April 2001

Examination of the conformity between IAS 1 to IAS 41 and the European Accounting Directives

DIRECTORATE-GENERAL MARKT

Internal Market and Financial Services

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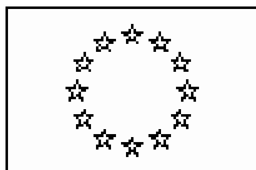

EUROPEAN COMMISSION

Internal Market DG

FINANCIAL MARKETS

Financial reporting and company law

6926/2001

Examination of the conformity between International Accounting Standards (IAS) and the European Accounting Directives:

IAS 1 – IAS 41

1. PREFACE

This document contains an examination of the conformity between the International Accounting Standards (IAS) and the European Accounting Directives. It has been prepared by the Contact Committee on the Accounting Directives (Contact Committee).

The Contact Committee is an advisory body comprising representatives of the Member States and representatives of the Commission. It has been set up by the Commission according to the requirements contained in Article 52 of Directive 78/660/EEC (4th Directive). The functions of the Contact Committee are:

— to facilitate harmonised application of the Accounting Directives through regular meetings dealing in particular with practical problems arising in connection with their application;

— to advise the Commission, if necessary, on additions or amendments to the Accounting Directives.

In 1990 the Commission published a selection of the most important opinions delivered by the Contact Committee concerning the application of the Accounting Directives in the Member States.

The present document is the result of a work carried out as a part of the New Accounting Strategy adopted by the Commission in November 1995. The purpose of this document is to analyse the degree of conformity between the requirements contained in the International Accounting Standards and the European Accounting Directives, so as to constitute the basis on which each Member State may decide whether and to what extent its companies can apply the International Accounting Standards when they wish to do so.

2. INTRODUCTION

In November 1995 the European Commission (EC) adopted a new approach to accounting harmonisation. In its Communication "Accounting harmonisation: a new strategy vis-à-vis international harmonization" the Commission underlined the need for the Union to move without delay in order to give the users and preparers of accounts a clear signal that companies seeking listings on the US and other world markets will be able to remain within the EU accounting framework. The Commission also stressed the need for the Union to strengthen its commitment and contribution to the international standard-setting process, which offers the most efficient and rapid solution for the problems of companies operating on a world-wide scale.

In June 2000, the Commission adopted its Communication "The EU's Financial Reporting Strategy: The Way Forward". The Communication proposes that all EU companies listed on a regulated market should be required to prepare their consolidated accounts in accordance with a single set of accounting standards, namely IASs from 2005, at the latest. Adoption of uniform, high quality financial reporting rules in EU capital markets will enhance overall market efficiency, thereby reducing the cost of capital for companies.

The EC realises that accounts prepared by European transnational companies in accordance with their national legislation, based on the Accounting Directives, do not meet the different standards required elsewhere in the world for international capital market purposes. These companies are therefore obliged to prepare two sets of accounts, one set that is in conformity with the Accounting Directives and another set that is required by the international capital markets. This situation is not satisfactory. It is costly and the provision of different figures in different environments is confusing to investors and to the public at large.

At the international level, harmonisation in accounting is well under way and it is based on the standards issued by the International Accounting Standards Committee (IASC). In July 1995, IASC reached an agreement with the International Organisation of Securities Commissions (IOSCO) on a joint work

programme with the aim of producing, in the medium-term, a core set of IASs to be applied by companies seeking a multinational listing of their securities. Since 1996 the IASC has undertaken a gradual and in-depth process of revision and development of the standards. Also, in 1999 the IASC finalised the core set of standards agreed with IOSCO. IAS provides a comprehensive and conceptually robust set of standards for financial reporting specifically intended to serve the needs of the international business community.

It is in this context that the present work has been carried out. If Member States are to allow their large companies to prepare their consolidated accounts on the basis of IAS, it is essential that these standards are not in conflict with the Accounting Directives. Therefore, the Contact Committee decided that, as a first step, it should examine the conformity of existing IAS with the Accounting Directives. The work carried out by the Contact Committee constitutes the basis on which each Member State will decide whether and to what extent its companies can apply IAS when they wish to do so.

This document contains the results of the examinations of the IASC Framework and all International Accounting Standards published as at 31 December 2000. It does not refer to IASs 7, 14, 15, 17, 18, 20, 24, 26, 29, 33 and 34 because a preliminary examination showed that the issues dealt with in these standards are not specifically covered in the Accounting Directives and because these standards do not raise any particular concerns regarding the general principles incorporated in these Directives. IAS 39 is not examined because the Accounting Directives are being amended to facilitate the adoption of this standard by EU companies. IAS 41 is not examined in detail either, because it is self-evident that IAS 41's fair value approach to the measurement of biological assets and the resultant recognition of unrealised gains in the profit and loss account is incompatible with both the requirement in Article 31.1(c)(aa) of the 4th Directive that only profits made at the balance sheet date may be included in the annual accounts, and the basic principle of Article 33 of the 4th Directive that increases in the value of fixed assets may be shown in the profit and loss account only to the extent that they are realised.

The Contact Committee will consider the compatibility of new and revised IASs that will subsequently be issued or revised by the International Accounting Standards Board, in further documents. The Contact Committee has not yet examined the compatibility between IAS and the Insurance Accounts Directive because at present there is no IAS that deals specifically with financial reporting by insurance undertakings.

The Contact Committee acknowledges that the number and complexity of the disclosures required under IAS goes well beyond that provided for by the Accounting Directives and may therefore result in additional burdens for companies. However, the Contact Committee also recognises that the companies which are likely to apply IAS already present financial information which goes beyond the minimum requirements of the Accounting Directives.

The work carried out by the Contact Committee is only a first step. European companies are not directly subject to the Accounting Directives but to the national legislation implementing the Accounting Directives and to national accounting standards. The national authorities and organisations responsible for setting accounting requirements in the Member States should reflect on the contents of this document, and possibly undertake a similar examination relating to the national rules issued within the context of the implementation of the Accounting Directives, as well as to other requirements adopted at the national level that are not directly linked to provisions contained in the Accounting Directives.

3. OBJECTIVE AND SCOPE OF THE ANALYSIS

The analysis in this document relates exclusively to the relationship between IAS and the Accounting Directives. The competence of the Contact Committee is restricted to matters relating to European

accounting legislation, and the Contact Committee as such cannot express any opinion relating to the relationship between IAS and any other requirements (notably national legislation or national accounting standards) that are not based on the Accounting Directives themselves.

The objective of the analysis reported in this document is to determine whether and to what extent conflicts between the IAS and the Accounting Directives exist and require to be resolved, so that European companies wishing to apply IAS in their consolidated accounts can do so without conflicting with European legislation. As stated above, however, the application of IAS in a national environment may require amendments to national law or national accounting standards. The analysis has sought to identify the areas where, as a result of options allowed by the Accounting Directives, such amendments are most likely to be necessary.

The compatibility of the IAS with the Accounting Directives can be examined in a number of different ways.

One approach would be to compare systematically the two accounting systems (IAS and Accounting Directives) and highlight the existing differences. However, this approach was dismissed because of the substantially different way in which accounting is dealt with in the Accounting Directives and in IAS.

— The Accounting Directives deal with general principles and do not aim at regulating all their possible practical applications, although this does not prevent them from containing sometimes very detailed guidance (for instance by imposing standard layouts). On the other hand, IAS refer to specific accounting issues, for which detailed guidance is provided, but do not take into account the legal environment in which these standards are to be applied in practice.

— The Accounting Directives apply to all companies having a certain legal structure, while in the EU IAS are in practice applied mainly by listed companies.

— The Accounting Directives are part of European company law and therefore constitute a legal system which is compulsory, while IAS are standards of voluntary application and have no specific linkage to legislation.

— The Accounting Directives have been elaborated in an environment sometimes strongly influenced by considerations such as creditor protection, profit distribution and taxation. IAS are generally formulated without consideration of these issues, and therefore result in requirements that have no particular linkage with any specific economic environment.

These differences have important practical consequences.

a. For example, the number and complexity of the disclosures required under IAS are in general significantly more demanding than those required under the Accounting Directives. This is due to the fact that the Accounting Directives provide for minimum requirements that aim at establishing minimum comparability and ensuring a minimum level of information. The approach of IAS is completely different in that they aim at ensuring the most complete guidance and uniformity in accounting treatments.

b. Rules relating to creditor protection and profit distribution are usually different from one country to another and are therefore not specifically taken into account by IAS, which aim at being as international as possible. Conversely, the Accounting Directives contain specific provisions that deal with these matters. For instance, Articles 34 and 37 of the 4th Directive do not allow profits to be distributed when the level of the reserves available for distribution does not exceed the amount necessary to cover the residual amortisation of certain capitalised expenditures (formation expenses

and costs of research and development).

Similarly, the derogations for fiscal considerations allowed in Articles 35.1(d) and 39.1(e) of the 4th Directive and also allowed in Article 29.5 of the 7th Directive are not permitted under IAS. These two Articles of the 4th Directive allow fixed and current assets to be subject to exceptional value adjustments for taxation purposes only, provided that the amount of the adjustments and the reasons for making them are indicated in the notes on the accounts. IAS do not permit such exceptional value adjustments, as they have been drawn up to deal with situations in which accounting is free from fiscal considerations.

For the above reasons, a systematic comparison between IAS and the Accounting Directives would result in the collection of a huge amount of differences. However, only a limited part of this information would be useful for the objective of the analysis. The Contact Committee has therefore not entered into a detailed examination of those issues that are logically dependent on the fundamentally different nature of the two systems (Accounting Directives and IASs).

Accordingly, the Contact Committee has proceeded with the consideration of individual issues by taking account of the relative importance and relationship with the particular environment in which the two different systems (IASs and Accounting Directives) exist. This has a number of consequences:

a. As this document refers exclusively to European Accounting legislation, the considerations here expressed refer exclusively to this specific framework. Any national application of the considerations expressed in this document can therefore only be made by taking into account the legal, economic and social environment in which these solutions might be adopted. The Accounting Directives often allow for different solutions; consequently the opinions expressed in this document are the consequence of the wide range of possibilities offered by the Accounting Directives themselves. In contrast, national rules are the consequence of a specific approach which is consistent in itself Therefore it may well be that the findings expressed in this document are not immediately applicable at a national level.

b. The present work focuses exclusively on consolidated accounts. As the 7th Directive refers to the 4th Directive for matters concerning the formats and valuation rules, this document also makes several references to the 4th Directive. However, this does not mean that the conclusions drawn in this document are equally applicable to the individual accounts. The fact that the considerations expressed by the Contact Committee in this paper refer exclusively to the preparation of consolidated accounts is consistent with the objective of the analysis and also with the characteristics of IAS. In fact, although IAS are in theory issued for both annual and consolidated accounts, they are in practice prepared with the main purpose of harmonising rules for consolidated accounts, which constitute the financial information made available to the international capital markets.

c. It is inappropriate to make any comparison between the contents of this document and the similar work carried out by IOSCO. Although the Contact Committee has benefited from the experience and the material provided by the European members of IOSCO's Working Party no.1, the fundamental difference in the objective of the two analyses (which results in different approaches) will necessarily lead to different outcomes. The objective of IOSCO is to set the conditions that IAS must satisfy in order to be recognised as the accounting standards that ensure that equivalent financial information is presented in the capital markets world-wide. This objective clearly differs from the objective of this document, as set out in paragraph 5 below.

4. STRUCTURE OF THE DOCUMENT

According to its objective, this document strives to deal with the problems faced by those European companies which, while complying with European legislation, also wish to prepare their consolidated accounts by applying IAS. For this purpose, what really matters is to identify to what extent IAS are compatible with European legislation. As for European transnational companies the application of the relevant national legislation deriving from the Accounting Directives is "a must", the issue of the possible incompatibilities between the IAS and the Accounting Directives is best addressed by looking at them from the point of view of the Accounting Directives. Accordingly, the purpose of this document is to analyse the problems that a hypothetical European company (which prepares its accounts according to the Accounting Directives) may face when it also wishes to comply with IAS.

When a company, in addition to satisfying the requirements of European legislation, also seeks compliance with IAS, it can be assumed that:

— this company is ready to accept all additional requirements imposed by IAS that do not conflict with the Accounting Directives.

— when the Accounting Directives leave directly to companies or permit Member States to leave to companies the possibility of choosing between two accounting treatments, the company will logically select the treatment that conforms with IAS.

Some of these cases are listed in the Section "Options available for companies as a result of the Accounting Directives which cannot be applied by companies wishing to comply with International Accounting Standards". Companies wishing to apply IAS should have no problems in complying with these additional requirements and should have no difficulty setting aside the above-mentioned options.

In the light of these assumptions, the possible conflicts between IAS and the Accounting Directives can be limited to the following:

— Cases where a requirement of an IAS is not allowed by an Accounting Directive or vice-versa. These cases are classified as "Requirements of International Accounting Standards which raise problems of conformity with the Accounting Directives". European companies would not be able to apply the requirements of the relevant IAS in such cases.

— Cases where a Member State option in an Accounting Directive is not allowed by an IAS. The Contact Committee has classified these cases as "Issues which might raise problems of compatibility between International Accounting Standards and the options granted by the Accounting Directives to Member States" because a problem would arise only when a specific option in the Accounting Directives is selected by a Member State. In this case, a company belonging to the Member State which has selected an option in the Accounting Directives which is not compatible with the requirements of IAS will not be able to comply with IAS. This part of the document thus points to areas which should be a particular focus for examination at national level.

— Finally, certain cases exist where the different wording used in an Accounting Directive and an IAS could be understood to be a possible source of conflict. For those cases that appeared to be important, this document explains the reasons why these differences should not be perceived as conflicts. These cases are listed in the Section "Other issues".

IASC Framework

The Contact Committee examined the IASC Framework and came to the conclusion that no conflict exists with the Accounting Directives, for two fundamental reasons:

1. The statements contained in the Framework do not override any rule contained in a specific standard.

2. The application of the Framework is not compulsory for companies complying with IAS.

Should the above-mentioned fundamental characteristics of the Framework be modified, then conflicts might arise and the Contact Committee would have to reconsider its opinion.

IAS 1 – Presentation of Financial Statements[10]

INTRODUCTION

IAS 1 "Presentation of Financial Statements" was issued by the International Accounting Standards Committee in August 1997. The standard is effective for financial statements covering periods beginning on or after 1 July 1998, although earlier application is encouraged.

The Contact Committee has examined IAS 1 in the context of the European Accounting Directives, and has listed in the following paragraphs a number of issues to be considered in deciding whether, and to what extent, to apply IAS 1 in European jurisdictions.

SPECIFIC ISSUES

Compliance with International Accounting Standards

Paragraph 11 of IAS 1 states that "Financial statements should not be described as complying with International Accounting Standards unless they comply with all the requirements of each applicable Standard and each applicable interpretation of the Standing Interpretations Committee." The Contact Committee welcomes the IASC's unambiguous establishment of the principle that full application of its standards is a necessary prerequisite for a company to assert that its financial statements comply with International Accounting Standards (IAS).

Fair presentation

Paragraph 10 of IAS 1 requires that "Financial statements should present fairly the financial position, financial performance and cash flows of an enterprise." It goes on to state that "The appropriate application of International Accounting Standards, with additional disclosure when necessary, results, in virtually all circumstances, in financial statements that achieve a fair presentation", and that (in paragraph 12) "Inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used or by notes or explanatory material."

Further, the Contact Committee notes that paragraph 13 of IAS 1 provides for those "…extremely rare circumstances when management concludes that compliance with a requirement in a Standard would be misleading…". IAS 1 requires that in those circumstances where "…departure from a requirement is necessary achieve fair presentation", management should depart from such requirement in a standard and explain such departure as prescribed by the disclosure requirements of paragraph 13. The Contact Committee notes that both IAS 1's use of the override and paragraph 13's disclosure requirements are fully consistent with the rules established by the Accounting Directives in similar circumstances and contained in Article 2.5 of the Fourth Directive.

The requirements contained in paragraph 13 clearly establish the pervasive nature of the "fair presentation" concept, whilst being a necessary complement to paragraph 10. It is now absolutely clear that accounts that hold themselves out as being drawn up in compliance with IAS must comply with all

the requirements of each applicable Standard and SIC Interpretation. At the same time, though, it is also clear that the achievement of fair presentation goes beyond mere compliance with the rules. The Contact Committee welcomes this clarification of the relationship between the compliance with IAS and fair presentation.

The Contact Committee notes further that the "fair presentation override" is a requirement (not an option) of IAS 1 to be applied in the extremely rare circumstances when management concludes that compliance with a requirement in a Standard would be misleading. IAS 1 confirms in paragraph 14 that "The existence of conflicting national requirements is not, in itself, sufficient to justify a departure in financial statements prepared using International Accounting Standards." It goes on to state (in paragraph 16) that it will only be the case that the application of a specific requirement in an International Accounting Standard might result in misleading financial statements "…when the treatment required by the Standard is clearly inappropriate and thus a fair presentation cannot be achieved either by applying the Standard or through additional disclosure alone. Departure is not appropriate simply because another treatment would also give a fair presentation."

The effect of this is that European companies that wish to comply both with International Accounting Standards and the Accounting Directives will not be able to resolve any conflict between the two systems through the use of the override, unless the application of a specific requirement in an International Accounting Standard would result in misleading financial statements and the application of the Directives would result in fair presentation.

The use by a company of the fair presentation override will, of course, have the knock-on effect of derogating another IAS requirement (i.e. the Standard being overridden). As a result, since this derogation is itself an IAS requirement, companies which invoke the override will, in the view of the Contact Committee, still be able to claim compliance with IAS under paragraph 11 of IAS 1 – provided that the requirements of paragraph 13 are complied with in full.

Prudence

The Contact Committee considered the substance of paragraph 20 of IAS 1. Although the important role played by prudence in the preparation of the accounts may not seem to have been fully acknowledged by this and subsequent paragraphs in IAS 1 (in contrast, for example, to going concern, accruals and consistency), the Contact Committee stresses that the application of prudence remains one of the main principles for ensuring the achievement of fair presentation under the Directives.

The Contact Committee notes that the IASC's *Framework* deals specifically (at paragraph 37) with prudence as a separate qualitative characteristic of financial statements. In so doing, it describes prudence as "…the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated."

Materiality and aggregation

Materiality and aggregation are considered in paragraphs 29 to 32 of IAS 1. The Contact Committee points out that these paragraphs should be read in the light of Article 4 of the Fourth Directive. Consequently, European companies should not apply IAS 1's general rules concerning aggregation to items which are preceded by letters or Roman numerals in the Fourth Directive layouts, since these items are considered to be the required minimum for separate presentation.

In addition, the Contact Committee notes that IAS 1 sets down in paragraphs 66 and 75 the individual line items which should, as a minimum, be shown on the face of the balance sheet and profit and loss account.

In broad terms, these correspond with the prescribed layouts under the Fourth Directive, although under certain circumstances the Directive may demand separate presentation in excess of that required by IAS 1.

Current/non-current distinction

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 paragraphs 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.[11] 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.

Changes in Equity

Paragraph 7 of IAS 1 states that "a complete set of financial statements includes the following components:

(a) balance sheet;

(b) income statement;

(c) a statement showing either:

(i) all changes in equity; or

(ii) changes in equity other than those arising from capital transactions with owners and distributions to owners;

(d) cash flow statement; and

(e) accounting policies and explanatory notes."

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.

Cash flow statements

Similarly, IAS 1 lists the cash flow statement as a component of financial statements. Although the Directives do not explicitly mention the cash flow statement, they do not exclude their preparation either, particularly in the light of Article 2.6 of the Fourth Directive. Consequently, the Contact Committee sees no conflict between IAS 1 and the Directives in the requirement for a cash flow statement to be a component of a set of financial statements.

Other disclosures

The Contact Committee notes that paragraph 102(d) of IAS 1 requires the disclosure of either the number of employees at the end of the period or the average for the period. Article 43.1(9) of the Fourth Directive requires European companies to disclose "the average number of persons employed during the financial year, broken down by categories". Consequently, European companies that wish to comply both with International Accounting Standards and the Accounting Directives should disclose at least the average number of employees during the financial year, broken down by category.

CONCLUSIONS

The Contact Committee has concluded that, subject to the above-mentioned observations, IAS 1 is compatible with European Accounting legislation.

IAS 2 – Inventories[8]

IAS 2 states in paragraph 6 that "inventories should be measured at the lower of cost and net realisable value". According to Article 39.1(b) of the 4th Directive, the lower value at which inventories should be valued is that "to be attributed to them at the balance sheet date". The question arises whether the value to attribute at the balance sheet date can differ from the net realisable value.

The Contact Committee arrived at the conclusion that, despite the difference in wording, the meaning is practically the same. The wording of the Accounting Directives does not make any specific reference to

the value which is "realizable" simply because it aims to be as comprehensive as possible. However, it appears difficult to imagine any practical case where the lower value to be attributed to inventories at the balance sheet date may be materially different from the net realisable value. Accordingly, no conflict arises between paragraph 6 of IAS 2 and Article 39.1(b) of the 4th Directive.

IAS 2 states in paragraph 10 (not in bold characters) that costs of conversions include a systematic allocation of fixed and variable production overheads. The inclusion of indirect production costs is allowed but not required by Article 35.3(b) of the 4th Directive. Moreover, the IAS requires both fixed and variable costs to be included, while nothing is mentioned in the Accounting Directives.

The Contact Committee has assumed that European companies willing to comply with IAS will select the option contained in Article 35.3(b).

The 4th Directive allows Member States to permit exceptional adjustments to be made, when they are necessary, if the valuation of the items is not to be modified in the near future due to fluctuations in value (Article 39.1(c)). Such exceptional adjustments are not permitted by IAS 2.

Even if the option contained in the 4th Directive is a Member State option, companies will always be free not to make the exceptional adjustments permitted. Therefore the Contact Committee has assumed that European companies willing to comply with IAS will not select the option contained in Article 39.1(c).

Article 38 of the 4th Directive allows certain stocks to be valued at a fixed quantity and value, if the quantity, value and composition thereof do not vary materially. This is not permitted by IAS 2.

The Contact Committee has assumed that European companies willing to comply with IAS will not select the option set out in Article 38 of the 4th Directive.

IAS 7 – Cash Flow Statements

The Contact Committee has not examined IAS 7 but the issues dealt with in this standard are not specifically covered in the Accounting Directives.

IAS 8 - Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies[8]

Difference in the wording exists between the definition of "extraordinary items" as contained in paragraph 6 of IAS 8 and the one contained in Article 29 of the 4th Directive.

The Contact Committee arrived at the conclusion that, despite the different wording, no significant differences can be perceived in practice. The Contact Committee also observed that the classification of an item as extraordinary or not may often depend on the size of the enterprise: the larger the business, the more often certain events may occur, with the consequence that they may be more correctly classified as ordinary items. This consideration has led to a trend whereby the number of items which are considered as extraordinary is decreasing.

IAS 9 - Research and Development Costs[8]

According to paragraph 15 of IAS 9 research costs cannot be capitalised, while development costs must be capitalised, when the conditions set out in paragraphs 16 and 17 are met. Under Article 37.1 of the 4th Directive, it is possible to capitalise both research and development costs, depending on national legislation.

The Contact Committee is therefore of the opinion that, where the national legislation of the Member State to which it belongs forbids the capitalisation of development costs, a company will not be able to follow the requirements of IAS 9.

IAS 10 – Events After the Balance Sheet Date[15]

IAS 10 (revised 1999) "Events After the Balance Sheet Date" was issued by the International Accounting Standards Committee in May 1999 and revises those parts of IAS 10 "Contingencies and Events Occurring After the Balance Sheet Date" that had not already been superseded by IAS 37 "Provisions, Contingent Liabilities and Contingent Assets". The revised standard becomes effective for annual financial statements covering periods beginning on or after 1 January 2000.

The Contact Committee has examined IAS 10 (revised 1999) in the context of the European Accounting Directives in order to consider whether, and to what extent, to apply IAS 10 in European jurisdictions.

NATURE OF REVISION

This revision of IAS 10 makes the following changes to the former standard:

- there is now formal reference in the definition of ‘events after the balance sheet date’ to the notions of ‘adjusting’ and ‘non-adjusting’ events. Although arguably implicit in the superseded standard, post-balance sheet events were not previously categorised in this way;

- the previous standard allowed the option for dividends in respect of the period covered by the financial statements that are proposed or declared after the balance sheet date but before approval of the financial statements to be either adjusted for or disclosed. The revised standard deletes the option to recognise a liability for dividends in these circumstances; however, the standard does allow companies the choice of disclosing such dividends either on the face of the balance sheet as a separate component of equity or in the notes to the financial statements;

- deletion of the requirement to adjust the financial statements where an event after the balance sheet date indicates that the going concern assumption is not appropriate for part of the enterprise. This is because, under IAS 1, the going concern assumption applies to an enterprise as a whole. However, the revised standard still requires that an enterprise should not prepare its financial statements on a going concern basis if events after the balance sheet date indicate that the going concern assumption is not appropriate;

- the introduction of new disclosures about the date of the authorisation for issue of the financial statements; and

- confirmation that an enterprise should update disclosures that relate to conditions that existed at the balance sheet date in the light of any new information that it receives after the balance sheet date about those conditions.

CONCLUSIONS

Although it is recognised that the practice has developed in a number of Member States for dividends proposed or declared after the balance sheet date to be shown in the balance sheet as a liability, the Accounting Directives are silent on this matter. However, Article 6 of the Fourth Directive provides for Member States the facility to authorise or require adaptation of the layout of the balance sheet and profit and loss account in order to include the appropriation of profit or the treatment of loss.

Therefore, IAS 10's abolition of the option to recognise a liability for proposed dividends has no impact on the revised Standard's conformity with the Directives. Companies that wish to disclose such dividends on the face of the balance sheet as a separate component of equity are permitted to do so within the framework of the Directives. This can be achieved either by creating a new caption for this purpose or by showing the proposed dividends under the heading 'Other reserves'.

In reviewing all the other changes introduced by the Standard, the Contact Committee has similarly concluded that there are no new conflicts introduced by the revisions to IAS 10.

IAS 11 - Construction Contracts[8]

IAS 11 prescribes in its paragraph 23 that construction contracts are normally accounted for by using the so-called "percentage of completion" method. The compatibility of this method with a correct application of the prudence principle has long been the subject of debate in Europe. Article 31.1(c)(aa) of the 4th Directive in fact permits the inclusion in income of "profits made at the balance sheet date" only. This rule could be interpreted as forbidding the inclusion in income of profits in proportion to the percentage of realisation of a contract.

The Contact Committee confirms the opinion that it previously delivered on this issue. According to the Contact Committee the "percentage of completion" method is acceptable under the 4th Directive, provided the following conditions are observed:

a. the total contract income is known,

b. the proportion of work completed can be calculated accurately,

c. the work on the contract must be sufficiently advanced.

IAS 12 – Income Taxes[12]

INTRODUCTION

In most jurisdictions the starting point for computing a company's liability to taxation is the profit reported in the financial statements. However, tax laws sometimes permit or require items to be recognised for tax purposes at different amounts, or on different bases, or over different periods to those used for the financial accounts. The tax effects of such differences between accounting and taxable profit for a given period are known as "deferred tax".

The issue in accounting for tax is whether, and how, deferred tax should be recognised in the financial statements. Two different approaches exist in this respect: the "income statement" liability method and the "balance sheet" liability method. The "income statement" liability method focuses on timing differences, which are the differences between taxable profit and accounting profit that originate in one period and reverse in one or more subsequent periods. The "balance sheet" liability method focuses on temporary differences, which are the differences between the amount attributed to an asset or liability for tax purposes (tax base) and the carrying amount of that asset or liability in the balance sheet. The two different approaches do not yield the same result in all cases, with the main differences being in the treatment of deferred tax on initial recognition of an asset or liability.

IAS 12 (revised) "Income Taxes", which was issued by the International Accounting Standards Committee in October 1996, requires deferred tax to be accounted for in full using the "balance sheet" liability method.

The Contact Committee on the Accounting Directives has examined the requirements contained in IAS 12 in the light of the requirements contained in the European Accounting Directives.

When deferred taxes are recognised in Europe, their calculation is normally based on the timing differences between items appearing in the profit and loss account and them being taxed ("income statement" liability method). The approach proposed in IAS 12 is likely to require changes to European practices in accounting for deferred taxation. However, the Contact Committee recognises that the differences between the "balance sheet" liability method as implemented in IAS 12 (which excludes certain types of temporary differences from its scope, for example those arising on the purchase of a non-deductible asset) and the "income statement" liability method as generally practised in Europe (which also recognises deferred taxes on some differences which are strictly temporary, for example fair value adjustments on consolidation) are in practice not as marked as it might appear in theory.

The Contact Committee has listed in the following paragraphs a number of issues to be considered in deciding whether, and to what extent, to apply IAS 12 in European jurisdictions.

SPECIFIC ISSUES

Prudence in the Recognition of Deferred Tax Assets

According to paragraph 24 of IAS 12, "a deferred tax asset should be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilised ....".

The Contact Committee considers that under the going concern assumption deferred tax assets may be recognised. In fact, if a company is not able to produce enough future taxable profits against which the deductible temporary differences can be utilised it means that it is not able to recover all its net assets and therefore that it may no longer be a going concern. However, there might be cases where the application of the prudence principle contained in Article 31.1(c) of the 4th Directive would require that these differences are not recognised.

The Contact Committee also considers that the notion of uncertainty inherent in paragraph 24 of IAS 12 through the use of the phrase "it is probable" should be assessed by European companies by applying the concept of prudence as expressed in the 4th Directive. This would ensure that deferred tax assets are recognised only when there is no reasonable doubt that future taxable profits will be available.

These considerations equally apply to deferred tax assets recognised in accordance with paragraphs 34 and 44 of IAS 12.

Existence of a "Probability Test" for Deferred Tax Liabilities

Paragraph 15 of IAS 12 states that "a deferred tax liability should be recognised for all taxable temporary differences, unless ....".

First, the Contact Committee considers that the term "deferred tax liability" used by IAS 12 would encompass both what is understood as a "liability" and as a "provision for taxation" under the European Accounting Directives, depending on the circumstances. Second, the Contact Committee points out that the recognition by European companies of deferred tax liabilities or provisions for taxation clearly depends on the condition that a future charge to tax will actually arise. While this condition is normally met for tax liabilities, in the case of provisions for taxation it would always be necessary to carry out a "probability test", in order to assess the level of certainty that the taxable differences identified will give rise to future tax charges, before recognising any provision for taxation.

The Contact Committee believes that the wording "all taxable differences" cannot be interpreted as relieving the reporting entity from the obligation to carry out the aforementioned assessment, since the application of Article 2.3 of the 4th Directive would not permit companies to set up a tax liability or a provision for taxation when it is not likely that the liability will arise.

Classification of Deferred Tax Assets as Current Assets

Paragraph 70 of IAS 12 states that "when an enterprise makes a distinction between current and non-current assets and liabilities in its financial statements, it should not classify deferred tax assets (liabilities) as current assets (liabilities)."

The Contact Committee points out that, according to Article 15.1 of the 4th Directive, assets are shown as fixed assets or current assets depending on the purpose for which they are intended. Fixed assets shall comprise those assets that are intended for use on a continuing basis for the purposes of the undertaking's activities (Article 15.2).

The Contact Committee also points out that paragraph 53 of IAS 1 states that ".... when an enterprise chooses not to make this classification (i.e. current/non-current), assets and liabilities should be presented broadly in order of their liquidity". This alternative approach permitted under IAS 1 allows companies which apply the Accounting Directives to prepare their balance sheets according to the Formats and, therefore, to disclose deferred tax assets in line with the Directive. This means that the items which correspond to the definition of deferred tax assets contained in paragraph 5 of IAS 12 will have to be classified as fixed assets or current assets according to the requirements of Article 15 of the 4th Directive. The Contact Committee cannot envisage a situation where a deferred tax asset would be classified other than as a current asset.

CONCLUSIONS

On the basis of the above considerations the Contact Committee has therefore concluded that IAS 12 is compatible with European Accounting legislation to the extent that the following conditions are fulfilled:

- The recognition of deferred tax assets is subject to a prudent assessment. A conflict with the Accounting Directives could arise when deferred tax assets are recognised in situations where reasonable doubts exist that taxable profit will be available against which the deductible temporary differences can be utilised.
- The recognition of deferred tax liabilities is subject to a probability test. A conflict with the Accounting Directives could arise when deferred tax liabilities or provisions for taxation are recognised for taxable temporary differences for which it is not likely that a future liability will arise
- The presentation of deferred tax assets and tax liabilities is made in accordance with the Formats prescribed by the Accounting Directives. IAS 1 makes provision for companies to avoid having to use the current/non-current classification in respect of balance sheet assets and liabilities. Consequently, companies which apply the Accounting Directives would be required to take advantage of this provision, with the result that paragraph 70 of IAS 12 would not apply, thereby enabling them to disclose deferred tax assets in line with the Directive.

ANNEX TO IAS 12

Summary of the provisions concerning Taxation contained in the Accounting Directives

The Accounting Directives do not specifically deal with accounting for taxation. However, the 4th Directive contains a number of requirements which are of relevance.

- Articles 35.1(d) and 39.1(e) state that if fixed or current assets are the subject of exceptional value adjustments for taxation purposes alone, the amount of the adjustments and the reasons for making them

must be indicated in the notes on the accounts.

- In the balance sheet lay-out, the amounts of tax payable included under "other creditors" should be separately disclosed (together with social security) and split in the part payable within 1 year and after more than 1 year (Article 9C and Article 10F/I).
- Provisions for taxation should be shown on the face of the balance sheet (Article 9B(2) and Article 10J(2)).
- Taxes on profit or loss should be shown in the profit and loss account, separately for ordinary activities and extraordinary activities. However, Article 30 permits an aggregation of these amounts, provided that they are separately disclosed in the notes.
- Article 43.1(10) requires that the extent to which the calculation of the profit or loss for the financial year has been affected by a valuation of the items made with a view to obtaining tax relief is indicated in detail in the notes to the accounts.
- Article 43.1(11) requires that the difference between the tax charged for the financial year and for earlier financial years and the amount of tax payable in respect of those years is indicated in the notes, provided that this difference is material for purposes of future taxation. This amount may also be disclosed in the balance sheet as a cumulative amount under a separate item with an appropriate heading.

The 7th Directive also contains a number of relevant requirements.

- Article 29.4 requires that "account shall be taken, in the consolidated balance sheet and in the consolidated profit and loss account, of any difference arising on consolidation between the tax chargeable for the financial year and for preceding financial years and the amount of tax paid or payable in respect of those years, provided that it is probable that an actual charge to tax will arise within the foreseeable future for one of the undertakings included in the consolidation."
- Article 29.5 requires that "where assets to be included in consolidated accounts have been the subject of exceptional value adjustments solely for tax purposes, they shall be incorporated in the consolidated accounts only after those adjustments have been eliminated. A member State may, however, require or permit that such assets be incorporated in the consolidated accounts without the elimination of the adjustments, provided that their amounts, together with the reasons for them, are disclosed in the notes on the consolidated accounts."
- Article 34.5(10) requires that the extent to which the calculation of the consolidated profit or loss for the financial year has been affected by a valuation of the items made with a view to obtaining tax relief is indicated (and, if material, detailed) in the notes to the accounts.
- Article 34.5(11) requires that the difference between the tax charged for the financial year and for earlier financial years and the amount of tax payable in respect of those years is indicated in the notes, provided that this difference is material for purposes of future taxation. This amount may also be disclosed in the balance sheet as a cumulative amount under a separate item with an appropriate heading.

IAS 14 – Segment Reporting

The Contact Committee has not examined IAS 14 but the issues dealt with in this standard are not specifically covered in the Accounting Directives.

IAS 15 – Information Reflecting the Effects of Changing Prices

The Contact Committee has not examined IAS 15 but the issues dealt with in this standard are not specifically covered in the Accounting Directives.

IAS 16 - Property, Plant and Equipment[8]

Paragraph 48 of IAS 16 states that "the depreciable amount of an asset is determined after deducting the residual value of the asset". The 4th Directive does not contain any reference to the "residual value" and in Article 35.1(b) of the 4th Directive the basis for depreciation is indicated as the "purchase price or production cost".

Although the wording of IAS 16 is clearly different from that of the Directive, this does not seem to have significant practical consequences. Therefore the Contact Committee has concluded that the use of a residual value in the calculation of the depreciable amount of an asset is not precluded under the present wording of the 4th Directive and no conflict arises.

Paragraph 56 of IAS 16 states that, if the recoverable amount of an item of Property, Plant and Equipment declines below its carrying amount, the carrying amount must be reduced. Article 35.1(c)(bb) of the 4th Directive states that "fixed assets are to be valued at the lower figure to be attributed to them at the balance sheet date, if it is expected that the reduction in their value is permanent". Therefore, paragraph 56 of IAS 16 requires that adjustments must also be made if it is not certain that the reduction in value will be permanent. In contrast, according to the 4th Directive, the adjustments must be made only if the reduction in value is permanent.

The Contact Committee arrived at the conclusion that the difference in wording does not constitute a difference in practice and that a conflict between paragraph 56 of IAS 16 and Article 35.1(c)(bb) of the 4th Directive therefore does not exist. It would not in fact be consistent with the general approach of IAS to consider that the reduction in value should be made even in those cases where one already knows that such a reduction would be reversed.

Commission document 6010/99: *IAS 16 (Revised 1998) "Property, Plant and Equipment" was issued by the International Accounting Standards Committee in September 1998 and supersedes the version of IAS 16 that was issued in revised form in 1993. The standard is effective for financial statements covering periods beginning on or after 1 July 1999, although earlier application is encouraged. If an enterprise applies this revised standard for financial statements covering periods beginning before 1 July 1999, the enterprise should both disclose that fact and adopt IAS 22 (Revised 1998) and IASs 36 and 37 at the same time.*

The Contact Committee has examined IAS 16 (Revised 1998) in the context of the European Accounting Directives in order to consider whether, and to what extent, to apply IAS 16 in European jurisdictions.

NATURE OF REVISION

Various paragraphs of IAS 16 were revised to be consistent with IAS 22 (Revised 1998) and IASs 36 and 37

CONCLUSIONS

There are no new conflicts introduced by the revisions to IAS 16.

IAS 17 – Leases

The Contact Committee has not examined IAS 17 but the issues dealt with in this standard are not specifically covered in the Accounting Directives.

IAS 18 – Revenue

The Contact Committee has not examined IAS 18 but the issues dealt with in this standard are not specifically covered in the Accounting Directives.

Nevertheless, the Contact Committee noted that IAS 18 adopts a transactions-based critical event approach for the recognition of revenues derived from the sale of goods and the rendering of services. In practice this means that the application of the requirements of IAS 18 would lead to a result that is not inconsistent with the requirement in Article 31.1(c)(aa) of the 4th Directive that only profits made at the balance sheet date may be included in the annual accounts.

IAS 19 – Employee Benefits[13]

INTRODUCTION

IAS 19 (Revised 1998) "Employee benefits" was issued by the International Accounting Standards Committee in February 1998. The standard is effective for financial statements covering periods beginning on or after 1 January 1999, although earlier application is encouraged.

The Contact Committee has examined IAS 19 in the context of the European Accounting Directives, and has listed in the following paragraphs the issues to be considered in deciding whether, and to what extent, to apply IAS 19 in European jurisdictions.

IAS 19 is intended for use in countries with different legal and regulatory environments, but the accounting solutions contained in the standard do not always reflect this variety. Consequently, certain accounting solutions in the standard are difficult to apply in many EU Member States.

SPECIFIC ISSUES

Little specific provision in the Directives

IAS 19 covers five broad types of employee benefit:

(a) short-term benefits (e.g. wages and salaries, sick pay, holiday pay, profit shares and bonuses);

(b) post-employment benefits (e.g. pensions, medical benefits);

(c) other long-term benefits (e.g. long-service awards, sabbatical leave etc.);

(d) termination benefits; and

(e) stock compensation plans.

By contrast the Fourth Directive addresses these issues both in much more general terms and only as disclosure requirements. The profit and loss account formats and Article 43.1(9) require disclosure of remuneration of employees, analysed between wages/salaries and social security costs; Article 43.1(12) requires disclosure of emoluments and provision for retirement pension of directors (or equivalent).

Short-term benefits

The detailed rules in IAS 19 for accounting for short-term employee benefits essentially require all such benefits to be accounted for on an accruals rather than a cash paid basis. They can therefore be seen as simply applying the general requirement for accruals accounting of Article 31.1(d) of the Fourth Directive to a particular case.

Post-employment benefits

The provisions of IAS 19 for post-employment benefits can be divided broadly into those for defined contribution pension schemes (and similar benefits) and defined benefit pension schemes (and similar benefits).

The requirements for defined contribution schemes, like those for short-term employee benefits, essentially require such schemes to be accounted for on an accruals rather than a cash paid basis. They can therefore be seen as simply applying the general requirement for accruals accounting of Article 31.1(d) of the Fourth Directive to a particular case.

The requirements for defined benefit schemes are considerably more complicated. However, in broad terms IAS 19 requires the liability for pensions to be measured as net present value of the liability to pay pensions less the market value of assets in the pension fund. The profit and loss charge for pensions is broadly the movement in this net liability from one period to the next. Under this approach, IAS 19 is simply allocating a cost by means of a complex calculation, such that it can be seen as falling within the general requirement for accruals accounting of Article 31.1(d) of the Fourth Directive. Consequently, the net liability would be disclosed in the balance sheet under the caption "Provisions for pensions and similar obligations", whilst in the event of their being a net receivable, this would be shown under the caption "Other debtors".

However, IAS 19 also incorporates a mechanism to spread certain gains and losses — in particular actuarial variations and the cost of past service benefits — 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.

Finally, whilst IAS 19 requires that pension fund liabilities are to be discounted, it is clear that discounting is not prohibited by the Fourth Directive.

Other long-term benefits

The liability for such benefits is essentially to be accounted for in the same way as defined benefit pension schemes, except that actuarial gains and losses and the cost of past service benefits are recognised immediately and not spread. Accordingly the comments in respect of such schemes above apply again here.

Termination benefits

IAS 19 lays down strict conditions as to when such costs can be recognised. Essentially provision for such costs can be made only when the reporting entity has a demonstrable commitment to providing such benefits as evidenced by a detailed plan of the location, function and approximate number of employees affected, the benefits to be given and the timing of implementation of the terminations.

This arguably implies a higher level of certainty for the recognition of such costs than Article 31.1(c)(bb)

of the Fourth Directive that requires provision for 'all foreseeable liabilities and potential losses.' This issue is discussed further in the context of IAS 37.

Equity compensation benefits

IAS 19 has requirements for the disclosure, but not the recognition or measurement, of such benefits. These requirements add to, and therefore do not conflict with, those of the Directives.

CONCLUSIONS

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.

The requirements of IAS 19 relating to termination benefits could be construed as prohibiting provision for items for which provision is required by the Fourth Directive (see discussion of conformity with IAS 37).

In other respects, IAS 19 is in conformity with the Directives.

Commission document 6003/00: *IAS 19 covers five broad types of employee benefit:*

(a) short-term benefits (e.g. wages and salaries, sick pay, holiday pay, profit shares and bonuses);

(b) post-employment benefits (e.g. pensions, medical benefits);

(c) other long-term benefits (e.g. long-service awards, sabbatical leave etc.);

(d) termination benefits; and

(e) stock compensation plans.

In dealing with post-employment benefits, IAS 19 incorporates a mechanism (known as the 'corridor approach') to spread certain gains and losses — in particular actuarial variations and the cost of past service benefits — 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 explicitly to 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.

In dealing with termination benefits, IAS 19 lays down strict conditions as to when such costs can be recognised. Essentially provision for such costs can be made only when the reporting entity has a demonstrable commitment to providing such benefits as evidenced by a detailed plan of the location, function and approximate number of employees affected, the benefits to be given and the timing of implementation of the terminations. This arguably implies a higher level of certainty for the recognition of such costs than Article 31.1(c)(bb) of the Fourth Directive which requires provision for 'all foreseeable liabilities and potential losses.' This issue is discussed further in the context of IAS 37.

IAS 20 – Accounting for Government Grants and Disclosure of Government Assistance

The Contact Committee has not examined IAS 20 but the issues dealt with in this standard are not specifically covered in the Accounting Directives.

IAS 21 - The Effects of Changes in Foreign Exchange Rates[8]

According to IAS 21, both positive and negative translation differences in exchange rates relating to monetary items are to be included in the profit and loss account. In Europe this question has caused a long-running debate. The Accounting Directives do not specifically address the problem. In Article 43.1 of the 4th Directive it is stated that the methods and rates used should be specified. While agreement has always existed on the fact that negative differences should be charged to the profit and loss account as soon as they arise, the inclusion of positive differences in income has long been debated.

Those who support the view that positive differences should not be included in income base their argument on the grounds that such amounts are unrealised profits which, according to Article 31.1(c)(aa) of the 4th Directive cannot be included in income. In contrast, those who propose to accept that positive differences are included in income, do so on the basis that the positive exchange differences are immediately realisable in the normal situation of a liquid market and therefore cannot be considered as unrealised profits. Not recognising these differences in income would give insufficient weight to the accruals principle stated in Article 31.1(d) of the 4th Directive.

After having carefully considered the different arguments raised on this complex issue, the Contact Committee has concluded that Article 31 of the 4th Directive does not exclude an interpretation whereby positive exchange differences may be included in the profit and loss account. However, the Contact Committee stresses that the question has been examined in relation with the preparation of consolidated accounts only.

The Contact Committee has also examined whether the possibility to include positive exchange differences in the profit and loss account should be limited to short-term monetary items. The Contact Committee has concluded that this limitation is not justified. In fact, the existence of very sophisticated financial instruments, makes it arbitrary to operate a distinction between short-term and long-term monetary items.

As a result, the Contact Committee is of the opinion that no conflict exists between IAS 21 and the Accounting Directives.

Article 39.3 of the Bank Accounts Directive allows Member States to require or permit that exchange differences arising on assets held as financial fixed assets, on tangible and intangible assets and on any

transactions undertaken to cover those assets be included in whole or in part in reserves not available for distribution and not be shown in the profit and loss account. Paragraphs 17 and 19 of IAS 21 provide for the inclusion in reserves only of exchange differences arising on monetary items that form part of an enterprise's net investment in a foreign entity: for such differences the inclusion in reserves is in any case compulsory.

The Contact Committee is of the belief that a conflict arises between Article 39.3 and IAS 21, to the extent that a Member State would require that differences other than those arising on monetary items that form part of an enterprise's net investment in a foreign entity are included in reserves and not shown in the profit and loss account.

Article 39.4 of the Bank Accounts Directive allows Member States to require that positive translation differences arising out of forward transactions, assets or liabilities not covered or not specifically covered by other forward transactions, or by assets or liabilities are not shown in the profit and loss account. This is not permitted by IAS 21.

The Contact Committee is of the opinion that, to the extent that this option is implemented by Member States, a conflict arises between IAS 21 and the Bank Accounts Directive.

IAS 21 contains a distinction of foreign operations in "integrated foreign operations" and "foreign entities" which is neither contained in the Bank Accounts Directive nor in the 7th Directive. The optional accounting treatment contained in Article 39.6 of the Bank Accounts Directive is provided for by IAS 21 only for foreign entities, for which it is however compulsory.

The Contact Committee is of the opinion that a conflict arises between IAS 21 and the Bank Accounts Directive whenever Member States apply the treatment contained in Article 39.6 to operations other than foreign entities. A conflict would also arise when Member States do not allow the application of such a treatment to foreign entities.

The Contact Committee is of the opinion that in the cases mentioned in above paragraphs, when a Member State permits banks and other financial institutions to apply certain accounting treatments which are in conflict with IAS, banks and other financial institutions wishing to comply with IAS will not select such accounting treatments.

IAS 22 - Business Combinations[8]

Paragraph 25 of IAS 22 could be interpreted as requiring that, in order to determine the cost of an acquisition, marketable securities issued by the acquirer should be valued at market value only. This could be interpreted as being in conflict with the prudence principle as stated in Article 31.1(c) of the 4th Directive.

After examination, the Contact Committee has concluded that the wording of paragraph 25 does not exclude that other considerations are taken into account in valuing the marketable securities issued by the acquirer. In fact, paragraph 25 states that "all aspects of the acquisition, including significant factors influencing the negotiations, need to be considered, and independent valuations may be used as an aid in determining the fair value of securities issued."

Therefore, the Contact Committee is of the opinion that no conflict arises.

Paragraphs 49-50-51 of IAS 22 state that negative goodwill should be treated as deferred income. Accordingly, it should be recognised as income on a systematic basis over a period not exceeding five years unless a longer period not exceeding twenty years from the date of acquisition can be justified.

Article 31 of the 7th Directive establishes the specific cases in which the recognition of negative goodwill in the profit and loss account may be made.

The rules contained in the 7th Directive differ from those in IAS 22 in the same respect and therefore a conflict arises.

However, the Contact Committee believes that in practice this conflict will only lead to material differences in extremely rare circumstances. Indeed, Article 31(a) of the 7th Directive states that the recognition in the profit and loss account can be made in so far as the expectation of unfavourable results or costs materialises. Normally, such an expectation relating to unfavourable costs and results will materialise gradually and in a limited period of time, so that the accounting treatment arising from the application of Article 31(a) of the 7th Directive would in practice have identical effects as the "systematic" recognition in income prescribed by IAS 22. In addition, the word "systematic" used by IAS 22 is not always understood as meaning "gradual, straight-line" amortisation.

As Article 31 does not state how negative goodwill should be treated, the Contact Committee suggests that the Commission, at the occasion of an amendment of the 7th Directive, propose a re-draft of Article 31, so as to clarify the accounting treatment of negative goodwill and bring it in line with the treatment required by IAS 22.

The pooling method is an option available to the Member States under Article 20 of the 7th Directive. Both the conditions under which the application of the method is permitted and the way that the method itself is applied as stated in Article 20 seem somewhat different from what is described in IAS 22.

The Contact Committee believes that the Accounting Directives do not specifically address accounting problems linked with mergers and acquisitions and that they therefore do not deal with the question of the application of the pooling method in cases of uniting of interests. Therefore, the comparison between Article 20 and IAS 22 is not always appropriate. However, for those cases where the conditions of applicability of the pooling method are the same, the Contact Committee feels that a conflict might arise, depending on the detailed national legislation which implements the option contained in Article 20.

According to paragraph 42 and 49 of IAS 22, goodwill can never be amortised on a period exceeding 20 years. In the Accounting Directives (4th Directive-Article 37, 7th Directive-Article 30) Member States may permit the amortisation of goodwill over a period longer than 5 years, depending on its useful life. When a Member State has applied the option contained in Article 37.2, a conflict could therefore arise, because the period of amortisation is limited to 20 years under IAS 22 while it could be longer under the Accounting Directives, depending on the useful life of the asset.

The Contact Committee is therefore of the opinion that a conflict could arise.

Article 30.2 of the 7th Directive allows Member States to permit positive consolidation differences to be immediately and clearly deducted from reserves. This is not permitted by IAS 22.

The Contact Committee has assumed that European companies willing to comply with IAS will not select the option of Article 30.2 of the 7th Directive.

Commission document 6010/99: IAS 22 (Revised 1998) "Business Combinations" was issued by the International Accounting Standards Committee in September 1998 and supersedes the version of IAS 22 that was issued in revised form in 1993. The standard is effective for financial statements covering periods beginning on or after 1 July 1999, although earlier application is encouraged. If an enterprise applies this revised standard for financial statements covering periods beginning before 1 July 1999, the enterprise should both disclose that fact and adopt IASs 36,37 and 38 at the same time.

The Contact Committee has examined IAS 22 (Revised 1998) in the context of the European Accounting Directives in order to consider whether, and to what extent, to apply IAS 22 in European jurisdictions.

NATURE OF REVISION

Various paragraphs of IAS 22 were revised to be consistent with IASs 36, 37 and 38 and, in addition, the treatment of goodwill was revised.

CONCLUSIONS

There are no new conflicts introduced by the revisions to IAS 22. In fact, IAS 22's revision of the accounting for negative goodwill now removes the previously identified potential conflict in this area.

IAS 23 - Borrowing costs[8]

According to paragraph 11 of IAS 23, 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.

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.

IAS 24 – Related Party Disclosures

The Contact Committee has not examined IAS 24 but the issues dealt with in this standard are not specifically covered in the Accounting Directives.

IAS 25 - Accounting for investments[8]

Paragraph 22 of IAS 25 could be interpreted in such a way that it required the valuation at the lower of cost and market value is to be made by following a "portfolio approach". This of course would be in contrast with the Accounting Directives, and in particular with Article 31.1(e) of the 4th Directive, which requires the separate valuation of the items of assets and liabilities. In addition, a valuation made under the so-called portfolio approach could be contrary to the prudence principle, by de facto permitting the inclusion in income of positive unrealised profit which would not be included if the portfolio approach were not applied.

However, paragraph 19 of IAS 25 clearly states that the portfolio approach is optional. There seems therefore to be a contradiction between the words in paragraph 22 and those in paragraph 19.

The Contact Committee has concluded that IAS 25 does not prescribe the use of the portfolio approach, which is only optional and therefore no conflict exists between IAS 25 and the Accounting Directives.

Article 37.2(a) of the Bank Accounts Directive allows Member States to permit that the value of loans and advances to credit institutions and customers, debt securities (including fixed-income securities) and shares and other variable-yield securities which are neither held as financial fixed assets nor included in a

trading portfolio is adjusted, within certain limits, to take into account the particular risks associated with banking. This adjustment goes beyond what is required as a result of the normal rules concerning value adjustments. In addition, Article 37.2(b) allows this lower value to be maintained until the credit institutions decide to reverse it. These accounting treatments are not permitted under IAS 25.

The Contact Committee is of the opinion that banks and other financial institutions wishing to comply with IAS will not apply the treatment provided for by Article 37, when implemented by Member States.

IAS 26 – Accounting and Reporting by Retirement Benefit Plans

The Contact Committee has not examined IAS 26 but the issues dealt with in this standard are not specifically covered in the Accounting Directives.

IAS 27 - Consolidated Financial Statements and Accounting for Investments in Subsidiaries[8]

The considerations expressed in this paragraph do not apply to those mixed groups comprising banks and insurance undertakings which are often referred to as "financial conglomerates", because this matter has not yet been specifically examined by the Contact Committee.

Article 14.1 of the 7th Directive states that an undertaking must be excluded from the consolidated accounts when its inclusion would be incompatible with the true and fair view. In contrast, IAS 27 only provides for an exclusion from consolidation when the control is intended to be temporary or where the subsidiary operates under severe long-term restrictions.

A conflict therefore exists between the 7th Directive and IAS 27 on this point. However, the mandatory exclusion from consolidation in Article 14.1 of the 7th Directive is not likely to occur frequently. As a matter of fact, a development has taken place since the adoption of the 7th Directive, whereby more and more subsidiaries have been included in consolidated accounts, regardless of the nature of their business compared with that of the parent undertaking. It is generally believed now that preference should be given to the inclusion of the subsidiary in the consolidated accounts with appropriate information (on a segmented basis) in the notes.

The Contact Committee believes that, although a conflict exists between the wording of Article 14.1 of the 7th Directive and IAS 27, the requirement to exclude a subsidiary from the scope of the consolidation on the basis of Article 14.1 should not be read today in the same way as it was intended when the 7th Directive was originally drafted. The Contact Committee therefore considers that the wording of IAS 27 which does not allow for any exclusion on the ground of different activities better reflects the present situation and suggests that the Commission, at the occasion of an amendment of the 7th Directive, propose a re-draft of Article 14, in order to bring it more in line with today's practice and with IAS 27.

Commission document 6005/99: Article 14.1 of the Seventh Directive states that an undertaking must be excluded from the consolidated accounts when its inclusion would be incompatible with the true and fair view. In contrast, IAS 27 only provides for exclusion from consolidation when control is intended to be temporary or where the subsidiary operates under severe long-term restrictions.

However, whilst there seems to be a textual conflict between IAS 27 and the Directive, whether or not this will have any effect in practice is a debatable point. For example, whilst IAS 27 does not allow for the exclusion from consolidation of a subsidiary on the grounds of different activities, it is a matter of judgement as to whether the consolidation of enterprises which undertake different activities would be incompatible with the true and fair view. In fact, current thinking is that such undertakings should be

consolidated, with the appropriate segmental information being given in the notes to the accounts in order to explain the performance of the individual operations. In the light of this, the Contact Committee does not see any case where Article 14 will require the exclusion of any undertaking from consolidation.[14]

<u>Commission document 6003/00:</u> Article 14.1 of the Seventh Directive states that an undertaking must be excluded from the consolidated accounts when its inclusion would be incompatible with the true and fair view. In contrast, IAS 27 only provides for exclusion from consolidation when control is intended to be temporary or where the subsidiary operates under severe long-term restrictions.

However, whilst there seems to be a textual conflict between IAS 27 and the Directive, whether or not this will have any effect in practice is a debatable point. For example, whilst IAS 27 does not allow for the exclusion from consolidation of a subsidiary on the grounds of different activities, it is a matter of judgement as to whether the consolidation of enterprises which undertake different activities would be incompatible with the true and fair view. In fact, current thinking is that such undertakings should be consolidated, with the appropriate segmental information being given in the notes to the accounts in order to explain the performance of the individual operations. In the light of this, the Contact Committee does not see any case where Article 14 will require the exclusion of any undertaking from consolidation.[14]

IAS 28 - Accounting for Investments in associates[8]

According to IAS 28, the use of the equity method should be discontinued in the cases prescribed under paragraphs 8 and 11b. The Accounting Directives do not provide for any discontinuance in the use of the equity method. Therefore, in theory a conflict arises. It is to be considered, however, that the cases listed in IAS 28 and allowing for discontinuance of the equity method will in practice result in the investments no longer constituting a participation in the sense of Article 17 of the 4th Directive. For that reason, under the Accounting Directives the equity method would also not be applicable.

The Contact Committee has therefore concluded that, although the rules contained in IAS 28 are not contained in the 7th Directive, the effect in practice will be the same and in substance no conflict arises.

<u>Commission document 6010/99:</u> IAS 28 (Revised 1998) "Accounting for Investments in Associates" was issued by the International Accounting Standards Committee in September 1998 and supersedes the version of IAS 28 that was issued in reformatted form in 1994. The revised text becomes effective when IAS 36 becomes operative – i.e. for financial statements covering periods beginning on or after 1 July 1999, unless IAS 36 is applied to earlier periods.

The Contact Committee has examined IAS 28 (Revised 1998) in the context of the European Accounting Directives in order to consider whether, and to what extent, to apply IAS 28 in European jurisdictions.

NATURE OF REVISION

Paragraphs 23 and 24 of IAS 28 were revised to be consistent with IAS 36.

CONCLUSIONS

There are no new conflicts introduced by the revisions to IAS 28.

IAS 29 – Financial Reporting in Hyperinflationary Economies

The Contact Committee has not examined IAS 29 but the issues dealt with in this standard are not specifically covered in the Accounting Directives.

IAS 30 - Disclosures in the Financial Statements of Banks and Similar Financial Institutions[8]

Article 38.1 of the Bank Accounts Directive provides that Member States must or may permit the creation of a "fund for general banking risks", depending on whether or not the Member State has adopted the option contained in Article 37 of the same Directive. According to Article 38.2, where the "fund for general banking risks" exists, the net balance of its increases and decreases must be shown separately in the profit and loss account. On the contrary, paragraphs 50 to 52 of IAS 30 require any increase or decrease of the fund for general banking risks to be separately disclosed as appropriation or increase of retained earnings and therefore do not allow any increase or decrease of this fund to be included in the profit and loss account.

The Contact Committee is of the opinion that when a Member State has implemented the options contained in Articles 37 and 38 of the Bank Accounts Directive, banks and other financial institutions wishing to comply with IAS should not apply those options.

IAS 31 – Financial Reporting of Interests in Joint Ventures[8]

In the cases listed in its paragraph 35, IAS 31 forbids the use of the equity method and of proportional 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 IAS 28 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 IAS 31 are not contained in the 7th Directive, the effect in practice will be the same and in substance no conflict arises.

Commission document 6010/99: IAS 31 (Revised 1998) "Financial Reporting of Interests in Joint Ventures" was issued by the International Accounting Standards Committee in September 1998 and supersedes the version of IAS 31 that was issued in reformatted form in 1994. The revised text becomes effective when IAS 36 becomes operative – i.e. for financial statements covering periods beginning on or after 1 July 1999, unless IAS 36 is applied to earlier periods.

The Contact Committee has examined IAS 31 (Revised 1998) in the context of the European Accounting Directives in order to consider whether, and to what extent, to apply IAS 31 in European jurisdictions.

NATURE OF REVISION

Paragraphs 39 and 40 of IAS 31 were revised and a new paragraph 41 was added in order for the standard to be consistent with IAS 36.

CONCLUSIONS

There are no new conflicts introduced by the revisions to IAS 31.

IAS 32 – Financial Instruments: Disclosure and Presentation[16]

INTRODUCTION

IAS 32 "Financial Instruments: Disclosure and Presentation" was issued by the International

Accounting Standards Committee (IASC) in March 1995 and, following minor amendment by IAS 39 "Financial Instruments: Recognition and Measurement", revised in December 1998. The original standard became effective for financial statements covering periods beginning on or after 1 January 1996, and the changes to IAS 32 become effective when an enterprise applies IAS 39 which, in turn, becomes effective for financial years beginning on or after 1 January 2001. In June 1998, the Standing Interpretations Committee (SIC) of the IASC issued an interpretation of IAS 32, SIC-16, applicable to accounting periods beginning on or after 1 July 1999, although earlier adoption is encouraged.

The Contact Committee has examined IAS 32 in the context of the European Accounting Directives, and has listed in the following paragraphs the issues to be considered in deciding whether, and to what extent, to apply IAS 32 in European jurisdictions.

SPECIFIC ISSUES

Most of the disclosures required by IAS 32 go far beyond those that are required by the Directives and, to that extent, are consistent with them. However, there are three presentational requirements of IAS 32 that are inconsistent with the Fourth and Seventh Company Law Directives and/or the Second Company Law Directive dealing with the maintenance of capital.

Classification of items as liabilities or equity

Paragraph 18 of IAS 32 requires that a financial instrument issued by the reporting entity should be treated as equity or debt according to whether it meets the definition of ‘financial liability’ rather than by reference to its legal form. This principle is carried forward into paragraph 23 (which requires instruments with the characteristics of both equity and financial liabilities to be accounted for in their separate components) and paragraph 30 (which requires the cost of servicing financial instruments to be treated as interest or to be debited directly to equity according to the balance sheet classification).

This means, for example, that a preference share with mandatory redemption rights is classified as a liability under IAS 32. This is contrary to the balance sheet formats set out in Articles 9 and 10 of the Fourth Directive, which provide a heading for ‘Subscribed capital’ within the heading ‘Capital and Reserves’. Where such shares are issued by a subsidiary, to include them within liabilities in the consolidated accounts, there is a conflict with Article 21 of the Seventh Directive, which requires minority interests to be included as ‘a separate item’ in the consolidated balance sheet.

In addition, to show shares within liabilities would frustrate the application of the Second Company Law Directive, which *inter alia* sets out rules for the distribution of profits and for action to be taken in the event of a serious loss of capital. These rules are based on relationships between, and multiples of, assets, liabilities and capital and reserves as shown in the accounts. The practical impact of those rules will vary according to whether shares are included within capital and reserves or liabilities. This is because, for example, the Second Directive is applied on the basis that redeemable preference shares are shown in the accounts within capital and reserves, and therefore to show them within liabilities as required by IAS 32 would distort the application of the Directive.

A possible solution to this conflict might be to show such shares, that are required to be classified as a liability under IAS 32, separately under an additional caption within the major heading ‘Capital and Reserves’.

Reporting interest and dividends

Paragraph 30 of IAS 32 requires that interest, dividends, losses and gains relating to a financial instrument, or a component part, classified as a financial liability should be reported in the income statement as expense or income. This gives rise to a conflict with Articles 23 to 26 of the Fourth Directive in the case of shares that are classified as subscribed capital under the Directive, but as liabilities under IAS 32. The Directive would not permit dividends on shares to be shown in the profit and loss account as interest payable as would be required by IAS 32.

Split accounting

Paragraph 23 of IAS 32 requires that the issuer of a financial instrument that contains both a liability and an equity element should classify the instrument's component parts separately as a liability or as equity. This approach is known as 'split accounting', and it means, for example, that a debt instrument that is convertible into equity at some future date should be classified in the balance sheet on a split basis, with the debt element being shown under liabilities and the option to convert to equity being shown under capital. The Fourth Directive does not address split accounting. Consequently, there is no conflict between the Directive and IAS 32's requirement to apply split accounting.

Offset of assets and liabilities

Paragraph 33 of IAS 32 requires amounts due and from the same third party to be netted where there is a legally enforceable right of set-off and an intention to settle net or simultaneously. Article 7 of the Fourth Directive prohibits any set-off between asset and liability items. However, in cases where there is a legally enforceable right, the net disclosure of asset and liability amounts does not constitute set-off. Consequently, the application of the provisions of paragraph 33 of IAS 32 does not give rise to a conflict with Article 7's set-off prohibition.

Own shares

A company's own shares do not fall within the definition of a financial asset in IAS 32. As a result, following the interpretation set out in SIC-16, any holdings by the reporting entity of its own shares (other than those held in connection with an employee compensation scheme) should be accounted for as a deduction from equity rather than as an asset. If the national law of a Member State permits own shares to be shown in the balance sheet, in accordance with Articles 9, 10 and 13 of the Fourth Directive they would have to be presented as fixed or current assets. However, showing own shares as assets in the balance sheet is not the treatment prescribed by IAS 32 in conjunction with SIC-16. Our document "Examination of the conformity between SIC-16 and the European Accounting Directives" deals with this situation more in detail and analyses it in the light of different particular circumstances.

CONCLUSIONS

1. In the main, IAS 32 merely supplements the disclosure requirements of the Accounting Directives.

2. The requirement in IAS 32 to treat certain financial instruments (for example, mandatorily redeemable preference shares) that are legally equity but, according to the criteria in IAS 32, in substance liabilities, as liabilities, conflicts with the balance sheet formats in the Fourth Directive and, where such instruments are issued by subsidiaries, the Seventh Directive. Such an accounting treatment would also frustrate the operation of the Second Law Company Directive. A possible solution to this conflict might be to show such financial instruments separately under an additional caption within the major heading 'Capital and Reserves'.

3. The requirement in paragraph 30 of IAS 32 that interest, dividends, losses and gains relating to a financial instrument, or a component part, classified as a financial liability should be reported in the income statement as expense or income causes a conflict with Articles 23 to 26 of the Fourth Directive in the case of shares that are classified as subscribed capital under the Directive, but as liabilities under IAS 32.

4. The Fourth Directive does not address split accounting. Consequently, there is no conflict between the Directive and IAS 32's requirement to apply split accounting in situations where a financial instrument contains both a liability and an equity element.

5. Article 7 of the Fourth Directive prohibits any set-off between asset and liability items. However, the application of the provisions of paragraph 33 of IAS 32 does not give rise to a conflict with Article 7's set-off prohibition.

6. The application of the definition of a financial asset as contained in IAS 32, as interpreted by SIC-16, results in own shares being shown as a deduction from equity rather than as an asset. There are particular situations in which this presentation is not consistent with the balance sheet layout requirements in the Fourth Directive. These particular situations are dealt with more in detail in our document "Examination of the conformity between SIC-16 and the European Accounting Directives".

<u>Commission document 6003/00:</u> *In the main, IAS 32 merely supplements the disclosure requirements of the Accounting Directives. However, there are two principal presentational requirements of IAS 32 that are inconsistent with the Fourth and Seventh Company Law Directives and/or the Second Company Law Directive dealing with the maintenance of capital.*

Classification of items as liabilities or equity

Paragraph 18 of IAS 32 requires that a financial instrument issued by the reporting entity should be treated as equity or debt according to whether it meets the definition of 'financial liability' rather than by reference to its legal form. This principle is carried forward into paragraph 23 (which requires instruments with the characteristics of both equity and financial liabilities to be accounted for in their separate components) and paragraph 30 (which requires the cost of servicing financial instruments to be treated as interest or to be debited directly to equity according to the balance sheet classification).

This means, for example, that a preference share with mandatory redemption rights is classified as a liability under IAS 32. This is contrary to the balance sheet formats set out in Articles 9 and 10 of the Fourth Directive, which provide a heading for 'Subscribed capital' within the heading 'Capital and Reserves'. Where such shares are issued by a subsidiary, to include them within liabilities in the consolidated accounts, there is a conflict with Article 21 of the Seventh Directive, which requires minority interests to be included as 'a separate item' in the consolidated balance sheet.

In addition, to show shares within liabilities would frustrate the application of the Second Company Law Directive, which inter alia sets out rules for the distribution of profits and for action to be taken in the event of a serious loss of capital. These rules are based on relationships between, and multiples of, assets, liabilities and capital and reserves as shown in the accounts. The practical impact of those rules will vary according to whether shares are included within capital and reserves or liabilities. This is because, for example, the Second Directive is applied on the basis that redeemable preference shares are shown in the accounts within capital and reserves, and therefore to show them within liabilities as required by IAS 32 would distort the application of the

Directive.

A possible solution to this conflict might be to show such shares, that are required to be classified as a liability under IAS 32, separately under an additional caption within the major heading 'Capital and Reserves'.

Reporting interest and dividends

Paragraph 30 of IAS 32 requires that interest, dividends, losses and gains relating to a financial instrument, or a component part, classified as a financial liability should be reported in the income statement as expense or income. This gives rise to a conflict with Articles 23 to 26 of the Fourth Directive in the case of shares that are classified as subscribed capital under the Directive, but as liabilities under IAS 32. The Directive would not permit dividends on shares to be shown in the profit and loss account as interest payable as would be required by IAS 32.

IAS 33 – Earnings Per Share

The Contact Committee has not examined IAS 33 but the issues dealt with in this standard are not specifically covered in the Accounting Directives.

IAS 34 – Interim Financial Reporting

The Contact Committee has not examined IAS 34 but the issues dealt with in this standard are not specifically covered in the Accounting Directives.

IAS 35 - Discontinuing Operations[17]

IAS 35 "Discontinuing Operations" was issued by the International Accounting Standards Committee in June 1998. The standard is effective for financial statements covering periods beginning on or after 1 January 1999, although earlier application is encouraged.

The Contact Committee has examined IAS 35 in the context of the European Accounting Directives, and has listed in the following paragraphs the of issues to be considered in deciding whether, and to what extent, to apply IAS 35 in European jurisdictions.

SPECIFIC ISSUES

Disclosure standard only

IAS 35 is concerned with disclosure only. It contains no recognition or measurement rules of its own, although it does require that provisions for discontinuing operations should be calculated in accordance with IAS 36 "Impairment of assets" and IAS 37 "Provisions, Contingent Liabilities and Contingent Assets". It also notes that IAS 19 "Employee Benefits" and IAS 16 "Property, Plant and Equipment" may also be relevant. The conformity of these IASs with the European Accounting Directives is considered in separate papers.

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.

CONCLUSIONS

IAS 35 does not conflict with the European Accounting Directives. However, the preferred disclosure of the pre-tax results of discontinued 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.

<u>Commission document 6003/00:</u> *IAS 35 is concerned with disclosure only and does not conflict with the Accounting Directives. However, the standard's stated preferred disclosure of showing the pre-tax results of discontinued operations on the face of the profit and loss account (see IAS 35 paragraphs 27(f) and 40) is incompatible with the use of the 'horizontal' profit and loss account formats set out in Articles 24 and 26 of the Fourth Directive, on the other hand it is compatible with the use of the vertical formats set out in Articles 23 and 25. However, any conflict with Articles 24 and 26 can be avoided by providing this information in the notes to the accounts instead of on the face of the profit and loss account.*

IAS 36 – Impairment of Assets[17]

INTRODUCTION

IAS 36 "Impairment of assets" was issued by the International Accounting Standards Committee in June 1998. The standard is effective for financial statements covering periods beginning on or after 1 July 1999, although earlier application is encouraged.

The Contact Committee has examined IAS 36 in the context of the European Accounting Directives, and has listed in the following paragraphs the of issues to be considered in deciding whether, and to what extent, to apply IAS 36 in European jurisdictions.

SUMMARY OF ISSUES

Cash-generating units

IAS 36 (paragraph 65) requires that, where possible, individual assets should be viewed for impairment. Where this is not possible, however, assets should be grouped into cash-generating units (CGUs), and a review for impairment undertaken at the level of the CGU, with any identified impairment allocated to the assets of the CGU. Potentially, this conflicts with Article 31.1(e) of the Fourth Directive, which requires that in all cases 'the components of asset and liability items must be valued separately'.

However, a reasonable case can be made that Article 31.1(e) should not be applied in such a way that it imposes a requirement that is sometimes impossible to fulfil. Consequently, if companies apply paragraph 65 of IAS 36 strictly, then they will be in compliance with the Directive. Where this is not possible, they will determine the recoverable amount of an individual asset by reference to the cash generating unit to which the asset belongs, as prescribed by IAS 36. Since the Directive is silent on what approach should be followed in such cases, it is clear that IAS 36 is not inconsistent with the Directive in this regard.

It should also be noted that IAS 36 does not recognise the distinction between temporary and permanent impairments. Under the standard, an impairment is recognised in all cases where the recoverable amount of an asset is less than its carrying amount (see paragraph 88), which means that all impairments should, in the context of the Fourth Directive, be regarded as permanent. This is because IAS 36's intrinsic discounted cash flow methodology for the measurement of an impairment loss means that only a permanent impairment will be recognised, and a temporary impairment will not be revealed by the application of the test.

Use of discounting

IAS 36 requires that an impairment should be recognised where carrying amount exceeds recoverable amount. Recoverable amount is the higher of net selling price and value in use, which the discounted net present cash-flows from the asset (or, where applicable, the CGU). Thus, where an asset is carried at value in use, its carrying value is a discounted amount. The use of discounting is not prohibited by the Fourth Directive.

Depreciation

Article 35.1(b) of the Fourth Directive requires fixed assets with a finite life to be systematically depreciated over that life. This could be said to imply a more even pattern of write-down of an asset that may well occur when IAS 36 is applied. At the same time, though, IAS 36 is in effect providing a methodology for complying with the additional requirement of Article 35.1(c)(bb) of the Directive that fixed assets should be written down where any permanent diminution in their value has occurred. Consequently, whilst it is clear that the impairment test is not a surrogate for depreciation, it provides a systematic methodology for the measurement and recognition of a permanent impairment.

CONCLUSIONS

There is no conflict between IAS 36 and the Accounting Directives. Article 31.1(e) of the Fourth Directive requires that in all cases 'the components of asset and liability items must be valued separately', whilst IAS 36 permits, in certain circumstances, assets to be grouped into cash-generating units (CGUs), and a review for impairment to be undertaken at the level of the CGU. However, the determination of impairment by reference to CGUs is only permitted under IAS 36 where it is not possible to estimate the recoverable amount of the individual asset. Consequently, provided companies apply the provisions of paragraph 65 of IAS 36 strictly, then there is no conflict between the standard and the Directive in this regard. This means that EU companies will not be able to hide behind IAS 36's CGU approach in order to avoid recording an impairment in respect of an asset that is capable of individual measurement.

IAS 37 – Provisions, Contingent Liabilities and Contingent Assets[17]

INTRODUCTION

IAS 37 "Provisions, Contingent Liabilities and Contingent Assets" was issued by the International Accounting Standards Committee in September 1998. The standard is effective for financial statements covering periods beginning on or after 1 July 1999, although earlier application is encouraged.

The Contact Committee has examined IAS 37 in the context of the European Accounting Directives, and has listed in the following paragraphs the of issues to be considered in deciding whether, and to what extent, to apply IAS 37 in European jurisdictions.

SUMMARY OF ISSUES

Lack of specific guidance in the Directives

There is little specific mention of provisions and contingencies in the Directives. Nevertheless, Article 43.1(7) of the Fourth Directive requires disclosure in the notes of the total amount of any financial commitments that are not included in the balance sheet, and Article 14 requires note disclosure of all guarantee commitments which are not recognised as liabilities in the balance sheet. Moreover, there are the general requirements of Articles 31.1(c)(bb) (account to be taken of all foreseeable liabilities and potential losses), 31.1(d) (account to be taken of all income and charges relating to the financial year) and 20 (types of item to be included in balance sheet format heading 'Provisions for liabilities and charges').

Recognition rules for provisions

Under the IAS, provisions are to be recognised in the accounts; contingent assets and liabilities are not recognised, but must in some cases be disclosed. The main issue to be considered therefore is the very broad one of whether the definition of 'provision' in the IAS includes all items that would be included by reference to the Articles referred to above.

IAS 37 (paragraph 14) requires that a provision must be recognised if (and only if) the reporting entity has, at the balance sheet date, a present obligation (whether legal or constructive) as a result of a past event which is more likely than not to result in an outflow of resources that can be estimated reliably.

If one considers just the bare words of Article 31 of the Fourth Directive and paragraph 14 of IAS 37, it would be quite easy to conclude that, whilst they are very differently expressed — the Directive focuses on recognition of expenses and the IAS on recognition of liabilities — the end result is much the same.

However, when the rules in IAS 37 for the application of paragraph 14 to specific cases are taken into account, the position is not so clear. For example, under paragraph 72 of the IAS, a provision for restructuring can be made only when the reporting entity (broadly speaking) has a detailed formal plan for the restructuring and has made its intentions public at or before the balance sheet date. Additionally, the plan must include a number of specific features, which include the business or part of the business concerned and the principal locations affected.

This means, for example, that if during the year to 31 December 1998 a company has clearly identified that one of its two factories must close to save costs, but has not decided which, IAS 37 prohibits provision for those closure costs, even if an intention to close one has been announced. Similarly, if the Board of Management of a company decides before the balance sheet date to reorganise the company (including terminating the employment of employees), and the decision is only announced after the balance sheet date (but before the accounts are approved), then IAS 37 would not permit a provision to be made for the reorganisation and termination payments, whilst Article 31 of the Fourth Directive would

require a provision to be made.

Consequently, under the Directive, a board decision would indicate that a "potential loss" (or "foreseeable risk" in the case of the German and French texts) exists. It is therefore hard to see how IAS 37's prohibition can be reconciled to the requirement of Article 31.1(c)(bb) to take account of 'all foreseeable liabilities and potential losses', if these words are construed according to their natural meaning.

Use of discounting

Where material, long term provisions are to be measured on a discounted basis, and this approach is not prohibited by (and therefore not inconsistent with) the Fourth Directive.

CONCLUSIONS

IAS 37's definition of provision as it is applied to the specific case of restructuring provisions is inconsistent with the Fourth Directive because it will prevent provision being made for items for which provision is required by Articles 31.1(c)(bb) and 31.1(d) of the Directive.

In other respects IAS 37 is not inconsistent with the Directives.

IAS 38 – Intangible Assets[17]

INTRODUCTION

IAS 38 "Intangible Assets" was issued by the International Accounting Standards Committee in September 1998. The standard is effective for financial statements covering periods beginning on or after 1 July 1999, although earlier application is encouraged.

The Contact Committee has examined IAS 38 in the context of the European Accounting Directives, and has listed in the following paragraphs the of issues to be considered in deciding whether, and to what extent, to apply IAS 38 in European jurisdictions.

SUMMARY OF ISSUES

Revaluations

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. 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.

Impairment review

All intangible assets are subject to the provisions of IAS 36 "Impairment of Assets". Accordingly the comments on that standard, together with the conclusion that there is no conflict between IAS 36 and the Accounting Directives, apply here as well.

Residual value

Paragraph 91 of IAS 38 requires the residual value of an intangible asset to be assumed to be zero unless the residual value can be determined by reference to an active market. In practice, this means that all non-homogeneous intangible assets (such as brand names, trademarks etc.) must be assumed to have residual value of zero.

Article 35.1(b) of the Fourth Directive requires that ‘the purchase cost 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.’ This differentiates between the ‘cost’ of the asset and the amount depreciated (described as ‘value’).

Development costs

IAS 38 requires development costs to be capitalised an intangible asset in certain limited circumstances and amortised over their estimated useful life, on which the IAS imposes a benchmark maximum life of 20 years. By contrast, Article 37 of the Fourth Directive requires such costs to be amortised over no more than five years, although Member States may derogate from this requirement in exceptional cases.

CONCLUSIONS

There are two potential conflicts between IAS 38 and the Fourth Directive, namely:

(a) IAS 38 allows intangible assets to be revalued to fair value; the Directive allows revaluation to cost adjusted for inflation; and

(b) the Directive imposes a maximum life of five years for development costs (albeit subject to derogation by Member States), which is not reflected in the IAS.

Nevertheless, because of the nature of these potential conflicts and the flexibility allowed by the standard, it is still possible for European companies to be in compliance with both IAS 38 and the Directives

IAS 39 – Financial Instruments: Recognition and Measurement

The Contact Committee has not examined IAS 39, but the Commission has put forward a proposal to amend the Fourth and Seventh Directives to allow fair value accounting and thus eliminate the conflicts between IAS 39 and these Directives.

IAS 40 – Investment Property[18]

INTRODUCTION

IAS 40, Investment Property, was issued on 3 May 2000. The standard is effective for annual financial statements covering periods beginning on or after 1 January 2001, although earlier application is encouraged.

The Contact Committee has examined IAS 40 in the context of the European Accounting Directives, and has listed in the following paragraphs the issues to be considered in deciding whether, and to what extent, to apply IAS 40 in EU jurisdictions.

IAS 40 prescribes the accounting treatment and related disclosure requirements for investment property, which is defined as property held to earn rentals or for capital appreciation or both, rather than for use in the production or supply of goods or services or for administrative purposes, or for sale in the ordinary course of business.

The standard requires that an investment property should initially be recognised at its cost. Thereafter, an enterprise has the free choice to select one of two accounting models, and to apply that model consistently to all of its investment property. The two models are:

(a) a fair value model: investment property should be measured at fair value and changes in fair value should be recognised in the profit and loss account; or

(b) a cost model: investment property should be measured under the benchmark treatment in IAS 16. An enterprise that chooses the cost model should disclose the fair value of its investment property.

IAS 40 states that a change from one model to the other should be made only if the change will result in a more appropriate presentation, and the standard states that this is highly unlikely to be the case for a change from the fair value model to the cost model.

SPECIFIC ISSUES

Unlike the Fourth Directive, IAS 40 makes no distinction between investment companies and other enterprises. Consequently, whilst IAS 40 allows all enterprises a free choice of accounting model on subsequent measurement of investment property, the choice is more limited in the case of EU companies subject to the Accounting Directives. This is because under Article 32 of the Fourth Directive the basic measurement principle is cost, and this is confirmed in Article 35 in its application to fixed assets. Nevertheless, Article 33 of the Fourth Directive allows Member States to permit or require in respect of all companies or any classes of companies the revaluation of tangible fixed assets. However, where this option is applied, Article 33 requires further that the difference between the cost and valuation amount must be transferred to a separate balance sheet reserve, known as the 'revaluation reserve'. The Article provides further that transfers to the profit and loss account from the revaluation reserve may be made only to the extent that the amounts transferred have been entered as charges in the profit and loss account or reflect increases in value that have been actually realised.

Consequently, in view of the provisions of Article 33, EU companies would be precluded from applying IAS 40's fair value model, which requires all value adjustments to be shown immediately in the profit and loss account, whether or not realised. Moreover, IAS 40's fair value model excludes the requirement to depreciate investment properties, which would be in conflict with Article 35.1 of the Fourth Directive.

However, in the case of investment companies, this conflict is avoided. This is because, under Article 60 of the Fourth Directive, 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.

CONCLUSIONS

IAS 40's fair value model conflicts with the basic principle of Article 33 of the Fourth Directive that increases in the value of fixed assets may be shown in the profit and loss account only to the extent that they are realised. This means that IAS 40's fair value option is not available to EU companies, other than investment companies. The Directive makes special provision for investment companies, which are permitted to measure their investments at market value, with changes in market value reflected in the profit and loss account.

However, it should be noted that IAS 40 gives enterprises the free choice in selecting the accounting model and therefore does not require the application of the fair value model. Consequently, EU

companies are still able to comply with both IAS 40 and the Fourth Directive by applying the cost model under paragraph 50 of IAS 40.

In other respects, IAS 40 is in conformity with, or at least not in conflict with, the Directives. Nevertheless, the Contact Committee requested the Commission to examine whether IAS 40's fair value model should be considered as part of the Commission's forthcoming programme of modernisation of the Accounting Directives.

IAS 41 is not examined in detail, because it is self-evident that IAS 41's fair value approach to the measurement of biological assets and the resultant recognition of unrealised gains in the profit and loss account is incompatible with both the requirement in Article 31.1(c)(aa) of the 4th Directive that only profits made at the balance sheet date may be included in the annual accounts, and the basic principle of Article 33 of the 4th Directive that increases in the value of fixed assets may be shown in the profit and loss account only to the extent that they are realised.