COMMISSION OF THE EUROPEAN COMMUNITIES

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2000/0043 (COD)

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Directives 78/660/EEC and 83/349/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. INTRODUCTION

The Fourth Council Directive of 25 July 1978[1] harmonises the content of annual accounts required by Member States of limited liability companies. The Seventh Council Directive of 13 June 1983[2] co-ordinates the content of consolidated accounts. The Fourth and Seventh Directives (referred to as the Accounting Directives) provide a frame of reference for, but do not govern directly, the accounts of those financial institutions that prepare their accounts under the provisions of Council Directive of 8 December 1986 on the annual and consolidated accounts of banks and other financial institutions (Bank Accounts Directive) and Council Directive of 19 December 1991 on the annual and consolidated accounts of insurance undertakings (Insurance Accounts Directive).[3]

In order to enhance comparability in financial reporting, the Fourth Directive sets out a legal framework for the presentation of the balance sheet, the profit and loss account and also disclosures required in the notes to the accounts (the 7th Directive sets out similar requirements for consolidated accounts). In addition to requirements on presentation, it prescribes methods for arriving at the value of items included in the balance sheet. Companies are required to value their assets at purchase price or production cost, commonly referred to as "historic cost". Member States may however allow or require companies to re-value certain assets, or to value certain assets at replacement cost. They may also permit or require other methods that take into account the effects of inflation on the items shown in the annual and consolidated accounts.

This proposal was foreseen in the Commission's Communication on Financial Services of October 1998[4], which reaffirmed the Commission's policy of maintaining consistency between the EU financial reporting framework and International Accounting Standards (IAS) as developed by the International Accounting Standards Committee (IASC). Further, the proposal is also included as an action point in the Communication of the Commission "Implementing the framework for financial markets: action plan".[5] This most recent Communication was welcomed by Ecofin in May 1999 and supported in the conclusions of the Cologne Council of 3/4 June 1999.

2. THE NEED FOR AN AMENDMENT TO THE ACCOUNTING DIRECTIVES

The accounting requirements set out in the Accounting Directives reflect the consensus views of users and preparers of accounts and accounting standard setters that were held at the time when the Directives were drawn up and adopted. Since then

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1 (78/660/EEC)
2 (83/349/EEC)
3 (86/635/EEC), (91/674/EEC)
4 Communication of the Commission "Financial Services : Building a framework for action" COM (1998) 625, 28.10.98.
5 Communication of the Commission "Financial Services : Implementing the framework for financial markets : Action Plan" COM (1999) 232, 11.05.99

there have been many developments in business practices, some of which have led to developments in both national and international accounting standards setting, but the Accounting Directives have by and large remained an appropriate framework for the accounts presented by EU companies.

However, the dynamic nature of international financial markets has now resulted in the widespread use of not only traditional primary financial instruments such as shares and bonds, but also various forms of derivative financial instruments such as futures, options, forward contracts and swaps. These relatively complex financial instruments are used mainly by the largest industrial companies across all sectors of the European economy as tools to manage financial risks that their businesses are exposed to from movements in variables such as interest rates, currency rates or equity or commodities prices. However, the use of these instruments for risk management purposes can itself bring significant associated risks for the companies that use them, and as a result some companies are now using financial instruments that can transform their financial position and risk profile overnight. The growth in the use of such financial instruments has outstripped the development of guidance for their accounting, including the guidance in the Directives. The present form and substance of the financial reporting on these instruments does not always reflect their impact and associated risks.

In response to the increasingly widespread use of these complex financial instruments the most influential accounting standards setters, including the IASC, have been working hard to adapt accounting standards in order to ensure that the financial impacts of these instruments are reflected in company financial statements appropriately and with full transparency. The proposed solutions have a common theme of moving away from the historical cost valuation model on which the Accounting Directives are based (historical cost being the price an asset or liability was acquired for) towards a method of valuing balance sheet items not currently permitted by the Directives, i.e. that of "valuation at fair value" or "fair value accounting", which most often refers to valuation according to what the item is worth in today's market rather than according to its original or replacement cost. The IASC has now introduced fair value accounting in a new standard on financial instruments, which requires certain financial assets and liabilities to be valued in the balance sheets of companies at fair value.[6] This will have a particularly significant impact in the case of derivative financial instruments, which often have no historic cost, but can have very material fair values.

Since the publication of the Commission's New Accounting Strategy,[7] the Commission's declared policy has been to keep the European Accounting Directives in line with IAS. This is in the interest of those typically large EU companies that wish to report using IAS because the international capital markets on which they raise capital demand that they report under internationally recognised accounting standards.

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[6] International Accounting Standard 39 – "Financial instruments : recognition and measurement". This standard becomes operative for financial statements covering financial years beginning on or after 1 January 2001. Earlier application is permitted as of the beginning of a financial year that ends after 15 March 1999 (the date of issuance of the standard).

[7] Communication from the Commission "Accounting Harmonisation : A New Strategy vis-à-vis International Harmonisation", COM 95 (508), November 1995.

Maintaining consistency of the Accounting Directives with IAS enables these companies to meet the capital market requirements and the requirements of the Accounting Directives using only one set of financial statements, which avoids inefficiencies and the potential for market confusion. Any further consolidation and integration of EU capital markets will only increase the pressure for EU companies participating in those markets to report under internationally recognised accounting standards. Market regulators, in particular the Forum of European Securities Commissions (FESCO) may take an increasing role in this area.

The support for this policy at Member State level is evidenced by the fact that, since the start of 1998, seven Member States have already amended national legislation or regulations to permit publicly traded companies to prepare their consolidated accounts in line with IAS instead of national legislation, as long as these accounts are in conformity with the Accounting Directives.

Without this proposed amendment, those companies that wish to use IAS whilst remaining in compliance with the Accounting Directives will face an obstacle in the valuation rules. In general terms, therefore, the purpose of this proposal is to modernise the Accounting Directives in line with business developments and associated developments in international accounting standard setting so that they remain in line with the capital market financial reporting requirements of internationally active European companies. It will therefore enable European companies to participate in the capital markets on equal terms with their non-European competitors.

This proposal is an action point in the Communication of the Commission "Implementing the framework for financial markets: action plan".[8] That Communication also contains some further action points on financial reporting. Those are likely to lead to a more general update of the Commission's New Accounting Strategy[9], going beyond the issue of fair value accounting but maintaining the view that financial reporting in the EU needs to be consistent with international developments.

3. THE IMPACT ON SMEs

The proposed amendment is not directed at SMEs because they are very largely not the companies who use these financial instruments and therefore they normally do not need to account for them. This was confirmed by the results of the Commission's Business Test Panel review, which showed that the proposal would affect 31% of all businesses surveyed. Of this 31%, 79% said that the proposal would not cause compliance costs. Of the 7% of all businesses who said they would incur compliance costs, the largest proportion are the large companies (over 250 employees). These findings correspond well with the intended purpose for the proposal which is aimed at allowing the internationally active publicly traded companies to comply with IAS

8 Communication of the Commission "Financial Services : Implementing the framework for financial markets: Action Plan" COM (1999) 232, 11.05.99.

9 Communication from the Commission on Accounting Harmonisation: A New Strategy vis-à-vis International Harmonisation, COM 95 (508), November 1995.

(including those that require fair value accounting) and still be in line with the Directives.

It is important to note that Member States can permit or require fair value accounting only for consolidated accounts, which in itself would rule out the option for most SMEs who by their very nature do not produce consolidated accounts. Although the proposal is not directed at SMEs and the Member States could choose to effectively exempt SMEs from the proposal by limiting its application to consolidated accounts, the proposal does allow the Member States to require the application of fair value accounting to SMEs if they judge it appropriate. A Member State could decide that a company which is entitled to exemptions under the thresholds fixed by the Directives, but that is also using complex financial instruments, should account for those instruments at fair value.

4. INSURANCE UNDERTAKINGS, BANKS AND OTHER FINANCIAL INSTITUTIONS

The financial statements of banks and other financial institutions as well as insurance undertakings are not directly governed by the Fourth and Seventh Directives. These institutions prepare their financial statements in accordance with Council Directive 86/635/EEC on the annual and consolidated accounts of banks and other financial institutions (Bank Accounts Directive) and Council Directive 91/674/EEC on the annual and consolidated accounts of insurance undertakings (Insurance Accounts Directive). This proposal does not affect the accounting requirements of those institutions that prepare their financial statements under the provisions of the Bank Accounts Directive and the Insurance Accounts Directive. After proper consultation with the relevant advisory committees for these institutions the Commission could bring forward at a later stage similar proposals for their accounting requirements in light of international and industry developments.

5. MAIN ISSUES CONSIDERED IN THE PREPARATION OF THIS PROPOSAL

This section gives a summary of the principal issues which the Commission considered in preparing this proposal. The issues were discussed at meetings of the Contact Committee on the Accounting Directives and at meetings of the Accounting Advisory Forum during 1997 and 1998.

Member State option or requirement

During the discussions in the Contact Committee, it became clear that all Member States believe that fair value accounting for certain financial instruments should be permitted under the Accounting Directives as soon as possible in order to keep up with international accounting developments. The Contact Committee recognised the urgent need to modernise the Directives in order to improve the financial reporting situation of European companies that compete in international markets and raise capital from international capital markets. Even those Member States that were less sure of its appropriateness in the short or medium term were of the view that fair value accounting will become increasingly important in the future.

In the light of these discussions, the Commission has taken the position that the proposal should take the form of a requirement for Member States to permit or require all or certain categories of companies to adopt fair value accounting. An alternative approach would be to propose a Member State option to permit or require all or certain categories of companies to adopt fair value accounting. However, that approach could lead to reduced comparability in the short term and for that reason the Commission has decided that the proposal should take the form of a requirement for Member States to permit or require the use of fair value accounting.

There was a strong consensus amongst the Member States that this proposal should contain sufficient flexibility not only to make it consistent with current developments in international accounting in the area of financial instruments, but to leave some room for further developments. Accounting for financial instruments is a fast evolving area of financial reporting and is under constant review and development by the world's accounting standard setters. For that reason, the proposal contains some freedom for Member States to interpret fair value accounting. It might have been possible to propose an amendment which introduced into the Directives one detailed system for fair value accounting. However, that one very detailed system could very quickly have become obsolete. The proposal is drafted in a way that will modernise the Accounting Directives as a *framework* which will enable European companies to report in line with current international developments, whilst also leaving some scope to enable them to follow further international developments. They will be able to report in line with the current IASC requirements without the very precise IASC requirements having been adopted into the Directives.

The discussion below on the scope of the amendment, notes that the proposal restricts the requirement to permit or require fair value accounting to those items where there is a sufficiently developed international consensus that fair value accounting is appropriate. It also specifies those balance sheet items that *cannot* be valued at fair value under this proposal, including most liability items. In addition, the proposal requires that where valuation of financial instruments at fair value is applied, all derivative financial instruments will have to be valued in the balance sheet at fair value. Some derivative instruments that have until now not been included in the balance sheet will come onto the balance sheet for the first time. Even where valuation of financial instruments at fair value is not applied, fair value disclosures will need to be made in respect of derivative instruments.

During the discussion in the Contact Committee, several Member States suggested that the use of fair value accounting should be permitted only in the consolidated accounts so that the annual accounts would continue to be based solely on historical cost. However, the majority of Member States opposed a solution that distinguishes between the accounting treatment in the annual accounts and consolidated accounts. Therefore the proposal requires Member States to permit or require all or certain categories of companies to adopt fair value accounting in both the annual and consolidated accounts, but Member States that wish to restrict the use of fair values to the consolidated accounts can do so.

As accounting for financial instruments is a fast evolving area of financial reporting the proposal contains a clause which provides for a review of how the proposal has worked in practice within three years of the proposal coming into effect, in the light of further developments in international accounting. This review will be carried out through the Contact Committee on the Accounting Directives in order to give Member States the opportunity to report on their experiences of how this proposal has worked in practice.

Scope of the proposal

Whilst the Contact Committee wished to see modernisation of the Accounting Directives, there was consensus that this proposal should not allow blanket application of fair value accounting to all financial instruments – which would replace historical cost as the basis of accounting valuation in the Accounting Directives. There is an international consensus that this method of valuation is appropriate – but only insofar as it relates to certain financial assets and liabilities. For example, there is as yet no international agreement on whether or not a company should be required to fair value its own debt or whether or not such fair value should take account of the company's own credit risk. The Commission considers that it would be premature for the Accounting Directives to make provision for something on which there is no international agreement. Consequently, this modernisation of the Accounting Directives is not intended to replace historical cost as the basis of the Accounting Directives. Fair value will therefore not be permitted for all balance sheet items. The method of valuation of items which are not financial instruments, such as fixed assets (for example land and buildings or plant and equipment) will be unchanged. Similarly, certain financial instruments, such as long-term debt, will continue to be stated at historical cost.

Having reached a consensus that this proposal should not allow blanket application of fair value accounting to all financial instruments, the Commission was faced with the challenge of deciding which financial instruments could be valued at fair value. The Commission considered including in the proposal detailed definitions of what financial instruments could and could not be valued at fair value. However, during the discussions with the Member States it became clear that there are two main difficulties with such an approach – first the difficulty of inserting definitions of accounting terms into the Accounting Directives, and secondly the difficulty of defining the instruments in a fast-changing environment.

The Accounting Directives have never followed a "definitions approach". They do not include definitions for assets, liabilities, equity, and many other items. Introducing detailed definitions of financial instruments is difficult because it would be based on concepts that are not defined in the Accounting Directives. Therefore, the proposal does not include generic definitions for a range of accounting terms used, such as "fair value", "financial instruments", "trading portfolio", "held-to-maturity items", "reliable markets" or "hedge accounting". This is entirely consistent with the principles that have underpinned the Directives since their adoption. As framework rules, they have not contained generic definitions of accounting terms which are well defined elsewhere in accounting standards and the accounting literature.

Any definitions of financial instruments that were included would become outdated very quickly in the light of the constantly growing variations of complex derivative financial instruments. The term 'derivative' is a generic one that covers a very wide range of financial instruments that 'derive' their value from an underlying price (such as the price of a commodity) or rate (such as an interest rate). Derivative instruments are constructed according to three basic structures: futures and forwards, swaps and options, and combinations of these structures. These structures can be applied to an almost limitless range of underlying assets whose value depends on changes in underlying rates or prices. Derivative instrument transactions occur both through financial exchanges and directly between counter-parties via over-the-counter transactions (OTC). OTC instruments tend to be individually tailored contracts designed to meet the specific risk management needs of the user and, for that reason, are often unique. The vast majority of derivative transactions are OTC (data from the Bank for International Settlements shows that approximately 85% of derivatives contracts are OTC and not traded on exchanges). Consequently, specifying a list of individual financial instruments that would qualify for valuation at fair value could not be achieved in any meaningful or practical way.

After having taken advice from experts in the financial services industry, after consultation with the Member States in the Contact Committee on the Accounting Directives and after extensive consultation with the business community, the Commission concluded that it is not feasible in practice to compile a list of financial instruments which can be valued at fair value, and as a consequence the proposal specifies the balance sheet items that *cannot* be valued at fair value under this proposal.

Where a company adopts fair value accounting, then all derivative financial instruments will have to be valued in the balance sheet at fair value. This means that some derivatives that have until now not been included in the balance sheet will come onto the balance sheet for the first time. This is in line with one of the main thrusts behind the international move towards fair value accounting – the encouragement of transparency in financial reporting by recognising, measuring and disclosing the nature of the risks associated with the use of complex financial instruments, which are themselves mostly used for risk management purposes.

Income recognition and distribution

The introduction of the possibility or requirement to adopt valuation at fair value of certain financial assets and liabilities raises issues to do with how to account for the changes in the fair values of items. Questions arise particularly concerning the effect of including “unrealised” gains in the profit and loss account. How does this affect the distribution of profits? Under the historical cost basis of valuation there is a significant degree of certainty about the “realisation” of profits when they are included in the profit and loss for the financial year because a purchase or sale transaction will have taken place. Under the fair value model, the value of an asset or liability may have changed and some gains may be included in the profit and loss account even though they may not have been “realised” in the sense that a transaction may well not have taken place. From a prudence or capital maintenance point of view it may not be seen as prudent for these gains to be available for distribution to shareholders.

In practice, the financial instruments most directly affected by this proposal will be financial assets and liabilities that are held for trading purposes, such as contractual obligations and securities that are bought and sold frequently for the purpose of generating a profit from short-term fluctuations in prices (both instruments that are traded on exchanges and OTC instruments). As these instruments are bought and sold frequently over the short term, the gains and losses are “realised” and there is more general acceptance that the changes in fair value should be accounted for through the profit and loss account in the same way as other trading transactions. These issues led to the inclusion in the proposal of a Member States option to restrict the use of fair values to items that are held for trading purposes and to exclude from fair value any items that are not held for trading purposes, including "held-to-maturity" items which are planned to be held for the longer term, usually for a pre-determined period.

Member States can choose to permit or require adoption of valuation at fair value of certain financial assets and liabilities which are held for trading purposes but also for non-trading purposes. They can permit or require that the changes in the fair values of non-trading instruments should be accounted for, not through the profit and loss account but through a fair value reserve in the equity section of the balance sheet. This deals with the concern that gains that may not have been realised should not be available for distribution to shareholders. The proposal allows Member States to determine the preferred accounting method upon the subsequent realisation of unrealised gains which had been included in equity.

Permitting or requiring changes in fair values to be recognised either in the profit and loss account or directly into equity is in line with similar mechanisms which already exist for other cases. Article 39(3) of the Bank Accounts Directive (86/635/EEC) allows Member States to require or permit differences produced by currency translation to be included in reserves not available for distribution, and Article 33 of the Fourth Directive allows revaluation with respect to certain items in the balance sheet, but requires at the same time that a revaluation reserve must be set up.

Hedge accounting

Hedging is a system of risk management where "hedging" instruments are used to "hedge" against possible value fluctuations in other underlying "hedged" instruments such as for example instruments whose value is dependent upon an interest or currency rate. The net effect of the changes in values of the hedging and the hedged instruments should be neutral over the life of the instruments and the changes in their values are generally accounted for together rather than separately. This is known as "hedge accounting". Although hedge accounting is not specifically dealt with in the Accounting Directives, its application is not in violation of their general principles. Several different approaches towards hedge accounting exist at the moment, and thinking on the subject is still developing. This is clearly evidenced by recent debates in the IASC. In light of this it would be unwise for the amendment of the Fourth Directive either to stifle any progress being made in this field or to prevent companies from using IAS. Consequently, the proposal permits changes in the value of hedging instruments to be recognised in equity rather than in the profit and loss account and does not lay down detailed rules for hedge accounting.

Disclosure

From discussions in the Contact Committee on the Accounting Directives it became clear that Member States would prefer a broad description of the required disclosures, rather than a plethora of new disclosures which would better be set down by accounting standards setters. Therefore, the proposal includes broad disclosure requirements. This allows Member States to prescribe more detailed disclosures if they wish to do so, and makes it possible for companies to continue innovation in the disclosure of financial instruments and fair values in accordance with the requirements of the capital markets and other users. The proposal requires that the annual report should give an indication of the company's risk management objectives and strategies in relation to its use of financial instruments, where fair value accounting is applied.

6. OUTLINE OF THE PROPOSED AMENDMENTS TO THE 4TH DIRECTIVE

A new section on "Valuation at fair value" is inserted into the Directive. The section contains Articles 42a, 42b and 42c. For consistency it is necessary to also update the requirements for disclosure in the notes to the accounts and in the annual report. This is done in Articles 43a, 43b, 43c and 46a.

Article 42a (new)

The purpose of Article 42a is to introduce a requirement for Member States to permit or require all or some classes of companies to value at fair value all financial instruments, including derivative financial instruments, except for some items which are listed in the Article. The proposal does not permit the valuation at fair value of long-term debt, or items that are not financial instruments such as land and buildings. Fair value is commonly understood as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable and willing parties in an arm's length transaction. In practice, there is often an active market in the instruments and the fair value will be the market value.

Article 42a allows Member States to limit the scope of application of the amendment, for instance by making it applicable to consolidated accounts only. Similarly, Member States may restrict its application to financial instruments that are held for trading purposes. Member States can also exclude from valuation at fair value those loans and advances originated by the reporting company itself, and commodity-based contracts originally designated for the purpose of meeting a company's expected purchase, sale or usage requirements in that commodity and which are expected to be settled by delivery of the commodity.

Where a Member State permits or requires that a company values financial instruments at fair value (even if only for trading instruments), all derivative financial instruments must be valued in the balance sheet at fair value. One consequence of this is that some derivatives that have until now not been included in the balance sheet will come onto the balance sheet for the first time, and the gains and losses of these items will be *accounted* for under Articles 42a, 42b and 42c.

Article 42b (new)

The purpose of Article 42b is to set out how fair value will be determined where valuation at fair value under Article 42a is applied. Fair value should be determined by reference to a market price, or by reference to generally accepted valuation models and techniques, where a market value is not readily identifiable (for example through option price models or discounted cash flows). If it is not possible to determine a reliable fair value using these methods, then the conclusion to be drawn is that valuation at fair value should not be applied and valuation should be in accordance with those rules that already exist in the Directive.

Article 42c (new)

The purpose of Article 42c is to set out how any resulting change in the fair value of an item is to be accounted for, where valuation at fair value under Article 42a is applied.

The change in the fair value of an item should normally be recognised in the profit and loss account for the financial year. However, Member States have the option of requiring that changes in the fair value of financial assets and liabilities that are not held for trading purposes should be recognised directly in equity, in a fair value reserve. Changes in the fair value of financial assets and liabilities that are not held for trading purposes that have been recognised directly in the fair value reserve must be removed from the fair value reserve upon realisation. Member States may lay down rules governing the use of those changes that had been recognised in equity, including rules governing the distribution to shareholders.

Article 42c also sets out how any resulting changes in the fair value should be accounted for under systems of hedge accounting. Changes in the fair value of items accounted for as hedging instruments can be recognised in the profit and loss account or can be included in a fair value reserve where they are accounted for under a system of hedge accounting that allows such changes in the value of hedging instruments not to be shown in the profit and loss account. Where such gains and losses have been included in a fair value reserve and the amounts in the reserve are no longer necessary, which will generally be the case where the instruments have come to maturity, or have been sold or exercised, or where the hedging relationship no longer exists, those cumulative gains and losses which have been recognised in equity must be removed from the fair value reserve. Member States may lay down rules governing the use of those changes that had been recognised in equity, including rules governing the distribution to shareholders.

Article 43a (new)

The purpose of Article 43a is to update the existing disclosure requirements for the notes to the accounts where valuation at fair value under Article 42a is applied. The notes to the accounts should state which items have been valued at fair value, what the fair values of these items are, how the fair values have been determined and what the impact is on the profit and loss account and the balance sheet, including the movements in any fair value reserve. The notes to the accounts should also include specific disclosure regarding derivative financial instruments.

Article 43b (new)

In cases where a company is permitted to use valuation at fair value in accordance with Article 42a (1), but decides not to do so, it will be necessary to *disclose* information about each class of derivative financial instruments which a company uses, including their fair value (*disclosing* the information means that it will be included in the notes to the accounts rather than *accounted* for, which would mean that it would be included on the face of the balance sheet and the profit and loss account).

Article 43c (new)

Article 35(1)(c)(aa) of the Directive already provides a company option to make value adjustments in respect of financial fixed assets which could result in those financial fixed assets being valued at a value lower than their historic cost. Where valuation at fair value is applied under Article 42a, then the option under Article 35(1)(c)(aa) will be automatically utilised. Where valuation at fair value is not applied under Article 42a, the accounting treatment under Article 35 (1)(c)(aa) remains available as an option. The company can therefore choose not to make value adjustments in respect of financial fixed assets.

The purpose of Article 43c is to introduce disclosure requirements for financial fixed assets where valuation at fair value is not applied and where the company chooses not to make value adjustments in respect of financial fixed assets under Article 35(1)(c)(aa). In that case, financial fixed assets may be carried at an amount in excess of their fair value. Article 43c therefore requires disclosure in the notes to the accounts of the fair value of these assets and the reasoning for not valuing these assets at fair value, including the nature of the evidence that provides the basis for the belief that the book value will be recovered.

Article 46a (new)

The use of complex financial instruments as risk management tools, particularly derivative instruments, can in some cases create new types of risk. This Article therefore requires that the annual report gives an indication of the company's risk management objectives and strategies in relation to its use of financial instruments.

Article 52a (new)

The purpose of Article 52a is to give the European Parliament and the Council an opportunity to review how this proposal has worked in practice within three years of its introduction, taking account of ongoing international developments. This review would be based on a report from the Commission.

7. OUTLINE OF THE PROPOSED AMENDMENTS TO THE 7TH DIRECTIVE

The proposed amendments to the 7th Directive flow *directly* from the proposed amendments to the 4thDirective because of the link between the Directives. They are merely consequential and do not contain any substantive changes. The introduction of Articles 42a, 42b, and 42c in the 4th Directive will feed through to the 7th Directive because of the cross references between the two Directives. Certain minor modifications of the 7th Directive are required to achieve full consistency.

Article 34a (new)

The purpose of Article 34a is to include in the notes to the consolidated accounts the corresponding disclosures that are required under Article 43a of the 4th Directive, where valuation at fair value under Article 42a of the 4th Directive is applied in the consolidated accounts.

Article 34b (new)

The purpose of Article 34b is to include in the notes to the consolidated accounts the corresponding disclosures concerning derivative financial instruments that are required under Article 43b of the 4th Directive.

Article 34c (new)

The purpose of Article 34c is to include in the notes to the consolidated accounts the corresponding disclosure requirements concerning financial fixed assets that are required under Article 43c of the 4th Directive, where valuation at fair value under Article 42a of the 4th Directive is not applied in the consolidated accounts. Where the option to make value adjustments in respect of financial fixed assets under Article 35(1)(c)(aa) of the 4th Directive is not applied in the consolidated accounts, and where consequently financial fixed assets may be carried in the consolidated accounts at an amount in excess of their fair value, it will be necessary to disclose the fair value of these financial fixed assets and the reasoning for not valuing these assets at fair value, including the nature of the evidence that provides the basis for the belief that the book value will be recovered.

Article 36a (new)

The purpose of Article 36a is to include in the consolidated annual report the disclosures relating to risk management objectives and strategies in relation to the use of financial instruments that are required under Article 46a of the 4th Directive.

Article 48 (new)

The purpose of Article 48 is to give the European Parliament and the Council an opportunity to review how this proposal has worked in practice within three years of its introduction, taking account of ongoing international developments. This review would be based on a report from the Commission.

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(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 44,

Having regard to the proposal from the Commission[10],

Having regard to the opinion of the Economic and Social Committee[11],

Acting in accordance with the procedure laid down in Article 251 of the Treaty[12],

Whereas:

(1) Article 32 of the Directive 78/660/EEC based on Article 54(3)(g) (now 44(2)(g))[13] of the Treaty requires the items shown in the annual accounts to be valued on the basis of the principle of purchase price or production cost.

(2) Article 33 of Directive 78/660/EEC authorises Member States to permit or require companies to re-value certain assets, to value certain assets at replacement cost or to apply other methods that take into account the effects of inflation on the items shown in the annual accounts.

(3) Article 29 of Directive 83/349/EEC based on Article 54(3)(g) (now 44(2)(g))[14] of the Treaty requires assets and liabilities to be included in consolidated accounts to be valued in accordance with Articles 31 to 42 and 60 of Directive 78/660/EEC.

(4) The annual and consolidated accounts of banks and other financial institutions are prepared in accordance to Council Directive 86/635/EEC, and the annual and consolidated accounts of insurance undertakings are prepared in accordance with Council Directive 91/674/EEC. The amendments in this Directive do not amend the provisions of Directives 86/635/EEC and 91/674/EEC, but the Commission may bring

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10 OJ C …, …, p. …

11 OJ C …, …, p. …

12 OJ C …, …, p. …

13 OJ No L 222, 14. 8. 1978, p11. Directive as last amended by Directive 1999/60/EC (OJ No L 162, 26. 6. 1999, p. 65).

14 OJ No L 193, 18. 7. 1983, p 1. Directive as last amended by Directive 90/605/EC (OJ No L 317, 16. 11. 1990, p. 60).

forward similar proposals to amend these Directives after having consulted the relevant advisory committees.

(5) The dynamic nature of international financial markets has resulted in the widespread use of not only traditional primary financial instruments such as shares and bonds, but also various forms of derivative financial instruments as futures, options, forward contracts and swaps.

(6) Leading accounting standard setters in the world are moving away from the historical cost model for the valuation of these financial instruments towards a model of fair value accounting.

(7) The Communication of the Commission on "Accounting Harmonisation: A New Strategy vis à vis International Harmonisation[15], called for the EU to work to maintain consistency between Directives 78/660/EEC and 83/349/EEC and developments in international accounting standard setting.

(8) In order to maintain consistency between internationally recognised accounting standards and Directives 78/660/EEC and Directive 83/349/EEC, it is necessary to amend these Directives in order to allow for certain financial assets and liabilities to be valued at fair value. This will enable European companies to report in line with current international developments.

(9) Comparability of financial information throughout the Community makes it necessary to require Member States to introduce a system of fair value accounting. Member States may permit or require the adoption of that system to all or certain categories of companies and to both the annual and consolidated accounts or to consolidated accounts only.

(10) Fair value accounting should only be possible for those items where there is a sufficiently developed international consensus that fair value accounting is appropriate. Fair value accounting should therefore not be applied to all financial assets and liabilities.

(11) The notes on the accounts should include certain information concerning the items in the balance sheet which have been measured at fair value. The annual report should give an indication of the company's risk management objectives and strategies in relation to its use of financial instruments.

(12) Accounting for financial instruments is a fast evolving area of financial reporting which necessitates a periodic review. This review should be carried out through the Contact Committee on the Accounting Directives in order to give Member States the opportunity to report on their experiences with fair value accounting in practice.

HAVE ADOPTED THIS DIRECTIVE:

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[15] COM(95) 508.

Article 1

Directive 78/660/EEC is hereby amended as follows:

1) The following Section 7a is inserted:

"SECTION 7a

Valuation at fair value

Article 42a

1. By way of derogation from Article 32, Member States shall permit or require in respect of all companies or any classes of companies, valuation at fair value of all balance sheet items, including derivative financial instruments, except for the items listed in paragraph 3.

2. Member States may restrict the permission or requirement set out in paragraph 1 to consolidated accounts as defined in Directive 83/349/EEC.

3. The following items shall not be valued at fair value:

   (a) balance sheet items that are not financial instruments;

   (b) liabilities, with the exception of liabilities which are:

      (i) held as part of a trading portfolio;

      (ii) accounted for as hedged items; or

      (iii) derivative financial instruments.

4. Notwithstanding paragraph 1, Member States may:

   (a) exclude items held-to-maturity, other than derivative financial instruments, from valuation at fair value;

   (b) exclude originated loans and advances not held for trading purposes from valuation at fair value;

   (c) restrict the valuation at fair value to items held for trading purposes. Where this restriction is applied, all derivative financial instruments are deemed to be held for trading purposes;

   (d) exclude commodity-based contracts that were originally designated for the purposes of meeting a company's expected purchase, sale or usage requirements in that commodity and which are expected to be settled by delivery of the commodity.

Article 42b

1. The fair value referred to in Article 42a is determined by reference to:

   (a) a market value, for those items for which a reliable market can readily be identified. Where a market value is not readily identifiable for an item but can be identified for its components, the market value of that item may be derived from that of its components; or

   (b) the value resulting from established valuation models and techniques, for those items for which a reliable market cannot be readily identified. Such valuation models and techniques should ensure a reasonable approximation of the market value.

2. Those items that cannot be measured reliably in a way that is free from material error and bias by the methods as described under either (a) or (b) of paragraph 1, may not be measured at fair value and should instead be measured in accordance with Articles 34 to 42.

Article 42c

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

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

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

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

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

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

2) The following Articles 43a, 43b and 43c are inserted:

"Article 43a

Where valuation at fair value has been applied under Article 42a, the notes on the accounts must indicate at least the following information:

(a) the items in the balance sheet that have been measured at fair value;

(b) where fair values have been determined in accordance with Article 42b(1)(b), the significant assumptions underlying the valuation models and techniques;

(c) per category of items measured at fair value, the fair value, and the profits or losses recognised directly in the profit and loss account and in the fair value reserve referred to in Article 42c(3);

(d) for the fair value reserve referred to in Article 42c(2) and Article 42c(3) a table showing separately:

(i) the amount of the reserve at the beginning of the financial year;

(ii) the differences included in the reserve during the financial year;

(iii) the amounts transferred from the reserve during the financial year and the nature of any such transfers;

(iv) the amount of the reserve at the end of the financial year;

(e) for each class of derivative financial instruments, information about the extent and nature of the derivative financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows

Article 43b

When a company is permitted to use valuation at fair value in accordance with Article 42a (1), but decides not to do so, the following disclosures should be given for each class of derivative financial instruments:

(a) information about the extent and nature of the derivative financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows;

(b) the fair value of the derivative financial instruments.

Article 43c

Where valuation at fair value has not been applied under Article 42a(1), and where a company has not made use of the option to make a value adjustment in respect of a financial fixed asset in accordance with Article 35(1)(c)(aa) and therefore carries that financial fixed asset at an amount in excess of its fair value, it should disclose:

(a) the book value and the fair value of either the individual assets or appropriate groupings of those individual assets; and

(b) the reasons for not reducing the book value, including the nature of the evidence that provides the basis for the belief that the book value will be recovered.”

3) The following Article 46a is inserted:

“Article 46a

Whether or not use has been made of valuation at fair value referred to in Section 7a, the annual report shall give an indication of :

(a) the company's financial risk management objectives and strategies in relation to its use of financial instruments, and how these objectives are implemented; and

(b) the company's exposure to price risk, credit risk, liquidity risk, counter-party risk, cash flow risk and risk of future developments in relation to its use of financial instruments .”

4) The following Article 52a is inserted:

“Article 52a

The Parliament and the Council shall, acting in accordance with the procedure laid down in Article 251 of the Treaty, acting on a proposal from the Commission and within three years of the adoption of this Directive, examine and, where necessary, amend Articles 42a, 42b, 42c, 43a, 43b, 43c and 46a of Directive 78/660/EEC in the light of the experience acquired in applying these Articles and taking account of international developments in the field of accounting.”

Article 2

Directive 83/349/EEC is hereby amended as follows:

1) The following Articles 34a, 34b and 34c are inserted:

“Article 34a

Where valuation at fair value has been applied in accordance with Article 42a(1) of Directive 78/660/EEC, the notes on the consolidated accounts must indicate at least the following information:

(a) the items in the consolidated balance sheet that have been measured at fair value;

(b) where fair values have been determined in accordance with Article 42b(1)(b) of Directive 78/660/EEC, the significant assumptions underlying the valuation models and techniques;

(c) per category of items measured at fair value, the fair value, and the profits or losses recognised directly in the consolidated profit and loss account and in the fair value reserve referred to in Article 42c(3) of Directive 78/660/EEC;

(d) for the fair value reserve referred to in Article 42c(2) and Article 42c(3) of Directive 78/660/EEC a table showing separately:

   (i) the amount of the reserve at the beginning of the financial year;

   (ii) the differences included in the reserve during the financial year;

   (iii) the amounts transferred from the reserve during the financial year and the nature of any such transfers;

   (iv) the amount of the reserve at the end of the financial year;

(e) for each class of derivative financial instruments, information about the extent and nature of the derivative financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows.

Article 34b

When a company is permitted to use valuation at fair value in accordance with Article 42a(1) of Directive 78/660/EEC, but decides not to do so, the following disclosures should be given for each class of derivative financial instruments:

(a) information about the extent and nature of the derivative financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows;

(b) the fair value of the derivative financial instruments.

Article 34c

Where an undertaking included in the consolidation has not applied valuation at fair value under Article 42a(1) of Directive 78/660/EEC and has not made a value adjustment in respect of a financial fixed asset in accordance with Article 35(1)(c)(aa) of Directive 78/660/EEC, and therefore carries that financial fixed asset at an amount in excess of its fair value the notes on the consolidated accounts must disclose:

(a) the book value and the fair value of either the individual assets or appropriate groupings of those individual assets; and

(b) the reasons for not reducing the book value, including the nature of the evidence that provides the basis for the belief that the book value will be recovered."

2) The following Article 36a is inserted:

"Article 36a

Whether or not use has been made of valuation at fair value referred to in Section 7a of Directive 78/660/EEC, the consolidated annual report shall give an indication of :

(a) the undertaking's financial risk management objectives, and how these objectives are met through its use of financial instruments; and

(b) information on the undertaking's exposure to price risk, credit risk, liquidity risk, counter-party risk, cash flow risk and risk of future developments in relation to its use of financial instruments."

3) The following Article 48 is inserted:

"Article 48

The Parliament and the Council shall, acting in accordance with the procedure laid down in Article 251 of the Treaty on a proposal from the Commission and within three years of the adoption of this Directive, examine and, where necessary, amend Articles 34a, 34b, 34c and 36a of Directive 83/349/EEC in the light of the experience acquired in applying these Articles and taking account of international developments in the field of accounting."

Article 3

1. Member States shall bring into force the laws, regulations and administrative provisions necessary for them to comply with this Directive before……. They shall forthwith inform the Commission thereof.

   When Member States adopt these provisions, they shall contain a reference to this Directive or shall be accompanied by such reference on the occasion of their official publication. The methods for making such reference shall be laid down by Member States.

2 Member States shall communicate to the Commission the main provisions of domestic law which they adopt in the field governed by this Directive.

Article 4

This Directive shall enter into force on the twentieth day following its publication in the *Official Journal of the European Communities.*

Article 5

This Directive is addressed to the Member States.

Done at Brussels,

For the European Parliament	*For the Council*
The President	*The President*