



Mr. Klaus-Heiner Lehne
Chair of the Committee on Legal Affairs
European Parliament
Bât. Altiero Spinelli – 10E205
Rue Wiertz 60
B - 1047 BRUSSELS

23 April 2012

Ref.: FRP/PRJ/TSI/SRO

Dear Mr. Lehne,

Re: FEE comments on the Legal Affairs Committee (JURI) Draft Reports of 26 and 28 March 2012 on EC proposal for the Transparency and Accounting Directives

On behalf of FEE*, we are writing in relation to some of the amendments currently discussed in JURI regarding the EC proposal for the Accounting Directive¹ and the Transparency Directive².

We believe that these issues and our comments thereon are also relevant to other European Parliament Committees dealing with the EC proposals for the Accounting and Transparency Directives.

Against this background, we thought that the additional comments below that supplement those presented in our letter of 24 February 2011 (attached) may contribute to informing your debate.

¹ EC proposal for the Directive on the Annual Financial Statements, Consolidated Financial Statements and Related Reports of Certain Type of Undertakings

² EC proposal for a Directive amending the Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and Commission Directive 2007/14/EC

We hope our comments, based on the experience and expertise of European accountants, may be of help to the Members of the European Parliament when considering these important matters. Should you wish to discuss any of these points in more details, please contact our CEO, Olivier Boutellis-Taft (obt@fee.be).

Sincerely,



Philip Johnson
President

Cc:

Ms. Sharon Bowles, Chair of ECON
Ms. Franziska Katharina Brantner, Rapporteur for opinion on the Accounting and
Transparency Directive
Mr. Elmar Brok, Chair of AFET
Ms. Fiona Hall, Rapporteur for opinion on the Accounting and Transparency Directive
Ms. Eva Joly, Chair of DEVE
Mr. Wolf Klinz, Rapporteur for opinion on the Accounting Directive
Ms. Arlene McCarthy, Rapporteur for the Transparency Directive
Mr. Vital Moreira, Chair of INTA
Mr. Helmut Scholz, Rapporteur for opinion on the Accounting and Transparency Directive
Ms. Sirpa Pietikäinen, Rapporteur for opinion on Transparency Directive
Danish Presidency of the Council of the European Union

Attachment:

FEE letter on the EC proposal for the Accounting and Transparency Directives issued on 24 February 2012.

APPENDIX 1 – COMMENTS RELATED TO THE AMENDMENTS PROPOSED TO THE TRANSPARENCY DIRECTIVE, WITH RELEVANCE TO THE ACCOUNTING DIRECTIVE

Disclosure on payments to governments should be in a report separate from the annual financial report³

- (1) We are supportive of the Commission initiative to improve transparency and accountability related to payments to governments of resource rich countries, although we do not believe that these objectives will be best met through disclosures mandated in the annual financial report as proposed in the amendments to the Transparency Directive.
- (2) In our view, the accounting requirements for the preparation of annual financial report including the financial statements should remain principles-based providing broad guidelines applicable for a variety of situations and on the basis of which the need for any particular disclosure can be determined. Describing specific and detailed rules for disclosures in such a level of granularity as proposed in the amendments would divert from this general principle and would result in information overload and unnecessary complexity in the annual financial report and especially the financial statements.
- (3) However, including payments to governments in a report separate from the annual financial report, specifically dedicated to such disclosures, would not be bound by this general principles as described above and could go into the level of detail and granularity as put forward.
- (4) Therefore, we recommend that the presentation of payments to governments should be included in a separate report outside of the annual financial report and outside the annual financial statements (for instance in a report available on the company's website).
- (5) This should be clearly stated in both the Accounting and Transparency Directives in a consistent way.
- (6) We also note that amendments to the Transparency Directive make reference to the principles of integrated reporting and would like to observe that 'Integrated Reporting' is a concept that is currently still in development. While FEE strongly supports the development of integrated reporting we are concerned that such a reference at this point in time may be misleading and may have unintended consequences including on the promising development of integrated reporting.

³ According to the Transparency Directive, the annual financial report is comprised of the "audited financial statements", the "management report" and the "statements made by the persons responsible within the issuer"

APPENDIX 2 - COMMENTS RELATED TO THE ACCOUNTING DIRECTIVE

General accounting principles should be applied to all aspects of financial reporting

- (7) FEE supports a principles-based Accounting Directive. Therefore, we welcome the introduction of high level general accounting principles, e.g. true and fair view, materiality, substance over form and prudence. Such principles should be applicable to all annual financial statements of all limited liability companies, regardless the size of the company.
- (8) Some of these principles are not novel to the Accounting Directive but they are essential for accounting to fulfil its primary function of providing relevant and useful information to various users. For the faithful representation to be achieved, it is important that these interrelated concepts be generally applicable to all aspects of financial reporting including recognition, measurement, presentation and disclosure.

The application of the prudence principle does not permit bias

- (9) We note that the amendment introduce the prudence principle. We support the inclusion of this principle, if it is meant as taking into account a certain degree of caution in the exercise of judgements needed in applying the detailed recognition and measurement requirements and in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities and expenses are not understated.
- (10) However, we believe the future Accounting Directive should clarify that the application of prudence does not allow the arbitrary understatement of assets or the income, or the arbitrary overstatement of liabilities or expenses.

The materiality principle contributes to relevant financial information and simplification

- (11) We are concerned with the amendments proposed regarding the materiality principle as they suggest limiting the use of the materiality principle to presentation and disclosure while removing it from referring to recognition and measurement which are two interrelated concepts.
- (12) The materiality principle (as an aspect of relevance) simply provides an exemption from complying with *all* the accounting requirements if the transaction is considered immaterial and would not impact the opinions and decisions of users based on the financial statements as a whole. Information contained in the financial statements still needs to remain complete in all material aspects in order to comply with the true and fair view. It does however not at all mean that a transaction would not be recognised in the financial statements or not be appropriately measured, but it allows for departure

from the *normal* recognition and measurement principles in relation to immaterial transactions. For instance, it should be possible that items with relatively low (immaterial) purchase price are immediately recognised and recorded as an expense in the profit and loss account instead of being capitalised, even if they are used over a period of time. To record these items as an asset and to depreciate them over their useful lifetime is often not justified on the basis of the uselessness of the result. Therefore, the application of the materiality principle contributes to the simplification of accounting for companies of all sizes.

- (13) Hence, we support the application of this principle to the entire accounting process including the interrelated concepts of recognition and measurement, and therefore the limitation of its use should not be allowed, not even via Member State option.

The principle of true and fair view should remain a cornerstone of financial reporting

- (14) We noted that some amendments propose to remove the reference to the true and fair view in Article 5.3 as a basis for allowing departure from the general principles of the Accounting Directive in exceptional cases. At the same time, a new provision permitting Member States to define these exceptional cases and lay down special rules for this purpose is added to Article 4.4. Together, these two amendments can easily be interpreted in a way that unfortunately reduces the adherence to the principle of the true and fair view in the preparation of financial statements.
- (15) The true and fair view is one of the most prominent and globally recognised general principles of accounting. Together with the substance over form principle, it requires the company to provide reliable financial information truly reflecting the underlying economic reality of the transactions, not only their legal form. This principle is aimed at achieving compliance with all the other accounting principles. All the accounting requirements should be subordinated to this principle and none should directly or indirectly prevent true and fair presentation.
- (16) The proposed amendments seem to give an option to Member States to introduce specific rules allowing departure from the general accounting principles, but not necessarily with the objective of contributing to compliance with the true and fair view but rather the contrary. This may have negative unintended consequences.
- (17) The departure from the general principles should only be allowed in exceptional cases to comply with the true and fair view and definitely not to divert from compliance with the true and fair view principle. Such departure should therefore not be prescribed in special rules laid down at Member States level. Hence, we recommend retaining the original EC text in both Article 5.3 and Article 4.4 without any amendments.

Fair value accounting should be permitted as a Member State option

- (18) We note that it is proposed to remove the provisions allowing Member States to permit or require the adoption of fair value accounting as an alternative measurement base for financial instruments and fixed assets.
- (19) In this respect, it is important to note that since the 2005 IAS Regulation requiring the use of IFRS for consolidated accounts of publicly-traded companies came into force, Member States have also been able to permit or require the application of IFRS for annual accounts (financial statements) of publicly-traded companies and of non publicly-traded companies.
- (20) This means that Member States can already permit or require for all companies, which fall under the scope of the 4th and 7th Directives, the use of the full set of IFRS which permits the use of fair value accounting as a measurement base for certain relevant account balances.
- (21) In some cases, fair value accounting, which reflects current market conditions, would provide more relevant information about the value of the underlying asset or liability than cost accounting, for instance for the valuation of financial instruments held for trading on a liquid market.
- (22) In order to facilitate comparability and thus increase the usefulness of financial statements and information, we recommend retaining a Member State option permitting or requiring fair value accounting as a measurement base for certain relevant account balances. This can be achieved by different means.

Consideration should be given to filing financial statements using XBRL

- (23) In the context of providing reliable and relevant information to the users, we would like to emphasise the important role that eXtensible Business Reporting Language (XBRL) can play in contributing to such goals. Properly implemented, XBRL enabled documents can provide a variety of benefits to reporting companies of all sizes. FEE supports initiatives considering the application of XBRL in financial reporting. We note the Economic and Monetary Affairs Committee makes a reference to XBRL as well.

Further concerns about the reduction of minimum disclosures

- (24) The original EC proposal created a fully harmonised reporting regime for the preparation of small companies' financial statements while prohibiting the Member States to require the presentation of further information. In our previous letter we expressed our concern about the fully harmonised regime and the limited disclosures for small companies.

- (25) We note that further reductions to the minimum disclosures are proposed by removing the disclosure requirement for post balance sheet events for any type of companies as well as the disclosure of related party transactions for small and medium-sized companies.
- (26) Such removals reduce the quality and the usefulness of the financial information available to the users, e.g. creditors and bankers and in some Member States the tax authorities. Finance providers require clear and fair presentation of the reporting company's net worth, operation and cash flow.
- (27) In particular, related party disclosures play an important role to support this information need because they could have a significant impact on the profit and loss account and the financial position of the company. They have the potential for distorting information since transactions between related parties (for instance a transaction between the company and its owner-manager) may have been entered into on conditions other than the ones applied between unrelated parties. For instance, they might use contract terms and purchase prices that might not have been used for other customers (i.e. what could be referred to as 'normal market conditions'). Therefore, providing information about such transactions including transfer of resources, services or obligations between the reporting company and a related party (either an entity or a person) is essential to support high quality financial reporting for companies of all sizes.
- (28) Therefore, we recommend reintroducing as mandatory disclosures the post balance sheet items for medium-sized, large and public interest entities. We also recommend mandatory disclosure of related party transactions for all types of companies, including small and medium-sized ones.
- (29) Additionally, as already recommend in our previous letter, in the context of the limited disclosure regime for small companies, we recommend deleting Article 17.2 and giving Member States an option to add further disclosure requirements that they deem necessary under their particular circumstances in order to comply with the true and fair view principle.

Indirect cost should not be mandated to be part of the cost of the produced item for small companies

- (30) We noted that an amendment to the definition of the "production cost" introduces a requirement to include a reasonable portion of other costs indirectly attributable to the produced item in the cost of the inventory for all companies.
- (31) In our view, it should not be mandated that indirect costs be part of the production cost for small companies. Such companies should remain able to decide whether or not such costs are a necessary part of the cost of inventory based on their own judgement. When considering facts and circumstances such as the cost to produce

such information or its relevance to users, it may not always be appropriate to include indirect cost, e.g. remuneration of the supervisor in the production line or cost of design of the product, in the cost of the item produced.

- (32) Therefore, should the Parliament wish to achieve further simplification and reduction of administrative burdens for small companies, we would recommend reintroducing the word “may” instead of “shall” in the definition of production cost. This would allow small companies to decide about the composition of the production cost based on their special circumstances.

Auditor's involvement with annual financial statements

- (33) We note with interest some amendments in relation to the involvement of the auditor with the annual financial statements. We are considering these amendments and other matters related to auditing in further detail and propose to comment on them separately at a later point in time.

APPENDIX 3 - FEE LETTER TO KLAUS-HEINER LEHNE ON THE EC PROPOSAL FOR THE ACCOUNTING AND TRANSPARENCY DIRECTIVES

Mr. Klaus-Heiner Lehne
Chair of the Committee on Legal Affairs
European Parliament
Bât. Altiero Spinelli – 10E205
Rue Wiertz 60
B - 1047 BRUSSELS

24 February 2012

Ref.: FRP/PRJ/TSI/SRO

Dear Mr. Lehne,

FEE is pleased to provide you its view on the EC proposal for a Directive on the Annual Financial Statements, Consolidated Financial Statements and Related Reports of Certain Type of Undertakings (“the Proposal”) including comments on amended Transparency Directive⁴ (“the Transparency Directive”), which have been issued by the Commission on 26 October 2011.

Building on a thorough debate among our expert groups and different constituencies, we trust the comments below reflect a useful European perspective on these matters, although some of our member organisation may present certain specific comments and proposals rooted in their respective national environments.

In our letter we would like to share firstly some general observations followed by a few suggestions for changes to specific provisions of the Proposal and the Transparency Directive that you may wish to consider.

FEE supports the objectives of better regulation and simplification

- (1) FEE welcomes proposals aimed at better regulation and simplification, as well as reducing excessive and unnecessary administrative burdens. Measures seeking to directly help job creation in the Member States have an important role to play in

⁴ EC Directive proposal on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and Commission Directive 2007/14/EC

helping companies in general and in particular small and medium sized companies, increasing productivity and promoting entrepreneurship. It is conceivable that entrepreneurship, through its innovation, greatly contributes to economic recovery and sustainable growth.

- (2) We also support the objective of improving European-wide comparability of the financial statements, especially for medium sized and large non-listed companies. This is particularly important in order to create a single market and support increased cross border operations as well as mergers and acquisitions of many European businesses.
- (3) We also welcome the Commission's efforts to allow simplification in the reporting obligations of "small issuers", to increase financial integration of European securities markets and to redirect the focus on longer term results.
- (4) We commend the Proposal for replacing the existing two Accounting Directives by a single one. They have been in place for many years and amended only on a piecemeal basis, resulting in requirements that are not addressing all the currently relevant accounting subjects. The introduction of the materiality principle and the mandatory use of the substance over form principle are particularly welcomed in this respect in order to avoid information overload, support simplification as well as reflect the economic reality and not merely the legal form of the transaction.

The Accounting Directives need a complete overhaul

- (5) The Commission should, in our view, have considered and carried out a broader exercise focused on a more fundamental review to better adapt the Directives to 21st century accounting requirements characterised by principles-based standards and reflecting the dynamic developments in corporate reporting. A more holistic approach, which we strongly favoured, would have required a complete revision of the existing Accounting Directives.
- (6) Therefore, we see the current Proposal as a positive step, although only first step towards such a goal. In our view, the future reporting requirements should introduce high-level principles based on an overarching accounting framework which sets the boundaries upon which detailed requirements can be outlined. This principles-based accounting framework should provide a sound conceptual basis for financial reporting describing the objective and the users of the financial statements as well as other qualitative characteristics of useful financial information such as relevance, timeliness, verifiability and understandability. In addition, common examples should be provided as guidelines which can be practically used in a variety of circumstances. Introducing unnecessary detailed requirements for all specific circumstances reduces flexibility and adaptability to the evolving needs of businesses and report users while the accounting theory and international financial reporting standards continue to evolve.

Accounting and auditing should not be characterised as burdens

- (7) We find it inappropriate that the Proposal characterises accounting including the preparation of the financial statements and auditing as "burdens" without recognising its beneficial role and added-value to corporate management and the economy as well as its public interest dimension. While there have been attempts to measure the costs, no real efforts were made to assess the benefits.
- (8) In practice, accounting is an essential management tool: it facilitates access to finance and creates the trust that enables trade. Auditing provides independent and objective assurance designed to add to the credibility and reliability of the financial information and contributes to enhancing the operational effectiveness of the internal control system related to financial reporting.
- (9) In order to achieve real benefits for companies and society, the simplification objectives need to be balanced with other public policy goals such as stakeholders' information, investors' protection, markets' stability, the reduction of transaction costs and the cost of capital; this is particularly important for SMEs' access to finance. An approach which characterises accounting and auditing as "burdens" without considering their added-value will in reality fail to achieve its envisioned benefits.
- (10) There is also a risk that a disproportionate reduction of the accounting and auditing requirements for small companies could lead to a significant reduction in the quality and usefulness of the financial information available to users such as trade creditors, business partners, managers, investors, employees, etc. Reliable and relevant financial information to users is a significant contributor to the efficient functioning of the economy and internal market. It also supports integration of new economies into the EU and dissemination of best practices.

Permit the use of IFRS for SMEs

- (11) From a European perspective, FEE regrets that the Proposal does not seize the opportunity to allow Member States to make their own decision regarding IFRS for SMEs⁵. It is unfortunate that this opportunity is missed because of differences in the accounting treatment of relatively minor matters between the Proposal and the current IFRS for SMEs⁶.
- (12) FEE supports high quality and principles-based global standards in financial reporting, which promote consistency and transparency: we believe that IFRS for SMEs fulfils these characteristics particularly for larger SMEs and large unlisted entities.

⁵ However France and Italy do not support this.

⁶ Differences are in the areas of presentation of unpaid subscribed share capital and the amortisation periods for goodwill whose expected useful life cannot be reliably estimated.

(13) There are a number of potential benefits to adopting IFRS for SMEs, including enhancing the comparability of financial statements, providing more relevant information to financial statement's users while balancing the costs and benefits from a preparer perspective and improving access to international funding. In conducting business with limited liability companies in different countries, lenders, creditors and other investors would benefit from a comprehensive financial reporting standard, which would improve the efficiency of cross border activities. Furthermore this would allow Member States which currently, in line with the relevant IFRS regulation, require the use of full IFRS for all limited liability companies, to ease the requirements for other than large companies without the necessity to develop their own national accounting framework.

FEE questions the real benefits of a fully harmonised reporting regime for small companies

(14) We support the proposed principle which requires the company, regardless of its size, to ensure that the financial information included in the financial statements gives a true and fair view of its financial condition and operating result.

(15) Article 4, General Provision, together with Article 17, Content to Notes to the Financial Statements, create a fully harmonised regime for the preparation of small companies' financial statements. Small companies will, overall, have a more limited disclosure regime, when compared to the previous Directives. Member States are not allowed to require the presentation of further information although such information is very likely to be needed to fulfil the general principle of true and fair view.

(16) Therefore, there is a concern that the prohibition of additional mandatory disclosures for small companies is likely to lead to a decline in the quality of the financial information available to users, while it will not result in any significant cost reductions because detailed accounting records containing such additional information must be kept by the company. Instead, it will mean that relevant information is not disclosed and stakeholders will lose confidence in whether all relevant disclosures have been made. Stakeholders, e.g. creditors and bankers, will continue to require a certain level of information, but in varying forms, thus creating additional reporting burdens for small companies. Relevant and reliable information not only enhances transparency, but is in many, if not all cases, needed for tax compliance.

(17) It is also difficult for us to follow the logic of EU legislation which requires full harmonisation of listed (through the mandatory adoption of IFRS) and small companies, whereas it proposes minimum harmonisation for medium-sized and large unlisted companies.

(18) For these reasons, we recommend deleting Article 17.2 and giving the Member States the option to add those further disclosure requirements for small companies that they deem needed under their particular circumstances, since we believe this reflects fully the subsidiarity principle of the EU Treaties.

Clarify the audit requirement for small companies

(19) The proposal lays down the general audit requirement for the annual financial statements of medium and large companies. However, it remains silent regarding the audit of small companies.

(20) FEE believes that Member States should continue to be able to decide whether they want to exempt small companies from audit requirements, as they are best placed to determine the actual need of small entities to be exempted from audit based on the principle of proportionality, the relative size of companies and the characteristics of the economy. The consequences of an exemption on tax assessment and inspection systems of individual Member States can also be a major matter of concern.

Permit Merger accounting as a simplification measure

(21) The provisions allowing merger accounting have been removed from the Proposal. This is likely to be of concern to many companies as merger accounting is widely used, particularly when accounting for transactions under common control or for group restructuring, where such treatment is also allowed by IFRS. It would also be burdensome to require acquisition accounting which requires detailed fair value assessment of assets and liabilities in these circumstances.

(22) Therefore, we recommend reinstalling the option for Member States to permit, but not require, merger accounting for transactions under common control or for group restructuring.

Consider the benefits of Cash flow statements

(23) We are of the view that the current drafting represents a missed opportunity to prescribe the preparation and presentation of a cash flow statement for certain types of companies in the Proposal. The cash flow statement is regarded as an essential tool to provide relevant information about the cash generating capacity of a company and to assist in making the connection between the balance sheet and profit and loss account. It gives, in combination with the profit and loss account, a more rounded and complete view of the performance and cash generation capacity of a company, which is particularly important in periods of instability.

(24) Therefore, we believe that the inclusion of the cash flow statement in the annual financial statements should become mandatory for large companies and should remain as an option for Member State to require it for medium-sized companies. For small companies the benefits of providing such a statement may not outweigh the costs of preparation, therefore we support the EC proposal not to require such statement for small companies.

Country-by-Country reporting should be in a separate report

(25) Both the Proposal and the Transparency Directive introduce a requirement for companies in the extractive industries and certain forestry companies to provide disclosures about their payments to government on a country-by-country basis.

(26) FEE is supportive of the efforts by the Commission to improve transparency and accountability in resource rich emerging economies, although we do not believe that these objectives can best be met through disclosure in the annual report, since this document is produced particularly to meet the information needs of investors.

(27) Therefore, we recommend that the Proposal and Transparency Directive explicitly provide for presentation of this information in a separate document outside of the annual report, probably available on company's websites. In addition, having divergent requirements in these two directives would be inefficient and burdensome. Therefore consistency between the two directives should be ensured.

Regulate distributions from company's reserves in the Company Law Directive

(28) Article 6.2 imposes restrictions on distributions from the revaluation reserve. However, the Second Company Law Directive is, in our view, the best place to deal with restrictions over distributions. The Accounting Directive regulates financial reporting, not distributions, and the inclusion of the restriction on the distribution of the revaluation reserve in Article 6.2 is therefore an anomaly and does not cover all similar cases.

(29) Therefore, we suggest deleting the third sentence in Article 6.2.

Avoid prescribing standard forms for management reports in the Transparency Directive

(30) We understand that the EC's intention to propose standard forms for management reports developed by ESMA was to simplify the reporting requirements for small issuers in the Transparency Directive. However, we are concerned that a *one size fits all* approach will fail in this case as management reports cover different aspects of a

company's business. Moreover, companies of various sizes from a whole range of industries face different risks and issues that need to be disclosed in such reports. FEE therefore recommends avoiding standardised forms and templates as legislated in Article 4 point 7.

Overall, we believe that the Proposal and the Transparency Directive should be supported and improved. We hope our comments, based on the experience and expertise of European accountants, may be of help to Members of the European Parliament when considering this important matter. Should you wish to discuss any of these points in more details, please contact our CEO, Olivier Boutellis-Taft (obt@fee.be).

Sincerely,

Philip Johnson
President

*** About FEE**

FEE (Fédération des Experts-comptables Européens – Federation of European Accountants) is an international non-profit organisation based in Brussels that represents 45 institutes of professional accountants and auditors from 33 European countries, including all of the 27 EU Member States.

FEE has a combined membership of more than 700.000 professional accountants, working in different capacities in public practice, small and big accountancy firms, businesses of all sizes, government and education, who all contribute to a more efficient, transparent and sustainable European economy.