OBJECTIVES OF AND ACHIEVEMENTS IN HARMONIZING THE LAWS ON ANNUAL FINANCIAL STATEMENTS WITHIN THE EUROPEAN ECONOMIC COMMUNITY

by Drs. G. J. Kramer

The Treaty of Rome states in rule 54.3.g that in respect of incorporated companies the guarantees required for safeguarding the interests of participants in and third parties dealing with such companies shall be coordinated.

That rule underlies a number of draft directives aimed at such coordination, the first of which directives is operative since 1968. The subsequent ones, however, have not yet been enacted by the Council of Ministers, partly pending Great Britain's joining the E.E.C., partly due to there being major objections against their unamended enactment. In respect of annual accounts, some draft directives have been published or are in the course of preparation. The draft of the 4th Directive deals with annual accounts proper and with publication rules for private companies. For public companies the first Directive regulates the publication.

Currently (May 1975) a preliminary Draft Directive regulating consolidation of annual accounts (Directive No. 6) is in the course of preparation within the sphere of the Directorate of the European Commission, the Governmental experts and the Groupe d'Etudes des Experts Comptables de la C.E.E.

A preliminary draft for Directive 7, related with the former and dealing with the definition of „a group", is in still an earlier phase. The 5th Draft Directive deals, *inter alia,* with the obligations of the managements of companies in respect of the preparation and presentation of annual accounts, and with the position of the public accountant who audits the accounts.

In a preliminary draft of a directive, with a view to warranting equivalence of auditor's opinions, an attempt has been made to phrase the requirements to be met in the various countries by the persons entitled to making statutory audits.

Thus, so far (May 1975), actual results as to the harmonization of annual accounts have not yet been achieved. None of the drafted directives has yet been approved by the Council of Ministers, let alone any of them having been incorporated into the legislation of the 9 Member States.

The 4th Draft Directive (revised edition, published February, 1974) which aims at coordinating structure and contents of annual accounts, accompanying annual reports, bases of valuation and disclosure requirements, has reached such a preparatory stage that it seems appropriate to analyse whether tendencies can be derived therefrom regarding the lines along which the harmonization will proceed.

According to the „Statement of Grounds" the views underlying the solutions selected by the European Committee can be summarized as follows:

- From nation to nation the requirements as to structure and contents of annual accounts vary considerably as regards both their quantity and their

quality.

- The terminologies used and uncertainties as to their meaning may give rise to reluctance in establishing business relations with enterprises.
- Information prepared in other countries cannot be compared with ratios prevailing at home; thus, readers are not in a position to analyse annual accounts prepared in other countries of the Community.

These findings may appear to be an obstacle for accomplishing and developing a common market.

It should be realized that coordination as required by the Treaty does not call for uniformly prepared annual accounts, but for equivalence of annual accounts insofar as the procurement of an insight into size and composition of net equity and results is involved.

When drafting the Directive aimed at giving directives for the national legislators, the Commission might have submitted modest general requirements conducive to arriving at an acceptable level of the quantity and the quality of the information to be provided in the various Member States. However, the Commission has not restricted itself to general requirements because such requirements would not have solved the problems indicated in the Statement of Grounds.

For solving those problems it is a prerequisite that there be greater conformity as to the presentation of the data and an identity of the concepts used in the various countries.

Be that as it may, the Commission has not striven for a detailed harmonization, which, ultimately, would have resulted in uniform regulations. It is not clear and it will not be considered here whether this stems from treaty-technical reasons (article 54 or article 100), or from the wish to leave room for further national developments.

As a consequence of the position taken by the Commission the rules submitted in the Directive fluctuate between the two poles liberty and uniformity.

Below it will be analysed to what extent this is the case and to what extent the aim of the Treaty laid down in its rule 54.3.g can be achieved by the proposals of the Committee.

The structure of the Directive is as follows:

Section 1. General rules
Section 2. Arrangement of the annual accounts
Section 3. Arrangement of the balance sheet
Section 4. Further rules concerning certain b/s items
Section 5. Arrangement of the profit & loss account
Section 6. Further rules concerning certain p & 1 items
Section 7. Valuation rules
Section 8. Contents of the notes
Section 9. Contents of the annual report

The remaining sections 10, 11 and 12 refer not to the annual accounts proper but to publication rules, special rules for the audit of and publication by private companies, and final provisions, respectively.

The rules given in the aforementioned sections can be distinguished into

three categories, to wit: imperative, optional for enterprises, and optional for the Member States.

Section 1 holds general imperative rules:

Article 2.1. Component parts of the annual accounts: balance sheet, profit & loss account, notes to the accounts.

Article 2.2. The annual accounts shall give a true and fair view of the assets and liabilities, financial position, and results of the company.

Article 2.3. They shall be clearly presented and conform with the provisions of this directive.

Unsolved remains the question of whether or not article 2.2. states an overriding principle. If developments result in a true and fair view requiring another presentation than the one prescribed in the Directive is then or is not article 2.2. decisive? This problem has induced the Groupe d'Etudes des Experts Comptables de la C.E.E. to submit a memorandum to the Council of Ministers, requesting the Council to provide a solution for adjusting the Directive to the dynamics of economic life.

Section 2 states in article 3 that the arrangement of annual accounts shall not be changed arbitrarily. In exceptional cases, however, enterprises may break this rule.

Although article 4 states imperatively that all items listed therein shall, in the prescribed form, be included in the annual accounts, it also entitles enterprises, if so required by their special nature, to adjust that form and to combine items if either they are of secundary significance, or, thus, are more clearly presented in the annual accounts. If items have been combined, they are to be analysed in the notes. Article 6 stipulates that neither assets and liabilities nor profits and losses shall be set off against each other.

Section 3, rules that assets shall be listed in order of increasing liquidity and liabilities in order of increasing maturity, and prescribes the arrangement of the balance sheet. Enterprises may opt for either the traditional account form or the vertical form.

In article 11, this section requires disclosure of guarantees and of the related securities.

Section 4 holds peremptory rules meant to prevent that enterprises, by an interpretation of their own, attribute different meanings to the same terms. The section includes, *inter alia,* rules about

- the criterion governing the grouping under fixed or current assets, respectively (fixed assets being those with a lasting use); movements in the amounts listed for fixed and some current assets must be elucidated in the notes (article 12);
- definition of the item land and buildings (article 13);
- definition of participations (article 14);
- definition of transitory items, e.g. prepaid expenses, returns received in advance, etc. (articles 15 and 18, respectively);
- definition of value adjustments, depreciation (article 16);
- definition of provisions (article 17).

By being peremptory, the wording of the definition tends towards exclusion of items of a similar nature, but not covered by one of the defini-

tions. Besides, the „Statement of Grounds" states that the definitions are meant to be exact in order to prevent secret or hidden reserves.

Section 5 offers, at the option of the enterprises, four arrangements of the profit & loss account, to wit two in traditional account form and two in vertical form. In each of the forms the presentation may be either sales less cost of sales, resulting in return on sales, or sales plus or minus the differences between opening and closing stocks of finished products and goods in process of production, less all costs incurred during the period under report.

Like section 4 in respect of the balance sheet, so section 6 gives peremptory rules in respect of the profit & loss account:

- Article 25 defines net sales (VAT shall be deducted from sales).
- Article 26 defines extraordinary income and charges.
- Article 27 requires that the tax amount due for the year and the amount of the future tax liability be stated separately in the profit & loss account. The Groupe d'Etudes makes a stand against this mixing of balance sheet and profit & loss account; it sticks to its wish that the total amount of taxes relating to the result for the period be disclosed.

Whereas sections 3 to 6 inclusive deal with formal rules as to form of presentation and uniformity of concepts and, in doing so, provide a basis for judging financial position and result displayed according to a uniform pattern (albeith with variations), section 7 is more drastic in that it affects the actual size of net equity and result.

To this aim article 28 primarily prescribes some general starting-points for the valuation, viz.:

a. the going-concern concept,
b. the concept of consistency,
c. the concept of prudence, and
d. the matching, or accruals concept.

Deviation from these starting-points is permissible in exceptional cases only, provided that the reason for the deviation as well as its effect on assets, liabilities, financial position and results be disclosed.

The Directive starts from the premiss that all items of the annual accounts are valued on the basis of historical cost (articles 32 to 39 inclusive).

Articles 30 and 31 grant the Member States deviations from the aforementioned premiss. According to article 30 the Member States may permit the use of replacement value or other methods recognizing current values in respect of some balance sheet items (plant, machinery, participations, stocks). Article 31 entitles the Member States to permit non-systematical revaluations (meant to be an escape for Member States that refuse application of article 30 but are willing to permit incidental revaluation). The Groupe d'Etudes has pressingly urged that the companies be granted the competence referred to in article 30.

Article 32 rules that formation expenses be amortized in no more than 5 years, provided that the national legislation authorizes inclusion of such expenses under assets. Here, again, a national proviso and no harmonization.

Article 33 rules that fixed assets be valued on the basis of cost. Direct and a reasonable part of indirect manufacturing costs are to be included in the

cost of fixed assets produced by the company itself. Interest on borrowed means may be included in cost. This article governs the depreciation of fixed assets („Value adjustments"); it holds peremptory rules for special value adjustments if it is anticipated that the decrease in value is of a permanent nature. Additional fiscal depreciations and consequential deferred tax liabilities shall be separately stated in the annual accounts.

Like article 32, article 34 requires that capitalized costs of research and development be amortized in no more than 5 years if the national legislation authorizes inclusion of this item under assets. The same amortization rule applies to the cost of goodwill bought from third parties.

Article 35 permits valuation at a fixed amount of some kinds of assets such as tools, that are available in rather stable and small quantities.

In a manner analogous to the ruling given in article 33, article 36 governs the valuation of current assets. It specifically states that Member States may grant a valuation below cost of goods subject to strong fluctuations in prices, if and when a drop in prices after the balance sheet date may be expected. The write-down shall be disclosed in the annual accounts.

Instead of valuation of stocks at cost, article 37 also permits similar goods to be valued on the basis of weighted average prices or by the Fifo-method or Lifo-method or some similar method. A material deviation between the latter outcome and valuation reached on the basis of actual cost as well as the consequential deferred taxes shall be disclosed in the annual accounts.

Article 38 permits capitalization of the difference between a borrowed amount and the corresponding higher redemption. Amortization of such difference must precede repayment.

Finally, article 39 prohibits provisions exceeding what is required by „sound commercial judgement".

Section 8, in article 41, lists eleven peremptory rules concerning the information about financial data that may have significance for the users of the annual accounts, e.g. about participations, guarantees given, analyses of sales and of income according to product groups and markets, composition of the staff, remuneration of managing and supervisory directors.

Finally, section 9 holds (limited) rules concerning the directors' reports as included in the annual report.

Conclusion

From the foregoing (Sections 2 to 6 inclusive) it appears that there are still many options. This provides a basis for the conclusion that, depending on the views and wishes of the persons preparing annual accounts for shareholders, the presentation given by such accounts may vary appreciably even though similar bases of valuation have been applied. On the other hand, however, it may be concluded that application of the same bases of valuation - even despite differing presentations - together with the uniformity of the concepts and the giving of similar information, provide a basis for similar conclusions about the enterprise concerned.

Thus, one may conclude that, in its revised the draft of the 4th Directive,

the Commission, in this respect, has satisfactorily achieved its object.

The same does not apply to the quality of the information to be supplied. In this respect section 7 clearly reflects the phase in which the European Economic Community finds itself. The current version of this section reflects a thinking in terms of historic cost; the development to current cost is reserved for the individual states. In this field freedom for the enterprises has not yet been created. The resulting disturbance increases as a result of inflation. Among accountants in Europe there is as yet no agreement as to the manner in which current values should be reflected in annual accounts. The present version of this section cannot be definite, although it certainly is a step forward as compared with the situation that prevailed some years ago, when amongst colleagues it was held that this section had to be deleted in order to allow full freedom to the companies.

If the Council of Ministers is willing to open the way for continuous adaption to developments, the better form will materialize eventually.