MEMO/04/246

Brussels, 28th October 2004

European Commission proposal for amending the Accounting Directives - Frequently Asked Questions

(see also IP/04/1318)

Collective responsibility of board members

Why is the Commission proposing to make board members collectively responsible for the financial statements of the company?

Under the national law of all EU Member States, the prevailing principle is collective responsibility of board members thereby strengthening the collective role of the entire board and enhancing self discipline within a board. Individual board members should not be responsible because this could allow some board members to "free ride" and not take responsibility. Collective responsibility also enhances scrutiny at the top.

The consultation carried out in spring 2004 showed support for confirming in EU law boards' collective responsibility towards their companies. This step was envisaged in the Commission's Action Plan on Modernising Company Law and Enhancing Corporate Governance in the EU, published in May 2003 (see IP/03/716 and MEMO/03/112) and would set a minimum standard across the EU.

However, the Commission's proposal is a first step. For the time being, the Commission proposes to confirm what already exists in Member States and that the Member States must ensure that their national law provides for appropriate liability rules and sanctions. The Commission will follow any further national initiatives with interest and will review the situation in due course.

How does this compare with the situation in the US?

Under the Sarbanes-Oxley-Act, Chief Executive officers (CEOs) and Chief Financial Officers (CFOs) in US-listed companies are individually responsible to the company, its shareholders and third parties for the company's financial statements. This approach cannot be used in Europe where the prevailing principle for drawing up financial statements is collective responsibility of board members. In a European context, the US-approach would mean that board members would have weaker incentives to exercise proper control over CEOs or CFOs.

Why is the Commission only proposing to make board members responsible towards the company?

Across the EU the prevailing principle in national systems is that board members are directly responsible towards the company. In other words shareholders cannot directly sue board members, for example for gross negligence in drawing up financial statements. Shareholders would have to sue first the company and then the company would have to sue the board members. Enshrining this in EU law would set a minimum level of responsibility across the EU.

Making board members directly responsible to shareholders across the EU would not be appropriate given different national traditions: for example in many Member States, shareholders already have the opportunity to approve annual financial statements in shareholder meetings.

Disclosure of off-balance sheet arrangements

What kind of off-balance sheet arrangements will fall under the new disclosure requirements proposed by the Commission?

In essence the Commission's proposal follows the "true-and-fair-view" principle, in other words that financial statements must present a true and fair view of the financial position of a company. No specific definition of such arrangements is given in the proposed amendments to the Directives, because sticking to a principles-based approach makes it difficult to circumvent transparency rules. However, the Commission considers that investors, shareholders and users of financial statements should be informed about a company's material interests in unconsolidated entities, such as special purpose entities (SPEs) or offshore entities. SPEs may be used efficiently, for example to spread risk, to raise finance or for similar objectives. But when a company decides to use SPEs or other arrangement to spread risks or raise financing and keep this off the balance sheet, shareholders and other users of financial statements should be informed about this.

Who will be affected by the new requirements?

Listed EU companies applying IAS would have to comply with these additional disclosure requirements, to the extent that they go beyond what is currently required under international accounting standards.

What is the problem with the current Accounting Directives, as far as off balance sheet arrangements are concerned?

The general disclosure requirements in the Accounting Directives for off-balance sheet commitments are too broad. Disclosure can be improved by adding a requirement for material off-balance sheet arrangements to be disclosed in the notes to the accounts.

Will the Commission ban companies from using special purpose Entities (SPEs) and offshore centres?

No, the Commission does not propose to ban SPEs or to prevent the use of offshore centres since they often serve legitimate business purposes: SPEs may be used efficiently, for example to spread risk or to raise finance. But the Commission is proposing that companies should provide much more information about all significant arrangements that are not included in the balance sheet. Otherwise, the users of financial statements might be misled about the true financial position of a company, as was the case for Parmalat or Enron.

The present Accounting Directives capture SPEs if they qualify as a subsidiary because the financial statements must include information concerning subsidiaries and the subsidiary itself will have to be consolidated. The Accounting Directives also capture cases where a participating interest has been recognised. However, SPEs can be organised to circumvent this.

How does the proposal on off-balance sheet arrangements fit with US law?

This proposal is coherent with what the US Securities and Exchange Commission (SEC) has introduced. Following Enron, all US-listed companies must provide information about the nature, business purpose and amount of their material off-balance sheet arrangements in their Management, Discussion & Analysis-report (similar to the annual report prepared by EU-companies) if the information is material for the understanding of the financial position of a company.

Transactions with related parties

Why is the Commission proposing more transparency in related party transactions for non-listed companies?

Transactions between a company and its key management or the spouse of a board member often do not occur under market-led conditions and may have a negative impact on a company's financial position. Put simply, transactions with so-called related parties can affect investors' confidence in companies' accounts.

There is satisfactory transparency regarding such transactions for all listed European companies under IAS 24
(see http://europa.eu.int/eur-lex/en/archive/2003/l_26120031013en.html) which has already been endorsed under Regulation (EC) 1606/2002. However, the Commission's Action Plan on Modernising Company Law and Enhancing Corporate Governance in the EU, proposed that greater transparency should be required from unlisted companies and that idea was widely supported in the consultation carried out in spring 2004. At present, the Accounting Directives require only that companies disclose information about transactions with affiliated undertakings, which are only one type of related party. This does not cover a whole range of other parties, such as management, family members etc.

Disclosure should be limited to what is material, in other words to those elements which are significant for an assessment of the financial situation of a company by a user of financial statements. The consultation showed only limited support for requiring disclosure of all material transactions, as is the case under IAS for listed companies. Applying the same logic of IAS to all unlisted companies would mean a substantial regulatory burden for them and would risk leading to disclosure of a disproportionate amount of information of limited interest.

Therefore, it is preferable to limit the disclosure to those transactions which have been concluded with the involvement of parties who may potentially have a conflict of interest, in other words transactions not performed at “arm’s length”, i.e. not under normal market conditions.

Who is a related party?

Since the Commission is committed to global accounting standards, it prefers to align the Accounting Directives with the existing definitions under IAS 24, which were generally recognised as satisfactory during the public consultation. This could be achieved by referring in the amended Accounting Directives to the definition in the relevant International Accounting Standard, which has already been endorsed by the Commission under the IAS Regulation.

What about small non-listed companies?

Under the proposal, Member States could exempt from the requirements small non-listed companies, defined as those with fewer than 50 employees, a balance sheet total of less than €3.65 million and a turnover of less than €7.50 million. Already the present Accounting Directives give an option to Member States to allow such small companies not to disclose transactions with affiliated undertakings - which is one type of related party. Therefore, the Commission considered that the same logic should apply in the case of an extension of the transparency rules to other kinds of related parties.

Corporate governance statement

What is the Commission proposing in respect of the Corporate Governance Statement?

It is proposing that listed companies should include in their annual report a coherent and descriptive statement covering the key elements of their corporate governance structure and practices

The Action Plan proposed that such a corporate governance statement should contain information on a range of aspects. The Take Over Bids Directive now already requires, in the annual report, disclosure of shareholders’ major holdings, and of their voting and control rights as well as of key agreements and the other direct and indirect relationships between these major shareholders and the company.

The Commission proposes here to complement the disclosure requirements under the Take Over Bids Directive, by adding the following elements that the corporate governance statement would have to include:

- A specific reference to the national corporate governance code the company applies, including “comply-or-explain” information: in other words if the company deviates in any way from the code, it must justify this to investors;
- Information about the risk management system and internal controls, explaining what kind of system exists and how it operates;
- Information about the operation of the shareholders’ meeting which is consistent with other parts of the Company Law Action Plan, in particular the future Directive on cross-border voting; and
- Details of the composition and operation of the board and its committees.

Companies would have to present the information about their corporate governance practices in a separate section of their annual report.

Does this not amount to a European Corporate Governance Code?

No. The Commission's proposal merely follows what is outlined in the Action Plan for Company Law and Corporate Governance, which means requiring listed companies to explain their corporate governance practices in comparison with the relevant national codes. Companies whose securities are not admitted to trading on a regulated market are not affected. The Commission has made quite clear its belief that the more national corporate governance codes converge towards best practice, the easier it will be to restore confidence in capital markets in the wake of the scandals that have shaken trust in some European companies. That is why it recently set up the European Corporate Governance Forum (see IP/04/1241). But that convergence can best be achieved by building on national traditions, not by attempting a "one size fits all" solution.