NON-PAPER OF COMMISSION SERVICES DG FISMA

MEETING OF THE ACCOUNTING REGULATORY COMMITTEE (ARC)

BRUSSELS, 17 SEPTEMBER, 2015

AGENDA ITEM V

This non-paper has been drafted for the sole purpose of continuing the discussions within the ARC on the meaning of the true and fair view criterion and its relevance to the endorsement process.

This non-paper does not bind the Commission services to continue the analysis or to initiate any other type of action on this matter.

True and fair principle

Following the evaluation of the Regulation 1606/2002 on the application of international accounting standards (hereafter the IAS Regulation), the Commission services have drafted this paper on the meaning of true and fair principle and its relevance to the endorsement process for discussion by ARC Members. This paper does not bind the Commission services to continue the analysis or to initiate any other type of action on this matter.

Legal framework

The IAS Regulation states that in order to contribute to a better functioning of the internal market, publicly traded companies must be required to apply a single set of high quality international accounting standards for the preparation of their consolidated financial statements.

The IAS Regulation finds that the reporting requirements set out in Directives 78/660/EEC and 83/349/EEC[1] (hereafter the Fourth and Seventh Accounting Directives) cannot ensure the

[1] The IAS Regulation refers to the Fourth and the Seventh Accounting Directives. However these Directives have been abolished by the adoption of the new accounting Directive. The 2013/34/EU Accounting Directive restates the same general principle of the old Accounting Directives and still does not defines the true and fair principle.

high level of transparency and comparability of financial reporting which is a necessary condition for building an integrated, effective and efficient capital market. It is therefore necessary to supplement the legal framework.

So the ultimate objective of IAS Regulation is the adoption and use of international accounting standards in the EU with a view to harmonising the financial information presented by the companies in order to ensure a high degree of transparency and comparability of financial statements and hence an efficient functioning of the Union capital market and of the Internal Market.

Article 3 of the Regulation provides **two conditions** to be met in order to adopt the international accounting standards, namely:

- they are not contrary to the true and fair view principle and are conducive to the European public good and,
- they meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

The European legislation does not provide a distinct definition of the principle of true and fair, but the Court of Justice has reviewed the principle in its case-law over the years (although not in cases concerning the application of IFRS).

In particular, the Court refers to the true and fair as "fundamental principle"[2] and the "primary objective"[3] of the Accounting Directives.

In case C-306/99, the Court states that the principle of true and fair view requires, *firstly*, that the annual accounts of companies should reflect the activities and transactions which they are supposed to describe and, *secondly*, that the accounting information should be given in the form judged to be the soundest and most appropriate for satisfying third parties' needs for information, without harming the interests of the company.

The Court further clarifies that the Fourth Accounting Directive sets out certain general principles (e.g. Articles 2, 31 and 42 of the Fourth Accounting Directive, now Article 6 of the 2013/34/EU Accounting Directive (hereafter the new Accounting Directive–See Annex to this note) which must guide the drawing up of the annual accounts of companies in all Member States. Those principles, where the principle of recognition and measurement on a prudent basis is of particular importance[4], necessarily have to be applied through the adoption of

[2] Case C-306/99, Banque internationale pour l'Afrique occidentale SA (BIAO) and Finanzamt für Großunternehmen in Hamburg of 7 January 2003.

[3]Case C-234/94, Waltraud Tomberger and Gebruder von der Wettern GmbH, of 27 June 1996.

[4] One of the IAS Regulation criteria for adopting international accounting standards is that they should not be contrary to the 'true and fair view' principle as set out in the Accounting Directive. Therefore, in the light of ECJ case-law, the conclusion could be drawn that the need to respect prudence is implicitly required by the IAS Regulation. However, the principle of prudence does not prevent the use of fair value, as the Accounting Directive (Article 8) requires Member States at least to permit companies to measure financial instruments at fair value in their consolidated financial statements. (See Commission Staff working document SWD(2015) 120 final "Evaluation of Regulation (EC) N° 1606/2002 of 19 July 2002 on the application of International Accounting Standards", accompanying the document "Report from the Commission to the

national rules which, provided that the requirements of the Fourth Accounting Directive are complied with, may vary according to the accounting practices of the Member States concerned.

So it is reasonable to conclude that the true and fair view principle is the overarching principle, the primary objective of the Accounting Directives and the application of this principle must, as far as possible, be guided by the general principles contained in the Accounting Directives, where the principle of recognition and measurement on a prudent basis is of particular importance. Only taking into account all these general principles, as far as possible, can ensure observance of the requirement of a true and fair view.

Finally the supremacy of the principle in question is also reasserted by the European legislator, by way of retaining the provisions of Article 4 paragraphs (3) and (4) of the new Accounting Directive, according to which

- where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, additional information as is necessary shall be given in the notes to the financial statements and
- in exceptional cases where the application of a provision of this Directive is incompatible with the 'true and fair view' principle, that provision must be departed from in order to give the true and fair view of the assets and liabilities.

Practical application

In general, the practical application of this true and fair view criterion in the endorsement procedure acknowledges that meeting the technical criteria listed in the IAS Regulation, in the light of the general principles of the new Accounting Directive (Art.6), including prudence, also leads to observance of the requirement of a true and fair principle.

European Parliament and the Council Evaluation of Regulation (EC) N° 1606/2002 of 19 July 2002 on the application of International Accounting Standards at page 48)

Annex – General Principles of the Accounting Directive

Article 6 of the 2013/34/EU Accounting Directive

General financial reporting principles

1. Items presented in the annual and consolidated financial statements shall be recognised and measured in accordance with the following general principles:

(a) the undertaking shall be presumed to be carrying on its business as a going concern;

(b) accounting policies and measurement bases shall be applied consistently from one financial year to the next;

(c) recognition and measurement shall be on a prudent basis, and in particular:

> (i) only profits made at the balance sheet date may be recognised,
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> (ii) all liabilities arising in the course of the financial year concerned or in the course of a previous financial year shall be recognised, even if such liabilities become apparent only between the balance sheet date and the date on which the balance sheet is drawn up, and
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> (iii) all negative value adjustments shall be recognised, whether the result of the financial year is a profit or a loss;

(d) amounts recognised in the balance sheet and profit and loss account shall be computed on the accrual basis;

(e) the opening balance sheet for each financial year shall correspond to the closing balance sheet for the preceding financial year;

(f) the components of asset and liability items shall be valued separately;

(g) any set-off between asset and liability items, or between income and expenditure items, shall be prohibited;

(h) items in the profit and loss account and balance sheet shall be accounted for and presented having regard to the substance of the transaction or arrangement concerned;

(i) items recognised in the financial statements shall be measured in accordance with the principle of purchase price or production cost; and

(j) the requirements set out in this Directive regarding recognition, measurement, presentation, disclosure and consolidation need not be complied with when the effect of complying with them is immaterial.

2. Notwithstanding point (g) of paragraph 1, Member States may in specific cases permit or require undertakings to perform a set-off between asset and liability items, or between income and expenditure items, provided that the amounts which are set off are specified as gross amounts in the notes to the financial statements.

3. Member States may exempt undertakings from the requirements of point (h) of paragraph 1.

4. Member States may limit the scope of point (j) of paragraph 1 to presentation and disclosures.

5. In addition to those amounts recognised in accordance with point (c)(ii) of paragraph 1, Member States may permit or require the recognition of all foreseeable liabilities and potential losses arising in the course of the financial year concerned or in the course of a previous financial year, even if such liabilities or losses become apparent only between the balance sheet date and the date on which the balance sheet is drawn up.