

Policy Statement

Standing for trust and integrity

November 2012



Financial Reporting

FEE Policy Statement on main issues of the accountancy profession on the EC Proposals for the recast of the 4th and 7th Accounting Directives

Introduction

FEE has been following closely the debate on the EC Proposals for the recast of the 4th and 7th Accounting Directives ("the EC Proposals") and also expressed detailed views in three public comment letters¹ on relevant matters since the issuance of the EC Proposals on 25 October 2011. Following the final report of the European Parliament Legal Affairs Committee (JURI) of 25 September 2012 and the Presidency compromise

text of the Council of 19 June 2012, FEE wishes to further inform the debate and help close the gap between the differences of views in the European Parliament and the Council. FEE considers that those involved in the decision should be in a position to make the best choice for Europe at what is a critical moment for the European economy and the internal market.

Simplification and reduction of administrative burdens

FEE has always been supportive of proposals aimed at better regulation and simplification. Measures seeking to reduce excessive and unnecessary administrative burdens have a significant role to play in increasing productivity and promoting entrepreneurship, especially for small and medium sized companies (SMEs).

However, in order to achieve real benefits for companies and society, in our view, the simplification objective needs to be meaningful and balanced with other public policy goals such as stakeholder information, investor and creditor protection, market stability, the reduction of transaction costs and the cost of capital. This is particularly important to enhance SMEs' access to finance in the current climate.

The EC Proposals are also very important for SMEs. They are the sector of business which prepares the financial and other information provided

by companies covering more than 99% or, in the larger jurisdictions, the overwhelming majority of the economic activity.

Therefore, it is inappropriate that the EC Proposals characterise accounting, including the preparation of financial statements and auditing, as "burdens" without recognising their beneficial roles, added value to the economy and their public interest dimension.

Accounting and auditing are not "administrative burdens" but essential tools to enable managers to manage, investors to invest and enterprises to trade, grow and create wealth and employment; accounting and auditing also have a public interest dimension by contributing to improving the functioning of markets and enhancing corporate governance, transparency and stability.

Accounting and financial reporting is not about Country-by-Country reporting

FEE notes that the political debate as it has developed to date has largely been centred on matters related to Country-by-Country reporting; this is evidently an important matter and we are supportive of the European Commission's initiative to increase transparency and accountability related to payments made to governments of resource rich countries.

However, other fundamental issues of a more "technical" accounting

nature, that after all were expected to be the main topics in an Accounting Directive and which will have a fundamental and lasting impact on the internal market, seem to be insufficiently addressed. Whilst FEE is supportive of efforts to improve transparency and accountability, it does not believe that Country-by-Country reporting should divert attention from the important goal of developing an accounting framework *fit for purpose* for the European economy.

¹ Link to the FEE website for FEE public comment letters on the EC recast of 4th and 7th Directives: http://www.fee.be/news/default.asp?library_ref=2&category_ref=214&content_ref=1512 and http://www.fee.be/publications/default.asp?library_ref=4&content_ref=1516

Country-by-Country reporting should also not obscure the understanding of financial information and FEE is therefore of the view that it is more appropriate that it remains in a separate report. This is also likely to best serve the needs of the stakeholders who have a particular interest in this information.

FEE would encourage everyone involved in the debate to take a broader perspective on the EC Proposals and focus on strategic objectives underpinning an accounting framework which is likely to remain applicable in Europe for a considerable period of time in the future. The future reporting requirements should introduce a high-level principle-based overarching accounting framework which sets the boundaries for detailed requirements. Many detailed aspects of the proposal have been discussed; however, the attempt to take the necessary holistic approach to develop a principle-based accounting framework has fallen short of expectations.

Therefore, FEE would like to offer further reflections on some specific elements of the EC Proposals, as well as on some subsequent amendments proposed by the EP JURI Committee and the EU Council. Building on thorough debate among expert groups and experienced practitioners from different constituencies, FEE believes the comments below provide the collective view of the European accountancy profession on these matters.

FEE encourages all parties involved in the trilogue to redirect their attention and focus on key accounting issues that are essential for the establishment of a robust and long-lasting European accounting framework.

Main matters related to accounting to be considered further

Introduction: general accounting principles should be applicable to all aspects of financial reporting

FEE has always been a long standing supporter of setting robust, high quality principles at European level and continues to be of the view that a principle-based approach to accounting and financial reporting is preferable over a rule-based and legalistic approach. A principle-based approach is capable of coping with developments arising in practice and also facilitates effective take-up as the current regulations and standards differ from one EU Member State to another.

As FEE supports a principle-based Accounting Directive, it welcomes the introduction of high level general accounting and reporting principles, such as the true and fair view, as well as materiality, substance over form and prudence. These principles are instrumental for accounting and reporting in fulfilling its primary function of providing relevant and useful information to users. These interrelated concepts should be generally applicable to all aspects of accounting and financial reporting including recognition, measurement, presentation and disclosure.

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

The EC Proposals create a fully harmonised disclosure regime for the preparation of small companies' financial statements. This would mean that the Member State regimes that exist currently for disclosures or notes to the financial statement would be replaced by a full maximum harmonisation approach. Member States would therefore no longer be allowed to require the presentation of any additional information for small companies, whether or not the Member State considered that such additional information would be needed to fulfil the general principle of presenting a true and fair view of the financial position and performance of a small company. The general provision of financial statements having

to give a true and fair view of the entities' assets, liabilities, financial position and profit or loss is now prescribed in the EC Proposals. A fully prescribed reporting regime for small entities seems to contradict this general provision.

In addition, the final report of the JURI Committee introduced further reductions to the prescribed set of disclosures and removed the requirements to disclose off-balance sheet transactions for small companies, related party transactions for small and medium-sized companies and post balance sheet events for any type of company.

In the current economic climate it is vital that businesses are able to access capital, an issue of particular importance for SMEs. In this respect, transparent financial information is crucial. We are therefore concerned about the possible effect of a further reduction of disclosures. This is likely to reduce the quality and the usefulness of the financial information available to users, while it will not result in any significant cost reductions, since companies will still be required to keep detailed accounting records. Instead, it will mean that relevant information is not disclosed and stakeholders may lose confidence in whether all relevant disclosures have really been made. Instead, FEE expects that some stakeholders, such as creditors, may in any case continue to require such relevant information, but in varying forms and at different points in time, thus creating additional reporting burdens for small companies.

However, it is encouraging to see that the Danish Presidency compromise text of the Council of 19 June 2012 at least introduces a Member State option to require, at national level, disclosures on off-balance sheet transactions, related party transactions (which are essential to transparency and trust) and post balance sheet events. We also welcome the Council's extension of the list of disclosures to some additional key items. It would be helpful to consider Council's position rather than seeking to restrict transparency further.

FEE urges all parties involved in the trilogue to re-introduce the mandatory disclosures on off-balance sheet and related party transactions as well as post balance sheet events for small companies.

FEE also recommends giving the Member States an option to require further disclosures for small companies that they deem necessary under their local and particular circumstances to comply with the overarching principle of presenting a true and fair view of the financial position and performance for all reporting entities, including small ones.

Fair value accounting should be permitted as a Member State option

The existing Accounting Directive provides an option for Member States to permit or require fair value accounting as an alternative measurement base for specific assets. In practice, some Member States already use this option and either allow or require the measurement of specific assets (e.g. investment properties) at fair value as it may provide more relevant information to users of the financial statements.

While the EC Proposals intended to keep this option, the JURI Committee in its final report proposes to prohibit this practice by the deletion of Article 7.1b which provided for a Member State option to use fair value accounting for specific assets, mainly for investment properties.

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.²

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 fair value accounting as a measurement base for certain relevant account balances.

In order to increase the usefulness of information in the financial statements, we encourage retaining a Member State option permitting or requiring fair value accounting for certain relevant account balances.

FEE supports the Council's approach to maintain the EC Proposal allowing Member States to permit or require the measurement of specific assets, mainly investment properties, at fair value. A blanket prohibition of fair value accounting as proposed by the JURI Committee will have significant negative implications for transparency and for those Member States that have already adopted this approach.

Therefore FEE urges the retention of the Member States option during the trilogue discussions.

Make the use of IFRS for SMEs possible

From a European perspective, FEE regrets that the EC Proposals do not seize the opportunity to allow EU Member States to make their own decision to opt to use IFRS for SMEs or not. This would be of help to certain jurisdictions, in particular Member States with limited standard-setting capabilities. It would be unfortunate if differences between the EC Proposals and the current IFRS for SMEs for the accounting treatment of relatively minor matters may impede the use of this standard in EU Member States which would like to use it.

FEE urges all the parties involved in the trilogue to permit Member States to opt for the use of IFRS for SMEs for national reporting purpose if they so desire. The Accounting Directive should not include obstacles which go against this.

Permit merger accounting as a simplification measure

FEE notes that the provisions allowing merger accounting are removed from the EC Proposals. This is likely to be of concern to certain companies as merger accounting is widely used and in practice often better reflects the economic substance of certain types of business combination, e.g. when accounting for transactions under common control or for a group restructuring. In the absence of merger accounting, it would also be burdensome to always require acquisition accounting which requires detailed fair value assessment of assets and liabilities which is not useful in these circumstances.

Therefore, we welcome the permission of merger accounting in the Danish Presidency compromise text of the Council (new Article 25a). This accounting option simplifies accounting and thus reduces costs for preparers. It is unfortunate that the final report of the JURI Committee has not also proposed this amendment.

² Reference is made to the EC survey results on the implementation of the IAS Regulation (1606/2002) in the EU and EEA for more details on countries using the option to permit or require IFRS for annual accounts of publicly-traded companies and of non publicly-traded companies: http://ec.europa.eu/internal_market/accounting/docs/ias/ias-use-of-options_en.pdf.

FEE calls on the parties involved in the trilogue discussions to all agree on the Council's compromise regarding new Article 25a permitting merger accounting.

Requiring cash flow statements would benefit enterprises and stakeholders

It is a missed opportunity not to have prescribed the preparation and presentation of a cash flow statement for certain types of companies in the EC Proposals.

The cash flow statement is 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.

It is unfortunate that the European Parliament Economic and Monetary Affairs (ECON) Committee's proposal to require the preparation of the cash flow statements for medium and large companies has not been carried forward in the final report of the JURI Committee.

FEE encourages the European Parliament as well as the Council and European Commission to take forward the ECON Committee's proposal related to the preparation of a cash flow statement during the trilogue discussions. FEE recommends as a compromise to require the inclusion in the annual financial statements of a cash flow statement for large companies and to introduce a Member State option to require it for medium-sized companies.

Auditing of small companies

Auditing should not be characterised as a burden

As stated above, the EC Proposals wrongly characterise accounting and auditing as "administrative burdens" and ignore their benefits and added-value to the economy as well as their public interest dimension.

Auditing provides independent and objective assurance designed to add to the credibility and reliability of the financial information disclosed. It also enhances the operational effectiveness of the internal control system related to the financial reporting process.

Indeed, the lack of audited financial information could lead to significant reduction of quality in the financial information available to users. Reliable and relevant financial information contributes significantly to the efficient functioning of enterprises, the economy and the internal market. It also supports European integration and dissemination of best practices which is of particular importance for less mature market economies. Good practices in accounting and auditing also contribute to structural reform. It opens up the benefits of the internal market to small entities and even more so to medium-sized entities.

Considering the wide diversity of circumstances prevailing across the EU, FEE believes that EU Member States need to retain the full possibility to decide whether they want to exempt some or all small companies from the audit requirement, as they are best placed to determine the appropriateness of such exemption on the basis of the principle of proportionality, the relative size of companies and the characteristics of their economy.

In the current climate, the consequences of an exemption on tax assessment and inspection systems of individual Member States can also be a major matter of concern. The Accounting Directive should provide the EU Member States with a clear legal basis to support this option.

FEE calls on the European Parliament as well as the Council and European Commission to retain the ECON Committee's proposal to include a requirement to audit the financial statements of small entities and provide EU Member States with an option to decide whether they want to exempt some or all small companies from the audit requirement.

About FEE

FEE (Fédération des Experts-comptables Européens – Federation of European Accountants) represents 45 professional institutes of accountants and auditors from 33 European countries, including all of the 27 European Union (EU) Member States. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 700.000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent and sustainable European economy.