PROPOSAL FOR A DIRECTIVE
AMENDING THE FOURTH AND SEVENTH DIRECTIVES

BRIEFING NOTE

In the aftermath of recent corporate scandals both in Europe and elsewhere FEE (Fédération des Experts Comptables Européens, European Federation of Accountants) welcomes the Commission's initiative – as already announced in its Communication and Action Plan – to modernise company law and enhance corporate governance. We in particular welcome:

- *A fuller disclosure of related party transactions and off-balance sheet arrangements, including SPEs;*
- *A new focus on corporate governance disclosures; and*
- *Clarification of board responsibilities.*

Although we support the Commission's intention to improve the representativeness of financial statements by providing more useful information about the economic performance of companies, we believe it appropriate to discuss to which extent this goal – which is well-accepted for listed companies – should also apply for non-listed companies, especially for SMEs.

In this paper FEE, the representative organisation of the European accountancy profession, briefly outlines its three main concerns with the existing proposals, two of which aim to tailor the requirements for non-listed companies.

1. Location of the corporate governance statement and related audit implications may inhibit development of disclosure.

2. Need for clarification of the term "arrangements".

3. Disclosure requirements for related party transactions should not go beyond IAS 24.

In addition, we wish to share some observations on the internal control disclosure requirement proposed.

1. <u>Location of the corporate governance statement and related audit implications may inhibit development of disclosure</u>

The proposed *Article 46a* requires listed companies to include a corporate governance statement in the annual report. Auditors are required under *Article 51.1* of the Fourth Directive to express an opinion concerning the consistency or otherwise of the annual report with the annual accounts for the same financial year.

In some Member States, the annual report – which under the Commission's proposals would include the corporate governance statement – is subject to a full audit requirement. This causes serious problems because corporate governance statements encompass elements that are not objectively verifiable because they cover subjective judgmental areas, such as performance related assessments.

If a full audit requirement is inadvertently imposed as a result of the positioning of the corporate governance statement in the annual report, there may be resistance to further development of corporate governance codes. Companies might provide less information, in particular on performance related issues, thereby undermining transparency and the quality of information available to investors.

If it is not intended to impose a full audit requirement on the corporate governance statement, this fact needs to be clarified in the Directive itself.

Proposed Solution

Rather than proposing a location for the corporate governance statement the proposal for a Directive should instead require that the corporate governance statement be submitted to the shareholders together with the annual accounts and annual report. This would allow those Member States that made the annual report subject to a full audit to find a solution that best suits their disclosure and auditing requirements.

2. **<u>Need for clarification of the term “arrangements”</u>**

The term “arrangements in *Article 1* amending *Article 43 (1) (7a)* is too vague for compliance to be consistently applied or verified. We recognise this is a principle-based general term intended to cover a wide range of off-balance sheet transactions. However, there is a need for clarification or guidance that sufficiently narrows down the great volume of routine transactions and arrangements that could be potentially disclosed and still captures in a comprehensive way all relevant off-balance sheet vehicles.

This proposal should be seen as an interim solution. In the long term, the substance over form principle should be introduced in the Fourth Directive; this could be achieved by introducing the principle of beneficial ownership (as opposed to legal ownership a control only) into the Directives, which should be qualified with additional specific individual provisions yet to be determined.

As a second step, the consolidation provisions in the Seventh Directive need to be enhanced to capture more SPEs (Special Purpose Entities)[1] and off balance sheet arrangements. Only those arrangements not covered by the proposed enhancements of the Directives should be disclosed in the notes to the accounts. This approach leads to a more robust longer term solution for those companies not using IFRS to cope with the current accounting problems of off balance sheet and SPEs arrangements.

Proposed Solution

A more specific definition of “arrangements” needs to be developed, perhaps with the help of IASB or sufficient guidance needs to be given on what is meant by “arrangement” for instance in the form of examples.

A strong message should be given by referring to the longer term solution in the preambles by indicating the intention for a more substantial reconsideration of these requirements in the Directive.

[1] Post Enron, IFRS was enhanced to deal with this issue, by modifying SIC 12.

3. Disclosure requirements for related party transactions should not go beyond IAS 24

Article 1 amending *Article 43 7(b)* of the Fourth Directive requires disclosure of the nature, business purpose and amount of transactions with related parties for all companies. This disclosure goes beyond the requirements of IAS 24[2]: nature and business purpose are not required disclosures under IAS 24. Moreover there are additional preparation and audit costs associated with this additional disclosure. The Proposed Directive only requires disclosure of those related party transactions "not concluded under normal commercial conditions". Since there is a risk that such a criterion will easily be circumvented, we strongly emphasise that the disclosure requirements should not go beyond the requirements of IAS 24.

The 23 March 2005 proposal of the EU Council suggests – with which we fully concur – that for companies that apply IFRS, a disclosure in accordance with IAS 24 is sufficient. Hence, *Article 43 7(b)* of the Fourth Directive would cause extensive disclosures over and above the IFRS (as endorsed) requirements for companies that do not apply IFRS. We believe this to be too far reaching.

Proposed Solutions

The words "nature and business purpose" should be deleted.

Additional observations

We welcome the Commission's judicious approach of, over time, carefully considering the topic of disclosures about risk management and internal control. FEE published in March a Discussion Paper on Risk Management and Internal Control in the EU to contribute to the debate on internal control disclosure. At this stage, FEE believes that the description of the company's internal control and risk management systems should be restricted to the main features of internal controls over financial reporting.

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[2] IAS/IFRS are mandatory for listed companies for the consolidated accounts for the financial year 2005 onwards.