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EXAMINATION OF THE CONFORMITY BETWEEN INTERNATIONAL ACCOUNTING STANDARDS APPLICABLE TO ACCOUNTING PERIODS BEGINNING BEFORE 1 JULY 1999 AND THE EUROPEAN ACCOUNTING DIRECTIVES

1. Introduction

In order to facilitate the application of International Accounting Standards by European companies for the 1999 financial reporting term, the Contact Committee has examined the conformity between all applicable International Accounting Standards and the European Accounting Directives. This examination covers all International Accounting Standards and interpretations of the Standing Interpretations Committee (together referred to as “IAS” in this document) in issue and applicable to accounting periods beginning before 1 July 1999.

Consequently, this examination does not include the requirements of the following new and revised standards: IAS 36 “Impairment of Assets” (effective 1 July 1999), IAS 37 “Provisions, Contingent Liabilities and Contingent Assets” (effective 1 July 1999), IAS 38 “Intangible Assets” (effective 1 July 1999), IAS 10 “Events after the Balance Sheet Date (Revised 1999)” (effective 1 January 2000) and IAS 39 “Financial Instruments: Recognition and Measurement” (effective 1 January 2001), as well as the amendments to IASs 16, 22, 28 and 31 which were consequential to the adoption of IASs 37 and 38. Analyses of these new and revised standards are available from the European Commission¹. European companies wishing to adopt early any of these new or revised standards on a voluntary basis should refer to these analyses in order to take note of any conflicts with the Accounting Directives that have been identified.

The interpretations of the Standing Interpretations Committee in issue and applicable to accounting periods beginning before 1 July 1999 are as follows: SIC-1 to SIC-3, SIC-5 to SIC-11, SIC-13 and SIC-15. SIC-4 was never issued in final form and is no longer on the SIC’s agenda. SIC-12, SIC-14 and SIC-16 all have an implementation date of 1 July

¹ For analyses of these new and revised standards see the European Commission’s website at http://europa.eu.int/comm/internal_market/en/company/index.htm.

1999, SIC–17 has an implementation date of 30 January 2000 and SIC–18 has an implementation date of 1 July 2000. Analyses of these SIC Interpretations are available from the European Commission.² European companies wishing to adopt early any of these SIC Interpretations on a voluntary basis should refer to these analyses in order to take note of any conflicts with the Accounting Directives that have been identified.

2. Objective and scope of the examination

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 EU accounting legislation, and the Committee therefore is not in a position to express any opinion relating to the relationship between IAS and any other rules (most notably, other national legislation or national accounting standards) which are not based on the Accounting Directives themselves.

The objective of this examination is to determine whether and, if so, to what extent conflicts between IAS applicable to accounting periods beginning before 1 July 1999 and the Accounting Directives exist so that European companies wishing and able to apply IAS in their consolidated accounts can do so without conflicting with European legislation.

3. The application of IAS options

As stated above, this document deals with the issues faced by those European companies that wish to prepare their consolidated accounts in accordance with IAS and, at the same time, are required to comply with European accounting legislation. In such cases, since the Accounting Directives have overriding effect, this examination assumes that any company wishing to comply with both frameworks:

- will select the appropriate accounting treatment which conforms with the Accounting Directives in cases where IAS lays down both a “Benchmark Treatment” and an “Allowed Alternative Treatment”;
- is ready to accept all additional requirements imposed by IAS that do not conflict with the Accounting Directives;
- will select the appropriate accounting treatment that conforms with IAS in cases where the Accounting Directives allow either companies or Member States the option of choosing between two accounting treatments; and

² For analyses of these SIC Interpretations see European Commission’s website at http://europa.eu.int/comm/internal_market/en/company/index.htm

- will apply the presentational requirements of IAS in such a way so as to be in conformity with the balance sheet and profit and loss account layouts prescribed respectively by Articles 9/10 and Articles 23 to 26 of the Fourth Directive.

4. Conclusions

The Contact Committee has concluded that there do exist one minor conflict and certain potential conflicts between those International Accounting Standards and interpretations of the Standing Interpretations Committee (SIC) that are in issue and applicable to accounting periods beginning before 1 July 1999. These are discussed below. IASs and SICs that the Commission has concluded are compatible with the European Accounting Directives are not listed in this document. However, this examination assumes that companies when applying these standards and/or interpretations follow the guidance set out in the analysis of each particular standard and/or interpretation (see, for example, examination on IAS 12)³:

4.1 IAS 27: Consolidated Financial Statements and Accounting for Investments in Subsidiaries: exclusion of an undertaking from consolidated accounts

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.⁴

4.2 IAS 19: Employee benefits

³ For a full analysis of the conformity between IAS and the Accounting Directives see the European Commission's website at http://europa.eu.int/comm/internal_market/en/company/index.htm.

⁴ 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 been specifically examined by the Contact Committee.

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.(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 37.⁵

⁵ This issue is discussed further in the context of IAS 37 – see “Examination of the conformity between IAS 35, IAS 36, IAS 37, IAS 38 IAS 22 (revised 1998), IAS 16 (revised 1998), IAS 28 (revised 1998), IAS 31 (revised 1998) and the European Accounting Directives”, Directorate-General XV, Internal Market and Financial Services, XV/6010/99, Brussels, 1999.

4.3 IAS 32: Financial Instruments: Disclosure and Presentation

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.

4.3.1 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’.

4.3.2 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.

4.4 IAS 35: Discontinuing operations

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.

4.5 SIC-5: Classification of Financial Instruments – Contingent Settlement Provisions

SIC-5 presents a potential conflict with the Accounting Directives that has already been highlighted in the Contact Committee's examination of the conformity between IAS 32 (Revised 1998) and the Directives (see 4.3 above). The requirement in SIC-5 to treat certain financial instruments that are legally equity but, according to the criteria in IAS 32, in substance liabilities, as liabilities, 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 would result in 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.

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However, a possible solution to this conflict might be to show such shares, that are required to be classified as a liability under SIC-5, separately under an additional caption within the major heading 'Capital and Reserves'.