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FEE STUDY

TO WHAT EXTENT CAN OPTIONS IN INTERNATIONAL ACCOUNTING STANDARDS BE USED FOR CONSOLIDATED ACCOUNTS UNDER THE EC ACCOUNTING DIRECTIVES?

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A. Introduction

In April 1999 FEE published its Study "Comparison of the EC Accounting Directives and IASs - a contribution to international accounting developments", with as purpose to create an understanding in individual Member States of developments in European thinking, especially in those Member States where the existing interpretations of the Accounting Directives to date have been narrower or in another way different from the interpretation of the Commission. The Comparison Study helped to identify whether all IASs can be applied and where obstacles or complications deserve extra attention within the framework of the Accounting Directives and is intended to be of help to both companies and accountants in assessing differences between the Directives and IASs. The Comparison Study did not address - at least not comprehensively - situations where a conflict between the IASs and the Directives can be avoided by using the appropriate options offered by the Accounting Directives and/or IASs. It may happen that in practice the company would prefer the IAS option conflicting with the Directives. The Comparison Study did not intend to present a comprehensive overview of those options that are not available to companies in a situation of compliance with Accounting Directives.

Also the European Commission has published various documents on the analysis which the Commission has carried out with the Member States on the compatibility of the various IAS with the Accounting Directives[1]. The Commission's documents have been quoted whenever relevant in the current study to provide a full picture of the opinions available. In principle, the Commission and Contact Committee interpretations are in line with FEE's interpretations.

This present study provides a comprehensive analysis of all options included in IASs for the consolidated accounts and investigates which options are not open to companies since they have to comply with the Accounting Directives. European companies have no possibility to follow these options despite some of them may be common international practice. By doing so the Study, in addition to the earlier published FEE Comparison Study hopes to give additional guidance to companies in Europe and their accountants wishing to apply IASs, in assessing the options within IASs and their compliance with the Accounting Directives.

[1]
- "Examination of the conformity between SIC-16 and the European Accounting Directives"
- "Examination of the conformity between IAS 35, IAS 36, IAS 37, IAS 38, IAS 22 (revised 1998), IAS 16 (revised 1998), IAS 28 (revised 1998), IAS 31 (revised 1998) and the European Accounting Directives", XV/6010/99, European Commission, 1999
- "Examination of the conformity between IAS 19 and the European Accounting Directives", XV/6020/99, European Commission, 1999
- "Examination of the conformity between IAS 32 (revised 1998) and the European Accounting Directives", XV/6026/99, European Commission, 1999
- "Examination of the conformity between International Accounting Standards and the European Accounting Directives", [Comparison document covering all IAS in force for accounting periods starting before 1 July 1998 (except IAS 32)], XV/6005/99, European Commission, 1999
- "Examination of the conformity between IAS 1 and the European Accounting Directives", XV/7030/98, European Commission, 1998
- "Examination of the conformity between IAS 12 and the European Accounting Directives", XV/7012/98, European Commission, 1998
- "An examination of the conformity between the International Accounting Standards and the European Accounting Directives", [Comparison document covering most IAS in force in 1996], Contact Committee/European Commission, 1996

These document are downloadable from website:
http://europa.eu.int/comm/internal_market/en/company/account/ias/index.htm.

Companies with limited liability in the European Union must operate within the framework provided by the Fourth and the Seventh Directives and in most cases comply with the implementation of the Directives in the national law of their Member State. Banks, insurance undertakings and other financial undertakings are also influenced by these Directives since the Bank Accounts Directive and Insurance Accounts Directive refer to certain articles of the Fourth and Seventh Directives. Changes to the Fourth and Seventh Directives may have implications for those Directives. Any direct application of IASs is at present only possible within the framework provided by the Accounting Directives. However, in a growing number of countries, the national law need no longer be complied with for the consolidated accounts of listed companies, providing that certain conditions are met.

In a number countries it is already possible to draw up financial statements in compliance with IASs, assuming compliance with the Directives. In others, this possibility has recently been created by amending legislation, with those financial statements still required to be in compliance with the Accounting Directives. Several European countries such as Austria, Belgium, France, Germany, Luxembourg, Italy and Spain allow or will allow the use of internationally accepted accounting standards in the consolidated accounts of mainly listed companies. In those countries, under certain conditions, not only the use of IASs is allowed but also the use of US GAAP. This study is, however, limited to an analysis of options within IASs and their compatibility with the Accounting Directives. The study does not address US GAAP.

B. Scope

The Study focuses on the possible obstacles in the Accounting Directives which hinder the use of options in IASs in the consolidated accounts where companies have the choice to adopt one method or the other - some times presented as a benchmark treatment and allowed alternative treatment or as equal option - to comply with IASs.

The Study deals only with the Fourth and Seventh Directives and does not address the Bank Accounts Directive (BAD) or the Insurance Accounts Directive (IAD), although some of the issues raised may also apply to the BAD and IAD through their linkage with the Fourth and Seventh Directives.

This Study aims to identify an overall point of view, taking into account the documents issued by the Commission and the Contact Committee on the Accounting Directives, including the Interpretative Communication of the Commission. In some cases, documents published by the Accounting Advisory Forum are referred to.

The Study focuses at the consolidated accounts and does not discuss options that are specific for the individual accounts. Examples of options that are specific for the individual accounts are IAS 27 para 29 and IAS 28 para 12 and 14.

This Study covers all extant IASs published or revised up to 30 April 2000 (up to IAS 40), including all SIC interpretations issued at that date. The Study does not address the options in IAS 25, since IAS 25 will be replaced by IAS 39 and IAS 40. It includes all recognition, measurement and presentation options. The Study does not cover the options in disclosure because the disclosure requirements of the IASs do not conflict with the Directives since the Directives set only minimum disclosure requirements. The Study does also not address the options in IAS 7 on cash flow statements since cash flow statements are not addressed by the Directives and therefore allowed by the Directives.

The Study presents a comprehensive overview of all options included in IASs. It compares the text of IASs with the relevant text in the Accounting Directives and refers to documents of the Commission, Contact Committee and Accounting Advisory Forum where relevant. It provides a conclusion as to whether or not all options offered by a certain IAS can be used by the companies respecting the Accounting Directives.

C. Summary

		Fourth and Seventh Directives	
IAS	**Alternative treatments in IAS**	**IAS treatment allowed**	**IAS treatment not allowed**
RECOGNITION AND MEASUREMENT			
1. Inventories cost formula (IAS 2. 21 and 23)	Benchmark: FIFO and weighted average Allowed Alternative Treatment: LIFO	All three	
2 (a) Changes in Accounting Policies (IAS 8, 49 and 54)	Benchmark: Adjusting Opening Balance of Retained Earnings Allowed Alternative Treatment: Adjusting Net Profit of Loss for the Current Period	Both	
2 (b) Fundamental Errors (IAS 8, 34 and 38)	Benchmark: Adjusting Opening Balance of Retained Earnings Allowed Alternative Treatment: Adjusting Net Profit or Loss for the Current Period	Both	
3. Valuation of fixed assets (IAS 16, 28 and 29)	Benchmark: valuation at cost Allowed Alternative Treatment: fair value at date of revaluation less depreciation and impairment losses	Both	

		Fourth and Seventh Directives	
IAS	**Alternative treatments in IAS**	**IAS treatment allowed**	**IAS treatment not allowed**
4. Corridor procedure (IAS 19.92 and 93)	Optional use of the corridor procedure to spread certain actuarial gains and losses	Immediate recognition	Corridor procedure not allowed
5. Presentation of grants (IAS 20.24)	Option to present grants gross (deferred income) or net (deducting from carrying amount of the related assets)	Both	
6 (a) Exchange differences (IAS 21.15, 20 and 21)	Benchmark: To expense foreign exchange differences Allowed Alternative Treatment: to recognise foreign exchange differences as capitalised costs	Both	
6 (b) Goodwill on acquisition of a foreign entity (IAS 21.33)	Goodwill and any fair value adjustments to assets or liabilities treated as assets and liabilities of the foreign entity or of the reporting entity	Both	
7. Treatment of minority interest share in allocation of cost of acquisition (IAS 22.32)	Benchmark Treatment: to include minority interest share in the value adjustments on acquisition Allowed Alternative Treatment: not to include minority interest share in the value adjustment on acquisition	Both	

		Fourth and Seventh Directives	
IAS	**Alternative treatments in IAS**	**IAS treatment allowed**	**IAS treatment not allowed**
8. Borrowing costs (IAS 23.7, 10 and 11)	Benchmark: expensing borrowing costs Allowed Alternative Treatment: capitalisation of borrowing cost provided that certain conditions are met.	Both	
9. Joint Ventures IAS 31.25, 32 and 35)	Benchmark: proportionate consolidation Allowed Alternative Treatment: equity method	Both	
10. Measurement of Intangible Assets (IAS 38. 63 and 64)	Benchmark: Measurement at cost Allowed Alternative Treatment: measurement at fair value	Cost	Fair value
11 (a) Gains and losses on fair value (IAS 39.103)	Recognition in income or inclusion in equity	Both In accordance with the proposed fair value amendments of the Accounting Directives, both treatments are allowed.	
11 (b) Trade Date vs. Settlement Date Accounting (IAS 39.30)	Option to use trade date or settlement date accounting for the purchase for financial assets.	Both	

		Fourth and Seventh Directives	
IAS	**Alternative treatments in IAS**	**IAS treatment allowed**	**IAS treatment not allowed**
12. Investment Property – Fair value model vs Cost model (IAS 40.24)	Enterprise choice for either fair value model or cost model for all its investment property	Cost model	Fair value model
PRESENTATION			
13 (a) Current/non-current classification (IAS 1.53)	Option to present assets and liabilities in separate current/non-current classifications	Classification in fixed/current	Classification in current/non-current
13 (b) Face of the Balance Sheet or in Notes (IAS 1.72)	Option to present further subclassification on the face of the balance sheet or in the notes	Both	
13 (c) Classification of expenses (IAS 1.77)	Option to classify expenses based on nature or their function within the enterprise	Both	

		Fourth and Seventh Directives	
IAS	**Alternative treatments in IAS**	**IAS treatment allowed**	**IAS treatment not allowed**
13 (d) Changes in equity (IAS 1.86)	Optional disclosure in equity statement or in the notes to the accounts	Both	
14. Formats for proportionate consolidation (IAS 31.28)	Specific captions for enterprise consolidated under the proportionate method or inclusion in ordinary captions	Both	
15. Discontinuing Operations (IAS 35.39)	Optional disclosure on face of the profit and loss account or in notes	In the notes	Disclosure on face of the profit and loss account not possible when using horizontal formats.

D. Conclusions

The analysis of all measurement and presentation options in the IASs is assuming a broad interpretation of the Accounting Directives. It shows that there are only a few options in IASs which cannot be used in the consolidated accounts being in line with IASs as well as with the Accounting Directives, because they are in conflict with the Accounting Directives:

Measurement

- certain aspects of the optional corridor approach in IAS19 are not allowed under the Accounting Directives
- fair valuing intangible assets, the allowed alternative treatment in IAS 38 is not allowed under the Accounting Directives
- use of the fair value model of IAS 40 is not allowed under the Accounting Directives (Also under the proposed amendment of the Directives to introduce fair value accounting this is not allowed)

Presentation

- Not to classify in current/non-current is not allowed under the Accounting Directives
- Under the horizontal format of the profit and loss account in the Accounting Directives it is not possible to disclose discontinuing operations on the face of the profit and loss account.

As concluded in the study "Comparison of the EC Accounting Directives and the IASs - A Contribution to International Accounting Developments" published in April 1999, among the FEE Member Bodies there are no significant differences in understanding of IASs. However, when examining the Accounting Directives the interpretation and understanding for different reasons may vary among the individual countries. Therefore, the positions of FEE presented here are not necessarily the opinions of all individual Member Bodies.

E. Analysis of Options in IASs

RECOGNITION AND MEASUREMENT

1. IAS 2 Inventories

Cost formulas

Benchmark Treatment

Para 21: ***The cost of inventories other than those dealt with in paragraph 19, should be assigned by using the first-in, first-out (FIFO) or weighted average cost formulas.***[2]

Allowed Alternative Treatment

Para 23: ***The cost of inventories, other than those dealt with in paragraph 19, should be assigned by using the last-in, first-out (LIFO) formula.***[1]

The Fourth Directive permits in Article 40 the use of all three cost formulas:

Art 40: 1. 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 methods.

Conclusion: Both the benchmark treatment of FIFO and weighted average cost formulas and the allowed alternative treatment of the LIFO formula are allowed under the Fourth Directive.

2. IAS 8 Net Profit or Loss for the Period, Fundamental Errors and changes in Accounting Policies

CHANGES IN ACCOUNTING POLICIES

Other changes in Accounting Policies - Benchmark Treatment

Para 49: ***A change in accounting policy should be applied retrospectively unless the amount of any resulting adjustment that relates to prior periods is not reasonably determinable. Any resulting adjustment should be reported as an adjustment to the opening balance of retained earnings. Comparative information should be restated unless it is impracticable to do so.***[3]

Other changes in Accounting Policies - Allowed Alternative Treatment

[2] SEE also SIC - 1, Consistency - Different Cost Formulas for Inventories

[3] SIC 8, First-Time Application of IASs as the Primary Basis of Accounting. This states that it is not appropriate to recognise the cumulative effect of changes resulting from the transition from national GAAP to IAS in the income statement (i.e., the Allowed Alternative Treatment set out in IAS 8.54 is not applicable to the first-time application of IAS as the primary accounting basis).

Para 54: ***A change in accounting policy should be applied retrospectively unless the amount of any resulting adjustment that relates to prior periods is not reasonable determinable. Any resulting adjustment should be included in the determination of the net profit or loss for the current period. Comparative information should be presented as reported in the financial statements of the prior period. Additional pro forma comparative information, prepared in accordance with paragraph 49, should be presented unless it is impracticable to do so.***

The Fourth Directive states the following concerning the opening balance:

31.1 (f): the opening balance sheet for each financial year must correspond to the closing balance sheet for the preceding financial year.

VIEWS IN MEMBER STATES

Back in 1992, in its 1992 FEE Analysis of European Accounting and Disclosure Practices, FEE has analysed Art 31.1 (f) in relation to changes in accounting policies:

Member States can be grouped into two broadly similar groups which have applied quite different interpretations to Article 31.1 (f). First, there are those countries which have applied a narrow interpretation of Article 31.1 (f), requiring that the opening balance sheet *must* be equal to the closing balance sheet, thereby prohibiting any adjustment against opening retained earnings. This is the position in Belgium, France, Germany, Greece, Italy, Luxembourg and Spain. A similar position occurs in the non-EU countries Finland, Norway, Sweden and Switzerland. However, it should be noted that in France exceptions to the general rule are permitted in cases of changes in accounting practice resulting from new accounting regulations. Second, there are those countries which have applied a more liberal interpretation to Article 31.1 (f) by allowing adjustments against the closing balance sheet of the preceding financial year in accordance with best accounting practice for that country, provided full disclosure is made in the notes to the accounts. This applies to Denmark, Ireland, the Netherlands and the United Kingdom. It is interesting to note that, in the case of Switzerland, a strict interpretation is applied to single accounts but a more liberal one is applied to consolidated accounts, where international reporting practices are likely to be more influential.

It was concluded that the IASC benchmark method conflicts with Art 31.1.f when this article is interpreted in the narrow sense, i.e. that the opening balance sheet must equal the closing balance sheet of the preceding financial period.

Conclusion: Since nowadays the trend is to interpret the Directives in the widest possible sense, in the view of the majority of FEE Member Bodies, it can be concluded that both the benchmark treatment of adjusting the opening balance of retained earnings and the allowed alternative treatment of adjusting net profit or loss for the current period would be permitted by the Accounting Directives. However, in some Member States, like Italy and – in particular with respect to the individual accounts – in Germany, it is still considered that according to the Fourth Directive any adjustment against equity is not possible.

FUNDAMENTAL ERRORS

Benchmark Treatment

Para 34: ***The amount of the correction of a fundamental error that related to prior periods should be reported by adjusting the opening balance of retained earnings. Comparative information should be restated, unless it is impracticable to do so.***

Allowed Alternative Treatment

Para 38: ***The amount of the correction of a fundamental error should be included in the determination of net profit or loss for the current period. Comparative information should be presented as reported in the financial statements of the prior period. Additional pro forma information, prepared in accordance with paragraph 34, should be presented unless it is impracticable to do so.***

The options are similar to the treatment of changes in accounting policy. The same article of the Fourth Directive applies.

<u>Conclusion</u>: Also for the correction of fundamental errors, in the view of the majority of FEE Member Bodies, it can be concluded that both the benchmark treatment of adjusting the opening balance of retained earnings and the allowed alternative treatment of adjusting net profit or loss for the current period would be permitted by the Accounting Directives. However, in some Member States, like Italy - and in particular with respect to individual accounts - in Germany, it is still considered that according to the Fourth Directive any adjustment against equity is not possible.

3. IAS 16 Property, Plant and Equipment

Benchmark Treatment

Para 28: ***Subsequent to initial recognition as an asset, an item of property, plant and equipment should be carried at its cost less any accumulated depreciation and any accumulated impairment losses.***

Allowed Alternative Treatment

Para 29: ***Subsequent to initial recognition as an asset, an item of property, plant and equipment should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations should be made with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.***

The Fourth Directive gives a general valuation principle historical cost but gives in Art 33 a Member State option to revalue:

Art 32: *The items shown in the annual accounts shall be valued in accordance with Article 34 to 42, which are based on the principle of purchase price or production cost.*

Art 33.1: The Member States may declare to the Commission that they reserve the power, by way of derogation from Article 32 and pending subsequent coordination, to permit or require in respect of all companies or any classes of companies:

(a) valuation by the replacement value method for tangible fixed assets with limited useful economic lives and for stocks;

(b) valuation by methods other than that provided for in (a) which are designed to take account of inflation for the items shown in annual accounts, including capital and reserves;

(c) revaluation of tangible fixed assets and financial fixed assets.

Where national law provides for valuation methods as indicated in (a), (b) and (c), it must define their content and limits and the rules for their application.

The application of any such method, the balance sheet and profit and loss account items concerned and the method by which the values shown are calculated shall be disclosed in the notes on the accounts.

Art 35.1 (a) Fixed assets must be valued at purchase price or production cost, without prejudice to (b) and (c) below.

(b) The purchase price or production cost of fixed assets with limited useful economic lives must be reduced by value adjustments calculated to write off the value of such assets systematically over their useful economic lives.

<u>Conclusion</u>: It can be concluded that the Fourth Directive allows for revaluation of fixed assets as a Member State option. Therefore both options: benchmark treatment of valuation at cost less any accumulated depreciation and any accumulated impairment losses and the allowed alternative treatment of fair value at date of revaluation less any subsequent accumulated depreciation and any subsequent accumulated impairment losses would not pose problems under the Accounting Directives.

Note

In SIC D18 it is indicated that para 39 of IAS 16 constitutes an option on the realisation of cumulative revaluation surplus. Although the word "may" is used this paragraph does not constitute an option but a requirement to transfer the cumulative revaluation surplus directly to retained earnings when the surplus is realised.

4. IAS 19 Employee Benefits

Corridor procedure

Actuarial Gains and Losses

Para 92: In measuring its defined benefit liability under paragraph 54, an enterprise should recognise a portion (as specified in paragraph 93) of its actuarial gains and losses as income or expense if the net cumulative unrecognised actuarial gains and losses at the end of the previous reporting period exceeded the greater of:

(a) 10% of the present value of the defined benefit obligation at that date (before deducting plan assets); and

(b) 10% of the fair value of any plan assets at that date.

These limits should be calculated and applied separately for each defined benefit plan.

Para 93: ***The portion of actuarial gains and losses to be recognised for each defined benefit plan is the excess determined under paragraph 92, divided by the expected average remaining working lives of the employees participating in that plan. However, an enterprise may adopt any systematic method that results in faster recognition of actuarial gains and losses, provided that the same basis is applied to both gains and losses and the basis is applied consistently form period to period. An enterprise may apply such systematic methods to actuarial gains and losses even if they fall within the limits specified in paragraph 92.***

The Fourth Directive does not address pensions specifically except for some disclosure requirements. However, Article 43.7 is widely interpreted as allowing no or only partial recognition of pension obligations with disclosure of the unrecognised obligation in the notes.

Art 31.1 The Member States shall ensure that the items shown in the annual accounts are valued in accordance with the following general principles: (…)

(c) valuation must be made on a prudent basis, and in particular:

(aa) only profits made at the balance sheet date may be included,
(bb) account must 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,
(cc) account must be taken of all depreciation, whether the result of the financial year is a loss or a profit;

(d) account must be taken of income and charges relating to the financial year, irrespective of the date of receipt or payment of such income or charges….

Art 42: Provisions for liabilities and charges may not exceed in amount the sums which are necessary.
The provisions shown in the balance sheet under 'Other provisions' must be disclosed in the notes on the accounts if they are material.

Art. 43.7: The total amount of any financial commitments that are not included in the balance sheet, in so far as this information is of assistance in assessing the financial position. Any commitments concerning pensions and affiliated undertakings must be disclosed separately.

In April 1999 FEE has published a study "Comparison of the EC Accounting Directives and IASs". This Study contained a chapter on employee benefits and considered as one of the issues whether the optional "corridor" approach prescribed by IAS 19 for the recognition of actuarial gains and losses is permitted under the Fourth Directive. The Study also referred to the Commission's and Contact Committee's interpretation, which is now finalised: Examination of the conformity of IAS 19 (revised 1998) and the European Accounting Directives:

Post-employment benefits

"However, IAS 19 also incorporates a mechanism to spread certain gains and losses - in particular actuarial variations and the cost of past service benefit - over more than one accounting period' and it is this mechanism that gives rise to a potential conflict with the Fourth Directive. Since the basic approach of IAS 19 is to explicitly recognise that the reporting entity has a liability to pay pensions and assets out of which to pay them, it follows that the 'corridor' approach must mean that, until the 10% threshold is triggered, some part of a known (within the terms of the IAS) liability is not being recognised at the balance sheet date, potentially on a semi-permanent basis. This is a conflict with the basic principle of Articles 31.1(c)(bb) and 31.1(d) that all foreseeable liabilities must be provided for and that all charges relating to the financial year must be recognised in that year.

However, it should be noted that IAS 19 does not require the application of the corridor approach, and European companies are still able to comply with both IAS 19 and the Fourth Directive by applying paragraph 93 of IAS 19. This would result in the immediate recognition of all actuarial gains and losses, both within and outside the corridor.

Commission's Contact Committee Conclusion

IAS 19's mechanism to spread certain gains and losses (known as the corridor approach) conflicts with the basic principle of Articles 31.1 (c)(bb) and 31.1(d) in the Fourth Directive that all foreseeable liabilities must be provided for and that all charges relating to the financial year must be recognised in that year. However, IAS 19 does not require the application of the corridor approach, and European companies are still able to comply with both IAS 19 and the Fourth Directive by applying paragraph. 93 of IAS 19. This would result in the immediate recognition in the profit and loss account of all actuarial gains and losses, both within and outside the corridor. The enterprise can also adopt any systematic method that results in faster recognition of actuarial gains and losses, provided that the conditions laid down in IAS 19 are respected."

In its Study FEE concluded:

"The corridor procedure and the spreading of past service cost, as permitted by IAS 19, might result in deferred charges or a net amount of the pension obligation lower than its full amount. This would not be in compliance with Article 31.1 (c) (bb) of the Fourth Directive, which states that account must be taken of all foreseeable liabilities. However, Article 43.7 of the Directive is widely interpreted as allowing no or partial recognition of pension obligations, the unrecognised obligation being disclosed in the notes. FEE is of the opinion that this interpretation is acceptable under Art 43.1 (7) of the Fourth Directive.

However, there is an incompatibility between the Directives and IAS 19 as regards actuarial gains. FEE considers that deferring actuarial gains would not be in compliance with Art 42 of the Fourth Directive which states that provisions may not exceed in amount the sums which are necessary. Since the corridor procedure is optional, companies do not need to use the corridor procedure. In this way, they could comply both with IAS 19 and the Fourth Directive. However, companies may wish to use the corridor approach to align with international practice whereas the Directive would not allow them to do so."

Conclusion: Based on the above analysis it can be concluded that certain aspects of the optional corridor procedure cannot be used under the Fourth Directive.

5. IAS 20 Accounting for Government Grants and Disclosure of Government Assistance

PRESENTATION OF GRANTS RELATED TO ASSETS

Para 24: ***Government grants related to assets, including non-monetary grants at fair value, should be presented in the balance sheet either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset.***

The Fourth Directive does not address government grants. In relation to the gross or net presentation of government grants, Article 7 of the Fourth Directive on netting is relevant:

Art 7: *Any set-off between asset and liability items, or between income and expenditure items, shall be prohibited.*

The Accounting Advisory Forum has published in 1995 a paper on government grants. Two methods of presentation in the balance sheet of government grants related to assets are commonly used in the EU: (i) the gross method, whereby the grant is accounted for as deferred income and (ii) the net method, whereby the grant is deducted in arriving at the carrying amount of the asset. The paper concludes that preference should be given to the gross method although the net method should also be allowed (in line with IAS 20) where capital grants may be offset against asset values. Para 25 and 26 of the Accounting Advisory Forum paper set out the arguments in support of using the net or gross method:

"(a) Acquisition cost in the sense of the Fourth Directive is the price paid plus expenses incidental thereto (Art 35.2). Therefore deducting the grant from the invoice price is consistent with this definition.

(b) The Fourth Directive prohibits in Article 7 the set-off between asset and liability items, which would rule out the net method. Moreover, Article 15.3 (a) of the Fourth Directive requires companies to disclose the purchase price or production cost of fixed assets before any value adjustment. (…)"

VIEWS IN MEMBER STATES

The net method would not be viewed as in conformity with the Fourth Directive in the UK. The text of the equivalent UK standard (SSAP4) refers to legal opinion that the equivalent paragraphs in UK legislation have the effect of prohibiting enterprises to which the legislation applies from accounting from grants, made as a contribution towards expenditure on fixed assets, by deducting the amount from the purchase price or production cost of the related asset.

Conclusion: FEE is of the opinion that both methods, the gross and net method, would be allowed under the Fourth Directive.

6. IAS 21 The Effects of Changes in Foreign Exchange Rates

TREATMENT OF EXCHANGE DIFFERENCES ARISING ON THE SETTLEMENT OF MONETARY ITEMS

Para 15: ***Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraphs 17 and 19.***

Allowed Alternative Treatment

Para 20: ***The benchmark treatment for exchange differences dealt with in paragraph 21 is set out in paragraph 15.***

Para 21: ***Exchange differences may result from a severe devaluation or depreciation of a currency against which there is no practical means of hedging and that affects liabilities which cannot be settled and which arise directly on the recent acquisition of an asset invoiced in a foreign currency. Such exchange differences should be included in the carrying amount of the related asset, provided that the adjusted carrying amount does not exceed the lower of the replacement cost and the amount recoverable from the sale or use of the asset.***[4]

SIC 11 on foreign exchange - capitalisation of losses resulting from severe currency devaluations provides more detailed guidance on the use of the allowed alternative treatment.

The issue is not addressed in the Fourth Directive. Art 35 seems not to cover the capitalisation of foreign exchange differences.

Art 35.4: *Interest on capital borrowed to finance the production of fixed assets may be included in the production costs to the extent that it relates to the period of production. In that event, the inclusion of such interest under 'Assets' must be disclosed in the notes on the accounts.*

VIEWS IN MEMBER STATES

According to the present German understanding of Article 35.4 of the Fourth Directive the capitalisation of exchange differences arising from the settlement of a liability arising directly on the recent acquisition of an asset invoiced in a foreign currency is seen to be not in line with the Fourth Directive. Following this understanding the purchase price of an asset invoiced in a foreign currency is determined by the liability converted with the exchange rate of the purchase time. Exchange differences resulting from further changes in the exchange rate are only subject to the corresponding liability but not to the relating asset as these exchange differences are no interest on capital borrowed, for which Art. 35 (4) of the Fourth Directive allows capitalisation, nor they are expenses incidental to the purchase price (Anschaffungsnebenkosten) allowed to be capitalised under Art. 35 (2) of the Fourth Directive.

Conclusion: FEE is of the opinion that both options - whether or not to capitalise exchange differences are possible under the Fourth Directive.

GOODWILL ARISING ON THE ACQUISITION OF A FOREIGN ENTITY

Para 33: **Any goodwill arising on the acquisition of a foreign entity and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign entity are treated as either:**

(a) assets and liabilities of the foreign entity and translated at the closing rate in accordance with paragraph 30; or

(b) assets and liabilities of the reporting entity which either are already expressed in the reporting currency or are non-monetary foreign currency items which are reported using the exchange rate at the date of the transaction in accordance with paragraph 11 (b).

[4] See also SIC-11, foreign Exchange - Capitalisation of Losses Resulting from Severe Currency Devaluations.

The issue is not addressed by the Seventh Directive.

Conclusion: Both options - goodwill on the acquisition of a foreign entity and any fair value adjustments to the carrying amount of assets and liabilities can be treated as assets and liabilities of the foreign entity or as assets and liabilities of the reporting entity - seem to be open under the Accounting Directives.

7. IAS 22 Business Combinations

Allocation of Cost of Acquisition

Benchmark Treatment

Para 32: The identifiable assets and liabilities recognised under paragraph 26 should be measured at the aggregate of:

(a) the fair value of the identifiable assets and liabilities acquired as at the date of the exchange transaction to the extent of the acquirer's interest obtained in the exchange transaction; and

(b) the minority's proportion of the pre-acquisition carrying amounts of the identifiable assets and liabilities of the subsidiary.

Any goodwill or negative goodwill should be accounted for under this Standard.

Allowed Alternative Treatment

Para 34: The identifiable assets and liabilities recognised under paragraph 26 should be measured at their fair values as at the date of acquisition. Any goodwill or negative goodwill should be accounted for under this Standard. Any minority interest should be stated at the minority's proportion of the fair values of the identifiable assets and liabilities recognised under paragraph 26.

Art 19 of the Seventh Directive covers the allocation of acquisition costs:

Art 19: 1. The book values of shares in the capital of undertakings included in a consolidation shall be set off against the proportion which they represent of the capital and reserves of those undertakings:

(a) That set-off shall be effected on the basis of book values as at the date as at which such undertakings are included in the consolidations for the first time. Differences arising from such set-offs shall as far as possible be entered directly against those items in the consolidated balance sheet which have values above or below their book values.

(b) A Member State may require or permit set-offs on the basis of the values of identifiable assets and liabilities as at the date of acquisition of the shares or, in the event of acquisition in two or more stages, as at the date on which the undertaking became a subsidiary.

(c) Any difference remaining after the application of (a) or resulting from the application of (b) shall be shown as a separate item in the consolidated balance sheet with an appropriate heading. That item, the methods used and any

significant changes in relation to the preceding financial year must be explained in the notes on the accounts. Where the offsetting of positive and negative differences is authorised by a Member Sate, a breakdown of such differences must also be given in the notes on the accounts.

2. *However, paragraph 1 above shall not apply to shares in the capital of the parent undertaking held either by that undertaking itself or by another undertaking included in the consolidation. In the consolidated accounts such shares shall be treated as own shares in accordance with Directive 78/660/EEC.*

Conclusion: Both options concerning the treatment of minority interest share in the value adjustments on acquisitions or not remain open under the Seventh Directive.

8. IAS 23 Borrowing Costs

Benchmark Treatment

Para 7: Borrowing costs should be recognised as an expense in the period in which they are incurred.

Allowed Alternative Treatment

Para 10: Borrowing costs should be recognised as an expense in the period in which they are incurred, except to the extent that they are capitalised in accordance with paragraph 11.

Para 11: Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard.[5]

Also the Fourth Directive addresses the capitalisation of borrowing costs:

Art 35.4: Interest on capital borrowed to finance the production of fixed assets may be included in the production costs to the extent that it relates to the period of production. In that event, the inclusion of such interest under 'Assets' must be disclosed in the notes on the accounts.

Art 39.2: The definitions of purchase price and of production cost given in Article 35 (2) and (current assets) (3) shall apply. The Member States may also apply Article 35 (4). Distribution costs may not be included in production costs.

The Commission's Contact Committee has addressed the issue back in 1996 in its first conformity examination: "An examination of the conformity between the International Accounting Standards and the European Accounting Directives". It came to the conclusion:

"According to paragraph 11 of IAS23, borrowing costs are to be capitalised, when they refer to the acquisition, construction or production of an asset that necessarily takes a substantial period to be made ready for its intended use or sale. On the other hand, according to Article 35(4) of the 4th Directive, borrowing costs may be capitalised when they refer to the "production" of an asset, and to the extent that they refer to the period of production.

[5] SEE also SIC-2, Consistency - Capitalisation of Borrowing Costs.

The Contact Committee observed that the term "production" contained in the 4th Directive should not be interpreted too narrowly. In fact, although the term "production" clearly excludes those activities which result in an asset being immediately ready for use or sale, the same term can perfectly cover other acquisitions which do not have these characteristics (for instance acquisitions of components which are then assembled). The Contact Committee has therefore concluded that IAS 23 does not conflict with Article 35(4) of the 4th Directive. The text is clearer and the formulation more precise."

The Commission also addresses the capitalisation of borrowing costs in its 1998 Interpretative Communication Concerning Certain Articles of the Fourth and Seventh Directive Council Directives on Accounting:

"41. Interest on capital borrowed to finance the production of fixed assets may, according to Article 35(4), be included in the production costs to the extent that it relates to the period of production. The term 'production' in Article 35(4) should not be interpreted too narrowly.

42. Borrowing costs relating to the construction of a fixed asset may equally qualify for capitalisation. In the same way, borrowing costs relating tot he acquisition of a fixed asset may also be capitalised provided the acquisition does not result in an asset being immediately ready for use or sale. Indeed, capitalisation of borrowing costs presupposes that a substantial period of time is needed before the asset is ready for its intended use or sale. As far as acquisitions are concerned, this could be the case where components are being acquired which are then assembled."

Conclusion: Both the benchmark treatment of expensing borrowing costs and the allowed alternative treatment of capitalisation provided that certain conditions are met are allowed under the Fourth Directive. However, pursuant to SIC 2.3, if an enterprise adopts the allowed alternative treatment, that treatment should be applied consistently to all borrowing costs that are directly attributable to the acquisition, construction or production of all qualifying assets of the enterprise. In contrast, under the Accounting Directives this treatment may be limited to like transactions

9. IAS 31 Financial Reporting of Interest in Joint Ventures

CONSOLIDATED FINANCIAL STATEMENTS OF A VENTURER.

Benchmark Treatment - Proportionate Consolidation

Para 25: In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using one of the two reporting formats for proportionate consolidation.

Allowed Alternative Treatment - Equity Method

Para 32: In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using the equity method.

Exception to Benchmark and Allowed Alternative Treatments

Para 35: A venturer should account for the following interests as if they are investments either at cost or in accordance with IAS 39, Financial Instruments: Recognition and Measurement[6]:

[6] Amended as a consequence of IAS 39.

(a) ***an interest in a jointly controlled entity which is acquired and held exclusively with a view to its subsequent disposal in the near future; and***

(b) ***an interest in a jointly controlled entity which operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.***

The Seventh Directive addresses in Art 32 on joint ventures:

Art 32: 1. *Where an undertaking included in a consolidation manages another undertaking jointly with one or more undertakings not included in that consolidation, a Member State may require or permit the inclusion of that other undertaking in the consolidated accounts in proportion to the rights in its capital held by the undertaking included in the consolidation.*

2. *Articles 13 to 31 shall apply 'mutatis mutandis' to the proportional consolidation referred to in paragraph 1 above.*

3. *Where this Article is applied, Article 33 shall not apply if the undertaking proportionally consolidated is an associated undertaking as defined in Article 33.*

Art 33.1: *Where an undertaking included in a consolidation exercises a significant influence over the operating and financial policy of an undertaking not included in the consolidation (an associated undertaking) in which it holds a participating interest, as defined in Article 17 of Directive 78/660/EEC, that participating interest shall be shown in the consolidated balances sheet as a separate item with an appropriate heading. An undertaking shall be presumed to exercise a significant influence over another undertaking where it has 20% or more of the shareholders' or members' voting rights in that undertaking. Article 2 shall apply*

Also the Commission's Contact Committee addressed the issue back in 1996 in its conformity study "An examination of the conformity between International Accounting Standards and the European Accounting Directives" and concluded that in substances no conflict arises:

"In the cases listed in its paragraph 35, IAS31 forbids the use of the equity method and of proportionate consolidation. The Accounting Directives do not provide for any particular valuation method not to be applied because of particular conditions. Therefore a conflict apparently exists. However, as already stated in paragraph 41 above, the circumstances which hinder the application of the proportional consolidation or of the equity method will impede the participation to be included in the consolidation and will therefore automatically impede, also under the Accounting Directives, its valuation according to the two above-mentioned methods.

The Contact Committee has therefore concluded that, although the rules contained in IAS31 are not contained in the 7th Directive, the effect in practice will be the same and in substance no conflict arises."

The Contact Committee did not address para 25 and 32 providing a choice between proportionate consolidation and the equity method.

Conclusion: Both options - the benchmark treatment of proportionate consolidation and the allowed alternative treatment of applying the equity method - are allowed under the Seventh Directive. Also the exception to the benchmark and allowed alternative treatments of accounting as investment would be allowed under the Seventh Directive.

10. IAS 38 Intangible Assets

Benchmark Treatment

Para 63: ***After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairm ent losses.***

Allowed Alternative Treatment

Para 64: ***After initial recognition, an intangible assets should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated amortisation and any subsequent accumulated impairment losses. For the purpose of revaluations under this Standard, fair value should be determined by reference to an active market. Revaluations should be made with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.***

The Fourth Directive addresses in Art 33 fair value accounting.

Art 33.1 *The Member States may declare to the Commission that they reserve the power, by way of derogation from Article 32 and pending subsequent coordination, to permit or require in respect of all companies or any classes of companies:*

(a) valuation by the replacement value method for tangible fixed assets with limited useful economic lives and for stocks;

(b) valuation by methods other than that provided for in (a) which are designed to take account of inflation for the items shown in annual accounts, including capital and reserves;

(c) revaluation of tangible fixed assets and financial fixed assets.

Where national law provides for valuation methods as indicated in (a), (b) and (c), it must define their content and limits and the rules for their application.

The application of any such method, the balance sheet and profit and loss account items concerned and the method by which the values shown are calculated shall be disclosed in the notes on the accounts.

However Article 33.1 (a) and (c) do not cover intangible assets and Art 33.1.1 (b) on inflation accounting seems not appropriate to conclude that fair valuing intangible assets would be permitted under the Fourth Directive. Under the Fourth Directive intangible assets can only be measured at historical cost.

Also the Commission's Contact Committee addressed the issue in its recently published "Examination of the Conformity between IAS 35, IAS 36, IAS 37, IAS 38, IAS 22 (revised 1998), IAS 16 (revised 1998), IAS 28 (revised 1998), IAS 31 (revised 1998) and the European Accounting Directives and draws the same conclusion:

"The benchmark treatment in IAS 38 (paragraph 63) is to carry intangible assets at cost less amortisation and impairment losses. However, as an allowed alternative (paragraph 64) intangible assets may be carried at a revalued amount, to be based on fair value in an active market which occurs rarely. By contrast, revaluation of intangible assets is permitted under the Fourth Directive only by virtue of Article 33.1(b), which permits a derogation to Member States to permit any asset to be carried at a method 'designed to take account of inflation'. Consequently, IAS 38's allowed alternative of revaluing intangible assets to fair value is inconsistent with the Directive, since accounting for assets at fair value is different to applying a valuation method which is "designed to take account of inflation". Nevertheless, European companies are still able to comply with both the Directives and IAS 38 by ensuring that they do not elect to apply the alternative treatment allowed under paragraph 64 of IAS 38."

<u>Conclusion</u>: The allowed alternative treatment of carrying intangible assets at revalued amount at the date of revaluation less any subsequent impairment losses is not allowed under the Fourth Directive.

11. IAS 39 Financial Instruments: Recognition and Measurement

GAINS AND LOSSES ON REMEASUREMENT TO FAIR VALUE

Para 103: A recognised gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship (see paragraphs 121-165) should be reported as follows:

(a) a gain or loss on a financial asset or liability held for trading should be included in net profit or loss for the period in which it arises (in this regard, a derivative should always be considered to be held for trading unless it is a designated hedging instrument - see paragraph 122);

(b) a gain or loss on an available-for-sale financial asset should be either:

i) included in net profit or loss for the period in which it arises; or

ii) recognised directly in equity, through the statement of changes in equity (see IAS 1, Presentation of Financial Statements, paragraphs 86-88), until the financial asset is sold, collected, or otherwise disposed of, or until the financial asset is determined to be impaired (see paragraph 117-119), at which time the cumulative gain or loss previously recognised in equity should be included in net profit or loss for the period.

In February 2000 the Commission published a proposal for a Directive amending the Fourth and Seventh Directives as regards the valuation rules for the annual and consolidated accounts of certain types of companies. In the introduction the Commission states: "Without this proposed amendment, those companies that wish to use IAS (including IAS 39) whilst remaining in compliance with the Accounting Directives will face an obstacle in the valuation rules. In general terms, therefore, the purpose of this proposal is to modernise the Accounting Directives in line with business developments and associated developments in international accounting standard setting so that they remain in line with the capital market financial reporting requirements of internationally active European companies. It will therefore enable European companies to participate in the capital markets on equal terms with their non-European competitors." (words in brackets added).

The proposed Art 42c addresses the accounting treatment of changes in fair value:

"1. Notwithstanding Article 31(1)(c)(aa), where a balance sheet item has been valued at fair value in accordance with Article 42a (1) a change in the fair value of that item should be included in the profit and loss account in arriving at the profit or loss for the financial year.

2. Member States may permit or require the gain or loss on a financial asset that is not held for trading purposes to be recognised directly in equity, in a fair value reserve. To the extent that gains and losses on such items that have been recognised in equity are actually realised, they must be removed from the fair value reserve. The Member States may lay down rules governing the use of the fair value reserve.

3. *Notwithstanding paragraph 1, the change in the fair value of an item measured in accordance with Article 42b should not be included in the profit and loss account in arriving at the profit or loss for the financial year, but must be included directly in the fair value reserve where:*

   (a) that item is accounted for as a hedging instrument under a system of hedge accounting that allows such changes in value not to be shown in the profit and loss account, or

   (b) such change in value relates to an exchange difference arising on a monetary item that forms part of a company's net investment in an affiliated foreign undertaking.

4. *The fair value reserve referred to in paragraph 3 should be reduced to the extent that the amounts shown therein are no longer necessary for the implementation of the valuation methods under the circumstances referred to in sub-paragraphs (a) and (b) of paragraph 3. The Member States may lay down rules governing the use of the fair value reserve."*

Under the proposal to amend the Directive recognition in income is the normal treatment, but Member States may permit or require the recognition in equity directly of fair value changes related to financial assets not held for trading purposes.

Conclusion: Under the proposed amendment of the Fourth Directive gains or losses on an available-for-sale financial asset both options, recognition in the profit and loss account and recognition directly in equity, are allowed.

TRADE VS SETTLEMENT DATE ACCOUNTING

Para 30: A 'regular way' purchase of financial assets should be recognised using trade date accounting or settlement date accounting described in paragraph 32 and 33. The method used should be applied consistently for each of the four categories of financial assets defined in paragraph 10. A 'regular way' sale of financial assets should be recognised using settlement date accounting.

The Fourth or Seventh Directives do not address the problem of trade date or settlement accounting for purchases of financial assets. Neither does the proposed amendment to the Accounting Directives.

Conclusion: The options of using trade date or settlement date accounting of purchases of financial assets does not pose problems under the Accounting Directives.

12. IAS 40 Investment Property

Para 24: An enterprise should choose either the fair value model in paragraphs 27 to 49 or the cost model in paragraph 50 as its accounting policy and should apply that policy to all of its investment property.

Para 28: A gain or loss arising from a change in the fair value of investment property should be included in net profit or loss for the period in which it arises.

The Fourth Directive is based on a historical cost model with an option to revalue categories of assets. In February 2000 the Commission has published a proposal for a Directive amending the Fourth and Seventh Directives as regards the valuation rules for the annual and consolidated accounts of certain types of companies. It introduces an option or requirement to use fair value of all balance sheet items, but with the exception of balance sheet items that are not financial instruments. So the possibility to use a fair value accounting model is not extended to non-financial assets. Therefore, European companies respecting the Accounting Directives can only apply the cost model.

The Fourth Directive does directly address investment companies and allows valuation at market value for these types of companies.

Art. 60: *Pending subsequent coordination, the Member States may prescribe that investments in which investment companies within the meaning of Article 5 (2) have invested their funds shall be valued on the basis of their market value.*

In that case, the Member States may also waive the obligation on investment companies with variable capital to show separately the value adjustments referred to in Article 36.

Conclusion: The possibility to use the fair value model of IAS 40 with inclusion of gains and losses directly in the profit and loss account for all investment property is not allowed under the Accounting Directives for other than investment companies. The application of both the Directives and IAS 40 implies the use of the cost model option provided under IAS 40 (with the exception of investment companies). This conclusion would also apply under the proposed amendment of the Directives to introduce fair value accounting since this amendment is limited to certain financial instruments.

PRESENTATION

13. IAS 1 Presentation of Financial Statements

THE CURRENT/NON-CURRENT DISTINCTION

Para 53: ***Each enterprise should determine, based on the nature of its operations, whether or not to present current and non-current assets and current and non-current liabilities as separate classifications on the face of the balance sheet. Paragraphs 57 to 65 of this Standard apply when this distinction is made. When an enterprise chooses not to make this classification, assets and liabilities should be presented broadly in order of their liquidity.***

The layouts are strictly prescribed by the Accounting Directives.

Art 15 of the Fourth Directive addresses the classification in fixed and current assets.

Art 15.1: *Whether particular assets are to be shown as fixed assets or current assets shall depend upon the purpose for which they are intended.*

In Chapter 20 of its Comparison Study of April 1999 FEE addresses the current/non-current presentation of assets and liabilities, it gives both the Commission's and Contact Committee's interpretation and FEE's position:

"The Commission and the Contact Committee have addressed the issue in their 1998 conformity examination of IAS 1, which states:

"Paragraph 53 of IAS 1 states that "Each enterprise should determine, based on the nature of its operations, whether or not to present current and non-current assets and current and non-current liabilities as separate classifications on the face of the balance sheet. Paragraphs 57 to 65 of this Standard apply when this distinction is made. When an enterprise chooses not to make this classification, assets and liabilities should be presented broadly in order of their liquidity." The Contact Committee considers that European companies are bound by the layouts prescribed by the Accounting Directives, since the layouts cannot be derogated, except in those specific cases prescribed by the Directives themselves.

Consequently, the Contact Committee is of the view that the layouts prescribed by the Fourth Directive would require European companies to present their assets classified as between "current assets" and "fixed assets". This distinction may well give a different result from that which would be obtained from a "current assets" and "non-current assets" distinction required by IAS 1. For example, long-term debtors and stocks which are not expected to be realised or sold within the normal course of the enterprise's operating cycle would be classified as "current assets" under the Directives, yet classified as "non-current assets" under IAS 1. Similarly, marketable securities which are not held for use on a continuing basis in a company's business and which are expected to be realised in more than twelve months from the balance sheet date would be classified as "current assets" under the Directives, yet classified as "non-current assets" under IAS 1.

Consequently, "non-current assets" under IAS 1 will not always be able to be equated with "fixed assets" under the Directives, which means that European companies will not be able to apply paragraph 57 to 65 of IAS 1, as this would result in a presentation differing from that which is required by the Fourth Directive. In these cases, European companies would have to select the choice afforded by paragraph 53 of IAS 1 of not making the current/non-current distinction. These companies would then make use of the facility offered by the last sentence of paragraph 53 of presenting assets and liabilities broadly in order of their liquidity. The Contact Committee is of the opinion that compliance with the layouts prescribed by the Accounting Directives would ensure such presentation."

FEE estimates that due to the flexible wording of para 53 of IAS 1, this standard offers a presentation option, regardless of the fact that the choice between the current/non-current presentation and another presentation should normally be based on the nature of the enterprise's operations. FEE shares the Commission's opinion that as the current/non-current presentation in IAS 1 is not always compatible with the Fourth Directive balance sheet format, the other type of presentation as prescribed by IAS 1, based on the liquidity of assets and liabilities should be adopted in order to be compatible with the Fourth Directive."

Conclusion: The option of not presenting current and non-current assets and current and non-current liabilities as separate classifications on the face of the balance sheet is not possible under the Accounting Directives.

INFORMATION TO BE PRESENTED EITHER ON THE FACE OF THE BALANCE SHEET OR IN THE NOTES

Para 72: An enterprise should disclose, either on the face of the balance sheet or in the notes to the balance sheet, further sub-classifications of the line items presented, classified in a manner appropriate to the enterprise's operations. Each item should be sub-classified, when appropriate, by its nature and, amounts payable to and receivable from the parent enterprise, fellow subsidiaries and associated and other related parties should be disclosed separately.

Art 4 of the Fourth Directive provide the general principles concerning the balance sheet:

Art 4: 1. *In the balance sheet and in the profit and loss account the items prescribed in Articles 9, 10 and 23 to 26 must be shown separately in the order indicated. A more detailed subdivision of the items shall be authorised provided that the layouts are complied with. New items may be added provided that their contents are not covered by any of the items prescribed by the layouts. Such subdivision or new items may be required by the Member States.*

2. *The layout, nomenclature and terminology of items in the balance sheet and profit and loss account that are preceded by Arabic numerals must be adapted where the special nature of an undertaking so requires. Such adaptations may be required by the Member States of undertakings forming part of a particular economic sector.*

3. *The balance sheet and profit and loss account items that are preceded by Arabic numerals may be combined where:*
   (a) they are immaterial in amount for the purposes of Article 2 (3); or
   (c) such combination makes for greater clarity, provided that the items so combined are dealt with separately in the notes on the accounts. Such combination may be required by the Member States.

4. *In respect of each balance sheet and profit and loss account item the figure relating to the corresponding item for the preceding financial year must be shown. The Member States may provide that, where these figures are not comparable, the figure for the preceding financial year must be adjusted. In any case, non-comparability and any adjustment of the figures must be disclosed in the notes on the accounts, with relevant comments.*

Conclusion: The options of disclosing sub-classifications either on the face of the balance sheet or in the notes to the accounts does not pose problems under the Accounting Directives, provided that the rules of the Directives are followed, in that in accordance with Article 4.3 (b) of the Fourth Directive, the combination of items preceded by Arabic numbers on the face of the balance sheet provides more clarity

CLASSIFICATION ON NATURE OF EXPENSES ON THEIR FUNCTION WITHIN THE ENTERPRISE

***Para 77:* An enterprise should present, either on the face of the income statement or in the notes to the income statement, an analysis of expenses using a classification based on either the nature of expenses or their function within the enterprise.**

The issue is not specifically addressed by the Fourth Directive. However, Articles 23/24 and 25/26 of the Fourth Directive give the various possibilities for presentation of the profit and loss account. Article 23/24 divides costs in raw material and consumables; other external changes: staff costs; value adjustments; other operating charges; interest payable and similar charges; extraordinary charges whereas Article 25/26 divides costs in costs of sales; distribution costs, administrative expenses; value adjustments; interest payable; extra ordinary charges, a more functional approach.

Conclusion: The options of classifications by nature or by function of expenses are both allowed under the Accounting Directives.

CHANGES IN EQUITY

Para 86: ***An enterprise should present, as a separate component of its financial statements, a statement showing:***

- ***(a) the net profit or loss for the period;***
- ***(b) each item of income and expense, gain or loss which, as required by other Standards, is recognised directly in equity, and the total of these items; and***
- ***(c) the cumulative effect of changes in accounting policy and the correction of fundamental errors dealt with under the Benchmark treatments in IAS 8.***

In addition, an enterprise should present, either within this statement or in the notes:

- ***(a) capital transactions with owners and distributions to owners;***
- ***(b) the balance of accumulated profit or loss at the beginning of the period and at he balance sheet date, and the movements for the period; and***
- ***(c) reconciliation between the carrying amount of each class of equity capital, share premium and each reserve at the beginning and the end of the period, separately disclosing each movement.***

The statement of changes in equity and whether capital transactions with owners and distributions to owners; specification of accumulated profit or loss and the reconciliation between the opening and closing balance should be disclosed in this statement or in the notes to the accounts is not addressed by the Fourth Directive, other than in Art 2.6 of the Fourth Directive which allows the disclosure of additional information.

The Contact Committee of the Commission has published in 1998 on "Examination of the conformity between IAS 1 and the European Accounting Directives" in which it is discussed whether a statement of equity is allowed under the Directives. It does not discuss whether both options of disclosing certain information in the notes or in the equity statement are allowed under the Fourth Directive.

"The statement of changes in equity required by IAS 1 is therefore a “separate component” of the financial statements. According to the Accounting Directives, financial statements are composed of a profit and loss account, balance sheet and notes on the accounts and do not explicitly mention the statement of changes in equity. However, the Contact Committee believes that statements of changes in equity certainly do contribute to better financial information and the Directives do not exclude their preparation.

Article 2(6) of the Fourth Directive states clearly that “The Member States may authorise or require the disclosure in the annual accounts of other information as well as that which must be disclosed in accordance with this Directive.” As far as the statement of changes in equity is concerned, the Contact Committee refers to paragraph 3 of the introduction to IAS 1. This paragraph states that this statement may be presented either as a “traditional” equity reconciliation in column form or as a statement of performance in its own right. The Contact Committee observes that when the requirements of International Accounting Standards are applied so as to be compatible with the Accounting Directives, they will give rise to movements which are normally reported either in the profit and loss account or in the balance sheet. Accordingly, the statement of changes in equity will normally take the form of a “traditional” equity reconciliation and not give rise to a statement of performance in its own right.

Nevertheless, in the opinion of the Contact Committee, any form of statement of changes in equity which would not result in an equity reconciliation statement but would rather give rise to a statement of performance in its own right would be acceptable to the extent that it does not conflict with the application of the layouts prescribed by the Fourth Directive."

Conclusion: Both disclosure in the equity statement and in the notes to the accounts of capital transactions with and distributions to owners; specification of accumulated profit and loss and the reconciliation between the opening and closing balance are possible under the Accounting Directives.

14. IAS 31 Financial Reporting of Interests in Joint Ventures

Para 28: ***Different reporting formats may be used to give effect to proportionate consolidation. The venturer may combine its share of each of the assets, liabilities; income and expenses of the jointly controlled entity with the similar items in its consolidated financial statements on a line-by-line basis. For example, it may combine its share of the jointly controlled entity's inventory with the inventory of the consolidated group and its share of the jointly controlled entity's property, plant and equipment with the same items of the consolidated group. Alternatively, the venturer may include separate line items for its share of the assets, liabilities, income and expenses of the jointly controlled entity in its consolidated financial statements. For example, it may show its share of the current assets of the jointly controlled entity separately as part of the current assets of the consolidated group; it may show its share of the property, plant and equipment of the jointly controlled entity separately as part of the property, plant and equipment of the consolidated group. Both these reporting formats result in the reporting of identical amounts of net income and of each major classification of assets, liabilities, income and expenses; both formats are acceptable for the purposes of this Standard.***

The Seventh Directive does not address the different reporting formats. The flexibility allowed within Art. 4 of the Fourth Directive should be sufficient to allow both options.

Conclusion: Both methods of reporting on proportionate consolidation are allowed under the Seventh Directive.

15. IAS 35 Discontinuing Operations

PRESENTATION OF THE REQUIRED DISCLOSURES

Para 39: ***The disclosures required by paragraph 27-37 may be presented either in the notes to the financial statements or on the face of the financial statements except that the disclosure of the amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation (paragraph 31(a)) should be shown on the face of the income statement.***

Article 4.1 of the Fourth Directive is relevant in this respect:

Art 4.1: *In the balance sheet and in the profit and loss account the items prescribed in Article 9, 10 and 23 to 26 must be shown separately in the order indicated. A more detailed subdivision of the items shall be authorised provided that the layouts are complied with. New items may be added provided that their contents are not covered by any of the items prescribed by the layouts. Such subdivision or new items may be required by the Member States.*

The illustrative disclosures would not be possible on the face of the profit and loss account under the Fourth Directive

Also the Commission's Contact Committee addressed the issue in its recently published "Examination of the Conformity between IAS 35, IAS 36, IAS 37, IAS 38, IAS 22 (revised 1998), IAS 16 (revised 1998), IAS 28 (revised 1998), IAS 31 (revised 1998) and the European Accounting Directives:

"IAS 35 is concerned with disclosure only. …

The bulk of the required disclosures are to be given by way of note. These narrative disclosures are additional to, and do not conflict with, the requirements of the Directives.

On the face of the accounts companies are:

(a) *required* to give profits or losses on disposal of assets (or settlement of liabilities) relating to discontinued activities and the related tax (paragraph 39); and

(b) *encouraged* to give (paragraph 40):

(i) revenue, expenses and pre-tax results of discontinued operations and the related tax; and
(ii) net cash flows attributable to the operating, investing and financing activities of discontinued operations.

The disclosure in (a) above is additional to, and not in conflict with, the requirements of the Directives.

If the disclosure in (b)(i) above is given on the face of the profit and loss account, there is no conflict with the 'vertical' profit and loss account formats set out in Articles 23 and 25 of the Fourth Directive so long as the total figures for all operations are given in addition to those for continuing and discontinued operations. However, it is not possible for a company that adopts the 'horizontal' profit and loss account formats set out in Articles 24 and 26 of the Fourth Directive to give pre-tax profit for discontinued operations on the face of the accounts as these formats do not strike a result at this level (although this information can be disclosed in the notes to the accounts).

The disclosure in (b)(ii) above affects the cash flow statement and is therefore additional to, and not in conflict with, the requirements of the Directives.

The Commission's Contact Committee conclusion:

IAS 35 does not conflict with the European Accounting Directives. However, the preferred disclosure of the pre-tax results of discontinued operations on the face of the profit and loss account is incompatible with the use of the profit and loss account formats set out in Articles 24 and 26 of the Fourth Directive. However, any conflict can be avoided by providing this information in the notes to the accounts instead of on the face of the profit and loss account."

Conclusion: FEE is of the opinion that the disclosures of discontinuing operations required by IAS 35.27 (f) are allowed only in the notes to the accounts and cannot be provided on the face of the profit and loss account, because the contents of discontinuing operations are already included in the line items as prescribed by the layout scheme of the Directives and therefore the addition of new line items would not be permissible under Article 4.1 of the Fourth Directive.