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Internal Market and Services DG

FREE MOVEMENT OF CAPITAL, COMPANY LAW AND CORPORATE GOVERNANCE
Accounting

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AGENDA PAPER FOR THE MEETING OF THE ACCOUNTING REGULATORY COMMITTEE ON 24TH NOVEMBER 2006 (DOCUMENT ARC/19/2006)

Subject: **Relationship between the IAS Regulation and the 4th and 7th Company Law Directives**
Meaning of *"Annual Accounts"*

1. ISSUE

1.1. The UK paper, sent to ARC Members on 20 June 2006, asks for the clarification of the term "annual accounts" for companies that, in accordance with Regulation 1606/2002, prepare their accounts using endorsed IFRS. The issue relates to the interaction between consolidation requirements contained in national legislation based on the Seventh Company Law Directive and in IAS 27 Consolidated and Separate Financial Statements.

1.2. According to the UK paper uncertainty exists as to what types of accounts have to be prepared as there are discrepancies between the consolidation requirements in the Seventh Directive and those of IAS 27 endorsed by the EU.

1.3. The situation highlighted by the UK paper is where a parent company, which is not obliged to present consolidated accounts according to the Seventh Directive, uses the option in Article 5 of the IAS Regulation and chooses to prepare its annual accounts using endorsed IFRS, which in turn may be thought to oblige it to prepare consolidated accounts. In this case, does the parent company have to prepare consolidated accounts?

1.4. There is consequently a need to clarify what rules take precedence in such a situation.

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2. LEGISLATIVE BACKGROUND

2.1. The term "annual accounts" comes from the Fourth Company Law Directive (78/660/EEC). Annual accounts shall be prepared by companies mentioned in Article 1.

2.2. The Seventh Company Law Directive (83/349/EEC) lays down when consolidated financial statements should be prepared (Articles 1, 2, 3(1), 4, 5-9, 11 and 12) as well as the required scope of consolidation.

2.3. Article 4 of the IAS Regulation (Regulation (EC) No 1606/2002) applies to companies whose securities are admitted to trading on a regulated market of any Member State and which are required to prepare consolidated accounts according to their national law derived from the Seventh Company Law Directive.

2.4. Article 5 of the IAS Regulation however, allows Member States to permit or require companies, whose securities are not admitted to trading on a regulated market of a Member State to prepare their annual and/or consolidated accounts in conformity with IFRS adopted under the IAS Regulation.

2.5. It also allows Member States to permit or require parent companies or individual companies whose securities are admitted to trading on a regulated market of a Member State to prepare their annual accounts in conformity with adopted IFRS.

2.6. Article 5 of the IAS Regulation, expressly refers to the annual accounts of a company as a set of financial statements different from consolidated accounts, i.e. individual statutory accounts. This is confirmed by the wording of Article 5(b) stating that "Member States may permit or require: … companies … to prepare their consolidated accounts and/or annual accounts" in conformity with adopted IFRS. Thus, Article 5 gives an option for annual accounts understood as individual statutory accounts to be prepared in conformity with adopted IFRS. Therefore, the requirement for annual accounts remains and the IAS Regulation just gives Member States the option to require or permit the use adopted IFRS in the annual accounts.

3. THE REQUIREMENTS OF IAS 27

3.1. IAS 27 (endorsed by Regulation EC (No) 1725/2003) defines the scope of its application in paragraph 1.

> "This standard shall be applied in the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent."

3.2. Paragraph 3 goes on to state:

> "This standard shall also be applied in accounting for investments in subsidiaries, jointly controlled entities and associates when an entity

elects or is required by local regulations to present separate financial statements."

3.3. Therefore, where a company is a parent, in almost all circumstances, IAS 27 requires the preparation of consolidated financial statements and the parent's separate financial statements are an additional set of financial statements which are not required by the standard.

3.4. The notion of separate financial statements as defined by IAS 27 is in connection to consolidated accounts and therefore is not the same as the notion of annual accounts as defined by the European legislation (including Directives). Separate financial statements are defined in IAS 27 as the financial statements of the parent company or of a venturer. If an entity does not have a subsidiary, associate or venturer's interest in a jointly controlled entity, §7 of IAS 27 clearly states that its annual accounts are not separate financial statements.

3.5. IAS 27 contains a limited exemption from the preparation of consolidated financial statements for a parent (paragraph 10).

4. INTERPRETATION

4.1. Firstly, the Fourth Directive requires the preparation of annual accounts. Secondly, a decision is taken whether or not to use IFRS as adopted by the EU for their preparation.

4.2. Consolidated accounts should be prepared if the conditions in the Seventh Directive are fulfilled.

4.3. The relationship between the Seventh Directive and the IAS Regulation has been clarified in the document "Comments concerning certain Articles of the Regulation (EC) No 1606/2002", published by the Commission on November 2003:[1]

> "As the IAS Regulation only applies to ‘consolidated accounts’, it only takes effect where such consolidated accounts are otherwise required.
>
> The determination of whether or not a company is required to prepare consolidated accounts will continue to be made by reference to national law transposed from the Seventh Council Directive. For the avoidance of doubt, the following Articles of the Seventh Council Directive are relevant to the existence of such a requirement: Articles 1, 2, 3(1) 4, 5-9, 11, and 12."

4.4. Consequently the Seventh Directive lays down when consolidated accounts should be prepared, and (where relevant) the IAS Regulation is applied. For companies in the scope of the Regulation, the rules of endorsed IFRS apply.

[1] http://ec.europa.eu/internal_market/accounting/docs/ias/200311-comments/ias-200311-comments_en.pdf

4.5. In addition, where a Member State uses Article 5 to permit or require annual accounts to be prepared in conformity with adopted IFRS, the scope of the requirement is limited to the preparation of such annual accounts only. The IAS 27 requirements to prepare consolidated accounts do not apply.

4.6. Adopted IFRS cannot therefore subsequently change the conditions which gave rise to its application. If this were not the case the rules on consolidation would differ across Member States depending on whether or not they provided for an Article 5 option. Given that the legal base of the IAS Regulation is Article 95(1) of the EC Treaty, which provides for adoption of measures for the approximation of Member States' laws, regulations and administrative actions, the result would be contrary to this fundamental objective.

5. CONCLUSION

5.1. **The Commission Services are of the opinion that a parent company always has to prepare annual accounts as defined by the 4th Directive. Where, under the 7th Company Law Directive, a parent company is exempted from preparing consolidated accounts, but chooses or is required to prepare its annual accounts in accordance with IFRS as adopted by the EU, those provisions in IAS 27 setting out the requirement to prepare consolidated accounts do not apply. Such annual accounts are described as having been prepared in accordance with IFRS as adopted by the EU.**

5.2. We draw your attention to the fact that this opinion of the Commission is not legally binding. According to the EC Treaty, the Court of Justice has a sole jurisdiction to interpret the acts of the institutions of the Community. The Commission also reserves the right to change its views presented in this paper.

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