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Discussion Paper for Stakeholder meeting on Friday 12th June 2009

**Subject: Modernisation and simplification of the 4th and the 7th Directives:
- Results of the public consultation and preliminary staff comments
on issues for further analysis**

Introduction:

The ideas presented in this non-paper have been brought together by Commission staff for the purposes of continued stakeholders consultation. In preparing the non-paper, staff have carefully considered the written comments to the consultation. The non-paper does not aim at representing a complete and/or final list of issues and their elements that will be addressed in the forthcoming proposal. The tentative conclusions are preliminary and may be subject to revision following comments from Member States and stakeholders.

A. General comments

The analysis of the comments received confirms that there is overall support for the Commission initiative to simplify and modernise the existing Accounting Directives in Europe. A substantial number of the proposals presented in the consultation paper are supported by stakeholders.

Although there is large support for the project in principle, a number of commentators highlights that the proposed changes do not go far enough in terms of simplification and reduction of administrative burden. Furthermore, certain issues would require a more detailed debate. A broader revision, including considerations regarding reporting requirements for "micro" entities, would be favourable for those commentators, although they acknowledge that the overall timing of the project may not allow the Commission to fulfil that expectation.

Stakeholders support that the Directives should continue to be based on a "minimum harmonisation approach". The Directives should furthermore clearly highlight the overarching principles on which accounting in Europe should be based. There is strong support for a clear focus on small companies in the spirit of "think small first".

Regarding the future role of the Directives different views were expressed by commentators. On one side, commentators prefer that the Directives only constitute a high level legal framework and general principles according to which Member States determine their own accounting requirements in conformity with the principle of subsidiarity. On the other side of the spectrum, commentators believe that the Directives should continue to provide detailed accounting requirements for all European limited liability companies, tailored for the specific needs of Europe. Supporters of this view argue that financial statements in the EU are used for wider purposes than investment decisions, such as capital maintenance and creditor protection. This issue seems to be even more crucial in view of the imminent publication of the IFRS for SMEs (expected for July). In the light of this a number of commentators suggest that the Directives should provide Member States with the possibility to make use of IFRS for SMEs – at least to certain categories of companies.

The Commission will be interested to hear stakeholders' views on the general comments.

B. Reactions on main proposals in the consultation paper – Staff analysis

Based on the analysis of stakeholders' comments, the Commission Services tentatively conclude that the following issues would be supported by a majority of stakeholders and should therefore be analysed further:

1. Put all **basic principles** in a separate section of the Directive
2. Restructure the Directive following a **bottom up approach**
3. Require medium-sized and large companies to present a **cash flow statement**
4. Simplify **layout requirements**
5. Reduce **disclosure requirements**
6. Clarify certain **valuation methods**
7. Streamline and modernise the **language and terminology**

These issues will be analysed in detail in the following chapters of this paper.

The analysis of responses confirmed that stakeholders seem to be broadly content with the current **threshold criteria and levels**, which are used to define the different company categories. Furthermore stakeholders did not favour a **reduction of the number of company categories**. Therefore the staff does not intend to pursue these issues.

On the following proposals, staff conclude that there is a clear lack of support by stakeholders and that these should therefore not be pursued:

1. Eliminating the requirement for medium-sized companies to provide an **annual report**
2. Lifting the **publication requirement for small** companies
3. Replacing the financial statements by a system of **key financial indicators for small** companies

C. Detailed discussion on proposals to be analysed further

In order to prepare a legal proposal and an impact assessment, the Commission staff would in particular like to discuss the following aspects with stakeholders:

1. BASIC PRINCIPLES IN A SEPARATE SECTION

The analysis of stakeholders' comments confirmed that there is support for a separate section in the Directive dealing with basic accounting principles.

The new section would be built on the following key principles:

- (1) True and fair view including override (Article 2)
- (2) Clarity principle (Article 2)
- (3) Going concern (Article 31)
- (4) Accruals principle (Article 31)
- (5) Prudence principle (Article 31)
- (6) Consistent application of valuation rules (Article 31)
- (7) General principle of purchase price or production cost (Article 32)
- (8) Separate valuation of components of assets and liabilities (Article 31)
- (9) Gross principle (Article 7)

Feedback on the following issues by stakeholders would be appreciated:

- Is there a need to align these principles with those included in international frameworks?
- Do you consider that principles should be added, e.g. the concept of relevance, materiality, cost benefit, substance over form?
- There is one specific question the staff would like to raise with stakeholders: Is there a need to retain Article 31(1a) which allows MS to "*permit or require account to be taken of all foreseeable liabilities and potential losses*" taking the modern test of recognising a provision where there is a present obligation, as a result of a past event, where it is probable that there will be an outflow of economic benefits in settlement of the obligation and a reliable estimate can be made of the obligation into account?

2. RESTRUCTURE THE DIRECTIVE FOLLOWING A BOTTOM UP APPROACH

In the context of a broad review of the Directives a majority of stakeholders expressed support for using a bottom up approach using the needs of SMEs as the starting point. Such an approach would improve the readability of the Directive, but would result in a substantial rewriting of the whole text. This would be technically challenging in the short time available for this exercise. Against this background, Commission staff tentatively intends to use the bottom up approach only for the disclosure part of the Directive.

The Commission will be interested to hear stakeholder's views on this tentative proposal.

3. REQUIRE CASH FLOW STATEMENTS

There was strong support for the revised Directive to require large companies to prepare cash flow statements. Many respondents furthermore thought that medium-sized companies should prepare a cash flow statement as it provides useful information to users of accounts (but few "users" or "user groups" did actually respond to the consultation). However, many commentators pointed out that such a measure would create rather than reduce burden. There was little enthusiasm for requiring small companies to prepare cash flow statements.

Several Member States have already implemented requirements for companies to prepare cash flow statements, either via accounting standards or legislation. These rules target large and medium-sized entities.

The majority of respondents did not favour an overly prescriptive layout. In light of the comments the Commission staff is tentatively envisaging that large and medium-sized companies, but not small ones, should prepare a cash flow statement. They should present a statement on the basis of the following structure:

Cash flow statement
Cash flows from operating activities
Cash flows from investing activities
Cash flows from financing activities
Net increase in cash and cash equivalents
Cash and cash equivalents at the beginning of the period
Cash and cash equivalents at the end of the period

Both the direct and the indirect method to establish a cash flow statement should be permitted. This should allow Member States, domestic standard-setters or companies to produce information that is particularly useful to their stakeholders.

The Commission will be interested to hear stakeholder's views on this issue.

4. SIMPLIFIED LAYOUTS

The majority of respondents were in favour of prescriptive layouts, commenting that this is important for comparability between companies. Many respondents felt that the layouts could however be streamlined thereby achieving more consistency in financial reporting. The Commission staff suggests the following minimum layouts for the profit and loss account and balance sheet:

Balance sheet

intangible assets;
investment property;
property, plant and machinery;
financial assets;
inventories;
trade and other receivables;
cash and cash equivalents;
issued capital and reserves;
provisions;
deferred tax liabilities and deferred tax assets;
financial liabilities;
liabilities and assets for current tax
trade and other payables.

Profit and loss account

net turnover;
cost of sales;
gross profit or loss;
distribution cost;
administrative expenses;
operating income;
income from investments;
interest receivable;

value adjustments; interest payable; tax on profit or loss on ordinary activities; profit or loss for the financial year.
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The minimum layout as proposed does not prescribe a certain sequence of elements or the titles. It should be allowed to add line items.

In the case of the balance sheet, assets will need to be distinguished between fixed and current, using the present distinction of continuing/non-continuing and amounts due to creditors will need to be split between amounts becoming due and payable within one year, after one year and more than one year.

Staff emphasises that there will still be a requirement to present additional information – either in the layouts or as disclosures – if this would be necessary to present a true and fair view.

The Commission staff would like stakeholders' comments on the suggested layouts presented above.

Extraordinary items have been excluded on the basis that separate disclosure of the extraordinary item would seem necessary to show a true and fair view.

Do stakeholders agree with this approach?

5. REDUCED DISCLOSURE REQUIREMENTS

The majority of stakeholders expressed support for a substantial reduction of disclosure requirements. Following the consultation, the Commission staff intends to introduce requirements based on a bottom-up approach. The structure of the notes section should be more principles based and should provide a short list of minimum requirements including

- the accounting policies,
- information that is required in the Directives but not presented elsewhere and
- any additional information that is relevant to the understanding of the financial statements.

The Commission staff notes that for small companies a number of exemptions is already addressed by the allowed use of abridged accounts (Article 44) in the current Directive. This should serve as a starting point for the revised Directive. With respect to medium-sized and large companies staff considers that the current requirements are more or less appropriate. Therefore, the following requirements are proposed for that section:

All companies (small, medium-sized and large) should provide in the notes to the accounts as a minimum the following information:

1. Accounting policies including valuation methods
2. Names, registered offices of undertakings with at least 20% stake in and all unlimited undertakings, if material
3. Nature and business purpose of arrangements not in the balance sheet and their financial impact, if material
4. Average number of persons employed

Information should be added only if it is material and as far as it is necessary to the understanding of the information provided in the financial statements.

For medium-sized and large companies no material changes are envisaged.

In comparison to the existing requirements for small companies in Europe under the 4th Directive this would encompass abolition of the following disclosure requirements:

- Article 43 (13) The amount of advances and credits granted to members of the administrative, managerial and supervisory bodies and commitments entered into on their behalf
- Article 43 (14b) for financial assets covered by Article 42a, carried at an amount in excess of their fair value and without use being made of the option to make a value adjustment: book value, fair value and the reasons for not reducing book value.
- Article 44 implementation of the use of "abridged notes" for small companies

The Commission would like to receive stakeholders' views on the appropriateness of these tentative proposals.

6. CLARIFY CERTAIN VALUATION RULES

This review was not intended to fundamentally change current accounting principles, and hence few changes will be proposed to existing valuation rules. ***However, the Commission would like to hear stakeholders' views on two possible amendments:***

- The removal of 'last in, first out' (LIFO) as a permitted stock valuation method. Respondents to the consultation have said it is no longer used in practice.
- Eliminate some outdated derogation possibilities in Article 33 (e.g. allowing the use of the replacement value method, methods to take into account inflation) by more modern wording.

- Removal of Article 35(1(d)) which states "if fixed assets are the subject of exceptional value adjustments for taxation purposes alone, the amount of the adjustments and the reasons for making them shall be indicated in the notes on the accounts." If this derogation is kept, does the requirement to produce such additional information as is necessary to show a true and fair view mean that such a disclosure is no longer necessary?

7. STREAMLINING AND MODERNISATION OF LANGUAGE AND TERMINOLOGY

At this stage, the Commission Services will concentrate on amendments to the 4th Directive. Consequential amendments will need to be made at least to the 7th Directive, the Insurance Accounts Directive and the Banks Accounts Directive.

A number of respondents to the consultation suggested that the terminology used in the Directives should be streamlined with IFRS wherever possible and practical.

The Commission staff would in particular appreciate stakeholders' views on the following:

- "Value adjustments" are referred to frequently within the directives and they encompass different things, e.g. impairment, depreciation or write downs. Is there a more modern expression for this?
- Can the expression "annual report" be replaced by "directors' report" as suggested by a number of stakeholders, without causing problems in any member state?
- Can the lengthy definition of provisions in Article 20(1) and (2) be replaced by the more modern expression "provisions are liabilities of uncertain amount or timing"

D. Any other issues to be considered

Thanks to all stakeholders for their valuable input!

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