounting Directives, including the Interpretative Communication of the Commission. In some cases, documents published by the Accounting Advisory Forum are referred to. In addition, other interpretations arising from different cultural backgrounds in the various Member States are described. In Member States there may be different views towards the Directives because during the past twenty years the professional press, researchers and practitioners have studied and interpreted the provisions of the Directives differently. Where Member States have implemented the Directives more or less literally into their national laws and the subsequent interpretation by academics or practitioners given is now in contradiction with the interpretation given by the European Commission, problems for companies and auditors within those Member States may arise. These Member States may face an "explanation gap" in justifying to the public how the exact wording of the Directives and national law can be interpreted differently than before. There is mention hereof only those situations where an implementation into national law of a common interpretation is different from the general or Commission interpretation of the Directives. Countries where no particular issues arise for the topic under review have not been mentioned. The Study does not intend to provide a comprehensive overview of the incompatibilities between IASs and national law, it only uses national cases to illustrate the differences in understanding and interpretation at national level.

This study covers all extant IASs published up to 31 December 1998, including all SIC interpretations issued at that date. IAS 39 has not been included in the review.

[1] Problems that might arise for the individual accounts only (e.g. from IAS 22 (revised 1998) and IAS 31, negative goodwill and joint ventures) will not be further examined within this study.

3. OBJECTIVE

One purpose of this study is to create an understanding in individual Member States of developments in European thinking, especially in those Member States where the existing interpretations of the Accounting Directives to date have been narrower or in another way different from the interpretation of the Commission (in its January 1998 communication). In addition, in countries where the use of internationally accepted standards has been allowed under the condition of compliance with the Directives, the study helps to identify whether all IASs can be applied and where obstacles or complications deserve extra attention. Companies must at present comply with the requirements of the Accounting Directives when drawing up financial statements, regardless of which set of accounting standards they apply, if any. Especially in these Member States, this Study seeks to structure the discussion about the acceptance of a different understanding of the Directives and the necessity of future amendments to the Directives. The Study is intended to be of help to both companies and accountants in assessing differences between the Directives and IASs in their national context.

This Study aims to highlight the different interpretations and bring to the public's attention certain new developments in the accounting area. The document should serve as a basis for an open dialogue between all the parties involved in accounting regulation and standard setting. The Study is technical in nature and is not intended to impact on the political debate on a future financial reporting strategy for Europe.

In the remainder of this document, a summary of the conclusions is provided (Part B). In Part C the current IASs and the Accounting Directives are compared. For each individual issue discussed in Part C of this Study, the general point of view citing the Commission's perspective is presented and interpretations and understandings in Member States are added where they seem materially different or explanation may be helpful. The FEE Study provides an extensive discussion of the accounting problems in Europe at present and hopes to provide useful background information to the Commission, Member States, Standard Setters and to users and preparers of financial statements and the accountancy profession.

B. CONCLUSIONS

For this Study, FEE has examined all International Accounting Standards and all SIC Interpretations published up to 31 December 1998. It can be concluded that among FEE Member Bodies there are no significant differences in understanding of IASs. However, when examining the Accounting Directives the interpretation and understanding varies to a great extent among the individual countries. The reasons for these different interpretations are various. As already described in the FEE Comparative Study on Conceptual Accounting Frameworks in Europe, the understanding of basic accounting principles is different from country to country. In addition, depending on the legal background of the countries, there is a difference in interpretation as far as legal requirements are concerned. Some countries use an approach that stresses the individual provisions while other countries use a more system oriented approach. The latter understand the Directive as a whole system and combine the individual requirements to a whole. This has some impact on how the absence of certain provisions in the Accounting Directives that are explicitly mentioned in IASs are understood. Some might think that, where there are no explicit rules, all treatments are possible while others are of the opinion that where there are no explicit rules, the general rules should be applied. In addition, the Directives are without detailed specifications on many topics. This may lead to hidden options as far as interpretation is concerned.

After having examined several topics it can, therefore, be concluded that for a wide range of issues a different understanding of accounting practices exists within Europe. As far as FEE's position on each topic is concerned, agreement has been found by the majority among the Member Bodies participating in the discussions. However, the positions of FEE presented here are not necessarily the opinions of all individual FEE Member Bodies. The conclusions of FEE do not deviate in substance from the Commission's conclusions in its conformity examinations.

The majority of FEE Member Bodies came to the conclusion that this study does not identify practical conflicts for which an amendment of the Directives would be needed, although from the point of view of some FEE Member Bodies a number of conflicts exists between the Directives and IASs and in their opinion would require an amendment of the Directives. In the following table, the outcome of the comparison between the individual provisions within IASs and the Accounting Directives is shown. The results have been grouped into three categories:

Category 1: There is an incompatability between IASs and the Accounting Directives, but the problem is considered as being of little practical relevance. It is recognised that the issue under consideration might pose problems for individual companies.

Category 2: No conflict exists between IASs and the Accounting Directives but clarification (in the form of an interpretative communication or in other form) from the Commission is needed.

Category 3: No conflict exists between IASs and the Accounting Directives, but some aspects of the issue merit further discussion (various issues).

	Category 1	Category 2	Category 3
GENERAL PRINCIPLES			
1. Prudence and realisation concepts			Differences in interpretation of the prudence and realisation principles are difficult to solve without a conceptual framework of accounting accepted throughout Europe. It should be considered if the IASC Framework could fulfil this role.
2. Substance over form principle		FEE believes that the absence of any reference to a substance over form principle within the Directives does not mean that this principle should not be applied when preparing financial statements in accordance with the Directives. The principle has direct links with the true and fair principle.	
3. Definition of asset and liability			The majority of FEE Member Bodies is of the opinion that the terms "asset" and "liability" within the Directives could be understood in the same way as the terms used within International Accounting Standards.
MEASUREMENT ISSUES			
4. Percentage of completion method / Realisation issues			The Commission has stated that the percentage of completion method is in line with the prudence and the realisation principles of the Directive. FEE assumes that the criteria describing the conditions under which the percentage of completion method can be applied that are used in the Commission's interpretative communication are consistent with IAS 11 and meant to be the same.
5. Percentage of completion method / Presentation issues		As far as the presentation of construction contracts within the balance sheet is concerned FEE would appreciate if the Commission could confirm the possibility of adding a separate caption as the amount has characteristics of both a receivable and work in progress.	
6. Impairment / Measurement			FEE observes that the possibility for a conflict between IAS 36 and the Directive is remote as only in rare circumstances will an impairment be considered as temporary. An interpretation of the term "permanent" could avoid different understandings as far as the valuation concept is concerned.

7. Impairment / Cash generating unit			FEE agrees with the Commission that there is no conflict between IAS 36 and the Directive on the cash generating unit concept. This concept can be seen as guidance on how to apply the impairment provisions of the Fourth Directive.
8. Research and development costs			*Recognition:* FEE believes that the wording of the Fourth Directive can be interpreted as allowing a different accounting treatment for research costs and development costs. *Amortisation:* Only in rare circumstances does the amortisation period exceed five years. This would be an exceptional situation under the Directive .
9. Split accounting			The special disclosure of convertible bonds required by the Directive should in FEE's opinion not be seen as a prohibition to use split accounting of compound instruments as envisaged in IAS 32.
10. Own shares			FEE is of the opinion that the treatment of deducting own shares from equity of SIC 16, would not pose problems under the Fourth Directive.
11. Employee benefits		*Future salaries increases:* opinions differ as to whether salary increases related to promotion can be taken into account when assessing pension obligations under the Fourth Directive. Clarification of the issue by the Commission would be appreciated.	*Corridor procedure and spreading of past service costs:* The option of using the corridor procedure under IAS 19 is not compatible with the Directive. In practice, however companies would prefer to follow the corridor procedure. *Discounting:* FEE is of the opinion that discounting of provisions for employee benefits is not only permitted by the Directive but should be considered as best practice. *Fair valuing plan assets:* fair valuing plan assets to determine the net defined benefit obligation is not prohibited by the Directive.

12. Provisions		FEE agrees with the Commission that in the case of lay-off of personnel a difference in practice may arise with IAS 37, since under common interpretations of the Directive a provision should be made regardless of the fact that the announcement has been made after the balance sheet date. FEE doubts if such a conclusion could also be drawn strictly based on the text of the Directive. In the case of decommissioning costs clarification from the Commission would be helpful as to whether these costs can be seen as forming part of production costs and therefore can be included in the cost of a fixed asset.	*Recognition:* no differences noted between IAS 37 and the Directive concerning the third party relationship and the probability concept. *Measurement:* no differences noted in principle between the best estimate concept of IAS 37 and the "necessary concept" of Art 42 of the Directive.
13. Foreign currency translation			Most of FEE members agree with the interpretation of the Contact Committee and the Commission that it is possible to recognise exchange gains in the profit and loss account resulting from the use of closing rates.
CONSOLIDATION ISSUES			
14. Negative goodwill			The purchase of an enterprise under an asset deal might lead to differences as regards the presentation of negative goodwill from the perspective of the Fourth Directive compared to the provisions in IAS 22. In addition, FEE observes that expected losses and expenses as referred to in IAS 22 correspond to a narrower concept than the concept of unfavourable results as per Art 31 of the Fourth Directive, the latter covering not only losses and expenses but also lower profits. FEE concludes however that practical application would not result in conflicts between IAS 22 and the Directives.
15. Reverse acquisitions	*Measurement:* The incompatibility as noted is considered as being of little practical relevance. The issue should at the moment only be treated in the context of any full amendment process of the Directive.	*Preparation of consolidated accounts:* FEE would welcome a clarification by the Commission that by applying the control concept of the Seventh Directive in a reverse acquisition only one set of accounts need be drawn up by the company that is deemed to be the acquirer.	

16. Scope of consolidation – exclusion from consolidation due to dissimilar activities	The incompatibility as noted by the Commission in 1996 and 1999 is confirmed by FEE. As the problem is considered as being of little or no practical relevance FEE agrees that the issue should be dealt with only in the context of any full amendment process of the Directive.		
PRESENTATIION ISSUES			
17 Elements of financial statements			FEE considers that additional information in the notes is always possible, although in some Member States the provision of additional statements would require legal change. In any case companies should not be prevented from providing additional statements. The presentation of this financial information should make clear whether these statements are part of the annual accounts or not.
18. Layout			According to international accounting practice it might be considered necessary to modify the layout of a company's financial statements in order to give a more adequate presentation of its financial status. FEE does not agree with the strict and formal approach the Commission takes in its interpretative communication.
19. Netting		In situations where only the right of set off exists without the intention to use it, application of IAS and the Commission interpretation may result in a different presentation since only the latter would impose netting. Clarification is needed from the Commission that its interpretation is not meant to impose a new requirement.	
20. Current / non-current			FEE like the Commission notes a potential problem between IAS 1 and the Directives as far as the option to differentiate between current and non-current assets and liabilities is concerned. The presentation based on the liquidity of assets and liabilities of IAS 1 is compatible with the Fourth Directive.
DEVELOPING ISSUES			
21. Fair value accounting of certain financial instruments	Conflict between the Fourth Directive and IAS 39: the Commission is in process of amending the Directive.		

As can be seen from the summary table above in the opinion of the majority of FEE Member Bodies there are no major problems between IASs and the Accounting Directives. However, future projects of the IASC are not included in the table and as described in section 22 some problems may occur and the Commission needs to find a proper mechanism to handle these in order to continue to facilitate the use of IASs.

The process of bringing the accounting system in the Accounting Directives in line with IASs now and in the future is rather sensitive. Further Commission interpretations and other (Contact Committee) papers may help to reduce perceived differences. However, the main difficulties arise from the interpretations in the Member States. Therefore the initiative to amend accounting tradition and bring the law closer to IASs must also come from the Member States themselves.

C. COMPARISON BETWEEN IASS AND THE ACCOUNTING DIRECTIVES

In this Study, all IASs published by 31 December 1998 have been examined, including all SIC interpretations issued at that date. IAS 39 has not been included in the review. Each topic has been considered as follows, a brief explanation of the issue arising is provided, then

(a) A direct comparison between the wording of the IASs and the Directives is given.
(b) After that, the Commission's interpretation is presented. The statements referred to in this subchapter include documents of the Commission and the Contact Committee. In some cases Accounting Advisory Forum documents are referred to.
(c) If there are different interpretations and understandings in Member States, these interpretations are described and compared to the general perspective. These understandings stem from national law or standards, use in practice and experience. These paragraphs are merely illustrative in nature and do not list all different interpretations within the Member States and are not intended to be comprehensive.
(d) Finally, FEE´s position is provided.

Only those IASs where an actual or potential conflict, or merely uncertainty about the understanding of a certain provision, exists are considered below. Consequently, the Study does not address situations where a conflict can be avoided by using the appropriate options offered by the Accounting Directives and/or IASs. However, it may happen that in practice the company would prefer the conflicting IAS option aligning with international practice. This situation is not treated as a difference, but included in the paper because of its practical implications. Only some of these cases are addressed. The Study is not intended to present a comprehensive overview of those options that are not available to companies in a situation of compliance with the Accounting Directives. Where there is no explicit wording and no general principle referring to certain issues within the Directives (or within IASs), no direct conflict situation has been observed. However, further guidance in the form of interpretations or in an other form may be needed. The FEE approach chosen complements the Contact Committee's process in identifying and assessing those situations that would prevent a company preparing accounts based on IASs within the framework of the Accounting Directives.

The Study does not include an analysis of IAS 35 "Discontinuing Operations", IAS 28 (revised 1998) "Accounting for Investments in Associates" and IAS 31 (revised 1998) "Financial Reporting of Interests in Joint Ventures", whereas the Contact Committee is to publish conformity examinations on these standards. Both the Contact Committee and FEE concluded that these standards do not conflict with the Accounting Directives.

GENERAL PRINCIPLES

1. PRUDENCE AND REALISATION CONCEPTS

In order to give the reader of this study a better understanding of differences in accounting treatments and opinions on accounting issues, two underlying concepts are discussed below: the realisation principle and the prudence principle.

(a) IAS versus Directives:

- International Accounting Standards

  IASC Framework:

  "para 37: (…) 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. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability."

  IAS 1 (revised 1997):

  "para 20: Management should select and apply an enterprise's accounting policies so that the financial statements comply with all the requirements of each applicable International Accounting Standard and Interpretation of the Standing Interpretations Committee. When there is no specific requirement, management should develop policies to ensure that the financial statements provide information that is:
  (a) relevant to the decision-making needs of users; and
  (b) reliable in that they:
  (i) represent faithfully the results and financial position of the enterprise;
  (ii) reflect the economic substance of events and transactions and not merely the legal form;
  (iii) are neutral, that is free from bias;
  (iv) are prudent; and
  (v) are complete in all material respects."

- Accounting Directives

  Art 31.1 (c) of Fourth Directive:

  "Valuation must be made on a prudent basis, and in particular:

  (aa) only profits made at the balance sheet date may be included,

  (bb) account must be taken of all foreseeable liabilities and potential losses arising in the course of the financial year concerned or of a previous one, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up."

(b) Commission's and Contact Committee's interpretation:

The Commission and the Contact Committee have addressed the concept of prudence in their 1998 conformity examination of IAS 1. In addition, the Accounting Advisory Forum published a paper on "Prudence and Matching" in 1997. On prudence, the conformity examination states:

"The Contact Committee considered the substance of paragraph 20 of IAS 1. Although the important role played by prudence in the preparation of the accounts may not seem to have been fully acknowledged by this and subsequent paragraphs in IAS 1 (in contrast, for example, to going concern, accruals and consistency), the Contact Committee stresses that the application of prudence remains one of the main principles for ensuring the achievement of fair presentation under the Directives.

The Contact Committee notes that the IASC's *Framework* deals specifically (at paragraph 37) with prudence as a separate qualitative characteristic of financial statements. In so doing, it describes prudence as "…the inclusion of a degree of caution in the exercise of 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."

(c) Interpretations in Member States:

As already noted in various articles and academic papers, as well as in earlier studies of the Accounting Advisory Forum and FEE, the status attributed to the prudence principle differs internationally and even within Europe.

One school of thought understands prudence as a principle having precedence over all other principles, a fundamental valuation rule to be applied in the preparation of the accounts. In some EU Member States, such as Austria, Germany and Luxembourg, this understanding lies at the basis of their interpretation of the Fourth Directive. Another school of thought, mainly represented by the Anglo-Saxon countries and standard setting bodies; the IASC, the ASB and the FASB, lists prudence among several qualitative characteristics that make the information provided in financial statements useful to users (see: Document of the Accounting Advisory Forum, 1996, para 9; FEE Comparative Study on Conceptual Accounting Frameworks in Europe, 1997).

Most of the differences between the countries derive from a different understanding of the moment of realisation of profit.

UK company law provides some further definition of realised profits, which implicitly links it to accounting standards and their development over time. Section 262 (3) of the Companies Act 1985 defines realised profits as "such profits or losses that fall to be treated as realised in accordance with principles generally accepted, at the time the accounts are prepared, with respect to the determination for accounting purposes of realised profits and losses."

Differing interpretations of the prudence principle may be explained by the fact that the objectives of financial reporting and the role of financial statements vary from country to country.

(d) FEE's position:

One of the purposes of financial statements identified in the preamble to the Fourth Directive is the protection of members and third parties (capital maintenance concept). In order to satisfy this objective, the general prudence principle is laid down in Art 31.1 of the Fourth Directive. No further definition of this principle is given in the Directive, but certain provisions relate to the prudence principle (e.g. Art 32, Art 35.1 (c)(aa) and (bb), Art 39.1(b), Art 20.2, Art 33.2 (a) and (c)).

In IAS 1 (revised 1997) para 20, prudence is listed amongst the qualities that information should have to ensure it is reliable. This indicates, for example, that it is of similar importance to neutrality and completeness, but that lower importance is attached to it than in the Fourth Directive.

According to the realisation principle of Art 31 of the Fourth Directive, only "profits made" at the balance sheet date may be included, which in fact is a question of the interpretation of the realisation principle. 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". The interpretation provided in the interpretative communication (to various subjects, e.g. construction contracts) and in the Contact Committee comparison document is a wider interpretation, contrasting with the narrow view that "realisation" is linked to being "confirmed on the market" or "paid" as some Member States interpret realisation.

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 may be difficult to resolve without a conceptual accounting framework being accepted throughout Europe. It should be considered if the IASC Framework could fulfil this role (category 3).

2. SUBSTANCE OVER FORM PRINCIPLE

The issue is to what extent the substance over form principle can be applied to all transactions under the Directives.

(a) IAS versus Directives:

- <u>International Accounting Standards</u>

  IASC Framework:

  "para 35: If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal of contrived form. For example, an enterprise may dispose of an asset to another party in such way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the enterprise continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction)."

  IAS 1 (revised 1997):

  "*para 20: Management should select and apply an enterprise's accounting policies so that the financial statements comply with all the requirements of each applicable International Accounting Standard and Interpretation of the Standing Interpretation Committee. Where there is no specific requirement, management should develop policies to ensure that the financial statements provide information that is:*

  (a) relevant to the decision-making needs of users; and

  (b) reliable in that they:

  (i) represent faithfully the results and financial position of the enterprise;
  (ii) reflect the economic substance of events and transactions and not merely the legal form;
  (iii) are neutral, that is free from bias;
  (iv) are prudent; and
  (v) are complete in all material respects."

  IAS 17:

  "*para 57: If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount should not be immediately recognised as income in the financial statements of a seller-lessee. If such an excess is recognised, it should be deferred and amortised over the lease term.*"

- <u>Accounting Directives</u>

  The substance over form principle is not addressed by the Directives. However, it could be argued that the overriding true and fair view principle would require that implicitly the substance over form principle is applied.

(b) Commission's and Contact Committee's interpretation:

The Commission and the Contact Committee have not addressed the issue in their publications.

(c) Interpretations in Member States:

Leasing issues are treated differently in the various Member States. However, in all countries there are elements of the principle of substance over form (see: FEE Comparative Study on Conceptual Frameworks in Europe, page 35).

In Germany, according to § 246 para 1, second sentence of the Commercial Code, the recognition of assets is depending on the economic ownership of these assets, not on the legal ownership. Moreover, there is no legal provision nor principle of proper accounting which would allow or require presentation of transactions or events in accordance with their economic substance where diverging from the legal form.

The principle of substance over form is expressly addressed in Italy in the law concerning the individual accounts of Banks and Insurance undertakings. On the contrary, the principle is not accepted in all other circumstances where the legal form always takes precedence over the economic substance of transactions. It is, however, always possible to include in the notes all the components of the economic substance in order to give a better understanding of the accounts. This is the case for leasing contracts, but may also be the case of compulsory posting made on the basis of the tax law, for the purpose of obtaining tax advantage. The Civil Code does not mention this principle at all, which is clearly addressed to in the Law DLgs 87/92 art. 7, c 4 on Banks and Insurance undertakings, and in the instructions issued by Banca d'Italia (Provv. 103 of 31.07.1992). The Accounting Standard 11 states that transactions should be presented in accordance with their substance, and not only on the basis of the legal form. There may be cases in which the accounting is made in compliance with the substance of the transaction.

In the UK and Ireland, FRS 5 "Reporting the Substance of Transactions", requires that a reporting entity's financial statements should report the substance of transactions into which it has entered (FRS 5 para 4). This is reflected in the ASB's revised draft Statement of Principles (para 3.11 to 3.13) which explain the principle of faithful representation in more detail.

(d) FEE's position:

Within IASs the substance over form principle is one of the principles of the Framework. In the Directives, the substance over form principle is not explicitly addressed but they do not prohibit companies from using this principle. The substance over form principle plays an important role in debatable issues such as sales and repurchase agreements (should they be accounted for as a sale and purchase or as a loan?) and leasing .

Clarification on this issue should be provided by an interpretation, explicitly addressing the importance and role of the principle. This matter should also be addressed with respect to the definition of assets and liabilities. It is the economic ownership rather than the legal ownership that requires an asset to be included in a company’s balance sheet. Therefore, FEE would appreciate an interpretation from the Commission stating that the substance over form principle is part of the generally accepted accounting principles.

FEE considers that the absence of any reference to the substance over form principle in the Directives does not mean that this principle should not be applied when preparing the accounts in accordance with the Directives. On the contrary, this principle has some direct links to the true and fair view concept (see: FEE, Comparative Study on Conceptual Accounting Frameworks in Europe, 1997) (category 2).

3. DEFINITION OF ASSET/LIABILITY

The issue is whether the understanding of an asset and liability in the context of International Accounting Standards is compatible with the same terms as used in the European Accounting Directives. This general problem is illustrated by the discussion on whether tax effects of a loss carry forward can be capitalised under the Fourth Directive.

(a) IAS versus Directives:

- International Accounting Standards

  IASC Framework:

  "para 49: The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:

  (a) An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.
  (b) A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. (…)"

  IAS 12:

  "para 34: A deferred tax asset should be recognised for the carry forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised."

- Accounting Directives

  In the Directives there is no specific definition of assets and liabilities. However, there are special requirements mentioned for goodwill (Art 37), expenses to be capitalised. Art 34 (formation expenses) and 37 and the layout specify the elements of the financial statements.

  Art 4.1 of the Fourth Directive:

  "In the balance sheet and in the profit and loss account the items prescribed in Articles 9, 10 and 23 to 26 must be shown separately in the order indicated. A more detailed subdivision of the items shall be authorised provided that the layouts are complied with. New items may be added provided that their contents are not covered by any of the items prescribed by the layouts. Such subdivision or new items may be required by the Member States."

(b) Commission's and Contact Committee's interpretation

So far, the Commission has not published any general guidance on how an asset/liability should be defined under the Directive.

As for the conformity between IAS 12 and the Accounting Directives, the Commission has published a paper in 1998 "Examination of the conformity between IAS 12 and the European Accounting Directives". The conclusions are as follows:

- "The recognition of deferred tax assets is subject to a prudent assessment. A conflict with the Accounting Directives could arise when deferred tax assets are recognised in situations where reasonable doubts exist that taxable profit will be available against which the deductible temporary differences can be utilised.
- The recognition of deferred tax liabilities is subject to a probability test. A conflict with the Accounting Directives could arise when deferred tax liabilities or provisions for taxation are recognised for taxable temporary differences for which it is not likely that a future liability will arise.

- The presentation of deferred tax assets and tax liabilities is made in accordance with the Formats prescribed by the Accounting Directives. IAS 1 makes provision for companies to avoid having to use the current/non-current classification in respect of balance sheet assets and liabilities. Consequently, companies which apply the Accounting Directives would be required to take advantage of this provision, with the result that paragraph 70 of IAS 12 would not apply, thereby enabling them to disclose deferred tax assets in line with the Directive.

The considerations equally apply to deferred tax assets in accordance with paragraphs 34 and 44 of IAS 12."

(c) Interpretations in Member States:

Member States try to identify the content of assets and liabilities by interpretation of their national law. Definitions were based on the characteristics of assets and liabilities and their relationship to legal fundamentals (e.g. creditors' protection, ownership). These implied definitions include criteria such as value, disposability, abstract and concrete accountability, ownership or rights associated with ownership, etc. The definitions do not necessarily comply with the definition of assets and liabilities as set in the IASC Framework.

In the UK, the ASB's revised draft Statement of Principles contains definitions of an asset and a liability (paras 4.7 and 4.24 respectively) similar to those in the IASC Framework.

According to the Interpretation prevailing in some Member States it is generally considered that the Directives do not allow the capitalisation of expenses and losses unless otherwise explicitly provided (see Art 4, 9 and 10 of the Fourth Directive), which is the case for:

- Formation expenses (Art 34)
- Research and development cost (Art 37).

Therefore, it is felt that losses and expenses must be charged in the profit and loss account where no legal provision specifically allows their capitalisation.

In other countries, there is no equivalent interpretation. It is considered that in the absence of a general definition of assets and liabilities in the Directives, it is not forbidden to create new items of assets or liabilities not initially envisaged by the Directive.

As for the tax effect of tax loss carry forward, they should be treated as a deferred tax asset according to IAS 12 para 34 and shown in the balance sheet if it is probable that future tax profits will be available against which the unused tax losses can be used.

In France, the Plan Comptable General makes it possible for consolidated financial statements to capitalise tax effects of loss carry forward where it is probable that this contingent assets will be recovered.

This method is not considered possible in Germany. According to German understanding a tax loss carry forward does not fulfil the recognition criteria. As a tax loss carry forward cannot be realised independent of the reporting entity, it is not regarded as an asset (Vermögensgegenstand) according to common understanding. From this point of view also the Fourth Directive contains specific recognition requirements for formation expenses (Art. 10, 34) and acquired goodwill (Art. 10, 37 II) which show that these items are not regarded as "assets" according to the general understanding of the Directive. Like tax loss carry forwards these items cannot be used separately by the reporting entity. This means that, as no specific recognition rule exists for tax loss carry forwards, they may not be recognised under the Fourth Directive.

In France, there was a long-lasting debate on whether or not to capitalise the initial operating losses suffered by a private company in operating a public utility such as a transportation infrastructure, the production and distribution of water, etc. The context is a contract concluded with a public authority for a long period, under which the private company has to build the facilities and to collect tolls or other fees from the users of the facility during the contract period. The facility is transferred to the public authority at the end of the contract for no consideration. In this sort of contract, the use of the facility and the related income for the private company often increases steadily during the first years of operations; the interest costs during this period are generally high as compared to interest costs incurred during the last period of the contract, As a consequence, heavy losses may be suffered during the first part of the contract, which are made good thanks to profit realised during the second part. The current position of the Conseil National de la Comptabilité (CNC) on this problem, issued in 1998, is that capitalisation as deferred charges of the first operating losses were possible providing strict conditions are met. However, the CNC state that the benchmark method is not to capitalise losses.

(d) FEE's position:

Taking into consideration the examples given it might seem evident that there are differences in the understanding of assets and liabilities within the Member States. FEE does not necessarily believe that a definition in the Directives could solve the problem; the majority of FEE Member Bodies is of the opinion that the definition of an asset and liability as used by the IASC is applicable for the interpretation of an asset and a liability within the framework of the Directives (category 3).

MEASUREMENT ISSUES

4. PERCENTAGE OF COMPLETION METHOD: REALISATION ISSUES

The issue is whether the percentage of completion method can be used for the valuation of construction contracts under the Fourth Directive.

(a) IAS versus Directives:

- International Accounting Standards

  IAS 11:

  "*para 22: "When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date (…).*"

  "*para 23:*

  In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all of the following conditions are satisfied:

  (a) total contract revenue can be measured reliably;
  (b) it is probable that the economic benefits associated with the contract will flow to the enterprise;
  (c) both the contract costs to complete the contract and the stage of contract completion at the balance sheet date can be measured reliably; and
  (d) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates."

- <u>Accounting Directives</u>

  The Accounting Directives do not explicitly deal with the treatment of long-term contracts or construction contracts. The general rules as set out in Articles 31. 1 (c), 32, 35. 1 (a), 35.3 and 35.4, 39.1 (a) and 39.2 of the Fourth Directive and Art 29. 1 of the Seventh Directive apply.

(b) Commission's and Contact Committee's interpretation:

According to the Contact Committee (Accounting Harmonisation in the European Community, 1990) and confirmed by the Commission's interpretative communication, both the percentage of completion method and the completed contract method are allowed under the Fourth Directive: "The application of the “percentage-of-completion” method is only allowed on condition that the prudence principle laid down in Art. 31.1 (c) is clearly observed. In other words:

- the total contract income must be known;
- it must be possible for the proportion of work completed to be calculated accurately; and
- the work on the contract must be sufficiently advanced.

Furthermore, when a loss is anticipated on a contract, a provision must be set up for the entire loss as soon as it is discovered.

Irrespective of the method chosen, appropriate information must be given in the notes on the accounts as to the method applied in accordance with Article 43 of the Directive.”

(c) Interpretations in Member States:

In some Member States, the treatment is not in agreement with the Commission's interpretation. In these Member States, the common understanding is that the percentage of completion method cannot be used under the current text of the Directives or at least only as an exception to the general valuation rules according to Art 31.2 of the Directive. In other Member States, the percentage of completion method is a widely applied method and is not seen as being in conflict with the Directives. Furthermore, some countries are of the opinion that the criteria for the percentage of completion method applied by the Commission are more narrowly defined than the criteria set out in IAS 11.

Italian law has established that "long-term contract work in progress may be accounted for based on the contractual revenues which can with reasonable certainty be said to have matured". Accordingly, when "reasonable certainty" exists for the revenues related to a completed portion of work and, therefore, the contractual gross margin can be considered as realised, the inventory may be valued using the percentage of completion method. In practice, however, the most widespread method in Italy is the completed contract method.

In the Netherlands, the percentage of completion method has been used for a long time. The law stipulates that profit can only be recognised if it has been realised. It is understood that, for work in progress, realisation could take place during construction.

In Ireland and the UK, SSAP 9, Stocks and long-term contracts (paragraph 29) requires that, where it is considered that the outcome of a long-term contract can be assessed with reasonable certainty before its conclusion, the prudently calculated attributable profit should be recognised in the profit and loss account as the difference between the reported turnover and related costs for that contract.

(d) FEE's position:

FEE agrees with the Commission that there is no conflict between IAS 11 and the Fourth Directive. The conditions to apply the percentage of completion method under IASs might be considered less strict than the conditions laid down by the Commission. Under IASs, the percentage-of-completion method must be applied if the total contract revenue can be measured reliably, whereas under the Commission's interpretation total contract income must be "known". In addition, according to IAS, the stage of contract completion at the balance sheet date should be reliably measurable while under the Contact Committee's interpretation the proportion of the work completed must be able to be calculated accurately. Although similar, these two terms are not defined and differences may arise. The third condition imposed by the Commission is implied by the first two conditions as it is necessary that the work on the contract is sufficiently advanced to estimate the income reliably. FEE assumes that the term "known" should be understood as having no different meaning to "estimated reliably" and "measured reliably", but it would have been helpful if the wording in the Commission interpretation had been the same as in IAS 11 (category 3).

5. PERCENTAGE OF COMPLETION METHOD: PRESENTATION ISSUES

The issue is how to present, within the balance sheet headings of assets, the amounts resulting from application of the percentage of completion method.

(a) IAS versus Directives:

- International Accounting Standards

  IAS 11:

  "para 42: An enterprise should present:

  (a) the gross amount due from customers for contract work as an asset; and

  (b) the gross amount due to customers for contract work as liability."

  "para 43: The gross amount due from customers for contract work is the net amount of:

  (a) costs incurred plus recognised profits; less

  (b) the sum of recognised losses and progress billings.

  for all contracts in progress for which progress billings exceed costs incurred plus recognised profits (less recognised losses)."

- Accounting Directives

  Articles 4 (1) and 9 (10) of the Fourth Directive require the balance sheet to show work in progress as a current asset. According to Article 32 this asset has to be measured at production cost, as defined in Article 39.

(b) Commission's and Contact Committee's interpretation:

The Commission and the Contact Committee have not addressed this issue in their publications.

(c) Interpretations in Member States:

In France, when the percentage of completion method is applied, work in progress shown on the balance sheet remains at cost with the recognised profit presented under another asset caption. This requirement is currently under review so that both items can be aggregated and presented as a receivable, in order to be in line with the common understanding of IAS 11 (only one balance sheet item).

In Germany, any application of the percentage of completion method is justified by § 252 (2) of the German Commercial Code, which is equivalent to Art 31 (2) of the Fourth Directive. As this exception relates only to the realisation principle, but not to the historical cost principle (Art. 32 of the Fourth Directive), the application of the percentage of completion method has to be presented in the same way as that prescribed at present for France. The aggregation of both items and presenting them as work in progress is considered to conflict with the requirement of the Directive, under which work in progress must be carried at cost. The company is the legal and economic owner of the work in progress as long as risks and rewards are not transferred to a third party.

In Italy, adoption of the percentage of completion method implies the following presentation on the balance sheet for amounts relating to contract work in progress.

- The value of the work and services performed, net of those paid, are shown in the balance sheet as inventory (debit position) and as revenues received in advance on the liabilities side (credit position).
- Customer advances, i.e. amounts paid by the customer before or when work is started, are shown under a specific heading on the liabilities side of the balance sheet.

In Ireland and the UK, the practice is to present the amount by which recorded turnover exceeds payments on account as a receivable, classified as amounts recoverable on contracts. Indeed, legal opinion obtained at the time of the revision of SSAP 9 confirmed that amounts recoverable on contracts should be classified under "Debtors" and cannot be classified under "Stocks".

In Belgium, the Netherlands and Spain, the global amount is regarded as work in progress. In other countries, the global amount is presented in one caption (work in progress or accounts receivable) resulting from different interpretations of Article 32 of the Fourth Directive.

(d) FEE's position

Based on the different interpretations of Article 32 of the Fourth Directive, the treatment of work in progress and the related recognised profit is different in various Member States. The two amounts are either shown separately or presented as one global aggregated amount in the balance sheet, each approach having its consequences for the presentation in the profit and loss account. This global amount could be presented either as work in progress or as receivable. The aggregation of both items might be considered to conflict with the requirements of Art 32 of the Fourth Directive for valuation at cost. FEE would recommend the application of Art 4.1 which allows the addition of a separate caption in the balance sheet as the amount has characteristics of both a receivable and work in progress. It would be appreciated if the Commission could confirm this interpretation (category 2).

6. IMPAIRMENT – MEASUREMENT

The questions raised are (i) whether the lower figure to be attributed to an asset according to the Fourth Directive could be the recoverable amount defined by IAS 36, which is the higher of an asset's net selling price and its value in use, and (ii) whether the Fourth Directive condition that the reduction in value should be permanent will not lead to an incompatibility with IAS 36 in which this recognition condition does not exist.

(a) IAS versus Directives:

- <u>International Accounting Standards</u>

  IAS 36:

  "para 5: <u>Recoverable amount</u> is the higher of an asset's net selling price and its value in use."

- <u>Accounting Directives</u>

  Art 35.1 (c) (bb) of the Fourth Directive:

  "Value adjustments must be made in respect of fixed assets, whether their useful economic lives are limited or not, so that they are valued at the lower figure to be attributed to them at the balance sheet date if it is expected that the reduction in their value will be permanent."

(b) Commission's and Contact Committee's interpretation:

The Commission and the Contact Committee have addressed this issue in their conformity examination of IAS 36 which will be published around the same time as this FEE Study. It states:

"Article 35.1(b) of the Fourth Directive requires fixed assets with a finite life to be systematically depreciated over that life. This could be said to imply a more even pattern of write-down of an asset that may well occur when IAS 36 is applied. At the same time, though, IAS 36 is in effect providing a methodology for complying with the additional requirement of Article 35.1(c)(bb) of the Directive that fixed assets should be written down where any permanent diminution in their value has occurred. Consequently, whilst it is clear that the impairment test is not a surrogate for depreciation, it provides a systematic methodology for the measurement and recognition of a permanent impairment."

(c) Interpretations in Member States:

In the UK and Ireland, two particular problems are raised by the comparison of the requirements of FRS 11 "Impairment of Fixed Assets and Goodwill" and those of the law. The first is that the law requires only permanent diminutions in value of fixed assets to be made, whereas the standard (like IAS 36) requires all impairments to be recognised. ASB accepts that, in broad terms, it is a matter of judgement whether an impairment is likely to be temporary or otherwise, and goes on to indicate that it may be prudent to regard all impairments as permanent diminutions in value. The second problem of consistency concerns whether all factors which might reverse an impairment question are required to be accounted for under the law (Art35.1 (c) (dd). Like IAS 36, the UK standard does not allow reversals of impairment simply for the unwinding of the discount or the occurrence of cash outflows. ASB does not regard these as reversal of the reason for the making of the value adjustment.

(d) FEE's position:

The reference in Art 35.1 (c) (bb) to the "lower figure to be attributed" is not defined by the Directive. As a consequence FEE considers that the lower amount can be the "recoverable amount" as mentioned in IAS 36 and therefore there is no incompatibility between the two provisions.

As for the second question, FEE observes that the possibility for a conflict between IAS 36 and the Fourth Directive is remote as only in rare circumstances will an impairment be considered as temporary. Even when such circumstances exist, the application of the prudence principle will usually lead to the conclusion that the reduction in value should be considered as permanent. In addition, the value in use concept is based on an assessment of future cash flows and incorporates the condition linked to the permanent character of the reduction in value (category 3).

7. IMPAIRMENT – CASH GENERATING UNIT

The issue is whether the IAS cash generating unit concept is in conflict with the separate valuation principle of the Directive.

(a) IAS versus Directives:

- International Accounting Standards

  IAS 36:

  "para 65: If there is any indication that an asset may be impaired, recoverable amount should be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an enterprise should determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit)."

- Accounting Directives

  Art 31 (1) (e) of the Fourth Directive:

  "The components of asset and liability items must be valued separately."

(b) Commission's and Contact Committee's interpretation:

The Commission and the Contact Committee have addressed the issue in their conformity examination of IAS 36 which will be published around the same time as this FEE Study. It states:

"There is no conflict between IAS 36 and the Accounting Directives. Article 31.1 (e) of the Fourth Directive requires that in all cases 'the components of asset and liability items must be valued separately', whilst IAS 36 permits, in certain circumstances, assets to be grouped into cash-generating units (CGUs), and a review for impairment to be undertaken at the level of the CGU. However, the determination of impairment by reference to CGUs is only permitted under IAS 36 where it is not possible to estimate the recoverable amount of the individual asset. Consequently, provided companies apply the provisions of paragraph 65 of IAS 36 strictly, then there is no conflict between the standard and the Directive in this regard. This means that EU companies will not be able to hide behind IAS 36's CGU approach in order to avoid recording an impairment in respect of an asset that is capable of individual measurement."

(c) Interpretations in Member States:

It is generally considered that impairment of capitalised goodwill involves the valuation of the whole business to which this goodwill relates.

In France, although no official release on IAS 36 has been issued, it is felt that this standard contains useful procedures to implement the lower of cost of fair value principle stated by the code de commerce. However, identifying cash generating units might raise a number of problems in practice.

In the UK and Ireland, the FRS 11 "Impairment of Fixed Assets and Goodwill" defines an income–generating unit as a group of assets, liabilities and associated goodwill that generates income that is largely independent of the reporting entity's other income streams. The assets and liabilities include those directly involved in generating the income and an appropriate portion of those used to generate more than one income stream.

(d) FEE's position:

At first sight, an incompatibility might exist between the concept of the cash generating unit, consisting of a bundle of assets, and the separate valuation approach that is obligatory according to the Fourth Directive. However, IAS 36 states: if the asset cannot be valued as such because it forms part of a group of other assets, the smallest identifiable unit should be taken as the measurement yardstick. If the asset can be valued individually, then, the principle of separate valuation should take place. In cases where groups of assets are examined for impairment, any reduction in value is allocated between the individual assets of the cash-generating unit. Therefore, FEE agrees with the Commission that it can be concluded that IAS 36 applies correctly the separate valuation concept and that there is no incompatibility with the Directive. Indeed, the cash generating unit approach stated in IAS 36 could be seen as a useful guidance to implement article 35.1(c) (bb) of the Fourth Directive concerning value adjustments to be made in respect of fixed assets (category 3).

8. RESEARCH AND DEVELOPMENT COSTS

In this section it has been assumed that Member States have permitted the capitalisation of research and development costs.

The issues are (i) whether it is possible to account differently for research costs and for development costs under the Fourth Directive, although no distinction between both categories is drawn by the Directive and (ii) whether the limited amortisation period of five years prescribed by the Directive is compatible with the corresponding requirement in IAS 38.

(a) IAS versus Directives:

- International Accounting Standards

  IAS 38 differentiates between research costs and development costs

  "para 7: (…)
  Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

  Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use. (…)"

  "para 42: No intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred."

  "para 43: This Standard takes the view that, in the research phase of a project, an enterprise cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is always recognised as an expense when it is incurred."

  "para 45: An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:

(a) *the technical feasibility of completing the intangible asset so that it will be available for use or sale;*
(b) *its intention to complete the intangible asset and use or sell it;*
(c) *its ability to use or sell the intangible asset;*
(d) *how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;*
(e) *the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and*
(f) *its ability to measure the expenditure attributable to the intangible asset during its development reliably."*

As far as depreciation is concerned para 79 is applicable.

"para 79: The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed twenty years from the date when the asset is available for use. Amortisation should commence when the asset is available for use."

- Accounting Directives

Article 37.1 (in part) of Fourth Directive:

"Article 34 shall apply to costs of research and development. In exceptional cases, however, the Member States may permit derogations from article 34(1)(a)."

Article 34.1(a) of the Fourth Directive:

"Where national law authorises the inclusion of formation expenses under "Assets", they must be written off within a maximum period of five years."

(b) Commission's and Contact Committee's interpretation:

The Commission and the Contact Committee have addressed the issue in their conformity examination of IAS 38 which will be published around the same time as this FEE Study and concludes towards a potential conflict on the amortisation of development costs:

"IAS 38 requires development costs to be capitalised as an intangible asset in certain limited circumstances and amortised over their estimated useful life, on which the IAS imposes a benchmark maximum life of 20 years. By contrast, Article 37 of the Fourth Directive requires such costs to be amortised over no more than five years, although Member States may derogate from this requirement in exceptional cases.

There are two potential conflicts between IAS 38 and the Fourth Directive, namely:

(a) IAS 38 allows intangible assets to be revalued to fair value; the Directive allows revaluation to cost adjusted for inflation; and
(b) the Directive imposes a maximum life of five years for development costs (albeit subject to derogation by Member States), which is not reflected in the IAS.

Nevertheless, because of the nature of these potential conflicts and the flexibility allowed by the standard, it is still possible for European companies to be in compliance with both IAS 38 and the Directives."

(c) Interpretations in Member States:

Recognition

In many Member States, for example the UK, France and Ireland, separate accounting requirements have been established in relation to research and development costs. In these countries, research costs are always expensed when incurred; development costs may be capitalised, at the option of the enterprise, providing strict conditions are met.

In Belgium, intangible assets such as the costs of research, construction and development of prototypes, products, inventions and know-how, which are to be used in the future development of the enterprise are addressed. No distinction is made between the two kinds of costs. Details have to be provided in the notes and in the annual report of the directors to the shareholders.

In Germany there is no particular provision dealing with the treatment of research and development costs. Their accounting treatment therefore follows general principles and they are only capitalised if they fulfil the definition criteria of an asset (Vermögensgegenstand) provided they meet the criteria of production costs. However, § 248 para 2 of German commercial Code prohibits the capitalisation of self generated intangible fixed assets in accordance with Art 9 of the Fourth Directive.

In Italy, a standard will soon be issued on the research and development topics. Currently, the most common accounting practice is for such costs to be expensed as the accounting treatment is influenced by tax considerations.

Under the guidelines of the Council for Annual Reporting in the Netherlands, research and development costs can be capitalised subject to the conditions as stated in IAS 9 paragraph 17. It is expected that this guideline will be brought into line with IAS 38.

In the UK and Ireland, SSAP 13 "Accounting for Research and Development" distinguishes between pure (or basic) research, applied research and development. In the case of applied research, the work undertaken must be directed towards a specific objective. Development is defined as the use of scientific or technical knowledge in order to produce new or substantially improved material, devices, products or services, to install new processes or systems prior to their commercial application or to improve substantially those already produced or installed.

Amortisation

UK and Irish company law requires research costs to be written off while allowing development costs as a heading in the formats to be capitalised under special circumstances. It is reasonable to assume that the conditions for capitalisation set out in the accounting standard do constitute such special circumstances. Such capitalised costs are merely subject to the general requirements of Para 6 of the Schedule that the cost "be reduced by provisions for depreciation calculated to write off that amount systematically over the period of the asset's useful economic life" which are applicable to all fixed assets.

(d) FEE´s position:

Recognition

The wording of the Fourth Directive could be interpreted as not allowing a different accounting treatment for research and development costs respectively. FEE notes that the Fourth Directive does not provide any definition of research costs nor of development costs. When implementing the Directive, Member States are not forbidden from providing definitions, in a way that research costs will never qualify for capitalisation. More generally, examples can be found in the Directive where the items presented within the same caption could be subject to different accounting rules. Therefore, FEE believes that, the wording of the Fourth Directive does not create any incompatibility with IAS 38 in respect of the recognition of such costs as assets (category 3).

Amortisation

The amortisation period for development costs required by IAS 38 is the useful life of the intangible assets, which can be greater than the maximum five years period prescribed by the Fourth Directive. However, Member States are allowed by Art 37.1. to provide for a longer period of amortisation in exceptional cases. If this option has been selected by a Member State, it could avoid any inconsistency between the Fourth Directive and IAS 38. In addition, the adoption of an estimated useful life of development cost greater than five years is rare in practice. FEE agrees that there is no incompatibility between IAS 38 and the Fourth Directive (category 3).

9. SPLIT ACCOUNTING (ALLOCATING AN ITEM BETWEEN DEBT AND EQUITY)

The issue is whether a financial instrument that contains both a liability and an equity element should be presented as one element or as two separate elements (equity and liability) in the balance sheet (referred to as split-accounting). As an illustration of the treatment required under IAS 32, a bond convertible into ordinary shares, issued at an interest rate lower than the interest that would have been borne by an ordinary bond, should be presented as two separate elements on the balance sheet, the first one as an equity element, the second one as a liability.

(a) IAS versus Directives:

- <u>International Accounting Standards</u>

  IAS 32:

  "para 23: The issuer of a financial instrument that contains both a liability and an equity element should classify the instrument's component parts separately in accordance with paragraph 18."

  "para 28: This Standard does not deal with measurement of financial assets, financial liabilities and equity instruments and does not therefore prescribe any particular method for assigning a carrying amount to liability and equity elements contained in a single instrument. Approaches that might be followed include:

  (a) assigning to the less easily measurable component (often an equity instrument), the residual amount after deducting from the instrument as a whole the amount separately determined for the component that is more easily measurable; and

  (b) measuring the liability and equity components separately and, to the extent necessary, adjusting these amounts on a pro rata basis so that the sum of the components equals the amount of the instrument as a whole."

- <u>Accounting Directives</u>

  The Directives do not address this form of split accounting. In Article 9, the presentation of the balance sheet item, Liabilities C.1 includes a caption "Debenture loans, showing convertible loans separately", requiring that convertible bonds should be presented separately from other bonds. Article 41 may also be of some relevance in this respect.

(b) Commission's and Contact Committee's interpretation:

The Commission and the Contact Committee have not addressed this issue in their publications.

(c) Interpretations in Member States:

In general, split accounting of this form is not a commonly used accounting method in Europe.

In Belgium, no breakdown of a financial asset is required by any national accounting regulation. Nevertheless, an advice nr. 139 of the Commission for Accounting Standards (Commission des Normes Comptables / Commissie voor Boekhoudkundige Normen- Bulletin nr. 25, June 1990) considers, in relation to bonds with warrants (subscription rights), that the value of the bond may be determined by reference to the actuarial value of a bond with similar characteristics of duration and rate; the value of the warrant is determined by the difference between the acquisition price of the bond with warrant, and the value determined as explained. In the case of conversion of a debt or bond convertible in equity, the comparison is drawn with an exchange of assets.

In France, the Conseil National de la Comptabilité, in an "avis" issued in December 1988, has rejected split presentation for bonds that are issued together with an option to subscribe ordinary shares.

In the Netherlands, the Council on Annual Reporting recently suggested the use of the form of split accounting required by IAS 32

In Ireland and the UK, FRS 4 "Capital Instruments" requires that convertible debt should be reported within liabilities and finance cost should be calculated on the assumption that the debt will never be converted. The amount attributable to convertible debt is stated separately from that of other liabilities.

(d) FEE 's position:

FEE considers that the disclosure of convertible bonds required by the Directive should not be regarded as a prohibition of the use of split accounting for compound financial instruments as envisaged in IAS 32 (category 3).

10. OWN SHARES

The issue is whether the accounting treatment of own shares is the same according to the Directive and IAS.

Own shares are referred to under SIC 16 as treasury shares.

(a) IAS versus Directives:

- International Accounting Standards

SIC 16:

"Consensus:

4. *Treasury shares should be presented in the balance sheet as a deduction from equity. The acquisition of treasury shares should be presented in the financial statements as a change in equity.*

5. *No gain or loss should be recognised in the income statement on the sale, issuance, or cancellation of treasury shares. Consideration received should be presented in the financial statements as a change in equity."*

- Accounting Directives

Article 8 of the Fourth Directive:

"For the presentation of the balance sheet, the Member States shall prescribe one or both of the layouts prescribed by Articles 9 and 10. If a Member State prescribes both, it may allow companies to choose between them."

Articles 9 C III 7, 9 D III 2, 10 C III 7, 10 D III 2 of the Fourth Directive.

"Own shares (with an indication of their nominal value or in the absence of a nominal value, their accounting par value) to the extent that national law permits their being shown in the balance sheet."

Article 13 of the Fourth Directive:

"1. Where an asset or liability relates to more than one layout item, its relationship to other items must be disclosed either under the item where it appears or in the notes on the accounts, if such disclosure is essential to the comprehension of the annual accounts.
2. Own shares and shares in affiliated undertakings may be shown only under the items prescribed for that purpose."

(b) Commission's and Contact Committee's interpretation

The Commission and the Contact Committee have the issue under examination, but their conclusions are not yet in the public domain.

(c) Interpretations in Member States:

In a number of Member States own shares are deducted from equity, presumably based on the clause "to the extent that national law permits their being shown in the balance sheet".

In France, the Conseil National de la Comptabilité issued on 17 December 1998 two "avis" dealing with own shares. In the first one which applies to individual financial statements, the CNC requires that own shares should be shown on the asset side of the balance sheet, normally within fixed assets and in some specific situations as part of current assets. In the second "avis", the CNC states that when own shares have been presented as fixed assets in the individual financial statements of a company, which is the normal presentation, they should be deducted from equity when preparing the consolidated financial statements of this company.

In the UK and Ireland, a recently proposed revision of Urgent Issues Task Force Abstract 13 adopts the practice of treating a company's interest in its own shares as a reduction in shareholders' funds.

(d) FEE's position

FEE has considered the various situations in which own shares are held and their appropriate accounting treatment. The following situations have been discussed:

1. own shares held with the view to influence the market price;
2. own shares to be cancelled, purchased with surplus cash resources;

3. own shares provided to the employees in a stock option plan or a stock purchase plan;
4. own shares held as investments to improve the company's capital/profit ratio

FEE agrees with the accounting treatment of deduction from equity for the following reasons:

- The cost of own shares include a share in the goodwill of the company. Presenting own shares as an asset would result in reflecting in the assets of the company a portion of its internally generated goodwill. This accounting treatment would seem to conflict with regulations that do not allow an enterprise to capitalise internal goodwill. The capitalisation of the future potential of the company – even if the carrying value is supported by the resale value of the shares – should therefore not be shown on the asset side.

- In general, own shares are not cancelled, where the company wants to be able to release them back into the market. This is a reduction in the capital attributable to third parties. Potential increases in capital are not reflected on the balance sheet as either a receivable or any other asset and thus the treatment of such treasury shares should be no different.

- A financial analyst will anyhow always net any share capital shown on the asset side with equity because the amount shown on the asset side does not have additional information value.

- When own shares are acquired to be provided to employees as part of employees stock options plans or stock purchase plans, there is no reason to treat them as a special category of own shares. Providing shares to employees with or without payment, has the same nature as an issue of shares for cash. The additional accounting consequences raised by the recognition of the corresponding employee benefit is outside of the scope of SIC 16.

FEE considers that when a company applies the Fourth Directive irrespective of the Member State option, it can choose not to recognise own shares on its balance sheet. In this case, the only possibility to account for own shares as a deduction from equity. In this way, there is no conflict between SIC 16 and the Fourth Directive (category 3).

11. EMPLOYEE BENEFITS

A comparison between IAS 19 and the Fourth Directive raises the following key issues:

- Is it permitted to take into consideration future salary increases related to inflation and/or promotion when assessing pension obligations under the Directive?
- Is the optional "corridor" approach prescribed by IAS 19 for the recognition of actuarial gains and losses permitted under the Directive?
- Is it permitted to defer the recognition of past service costs under the Directive?
- Is the discounting of pension obligations an acceptable valuation procedure under the Directive?
- Does the Directive allow the fair valuing of pension plan assets, as required by IAS 19 and do certain assets qualify as plan assets under IAS 19?

(a) IAS versus Directives:

- International Accounting Standards

  The requirements of IAS 19 (revised) concerning pensions and other post-retirement employees benefits are detailed but the essential paragraphs are as follows:

  "para 7: Plan assets are assets (other than non-transferable financial instruments issued by the reporting enterprise) held by an entity (a fund) that satisfies all of the following conditions:

(…)

(c) to the extent that sufficient assets are in the fund, the enterprise will have no legal or constructive obligation to pay the related employee benefits directly."

"para 54:The amount recognised as a defined benefit liability should be the net total of the following amounts: (…)

(d) minus the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly (see paragraphs 102-104)."

"para 56: An enterprise should determine the present value of defined benefit obligations and the fair value of any plan assets with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date."

"para 83: Post-employment benefit obligations should be measured on a basis that reflects:

(a) estimated future salary increases;

(b) the benefits set out in the terms of the plan (or resulting from any constructive obligation that goes beyond those terms) at the balance sheet date; and

(c) estimated future changes in the level of any state benefits that affect the benefits payable under a defined benefit plan, if, and only if, either:

(i) those changes were enacted before the balance sheet date; or

(ii) past history or other reliable evidence, indicates that those state benefits will change in some predictable manner, for example in line with future changes in general price levels or general salary levels."

"para 92: In measuring its defined benefit liability under paragraph 54, an enterprise should recognise a portion (as specified in paragraph 93) of its actuarial gains and losses as income or expense if the net cumulative unrecognised actuarial gains and losses at the end of the previous reporting period exceeded the greater of:

(a) 10% of the present value of the defined benefit obligation at that date (before deducting plan assets); and

(b) 10% of the fair value of any plan assets at that date.

These limits should be calculated and applied separately for each defined benefit plan."

"para 96: In measuring its defined benefit liability under paragraph 54, an enterprise should recognise past service cost as an expense on a straight-line basis over the average period until the benefits become vested. To the extent that the benefits are already vested immediately following the introduction of, or changes to, a defined benefit plan, an enterprise should recognise past service cost immediately."

"para 102: The fair value of any plan assets is deducted in determining the amount recognised in the balance sheet under paragraph 54. When no market price is available, the fair value of plan assets is estimated; for example, by discounting expected future cash flows using a discount rate that reflects both the risk associated with the plan assets and the maturity or expected disposal date of those assets (or, if they have no maturity, the expected period until the settlement of the related obligation)."

- Accounting Directives

Art 20.1 of the Fourth Directive:

"Provisions for liabilities and charges are intended to cover losses or debts the nature of which is clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which they will arise."

Art 42 of the Fourth Directive:

"*Provisions for liabilities and charges may not exceed in amount the sums which are necessary*."

Art 43.7 of the Fourth Directive (disclosure in the notes):

"*The total amount of any financial commitments that are not included in the balance sheet, in so far as this information is of assistance in assessing the financial position. Any commitments concerning pensions and affiliated undertakings must be disclosed separately."*

(b) Commission's and Contact Committee's interpretation:

The Contact Committee draft paper on the examination of the conformity of IAS 19 (revised) with the Directives, which we understand will be published in summer, includes the following statements – draft version, subject to change - on the issues identified by FEE:

The corridor procedure and the spreading of past service cost

" IAS 19's mechanism to spread certain gains and losses (known as the corridor approach) conflicts with the basic principle of Articles 31.1(c)(bb) and 31.1(d) in the Fourth Directive that all foreseeable liabilities must be provided for and that all charges relating to the financial year must be recognised in that year. However, IAS 19 does not require the application of the corridor approach, and European companies are still able to comply with both IAS 19 and the Fourth Directive by applying paragraph 93 of IAS 19. This would result in the immediate recognition in the profit and loss account of all actuarial gains and losses, both within and outside the corridor. The enterprise can also adopt any systematic method that results in faster recognition of actuarial gains and losses, provided that the conditions laid down in IAS 19 are respected."

Taking account of future salary increases

The Commission and the Contact Committee have not addressed this issue in their conformity examination of IAS 19.

Discounting

"Whilst IAS 19 requires that pension fund liabilities are to be discounted, it is clear that discounting is not prohibited by the Fourth Directive."

Fair valuing and definition of plan assets

The Commission and the Contact Committee have not addressed this issue in their conformity examination of IAS 19.

(c) Interpretations in Member States:

The corridor procedure and the spreading of past service cost.

The corridor procedure and the spreading of past service costs may result in deferral of charges or income, with the result that the recognised amount of the provision for such costs may be lower or greater than the actual amount.

In France, Art 43.1 (7) of the Directive has been implemented in Art 9 of the Code de Commerce and it is commonly believed that application of the corridor procedure would not be incompatible with the Fourth Directive. The same view prevails in Luxembourg. However, in both countries, no opinion has been expressed on the problem raised by the deferring of actuarial gains, which results in an amount of provision higher than the necessary one.

As for past service costs, there is no uniform treatment at present within Europe (see: FEE Survey on Pensions and other Retirement Benefits in EU and non-EU countries, page 158). Two types of methods currently exist:

(a) past service costs are fully expensed when they arise (e.g. Germany);
(b) past service costs are spread over the remaining working lives of the existing employees (e.g. UK, France).

The first method is not allowed by IAS 19. Method (b) has not been regarded as creating an inconsistency with the Fourth Directive.

Taking account of future salary increases

In Germany, the discussion about the inclusion of expected future salary increases has been reopened and is still going on. The present understanding is different for increases related to inflation as opposed to increases due to promotions. The inclusion of expected salary increases related to inflation is allowed if the interest rate used for discounting reflects expected inflation. Future salary increases due to promotion may not be included as long as no decision has been made about, or any promise given of the promotion. If this condition has not been satisfied, the present obligation of the company is determined by the situation at the balance sheet date. The decision about future promotion is regarded as an event after the balance sheet date that should not be reflected in the measurement of the provision.

This understanding is not shared by other countries, such as France, Ireland and the UK, where expected salary changes, regardless of whether they relate to inflation or promotion, are taken into account when assessing the post retirement provisions.

Discounting

In every Member State where defined benefit schemes are common, discounting is used to measure the defined benefit obligation.

Fair valuing and definition of plan assets

The way in which the present value of the defined benefit obligation is calculated in the Netherlands can differ. The Council for Annual Reporting merely states that the provision should be sufficient to cover the vested benefits and should be calculated on an actuarial basis accepted by the Verzekeringskamer (Insurance Supervisory Board), (a government agency supervising pension funds) using a discount rate of 4%. The Council for Annual Reporting is, however, revising its guideline to bring it into line with IAS 19.

In Ireland and the UK, plan assets are not considered as assets of the sponsoring employer. Fair valuing plan assets is only carried out to assess the periodic cost for post retirement defined benefit schemes and not to measure the sponsoring employer's own assets. The accounting treatment of pension costs, on which the existing accounting standard is SSAP 24, is at present the subject of debate. Some of the key issues were addressed in the ASB's recent discussion paper "Aspects of accounting for pension costs". However, there is no indication that SSAP 24 was thought to raise any conflict with the legal requirements.

In Germany there are several means by which post-employment benefits can be provided. One of them is to establish a separate pension fund for a defined benefit pension plan ("Unterstützungskasse"). The company commits itself to pay the post-employment benefits to the employee by this pension fund. The company contributes assets to the pension fund, which the pension fund uses only to pay the post-employment benefits. This kind of pension fund does not guarantee a legal claim on the post-employment benefits towards the employee. If the pension fund does not discharge the post-employment benefits, the company is secondarily liable to meet the obligation instead of the pension fund.

In Germany companies have the option according to Art 20.1 and Art 43.1(.7) of the Fourth Directive to recognise a provision for obligations to pay post-employment benefits for which they are secondarily liable. The provision has to be measured by the "amount necessary" (Art 42 of the Fourth Directive), i.e. the amount of the difference between the post-employment benefit liability and the fair value of the net assets held by the pension fund. The assets held by the pension fund do meet the definition of plan assets in IAS 19.7 and are measured accordingly.

In Sweden, a common means of financing occupational pension provisions is the establishment of book reserves on the sponsoring company's balance sheet, supported by mutual credit insurance. A company may as an alternative contribute assets to a separate pension fund established for the purpose of managing the assets, to back the pension obligations. The assets may only be used to reimburse the enterprise for payment of benefits. The benefit obligation remains with the enterprise. It can be questioned whether these assets qualify as plan assets under IAS 19.

(c) FEE's position:

The corridor procedure and the spreading of past service cost

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 lower 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, 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 (category 3).

Taking account of future salary increases

IAS 19 (revised) requires the inclusion of estimated future salary increases in past-employment benefit obligations. A distinction may need to be drawn between future salary increases related to compensation for inflation and future salary increases related to promotion. The former should be taken into account in assessing pension obligations under the Fourth Directive. Opinions differ as to whether the latter salary increases should be taken into account. FEE would appreciate clarification of this issue (category 2).

Discounting

According to IAS 19, the pension obligation at the balance sheet date should recognise the total of discounted future payments of benefits. The question is whether discounting is acceptable under the provisions of the Fourth Directive, in particular Article 31.1 (c) (bb).

FEE notes that, although discounting is not specifically addressed in the Fourth Directive, Article 42 states "provisions for liabilities and charges may not exceed the amount in sums which are necessary". Without discounting, the pension obligation shown on the balance sheet would misrepresent the size of the burden and not give a true and fair view. Therefore, FEE is of the opinion that discounting of provisions for employee benefits is not only permitted by the Directive but should be considered as best practice (category 3).

Fair valuing and definition of plan assets

IAS 19 requires that plan assets under a defined benefit plan should be fair valued in order to determine the net amount of the obligation. Plan assets commonly comprise financial instruments or property investments. Some may argue that fair valuing financial instruments is not currently allowed by the Fourth Directive. When fair valuing of financial instruments is included in the Directive, it would still not be possible to fair value property investments as the Commission's proposals limit fair valuing to financial instruments.

FEE notes that the definition of plan assets in IAS 19 implies that they are not controlled by the sponsoring enterprise and cannot be recognised on its balance sheet. As a consequence, fair valuing plan assets to determine the net defined benefit obligation is not prohibited by the Directive (category 3).

12. PROVISIONS

The issue is whether the Directives require the recognition of a provision in circumstances where a provision would be prohibited by IAS 37.

(a) IAS versus Directives:

- International Accounting Standards

  IAS 37:

  "para 14: A provision should be recognised when:

  a) an enterprise has a present obligation (legal or constructive) as a result of a past event;
  b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
  c) a reliable estimate can be made of the amount of the obligation.

  If these conditions are not met, no provision should be recognised."

  "para 36: The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date."

  "para 40: Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the enterprise considers other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount. For example, if an enterprise has to rectify a serious fault in a major plant that it has constructed for a customer, the individual most likely outcome may be for the

repair to succeed at the first attempt at a cost of 1,000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary."

"para 42: The risk and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision."

"para 45: Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation."

"para 63: Provisions should not be recognised for future operating losses."

"para 66: If an enterprise has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision."

"para 72: A constructive obligation to restructure arises only when an enterprise:

a) has a detailed formal plan for the restructuring identifying at least:

i) the business or part of a business concerned;
ii) the principal locations affected;
iii) the location, function, and approximate number of employees who will be compensated for terminating their services;
iv) the expenditures that will be undertaken; and
v) when the plan will be implemented; and

b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it."

- Accounting Directives

Art 20 (1) of the Fourth Directive:

"Provisions for liabilities and charges are intended to cover losses or debts the nature of which is clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which they will arise"

Art 20 (2) of the Fourth Directive[2]:

"The Member States may also authorise the creation of provisions intended to cover charges which have their origin in the financial year under review or in a previous financial year, the nature of which is clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which they will arise."

Art 31.1 (c) (aa) and (bb) of the Fourth Directive:

"*Valuation must be made on a prudent basis, and in particular:*

(aa) only profits made at the balance sheet date may be included,

(bb) account must be taken of all foreseeable liabilities and potential losses arising in the course of the financial year concerned or of a previous one, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up."

[2] Art 20 (2) is not considered as a difference since it is a Member State option.

Art 42 of the Fourth Directive:

"Provisions for liabilities and charges may not exceed in amount the sums which are necessary. The provisions shown in the balance sheet under "Other provisions" must be disclosed in the notes on the accounts if they are material."

(b) Commission's and Contact Committee's interpretation:

In the Interpretative Communication the Commission points out that the "basic approach behind these provisions is that a relation to a third party exists (e.g. supply or service contract, legal proceedings, etc.). Provisions which meet these conditions must be formed irrespective of the profit or loss for the financial year in accordance with the general principle laid down in Art 31.1 (c) (bb). This article requires that account must be taken of all foreseeable liabilities and potential losses arising in the course of the financial year concerned or of a previous one, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up.

Provisions according to Art 20.2, however, do not cover provisions for losses and debts, but only provisions for charges. These are expenses which do have their origin in the financial year under review or in a previous financial year, the nature of which is clearly defined and which at the balance sheet date are either likely to be incurred or certain to be incurred but uncertain as to amount or as to the date on which they will arise. Although there is no obligation to a third party, the possibility to create a provision in this case gives companies the opportunity to calculate the profit or loss for the period more precisely. This is meant to cover, for example, major and recurring maintenance costs over a number of years and expenditure on major repairs."

This opinion has been confirmed in the Commission's document on accounting for the changeover to the euro: "Setting up provisions for changeover costs under Art 20.1 is only possible in situations where a relationship with a third party exists. However, it is not required that an actual commitment already exists on the balance sheet date. Under Art 20.2 provisions for changeover costs are only allowed when these costs arise in the financial year concerned, or a previous one. The decision by the Council of Ministers to introduce the euro or the ability of a company to identify reasons for expected future costs are in themselves not a sufficient reason for setting up provisions."

In their 1999 conformity examination of IAS 37, which is to be issued around the same time as this FEE Study, the Commission and the Contact Committee have examined whether the definition of "provision" in the IAS includes all items that would be included by reference to Art 43.1 (7), Art 31.1 (c) (bb), Art 31 (d) and Art 20 and concluded on an inconsistency with the Fourth Directive regarding certain restructuring provisions:

"If one considers just the bare words of Article 31 of the Fourth Directive and paragraph 14 of IAS 37, it would be quite easy to conclude that, whilst they are very differently expressed – the Directive focuses on recognition of expenses and the IAS on recognition of liabilities – the end result is much the same.

However, when the rules in IAS 37 for the application of paragraph 14 to specific cases are taken into account, the position is not so clear. For example, under paragraph 72 of the IAS, a provision for restructuring can be made only when the reporting entity (broadly speaking) had a detailed formal plan for the restructuring and has made its intentions public at or before the balance sheet date. Additionally, the plan must include a number of specific features, which include the business or part of the business concerned and the principal locations affected.

This means, for example, that if during the year to 31 December 1998 a company has clearly identified that one of its two factories must close to save costs, but has not decided which, IAS 37 prohibits provision for those closure costs, even if an intention to close one has been announced. Similarly, if the Board of Management of a company decides before the balance sheet date to reorganise the company (including terminating the employment of employees), and the decision is only announced after the balance sheet date (but before the accounts are approved), then IAS 37 would not permit a provision to be made for the reorganisation and termination payments, whilst Article 31 of the Fourth Directive would require a provision to be made.

Consequently, under the Directive, a board decision would indicate that a "potential loss" (or "foreseeable risk" in the case of the German and French texts) exists. It is therefore hard to see how IAS 37's prohibition can be reconciled to the requirement of Article 31.1(c)(bb) to take account of 'all foreseeable liabilities and potential losses', if these words are construed according to their natural meaning.

IAS 37's definition of provision as it is applied to the specific case of restructuring provisions is inconsistent with the Fourth Directive because it will prevent provision being made for items for which provision is required by Articles 31.1(c)(bb) and 31(d) of the Directive."

(c) Interpretations in Member States:

Recognition

In Belgium, account has to be taken of all foreseeable liabilities, contingent losses and reductions in value arising during the period for which the annual accounts are being prepared or in prior periods, even if those liabilities, losses and diminutions in value only become known between the balance sheet date and the date when the annual accounts are adopted by the responsible body of the enterprise (Royal Decree of 8 October 1976, article 19). This implies that provisions must be established even when no relation to a third party -or even when no constructive obligation- exists. For instance, provisions should be made for charges resulting from technical warranties relating to sales made or services already rendered by the enterprise.

In France, the regulations on provisions are the following:

(1) Article 8 of the Decree of 11 November 1983 states that provisions should be made for risks or changes that arise as a result of past events or current conditions.

(2) The definition of provisions provided by the Plan Comptable Général (page I 39) is slightly different: a provision is intended to cover risks and charges which are probable as a result of past events or current conditions, the nature of these risks and charges being clear although their final occurrence is uncertain.

(3) The Plan Comptable Général (page I 25) also requires certain provisions for charges to be spread over several accounting periods. Such provisions cover anticipated expenditures, for example major repair and maintenance costs, which should not be expensed in full when incurred. These provisions should meet the following conditions:
   - they should cover major expenditures to be incurred every several years and which are not ordinary repairs;
   - they should be planned when the related asset is acquired on the basis of the expected repairs and the useful life of the related asset.

(1) In addition, article 14 of the Code de Commerce states that all necessary provisions should be recognised. The only exception relates to pension commitments for which the recognition on balance sheet is not necessary (article 9 of the Code de Commerce)

As a consequence of these rules, the general practice in France is to recognise all necessary provisions even when they are not tax deductible. Restructuring provisions are provided for even if the decision is formally taken after the balance sheet date. Provision for future major repair costs is a common accounting practice in sectors such as shipping, air transportation, steel industry. In this context, the future implementation of IAS 37 could have significant effects on companies applying IASs.

In Germany Art 20 (1) of the Fourth Directive is implemented by § 249 (1) of the Commercial Code. It is common understanding that a provision is made only where there is a legal or constructive obligation to a third party at the balance sheet date. Included are provisions to be recognised for onerous contracts. It is not necessary to identify specifically the third party.

The Italian legislation uses terms such as "certain or probable" liabilities. Accordingly, two types of liability are taken into account:

- Provisions for certain liabilities the amount or due date of which is uncertain;
- Provisions for liabilities which are probable (provisions for risks). These "contingent liabilities", relate to existing situations where the outcome is dependent on some factor that will be resolved in the future.

In the Netherlands, provisions can be made for present and expected obligations and losses. There is no need for an obligation to be present at the balance sheet date. However, a risk of occurrence of the obligation or loss should exist at the balance sheet date. The risk should not be of a general nature. It must be specific and concrete. However in 1998 in a case before the Court of Appeal it was decided that only the clear causal connection between the cash outflow and a relevant event in the fiscal year is required.

In the UK a new standard (FRS 12) has recently been adopted for March 1999 year ends. In comparing UK law and the UK standard (which is very similar to IAS 37) the ASB concludes that "the requirements of the FRS are expressed in more specific terms than the requirements in Schedule 4. However, although the Act and the FRS define provisions in different terms, the Board believes that, when taken in their respective contexts, the FRS is consistent with the requirements of Schedule 4". The ASB's opinion is that where the law requires provisions to be made for losses that are likely or certain to be incurred, this must be read in conjunction with the requirement that losses or liabilities must be in respect of the financial year or a previous year. In its view this supports the need for a past event to have given rise to the loss or liability, but this does not support provisions for future losses where there has been no such past event.

Measurement

In Germany provisions are generally not allowed to be discounted. Discounting is considered to conflict with the realisation principle contained in Art. 31 (1) (c) (aa) of the Fourth Directive, which has been incorporated into German law by § 252 para. 1 No. 4 of the Commercial Code. This conclusion is based on the assumption that discounting is equivalent to the anticipation of future earnings resulting from the enterprise's use of the funds embodied in the accrued amount of the provision. This was clarified by the German legislator in 1994. § 253 para. 1 sentence 2 of the Commercial Code now states, that provisions are only allowed to be discounted when the amount to be discharged contains an (implicit or explicit) interest component. Only in such cases discounting is required and allowed by the realisation principle. In this instance an interest-bearing liability of uncertain amount is seen to exist and the interest expense has to be charged to the respective periods of the duration of the liability.

In Germany there are practical difficulties in ascertaining whether the amount to be discharged contains an interest component. It is generally held that an interest component does not exist for obligations that are to be fulfilled in kind or obligations resulting from public law (eg. resulting from environmental regulations). Obligations that have to be paid in cash are only presumed to contain an interest component if the interest component is sufficiently specified. This condition is met, for example, if the parties to the transaction have agreed that the debtor has to pay less, in case of settling the obligation prior to its maturity, than the originally agreed amount payable or the parties to the transaction have agreed that the debtor can choose between the immediate fulfillment of his obligation or an extension to the date of payment.

It is the general practice in Italy not to discount provisions.

(d) FEE´s position:

FEE has not addressed the problem raised by Art 20.2 of the Fourth Directive as it is a Member State option.

The issue on provisions according to Art 20.1 has two different aspects: recognition and measurement. These two aspects are treated separately:

(i) *Recognition*: IAS 37 does not permit the creation of a provision for future losses unless there is an onerous contract (para 63-69). The Directive requires a provision for future losses when their nature is clearly defined and they are likely to be incurred. There is an identical concept behind the two stipulations. First, the Directive anticipates provisions for liabilities and charges intended to cover losses or obligations that are clearly defined. Although not explicitly mentioned provisions for liabilities can only refer to a third party relationship; the term "liability" always implies a relationship with another party. As far as this point is concerned FEE shares the Commission's opinion that there is no difference between IAS 37 and the Directive. Secondly, IAS 37 includes the probability concept. A provision can only be recognised when the probability test is met ("when it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation"). The corresponding stipulation within the Directive is the requirement that the nature of the provisions is clearly defined and the provisions are likely to be incurred or certain to be incurred but uncertain as to amount or as to the date on which they will arise. Thus no significant differences can be identified (category 3).

Many Member States interpretations of Art 20.1 (as described under (c)) go beyond IAS 37.

(ii) *Measurement*: In the terminology of IAS 37 the amount recognised as a provision should be the "best estimate at the balance sheet date of the expenditure required to settle the obligation" (para 36). According to the Directive, the amount necessary (Art 42) must be recognised. In order to determine the amount necessary, the general valuation rules including the prudence principle apply. The prudence principle must also always be considered in the valuation process according to IAS (see IASC Conceptual Framework), thus the result should be similar and no difference between IASs and the Directive should arise. Differences may occur due to the fact that in some Member States there is a different understanding of prudence in particular in relation to individual items or small populations. (category 3).

The issue on provisions is illustrated with four examples:

a) For the changeover cost due to the introduction of the euro and caused by the millennium problem, IAS 37 would not permit a provision as no obligation to a third party is established (see also SIC 7). This view has been shared by the Commission paper "Accounting for the Introduction of the Euro". As set out in the Commission's paper, setting up provisions for changeover costs under Art 20 (1) is only possible in situations where a relationship with a third party exists.

b) Art 20 (1) of the Fourth Directive covers provisions for environmental risks if the criteria are met. The example of environmental cost is explicitly mentioned in the Commission's Interpretative Communication where environmental liabilities and risks should be provided if the company has a legal or contractual obligation to prevent, reduce or repair environmental damage or if the company's management is committed to prevent, reduce or repair environmental damage. Under IAS 37 there is no separate treatment for environmental costs (also see example 2 B in Appendix of IAS 37), thus the general rules for recognition apply. Both the Directive and IAS 37 require recognition where a loss or debt is identified and a legal or contractual obligation exists.

c) There is uncertainty about the appropriate interpretation of the Directive concerning the lay-off of personnel. There are different views as to when a provision should be recorded. Is it necessary for an announcement to be made of the lay-off prior to the balance sheet date or is it sufficient if the announcement takes place between the balance sheet date and the finalisation of the accounts? Under common interpretations of the Directive and in current practice a provision should be made when an announcement is made after the balance sheet date. This would not be in line with IAS 37.72. FEE agrees with the Commission that IAS 37 applied in that situation to restructuring provisions can be inconsistent with the general interpretation of the Directive and current practice in Europe. FEE doubts however if such a conclusion could also be drawn strictly based on the texts of Art 20, 31 and 43 without taking current practice into account (category 2).

d) Provisions for decommissioning costs required by IAS 37 and IAS 16 are not covered by the Fourth Directive. The costs of property, plant and equipment include by IAS 16 (revised 1998).15 the estimated cost of dismantling and removing the asset and restoring the site, to the extent that these costs are recognised as provisions in accordance with IAS 37. There is uncertainty whether decommissioning costs can be included in the production costs in accordance with Art 35.3 (a): can they be regarded as costs directly attributable to the production. Further clarification from the Commission would be helpful (category 2).

13. FOREIGN CURRENCY TRANSLATION

The issues are:

(1) whether foreign currency monetary items can be translated at the closing rate at the balance sheet date or at the rate of inception of the transaction;
(2) whether the related positive exchange differences can be recognised in the profit and loss account under the realisation principle of Article 31.1 (d) of the Fourth Directive.

Foreign currency translation issues that arise in connection with consolidation are not addressed.

(a) IAS versus Directives:

- International Accounting Standards

  IAS 21:

  "para 11: At each balance sheet date:

  (a) foreign currency monetary items should be reported using the closing rate;

  (b) non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and

  (c) non-monetary items which are carried at fair value denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined."

  "para 15: Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraphs 17 and 19."

- Accounting Directives

  The Fourth and the Seventh Directives do not explicitly mention the issue of foreign currency translation of transactions with respect to valuation and measurement. However, the general rules of Articles 31 and 32, in particular those that concern the realisation principle, apply.

Art 43.1(1) of the Fourth Directive:

"In addition to the information required under other provisions of this Directive, the notes on the accounts must set out information in respect of the following matters at least: the valuation methods applied to the various items in the annual accounts, and the methods employed in calculating the value adjustments. For items included in the annual accounts which are or were originally expressed in foreign currency, the bases of conversion used to express them in local currency must be disclosed."

(b) Commission's and Contact Committee's interpretation:

Having carefully considered the different arguments, the Contact Committee concluded in its comparison document of 1996 "An examination of the conformity between the international accounting standards and the European accounting directives" (para 37) that: "Article 31 of the Fourth Directive does not exclude an interpretation whereby positive exchange differences may be included in the profit and loss account. Furthermore, this possibility exists for both short-term and long-term items. Because of the existence of very sophisticated financial instruments, it would indeed be arbitrary to operate a distinction between short-term and long-term monetary items". This position is confirmed in the Commission's interpretative communication, issued in 1998.

(c) Interpretations in Member States:

In certain Member States, exchange gains cannot be taken into account until realised which, in their understanding, means being actually received in the form of payment/receipt or closing of the contract. In these Member States, it is difficult to accept that this is no longer the case.

In France, a different treatment is used for annual and consolidated accounts. For the consolidated accounts, it is permitted to recognise the exchange gains in the profit and loss account whereas in the statutory accounts they are deferred.

In Germany, the use of the closing rate in the context of exchange gains is not allowed, except for receivables or liabilities resulting from normal business activities that will be settled within 12 months. These may be reported using the closing rate. If a company follows this treatment, related gains should be included in the profit and loss account. This approach was adopted solely for practical reasons, and is not based on a general understanding of the principles of realisation and historical cost.

In Italy, short-term foreign currency receivables and payables existing at the balance sheet date i.e. those due after less than 12 months, including the current portion of long-term receivables and payables, that result from either financial or commercial operations, must be reported using exchange rates at the balance sheet date. Translation differences arising from the translation of individual receivables and payables at balance sheet date exchange rates are credited and debited, respectively, to the income statement.

In the UK and Ireland, all exchange gains or losses on settled transactions and unsettled short-term monetary items should be reflected as part of the profit and loss for the year from ordinary activities (SSAP 20, para 49). The standard setter recognised that gains on long-term monetary items, however, might well breach the equivalent of Art 31.1 (c) (aa). Users were therefore advised to treat such circumstances as falling under the equivalent of Art 31.2.

(d) FEE's position:

Whilst the Contact Committee document stresses that the question has only been examined in relation to the preparation of consolidated accounts, the interpretative communication refers to the Fourth Directive. Most of FEE's members agree with the interpretation of the Contact Committee and Commission that under Art 31, it is possible to recognise exchange gains in the profit and loss account resulting from the use of the closing rate. The problem will be less significant as soon as the proposals on the use of fair value for financial instruments are incorporated in the Directive (category 3).

CONSOLIDATION ISSUES

14. NEGATIVE GOODWILL

The issue is whether the treatment of negative goodwill in the profit and loss account as required by IAS 22 is possible in all circumstances under the Accounting Directives.

(a) IAS versus Directives

- International Accounting Standard

  IAS 22 (revised 1998):

  "para 59: Any excess, as at the date of the exchange transaction, of the acquirer's interest in the fair values of the identifiable assets and liabilities acquired over the cost of the acquisition, should be described as negative goodwill."

  "para 61: To the extent that negative goodwill relates to expectations of future losses and expenses that are identified in the acquirer's plan for the acquisition and can be measured reliably, but which do not represent identifiable liabilities at the date of acquisition (…), that portion of negative goodwill should be recognised as income in the income statement when the future losses and expenses are recognised. If these identifiable future losses and expenses are not recognised in the expected period, negative goodwill should be treated under paragraph 62 (a) and (b)."

  "para 62: To the extent that negative goodwill does not relate to identifiable expected future losses and expenses that can be measured reliably at the date of acquisition, negative goodwill should be recognised as income in the income statement as follows:

  (a) the amount of negative goodwill not exceeding the fair values of acquired identifiable non-monetary assets should be recognised as income on a systematic basis over the remaining weighted average useful life of the identifiable acquired depreciable/amortisable assets; and

  (b) the amount of negative goodwill in excess of fair values of acquired identifiable non-monetary assets should be recognised as income immediately."

  "para 63: To the extent that negative goodwill does not relate to expectations of future losses and expenses that have been identified in the acquirer's plan for the acquisition and can be measured reliably, negative goodwill is a gain which is recognised as income when the future economic benefits embodied in the identifiable depreciable/amortisable assets acquired are consumed. In the case of monetary assets, the gain is recognised as income immediately."

  "para 64: Negative goodwill should be presented as a deduction from the assets of the reporting enterprise, in the same balance sheet classification as goodwill."

- Accounting Directives

  Art 31 of the Seventh Directive:

  "*An amount shown as a separate item, as defined in Art 19 (1) (c), which corresponds to a negative consolidation difference may be transferred to the consolidated profit-and-loss account only:*

  (a) where that difference corresponds to the expectation at the date of acquisition of unfavourable future results in that undertaking, or to the expectation of costs which that undertaking would incur, in so far as such an expectation materialises; or

  (b) in so far as such a difference corresponds to a realised gain".

(b) Commission's and Contact Committee's interpretation:

The Contact Committee doubted (in its 1996 examination of the conformity between IASs and the European Accounting Directives) the materiality of the practical consequences of this conflict (the comments refer to the old version of IAS 22): "However, the Contact Committee believes that in practice this conflict will only lead to material differences in extremely rare circumstances. Indeed, Article 31.a of the Seventh Directive states that the recognition in the profit and loss account can be made in so far as the expectation of unfavourable results or costs materialises. Normally, such an expectation relating to unfavourable costs and results will materialise gradually and in a limited period of time, so that the accounting treatment arising from the application of Article 31.a of the Seventh Directive would in practice have identical effects as the "systematic" recognition in income prescribed by IAS 22. In addition, the word "systematic" used by IAS 22 is not always understood as meaning "gradual, straight-line" amortisation. As Article 31 does not state how negative goodwill should be treated, the Contact Committee suggests that the Commission, at the occasion of an amendment of the Seventh Directive, propose a re-draft of Article 31, so as to clarify the accounting treatment of negative goodwill and bring it in line with the treatment required by IAS 22".

In their conformity examination of IAS 22 (revised 1998) which will be published around the same time as this FEE Study the Commission and the Contact Committee have examined the revised text of IAS 22 and concluded that: "There are no new conflicts introduced by the revisions to IAS 22. In fact, IAS 22's revision of the accounting for negative goodwill now removes the previously identified potential conflict in this area."

(c) Interpretations in Member States:

In Italy, the application of the equity method in evaluating a participation, art. 33 of DLgs 127/91 does not allow the recognition of negative goodwill as income, but requires it to be transferred to an undistributable reserve within the equity. In effect it may be an indirect correction of the equity of the participation, due to unforeseeable future losses or expenses, to be put to an individual reserve.

Dutch law states that if the net asset value (intrinsic value) of an acquisition (after recognition of the effect of expected future losses on the value of the assets and after forming necessary restructuring reserves) is higher than the acquisition price, the difference is an unrealised profit that has to be accounted for as a revaluation reserve. This revaluation reserve is not available for dividend distribution until the acquisition is sold. Since in the Netherlands equity in statutory and consolidated accounts are the same, the treatment of negative goodwill is the same as well. However, the Council on Annual Reporting has interpreted the legal rules in a way that is very close to the treatment of the difference by IAS 22.

In Ireland and the UK, FRS 10, "Goodwill and Intangible Assets", requires that negative goodwill should be recognised and separately disclosed on the face of the balance sheet, immediately below the goodwill heading. It should be recognised in the profit and loss account in the periods in which the non-monetary assets acquired are depreciated or sold. Any negative goodwill in excess of the values of the non-monetary assets should be written back in the profit and loss account over the period expected to benefit from that negative goodwill. The write back of negative goodwill under a very similar accounting standard to IAS 22, does not apparently give rise to legal problems (Appendix 1 to FRS 10).

(d) FEE´s position:

FEE agrees that the application of IAS 22 (revised 1998) would normally result in an acceptable implementation of Art 31 of the Directive and that therefore no conflict any longer exists.

FEE has identified another issue: Negative goodwill is only addressed by the Seventh Directive and not explicitly addressed by the Fourth Directive. However, the situation when a business is acquired under an asset deal ("A business combination may involve the purchase of the net assets, including any goodwill, of another enterprise rather than the purchase of the shares in the enterprise." IAS 22.4) might lead to a negative difference. Such difference must be treated as negative goodwill according to IAS 22. Considering that IASs are mostly applied in consolidated accounts of European companies, it was decided not to further examine the problem. It is FEE's opinion that there are two solutions to the problem: (i) adding an additional caption in the individual accounts to recognise negative goodwill; then there is no problem for consolidation. (ii) restating the individual accounts for consolidation purposes and recognising negative goodwill in the consolidation.

FEE observes that expected losses and expenses as referred to in IAS 22 correspond to a narrower concept than the concept of unfavourable results as per Art 31, the latter covering not only losses and expenses but also lower profits. The recognition in income of negative goodwill, when the losses and expenses are incurred, as prescribed by IAS 22, is also an acceptable procedure under Art 31. To the extent that negative goodwill does not relate to future losses and expenses, IAS 22 provides for it to be transferred to income on a systematic basis over the useful lives of the depreciable assets. As this procedure can be explained by poor profitability of the assets acquired, it seems that it can also be accepted under Art 31 of the Directive.

The immediate transfer to income of a portion of the negative goodwill, which is prescribed by IAS 22, is also acceptable under Art 31 (b) (category 3).

15. REVERSE ACQUISITIONS

The issue is whether in the rare circumstances of a reverse acquisition the IAS treatment 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, is allowed by the Accounting Directives.

(a) IAS versus Directives:

- International Accounting Standards

  IAS 22 (revised 1998):

  "para 12: 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 enjoying the voting or other powers identified in paragraph 10. The enterprise issuing the shares is deemed to have been acquired by the other enterprise; the latter enterprise is deemed to be the acquirer and applies the purchase method to the assets and liabilities of the enterprise issuing the shares."

- <u>Accounting Directives</u>

  Art 1.1 of the Seventh Directive:

  "1. A Member State shall require any undertaking governed by its national law to draw up consolidated accounts and a consolidated annual report if that undertaking (a parent undertaking):

  (a) has a majority of the shareholders' or members' voting rights in another undertaking (a subsidiary undertaking); or

  (…)

  (c) has the right to exercise a dominant influence over an undertaking (a subsidiary undertaking) of which it is a shareholder or member, pursuant to a contract entered into with that undertaking or to a provision in its memorandum or articles of association, where the law governing that subsidiary undertaking permits its being subject to such contracts or provisions. A Member State need not prescribe that a parent undertaking must be a shareholder in or member of its subsidiary undertaking. Those Member States the laws of which do not provide for such contracts or clauses shall not be required to apply this provision; or

  (…)"

  Art 4.1 of the Seventh Directive:

  "For the purposes of this Directive, a parent undertaking and all of its subsidiary undertakings shall be undertakings to be consolidated where either the parent undertaking or one or more subsidiary undertakings is established as one of the following types of company:

  (…)"

  Art 19.1 (a) of the Seventh Directive:

  "The book values of shares in the capital of undertakings included in a consolidation shall be set off against the proportion which they represent of the capital and reserves of those undertakings:
  (a) That set-off shall be effected on the basis of book values as at the date as at which such undertakings are included in the consolidations for the first time. Differences arising from such set-offs shall as far as possible be entered directly against those items in the consolidated balance sheet which have values above or below their book values."

(b) Commission's and Contact Committee's interpretation:

The Commission and the Contact Committee have examined the conformity between IAS 22 (revised) and the Accounting Directives, but did not refer specifically to reverse acquisitions. It is concluded that there are no conflicts between IAS 22 and the Directives.

(c) Interpretations in Member States:

Reverse acquisitions are rarely used in most of the countries therefore there is hardly any experience with the accounting treatment of reverse acquisitions both under the Accounting Directives and under national law.

In Austria, Belgium, Germany, Luxembourg and the Netherlands reverse acquisitions are not addressed in the law or accounting standards.

In Austria and Germany the application of reverse acquisition accounting as set out in IAS 22.12 is not allowed, since even if control has passed to the acquired enterprise, the acquiring enterprise has to prepare consolidated financial statements.

In the UK a common motive for a reverse take-over is to acquire a stock exchange listing or other privilege in an indirect, less onerous, way. In such cases, IAS 22 requires that the entity issuing the shares (that is, the legal parent) is deemed to be acquired by the other (that is, the legal subsidiary) and the fair value exercise is carried out on the basis. The UK accounting standard FRS 6 'Acquisitions and mergers' notes that this treatment is incompatible with the Companies Act. In the light of this, it had been suggested that it was not possible to invoke the Act's true and fair override in order to fair value the acquiror rather than the acquiree. This issue was considered by the Urgent Issues Task Force (UITF), which concluded in July 1996 that, whilst each case should be considered on its merits, there are some instances where it would be appropriate to use the true and fair override and apply 'reverse acquisition accounting'. It also agreed this is simply an application of the general requirement of the true and fair override that may be invoked in the circumstances prescribed by the Act.

(d) FEE's position:

Preparation of consolidated accounts

The Seventh Directive does not specifically address reverse acquisitions. The Seventh Directive is based on the legal concept of the parent undertaking drawing up the consolidated accounts. The company that ought to draw up accounts under IAS 22 in the reverse acquisition might be different from the company (parent undertaking) that ought to draw up accounts under the Seventh Directive. FEE is of the opinion that this would not constitute a difference between the IAS and the Seventh Directive as long as both set of accounts are drawn up, although it might be confusing to the reader of the accounts. A clarification from the Commission that the control concept could be applied to the reverse acquisition and only one set of accounts need to be drawn up by the company deemed to be the acquirer would be helpful (category 2).

Measurement

The Seventh Directive does not address the measurement aspect of reverse acquisitions. Art 19.1 (a) requires the purchase method to the applied by the acquirer to the acquired company. IAS 22.12 however imposes the application of the purchase method to the company which is in substance the acquired company but is the legal acquirer in a reverse acquisition. FEE is of the opinion that this constitutes a conflict since IAS 22.12 requires a mirror treatment from the normal situation in case of a reverse acquisition: i.e. fair values should be ascribed to the assets and liabilities of the legal acquirer whereas under the Directive the purchase method would be applied to the acquired company. Article 19.1 (a) requires differences between the net assets and the investment be allocated to the appropriate items in the consolidated balance sheet. It is not made explicit whether this should be the items of the acquiring company or the acquired company. However also in this case for the determination of the difference to be allocated, it makes a difference to which company the purchase method is applied: the in substance acquired company (IAS 22.12) or the formally acquired company (Seventh Directive Art 19). It might be appropriate in case of a reverse acquisition to involve the true and fair override.

Since reverse acquisitions rarely occur in practice, the problem is regarded as being of little practical relevance and would only need to be addressed in the context of full revision of the Directives. Although reverse acquisition accounting is extremely rare, this might change if the use of the pooling of interests method is reduced in the future. For example, companies might see structuring transactions as reverse acquisitions as reducing goodwill and the related amortisation charges in subsequent years. If reverse acquisitions were to arise more frequently, an amendment of the Seventh Directive may be needed (category 1).

16. 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 requires full consolidation of all subsidiaries.

(a) IAS versus Directives:

- International Accounting Standards

  IAS 27:

  "para 11: A parent which issues consolidated financial statements should consolidate all subsidiaries, foreign and domestic,(…)."

  "para 14: Sometimes a subsidiary is excluded from consolidation when its business activities are dissimilar from those of the other enterprises within the group. Exclusion on these grounds is not justified because better information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the different business activities of subsidiaries. For example, the disclosures required by International Accounting Standard IAS 14, Reporting Financial Information by Segment, help to explain the significance of different business activities within the group."

- Accounting Directives

  Art 14.1 of the Seventh Directive:

  "Where the activities of one of more undertakings to be consolidated are so different that their inclusion in the consolidated accounts would be incompatible with the obligation imposed in Art 16 (3), such undertakings must, without prejudice to Article 33 of this Directive, be excluded from the consolidation."

(b) Commission's and Contact Committee's interpretation:

The Contact Committee raised an incompatibility between the Seventh Directive and IAS 27 with reference to the scope of consolidation. As Art 14.1 of the Seventh Directive includes a mandatory exclusion for certain undertakings from the scope of consolidation a conflict situation exists between the Seventh Directive and IAS 27 on this point which has been explicitly identified by the Contact Committee:

"The Contact Committee believes that, although a conflict exists between the wording of Art. 14.1 of the Seventh Directive and IAS 27, the requirement to exclude a subsidiary from the scope of the consolidation on the basis of Art 14.1 should not be read today in the same way as it was intended when the Seventh Directive was originally drafted. The Contact Committee therefore considers that the wording of IAS 27 which does not allow for any exclusion on the ground of different activities better reflects the present situation and suggests that the Commission, at the occasion of an amendment of the Seventh Directive, proposes a redraft of Article 14, in order to bring it more in line with today's practice and with IAS 27."

In the Interpretative Communication the opinion of the Contact Committee has been confirmed: "Since the adoption of the Directive a development has taken place whereby more and more subsidiaries have been included in the consolidated accounts, regardless of the nature of their business compared with that of the parent undertaking. Preference is given to the inclusion of the subsidiary in the consolidated accounts with appropriate information (on a segmented basis) in the notes. Article 14.1 should be read in the light of this development and exclusion from the scope of consolidation should therefore only take place in very rare circumstances when the application of the true and fair view principle so requires".

This position is again confirmed by the Examination of the Conformity between IASs and the European Accounting Directives (1999 paper of the Contact Committee) which states:

"However, whilst there seems to be a textual conflict between IAS 27 and the Directive, whether or not this will have any effect in practice is a debatable point. For example, whilst IAS 27 does not allow for the exclusion from consolidation of a subsidiary on the grounds of different activities, it is a matter of judgement as to whether the consolidation of enterprises which undertake different activities would be incompatible with the true and fair view. In fact, current thinking is that such undertakings should be consolidated, with the appropriate segmental information being given in the notes to the accounts in order to explain the performance of the individual operations. In the light of this, the Contact Committee does not see any case where Article 14 will require the exclusion of any undertaking from consolidation[3]."

(c) Interpretations in Member States:

In France, the view is widely held that the law requiring the use of the equity method to consolidate companies with dissimilar activities, did not preclude full consolidation of these subsidiaries . This interpretation was adopted by the French Commission of Operation de Bourse on an official basis, in order to permit application of the US standard FAS 94.

Before the implementation of the Seventh Directive, it was common practice in the Netherlands to exclude subsidiaries from the consolidation owing to dissimilarity of activities. After the implementation, the rules were interpreted much more strictly. The Council for Annual Reporting (Raad voor de Jaarverslaggeving) states that consolidation could and should be avoided only in the case of highly dissimilar activities which relate to a large extent to third parties.

In the UK and Ireland, FRS 2, Accounting for Subsidiary Undertakings, para 25, requires that a subsidiary should be excluded from consolidation where (inter alia) (c) the subsidiary undertaking's activities are so different from those of other undertakings to be included in the consolidation that its inclusion would be incompatible with the obligation to give a true and fair view. It is exceptional for such circumstances to arise and it is not possible to identify any particular contrast of activities where the necessary incompatibility with the true and fair view generally occurs.

(d) FEE´s position:

FEE agrees with the description of the conflict situation as discussed in the Contact Committee comparison document and in the later interpretative communication and 1999 conformity examination.

However, the 1994 published Report of the FEE Task Force on Financial Conglomerates to the European Commission on the Form and Content of the Consolidated Financial Statements of Financial Conglomerates states regarding Art 14 of the Seventh Directive: "Banking and insurance conglomerates do now exist and increasingly regard themselves as being engaged in what is in essence one comprehensive activity of providing financial services; this trend has been documented by a recent OECD publication, "Financial Conglomerates" (Paris 1993). The relatively recent appearance of the terms "bancassurance" and "Allfinanz" in European financial sector terminology is further confirmation of this attitude and furthermore the conglomerates themselves consider that consolidation, far from being incompatible with the presentation of a true and fair view, in fact enhances it".

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[3]The considerations expressed in this paragraph do not apply to those mixed groups comprising banks and insurance undertakings which are often referred to as "financial conglomerates", because this matter has not been specifically examined by the Contact Committee.

FEE agrees that the true and fair view is usually achieved by including all subsidiaries in the scope of consolidation. Only in those rare cases where an exclusion from the scope of consolidation is necessary for the true and fair view should the exclusion clause be applied. Giving a true and fair view is one of the main objectives of both Accounting Directives (Art 2.4 of the Fourth Directive and Art 16.3 of the Seventh Directive) and the IASs (Framework para 46), therefore, any impairment of that objective must be avoided. However, FEE agrees that the problem is of little or no practical relevance, therefore FEE agrees that the issue should be dealt with only in the context of any full amendment process of the Directive (category 1).

PRESENTATION ISSUES

17. ELEMENTS OF FINANCIAL STATEMENTS

The issue is whether additional financial statements such as a cash flow statement can be provided as part of the annual accounts under the Accounting Directives.

(a) IAS versus Directives:

- International Accounting Standards

  IAS 1 (revised 1997):

  "para 7: A complete set of financial statements includes the following components:

  (a) balance sheet;
  (b) income statement;
  (c) a statement showing either:
  (i) all changes in equity; or
  (ii) changes in equity other than those arising from capital transactions with owners and distributions to owners;
  (d) cash flow statement; and
  (e) accounting policies and explanatory notes."

- Accounting Directives

  Art 2.1 of the Fourth Directive:

  "The annual accounts shall comprise the balance sheet, the profit and loss account and the notes on the accounts. These documents shall constitute a composite whole."

  Art 2.6 of the Fourth Directive:

  "The Member States may authorise or require the disclosure in the annual accounts of other information as well as that which must be disclosed in accordance with this Directive."

(b) Commission's and Contact Committee's interpretation:

In the 1998 "Examination of the conformity between IAS 1 and the European Accounting Directives" the statement of performance and the cash flow statement are referred to and it is concluded that both would be acceptable as components of a set of financial statements:

Statement of performance

" As far as the statement of changes in equity is concerned, the Contact Committee refers to paragraph 3 of the introduction to IAS 1. This paragraph states that this statement may be presented either as a "traditional" equity reconciliation in column form or as a statement of performance in its own right. The Contact Committee observes that when the requirements of International Accounting Standards are applied so as to be compatible with the Accounting Directives, they will give rise to movements which are normally reported either in the profit and loss account or in the balance sheet. Accordingly, the statement of changes in equity will normally take the form of a "traditional" equity reconciliation and not give rise to a statement of performance in its own right. Nevertheless, in the opinion of the Contact Committee, any form of statement of changes in equity which would not result in an equity reconciliation statement but would rather give rise to a statement of performance in its own right would be acceptable to the extent that it does not conflict with the application of the layouts prescribed by the Fourth Directive."

Cash flow statement

"Similarly, IAS 1 lists the cash flow statement as a component of financial statements. Although the Directives do not explicitly mention the cash flow statement, they do not exclude their preparation either, particularly in the light of Article 2 (6) of the Fourth Directive. Consequently, the Contact Committee sees no conflict between IAS 1 and the Directives in the requirement for a cash flow statement to be a component of a set of financial statements".

(c) Interpretations in Member States:

In Belgium, there are no statutory or professional regulations relating to cash flow statements, excepted in the attachments Schema A and Schema B to the Royal Decree of 31 October 1991 relating to the prospectus to be published in cases of public issuance of securities.

In Germany it is common understanding that companies are allowed to include more information in their financial statements than required by law. Furthermore, listed companies are obliged to include a cash flow statement and segmental reporting in the notes of the consolidated accounts (§ 297, sect 1 German Commercial Code in the 1998 version).

In Spanish legislation, presentation of a funds flow statement is obligatory.

In Ireland and the UK, the ASB's revised draft Statement of Principles (para 7.4) identifies the primary financial statements as :

(a) the profit and loss account and the statement of total recognised gains and losses;
(b) the balance sheet; and
(c) the cash flow statement
together with the notes to the financial statements.

FRS 3 Reporting Financial Performance requires that a statement of total recognised gains and losses is used to segregate certain items of a holding or valuation nature from operating items included in the profit and loss account. Requirements relating to cash flow statements are set out in FRS 1.

The general interpretation has been that the Directives set out minimum requirements to which individual companies are free to add further information as they wish. The contents of FRS 3 are seen by the ASB as "supplementing those legal requirements, while remaining within their bounds" (paragraph 67). When the requirements of accounting standards go beyond the legal requirements, these would be viewed as additional information necessary so that the accounts give a true and fair view (Article 2.4).

(d) FEE's position:

Doubt remains whether the list as set out in Art 2.1 of the Fourth Directive is an exclusive list of the components of the "annual accounts". The discussion mainly focuses on the obligatory or voluntary inclusion of a cash flow statement and of an additional income statement in the accounts as required by IAS 1 para 7 c. Neither the Fourth nor the Seventh Directives require the presentation of statements of cash flows or comprehensive income.

FEE notes that the Commission sees no conflict between IAS 1 and the Directives in the requirement for a cash flow statement or a statement of performance to be a component of a set of financial statements be it the latter should not conflict with the application of the layouts prescribed by the Fourth Directive.

Reporting performance, either through the use of a second performance statement or other means, is an area in which there is a need to have the opportunity to develop possible solutions. These may conflict with existing formats set out in the Directive. No doubt other cases will arise so experimentation should not be precluded.

Article 2.6. of the Directive allows Member States to authorise or require the disclosure in the annual accounts of other information in addition to the information which must be disclosed in accordance with the Directive.

Additional information is always possible, even without specific Member States requirements, when it is included in the notes. Article 43 of the Directive provides a list of items to be included in the notes, which is not exhaustive. If the additional information is to be provided through an additional statement, such as a cash flow statement or a comprehensive income statement, legal change is considered necessary in some Member States to make this additional statement possible.

FEE considers that if such laws, where considered necessary, have not been passed, the companies should not be prevented from providing these additional statements; in this case, these statements could be considered as part of the notes. The presentation of this financial information by companies should make clear whether these statements are part of the annual accounts or not (category 3).

18. LAYOUT

The issue is whether the layout of the Directive is compatible with the presentation requirements as set out in IASs.

(a) IAS versus Directives:

- International Accounting Standards

  IASs do not mention a special layout for the elements of the financial statements.

  IAS 1:

  "para 66: As a minimum, the face of the balance sheet should include line items which present the following amounts:

  (a) property, plant and equipment;
  (b) intangible assets;
  (c) financial assets (excluding amounts shown under (d), (f) and (g));
  (d) investments accounted for using the equity method;
  (e) inventories;
  (f) trade and other receivables;

(g) cash and cash equivalents;
(h) trade and other payables;
(i) tax liabilities and assets as required by IAS 12, Income Taxes;
(j) provisions;
(k) non-current interest-bearing liabilities;
(l) minority interest: and
(m) issued capital and reserves."

"para 67: Additional line items, headings and sub-totals should be presented on the face of the balance sheet when an International Accounting Standard requires it, or when such presentation is necessary to present fairly the enterprise's financial position."

"para 68: This Standard does not prescribe the order or format in which items are to be presented. Paragraph 66 simply provides a list of items that are so different in nature or function that they deserve separate presentation on the face of the balance sheet. Illustrative formats are set out in the Appendix to this Standard. Adjustments to the line items above include the following:
(a) line items are added when another International Accounting Standard requires separate presentation on the face of the balance sheet, or when the size, nature or function of an item is such that separate presentation would assist in presenting fairly the enterprise's financial position; and
(b) the descriptions used and the ordering of items may be amended according to the nature of the enterprise and its transactions, to provide information that is necessary for an overall understanding of the enterprise's financial position. For example, a bank amends the above descriptions in order to apply the more specific requirements in paragraphs 18 to 25 of IAS 30, Disclosures in the Financial Statements of Banks and Similar Financial Institutions."

- Accounting Directives

Art 4.1 of the Fourth Directive:

"In the balance sheet and in the profit and loss account the items prescribed in Articles 9, 10 and 23 to 26 must be shown separately in the order indicated. A more detailed subdivision of the items shall be authorised provided that the layouts are complied with. New items may be added provided that their contents are not covered by any of the items prescribed by the layouts. Such subdivision or new items may be required by the Member States."

(b) Commission's and Contact Committee's interpretation:

In the Commission's interpretation document of 1998 the following is stated in paragraph 61: "If an undertaking which is required to prepare its consolidated accounts in conformity with the Seventh Directive wishes to satisfy at the same time the requirements following from other rules such as International Accounting Standards (IAS) or US Generally Accepted Accounting Principles (GAAP), this is only possible to the extent that the consolidated accounts remain in conformity with the 7th Directive. This is particularly relevant for the layouts of the accounts and for the valuation methods.

The consolidated balance sheet and profit and loss account must be drawn up in accordance with the requirements of the Directive. This means that no other adjustments to the layouts in the Fourth Directive than those allowed by Article 4 of this Directive can be made."

This has been confirmed in the 1999 conformity examination between IASs and the European Accounting Directives.

(c) Interpretations in Member States:

In using the formats UK companies have made use of the following legal provisions to adapt the statutory layouts to what seems best in their circumstances:

- the ability to adapt and combine Arabic numeral items (from Art 4) especially in the profit and loss account
- adding further items to the formats (under Art 2 and 4)
- omitting format headings where these are immaterial, under a general immateriality provision in the Companies Act (para 86 of Schedule 4)
- adapting the subtotalling and totalling of profit and loss account and balance sheet since the formats include relative few of these as captions.

(d) FEE's position:

FEE is of the opinion that there is no specific incompatibility between the Directives and IASs since IASs do not provide strict layout schemes. According to international accounting practice it might be considered necessary to modify the layout of a company's financial statements in order to give a more adequate presentation of its financial status, even though this specific presentation would not be in conformity with the Directive. The Commission takes a very strict position that the formats cannot be changed other than allowed by Art 4 of the Fourth Directive (subdivisions, new items added). FEE has difficulties in understanding why the criteria "modern accounting practice" as well as "dynamic interpretation" cannot be used also for amending the existing interpretation related of the layout schemes in the Directive where as they can for measurement issues. FEE therefore does not agree with the strict and formal approach the Commission takes in its interpretative communication despite that fact that no incompatibility between IASs and the Directive has been observed (category 3).

19. NETTING

The issue is whether netting requirements are compatible under IAS and the Accounting Directives.

(a) IAS versus Directives:

- International Accounting Standards

  Several IASs require the netting of assets and liabilities or income and expenditure items (such as: IAS 19 - Employee Benefits, IAS 32 - Financial Instruments: Disclosure and Presentation; etc).

  IAS 1 (revised 1997):

  "para 33: Assets and liabilities should not be offset except when offsetting is required or permitted by another International Accounting Standard."

  "para 34: Items of income and expense should be offset when, and only when:

  (a) an International Accounting Standard requires or permits it; (…)"

  "para 36: IAS 18, Revenue, defines the term revenue and requires it to be measured at the fair value of consideration received or receivable, taking into account the amount of any trade discounts and volume rebates allowed by the enterprise. An enterprise undertakes, in the course of its ordinary activities, other transactions, which do not generate revenue but which are incidental to the main revenue generating activities. The results of such transactions are presented, when this presentation reflects the substance of

the transaction or event, by netting any income with related expenses arising on the same transaction. For example:

(a) gains and losses on the disposal of non- current assets, including investments and operating assets, are reported by deducting from the proceeds on disposal the carrying amount of the asset and related selling expenses;

(b) expenditure that is reimbursed under a contractual arrangement with a third party (a sub-letting agreement, for example) is netted against the related reimbursement; and

(c) extraordinary items may be presented net of related taxation and minority interest with the gross amounts shown in the notes."

IAS 32:

"para 33: A financial asset and a financial liability should be offset and the net amount reported in the balance sheet when an enterprise:

(a) has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously."

- Accounting Directives

Art 7 of the Fourth Directive:

"Any set-off between asset and liability items, or between income and expenditure items, shall be prohibited."

(b) Commission's and Contact Committee's interpretation:

In the Interpretative Communication, the Commission states that "the setting-off cases referred to in Article 7 should not be confused with the cases where a legal right exists to set off claims and debts by virtue of the law or of a contractual arrangement. An immediate consequence of the legal right to set off is that only the remaining amount can and must be shown in the accounts. There exists, however, complex transactions where the income and expenditure involved is, from an economic viewpoint, without importance as regards the final outcome of the transaction. In some cases the true and fair view principle would require that only the final result of a complex operation be shown, although every case must be judged on its own merits".

(c) Interpretations in Member States:

In France, the interdiction to set-off as a result of Article 7 of the Directive appears to have been strictly interpreted. The following examples can be given:

(i) Gains or losses from disposal of fixed assets must be split: the carrying value of the assets disposed should be presented as an exceptional expense and the proceeds from the disposal as an exceptional income. In most other EU countries, the net amount forms an income item if it is a gain or, if it is a loss, an expense item.

(ii) It was considered as necessary to change the law in order to allow enterprises to recognise in the same income statement item the credit and debit rounding amounts resulting from the introduction of the euro.

The Italian law states that "the netting of items is not permitted". Nevertheless, in determining the amounts to be shown in the financial statements certain examples of netting are permitted as they are required by correct accounting practice or by accounting policies.

In Germany, Austria, Belgium, Ireland and the UK the netted figure of the proceeds and the book value (the gain or loss of the disposal) must be included in the profit and loss account. The gains (and losses) are aggregated and normally presented as “other operating income” (“other operating charges”). Gains and losses on different items may not be netted.

(d) FEE´s position:

FEE agrees with this general orientation of the interpretation of the Commission quoted under (b) showing the Commission intends to adopt a flexible position on the netting issue.

However, FEE has a concern about the current wording of the interpretation. If it is taken literally, the text would impose netting each time a legal right to set off exists. IAS requires netting in situations where not only a legal right exists but also where the intention of the enterprise is to use this right. In situations where only the right to set off exists without the intention to use it, application of IAS and of the Commission interpretation may result in a different presentation. FEE is of the opinion that clarification is needed from the Commission in that its interpretation is not meant to impose a new requirement (category 2).

FEE would suggest that the Commission interpretation should be amended so that it is consistent with IAS.

20. CURRENT/NON-CURRENT PRESENTATION OF ASSETS AND LIABILITIES

The question is whether the choice for the current and non-current presentation of assets and liabilities, which should be based on the nature of a company's operations according to IAS 1, is compatible with the Fourth Directive balance sheet formats.

(a) IAS versus Directives:

- International Accounting Standards

  IAS 1:

  "para 53: Each enterprise should determine, based on the nature of its operations, whether or not to present current and non-current assets and current and non-current liabilities as separate classifications on the face of the balance sheet. Paragraphs 57 to 65 of this Standard apply when this distinction is made. When an enterprise chooses not to make this classification, assets and liabilities should be presented broadly in order of their liquidity."

- Accounting Directives

  Art 15.1 of the Fourth Directive:

  "Whether particular assets are to be shown as fixed assets or current assets shall depend upon the purpose for which they are intended."

(b) Commission's Contact Committee's interpretation:

The Commission and the Contact Committee have addressed the issue in their 1998 conformity examination of IAS 1, which states:

"Paragraph 53 of IAS 1 states that "Each enterprise should determine, based on the nature of its operations, whether or not to present current and non-current assets and current and non-current liabilities as separate classifications on the face of the balance sheet. Paragraphs 57 to 65 of this Standard apply when this distinction is made. When an enterprise chooses not to make this classification, assets and liabilities should be presented broadly in order of their liquidity." The Contact Committee considers that European companies are bound by the layouts prescribed by the Accounting Directives, since the layouts cannot be derogated, except in those specific cases prescribed by the Directives themselves.

Consequently, the Contact Committee is of the view that the layouts prescribed by the Fourth Directive would require European companies to present their assets classified as between "current assets" and "fixed assets". This distinction may well give a different result from that which would be obtained from a "current assets" and "non-current assets" distinction required by IAS 1. For example, long-term debtors and stocks which are not expected to be realised or sold within the normal course of the enterprise's operating cycle would be classified as "current assets" under the Directives, yet classified as "non-current assets" under IAS 1. Similarly, marketable securities which are not held for use on a continuing basis in a company's business and which are expected to be realised in more than twelve months from the balance sheet date would be classified as "current assets" under the Directives, yet classified as "non-current assets" under IAS 1.

Consequently, "non-current assets" under IAS 1 will not always be able to be equated with "fixed assets" under the Directives, which means that European companies will not be able to apply paragraph 57 to 65 of IAS 1, as this would result in a presentation differing from that which is required by the Fourth Directive. In these cases, European companies would have to select the choice afforded by paragraph 53 of IAS 1 of not making the current/non-current distinction. These companies would then make use of the facility offered by the last sentence of paragraph 53 of presenting assets and liabilities broadly in order of their liquidity. The Contact Committee is of the opinion that compliance with the layouts prescribed by the Accounting Directives would ensure such presentation."

(c) Interpretations in Member States:

The Dutch Guidelines from the Council of Annual Reporting (RJ 254.102) recommend to include the short-term part of long-term debt under current liabilities which is different from IAS 1.

(d) FEE's position:

FEE estimates that due to the flexible wording of para 53 of IAS 1, this standard offers a presentation option, regardless of the fact that the choice between the current/non-current presentation and another presentation should normally be based on the nature of the enterprise's operations. FEE shares the Commission's opinion that as the current/non-current presentation in IAS 1 is not always compatible with the Fourth Directive balance sheet format, the other type of presentation as prescribed by IAS 1, based on the liquidity of assets and liabilities, should be adopted in order to be compatible with the Fourth Directive (category 3).

DEVELOPING ISSUES

21. FAIR VALUE ACCOUNTING OF CERTAIN FINANCIAL INSTRUMENTS

The Commission is undertaking a project to amend the Fourth Directive in order to introduce fair value accounting for certain financial instruments. A proposal setting out the amendments is expected in 1999. So far, the Fourth Directive applies the historical cost convention and only provides one major exception, which is included in Article 33 as a Member States option.

FEE welcomes the initiative taken by the Commission and hopes that the revision of the Fourth Directive will be sufficient to permit the adoption of the IAS interim solution on fair valuing for financial instruments of IAS 39 and will enable accounting standard setters to develop a long-term more comprehensive approach (category 1).

22. FUTURE PROJECTS

FEE is aware that the IASC is constantly working on new projects which might create further incompatibilities between IASs and the Accounting Directives. The projects on investment properties and agriculture might result in incompatibilities with the Accounting Directives. FEE would welcome an approach by the Commission that enables European companies to use IASs without generating conflicts with Accounting Directives.

Documents referred to in the study

Accounting Advisory Forum:	Cash Flow Statements, 1997.
Accounting Advisory Forum:	Prudence and Matching, 1997.
Contact Committee on the Accounting Directives:	Accounting Harmonisation in the European Community, 1990.
Contact Committee on the Accounting Directives:	An examination of the conformity between the international accounting standards and the European accounting directives, 1996.
European Commission:	Accounting Harmonisation: a new strategy vis-à-vis international harmonisation, 1995.
European Commission:	Accounting for the Introduction of the Euro, 1997.
European Commission:	Interpretative Communication concerning certain Articles of the Fourth and Seventh Council Directives on Accounting, 1998.
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Abbreviations used in the study

ASB	*Accounting Standards Board*
EC	*European Commission*
ED, E	*Exposure Draft*
FASB	*Financial Accounting Standards Board*
FEE	*Fédération des Experts Comptables Européens*
IAS	*International Accounting Standard*
IASC	*International Accounting Standards Committee*
IOSCO	*International Organisation of Stock Exchange Commissions*
OECD	*Organisation of Economic Cooperation and Development*
R&D	*Research and Development*
SME	*Small and Medium-sized Enterprise*
US-GAAP	*US - Generally Accepted Accounting Principles*