Date

21 February 2005

Le Président

Fédération des Experts Comptables Européens AISBL

Rue de la Loi 83
1040 Bruxelles
Tél. 32 (0) 2 285 40 85
Fax: 32 (0) 2 231 11 12
E-mail: secretariat@fee.be

Dr. Alexander Schaub
Director General
European Commission
Internal Market DG
Rue de la Loi 200
B – 1049 BRUXELLES

Cc: Mr. Jürgen Tiedje
Mr. Lars Vind Sørensen

Dear Dr. Schaub,

Re: Proposal for a Directive Amending the Fourth and Seventh Directives

FEE (Fédération des Experts Comptables Européens, European Federation of Accountants) has considered the proposal to amend the Fourth and Seventh Directives in relation to board responsibilities, related parties, SPEs, and corporate governance statement and is pleased to submit its comments and observations. FEE welcomes the initiative of the Commission as already announced in the Communication and Action Plan to modernise company law and to enhance corporate governance.

In the aftermath of recent scandals both in Europe and elsewhere FEE particularly supports:

- A fuller disclosure of related party transactions and of off-balance sheet arrangements including SPEs;
- A new focus on corporate governance disclosures;
- A clarification of the board responsibilities, notably the collective board responsibility.

Although we understand the Commission's intention to improve the representation of faithfulness of financial statements by providing a more useful information about the economic performance of a company, we consider it appropriate to discuss in more general terms to which extent this goal - which is well-accepted for listed companies - should also apply for non-listed companies, especially for SME´s.

Our main comments on the proposal to amend the Fourth and Seventh Directives are:

- There is a need to establish a definition of the term "arrangements" in Article 43.1 (7a) although we recognise how difficult developing such a definition will be.
- The formulation of the requirement to disclose related party transactions should not go beyond IAS 24.
- There is a need to clarify the audit requirements for the corporate governance statement, including the implications of positioning the corporate governance statement in the annual report.

We acknowledge the need for the Commission to establish a EU-framework for collective responsibility of board members, formalising what is current prevailing in Member States. We appreciate this recognition that companies themselves are the first line of "defence" in reporting and auditors the second. The auditor should not have a wider responsibility than members of the administrative, management and supervisory bodies.

Some detailed technical and drafting comments are included in the appendix to this letter.

General

1. We appreciate that the Commission has proposed to introduce elements of IFRS in the Fourth and Seventh Directives, for the first time with a direct mention of an IFRS (endorsed IAS 24) in the articles of the Directive itself. This requires implementation of parts of IFRS in national GAAP, which we believe to be a positive move given the aim of convergence in this area.

2. We note that the proposed amendments to the Directives introduce in certain articles the concept of materiality that was so far not specifically mentioned in the Directives. We would prefer if the materiality concept would be introduced as a separate general article, rather than in specific articles, since it is a general concept underlying the Directives. Such a definition should be based on IFRS or refer directly to IFRS where it is stated that information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements (IASB Framework paragraph 30 and IAS1.11).

3. We appreciate the objective of providing shareholders and other stakeholders with reliable, complete and easy accessible information. But since the concept of materiality is being expressly introduced into the Directives, it should necessarily follow that there should be no separate requirements for companies to disclose a level of information which is inconsistent with the overriding criterion of materiality. We welcome the enhanced transparency sought on related parties' transactions and off-balance sheet arrangements but also agree with the objective of avoiding unnecessary burdens on companies. There is a risk that disclosure of large numbers of normal transactions might prevent users of accounts from focusing on those arrangements that should be of real concern. Therefore each of the additional disclosure requests needs to be assessed as to the volume and relevance of the disclosures and the related practicalities and we give our views below.

Off-balance Sheet Arrangements and SPEs

4. We support the objective of the Commission of ensuring that material Special Purpose Entities (SPEs) are brought to the attention of the user of the financial statements. We also acknowledge that SPEs can be organised to avoid inclusion in consolidation and that any definition of SPEs risks circumvention. We appreciate that in light of the recent scandals there is a need for short term measures as part of the overall anti-fraud measures proposed by the Commission and the recognition by the Commission itself in the explanatory memorandum of the difficulties of such a short term measure and the risk of circumvention.

5. We believe that the current proposal should be seen as an interim solution. We wish to point out the need for considering a more robust longer term solution for non-listed companies not using IFRS based on the substance over form principle to avoid too many individual disclosures which risk to be confusing to the users of financial statements. It could be considered to introduce the principle of beneficial ownership (as opposed to legal ownership or control only) into the Directives, which needs to be qualified by additional specific individual provisions which have yet to be determined. This would improve the comparability of financial statements and benefit the desired harmonisation of European accounting by increasing convergence with IFRS. As a second step, the consolidation provisions in the Seventh Directive need to be enhanced to capture more SPEs and off balance sheet arrangements. Only those arrangements not covered by the proposed principle of beneficial ownership and the proposed enhancement of the consolidation requirements should be disclosed in the notes to the accounts.

6. The Commission proposes to improve disclosures by imposing a specific requirement in the notes to the accounts for material off-balance sheet arrangements, including SPEs. However we are of the opinion that the term "arrangements" in Article 1, amending the Fourth and Seventh Directives Articles 43 (1) (7a), is too vague for compliance to be consistent or to be consistently assured or verified. It is likely to be applied inconsistently because the interpretation of such a term could be very different depending on personal knowledge and background, given that the term is not used elsewhere in the Fourth and Seventh Directives. Translation of such a general term is likely to result in even greater inconsistency. We accept that preamble 7 gives a certain idea as to which arrangements are aimed at,

but it does not sufficiently narrow down the great volume of transactions and arrangements many companies could feel obliged to disclose.

7. We recognise that it is difficult to develop a practicable and useful definition of "arrangements". We note that the IASB has addressed special purpose entities in SIC 12 in relation to IAS 27. However, SIC 12 does not give a definition for entities that are not consolidated but which should be disclosed in a company's financial statements. We suggest that further development of the definition of "arrangements" is needed before the text is ready for inclusion in a directive. We are currently working on a proposal for a definition. Such a definition should catch in a comprehensive way all off balance sheet arrangements aimed at, but avoid that contracts and agreements are included, such as sales orders and employee contracts, that are as part of normal business not included in the financial statements. We are pleased to share views with you on our current thinking and intend to submit our proposals to you in due course.

8. We note that Article 1(2) of the Seventh Directive now gives Member States the option to require the consolidation of an undertaking for which the parent has power to exercise dominant influence or control, without the need for a participating interest. This addresses situations similar to SIC-12 where a company has significant beneficial interest in an SPE without owning it. The proposed Directive should clarify that where Member States have not required the consolidation under Article 1(2), this undertaking be disclosed as arrangements under the proposed Article 34(7a).

9. It would be helpful if the Commission could announce its intention to carry out a review/survey after a certain period of time as to how the term "arrangements" is implemented and used in practice in the various Member States and what type of "arrangements" are captured in the different Member States. Also the IASB could be requested to consider the terminology of "arrangements" since this term is equally used in SIC 12. In addition, it would be helpful if the recitals could indicate that disclosure of "arrangements" are not necessarily sought on an individual basis, but that disclosures of "arrangements" of similar kinds can be aggregated.

10. The Commission explains in the Explanatory Memorandum that " to the extent that this disclosure goes beyond what is required under IAS, listed EU companies would also have to comply with this disclosure through an amendment to the Accounting Directives". We are uncertain of the legal basis for this analysis. In its November 2003 guidance, "Comments concerning certain Articles of the Regulation (EC) No 1606/2002", the Commission advises that companies preparing accounts under the Regulation are subject to the Accounting Directives in so far as they deal with matters not covered by IAS, including "the audit, consolidated annual report and certain disclosures that are beyond the scope of IAS" (paragraph 3.3.). The proposed disclosures on off-balance sheet arrangements do not seem to fall within these categories. We therefore urge the Commission to publish its current thinking on the interaction of the Directives and the IAS Regulation, appending any advice received from its legal services on this issue. Companies and their auditors seeking to ensure that financial statements comply with both IFRS and European legislation require clarity and certainty in this area as soon as possible.

<u>Related Party Transactions</u>

11. We welcome the Commission's objective to enhance transparency about related parties' transactions for non-listed companies beyond affiliated undertakings in order to restore and promote public confidence in a company's financial statements. Related party transactions are often of particular significance in privately owned companies, notably SMEs. We also welcome the emphasis put by the Commission in the explanatory memorandum on the need to avoid unnecessary burdens for non-listed companies. It would be helpful if this emphasis could be repeated in recital 4.

12. The text of Article 1, amending the Fourth Directive, Article 43 7(b) requires disclosure of the nature, business purpose and amount of transactions with related parties. This disclosure goes beyond the requirements of IAS 24, in particular in requiring disclosure of the nature and business purpose of such transaction. We are of the opinion that disclosures requested for all companies should not go beyond IAS 24 in that specific justification. This also seems to contradict the intention of the Commission as set out in the explanatory memorandum where the transparency required for all listed European companies under IAS is described as satisfactory. In practice, the need to identify, explain and corroborate the

purpose(s) of all material related party transactions is likely to involve preparation and audit costs for many non-listed companies that far outweigh the benefits to users of their financial statements. We suggest that the words "nature and business purpose" be deleted.

13. We appreciate the intention of the Commission to avoid unnecessary burdens for non-listed companies by limiting the disclosure requirements for related parties transactions to those that are not concluded "under normal commercial conditions". However there is a risk that the criterion "under normal commercial conditions" will be circumvented by considering most if not all of the transactions to be normal. An alternative that could be considered by the Commission would be the disclosure of all related party transactions as required under IAS 24, with disclosure of similar transactions on an aggregated basis.

14. If the above recommendation is not followed, it would be helpful to give some further indication of the term "under normal commercial conditions". In accounting terms normally "at arm's length basis" is the expression used. Since the explanatory memorandum seems to indicate that exactly the same is meant by adding this term in brackets (page 5: "not carried out under normal commercial conditions (i.e. not at arm's length)" we prefer the use of "at arm's length". A further precision could be included by referring in the recitals to "comparison in the market" and "reasonable under the circumstances". Given the audit implications we recommend that it should be the responsibility of the preparer to provide evidence that all related party transactions have either been carried out at arm's length or disclosed. Amending the disclosure requirements to refer to those transactions that "cannot be demonstrated to be concluded at arm's length" could reinforce the obligation on the preparer to provide that evidence.

15. The same remarks as set out in paragraphs 7 to 9 above would also apply to Article 2 amending the Seventh Directive.

16. We note that Article 2 amending Article 34 of the Seventh Directive refers in 7 (a) to the "undertakings included in the consolidation taken as a whole" whereas 7 (b) refers to the "parent undertaking and other undertakings included in the consolidation". The "parent undertaking and the other undertakings" are already required to disclose this information in the individual accounts (Article 43 7(b)). We are of the opinion that there is a need to clarify the article so that transactions with related parties within the group (i.e. of the parent company and of subsidiaries that are eliminated by consolidation) are not subject to this disclosure requirement in the consolidated accounts.

Audit Requirements for the Corporate Governance Statement and Implications of Positioning in the Annual Report

17. We welcome the requirement for listed companies to disclose information about their corporate governance practices and acknowledge that information about corporate governance structures are of great importance for European capital markets and European investors. Article 1 amending the Fourth Directive, Article 46a requires for listed companies that a corporate governance statement is included as a separate part of the annual report. Inclusion in the annual report will require auditors to verify, under Article 51.1. (b) of the Fourth Directive, that the annual report is consistent with the annual accounts for the same financial year. We support this limited responsibility.

18. However, some Member States have gone beyond this requirement and made the annual report, which would include the corporate governance statement, subject to a full audit requirement.

19. This is of concern because not all elements of such a statement are objectively verifiable. For example, in some Member States the corporate governance code requires the board to be an effective forum for discussion between directors. A statement of compliance with the code, as required by the proposed amendments, implicitly confirms that this objective has been achieved although such an assertion is impossible to verify. If a full audit requirement is inadvertently imposed as a result of the positioning of the corporate governance statement in the annual report, there will be resistance to further development of corporate governance codes in order to cover the judgemental areas that are so important to stakeholders.

20. We understand that it is not the intention of the Commission to make the corporate governance statement subject to a full audit requirement but only to consistency verification as required under Article 51.1 (b). We therefore ask this at least to be explained in the recitals. This would nevertheless allow Member States that wish to do so to impose full audit requirements for the objectively verifiable parts of the corporate governance statement. We also suggest that the proposal should be less prescriptive about the location of the corporate governance statement, only requiring that the corporate governance statement should be submitted to the shareholders together with the annual accounts and the annual report. This would allow those Member States that require the annual report to be subject to full audit to find a solution that suits their reporting and auditing arrangements.

21. Article 46a required certain disclosures as part of the corporate governance report. Article 46a (1) requires "a reference to the corporate governance code the company has decided to apply or is subject to under law of the Member State where it has its registered seat, accompanied by an indication of where the rest of the text of the applied corporate governance code is publicly available" (emphasis added). We note in certain countries that the applicable Code is determined by where the company is listed rather than where it is registered. Many listed companies have secondary listings and can as a result be subject to several corporate governance codes. We therefore suggest considering replacing the word "registered" by "listed".

Internal Controls and Risk Management Systems

22. We welcome the Commission's judicious approach of, over time, carefully considering the topic of risk management and internal control together with issues highlighted by the implementation of relevant aspects of the Sarbanes-Oxley Act in the US and the new requirements in Europe for example in French law. FEE is currently working on a project on reporting on internal control and expects to publish a Discussion Paper on Risk Management and Internal Control in due course.

Responsibility of Board Members

23. Art. 50b of the Fourth Directive (and Art. 36a of the Seventh Directive) specifies that collective board responsibility applies in relation to preparation and publication of the annual accounts and annual report. We believe that collective responsibility does not and should not lead to the same responsibility for the management board members and supervisory board members under a two tier system since the tasks of both boards are different. The tasks of the supervisory board consist of oversight over the process in contrast to the task of the management board, which is the preparation of the financial information. This differentiation could be clarified and made explicit by adding some words to the proposed text of Article 50 to such as: "Member States shall ensure that members of the administrative, management and supervisory bodies of the company are collectively responsible towards the company for carrying out their functions in ensuring that the annual accounts and the annual report are drawn up and published in accordance with the requirements of this Directive".

24. The collective responsibility is restricted to the company since according to the Frequently Asked Questions (published by the Commission together with the proposals to amend the Fourth and Seventh Directives) this is the prevailing system across the European Union. Member States can extend this responsibility since the proposal provides for minimum requirements. The Commission Communication of September 2004 on Preventing and Combating Corporate and Financial Malpractice indicates that the first line of defence is the internal control in a company, in particular by board members. The second line of defence is primarily the auditors. Auditors have to audit the accounts prepared or approved by members of the administrative, management and supervisory bodies of the company. We are of the opinion that the Directive or at least the recitals should make it clear that the group of stakeholders to whom the auditor is responsible cannot be wider than the group to whom those bodies are themselves responsible.

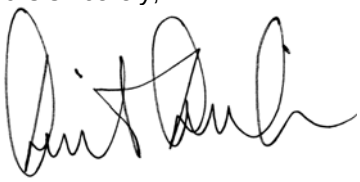
25. We regret that the proposal to amend the Directives does not include a requirement that board members should be responsible for volunteering all relevant information to the auditors without being specifically asked. We also regret that no reference is made to sanctions against directors who

knowingly mislead auditors or withhold information from auditors, whereas in some countries this is a criminal offence under law.

26. Article 1, Article 60a and Article 2, Article 48 address criminal sanctions and penalties. It requires penalties and measures to be effective, proportionate and dissuasive. We note the text of recital 2, which indicates that collective responsibility should not prevent courts or other enforcement bodies in the Member States from being able to impose sanctions on an individual board member. We stress the importance of penalties and measures being proportionate. We suggest that the preambles make clear that this means an individual consideration of each board member in case of sanctions despite their collective responsibility for the preparation and publication of the accounts and annual report. It is crucial that (management and supervisory) board members should be held responsible for any violation only of their respective tasks.

We would be pleased to discuss with you any aspect of this letter you may wish to raise with us

Yours sincerely,



David Devlin
President

Appendix – Some detailed suggestions and drafting suggestions:

1. In our opinion recital 6 needs to refer to "additional risks and benefits" since all of the other companies activities also give rise to benefits and risks.

2. We wonder why the terminology used in Article 2 amending the Seventh Directive, Article 34 7(a) is different from the amendment to the Fourth Directive. We suggest that the same wording is used: "material" instead of "direct relevance and assistance".

3. The materiality of transactions should not only be considered for an individual transaction but also for a group of similar transactions. It would be helpful if the recitals could make clear how materiality is to be understood. Our understanding is that it has to be understood in the context of the individual or group accounts rather than to the related party as such.

4. Article 2 amending the Seventh Directive, Article 34 7(b) refers to undertakings included in the consolidation. We believe that the text should refer to "body of undertakings" as used elsewhere in the Seventh Directive since this is the broader term covering the group (of consolidated and non-consolidated undertakings).

5. The definition of related party is set out in paragraph 9 of IAS 24 instead of in paragraph 3 (as changes in the Improvements Project). We suggest that the number of the relevant paragraph of IAS 24 is not referred to in the amendments to the Fourth and Seventh Directives.

6. Article 1, amending the Fourth Directive in Article 46a.3 requires that the corporate governance statement include a description of the company's internal controls and risk management systems. From recital 8 we understand that it concerns internal controls and risk management systems in relation to the financial reporting process. This should be clarified within the text of the Directive itself.

7. We note that Article 2, amending the Seventh Directive Article 36 (2) (f) limits the description of the group's internal control and risk management system to those in relation to the process for preparing consolidated accounts.

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