FÉDÉRATION DES EXPERTS COMPTABLES EUROPÉENS
EUROPEAN FEDERATION OF ACCOUNTANTS

FURTHER PRELIMINARY FEE POSITION IN RELATION TO SIMPLIFICATION FOR SMEs: ACCOUNTING AND AUDITING ASPECTS

17 April 2007

The European Commission is continuing the discussion within the Accounting Regulatory Committee and Auditing Regulatory Committee on the subject of possible simplification proposals for SMEs. This discussion has given rise to a number of issues which were not addressed in the FEE position paper of 21 March or not in a sufficient level of detail (see the attachment where this position has been reproduced without changes). Where additional detail is provided it is broadly consistent with the 21 March paper, and the discussion of the Working Group. This document sets out a preliminary FEE position on these additional issues which are:

- *Introduction of a category of micro-enterprises.*
- *SME thresholds.*
    - *Practical application.*
    - *Facilitating future revisions of the thresholds.*
- *Release small companies from publication requirements.*
- *Allow medium-sized companies to use exemptions currently available for small companies.*
- *Consolidation requirements.*
- *Accounting for deferred taxation.*
- *Disclosures.*

1. Introduction of a category of micro-enterprises

The EC is considering the introduction of a category of micro-enterprises: fewer than 10 employees, balance sheet total below 0.5 million Euros and a turnover of below 1 million Euros. A Member State option could be introduced to allow Member States to exclude micro-enterprises entirely from the Accounting Directives. Furthermore the EC is also considering a requirement to exempt micro-enterprises fully from statutory audit.

1. Introducing a fourth category of company would in our view render the regulatory system unnecessarily complex and would ignore the fact that such micro-enterprises have chosen to operate under the legal form of a limited liability company, whereas they could have chosen a different legal form. All limited liability companies, in common with other businesses, need to have sound accounting systems, resulting in reliable financial information that can be used for different purposes, including tax purposes. There is the danger that wide-spread deregulation for micro-enterprises might adversely affect the perceptions of owner/managers as to the importance of consistently prepared

credible financial information. Companies, including micro-enterprises, would benefit from better – clearer and simplified – legislation with, as a starting point the Fourth and Seventh Directives being made more accessible and up to date.

2. At present, micro-enterprises are accustomed to report publicly. This information not only enhances transparency, comparability and harmonisation, but is in many, if not all cases, needed for tax purposes. Moreover it provides credible financial information for minority shareholders. The existing (public) reporting obligation is not perceived as being unduly onerous and its continuance would not constitute a major administrative burden. Removing such a requirement – without a careful assessment of the impact – will make it difficult to restore in future, should this seem desirable. Many companies would consider any change from the current situation as a burden.

3. Choosing to operate under limited liability comes with certain obligations in relation to transparency and accountability. Whether these micro-entities as part of the population of small companies as a whole, or as a separate category, could benefit from less onerous reporting requirements within the Directives whilst still providing sufficient transparency to their stakeholders, requires further consideration.

4. It is inconsistent to leave the reporting decision for micro-enterprises to Member States but at the same time to require an exemption from statutory audit for all micro-enterprises. This is undermining the principle of subsidiarity. The exemption from audit should remain a Member State option.

5. The removal of the Member State option to require statutory audit of small companies is not considered to be a feasible proposal for a number of reasons. In particular, the decision on whether a certain size of company would need to be audited or not should be taken in the context of the economy in which such companies operate and, therefore, should be taken at the Member State level. Additionally, the risk which is associated with a particular type of company is not necessarily determined by the size of the company, for example a public company, business corporation, a private company, limited by shares or guarantee, a labour sponsored capital company, government corporation or widely held corporation.

2. SME Thresholds

2.1 *Making practical application more appropriate for SMEs*

Article 12 of the Fourth Directive includes a 2 year period (move to a higher or lower category) for meeting two of the three criteria. The suggestion is to introduce a period of 5 years (to a higher category) and of 1 year (to a lower category).

6. We are not aware that the existing system of a two-year adaptation period has given rise to administrative burdens or unfair treatment of companies. A period of two years either way allows companies to have an exceptionally good or bad

year in isolation, without it having an immediate impact on reporting requirements.

7. We therefore strongly recommend maintaining the existing adaptation period of two years. If the proposal were implemented it could lead to an undesirable information deficiency for the stakeholders of growing companies. It could mean that micro-companies which became 'small' companies would only be required to report under Fourth directive rules after they had spent five years in the higher category; in the case of fast-growing companies, which did not spend the required five years within a particular category, they could conceivably grow from micro-size to medium-size without being subject to any reporting requirement at all. We consider that this could prove dangerous not only for the companies themselves but for their creditors and other stakeholders, who in some cases could see companies becoming insolvent before they became subject to reporting requirements. We also consider that these proposals are contrary to the overall direction of other EC projects, which accept the need for more transparency.

8. Reduction of the period for less detailed requirements to one year when a company has reduced in size is also too short: the company may have had an exceptionally "bad year" and as a result it might fall into a lower reporting category in which it then can stay there for five years. Moreover most companies use a "model" set of financial reporting schedules, based in their software on a chart of accounts - which would be different for smaller and larger companies. In practice companies will not immediately change their model of accounts as this is costly especially where it concerns specially developed tailor-made software. This is undermining the transparency and harmonisation initiatives, but also the objective of creditor and other stakeholder protection.

3. Release small companies from publication requirements

It is suggested to include a full exemption from the publication requirements for small companies.

9. In our opinion publication of the accounts does not constitute a burden once the accounts have already been prepared. Public reporting increases transparency and provides added value to a wide range of stakeholders: managers, business partners, bankers, creditors, investors, employees, trade unions, and public administrations. Publication requirements have in addition a disciplinary effect on enterprises. A reduction in publication requirements will in many situations and several countries transfer the burden to other parties that rely on the (audited) financial statements, as they will need to acquire reliable financial information in alternative ways. Many stakeholders (e.g. co-operation partners and debtors) seek information from the official trade register on the credit standing of the company, financial information regarding its stability, the statutes (company articles), as well as names of the board members, managing director(s), authorised signatories, auditors and the company's track record. If this information is no longer published, it leads to a very complex and much

more costly way for all parties involved to secure many matters of day to day business.

10. The different legislative environments and related systems of controls in which audited financial statements play an important role should not be ignored. The proposals under discussion have not provided substantial evidence that unregulated markets will not lead to insufficient or unreliable information. A well-functioning and sustainable economy also benefits from proportionate statutory requirements beyond reliance on agency theory and private contracting. A thorough impact assessment needs to be carried out to assess whether the measures do not have a detrimental effect on the economy at large.

4. Allow medium-sized companies to use exemptions currently available for small companies

It is proposed to extend the exemption for small companies to <u>*certain*</u> *medium-sized companies (there is no general exemption envisaged) based on a "risk based" approach. This would include an exemption from statutory audit, but with a safeguard that a third party can require an audit.*

11. Surveys indicate that medium-sized companies represent on average a share of less than 2 percent in number of all European companies[1]. Accordingly, the impact of changes to Directive provisions relating to medium-sized companies on the economy as a whole may not be major. Given their size and involvement in the economy, most of these companies might be expected to opt for a voluntary audit even if auditing of the financial statements was not mandatory. So the overall administrative cost saving may be limited and not exceed the benefits of having a statutory audit. Additionally, there are public interest aspects for employees, suppliers, customers, banks, tax authorities, etc to medium-sized companies.

12. We consider that the application of a risk based approach would be complex and risks creating a further category of companies. A "risk-based" approach requires clear criteria to be set, which cannot be confined to share-ownership but should take into account the extent of liabilities and borrowing and include a series of financial ratios and indicators. Questions arise as to who will monitor the risk-assessment, how shall changes in company's risk profile be recorded and checked and how can criteria be consistently applied? Accordingly we have doubts about the merits of embedding a risk-based approach in legislation.

13. Any extension of small company exemptions to medium-sized companies as a Member State option should be only considered following a thorough impact assessment to determine whether the benefits of further relaxation outweigh the potential costs.

[1] See DG Internal Market/Ramboll management, Report on impacts of raised thresholds defining SMEs, December 2005, Figure 8, page 30/31.

14. As is the case with the exemption from statutory audit for small companies, not all Member States are likely to take up this exemption, depending on the particular circumstances of their jurisdiction.

15. We would not favour granting exemptions from the disclosures in the notes or in the annual report. The annual report provides important information on going concern and post-balance sheet events that are also of interest to the stakeholders and market concerning medium-sized companies.

5. Consolidation requirements

5.1 Article 57

The proposal seems to turn the Member State option of Article 57 of the Fourth Directive for subsidiaries under certain conditions (guarantee) into a company option for small subsidiaries.

16. Before Article 57 could be turned from a Member State option into a company option (as it seems the EC is proposing), whereby all subsidiaries are exempted from the content, auditing and publication requirements of their individual statutory accounts when a number of conditions are fulfilled[2], it needs to be investigated why few Member States have taken up the existing provisions of Article 57 of the Fourth Company Law Directive. The reasons might be associated with the following concerns:

- Parent guarantee for subsidiary commitments might be problematic in case of companies with minority shareholders;
- There are certain risks for the parent company;
- There is a lack of detailed information at the local level as some stakeholders might still be interested in the individual company's financial statements (workers council, tax authorities);
- The Article is complex and may lead to uncertainty about the position of the creditors;

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[2] Article 57 of the Fourth Council Directive
Notwithstanding the provisions of Directives 68/151/EEC and 77/91/EEC, a Member State need not apply the provisions of this Directive concerning the content, auditing and publication of annual accounts to companies governed by their national laws which are subsidiary undertakings, as defined in Directive 83/349/EEC, where the following conditions are fulfilled:
(a) the parent undertaking must be subject to the laws of a Member State;
(b) all shareholders or members of the subsidiary undertaking must have declared their agreement to the exemption from such obligation; this declaration must be made in respect of every financial year;
(c) the parent undertaking must have declared that it guarantees the commitments entered into by the subsidiary undertaking;
(d) the declarations referred to in (b) and (c) must be published by the subsidiary undertaking as laid down by the laws of the Member State in accordance with Article 3 of Directive 68/151/EEC;
(e) the subsidiary undertaking must be included in the consolidated accounts drawn up by the parent undertaking in accordance with Directive 83/349/EEC;

- The Article is (perceived to be) more difficult to apply across borders should, for example, a creditor of a subsidiary based in one country seek to make a claim against the guarantee of the parent company which is based in another country as different legal systems apply. However the Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgements in civil and commercial matters is assumed to have largely taken away this problem.

17. The group auditor assesses the level of audit necessary for the consolidated accounts. Whether or not an audit is needed for the individual accounts is a different discussion which will not necessarily depend on whether or not Article 57 is adopted. The administrative savings might be limited – for instance, if the group auditors decide they need an audit of the subsidiary then this will need to be performed anyway irrespective of Article 57.

5.2 Relationship IAS Regulation and Seventh Directive

The issue is whether parent companies that have subsidiaries which are immaterial would fall under the IAS Regulation and would be required to prepare IFRS financial statements.

18. First of all clarification needs to be provided by the EC on the relationship between the Directives (national law) and the IAS Regulation. If the consensus is that such parent undertakings would be required to prepare IFRS based consolidated accounts, the EC is proposing that a simplification could be considered to relieve such undertakings from the requirement to prepare IFRS based consolidated accounts. However the simplification exercise was intended to address SME issues. We query the benefits of pushing listed companies towards national GAAP instead of IFRS.

6. Disclosure requirements for deferred taxation (Article 43.11 Fourth Directive)

It is suggested to change this disclosure requirement since it is burdensome to obtain the information and since preparers and users do not consider this information to be of relevance.

19. Accounting for deferred taxation is not treated by the Directives except for the disclosure requirement but by national accounting legislation, national accounting standards or IFRS. Once deferred taxation is accounted for, the disclosures are not burdensome and are in fact (both in cases of tax liabilities and tax credits) considered helpful. Moreover there is an existing Member State option (Article 44.1 Fourth Directive) which allows Member States to permit small companies to draw up abridged notes without the disclosure requirement of Article 43.11. We question whether there is a burden for medium-sized companies or whether the benefits of disclosure outweigh the perceived disadvantages.

7. Disclosures

7.1 Deletion of requirement to explain formation expenses (Article 34.2)

20. The preferred method in accounting – and the required method under IFRS (IAS 38.19) – is to expense formation expenses. If this preferred method is not followed it seems important to explain the amount of formation expenses that is capitalised. If the formation expenses are expensed, no further explanation is needed.

7.2 Omission of disclosure requirement of the breakdown of net turnover into categories of activity and geographical markets (Article 43.8)

21. We are of the opinion that this disclosure requirement is not essential and could be omitted. Moreover there is an existing Member State option (Article 44.1 Fourth Directive) which allows Member States to present small companies to draw up abridged notes without the disclosure requirement of Article 43.8.

APPENDIX

FEE'S POSITION ON EC SIMPLIFICATION PROJECT WITH FOCUS ON FINANCIAL REPORTING AND AUDITING ASPECTS

21 March 2007

One of the key objectives of the Barosso Commission is to simplify and to reduce the administrative burdens for companies in the EU with a target for reducing these burdens by 25% overall in the medium term. On 14 November 2006 the European Commission issued a working document on measuring costs and reducing administrative burdens in the European Union accompanying the Strategic Review of Better regulation in the EU. In January 2007 the European Commission issued an Action Programme.

The target has been set for all areas of European legislation which affects companies, including financial reporting, auditing and company law. In order to initiate informal discussions and an informal consultation of the relevant organisations the European Commission has issued two documents: "Simplification of accounting rules for small and medium-sized companied – Discussion of possible amendments to the Fourth and Seventh Company Law Directives" and "Making an SME Audit Simpler and more Relevant, basis for discussion (draft)" in respectively December 2006 and January 2007. This FEE paper contains the initial reactions of the profession to both documents.

1. GENERAL

1. FEE supports the objectives of better regulation and the simplification of administrative burdens that are instrumental in this respect. Better regulation and simplification has to be pursued in a targeted way to achieve real benefits for enterprise and have also to be balanced with other public policy goals. As practical experience demonstrates, unregulated markets may lead to a situation in which insufficient and unreliable information is provided which undermines the optimal functioning of the market. The accounting and audit profession plays a key role in providing the transparency required by market participants, which reduces the costs of capital and helps markets work better and also safeguards the public interest.

2. Policy initiatives in the financial reporting and auditing sphere will have a significant impact on the EU economy: for this reason they must be pursued with great care on the basis of a thorough impact assessment. The costs and the benefits of both the current requirements and the envisaged simplifications have to be assessed and all the consequences of policy initiatives carefully weighed to arrive at net costs or net benefits.

3. The simplification and harmonisation initiative as currently presented by the European Commission in the areas of accounting and auditing would benefit from a clear overall direction and vision of what the European Commission is trying to achieve in these areas: What is a sustainable long term structure (what is the "master plan")? Therefore, the proposals would benefit from the inclusion of a number of key principles which illustrate how the European Commission would like financial reporting and auditing to evolve in the short, medium and long term.

4. We welcome the EC initiative to make the Fourth and Seventh Directives more relevant to further harmonisation of accounting in Europe, aiming at providing a modern accounting framework for companies in the EU. The Directives, which were mainly developed some thirty years ago, in their current form no longer fully match an appropriate accounting framework for financial reporting in the modern world. However, the objectives of reducing administrative burdens and of achieving harmonisation, increased transparency and comparability may have different - even opposite - impacts, at least for individual companies. The profession would favour a fundamental review of these Directives. In the short term a contribution could be made by reducing the options as set out in section 2.1.2.

5. The revised Directive on Statutory Audit of Annual Accounts and Consolidated Accounts was adopted only in 17 May 2006 and has an implementation period in EU Member States of two years, that is up to mid-2008. A considerable number of Member States have just started to implement the Statutory Audit Directive and will need to spend considerable time, efforts and resources to implement the Directive in their national legislation for the mid-2008 deadline. It is therefore too early to draw any conclusions or to include the Statutory Audit Directive within the simplification process.

6. The European Commission, through the Accounting Regulatory Committee and the Auditing Regulatory Committee, has carried out surveys on accounting and auditing for SMEs. Several of FEE's member bodies have been involved, at the request of their government, to assist in completion of the questionnaires. Publication of the results of these Member State surveys would enhance the debate on the European Commission simplification project.

7. Most of the changes suggested in the EC papers on simplification of accounting and auditing rules for SMEs of respectively December 2006 and January 2007 are unlikely to result in any substantial cost savings or reductions in administrative burdens. In our experience the main burdens imposed on companies are not mainly in the financial reporting area but rather in other areas such as:

    - Statistical requirements

- Corporate tax requirements
- Multiple, overlapping filings for different regulatory purposes
- Frequency of reporting requirements in certain countries
- Insufficient use of electronic reporting to avoid double reporting
- Legal requirements for incorporating new companies
- VAT and other indirect tax requirements
- Dividend distribution requirements
- Health and safety legislation and returns
- Employment legislation and returns
- Local taxes, including property taxes
- Administration (calculation, payment and statistical reporting to authorities) of miscellaneous social security programs.

8. FEE understands that the initiative to reduce administrative burdens covers a wide range of areas throughout the remit of the European Commission. We note that the current DG Market initiative covers not only accounting and auditing but the whole field of company law, including other company and corporate governance requirements included in the Company Law Directives. FEE has until now not been involved in the latter part but realises that discussions are taking place at the level of the European Corporate Governance Forum and the Advisory Group. FEE believes that it can also provide a useful contribution to this part of the discussions.

1.1 Benefits of financial reporting and auditing

9. FEE notes that accounting and auditing are sometimes categorised as "burdens" or "costs" without adequate reference to their beneficial role within the enterprise economy and their public interest dimension. Accounting and auditing are in fact tools that provide added value to a wide range of stakeholders: managers, business partners, bankers, creditors, investors, employees, trade unions, and public administrations. Reduction of accounting and auditing requirements will in many situations and several countries increase the burdens on other parties that rely on audited financial statements since they will need to acquire reliable financial information in alternative ways. The different legislative environments and related systems of controls in which audited financial statements play an important role should not be ignored. There is evidence that unregulated markets may provide insufficient or unreliable information and that a well-functioning and sustainable economy also benefits from proportionate statutory requirements beyond reliance on agency theory and private contracting.

10. Accounting is an essential facilitator of cross-border trade. There is a need for more internationally comparable and harmonised financial statements, especially for medium sized and large non-listed companies, because of increasing cross border operations, mergers and acquisitions involving companies in different Member States, increasing internationalisation of capital markets and related supervision within the EU, and requirements following Basel II. Financial reporting is the only common language for the 23 million European SMEs across 27 different Member States with 23 different languages.

11. A reduced involvement of accountants and auditors in SMEs will have implications for the quality of the internal management and controls of such SMEs and could potentially increase the risk of failures and fraud. The benefits of the audit process will be lost. SMEs often do not have strong financial expertise in-house so rely on independent external input received from professional accountants to improve financial and management controls. Reporting and related audit, enhancing the quality of the reporting, provides transparency and helps SMEs to get access to finance.

12. Accounting and auditing requirements support the development and the integration of new economies into the EU and contribute to the dissemination of best practices. Market forces are not able to impose best financial reporting and related audit practices to the same extent in all Member States. Looser financial reporting and audit requirements risk to further opening up the EU internal market to fraudulent activities from outside the Union.

13. Consistency of policy making is a further key principle of better regulation. Simplification must contribute to other policy objectives, not undermine them. Initiatives to simplify accounting and auditing requirements must be consistent with efforts in relation to the fight against money laundering, the strengthening of statutory audit in relation to consolidated accounts (which might be undermined by abandoning the auditing of subsidiaries) and addressing the concentration of the audit market.

14. The Competitiveness Council meeting of 19 February 2007 recognised the importance of information obligations as set out in its press release, page 8 on an action plan for reducing administrative burdens *"It is clear that these measures should not compromise the underlying purpose of the legislation or the need to protect the Community's financial interests and ensuring sound financial management, information obligations will remain necessary."*

1.2 Thresholds

15. The June 2006 amendments to the Fourth and Seventh Company Law Directives, raised the existing thresholds in Member States by 20 percent. This is a Member State option. Those increased thresholds have yet to be implemented. However, some Member States have already indicated that they will not opt to implement the increases.

16. FEE is strongly of the opinion that the implementation of the thresholds should remain a Member State option.. There is no one size that fits all: the extent to which the thresholds are implemented by Member States largely depends on the size of the national economy and the significance of audited financial statements to third parties (for example taxation authorities). Higher audit thresholds for SMEs might be offset by additional costs that SMEs may face in having to provide greater certainty to banks, vendors, shareholders and tax authorities. The audit plays an important role in serving the public interest to strengthen accountability and reinforce trust and confidence in financial reporting.

17. Before any further change is made, a regulatory impact assessment is needed to assess the impact on individual countries, on significant stakeholders within these countries and important economic sectors.

1.3 Scope discussion

18. The simplification exercise should only focus on a certain category of companies. Listed companies are covered by the IAS Regulation and have to apply IFRS in their consolidated accounts. For the large non-listed companies, whether they operate under a limited liability form or other form, given their public interest, it is difficult to argue that there is a need for simplification. The scope of the simplification exercise should be limited to small and medium-sized companies operating under a limited liability format in the Fourth Directive.

19. Limited liability companies, in common with other businesses, need to have sound accounting systems, resulting in reliable financial information that can be used for different purposes including tax purposes. Companies would however benefit from better – clearer and simplified – legislation, with as starting point the Fourth and Seventh Directives, made more accessible and up to date.

20. Choosing to operate under limited liability comes with certain obligations in relation to transparency and accountability. In the EU there are a large number of very small companies, the micro companies with very few employees and a relatively low turnover that are essential for the economy. It could be examined if these micro-entities could benefit from less onerous reporting requirements whilst still providing sufficient transparency to their stakeholders. To incorporate or not however remains the choice of the individual business since there are different legal forms available to these types of business involving fewer administrative burdens.

2. FINANCIAL REPORTING

2.1 Enhancement of the quality of financial reporting

21. The European Commission paper on accounting simplification states that the "Accounting Directive must take as its starting point the actual needs of SMEs and the users of their accounts". If financial reports are to be useful and relevant, investigating who are the users and what are their needs is critical in the development of a European financial reporting framework for SMEs. In the past there has been a lack of research and therefore evidence to determine the needs of users. Those needs may vary across Member States; for example, there is evidence that the information requirements of banks differ from one jurisdiction to another. This evidence is clearly an important starting point. Recognising the need for evidence based policy making, the International Federation of Accountants (IFAC) have commissioned research into micro-entities, defined as entities employing ten or less. The focus of this research will be on owners, users and managers as preparers of financial reports.

22. It can be argued that it is not so much the requirements resulting from the Accounting Directives that cause the administrative burdens, but rather the national additional requirements imposed in the form of national GAAP or otherwise.

23. We would prefer changes to the Accounting Directives to take the form of fundamental reconsideration of the Directives so that they would consist of high-level principles combined with some more detailed requirements in particular concerning formats and notes to the accounts. These principles should provide the broad content of balance sheet and profit and loss account, cash flow statement (optional) and notes to the accounts, as well as measurement and recognition principles and a limited number of significant disclosure areas. These principles should be aligned with those principles underlying IFRS (and certainly not contradicting IFRS). Introducing too detailed requirements provides a risk that they will become out of date when the international standards change. For larger companies more complexity can be introduced following national GAAP, IFRS for SMEs or IFRS (see paragraph 25).

24. Practical experience indicates that the costs of introducing financial reporting standards/guidelines are significantly reduced where suitable software is used. However, for the software to be effective it is critical that the principles are common and can be fully captured by the software and preparers do not need to look elsewhere to adopt accounting principles for particular transactions. This also supports the case for less options and greater harmonisation. Also web-based technology such as XML and XBRL may deliver significant cost savings in the compilation and dissemination of financial information for businesses. There are extensive developments in on-line software and new data processing models that will arrive over the next few years. Software suppliers would be stimulated to support such initiatives if there is the prospect of a single set of software that could deliver all regulatory returns in every European country.

2.1.1 IFRS for SMEs

25. Our current view is that the Directives should include a Member State option to permit or require use of the “IFRS for SMEs” by all companies covered by the Directives that are not listed. This gives Member States the possibility to grant a free choice to the individual company whether to apply “IFRS for SMEs”; or national legislation based on the Accounting Directives; or a requirement to apply “IFRS for SMEs”; or a requirement to apply national legislation. It will then be up to the Member State to decide, if and for what companies “IFRS for SMEs” should be required or allowed, for instance whether “IFRS for SME” would be required for large and medium-sized companies, whereas smaller companies could be given a free choice between “IFRS for SMEs” and national GAAP or, alternatively, the use of “IFRS for SMEs” could be prohibited. However, it should be taken into account that any option to use “IFRS for SMEs” instead of the Accounting Directives may increase the factual pressure on the companies to use such an option.

2.1.2 Reduction of options

26. As stated before the profession would strongly favour a fundamental review of the Accounting Directives. Realising that a quick short term solution may be needed the European Commission may wish to consider a review of the options included in the Directives.

27. A reduction in Member State or company options in the Directives is unlikely to contribute to a substantial reduction in administrative costs, and may not be regarded as beneficial by companies that use any of the options that are withdrawn. However, we believe that in the short term it would be beneficial in terms of harmonisation and comparability, and overall may lead to a better balance between cost and benefits since better transparency will be achieved.

28. Methods used by all or nearly all Member States should be introduced as requirements and methods not used should be removed. Methods that are used by very few Member States need to be further investigated.

29. An initial review by FEE indicated several options in the measurement and recognition area that the European Commission may wish to consider removing. These options are listed in the appendix. This list is not intended to be comprehensive.

30. In reviewing the options, the primary objectives should be improvement of the quality of financial reporting and cross-border harmonisation through an alignment to IFRS. Simplification should only be an objective as far as a defined minimum quality of financial reporting is ensured.

2.2 Reduction of disclosure requirements

31. Also a reduction of disclosure requirements will not constitute any substantial reduction in administrative burdens as long as the information is directly available in the company. If some of the current options in the Directives are to be removed as suggested earlier also the related disclosure requirements can be omitted. If a more fundamental review of the Directives would be carried out also the disclosure requirements could be considered in that they should be kept at a principles-based level. However, as the disclosure requirements of the directives are less burdensome compared with full IFRS or even "IFRS for SMEs", the potential for further reductions are very limited provided that a minimum level of information value is intended to be kept for financial reporting according to the Directives.

3. AUDITING

3.1 Amend or remove options in the Company Law Directives

32. Amending or removing options in the Company Law Directives for European Member States to exempt or not exempt small and/or medium-sized companies from the statutory audit requirement could have a significant impact on the EU economy. There are a number of issues that need to be taken into account when

considering the implications of changing the thresholds. In particular there are implications for the quality of financial information on the public record, the levels of economic crime such as money laundering and the fight against corruption. There is also a public interest issue for stakeholders such as employees, lenders, suppliers, customers, banks, tax authorities etc. in smaller and medium-sized entities. Furthermore, the risk which is associated with a particular type of company is not necessarily determined by the size of the company. A rise in the threshold might adversely impact competition and choice in the market place at a time where there are calls to encourage more competition in the audit field so as to create more choice for businesses. A change in the threshold may result in some audit firms choosing to come out of the audit market which would impact on companies and other entities in local communities that might require registered auditors.

33. For these reasons the proposals must be pursued with great care on the basis of a thorough impact assessment. The cost and the benefits of both the requirements and the envisaged simplifications need to be assessed and all the consequences of policy initiatives have to be carefully weighed, in arriving at net costs or net benefits.

34. A combination of mandatory audit exemption for small companies with the introduction of an option to exempt medium-sized companies from statutory audit requirements could have a significant impact on the European Union economy, for the reasons stated above.

35. A discussion on the thresholds is included in paragraphs 15 to 17 of the general part.

3.1.1 Medium-Sized Companies

36. Any extension of audit exemption to medium-sized companies as a Member State option should be only considered alongside a thorough impact assessment to consider whether the benefits of further relaxation outweigh the potential costs (as outlined above).

37. Surveys indicate that medium-sized companies represent on average a share of less than 2 percent in number of all European companies[3]. Accordingly, the impact of changes to Directive provisions relating to medium-sized companies on the economy as a whole may not be major. Given their size and involvement in the economy many of these companies may be expected to go for a voluntary audit. So the overall administrative cost saving may be limited and not exceed the benefits of having a statutory audit.

38. Additionally, the European Commission should be aware that there are nevertheless public interest aspects for employees, suppliers, customers, banks, tax authorities, etc to medium-sized companies with over 50 employees.

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[3] See DG Internal Market/Ramboll management, Report on impacts of raised thresholds defining SMEs, December 2005, Figure 8, page 30/31.

39. As is the case with the exemption from statutory audit for small companies, not all Member States are likely to take up this exemption, depending on the particular circumstances of their jurisdiction.

3.1.2 Small companies

40. The removal of the Member State option to require statutory audit of small companies is not considered to be a feasible proposal for a number of reasons. First of all, a decision on whether a certain size of company would need to be audited or not should be taken in the light of the context of the economy in which such companies operate and, therefore, should be taken at the Member State level. Additionally, the risk which is associated with a particular type of company is not necessarily determined by the size of the company.

3.2 Introduce a New Type of Assurance Designed Specifically for SMEs

41. In September 2006 FEE issued a briefing note "Implementation of International Auditing Standards for All Statutory Audits in the European Union" arguing that it is in the public interest if statutory audits of all companies are carried out in accordance with international standards, as the public and users of financial statements expect the same level of assurance from the audit of an SME as from the audit of a publicly traded company. The note addresses the confusion and misunderstanding which could result should there be different auditing standards for different size or type of entities. However, assurance services other than audit can be introduced to co-exist next to auditing services as long as the level of assurance, which is lower than in an audit, provided is clearly stated in the 'accountant's report'.

42. However, introducing a new type of assurance designed specifically for SMEs is not supported by FEE since users already have difficulties understanding the two existing levels of assurance (reasonable and limited). The expectation gap that currently exists will not be easier to reduce were the types of engagements offered to be expanded by the introduction of a "new" engagement with different levels of assurance. Despite these concerns, it is worthwhile monitoring the experience of one of the UK accountancy bodies to determine whether there is indeed a market for assurance type services other than audit as an option for otherwise audit-exempt companies. There is also a distinct need to consider how the issue of expectation gap may be effectively addressed.

43. Apart from ISRE 2400 *Engagements to review financial statements*, a generic standard on review engagements, currently there is no specific standard on limited assurance service for audit-exempt companies issued by the IAASB. If there is a requirements for an assurance service, IAASB would need to be called on to develop a suitable standard on assurance type services for this specific market. The current timetable of IAASB fully focuses on the clarity project for the International Standard on Auditing (ISAs) and thus, such an international standard might not be available in the short term, as it does not yet fit in their time frame.

3.3 Subsidiaries

44. The European Commission proposes to mandate a level of assurance on statutory financial statements of SMEs prepared under the Fourth Directive that would not exceed the level of assurance required by the group auditor on the reporting information prepared by the SME for group purposes, but not to be lower than a "limited review" type of assurance.

45. It should be noted that Article 57 of the Fourth Company Law Directive already includes a Member State option to exempt subsidiary undertakings from the content, auditing and publication of annual accounts where a number of conditions are fulfilled[4]. Where fully implemented in a Member State no audit (or lesser assurance) is required of the annual accounts of the subsidiary. Currently this Member State option, according to FEE's knowledge, has not been taken up by many Member States.

46. Apart from being a Member State option and not being mandated, the existing provisions of Article 57 of the Fourth Company Law Directive go further than the current European Commission proposal in not requiring any assurance on the subsidiary level.

47. It is not entirely clear why few Member States have taken up the existing provisions of Article 57 of the Fourth Company Law Directive, but the reasons might be associated with the following concerns:

- Parent guarantee for subsidiary commitments might be problematic in case of companies with minority shareholders;
- There are certain risks for the parent company;
- There is a lack of detailed information at the local level as some stakeholders might still be interested in the individual company's financial statements (workers council, tax authorities).

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[4] Article 57 of the Fourth Council Directive
Notwithstanding the provisions of Directives 68/151/EEC and 77/91/EEC, a Member State need not apply the provisions of this Directive concerning the content, auditing and publication of annual accounts to companies governed by their national laws which are subsidiary undertakings, as defined in Directive 83/349/EEC, where the following conditions are fulfilled:
(a) the parent undertaking must be subject to the laws of a Member State;
(b) all shareholders or members of the subsidiary undertaking must have declared their agreement to the exemption from such obligation; this declaration must be made in respect of every financial year;
(c) the parent undertaking must have declared that it guarantees the commitments entered into by the subsidiary undertaking;
(d) the declarations referred to in (b) and (c) must be published by the subsidiary undertaking as laid down by the laws of the Member State in accordance with Article 3 of Directive 68/151/EEC;
(e) the subsidiary undertaking must be included in the consolidated accounts drawn up by the parent undertaking in accordance with Directive 83/349/EEC;
(f) the above exemption must be disclosed in the notes on the consolidated accounts drawn up by the parent undertaking;
(g) the consolidated accounts referred to in (e), the consolidated annual report, and the report by the person responsible for auditing those accounts must be published for the subsidiary undertaking as laid down by the laws of the Member State in accordance with Article 3 of Directive 68/151/EEC.

48. FEE does not support the current European Commission proposal to mandate a level of assurance on statutory financial statements prepared under the Fourth Directive that would not exceed the level of assurance required by the group auditor on the reporting information prepared by the SME for group purposes, but not be lower than a "limited review" type of assurance. However, European Member States should give consideration to the application of the existing provisions of Article 57 of the Fourth Directive. The Commission may need to examine the implementation of Article 57 and, in particular, the reasons why this Member State option has not been used.

APPENDIX – Reduction of Options and Modernisation

An initial review by FEE indicated several options in the measurement and recognition area that the European Commission may wish to consider removing. These options are listed below. Time did not allow for a complete review of the Directives covering all the options (Company and Member States options) included in the Directives in form of “may”, “need not”, “permit”, “allow”, etc. The list below is not intended to be comprehensive:

1. The review of the options is not specifically focused on SMEs, but at modernisation, harmonisation and comparability and is expected to lead to a better balance between costs and benefits since transparency will be improved (para 27).

2. The removal of certain options on measurement and recognition may have implications for the lay-out and format of the balance sheet and the profit and loss account.

3. The removal of certain options on measurement and recognition implies that the related disclosure requirements can also be omitted.

- Article 20.2 of the Fourth Directive: The Member States *may* also authorize 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.
  Article 20.1 is sufficient on the creation of provisions. Article 20.2 needs to be deleted since IAS 37.14 requires a present obligation in order to be recognised as a provision and does not give an option. Some of the wording in Art. 20.2 is not in line with the requirement of a present obligation in contrast to a prohibited provision for future operating expenses (IAS 37.63).

- Article 31.1a of the Fourth Directive: In addition to those amounts recorded pursuant to paragraph (1)(c)(bb), Member States *may permit or require* account to 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.
  Article 31.1a needs to be deleted in order to be in line with IFRS (IAS 37.15).

- Article 34.1(a) of the Fourth Directive: *Where national law authorizes* the inclusion of formation expenses under ‘Assets’, they must be written off within a maximum period of five years.
  The inclusion of formation expenses under ‘Assets’ should be prohibited to bring the law in line with IFRS (IAS 38.19).

- Article 35.1 (c)(aa) of the Fourth Directive: Value adjustments *may* be made in respect of financial fixed assets, so that they are valued at the lower figure to be attributed to them at the balance sheet date.
  The option needs to be turned into a requirement in order to be in line with IFRS (IAS 39.58-70).

- Article 35.1(c)(dd) of the Fourth Directive: Valuation at the lower of the values provided for in (aa) and (bb) *may* not be continued if the reasons for which the value adjustments were made have ceased to apply.
  The option needs to be turned into a requirement to reverse in order to be in line with IFRS (IAS 36.114) and to ensure a true and fair view.

- Article 37.1 of the Fourth Directive: Article 34 shall apply to costs of research and development. In exceptional cases, however, the Member State *may* permit derogations from Article 34 (1) (a). In that case, they may also provide for derogations from Article 34 (1) (b). Such derogations and the reasons for them must be disclosed in the notes to the accounts.
  Development costs need to be recognised (delete option to expense), but write off period of 5 years to be deleted (instead: depreciation over expected economic life). The impairment only approach should be possible, but not be required.
  (To bring closer to IAS 38.57)
  NB: If the IFRS for SMEs continues to allow expensing (as is the case in the Exposure Draft), the existing option needs to be maintained in order not to create a difference with IFRS for SMEs.

- Article 37.2 of the Fourth Directive: Article 34 (1) (a) of the Fourth Directive shall apply to goodwill. The Member States may, however, permit companies to write goodwill off systematically over a limited period exceeding five years provided that this period does not exceed the useful economic life of the asset and is disclosed in the notes on the accounts together with the supporting reasons therefore.
  The current text of the article is no longer appropriate. Goodwill needs to be capitalised (delete option to expense), but write off period of 5 years is to be deleted. The article should either allow for capitalisation and systematic amortisation and for capitalisation and "impairment only" as optional treatments or the entire article can be removed. In the latter case, it would be left to the (national) standard setters to set the detailed requirements which can be different for SMEs and larger companies. This would bring it closer to IFRS 3.54. However, the method finally selected in IFRS for SMEs needs to be awaited. .

- Article 30.2 of the Seventh Directive, goodwill: A Member State *may permit* a positive consolidation difference to be immediately and clearly deducted from reserves.
  Option to deduct goodwill directly from reserves to be removed since not allowed under IFRS (IFRS 3.51). Article 30.2 needs to be deleted.

- Art. 39.1(c) of the Fourth Directive: The Member State *may permit* exceptional value adjustments where, on the basis of a reasonable

commercial assessment, these are necessary if the valuation of these items is not to be modified in the near future because of fluctuations in value. The amount of these value adjustments must be disclosed separately in the profit and loss account or in the notes on the accounts.
The Article 39.1 (c) needs to be deleted to bring in line with IAS 2.9, IAS 36 and IAS 39.58-70.

- Art. 39.1(d) of the Fourth Directive: Valuation at the lower value provided for in (b) and (c) *may* not be continued if the reasons for which the value adjustments were made have ceased to apply.
  The option needs to be turned into a requirement to reverse to bring it in line with IFRS (IAS 2.33, IAS 39.65-70, and to ensure a true and fair view.

- Article 40 of the Fourth Directive: The Member States *may permit* the purchase price or production cost of stocks of goods of the same category and all fungible items including investments to be calculated either on the basis of weighted average prices or by the 'first in, first out' (FIFO) method, the 'last in, first out' (LIFO) method, or some similar method.
  The use of LIFO or a similar method should be removed, since this method is in practice not used and in order to bring the article in line with IAS 2.25.

- Article 41 of the Fourth Directive: Where the amount repayable on account of any debt is greater than the amount received, the difference *may* be shown as an asset. It must be shown separately in the balance sheet or in the notes on the accounts.
  The option to expense immediately needs to be removed in order to bring Article 41 more in line with the effective interest method of IAS 39.

- Article 42 (a) to (f) of the Fourth Directive: *for small companies or for SMEs a simplified accounting for financial instruments could be considered as proposed in the EFRAG letter of 6 July 2005 to the IASB on the Questionnaire on Possible Recognition and Measurement Modifications for Small and Medium-sized Entities (SMEs) and the forthcoming draft letter on the ED IFRS for SMEs.*

- Article 13.3 of the Seventh Directive: In addition, an undertaking *need not* be included in consolidated accounts where:
  (a) severe long-term restrictions substantially hinder:
    (aa) the parent undertaking in the exercise of its rights over the assets or management of that undertaking; or
    (bb) the exercise of unified management of that undertaking where it is in one of the relationships defined in Article 12 (1); or
  (b) the information necessary for the preparation of consolidated accounts in accordance with this Directive cannot be obtained without disproportionate expense or undue delay;
  All material subsidiaries over which the parent undertaking has control should be consolidated especially SPEs in line with IAS 27.12 and SIC 12 (control defined as in IAS 27, which goes beyond legal control). No optional treatment should be allowed. Article 13.3(a) could be kept as it includes similar conditions as IAS 27.21. However, Article 13.3(b) needs to be deleted

since it is not in line with IAS 27. Alternatively Article 13.3 could be deleted and detailed requirements could be left to (national) standard setters.

- Article 26.2 of the Seventh Directive: A Member State *may permit* derogations from the provisions of paragraph 1 (c) above where a transaction has been concluded according to normal market conditions and where the elimination of the profit or loss would entail undue expense. Any such derogations must be disclosed and where the effect on the assets, liabilities, financial position and profit or loss of the undertakings, included in the consolidation, taken as a whole, is material, that fact must be disclosed in the notes on the consolidated accounts.
  All intra-group transactions need to be eliminated in order to be in line with IFRS (IAS 27.24). Article 26.2 needs to be deleted.

Modernisation of requirements

Several subjects are not covered by the current text of the Directives such as cash flow statements, deferred taxation pensions, leasing. These subjects are addressed in the (national) accounting standards. We are not aware that the lack of addressing these subjects in the Directives has lead to a larger degree of disharmonisation or divergence of practices. Therefore a modernisation of the Directive in the short term for these issues seems not of high priority.

The following article might be deleted in order to modernise the Fourth Directive in light of current accounting and to align with IFRS:

- Article 29 Fourth Directive: Income and charges that arise otherwise than in the course of the company's ordinary activities must be shown under ‘Extraordinary income and extraordinary charges’.
  We suggest deleting the Article, because it is not common any more in international standards.