

CORPORATE SECTOR ACCOUNTING AND AUDITING IN THE ACQUIS COMMUNAUTAIRE

A BUILDING BLOCK OF THE INTERNAL MARKET
2ND EDITION



THE WORLD BANK
CENTRE FOR
FINANCIAL REPORTING REFORM



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PREFACE

The World Bank's Centre for Financial Reporting Reform (CFRR) is pleased to present this second edition of the Guide to Corporate Sector Accounting and Auditing in the Acquis Communautaire. The Guide seeks to facilitate understanding of the *acquis communautaire* and also to emphasize the importance of reliable accounting and auditing in achieving sustainable economic growth. The first edition of this Guide (issued in 2007) was prepared by a World Bank team comprising Frederic Gielen, Erik van der Plaats, Ana Cristina Hirata Barros and Jennie Tranter, under the supervision of John Hegarty and with inputs from a number of officials from the European Commission and other relevant European institutions.

Henri Olivier, Secretary General of the *Fédération Européenne des Experts-Comptables (FEE)*, reviewed this second issue of the Guide and assisted the staff of the CFRR in updating it.

Despite the extent and quality of the external assistance received in preparing the Guide, the CFRR is solely responsible for its contents.



ABOUT THE CFRR

The Centre for Financial Reporting Reform (CFRR) located in Vienna, Austria, is responsible for the World Bank's corporate sector financial reporting activities in Europe and Central Asia (ECA). The Centre provides knowledge services and assistance in developing the capacity for effective corporate financial reporting. Services offered by the CFRR include analytical and advisory services, learning and skill development, know-how and knowledge transfer, and technical assistance and institutional strengthening. The CFRR manages two regional programs that aim to raise the quality of corporate financial reporting in Europe: The Road to Europe: Program of Accounting Reform and Institutional Strengthening (REPARIS) and the Financial Reporting Technical Assistance Program (FRTAP). REPARIS is a regional program funded by the Austrian government (through the Ministry of Finance and the Austrian Development Agency), and the governments of Luxemburg and Switzerland that aims to help create a transparent policy environment and effective institutional framework for corporate reporting aligned with the *acquis communautaire* in South-Central and South-East Europe. Participating countries/entities include Albania, Bosnia and Herzegovina, Croatia, Kosovo, Former Yugoslav Republic of Macedonia, Moldova, Montenegro, and Serbia. FRTAP, which is funded by the government of Switzerland through its "enlargement contribution", supports new EU member states in implementing sustainable regulatory and institutional frameworks and in furthering the correct implementation of the *acquis communautaire* in the area of financial reporting. Currently, the Czech Republic, Latvia, Poland and Slovenia are participants in FRTAP.

DISCLAIMER

This Guide is intended to provide a general overview of the relevant sections of the *acquis communautaire* on financial reporting and auditing and does not attempt to give anything more than an introduction to the issues. It is not meant to be an exhaustive rendition of the law, nor is it legal advice to those reading it. The findings, interpretations, and conclusions expressed in this guide are entirely those of the authors. They do not necessarily represent the views of the World Bank, its Executive Directors, or the countries they represent.

INTRODUCTION

We are pleased to introduce the second edition of this Guide, which is designed to ensure that a comprehensive overview of the relevant provisions of the *acquis communautaire* is available to policymakers, regulators, and other stakeholders in countries with a “European vocation” (EU Member States, those negotiating accession or hoping to do so, those covered by the European Neighborhood Policy) or those simply wishing to take the EU regulatory model into account when devising their own national approaches.

This Guide outlines and summarizes the European Union (EU) legislative framework governing corporate sector accounting and auditing. It is primarily intended for an audience with little prior knowledge of the EU. Consequently, rather than delving directly into the issues of accounting and auditing, the Guide begins by giving a brief history and overview of the EU, its institutions and legislative processes (Section I). Subsequently, in Section II, the Guide focuses on the development of the Internal Market, particularly in the areas of financial market integration and company law harmonization. Readers who are familiar with these matters may wish to go straight to Section III. Section III addresses the harmonization of accounting and auditing in the EU. These topics have grown in importance over time with the increasing efforts to complete the Internal Market, particularly regarding company law harmonization. Finally, Section IV of this Guide looks at the most pressing accounting and auditing issues for the EU. These issues are currently a central focus for EU policymakers and will remain so for the foreseeable future.

This document will also be published on the internet and it is planned that the web version will be periodically updated to reflect changes in the *acquis communautaire*.

Henri Fortin

Head, World Bank Centre for Financial Reporting Reform

Vienna

August 2011

OVERVIEW OF THE EUROPEAN UNION

1. A number of treaties provide the fundamental basis of the European Union (EU). The EU's origins can be traced to the Treaty establishing the European Coal and Steel Community (ECSC), also referred to as the Treaty of Paris, which came into force in 1952.¹ The ECSC's original objective was to "lead to the realization of the first concrete foundation of a European federation indispensable to the preservation of peace" following the two World Wars.² In addition to this underlying motive, the ECSC rested primarily upon the ideas of economic growth, free market competition, and the improvement of living standards. The initial success achieved by the ECSC led to a succession of treaties, which gradually created the institutional bodies and the body of EU laws known collectively as the *acquis communautaire* (see paragraph 12). Each successive treaty (or treaty revision) and change to the *acquis communautaire* has aimed at bringing the Member States closer together economically, socially, and politically in order to promote the region's stability and economic growth.

2. This section begins with an overview of the main treaties establishing the EU. It then looks at the current state of EU membership and its various policies towards its neighbor countries, particularly as regards accession. This section then examines the *acquis communautaire* and the legislative means by which it is developed, as well as its application in practice. Finally, it reviews the institutions established by the treaties and the policy-making process through which these institutions interact.

A. THE MAIN TREATIES³

3. Following the Treaty of Paris, the Treaty of Rome (commonly referred to as the "EC Treaty") entered into force on 1 January 1958, creating the European Economic Community (EEC). The EC Treaty laid down the framework for bringing about a common market and developing a number of common policies. It contained from the outset a legal basis for company law harmonization. At that time, the role of the European Parliament in the law-making process was only advisory (through the so-called "consultation procedure"; see paragraph 26).

¹ For more detail on the ECSC, see http://europa.eu/legislation_summaries/institutional_affairs/treaties/treaties_ecsc_en.htm.

² French Minister of Foreign Affairs Robert Schuman's speech on May 9, 1950.

For full text, see http://europa.eu/abc/symbols/9-may/decl_en.htm.

³ See http://europa.eu/abc/treaties/index_en.htm

4. However, once these initial moves towards greater community integration had been completed, the integration process lost momentum by the early 1980s. Amidst mounting political criticism, the EEC's political leaders decided to move forward by passing the Single European Act (SEA). The SEA, which entered into force on 1 July 1987, adapted the Treaty of Rome in order to hasten the completion of the Internal Market by 31 December 1992. It introduced a new legal basis for harmonization of laws in order to establish the Internal Market, and a new legislative procedure (the "cooperation procedure," see paragraph 27).

5. The Treaty on European Union, also referred to as the Maastricht Treaty, entered into force on 1 November 1993, and built on the integration successes of the SEA. It changed the name of the European Economic Community to "the European Community" and introduced detailed provisions for the creation of an economic and monetary union. It also introduced a new legislative procedure (the "codecision procedure," see paragraph 28) as well as the principle of subsidiarity (see paragraph 16).

6. The Treaty of Amsterdam, which entered into force on 1 May 1999, amended and renumbered the previous Treaties. It strengthened the role of the European Parliament and extended the scope of the co-decision procedure's application.

7. In anticipation of the addition of ten new Member States, the Treaty of Nice entered into force on 1 February 2003. The treaty reformed institutions to enable the EU to function efficiently after its enlargement to 25 Member States.

8. The Treaty establishing a Constitution for Europe was signed in Rome on 29 October 2004. The intention of this document was to replace the existing treaties with a single text and bring about a large number of institutional changes aimed at increasing the efficiency and democratic legitimacy of EU decision-making. Negative referenda in France and the Netherlands meant that the treaty failed to be ratified by all Member States.

9. Subsequently on 13 December 2007, EU leaders signed the Treaty of Lisbon, which was designed to bring an end to years of negotiation on institutional issues and "to complete the process started by the Treaty of Amsterdam and by the Treaty of Nice with a view to enhancing the efficiency and democratic legitimacy of the EU and to improving the coherence of its action." It includes an important overhaul of the Maastricht Treaty and the Treaty of Rome including a proposal that the EU will take on a single legal personality, strengthening the role of the European Parliament and extending the codecision making process.⁴ After some political turbulence, the Treaty of Lisbon was ratified by all 27 Member States and entered into force on 1 December 2009. A coordinated version of the Treaty on the functioning of the European Union (TFEU) was published in the Official Journal of the European Union on 9 May 2008.

⁴ Egenhofer, C. Kurpas, S. van Schaik, L. (2009), "The Ever-Changing Union. An Introduction to the History, Institutions and decision making Processes of the European Union." Centre for European Policy Studies, Special Report, January 2009

B. MEMBER STATES, ACCESSION AND THE EUROPEAN NEIGHBORHOOD POLICY

10. The EU currently comprises 27 Member States. In 1958, the Treaty of Rome created a common market and customs union, and provided for the free movement of capital and labor among the six signatories: Belgium, France, Germany, Italy, Luxembourg and the Netherlands. Additional Member States were added to the EU through five enlargements (see Annex: Timeline).

11. Croatia and Turkey are candidate countries and started accession negotiations in October 2005. Croatia completed its accession negotiations on 30 June 2011 and is expected to become the EU's 28th Member State in July 2013. In December 2005, the European Council granted the former Yugoslav Republic of Macedonia the status of a candidate country. In December 2010 Montenegro and Iceland were also granted the same status. Serbia formally submitted its application in December 2009. All the other Western Balkan economies are potential candidates: Albania, Bosnia and Herzegovina and Kosovo. The EU has repeatedly reaffirmed at the highest level its commitment to eventual EU membership of the Western Balkan countries, provided they fulfill the accession criteria. There are several associative frameworks that extend EU relationships throughout its geographic region. Norway, Iceland and Liechtenstein are members of the "European Economic Area" (EEA) and therefore have access to the EU single market; however, they are not allowed to participate in the EU decision-making process. Following a referendum in 1992, Switzerland rejected EEA membership; however it enjoys privileged relations with the EU Internal Market through a number of bilateral agreements. In addition, the EU has Association and/or Partnership and Cooperation Agreements⁵ with many other countries, including through the Stabilisation and Association Process (SAP)⁶ and European Neighborhood Policy (ENP).⁷ These relationships imply varying degrees of harmonization with the *acquis communautaire*. Whereas the Stability and Association Processes explicitly include provisions for future membership, the EU is not offering ENP countries/entities the possibility of membership, at least for the time being. As is evident from the large number of associative relationships, the sphere of influence of the EU's institutions and of the *acquis communautaire* extend far beyond the borders of current EU Member States.

C. THE ACQUIS COMMUNAUTAIRE

12. The entire body of EU laws is known collectively as the *acquis communautaire* (the "acquis"). The term is most often used in connection with preparations by candidate

⁵ These agreements are signed bilaterally and each agreement sets forth a different set of objectives. Some agreements focus on economic dialogue, political dialogue, and/or trade liberalization, among other themes, while others are precursors to an accession treaty.

⁶ See http://europa.eu/legislation_summaries/glossary/stabilisation_association_process_en.htm.

⁷ The European Neighborhood Policy applies to the EU's immediate neighbors by land or sea, i.e. Algeria, Armenia, Azerbaijan, Egypt, Georgia, Israel, Jordan, Lebanon, Moldova, Morocco, Syria, Tunisia, Ukraine, and West Bank & Gaza. Although Russia is also a neighbor of the EU, the EU's relations with Russia are instead developed through a "Strategic Partnership." See http://ec.europa.eu/world/enp/index_en.htm.

countries to join the EU. Within the context of EU accession, a country must meet certain criteria, among which is the adoption of the *acquis*. All Member States must comply with the *acquis* unless they have negotiated an opt-out. Although new Member States may be granted transition periods for implementation, they will not be granted permanent 'opt-outs'. For the enlargement negotiations with Croatia and Turkey, the *acquis* has been divided into 33 chapters. Chapter 6 (Company Law) has greatest relevance to corporate sector accounting and auditing; Chapters 2 (Freedom of Movement for Workers) and 3 (Right of Establishment and Freedom to Provide Services), Chapter 4 (Free Movement of Capital), Chapter 8 (Competition Policy), and Chapter 9 (Financial Services) also have some implications. When applying for membership, an applicant country will receive a roadmap from the European Commission tracing its progress in adopting the *acquis*. Accession negotiations may be concluded even if the *acquis* has not been fully adopted, as transitional measures may be introduced after accession. However, transposition periods and specific transitional measures are rarely applied in the context of Chapter 6.

13. Each Association Agreement/Partnership and Cooperation Agreement sets out a different agenda for approximation to parts of the *acquis* although generally there are no deadlines. Association Agreements with Algeria, Armenia, Azerbaijan, Belarus, Egypt, Georgia, Israel, Jordan, Lebanon, Moldova, Morocco, Syria, Tunisia, Ukraine, and West Bank & Gaza have entered into force. As the EU does not offer the incentive of membership to these countries in exchange for aligning their legislation with the *acquis*, ENP countries/entities may not be as keen on adapting to the *acquis* as accession countries. However, in return for progress on relevant reforms, ENP countries can benefit from greater integration into European programmes and networks, increased financial assistance and enhanced market access.

14. The *acquis* includes all primary legislation (Treaties), secondary legislation (regulations, directives, decisions, recommendations, etc.) and case law (judgments of the European Courts). As EU legislation is constantly changing (e.g., new directives are enacted, regulations are amended), the *acquis* is not a static document, but one that is in constant evolution.

i. Main legislative instruments

15. Article 288 of the Treaty on the functioning of the European Union (TFEU) states that "to exercise the Union's competences, the institutions shall adopt regulations, directives, decisions, recommendations and opinions". The ordinary legislative procedure consists in the joint adoption of a regulation, a directive or a decision by the European Parliament and the Council, on a proposal of the Commission (Art.289 TFEU)⁸:

- Regulations are addressed to and directly applicable and binding in all EU Member States without the need for any national implementing legislation.⁹ Regulations are the type of legislation that most closely resemble a domestic statute and are used when uniformity is crucial.
- Directives are binding with respect to the results to be achieved and the time limit within which the objectives must be reached; however, they leave to national

authorities the choice of form and means for achieving those results. Directives have to be transposed into national legislation in accordance with the procedures of the individual Member States and by a fixed date. The deadline for Member States to transpose a directive into national law is generally between 18 to 24 months after its publication. Directives are the most frequently used instrument in relation with the establishment of the internal market (Art.50 TFEU).

- Decisions are binding in all their aspects for those to whom they are addressed. Decisions do not require national implementing legislation. A decision may be addressed to any or all Member States, to enterprises or to individuals.
- Recommendations, opinions, interpretative communications, and Commission comments are non-binding and are considered “soft law.” Soft law can be defined as “rules of conduct, which in principle have no legally binding force but which nevertheless may have practical effects.”¹⁰ As such they promote good practice throughout the EU. Soft law is often the starting point for the “Communitarization” of a particular policy area, acting as the precursor to the development of hard law.¹¹

ii. Main legislative principles

16. A number of legislative principles govern the way the EU formulates and implements public policy, and how these policies affect the national legislation of individual Member States. The first of these is the principle of subsidiarity, introduced by the Maastricht Treaty. According to this principle, in areas which do not fall within its exclusive competence, the EU may act only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States but can rather, by reason of the scale or effects of the proposed action, be better achieved at EU level. This is intended to ensure that decisions are taken as closely as possible to the citizen in order to avoid too much centralization of power. Other principles include the principle of proportionality, which requires that any Community action should not go beyond what is necessary to achieve the objectives of the treaty.

17. Before the Lisbon Treaty, EU legislative measures provided for the European Commission to be assisted by committees in accordance with the “comitology decision” (Decision of 28 June 1999 modified on 17 July 2006). The committees consist of representatives from Member States and are chaired by the Commission. The Commission can only adopt implementing measures if it obtains the approval by the Member States meeting within the committee and absent objections from the European Parliament. Examples include the Accounting Regulatory Committee and the Audit Regulatory Committee.

⁸ Although the legal acts did not change, the Lisbon Treaty substantially modified the procedure to adopt these legal acts. Consolidated versions of the Treaty on European Union and the Treaty on the functioning of the European Union (OJ C115, 9.5.2008). See http://europa.eu/lisbon_treaty/full_text/index_en.htm

⁹ However in practice national legislation often has to be changed or removed in order to comply with Regulations.

¹⁰ Snyder, F. (1993), “The Effectiveness of European Community Law: Institutions, Processes, Tools and Techniques.”

¹¹ Chalmers, Damian (1998), “European Union Law, Volume I: Law and EU Government,” Dartmouth Publishing, Aldershot, England.

18. Since the Lisbon Treaty, a new legal framework has replaced the comitology. The Treaty formally distinguishes between two kinds of comitology measures: delegated acts (based on Art.290 TFEU) and implementing acts (based on Art.291 TFEU). Article 290 makes the Commission solely responsible for drafting and adopting delegated acts, although the European Parliament and the Council have an ex-post right of control as they can oppose or revoke the delegation.

19. Article 291 provides that where uniform conditions for implementing legally binding Union acts are needed, those acts shall confer implementing powers on the Commission. The rules and general principles concerning mechanisms for control by Member States of the Commission's exercise of implementing powers have been laid down by a Regulation of the European Parliament and the Council of 16 February 2011 (EU/182/2011).¹² Implementing acts will easily be identified since the Treaty requires that the word 'implementing' be inserted in the title of these acts.

20. The new "examination procedure" confirms that, in order to prepare an implementing act, the Commission shall be assisted by a committee composed of representatives of the Member States where opinions will be delivered with a weighted majority. The committee shall be chaired by a representative of the Commission who shall not take part in the committee vote. If the committee does not reach a conclusion or when its opinion is negative, the Regulation provides for a possible appeal mechanism by the European Commission. Where a basic act is adopted under the ordinary legislative procedure, either the European Parliament or the Council may at any time indicate to the Commission that, in its view, a draft implementing act exceeds the implementing powers provided for in the basic act. In such a case, the Commission shall review the draft or withdraw the draft implementing act.

D. EU INSTITUTIONS & THE EU POLICY-MAKING PROCESS

*i. The primary EU Institutions*¹³

21. At the core of the EU there are seven main institutions, each playing a specific role: the European Commission, the European Parliament, the European Council, the Council of Ministers of the European Union, the Court of Justice, the Court of Auditors and the European Central Bank. The European Commission (the "Commission") is the driving force and executive body of the EU, playing a central role in the European decision making process.¹⁴ As such, it is responsible for proposing new legislation to the

¹² Regulation EU/182/2011 of 16 February 2011 laying down the rules and general principles concerning mechanisms for control by Member States of the Commission's exercise of implementing powers. JO L 55 of 28 February 2011

¹³ See http://europa.eu/abc/panorama/howorganised/index_en.htm for a more comprehensive description of how the EU is organized.

¹⁴ The Commission has five basic functions: the right and duty of initiating Community action and legislation; the guardian of the Treaties; the responsibility for the implementation of Community decisions; the decision-making authority in the field of competition policy; and the external representation of the European Community. Op cit. Egenhofer, C, Kurpas, S, van Schaik, L. (2009)

European Parliament and Council. Additionally, it manages and implements the EU's policies and budget, "enforce[s] European law (jointly with the Court of Justice) [and] ... represent[s] the EU on the international stage, for example by negotiating agreements between the EU and other countries."¹⁵ The Commission has 27 Commissioners who are in charge of Directorates-General (DGs), or institutionalized policy areas. Each DG and its staff are managed by a Director-General. The Directorates-General are broken down into policy sub-units called Directorates, which are further broken down into more specific Units. The entire European Commission is meant to function above the level of national interests.

22. In contrast to the supranational EU-level focus of the Commission, the European Council and the Council of Ministers of the European Union (the "Council") directly represent the Member States. They consist respectively of Head of States or Government¹⁶ and of Member States' Ministers in different configurations depending on the subjects under discussion. Each country has a number of votes in the Council broadly reflecting the size of its population, but weighted in favor of smaller countries. The Council shares with the European Parliament the responsibility for passing EU laws.¹⁷ Once the Commission issues a proposal, the Council is responsible for either approving or rejecting the proposal. The Member States hold the Presidency of the Council on a six-month rotational basis. The subject at hand in the Council determines which ministers from Member States attend a Council meeting. The Council is administered by a General Secretariat which briefs the Presidency, helps prepare the agenda, and reports on progress. The Committee of Permanent Representatives (COREPER) is the Council's key committee, in which the permanent representatives of all EU Member States sit and prepare the formal Council meetings by trying to secure political agreement among the Member States.

23. The European Parliament's Members are directly elected every five years and represent the citizens of the EU. There are 736 Members representing all 27 EU Member States. The main function of Parliament is to pass European laws on the basis of proposals presented by the European Commission. Parliament shares this responsibility with the Council of the European Union. Over time, the European Parliament's role in approving legislation along with the Council has increased. Twenty standing committees exist within Parliament. The Committee on Economic and Monetary Affairs (ECON) and the Committee on Legal Affairs (IURI) share responsibilities for the regulation and supervision of financial services, institutions and markets including financial reporting, auditing, accounting rules, corporate governance and other company law matters specifically

¹⁵ See http://europa.eu/institutions/inst/comm/index_en.htm

¹⁶ The wording "European Council" refers solely to the meeting of the Heads of State and Government from the respective Member States. It has a permanent President and the President of the Commission also attends the meetings. The European Council provides the Union with the necessary impetus for its development and defines the general political directions and priorities thereof. It does not exercise legislative functions, which is the responsibility of the Council of the European Union. Further details on the different configurations of this institution can be found at: <http://www.consilium.europa.eu/show-Page.asp?id=429&lang=en&mode=g>

¹⁷ It is also in charge of the EU's foreign, security and defense policies, and is responsible for key decisions on justice and freedom issues.

concerning financial services. With regard to EU law-making procedures, the Parliament is included in decisions via three processes described below in paragraphs 26 to 28.

24. The European Court of Justice (ECJ) ensures that EU laws are enforced by Member States and are coherently interpreted and applied uniformly across the EU. In addition, the ECJ plays a pivotal role of “referee” between the EU and its Member States, as well as between the EU’s own institutions.

25. Over time and with the passing of successive treaty reforms, the distribution of powers of these institutions has shifted, particularly as regards the Commission, the Council and Parliament. Successive EU founding treaties set forth three main procedures (described in paragraphs 26-28) under which these institutions make and/or implement EU policy. A distinctive feature of each procedure is the degree of influence of the Parliament. Consultation grants the least amount of influence to Parliament; cooperation increases the powers of Parliament, and the ordinary legislative procedure grants the most power to Parliament in the policy-making process.

ii. The law-making process

26. The consultation procedure was the legislative procedure originally provided for under the Treaty of Rome. It obliges the Council to consult the European Parliament before voting on a Commission proposal. However, Parliament’s opinion is not binding on the Council. Until 1987 this procedure applied to the harmonization of company and accounting law. The Fourth and Seventh EU Company Law directives on annual and consolidated accounts were adopted on the basis of this procedure.

27. The cooperation procedure was introduced by the SEA. It gives the European Parliament greater influence in the legislative process, by allowing it two “readings.” The scope of this procedure was considerably extended by the Maastricht Treaty (see paragraph 5); however, the Treaty of Amsterdam (see paragraph 6) superseded most uses of the cooperation procedure by introducing the co-decision procedure. Since then, the cooperation procedure has applied exclusively to the field of economic and monetary union.

28. The Treaty of Lisbon (see paragraph 9) further expanded the influence of the European Parliament. The co-decision procedure, since renamed the “ordinary legislative procedure”, places the European Parliament and the Council of Ministers on an equal footing (i.e., no institution may adopt legislation without the other’s assent and both institutions have the power to reject legislation). The ordinary legislative procedure allows legislative proposals to be adopted in one or two readings or after a conciliation procedure.¹⁸ The ordinary legislative procedure to adopt regulations or directives is the core legislative procedure for the purpose of EU law-making in the areas of company law, including accounting and auditing.

¹⁸ See http://ec.europa.eu/codecision/procedure/index_en.htm.

iii. EU Institutions primarily responsible for Corporate Sector Accounting and Auditing

29. The Directorate-General for Internal Market and Services is one of the 44 Directorates-General and other specialized services which make up the European Commission (see paragraph 21). Its main role is to coordinate the Commission's policy on the European Single Market, which aims to ensure ever greater European market integration and the free movement of people, goods, services and capital within the EU.¹⁹

30. In that context, DG Internal Market and Services is responsible for policies and regulations concerning financial services, company law, financial reporting, professional qualifications, free movement of services, and freedom of establishment. In the field of accounting, the work of the DG is directed at improving the quality, comparability and transparency of the financial information provided by companies. In the field of statutory audit, the DG's work is directed towards improving the quality of statutory audit throughout the EU. Another Directorate-General, DG Enterprise, also plays an important role in enhancing the Internal Market by developing policies, laws and regulations for specific industries.

31. The European Parliament (see paragraph 23) has two committees that address the topics of company law, accounting and auditing, the Committee on Economic and Monetary Affairs and the Committee on Legal Affairs.

¹⁹ See http://ec.europa.eu/internal_market/index_en.htm.



A. BACKGROUND TO THE EU INTERNAL MARKET

32. One of the main objectives of the Treaty of Rome was the creation of a single common market, with free movement of goods, persons, services and capital, to accelerate improvements in standards of living. Although a customs union was in force from 1 July 1968, the integration process had slowed considerably by the early 1980s. In order to revive the effort to integrate the European market, the Commission adopted the *White Paper on the Completion of the Internal Market* in June 1985. This paper set out an ambitious program (the “Europe 1992” program) to create a truly effective internal market by the end of 1992.

33. In 1987, the Single European Act introduced the notion of an “internal market” into the existing Articles of the Treaty of Rome, now used interchangeably with the original expression, “common market.” Although both concepts refer to market integration and the elimination of all obstacles to intra-Community trade throughout the EU, the “Internal Market” is seen as a more fully integrated evolution of the “common market”. The Single European Act introduced a new provision (Article 95) that empowers the Council to adopt, by a qualified majority vote, measures regarding the establishment and functioning of the Internal Market. In addition, a new policy in the area of harmonization emerged, shifting the Commission’s previous aim of comprehensive harmonization of laws, including in the area of company law, to a reduced approach, based on the subsidiarity principle, focusing on the harmonization of only those laws and policies deemed to be essential.

34. Although the “Europe 1992” project resulted in the adoption of most of the 282 Internal Market directives from the 1985 White Paper by 1 January 1993, a number of significant measures were still missing. In addition, serious problems existed with the transposition of these directives within individual Member States. The Commission therefore issued a 1996 communication on *The Impact and Effectiveness of the Single Market*²⁰ to renew attention on the Internal Market project: it highlighted the gaps in the current framework, the absence of competition in a number of sectors and the continuing existence of barriers to trade resulting from a variety of national rules. It underlined the need for concerted action in the areas of company law and financial services. Since then, there has been significant progress in deepening the integration of the Internal Market. In the run up to the 20th anniversary of the symbolic date of 1992, Professor Mario Monti was asked by the President of the Commission to prepare

²⁰ See http://ec.europa.eu/internal_market/economic-reports/docs/single_en.pdf.

a report containing options and recommendations for the future of the internal market. Professor Monti's report, *A New Strategy for the Single Market*, was tabled on 9 May 2010 and proposed a new set of initiatives to deliver a stronger single market in Europe. Fifty proposals were selected by the Commission as priorities in its Communication of October 2010 *Towards a Single Market Act*²¹. Commissioner Michel Barnier and the European Commission intend to keep the Single Market Act high on the political agenda to ensure that these actions are implemented by the end of 2012. The following section describes in more detail the EU's strategies towards the internal market.

B. THE EU'S INTERNAL MARKET STRATEGIES

35. The EU has launched a number of strategies and action plans to move nearer to completing the Internal Market. The European Commission followed up on its 1996 Communication with the European Council's 1997 Action Plan for the Single Market.²² This action plan stressed the need (a) to promote greater competitiveness of European capital markets as a means for attracting trade and investment, as well as (b) to make European companies more attractive in international capital markets. These two goals would be achieved through greater harmonization of intra-EU legislation and by harmonizing EU accounting rules with internationally accepted accounting standards. Within the Commission's subsequent 1999 Strategy for Europe's Internal Market, four strategic objectives were outlined:

- to improve the quality of life of citizens,
 - to enhance the efficiency of Community product and capital markets,
 - to improve the business environment, and
 - to exploit the achievements of the Internal Market in a changing world.
- These objectives continue to be valid today.

36. Each of these strategic objectives was accompanied by a number of operational objectives, which were intended not only to contribute to the achievement of the Strategy's goals but also to act as a benchmark for the progress of the Strategy. Those relevant to company law, including accounting and audit, are:

- the Financial Services Action Plan (1999)²³ followed by the Lamfalussy Report (2001)²⁴ proposing institutional measures to accelerate the implementation of the FSAP's objectives;
- the Lisbon Strategy (2000)²⁵;
- the Winter Report (2002)²⁶ followed by the Company Law Action Plan (2003)²⁷;

²¹ Doc COM(2010) 608 final/2;

See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0608:REV1:EN:PDF#page=2>

²² See http://europa.eu/legislation_summaries/other/170002_en.htm.

²³ See http://ec.europa.eu/internal_market/finances/docs/actionplan/index/action_en.pdf.

²⁴ See http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf.

²⁵ See http://ec.europa.eu/growthandjobs/pdf/lisbon_en.pdf.

²⁶ See http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf.

²⁷ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52003DC0284:EN:HTML>.

- the Internal Market – Priorities 2003–2006 (2002)²⁸;
- the White Paper on Financial Services Policy (2005–2010) (2005)²⁹;
- the de Larosière report (February 2009)³⁰ and
- the Monti report (May 2010)³¹.

37. The corporate scandals and financial turbulence in the first decade of the century reemphasized the importance of ensuring high-quality financial reporting and enforcement through an updated Internal Market Strategy in the area of financial services. A legislative package to strengthen financial supervision in Europe was approved in September 2010, including the creation of a European System of Financial Supervisors with three new European Supervisory Authorities. The approval of these proposals changes substantially the framework of regulation for financial services in Europe. (See paragraphs 47–48)

38. One priority of the Internal Market Strategy is the integration of services markets, which is of particular relevance to corporate sector accounting and auditing. In the field of services, there are still considerable differences between Member States in their domestic legislation, which is a barrier to the free movement of services. This barrier affects all stages of the business process and can deter companies from operating in other Member States.

39. The European Commission's first report on the implementation of the Internal Market Strategy Priorities for 2003–2006 found that too many European industries, including accounting services, still operated in fragmented markets due to barriers to trade and differences in standards and regulations. Fragmented markets hamper innovation and productivity growth and keep prices in some parts of the EU at higher levels than they would be in a more integrated Internal Market. Although the Internal Market has boosted EU economic growth and created jobs over the past ten years, much still needs to be done to build on that success. The European Commission's second report on the implementation of the Internal Market Strategy 2003–2006³² pointed to the need for a stronger focus on completing the legal framework of the Internal Market, ensuring greater coherence with other EU policies and also on making the legal framework of the Internal Market more consistent with the global economic framework.

40. The market turmoil that began in mid-2007 re-emphasized the need to continue to improve framework conditions for businesses, particularly for small- and medium-sized businesses, which, in contrast to large companies, often find the single market fragmented and difficult to penetrate. In its 2009 Annual Management Plan³³ DG Internal Market and Services outlined its general and operational objectives.

²⁸ See http://eur-lex.europa.eu/LexUriServ/site/en/com/2003/com2003_0238en01.pdf.

²⁹ See http://ec.europa.eu/internal_market/finances/policy/index_en.htm.

³⁰ See http://ec.europa.eu/internal_market/finances/committees/index_en.htm#delarosierereport.

³¹ See http://ec.europa.eu/internal_market/strategy/docs/monti_report_final_10_05_2010_en.pdf.

³² See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2005:0011:FIN:EN:PDF>.

³³ See http://ec.europa.eu/dgs/internal_market/docs/amp_2009_en.pdf.

These include:

- Facilitating the free movement of qualified professionals inside the EU;
- Contributing to the competitiveness of EU business by developing an efficient EU company law framework;
- Ensuring the comparability and transparency of listed company accounts throughout the EU and in third countries, notably by ensuring that international standards are prepared by an organization with good governance and due process, as well as with sufficient EU input;
- Working towards simplifying accounts for small- and medium-sized enterprises;
- Improving audit quality and the structure of the audit market in order to ensure a high level of confidence in company reporting; and
- Ensuring the correct implementation and effective enforcement of EU rules on company law, free movement of capital and statutory audit by all Member States in order to ensure transparent company reporting and to uphold shareholders' rights.

C. THE FINANCIAL SERVICES ACTION PLAN (FSAP)

41. One of the key operational objectives to be achieved by the Strategy for Europe's Internal Market was the implementation of the Financial Services Action Plan (FSAP). EU policymakers viewed the integration of financial services as crucial following the introduction of the single currency, as the financial sector acted as "the motor for [economic] growth and job creation."

42. The FSAP contained some 40 measures aimed at achieving an integrated market for financial services in the EU. It set out indicative priorities and a timetable for specific measures to achieve three strategic objectives:

- establishing a single market in wholesale financial services;
- making retail markets open and secure; and
- strengthening the rules on prudential supervision.

43. After the regulatory aspects of the FSAP had been carried out, the Commission concluded that the EU financial services industry (banking, insurance, securities, asset management) still had strong untapped economic and employment growth potential. It issued a White Paper in December 2005, entitled "Financial Services Policy 2005-2010" detailing the subsequent implementation phase of the FSAP. The policy explored the best ways to deliver further benefits of financial integration to industry and consumers alike. Priorities included consolidating progress, ensuring sound implementation and enforcement of existing rules; driving through better regulation principles into all policy making; enhancing supervisory convergence; creating more competition between service providers and expanding the EU's external influence in globalizing capital markets.

44. A number of other EU initiatives complement the FSAP. In 2000, the European Council reaffirmed the need to achieve Community financial market integration, calling

for the acceleration and completion of the FSAP by 2005 in the context of increasing Europe's global competitiveness through the Lisbon Agenda (see Box 1: The Lisbon Agenda).³⁴

45. These initiatives included the 2002 Winter Report, which recommended a modern regulatory framework in the EU for company law, the Company Law Action Plan (CLAP) of 2003 (see paragraph 52), and the Commission's Communication, *Internal Market Strategy-Priorities 2003-2006*. This Communication drew upon previous Internal Market Strategies and aimed at strengthening the Internal Market in the light of the EU's enlargement. Of the numerous goals that this Communication prioritized, the two most urgent were the implementation of outstanding FSAP legislation and the development and implementation of "better governance." Following the global accounting scandals which occurred during and after 2000, these priorities were revised to the following: (a) completing the legislative reforms as laid out in the FSAP in 1999, (b) improving corporate governance and (c) harmonizing company law.

Box 1: The Lisbon Agenda

The European Council met in Lisbon, Portugal in March 2000, to discuss the achievements of the EU since the adoption of the Maastricht Treaty in 1992. In particular, the Council addressed the need for more rapid economic development in light of increasing globalization and the spread of information technology. Following the Lisbon meeting, the Council issued the Lisbon Agenda, which comprised a ten-year strategy (2000-2010) for transforming Europe into the world's leading knowledge economy. The Agenda addressed a broad range of issues, including the Internal Market and Financial Services. The Lisbon Agenda called for lowering regulatory costs and removing barriers to cross-border trade in services within the Internal Market. It also called for full integration of financial services and capital markets.

The Lisbon Agenda was reviewed by a High Level Group in 2004 in a report commonly referred to as the Kok Report¹, and a White Paper was published in May 2005 outlining Financial Services Policy for 2005-2010.¹ As most FSAP legislation had been adopted by this point, the guidelines of this updated financial services policy focused on the "dynamic consolidation" of this legislation.

46. A difficult problem in EU law-making results from the length of the procedures involved, especially when directives have to be transposed into national legislation. This seemed to be especially harmful in the areas covered by the Financial Services

³⁴ See http://ec.europa.eu/growthandjobs/pdf/lisbon_en.pdf.

³⁵ These bodies currently include the Accounting Regulatory Committee (ARC), the European Securities Committee (ESC), the Committee of European Securities Regulators (CESR), the European Banking Committee (EBC), the Committee of European Banking Supervisors (CEBS), the European Insurance and Occupational Pension Committee (EIOPC), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), the Audit Regulatory Committee (AuRC) and the European Group of Auditors' Oversight Bodies (EGAOB).

Action Plan. In 2001, a Committee of Wise Men on the Regulation of European Securities Markets produced the *Lamfalussy Report*. This report set out a transparent process of policymaking and laid down a regulatory approach involving different levels of measures and bodies in what has come to be known as the Lamfalussy Process.³⁵ The first level involves using the codecision process with the Council and Parliament to arrive at agreement on the broad principles contained in the legislation. The second level subsequently enhances the broad principles by adding measures for the actual implementation of the first level legislation. These first two levels aim to promote greater transparency in the overall legislative process as well as greater consultation with stakeholders in the process. The next two levels of the Lamfalussy Process, Levels 3 and 4, are respectively the coordination of Member States' implementation efforts in an advisory capacity and the proper enforcement of the Lamfalussy measures across the EU. The Lamfalussy Process overall has been praised for leading to quicker political agreement on financial markets legislation. Most notably, the process has been credited with contributing to the timely delivery of the Market Abuse Directive (2002), the Prospectus Directive (2003), the Market in Financial Instruments Directive (2004), and the Transparency Directive (2004).³⁶

47. Following the review of the Lamfalussy Process carried out in 2007 by the Commission, the Inter-Institutional Monitoring Group and the Council, the Commission initiated a range of actions with a view to strengthening the Lamfalussy Process, and in particular, improving cooperation between national supervisors and convergence in their practices. These included, amongst others, a review of national supervisory and sanctioning powers, of voluntary delegation of tasks, of provisions on supervisory cooperation and exchange of information and of consistency of terminology in EU financial services directives. However, the financial turmoil in 2007-2009 revealed some weaknesses in the system and demonstrated the need to strengthen existing mechanisms and institutions in order to better deal with cross-border and systemic issues. In particular, regulatory responses were needed to prevent repetition of major financial systemic crises. The foundations of the new structure were defined in a report prepared under the leadership of Jacques de Larosière, a former head of the IMF, and issued in February 2009.³⁷

48. The report presented an analysis of the financial crisis, using this to draw up its recommendations for regulatory changes. The de Larosière group put forward 18 detailed recommendations, including developing common rules for investment funds across all 27 EU countries, capping bankers' bonuses in line with shareholder interests and establishing a crisis management system for the EU's financial sector. The key principles of the de Larosière report were endorsed by the Commission and led to the comprehensive reform of financial regulation and supervision. The new system includes a supervisory system that combines much stronger oversight at EU level, whilst maintaining a clear role for national supervisors. Furthermore, an early warning body under ECB auspices has been set up to identify and tackle systemic risks and to

³⁶ See http://ec.europa.eu/internal_market/securities/docs/lamfalussy/sec-2004-1459_en.pdf.

³⁷ See http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf.

make recommendations for a core set of regulatory standards throughout the EU. The new European Systemic Risk Board (ESRB, the early warning body) and the European System of Financial Supervisors (ESFS) started operating on 1 January 2011.³⁸ The ESFS, composed of national supervisors and the three new European supervisory authorities: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and European Securities and Markets Authority (ESMA) have stronger powers than the committees (CEBS, CEIOPS and CESR) that they replaced.

D. COMPANY LAW HARMONIZATION

49. Although the Treaty of Rome established the European Community in 1958, significant disparities between Member States' company law systems remained until the 1970s. These disparities hampered the deepening of the Internal Market as, for example, corporate board structures and accounting practices differed greatly between Member States. Therefore, a number of Member States actively insisted that the grant of the right of establishment to companies from all Member States be counterbalanced by at least some degree of harmonization of national company laws. One key objective of company law harmonization was to avoid regulatory arbitrage, whereby companies could choose to incorporate in a Member State with lax company laws and then establish themselves in other Member States. Two further objectives were to facilitate the freedom of establishment of companies and to guarantee legal certainty in intra-Community operations.

50. European company law harmonization was also seen as an integral part of an industrial policy to make European companies more competitive. Directives and regulations had to provide European companies with instruments and rules to facilitate cross-border mergers and cooperation to allow them to trade and restructure at a European level.³⁹ Policymakers also realized the need for specific action to harmonize financial reporting and financial disclosure practices throughout the EU. These measures were seen as necessary to make company financial information comparable and equivalent in order to protect creditors and other third parties. Harmonization was achieved through a series of EU Company Law Directives: the Fourth Company Law Directive on annual accounts of companies with limited liability (1978); the Seventh Company Law Directive on consolidated accounts of companies with limited liability (1983); the Eighth Company Law Directive on the approval of persons responsible for carrying out the statutory audits of accounting documents (1984); the Banking Accounts Directive (1986); and the Insurance Accounts Directive (1991). These directives are discussed in greater detail in Section III of this guide.

³⁸ Regulations of the European Parliament and Council establishing the ESRB, the European System of Financial Supervision and the three Authorities are published in the Official Journal of the EU L.311 of 15 December 2010

³⁹ The Third Directive (1978) on mergers and the Sixth Directive (1982) on divisions, as well as the Directive on cross-border mergers (2005) and the Regulations on the Statute for a European Company (2001) and on the European Economic Interest Grouping (1985) fall within this category.

51. As one of its main objectives, the FSAP called for an EU-wide review of financial reporting. It reiterated the importance of comparable, transparent, and reliable financial information for efficient and integrated financial markets. In particular, the FSAP highlighted the need for debate on how this objective could be aligned with international best practices, which in the Commission's view included International Accounting Standards (IAS). In 2002, a regulation requiring publicly-traded entities to prepare their consolidated accounts in accordance with IAS was issued (see paragraph 105).⁴⁰

Box 2: Measures adopted in June 2006 (DIR 2006/46/EU) based on measures proposed in the CLAP

Enhanced corporate governance disclosure	Publicly-traded companies required to issue a "corporate governance statement" in their annual report to cover issues such as whether the company complies with a corporate governance code, information about shareholders' meetings and the composition and operation of the board and its committees.
Confirming at EU level the collective responsibility of board members for annual and consolidated accounts	Board members to be collectively responsible for annual and consolidated accounts as well as key non-financial information.
Increasing disclosure of group structure and relations, both financial and non-financial	Companies required to disclose related-party transactions, including "other types of related parties" not previously included in the Fourth Directive.

52. As discussed in paragraph 45, the Commission published the Winter Report in 2002 which underlined the need for immediate action on improving the EU framework for corporate governance. This led to the Commission's communication on Company Law and Corporate Governance in 2003. The European Commission then held a consultation on this communication, Modernizing Company Law and Enhancing Corporate Governance in the European Union: A Plan to Move Forward. The Plan, known as the Company Law Action Plan (CLAP), adopted on 21 May 2003, proposed a set of initiatives aimed at strengthening shareholders' rights, reinforcing protection for employees and creditors, and increasing the efficiency and competitiveness of European business. It also detailed a series of corporate governance initiatives aimed at boosting confidence in capital markets. The CLAP was based on a comprehensive set of proposals, grouped in six chapters: corporate governance; capital maintenance and alteration; groups and pyramids; corporate restructuring and mobility; the European Private Company; and cooperatives and other forms of enterprises. It led to the adoption of two recommendations and a directive amending the Fourth and Seventh EU Company Law Directives (see Box 2: Measures adopted in June 2006 (DIR 2006/46/EU) based on measures proposed in the CLAP). These recommendations and the directive are discussed in greater detail in Section III of this guide.

⁴⁰ Within this paper, publicly-traded companies are those companies with securities admitted to trading on a regulated market in the European Union.



ACCOUNTING AND AUDITING IN THE ACQUIS COMMUNAUTAIRE

53. The Treaty of Rome set out conditions to coordinate Member States' economic policies and bring about the completion of the Internal Market, based on the principle of an open market economy with free competition. Although the Treaty in its original form did not mention the harmonization of accounting and auditing in the EU, such harmonization became more important as efforts to complete the Internal Market proceeded and, especially, once the harmonization of company law became an issue. The many differences between national systems of accounting, auditing and company law were perceived to hinder trade and the movement of capital within the EU. Thus, the harmonization of accounting and auditing across the EU became a means by which greater transparency and comparability of financial reporting could facilitate freer trade and movement of capital across Member States (see Box 3: Examples of the Reasons for Harmonization). This section summarizes those parts of the *acquis communautaire* which relate to accounting, financial reporting, and auditing.

Box 3: Examples of the Reasons for Harmonization⁴¹

<i>Creditors</i>	Align safeguards to protect creditors of Limited Liability Companies.
<i>Investors, financial analysts, parent-companies, etc.</i>	Need to be able to understand the annual/ consolidated accounts of European companies whose shares they might wish to buy, hold, or sell. Also need to appraise the performance of subsidiaries and appraise other European companies for potential takeovers.
<i>Preparers of accounts</i>	Within multinationals, the work of accountants to prepare and consolidate accounts is much simplified if annual accounts from all around the EU are prepared on the same basis.

A. ACCOUNTING: THE ACQUIS COMMUNAUTAIRE AS IT APPLIES TO CORPORATE SECTOR ACCOUNTING

54. Two directives form the core of the *acquis communautaire* on corporate sector financial reporting: the Fourth EU Company Law Directive (1978)⁴² ("the Fourth Direc-

⁴¹ Adapted from Christopher Nobes, Robert Parker (2004), *Comparative International Accounting*, Eighth Edition, Harlow, United Kingdom

⁴² For a recent consolidated version of the Fourth EU Company Law Directive, see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1978L0660:20090716:EN:PDF>.

tive”) which covers annual accounts⁴³ of companies, and the Seventh EU Company Law Directive (1983)⁴⁴ on consolidated accounts (“the Seventh Directive”). In adopting these two directives, the EU was attempting to harmonize accounting. However, the directives include dozens of provisions that begin with expressions such as “Member States may permit or require [...]” Given this flexibility, the resulting harmonization achieved within the EU was not complete. This might be explained, to some extent, by the differences in the “purposes of various national accounting systems in the EU. They include the differences between creditor orientation in the traditional Franco-German systems and investor orientation in the Anglo-Dutch systems; between law/tax-based rules and private sector standards.”⁴⁵

55. Two additional directives were issued to cover the specific nature of the banking and insurance sectors; the Banking Accounts Directive of 1986,⁴⁶ and the Insurance Accounts Directive of 1991.⁴⁷ Taken together, these four directives are the fundamental pillars of the *acquis communautaire* on corporate sector accounting. They did much to harmonize national legislation with respect to the obligation to prepare annual and consolidated accounts, as well as the audit and publication of accounts.

56. However, EU policy-makers recognized in the mid 1990’s that greater harmonization of financial reporting was needed for EU capital markets to function efficiently in an increasingly globalized world. This led to amendments to these directives and the adoption of Regulation (EC) No 1606/2002 of the European Parliament and the Council of July 19, 2002 on the application of International Accounting Standards (now IFRS). Regulation (EC) No 1606/2002 required all companies whose securities are admitted to trading on a regulated market of any Member State (hereafter referred to as ‘publicly-traded companies’) to present their consolidated accounts in accordance with endorsed IFRS from 2005. The key legislation is summarized below.

i. The foundations of the *acquis communautaire* on corporate sector accounting

a. The Fourth EU Company Law Directive (the “Fourth Directive”)⁴⁸

Scope and Objective

57. The Fourth Directive is the backbone of the *acquis communautaire* on financial reporting for limited liability companies established within the EU. It lays down rules

⁴³ “Annual accounts” is the term used in EU Company Law Directives when referring to legal entity or individual financial statements of a company.

⁴⁴ For a recent consolidated version of the Seventh EU Company Law Directive, see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1983L0349:20090716:EN:PDF>.

⁴⁵ Christopher Nobes, Robert Parker (2004), op. cit., p. 96.

⁴⁶ For a recent consolidated version of the Banking Accounts Directive, see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1986L0635:20060905:EN:PDF>

⁴⁷ For a recent consolidated version of the Insurance Accounts Directive, see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1991L0674:20060905:EN:PDF>

⁴⁸ A Member State may exempt companies which are not profit making from the Fourth and Seventh Directive requirements as a consequence of the definition of companies or firms as outlined in Article 48 of the Treaty establishing the European Community. It states that ‘companies or firms’ comprise companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are not-for-profit. So far, Luxembourg, Ireland, and Greece appear to be the only Member States to have taken advantage of this exemption.

and principles for the preparation, presentation and publication of annual accounts by limited liability companies. Furthermore, the Fourth Directive forms the basis for the Seventh Directive (on consolidated accounts) and the two sector-specific directives, the Bank and Insurance Accounts directives.

58. The Fourth Directive covers the annual accounts of limited liability companies. Article 1 sets out the types of companies in each Member State, which fall under the scope of the directive (e.g., in the United Kingdom: public companies limited by shares or by guarantee, private companies limited by shares or by guarantee, partnerships, limited partnerships, unlimited companies).

59. Annual accounts under the Fourth Directive must include a balance sheet, a profit and loss account, and notes on the accounts. The directive does not require a cash flow statement or a statement of changes in equity. However, Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 introduced the following provision within Article 2 of the Fourth Directive: “Member States may permit or require the inclusion of other statements in the annual accounts.”

60. The Fourth Directive states that the objective of the annual accounts is to provide a true and fair view of the financial position and performance of the company. This would normally be obtained by applying the provisions of the directive. However, in exceptional cases the directive requires a departure from the provisions of the directives if that is needed to provide a true and fair view. This so-called “true and fair view override” has been extensively discussed and remains a heavily-debated topic in the context of international accounting standard setting.⁴⁹

61. One of the amendments to the Fourth Directive (Directive 2006/46/EC), which came into effect in September 2008, requires the members of the administrative, management and supervisory bodies of the company to be collectively responsible at least to the company for the annual accounts, the annual report and, when required, the corporate governance statement. This amendment introduced into legislation a recommendation made in the Winter Report (see paragraph 52).

62. The directive contains relatively prudent recognition and measurement principles (referred to as “valuation rules” in the directives).⁵⁰ Moreover, some recognition and measurement options allow Member States to closely align financial reporting requirements with tax accounting.⁵¹

63. This may be explained by the fact that “in most continental European countries

⁴⁹ For example, refer to Alexander, D. (1993), A European true and fair view?, *European Accounting Review*, Vol. 2, No. 1.

⁵⁰ It should be noted that the Directive includes very few recognition principles. For example, the principles governing the recognition of the revenue from the sale of goods or the rendering of services are only briefly set out.

⁵¹ Gielen, Hegarty (2007), *An Accounting and Taxation Conundrum: The Relationship between Corporate Income Tax Accounting and Financial Accounting: A Pan-European Perspective in the Context of Adoption of International Financial Reporting Standards (IFRS)*, World Bank, Washington, USA.

[...], the traditional paucity of 'outside' shareholders has meant that external financial reporting has largely been invented for the purposes of protecting creditors and for governments, as tax collectors or controllers of the economy. [...] It also seems likely that the greater importance of creditors in these countries leads to more careful (prudent, conservative) accounting."⁵²

64. With the adoption of Regulation (EC) No 1606/2002 and the subsequent endorsement of individual IFRS,⁵³ new recognition and measurement principles became part of the *acquis communautaire*, in particular measurement at fair value. Some of the Fourth and Seventh Directives' prudent recognition and measurement principles needed to be modified to enable the use of fair value in certain circumstances. Therefore, the Fourth and Seventh directives were amended in 2001 and 2003 to allow the use of fair value and to pave the way for the endorsement of IFRS. As a consequence, the Fourth Directive currently includes a broad range of measurement options. In particular Section 7a provides for specific rules related to valuation at fair value of financial instruments, including derivatives. The directive defines how fair value will be determined, whether changes in fair value will be included in the income statement or directly in equity, and what information needs to be disclosed in the notes.

65. The Fourth Directive sets out standardized formats for the lay-out of the balance sheet and the profit and loss accounts. The Fourth Directive also defines the minimum contents of the notes to the annual accounts and the format of the annual management report. However, it does not impose a uniform chart of accounts as exists, for example, in Belgium, France or Spain.

66. Directive 2006/46/EC amending the Fourth Directive, which came into effect in September 2008, requires companies to disclose off-balance-sheet arrangements and related-party transactions in the notes to the annual accounts. Moreover, publicly-traded companies now have to issue a corporate governance statement in their annual management report or in a separate report published together with the annual report (Article 46a).

Exemptions for Small and Medium-sized Enterprises (SMEs)

67. As discussed above, the Fourth Directive applies to all limited liability companies. However, the directive provides Member States with several options to ease the financial reporting burden on small and medium-sized companies, as defined in Articles 11 and 27 of the Fourth Directive, i.e.:

- Definition of Small Companies: Small-sized companies may not exceed two of the following three thresholds for two consecutive years: (a) balance-sheet total: € 4,400,000; (b) net turnover: € 8,800,000; (c) number of employees: 50. Member States may set lower thresholds.

⁵² Christopher Nobes, Robert Parker (2004), op. cit., p. 23.

⁵³ To be adopted for application in the EU a standard must meet the conditions set out in Article 3 of Regulation (EC) No 1606/2002: Its application must result in a true and fair view of the financial position and performance of an enterprise; it must be conducive to the European public good; and it must meet basic criteria as to the quality of information required for financial statements to be useful to users.

- Definition of Medium-sized Companies: Medium-sized companies may not exceed two of the following three thresholds for two consecutive years: (a) balance-sheet total: € 17,500,000; (b) net turnover: € 35,000,000; (c) number of employees: 250. Member States may set lower thresholds.
- The values of the monetary thresholds are regularly increased to take into account monetary and economic developments.⁵⁴

68. Member States have the possibility of allowing small companies to draw up abridged accounts and notes to the accounts, and to exempt small companies from the requirement for a statutory audit and from drawing up an annual report. Member States can also allow medium-sized companies to adopt different layouts for the profit and loss account, to prepare aggregate balance sheet information, not to draw up consolidated accounts, and to leave out non-financial information from the annual report. However, consistent with the EU's overarching objective of protecting investors, the exemptions available to small and medium-sized companies do not apply to publicly-traded SMEs.

69. There are large differences between Member States regarding how these thresholds are set. These reflect differences in policymakers' priorities which may be explained by:

- Concerns about the potential inclusion of "public interest" companies: some Member States are concerned that accepting the thresholds set out in the directive may result in including fairly large companies, where full financial information is of interest to financial institutions, public and private shareholders and to the public in general.
- Concerns about the impact on SME financial management practices: some Member States are concerned that the relief options may affect SMEs' financial management practices and, indirectly, the processes of tax collection by Governments.
- The perception by some Member States that follow the directive's thresholds for defining SMEs that higher thresholds are a key way of limiting the administrative burdens on companies.

70. The most commonly implemented options appear to be in relation to publication of an abridged balance sheet and the profit and loss statement. Exempting small companies from statutory audit is implemented in most Member States although only a minority of Member States has adopted the maximum thresholds allowed by the Directive (e.g., Germany, Luxembourg, the Netherlands, and the United Kingdom).

71. More recently, in order to reduce the administrative burdens on micro-entities, the European Commission has proposed allowing Member States to exempt them from the application of the accounting directives.⁵⁵ Micro-entities would be companies not exceeding two of the following three thresholds for two consecutive years: (a) balance-sheet total: € 500,000; (b) net turnover: € 1,000,000; (c) number of employees: 10. Applying the general principle of subsidiarity, these micro-entities would then be submitted to the regulatory regime defined at national level. The European Parliament has approved the proposal but the Council has so far not done so.

⁵⁴ The latest such amendment dates to June 14, 2006, with the adoption of Directive 2006/46/EC.

⁵⁵ See http://ec.europa.eu/internal_market/accounting/docs/news/legal_proposal_en.pdf

Publication and Statutory Audit

72. The Fourth Directive requires limited liability companies to publish their annual accounts, annual report, and the statutory auditor's report by filing them with a commercial register (e.g. Companies House in the United Kingdom). The publication of the accounting documents follows the mechanisms set out in the First EU Company Law Directive (the "First Directive"). The First Directive requires Member States to provide for appropriate penalties in the case of failure to disclose these accounting documents. It also requires Member States to make these accounting documents available in electronic form from 1 January 2007.

73. The scope of statutory audit also derives from the Fourth Directive, which requires that, except for the exemptions available for small companies, annual accounts of all limited liability companies be audited by an approved statutory auditor. Statutory auditors are also required to express an opinion concerning the consistency of the annual report with the annual accounts. The Fourth Directive defines the types of audit opinions and the structure of the audit reports. A comprehensive regime applicable to statutory auditors is defined by Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (the "new Eighth Directive", see paragraph 121).

Recent Amendments to the Fourth Directive

74. The most recent amendment to the Fourth Directive in 2009 aimed at alleviating administrative burdens on smaller companies. Directive 2009/49/EC slightly reduced the disclosure requirements on these companies.⁵⁶ However, the European Commission plans to carry out a more fundamental overhaul of the directive. It has carried out a public consultation on reviewing the accounting directives with the aims of reducing the administrative burden on small enterprises ("think small first") as well as making qualitative improvements for all enterprises in the scope of the directives. An additional objective is to increase the clarity of the text for lawmakers and users in general.⁵⁷

b. The Seventh EU Company Law Directive (the "Seventh Directive")

Scope and objective

75. The Seventh Directive lays down rules and principles for the preparation, presentation and publication of consolidated accounts and a consolidated annual report by groups of "undertakings" (this term includes companies and other entities).

76. Consolidated accounts under the Seventh Directive must include a consolidated balance sheet, a consolidated profit and loss account, and notes on the consolidated accounts. The directive does not require a consolidated cash flow statement or a consolidated statement of changes in equity. However, Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 introduced the following provision

⁵⁶ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:164:0042:0044:EN:PDF>

⁵⁷ See http://ec.europa.eu/internal_market/consultations/docs/2009/accounting/20090226_consultation_en.doc

within Article 16 of the Seventh Directive: “Member States may permit or require the inclusion of other statements in the consolidated accounts.”

77. The Seventh Directive states that the objective of the consolidated accounts is to provide a true and fair view of the financial position and performance of the group of undertakings, which would normally be obtained by applying the provisions of the directive. However, in exceptional cases the directive requires a departure from the provisions of the directive if that is needed to provide a true and fair view.

78. One of the amendments to the Fourth Directive of June 2006 (Directive 2006/46/EC), which came into effect in September 2008, requires the members of the administrative, management and supervisory bodies of the company to be collectively responsible at least to the company for the consolidated accounts, the consolidated report and, when required, the corporate governance statement.

Recognition and Measurement Principles

79. Recognition and measurement principles (referred to as “valuation rules” in the directives) in the Seventh Directive are defined by reference to the Fourth Directive. The assets and liabilities of undertakings must be recognized and measured in accordance with the Fourth Directive (Article 29). As mentioned in paragraph 64, these relatively prudent principles were amended in 2001 and 2003 to allow the use of fair value and to pave the way for the endorsement of IFRS.

80. A parent undertaking is required to prepare consolidated accounts if it has legal or economic control over subsidiary undertakings (wherever they are established). The detailed criteria for determining legal or economic control are very similar to the consolidation criteria of IAS 27, Consolidated and Separate Financial Statements. If the parent undertaking is itself a limited liability company, it has to prepare both annual accounts and consolidated accounts.

81. The Seventh Directive requires full consolidation of all subsidiaries in the consolidated financial accounts by eliminating intra-group transactions and intra-group profits. However, Member States may allow exclusions from consolidation in cases where IFRS requires the subsidiary to be consolidated.

Presentation

82. The Seventh Directive requires the same standardized formats for the lay-out of the consolidated balance sheet and the consolidated profit and loss statement as the Fourth Directive. The Seventh Directive further sets out a number of essential adjustments resulting from the particular characteristics of consolidated accounts as compared with annual accounts (e.g. minority interests). The Seventh Directive also defines the minimum contents of the notes to the consolidated accounts and the format of the consolidated annual report. The notes must include specific information about the subsidiary undertakings included in the consolidation, such as their registered office and the proportion of the capital held by the parent undertaking.

83. One of the amendments to the Seventh Directive of June 2006 (Directive 2006/46/EC) requires companies to disclose off-balance-sheet arrangements and related-party transactions in the notes to the consolidated accounts. Moreover, publicly-traded companies will have to issue a corporate governance statement in their annual management report.

Exemptions and Simplifications for Small and Medium-sized Groups

84. The Seventh Directive includes a number of possible exemptions and simplifications that Member States may decide to implement in their national law:

- Small groups may be fully exempted from preparing consolidated accounts if two of their consolidated thresholds (i.e., consolidated balance sheet, net turnover, and number of employees in the group) do not exceed the criteria applicable to medium-sized companies (see paragraph 67). However, consistent with the EU's overarching objective of protecting investors, the exemptions available to small and medium-sized groups do not apply to publicly-traded groups.
- Member States may exempt sub-groups of companies from preparing separate consolidated accounts if they are part of a larger group preparing and publishing audited consolidated financial statements in accordance with the Directive or in an equivalent manner, if the parent company is not established in the EU.

Publication and Statutory Audit

85. The publication requirements are identical to the Fourth Directive (see paragraph 72). However, contrary to the Fourth Directive, when consolidated accounts are required by the Seventh Directive, they must be subject to a statutory audit, i.e. no exemption from statutory audit applies.⁵⁸

Recent Amendments to the Seventh Directive

86. In June 2006, the European Parliament and the Council adopted a directive amending the Fourth and Seventh Company Law Directives, which Member States had until September 2008 to transpose into national law.⁵⁹ The main points contained in this directive were discussed in paragraphs 66 and 83 above. The most recent amendment in 2009 (Directive 2009/49/EC) aimed at alleviating administrative burdens on smaller companies by slightly reducing the disclosure requirements.

c. Directive on the Annual Accounts of Banks and other Financial Institutions (The "Bank Accounts Directive")

87. The Fourth and Seventh Directives acknowledged the special nature of the activities of banks and other financial institutions (hereafter referred to as "banks") and of insurance undertakings by allowing Member States not to bring those bodies within the

⁵⁸ The Seventh Directive requires that consolidated accounts when required under the Directive, be audited. However, where a small or medium-sized group elects to prepare consolidated accounts, although it is not required to under the Directive (e.g., to provide additional information about the group's performance to its shareholders), there is no statutory requirement that these accounts be audited.

⁵⁹ See http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_224/l_22420060816en00010007.pdf.

scope of the directives when implementing them. The gap in respect of banks was filled by the Bank Accounts Directive, and the gap in respect of insurance undertakings was filled by the Insurance Accounts Directive.

88. The Bank Accounts Directive (86/635/EEC)⁶⁰ applies to the annual and consolidated accounts of banks established in the EU regardless of their legal form (but not to branches, see paragraph 101). The Bank Accounts Directive covers the same areas as the Fourth and Seventh Directives and most of its general provisions are to be read across directly from them. Apart from applying these read-across provisions to banks, the directive sets out specific formats for the balance sheet and for profit and loss statements; it determines what items should be included under each statement heading; it requires a number of additional disclosures in the notes to the accounts; it establishes specific measurement principles; and it adapts the consolidation requirements set out in the Seventh Directive.

89. The provisions set out in the directive contain a number of options for Member States:

- “Hidden reserves”: Member States have the option to allow banks to understate by up to 4 per cent the value of certain assets (e.g., loans and advances). The principal arguments for the maintenance of these “hidden reserves” – which had been widely used in the past – related to the importance of maintaining confidence and thus stability in financial markets and the consequent need to smooth out the fluctuation in profits from year to year inherent in the banking business. The principal arguments against the maintenance of “hidden reserves” were that they limited the usefulness of the profit figure in the accounts as an indicator of performance and that their existence is inconsistent with the need for creditors and shareholders to be in a position to make informed assessments of a bank’s financial strength, its short-term performance and long-term trends.
- Fund for general banking risks: if the “hidden reserves” option is permitted but not exercised, Member States have the option to permit banks to create a fund for general banking risks; if “hidden reserves” are not permitted, the directive requires that banks be permitted to create such a fund. The fund is intended as a means of allowing banks to set aside amounts required to cover “the particular risks associated with banking” and is disclosed as a balance sheet liability.
- Foreign currency translation: the general rule was that assets and liabilities should be translated at the spot rate at the balance sheet date. Member States may, however, require or permit assets held as non-monetary assets to be translated at the rates ruling on the dates of their acquisition. Outstanding forward and spot exchange transactions should be translated at the spot rates of exchange ruling on the balance sheet date. However, Member States may require forward transactions to be translated at the forward rate ruling on the balance sheet date. The directive also included a number of other options regarding foreign exchange translation.

⁶⁰ For the most recent consolidated version of the Bank Accounts Directive, see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1986L0635:20060905:EN:PDF>.

90. There is some doubt as to whether the application of the specific recognition and measurement possibilities of the Bank Accounts Directive provides a true and fair view of the financial position and performance of banks. Also, the many options available to Member States hinder comparability within the EU. At the time of the adoption of the directive, the more important policy prerogative appeared to be maintaining public trust in the stability of the banking sector by allowing income smoothing and the creation of reserves. The requirement to apply endorsed IFRS changed this drastically for publicly-traded banks, which prepare consolidated accounts (see paragraph 105).

91. After IFRS became mandatory for the consolidated accounts of publicly-traded banks, the Committee of European Banking Supervisors (which became the European Banking Authority - EBA - in January 2011) issued guidance on a standardized financial reporting framework for banks based on IFRS (FINREP).⁶¹ This framework should enable banks to use the same standardized data formats and data definitions for financial reporting in all countries where the framework will be applied. This is intended to reduce the reporting burden for banks that have cross-border operations, and to reduce the barriers to the development of an efficient internal market in financial services. CEBS published a revised version of its guidelines on 15 December 2009. Changes in IFRS which have been endorsed by the European Commission have been incorporated into the revised FINREP. Further major changes to the accounting standards governing banks are expected and FINREP will be revised in due course to take account of the changes that may arise in IAS 39 (IFRS 9), as well as IAS 1.

92. CEBS also published Guidelines on Common Reporting (COREP).⁶² These guidelines are intended to be used by banks when preparing prudential reports to be sent to any EU Supervisory Authority according to the new capital framework established in the Capital Requirements Directive, which implements the revised international capital framework (Basel II) in the EU. This international regulatory framework is itself being reviewed in the wake of the international financial crisis ("Basel III") and the EBA, as CEBS successor, will amend the COREP guidelines once these changes are implemented in the EU.

d. Insurance Undertakings Directive (the "Insurance Accounts Directive")⁶³

93. The Insurance Accounts Directive (91/674/EEC)⁶⁴ draws on a large number of the provisions in the Fourth and Seventh directives which had not, until then, applied to insurance undertakings. Notwithstanding a few exceptions (e.g. undertakings which are not companies within the meaning of Article 58 of the Treaty and certain bodies or mutual associations), the directive applies to undertakings engaged in life, non-life or reinsurance business.

⁶¹ See <http://www.eba.europa.eu/Supervisory-Reporting/Introduction.aspx>

⁶² See <http://www.eba.europa.eu/Supervisory-Reporting/COREP.aspx>

⁶³ This section draws on a Consultative Document issued by the Department of Trade and Industry, United Kingdom in June 1992.

⁶⁴ For the most recent consolidated version of the Insurance Accounts Directive, see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31991L0674:EN:NOT>

94. The directive requires insurance undertakings to prepare accounts comprising a balance sheet, a profit and loss account, and notes. The directive requires that the accounts be prepared in accordance with its detailed provisions and, by referring to the Fourth and Seventh Directives, requires that individual and consolidated accounts give a true and fair view of the financial position and performance of insurance undertakings. This had not been required for insurance undertakings throughout the EU prior to the directive.

95. The differences from the requirements which are imposed on companies in general (through the Fourth and Seventh Directives) include, but are not limited to, the following issues:

- Valuation of investments: most assets of insurance undertakings are investments held to meet future liabilities to policyholders and therefore there is considerable interest in the method of valuation employed. The categories of fixed and current assets required by the Fourth Directive are abandoned in favor of a single concept of investments which includes all lands and buildings.⁶⁵ The Insurance Directive provides that investments may be valued either according to historical cost principles or at current value (values according to the non-chosen option should however be presented in the notes). It does not seek to choose between the merits of either method.
- The fund for future appropriations: a Member State may permit an insurance undertaking to include amounts whose allocation either to policyholders or to shareholders remains undetermined at the close of the financial year. The fund for future appropriations is largely a holding account to enable a smooth flow of surplus to emerge.
- Deferred acquisition costs: the Insurance Directive requires that the costs of acquiring insurance policies be deferred in accordance with the Fourth Directive, insofar as a Member State decides not to prohibit deferral.
- Technical provisions: the directive requires insurance undertakings to draw up sector-specific provisions, including technical provision for unearned premiums, life assurance provision, claims outstanding and equalization provisions.⁶⁶

96. While the directive broadly harmonizes accounting for insurance undertakings in the EU, the existence of numerous options restricts comparability. The requirement to apply endorsed IFRS changed this drastically for publicly-traded insurance undertakings which prepare consolidated accounts (see paragraph 105).

97. In addition, the European Commission is undertaking a significant amount of work to improve the links between the annual/consolidated accounts and the supervisory returns required from insurance undertakings. This issue is particularly important in the context of the Commission's proposed new regulatory framework for insurance companies ("Solvency II"), as it relates to the issue of highlighting what are supervisors'

⁶⁵ Land and buildings occupied by the insurance undertaking must be disclosed separately.

⁶⁶ Provision to compensate the frequent fluctuation in claims that characterize natural events.

needs for accounting information, as well as identifying possible alternatives where such information or inputs can be found.⁶⁷

98. The prudential directives require every insurance undertaking to produce an “annual account, covering all types of operation, of its financial situation, [and] solvency [...]”⁶⁸ There is no general requirement that this set of annual accounts should be established in accordance with the Insurance Accounts Directive or endorsed IFRS.

99. However, to a large extent Member States have used financial reporting and supervisory reporting requirements to arrive at a situation where the same accounting rules are used for both purposes. Several Member States use the same set of accounts in principle without adjustments; others perform certain adjustments or require additional information for supervisory purposes. A few Member States have more extensive supervisory reporting rules, in certain cases leading more or less to a separate set of prudential financial statements. However even these separate financial statements normally take the annual and consolidated accounts as their starting points.

100. The Commission evaluated different accounting alternatives for the Solvency II project. In that context, there appears to be increasing alignment between the unfolding proposals for Solvency II and the International Accounting Standards Board (IASB) project on Insurance Contracts (IFRS4 Phase II). The IASB originally planned to issue the standard on insurance contracts in 2011. The Committee of European Insurance and Occupational Pensions Supervisors (which was transformed into the European Insurance and Occupational Pensions Authority - EIOPA - in January 2011) has advised the European Commission on the development of Solvency II and presented a paper to the IASB outlining the structure and work of Solvency II, arguing that the solvency system should be compatible with IFRS.

e. Other relevant Company Law Directives and “soft law” Instruments

101. A number of other important directives and “soft law” instruments relate to accounting, including:

- Directive 2009/101/EC on coordination of safeguards for the protection of the interests of members and third parties.⁶⁹ Among other things, the Directive requires companies to publish specific company information in a commercial register or companies register in the Member State in which they are registered. Member States shall ensure that the filing of all documents is possible by electronic means.

⁶⁷ The solvency margin is the amount of regulatory capital an insurance undertaking is obliged to hold against unforeseen events. Solvency margin requirements have been in place since the 1970s and have been amended by the Solvency I Directives in 2002. Whereas the Solvency I Directives aimed at revising and updating the current EU solvency regime, the Solvency II project is a fundamental and wide-ranging review of the current insurance Directives to ensure adequate policy-holder protection in all EU Member States.

⁶⁸ See Directive 73/239/EEC Article 19, Directive 79/269/EEC Article 23.

⁶⁹ Before 21 October 2009, this Directive was referred to as the First Company Law Directive - 68/151/EEC. See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1968L0151:20070101:EN:PDF>

Financial information which is required to be published in accordance with EU Directives must be included in the documents available in the register. A copy of the whole or any part of the documents must be obtainable on application by paper means or by electronic means as the applicant chooses.

- The Second Company Law Directive (77/91/EEC): minimum capital and capital maintenance.⁷⁰ The Second Directive was adopted in 1976. It sets forth the means of coordination of safeguards for the “minimal equivalent protection for both shareholders and creditors” of public liability companies. It sets out two principles which Member States must adhere to (i) the minimal capital with which a company must initially begin and subsequently maintain, and (ii) shareholders’ rights regarding the issuance of new capital and the payment for shares. It includes detailed rules on the formation and the maintenance, increase or reduction of their capital. Profit distribution is also regulated.
- The Eleventh Company Law Directive (89/666/EEC): disclosure requirements in respect of branches.⁷¹ The Eleventh Directive, adopted in 1989, sets forth the disclosure requirements for branches of companies operating in Member States. These branches can be of a company under the jurisdiction of another Member State or of a third country. While subsidiaries of companies incorporated in one Member State fall under the jurisdiction of the host Member State, the treatment of foreign branches of a company was unclear until the adoption of the Eleventh Directive.
- Directive 89/117/EEC: accounting documents of branches of foreign credit and financial institutions.⁷² This directive extends the Eleventh Directive to include branches of credit institutions.
- Recommendation 2001/453/EC: recognition, measurement and disclosure of environmental issues in the annual accounts and annual reports of EU companies.⁷³ This recommendation was adopted in order to address the lack of harmonization of Member States’ rules and definitions concerning the disclosure of environmental information. Because this information was often considered to be unreliable or was lacking altogether, this Commission recommendation seeks to set a standard for its disclosure.

ii. Developing Integrated and Liquid Capital and Financial Markets: Regulation (EC) 1606/2002 on the Application of IFRS

a. Developing Integrated and Liquid Capital and Financial Services Markets

102. These accounting directives brought about a degree of harmonization and improvements in the quality of financial information across the EU; however, by the end of the 1990s it was clear that financial statements drawn up in compliance with the Fourth and Seventh directives did not fully achieve the intended policy objectives, in-

⁷⁰ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1977L0091:20070101:EN:PDF>; As a follow up to the Company Law Action Plan, substantial amendments were introduced by Directive 2006/68/EC of 6 September 2006 to simplify and modernize the Second Directive.

⁷¹ See http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi:celexplus:prod!DocNumber&lg=en&type_doc=Directive&an_doc=1989&nu_doc=666

⁷² See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31989L0117:EN:HTML>

⁷³ See http://eur-lex.europa.eu/LexUriServ/site/en/oj/2001/l_156/l_15620010613en00330042.pdf

cluding the creation of an integrated market in financial services as set out in the FSAP adopted in May 1999 (see paragraph 36).

103. In 2000, the Commission outlined a strategy designed to eliminate the remaining barriers to cross-border trading in securities. In particular, this strategy recommended that there be one set of accounting standards so that company accounts throughout the EU would be more transparent and could be compared more easily. The Commission indicated that the adoption of IFRS (then International Accounting Standards) was the way forward.

"[The adoption of IFRS] signals Europe's firm intention to remove accounting differences as a step forward towards developing integrated, deep and liquid capital and financial services markets to improve capital raising efficiency while preserving investor protection."

Frits Bolkestein, *Commissioner for the Internal Market*, Brussels, June 2000.

104. Right at the outset, the Commission stressed two fundamental preconditions for achieving its policy objectives:

- The need for legal certainty: the Commission contemplated the establishment of an endorsement mechanism at the level of the EU with a two-tier structure (a technical level and a political level) to confirm the standards that would have to be applied (See Box 5: Major Bodies Involved in the Endorsement of IFRS in the EU).
- The need for proper enforcement: the Communication noted that high quality accounting standards would not automatically guarantee transparent financial reporting; rigorous and disciplined application would be vital for the credibility of accounts. To achieve this, the Commission stressed the need for high quality statutory audit (which partly led to the revision of the Eighth EU Company Law Directive as discussed in paragraph 121) as well as strengthened co-ordination among European securities regulators in order to establish the consistent enforcement of high quality financial reporting throughout the EU.

b. Regulation (EC) 1606/2002 on the Application of IFRS

105. Regulation (EC) 1606/2002 of the European Parliament and of the Council on the application of IFRS⁷⁴ ("Regulation 1606/2002") was issued on July 19, 2002. It requires publicly-traded companies, including banks and insurance companies, to prepare their consolidated accounts in accordance with IFRS endorsed by the EU for financial years beginning January 1, 2005.⁷⁵ Within this paper, "publicly-traded companies" are those

⁷⁴ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2002R1606:20080410:EN:PDF>.

⁷⁵ The Regulation allows Member States to defer the application of certain provisions until 2007 for those companies publicly-traded both in the EU and on a regulated third-country market which are already applying another set of internationally accepted standards as the primary basis for their consolidated accounts as well as for companies which have only publicly-traded debt securities.

companies with securities admitted to trading on a regulated market in the EU (See Box 4: Regulated Market). Understanding what a “regulated market” entails is therefore important to assess the actual scope of Regulation 1606/2002.

Box 4: Regulated Market

A “regulated market” is defined in Article 4(1), point 14, of Directive 2004/39/EC of the European Parliament and of the Council of April 21, 2004 on markets in financial instruments (MiFID), i.e. “a multilateral system [...], which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments [...], and which is authorized and functions regularly [...]”

In accordance with Article 47 of the MiFID Directive, each Member State draws up a list of the regulated markets for which it is the home Member State and forwards it to the Commission.⁷⁶ The Commission publishes a list of all regulated markets in the Official Journal of the EU and updates it at least once a year.

In the UK, for example, the Main List is a “regulated market”. By contrast, the Alternative Investment Market (“AIM”) is an “exchange-regulated market” (under MiFID, exchange-regulated markets are now referred to as “multilateral trading facilities” (MTFs). Therefore, companies quoted on AIM are not subject to the requirements of Regulation 1606/2002.

Application of IFRS in Annual Accounts

106. In accordance with the principle of subsidiarity, Regulation 1606/2002 gives Member States the option to permit or require publicly traded companies to prepare their annual accounts in conformity with endorsed IFRS. Also, Member States may extend this permission or this requirement to other companies as regards the preparation of their consolidated accounts and/or their annual accounts. As of the date of this publication, only a few Member States have exercised the option to require the use of IFRS in their annual accounts (e.g., Bulgaria, Cyprus, Malta and, in Estonia, Latvia, Lithuania, Slovakia, Slovenia, for credit institutions); all member states have to some extent exercised the option to allow other companies to use IFRS for their consolidated financial statements. The Commission regularly updates a table summarizing the intentions and decisions of Member States and EEA countries concerning their use of these options in Regulation 1606/2002.⁷⁷

107. The small number of Member States requiring (or, to a lesser extent, allowing) companies to use IFRS is partly explained by the fact that IFRS are increasingly developed to address the needs of large, publicly accountable entities. This is implicitly recognized by the IASB’s Basis for Conclusions of the IFRS for Small and Medium-sized Entities.

⁷⁶ See http://ec.europa.eu/internal_market/securities/isd/index_en.htm.

⁷⁷ See http://ec.europa.eu/internal_market/accounting/docs/ias/ias-use-of-options_en.pdf.

The IASB noted that “circumstances of SMEs can be different from those of larger, publicly accountable entities in several ways, including:

- The users of the entity’s financial statements and their information needs;
- How the financial statements are used;
- The depth and breadth of accounting expertise available to the entity; and
- SMEs’ ability to bear the costs of following the same standards as the larger, publicly accountable entities.”

Legal Certainty

108. The IASB is the body which issues IFRS.⁷⁸ However, IFRS are not automatically adopted by the EU as they are issued by the IASB. Instead, each standard must first be endorsed individually by the European Commission before it can enter into force. Article 3 of Regulation 1606/2002 sets three conditions that individual IFRS must meet in order to be endorsed and adopted for use under Regulation 1606/2002:

- Its application must result in a true and fair view of the financial position and performance of an enterprise: this principle is considered in the light of the Fourth and Seventh Directives but does not imply a strict conformity with each and every provision of those directives;
- It must be conducive to the European public good (this is sometimes interpreted as follows: “IFRS accounts should build the foundation of a level playing field for European companies to compete for financial resources on EU and international capital markets”); and
- It must meet basic criteria as to the quality of information required for accounts to be useful to users (i.e., the understandability, relevance, reliability and comparability required of financial information needed for making economic decisions and assessing the stewardship of management).

109. As of the date of this publication, the Commission has endorsed or is about to endorse all existing standards or amendments to standards (IASs and IFRSs) issued by the international standard setter and which are still applicable. However, some differences continue to exist concerning financial instruments. IAS 39 was approved with a “carve out” of some paragraphs concerning fair value hedge accounting. The IASB intends to replace IAS 39 with a new standard for financial instruments, IFRS 9. These standards and proposed standards are very much debated in Europe and none of them has been endorsed so far. In addition, the endorsement process requires time. Consequently, there will always be a risk that some standards become applicable in Europe at a later date than the one defined by IASB.⁷⁹ Regulation 1606/2002 also requires that interpretations of the standards be endorsed following the same procedure. All inter-

⁷⁸ See <http://www.iasb.org/Home.htm>.

⁷⁹ EFRAG frequently updates the Endorsement Status Report. The report contains an overview per issued standard and interpretation, listing the date of the endorsement date and the date the endorsed standard/interpretation was published in the Official Journal of the European Union. See <http://www.efrag.org/content/default.asp?id=4090>

pretations by the Standards Interpretation Committee (SIC) before 2001 and the IFRS Interpretation Committee since then, relating to standards which are still applicable, have been approved by the Commission.

110. The endorsement process established by the Commission in accordance with Regulation 1606/2002 involves a number of stakeholders (see Box 5: Major Bodies involved in the Endorsement of IFRS in the EU). The endorsement process was established to act expeditiously on standards and interpretations adopted by the IASB. It also provides a framework to deliberate, reflect and exchange information on IFRS among the main stakeholders in financial reporting in the EU, in particular national accounting standard setters, supervisors in the fields of securities, banking and insurance, central banks including the European Central Bank, the accounting profession and users and preparers of accounts.

Box 5: Major Bodies involved in the Endorsement of IFRS in the EU

The **European Financial Reporting Advisory Group (EFRAG)**,⁸⁰ is a private-sector initiative set up in 2001 by a number of parties in Europe involved in financial reporting (e.g., users, preparers, the accountancy profession, national standard setters). Its work comprises two main tasks: providing input to the IASB in the standard-setting process, and providing technical advice to the Commission on the application of IFRS in Member States. When the IASB issues a new standard, EFRAG reviews it and issues an opinion on it; EFRAG also elaborates an analysis of the costs and benefits of each IFRS for both EU users and preparers and forwards the documents to the European Commission. EFRAG is made up of a Technical Expert Group (TEG), which conducts the majority of the technical evaluation and advice, and a Supervisory Board to ensure European interest and legitimacy. EFRAG is to act in the interest of Europe as a whole, and not in any national or other interest. EFRAG's technical group meets on a monthly basis and must respond to the Commission with its endorsement advice within two months of an IFRS being published by the IASB.

The **Accounting Regulatory Committee (ARC)**⁸¹ was established by Article 6 of Regulation 1606/2002 to provide the Commission with an opinion on proposals to endorse new IFRS and amendments to existing IFRS. It is composed of high-level representatives from Member States, mainly from the respective Ministries of Finance, and is chaired by the Commission. The ARC decides on the applicability of the IFRS within the EU based on existing Member State and Community legislation.

The **European Commission**⁸² first receives the technical opinion from EFRAG. The Commission then makes a proposal to either adopt or reject the standard (or amendment) and submits this proposal directly to the ARC along with a report detailing the standard and its conformity with the existing Accounting Directives.

⁸⁰ See <http://www.efrag.org/>

⁸¹ See http://ec.europa.eu/internal_market/accounting/committees_en.htm#arc

⁸² See http://ec.europa.eu/index_en.htm

The Commission can endorse the standard if:

- the ARC approves the standard and the EP and the Council do not oppose; or
- in the event the ARC does not approve the standard, the Commission may override the ARC's refusal with support from the Council and the EP.

When the ARC issues a positive opinion on a standard, the Commission then forwards it to the Parliament⁸³ and to the Council⁸⁴, which have a three-month period to scrutinize the standard. Should the Parliament or the Council oppose the proposed standard, the Commission may not adopt it.

In February 2007, the European Commission appointed the seven members of the **Standards Advice Review Group**⁸⁵ whose task is to advise the Commission on the endorsement process of IFRS and the decisions of the IFRS Interpretations Committee. It will assess whether EFRAG's opinions on the endorsement of IFRS and interpretations from the IFRS Interpretations Committee are balanced and objective.

Proper Enforcement

111. The European Commission had recognized that only properly enforced IFRS would bring about the expected policy objectives (see paragraph 104). Also, as discussed in paragraph 145, proper enforcement was one of the pre-conditions for the US Securities and Exchange Commission (SEC) to eliminate the need for reconciliation between IFRS and US GAAP for European companies issuing securities on US capital markets.

112. In this context, Regulation 1606/2002 requires Member States to take appropriate measures to ensure compliance with IFRS. The Committee of European Securities Regulators (CESR; since January 2011, the European Securities Markets Authority, ESMA) has developed a common European approach to enforcement.⁸⁶ The Review Panel, a peer pressure group established in 2003 by CESR, intends to contribute to supervisory convergence through the consistent and timely implementation of Community legislation in the Member States. It maintains a database on the implementation of CESR standards on financial reporting covering Standard no.1 on Enforcement of standards on financial information and Standard no.2 on Co-ordination of Enforcement Activities.⁸⁷ ESMA has decided to maintain a database with the relevant enforcement decisions taken by independent EU National Enforcers in respect of financial statements.

⁸³ See http://www.eurparl.europa.eu/news/public/default_en.htm

⁸⁴ <http://www.consiliium.europa.eu/showPage.aspx?id=1&lang=en>

⁸⁵ See http://ec.europa.eu/internal_market/accounting/committees/sarg_en.htm

⁸⁶ See <http://www.cesr-eu.org/index.php?page=&mac=0&id=>

⁸⁷ See respectively <http://www.esma.europa.eu/popup2.php?id=6061> and <http://www.esma.europa.eu/popup2.php?id=5788>

The purpose of this is to increase convergence amongst enforcers' activities across Europe. The most relevant of these decisions are gathered by the European Enforcers Co-Ordination Sessions (EECS) and are published on the ESMA website.⁸⁸

c. Interaction between Regulation 1606/2002 and the Accounting Directives

113. With the adoption of Regulation 1606/2002 and the subsequent endorsement of individual standards, IFRS have become part of the *acquis communautaire*. The regulation does not supersede the existing accounting directives. However, since the accounting directives apply to companies through their transposition into national law, there is no direct interaction between the accounting directives and the regulation; only the latter is directly applicable to companies. Specifically, the interaction is one between national law and Regulation 1606/2002.

114. The issue of interaction is only relevant to the extent that national law deals with the same subject matter as Regulation 1606/2002. Some aspects of national law which have been transposed from the accounting directives deal with matters outside the scope of the Regulation and continue to apply (e.g. the responsibility for the preparation of accounts, the requirement for a statutory audit, the requirement for publication of accounts). In 2003, the Commission commented on these matters and clarified the interaction between the directives (as implemented by Member States) and Regulation 1606/2002.⁸⁹

iii. Other Relevant Financial Market Directives

115. Prospectus Directive (2003/71/EC)⁹⁰: the Prospectus Directive, which replaced the Public Offer Directive and some parts of the Consolidated Admission and Reporting Directive, came into force on 31 December 2003. It regulates the laws in relation to the drawing up and the publication of prospectuses when securities are offered to the public and/or admitted to trading on a regulated market in the EU. It is a maximum harmonization directive in relation to the contents and format of prospectuses and, as such, Member States may not impose additional disclosure provisions to those required by the directive. One of the major consequences of the directive is the "passport", i.e. the ability to raise capital in any of the 27 Member States on the basis of a prospectus which has been drawn up and approved in one Member State. This was one of the central priorities set forth in the FSAP in 1999 (see paragraph 36). Directive 2010/73/EU of 24 November 2010 amends the original version of the Prospectus Directive in order to reduce to a minimum the burdens weighing on companies, without compromising the protection of investors and the proper functioning of securities markets in the Union.

⁸⁸ See http://www.esma.europa.eu/index.php?page=contenu_groups&id=58&docmore=1#doc

⁸⁹ See http://ec.europa.eu/internal_market/accounting/docs/ias/200311-comments/ias-200311-comments_en.pdf

⁹⁰ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2003L0071:20080320:EN:PDF>

116. The Prospectus Directive requires that issuers include consolidated accounts prepared in conformity with the requirements of Regulation 1606/2002, i.e. endorsed IFRS. The Commission regulation EC/1569/2007 of 21 December 2007 established a mechanism for the determination of equivalence of accounting standards applied by third country issuers of securities. The Generally Accepted Accounting Principles (GAAPs) of the US, Japan, China, Canada, South Korea and India were found to be equivalent to IFRSs as adopted by the EU. The Commission will review the situation of some of these (China, Canada, South Korea, and India) by 2011 at the latest. Under certain conditions, other third country issuers may also be permitted to use financial statements drawn up in accordance with other third country GAAP to provide historical financial information for a period commencing any time after 31 December 2008 and expiring no later than 31 December 2011.⁹¹

117. Transparency Directive (2004/109/EC)⁹²: the Transparency Directive addresses one of the central priorities set out in the FSAP, i.e. the transparency of financial information supplied by issuers whose securities are admitted to trading on a regulated market. Regulation 1606/2002 had already paved the way for a convergence of financial reporting standards throughout the EU for those issuers. The Transparency Directive builds on this approach with regard to annual and interim financial reporting. It requires that:

- an issuer shall make public its annual financial report at the latest four months after the end of each financial year; and
- an issuer of shares or debt securities shall make public a half-yearly financial report covering the first six months of the financial year as soon as possible after the end of the relevant period, but at the latest two months thereafter.

118. The annual financial report must include the audited accounts, the management report, and statements made by the persons responsible within the issuer, whose names and functions must be clearly indicated, to the effect that, to the best of their knowledge, the accounts prepared in accordance with the applicable accounting standards give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer and the undertakings included in the consolidation taken as a whole. Where the issuer is required to prepare consolidated accounts, the audited financial statements shall be drawn up in accordance with IFRS.

119. The Commission adopted on 8 March 2007 a directive laying out detailed rules for the implementation of certain provisions with regard to the harmonization of the transparency requirements prescribed within the original Transparency Directive, such as disclosure of certain voting rights, of the issuer's choice of home Member State, of the condensed set of half-yearly financial statements, and of any major holdings or changes thereto.⁹³

⁹¹ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:340:0066:0068:EN:PDF>

⁹² See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONLEG:2004L0109:20080320:EN:PDF>

⁹³ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:069:0027:0036:EN:PDF>

120. The Takeover Bid Directive (2004/25/EC)⁹⁴: The Takeover Bid Directive is another of the priorities set out in the FSAP to establish the minimum requirements for company takeovers involving issuers whose securities are admitted to trading on a regulated market. The directive requires Member States to have in place a designated national authority supervising takeover activities and to ensure equal treatment of security holders as well as sufficient time and information in advance of a takeover bid decision, among other stipulations.

B. AUDITING: THE ACQUIS COMMUNAUTAIRE AS IT APPLIES TO CORPORATE SECTOR AUDITING

121. On May 17, 2006, the European Parliament and European Council issued a new Eighth Directive on statutory audits of annual accounts and consolidated accounts which entered into force on June 29, 2006. This directive (2006/43/EC)⁹⁵ repeals and replaces the previously existing Eighth Company Law Directive issued in 1984 (the “old Eighth Directive”). Although the old Eighth Directive made major progress on harmonizing the education and training requirements for statutory auditors, it did not address how a statutory audit should be carried out and did not deal with ethical and independence principles in detail. Recognizing these shortcomings, the Commission issued in 1998 a Communication, *Statutory Audit – the Way Forward*, and established the EU Committee on Auditing.

122. The overall objective of the new Directive, which is often described as “the new Eighth Directive” is to improve and harmonize audit quality and to support public confidence in the statutory audit function. To that end, the directive sets out requirements for (a) education and training, (b) approval and registration of statutory auditors and audit firms, (c) ethical principles and auditor independence, (d) auditing standards, (e) quality assurance, (f) public oversight, (g) the appointment and removal of auditors, and (h) audit committees for public interest entities. In addition, the directive aims to improve the functioning of the Internal Market via provisions on recognition of auditors from other Member States and easing restrictive rules on the ownership and management of audit firms. The directive also promotes regulatory co-operation within the EU, and deals with the approval of auditors from third countries and the registration of audit firms from third countries.

Legislative approach

123. The directive is a minimum harmonization directive and, as such, Member States are allowed to enact more stringent or additional requirements. However, the directive prevents spill-over effects from more stringent national regulations in the case of group audits and issuers from other Member States. Furthermore, the directive supports the idea of home-country control on the basis of mutual recognition of equivalence and promotes close co-operation between Member State regulators. The European Group

⁹⁴ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2004L0025:20090420:EN:PDF>

⁹⁵ See http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/L_157/L_15720060609en00870_107.pdf

of Auditors' Oversight Bodies (EAOB) facilitates cooperation between audit regulators in the EU.

124. In line with the principle of proportionality, the directive sets out more stringent and/or additional requirements for the statutory audits of public interest entities (PIEs). The directive defines PIEs as publicly traded companies, banks, and insurance undertakings. It allows Member States to expand the definition of public interest entities.

125. The directive follows the Lamfalussy approach to capital market regulation by allowing the Commission to adopt (binding) implementing measures for certain provisions such as auditing standards, ethics and independence, quality assurance and the equivalence of third-country systems of quality assurance, discipline, and public oversight. The procedure involves Member States through the Audit Regulatory Committee and the European Parliament.

Education and Training

126. The directive makes few changes to the minimum requirements on education and training as compared to the old Eighth Directive. The education and training cycle includes university entrance or the equivalent level at the start, the completion of theoretical instruction, three years of practical training, some of which must be with a statutory auditor or audit firm, and a final examination of professional competence equivalent to university degree level. The directive lists the curriculum subject matters for the theoretical instruction, including accounting, auditing, tax, civil, commercial and company law. Furthermore, statutory auditors must undergo continuing education programs in order to maintain their approval and registration.

Approval and Registration of Statutory Auditors and Audit Firms

127. Only persons who have met the qualification requirements and are of good repute can be approved as statutory auditors. They must be registered in an electronically accessible public register before they can conduct statutory audits.

128. The directive also requires the approval and registration of audit firms. It sets out restrictions on the ownership and management of audit firms. Natural persons having the relevant knowledge (or, should Member States decide so, statutory auditors) or other audit firms shall have at least a majority of the voting rights and represent a majority of members in the administrative or management body. The majority threshold should not exceed 75% in the latter case. This is to ensure that the statutory audits cannot be compromised by other commercial interests or undue influence.

129. However, under the old Eighth Directive, some Member States required auditors and audit firms to be approved nationally, sometimes preventing foreign ownership and management of national audit firms. Such restrictions on approval are no longer possible under the new Eighth Directive, and Member States must allow statutory auditors or audit firms approved in other Member States to own and manage audit firms. In addition, restrictions on ownership and voting rights have been reduced compared to the old directive. Statutory auditors carrying out an audit on behalf of an audit firm should always be approved and registered in the host Member State.

Ethics and Independence

130. The directive contains stipulations on professional ethics (public interest, integrity, objectivity and professional competence), independence, and confidentiality and professional secrecy. The approach to auditor independence builds upon the Commission's recommendation on auditor independence, whereby the statutory auditor self-assesses the risks to his independence and applies mitigating safeguards. In many ways the Recommendation is comparable to the Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants (IESBA). However, full compliance of the IESBA Code with the combination of the recommendation and the new Eighth Directive has not yet been demonstrated. The new Eighth Directive states that statutory auditors or audit firms shall not carry out a statutory audit if there is any direct or indirect financial, business, employment or other relationship – including the provision of non-audit services – between the statutory auditor, the audit firm or the network to which the audit firms belongs, and the audited entity that would compromise the independence of the auditor.

131. Member States have diverging views as to what discretion can be given to the auditor to self assess the risks to their independence. Therefore, the directive gives the Commission the possibility of adopting binding implementing measures that would narrow the auditor's discretion in assessing risks and applying safeguards. The Commission could, for example, adopt a list of prohibited non-audit services. The auditor's assessment of his independence is complemented by other safeguards included in the directive, such as the audited entity having to disclose in the notes to its financial statements the audit fee and the fees for non-audit services paid to its statutory auditor or audit firm. In the case of the statutory audit of public interest entities, the auditor has to declare in writing his independence and disclose any additional services to the entity's audit committee; the key audit partner should be rotated at least every seven years.

Auditing Standards

132. The directive provides that Member States must require the use of International Standards on Auditing (ISA) after they have been adopted by the Commission through the comitology process (or as delegated acts under the Lisbon Treaty). However, the directive does require the Commission to adopt ISA or set out a timescale for it to do so, though it sets out basic conditions which have to be met before ISA could be adopted. ISAs should (a) have been prepared following a proper due process, (b) be of high quality, and (c) be conducive to the European public good. Member States may add to, or in exceptional circumstances carve out, elements of ISA only when it relates to legal differences in the scope (mandate) of the statutory audit, which may differ from the scope defined in ISA.

133. The directive also has a specific provision on international group audits, for which the group auditor should be solely responsible and have appropriate documentation concerning the audit of components in third countries. The directive prescribes that the individual auditor shall case sign the audit report to stipulate his professional accountability.

Quality Assurance

134. Each Member State shall establish a system of quality assurance covering all statutory auditors and audit firms in compliance with the functional criteria of the directive. The system of quality assurance shall be independent from the reviewed statutory auditors and audit firms, have secure and independent funding, have sufficient resources, and be of sufficient quality. The directive also defines the scope of the quality review/inspection as an assessment of compliance with auditing standards and independence requirements, and defines the quantity and quality of the resources to be used. Quality assurance must take place at least every six years (every three years for statutory audits of public interest entities), with the overall results being published annually and, where needed, followed up on.

135. The Commission issued on 6 May 2008 Recommendation 2008/362/EC on external quality assurance for statutory auditors and audit firms auditing public interest entities.⁹⁶ This recommendation provides guidance for implementing independent quality assurance systems for statutory auditors and audit firms conducting an audit of public interest entities. Independent oversight bodies must play an active role in the inspections of audit firms. The recommendation provides guidance for ensuring the independence of the inspection system. Focusing on PIEs is justified by the priority given to co-operation between Member States and third country oversight bodies. However, the Commission considered that there is no need to provide detailed guidance with regard to the quality assurance systems for statutory auditors and audit firms auditing entities other than public interest entities.

System of Public Oversight

136. Each Member State must establish an effective system of public oversight in compliance with the functional criteria of the directive. This system is to be governed by non-practitioners knowledgeable in areas relevant to statutory audit and will subject all statutory auditors and audit firms to public oversight. This aspect overlaps with many of the others set forth in the directive, as this system will have the ultimate oversight not only of auditor approval and registration, but also of all standards adoption, continuing education, quality assurance, and investigative and disciplinary systems. There is to be coordination between respective Member State systems of public oversight, in addition to mutual recognition of regulatory arrangements between Member States. Member States are responsible for designating the competent authorities to carry out the duty of public oversight and to co-ordinate cooperation at EU level. The European Commission has published a list of competent authorities for the tasks provided for in the statutory audit directive; this mainly comprises those bodies charged with public oversight activities.⁹⁷

Appointment and Dismissal

137. In order to keep a sufficient arm's length distance between the management of the company and the auditor, the auditor shall not be directly selected and appointed by

⁹⁶ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:120:0020:0024:EN:PDF>

⁹⁷ See http://ec.europa.eu/internal_market/auditing/docs/dir/100201_competent_authorities_SAD_en.pdf

the company's management, but rather by the general meeting of shareholders. The directive also specifies that the dismissal of auditors during their mandate can be done only on proper grounds and must be communicated to the public oversight authority.

Statutory audit of Public Interest Entities (PIEs)

138. The directive includes some additional requirements concerning the statutory audit of PIEs. Audit firms which audit PIEs must present an annual transparency report with information on the firm's (a) legal structure, (b) governance and ownership, (c) network arrangements, (d) systems of internal quality control, and (e) the basis of partners' remuneration.

139. PIEs must have an audit committee with specified tasks such as monitoring the financial reporting process and statutory audit. The audit committee is an important element for safeguarding audit quality and auditor independence, and it is involved in the selection of the auditor. The statutory auditor must report to the audit committee on key matters arising during the audit and on independence issues. The directive provides several exemptions from the audit committee requirement, such as for subsidiaries and investment undertakings.

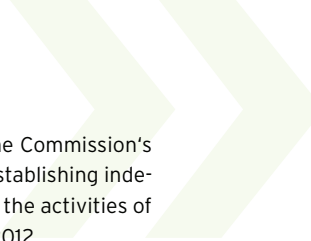
Approval of Third-country Auditors

140. Competent authorities of Member States may approve third-country auditors as statutory auditors. These third-country auditors are subject to the same approval procedure as Member State auditors wishing to carry out audits in a second Member State, mandating good repute as well as the above mentioned educational requirements.

Registration of Third-country Audit Firms

141. Third-country (i.e. non-EU) auditors and audit firms are subject to registration where they audit a company which has equity and/or debt traded on an EU Member State regulated market. This may be waived in some cases with regard to debt securities traded by professional investors. Registered third-country auditors and firms will be subject to the same systems of oversight, quality assurance, and investigation and penalty systems as their EU equivalents. The new Eighth Directive sets out more specific limitations for the registration of third-country audit entities. Mainly, such audits should be carried out in accordance with ISAs or equivalent approved standards. The directive also sets out the specifics of cooperation with competent authorities from third-countries, as regards working arrangements and the transfer of working papers or other documents.

142. Third-country auditors and auditing entities may be exempted from these requirements if their third-country system has been deemed as equivalent to the EU system with respect to public oversight, quality assurance, investigations and penalties. On 19 January 2011, the Commission decided to recognize the equivalence of the audit oversight systems in 10 third countries (Australia, Canada, China, Croatia, Japan, Singapore, South Africa, South Korea, Switzerland and the USA). This not only allows Member States to exempt the statutory auditors and audit firms originating from these countries from registration, but also allows their oversight authorities to have access to



audit working papers for the purpose of their oversight activities.⁹⁸ The Commission's assessments show that 20 other third countries are in the process of establishing independent public oversight systems for auditors. A transitional period for the activities of auditors from these 20 third countries has been granted until 31 July 2012.

⁹⁸ Articles 46 and 47 of Directive 2006/43/EC – The EC Decision of 19 January is published in the Official Journal of the EU L/15 of 20 January 2011.

IV. CURRENT ISSUES

143. The EU has made great strides in harmonizing corporate sector accounting and auditing within its Member States. As is evident in the recent adoption of the new Eighth Directive and the updates to the Fourth and Seventh Company Law Directives, the EU's efforts have intensified over time and are increasingly international in scope. Despite this progress, there a number of issues which the EU will need to address either in the immediate future or in the longer term. These include the convergence of IFRS with US GAAP and other GAAP and the recognition of equivalence between these standards; financial reporting by SMEs; the handling of registration and oversight of third country auditors and audit entities; the resolution of the debate surrounding the extent of auditor liability; the Commission's proposed adoption of International Standards on Auditing (ISA) and more broadly the future role of statutory auditors.

A. IFRS CONVERGENCE WITH US GAAP AND RECOGNITION OF EQUIVALENCE

144. Until 2007, in order to be publicly traded on both American and European securities exchanges, European companies had to incur the costs of reconciling their financial statements with US GAAP.⁹⁹ The European strategy towards IFRSs was partly motivated by the idea that global standards could avoid such reconciliation costs. From 2006, this issue became an important item on the agenda of the regulatory dialogue between EU and US policy-makers. After IFRS had been adopted for several years in Europe, the US Securities and Exchange Commission (SEC) decided on 15 November 2007 to do away with the need for foreign private issuers to reconcile financial statements drawn up in accordance with "IFRSs as published by the IASB" to US GAAP. However the decision was made on the understanding that the IASB and FASB would continue working on reducing the differences between the two major financial reporting frameworks, a process usually described as "convergence".

145. Convergence and consistent application of standards remain the essential elements for achieving the objective of having a single set of financial reporting standards for the world. In 2006, the FASB and the IASB agreed a Memorandum of Understanding (MoU) that described a programme to achieve substantial convergence between the two sets of standards. The two boards issued a further statement in November 2009 outlining further steps for completing their convergence work by 2011. The issue of the consistent application of standards was also a concern of securities supervisors in countries applying IFRSs and also in the US. In April 2004, the CESR issued its

⁹⁹ FEE Position Paper March 2006, "Financial Reporting: Convergence, Equivalence and Mutual Recognition".

Standard no. 2 on Financial Information - Coordination of Enforcement which aimed to achieve the necessary coordination and convergence of enforcement activities carried out by EU National Enforcers. This Standard is a principle-based standard establishing a framework that will be completed by implementation measures necessary for the realization of the identified principles.¹⁰⁰

B. IFRS CONVERGENCE WITH OTHER GAAP AND RECOGNITION OF EQUIVALENCE

146. EU Commissioner Charlie McCreevy stated in a speech in April 2006 that the EU would increasingly need to adapt its efforts to facilitate cross-border investment by taking international financial developments into account.¹⁰¹ Although the EU in the past has focused much of its attention on solving divergences with US financial market standards, there is growing interest in, and attention to, other international capital markets such as those of China and India. These countries are increasing their cooperation with the IASB in order to bring more transparency and comparability to their financial statements on the global markets. This was underlined by the Commission White Paper, Financial Services Policy 2005-2010 (see paragraph 36), in which the Commission declared its intention to widen its dialogue and cooperation with emerging players in the global financial markets and to seek their stronger representation in international bodies such as the Basel Committee and IOSCO.¹⁰²

147. As explained above (see paragraph 118), the European Commission regulation EC/1569/2007 of 21 December 2007 established a mechanism for the determination of equivalence of accounting standards applied by third country issuers of securities. Financial reporting standards of the US and Japan were found to be equivalent to IFRS as adopted by the EU. For some other countries (including China, Canada, South Korea and India), the Commission took temporary decisions in the expectation that these countries would move towards IFRSs by 2011 at the latest. Issuers from these countries are not obliged to restate historic financial information in accordance with endorsed IFRS. In addition, the SEC has already announced that it will decide during 2011 whether IFRSs may be used also by US-based issuers to prepare their financial statements. A positive decision from the SEC would clearly make IFRS a generally accepted global framework for financial reporting. In the meantime a growing number of countries around the world have decided to move towards IFRS, which makes any further equivalence decision superfluous.

¹⁰⁰ See http://www.cesr-eu.org/index.php?page=document_details&from_title=Documents&id=2047

¹⁰¹ Speech by Charlie McCreevy, EU Commissioner for Internal Market and Services, "Global convergence of accounting standards: the EU perspective", at the IASCF (International Accounting Standards Committee Foundation) Conference. 6 April 2005, Frankfurt.

¹⁰² See http://ec.europa.eu/internal_market/finances/docs/white_paper/white_paper_en.pdf

C. SME FINANCIAL REPORTING

148. The EU is increasingly prioritizing financial reporting issues for small and medium-sized enterprises (SMEs). As Günter Verheugen, Vice President of the European Commission responsible for Enterprise and Industry, stated “small and medium-sized enterprises are the engine of the European economy. They are an essential source of jobs, create entrepreneurial spirit and innovation in the EU, and are thus crucial for fostering competitiveness and employment.”¹⁰³ A recent report¹⁰⁴ concluded that there were approximately 3.7 million small companies and 66,000 medium-sized companies (as defined within the scope of the Fourth Directive) in the 20 Member States for which data were available.¹⁰⁵

149. As discussed previously, EU Member States can allow small companies to draw up abridged accounts and notes to the accounts, and to exempt small companies from the requirement for a statutory audit as well as from drawing up an annual report. Member States can also allow medium-sized companies to adopt a different layout for the profit and loss account, to present aggregate balance sheet information, not to draw up consolidated accounts, and to leave out non-financial information from the annual report. As a part of the Commission’s better regulation initiative, DG Internal Market and Services is examining further simplifications for SMEs in the field of financial reporting.

150. In July 2009, the IASB issued its IFRS for SMEs reporting standard, a simplified version of IFRS intended for use by SMEs, for whom the full IFRS was too complex. Several EU Member States expressed their intention to allow smaller companies to use this standard in their domestic environment. The European Commission launched a public consultation on the issue but no clear response resulted.¹⁰⁶ As demonstrated by EFRAG in a study commissioned by the Commission,¹⁰⁷ there are very few inconsistencies between accounting directives and IFRS for SMEs that would prevent a Member State from requiring or allowing this standard to be applied for companies falling outside the scope of regulation 1606/2002.

D. REGISTRATION AND OVERSIGHT OF THIRD-COUNTRY AUDITORS AND AUDIT ENTITIES¹⁰⁸

151. There are approximately 1,700 third-country companies with securities admitted to trading on a regulated market in the EU (mainly in Ireland, Luxembourg, and the United Kingdom). These issuers are incorporated in approximately 60 non-EU countries, pre-

¹⁰³ See http://ec.europa.eu/internal_market/accounting/docs/studies/micro_entity_en.pdf

¹⁰⁴ DG Internal Market. Report on impacts of raised thresholds defining SMEs: Impact assessment on raising the thresholds in the Fourth Company Law Directive (78/660/EEC) defining small- and medium-sized companies. December 2005. p.12. Online at http://www.lzra.lv/files/1150789014_EC_Report_impacts_of_raised_thresholds_defining_SMEs_0512.pdf#search=%22Ramboll%20small-sized%20companies%22

¹⁰⁵ Data were not available for Cyprus, Latvia, Lithuania, Malta, and the Slovak Republic.

¹⁰⁶ See http://ec.europa.eu/internal_market/accounting/sme_accounting/review_directives_en.htm

¹⁰⁷ EFRAG Compatibility Analysis: IFRS for SMEs and the EU Accounting Directives of 3 June 2010, <http://www.efrag.org/news/detail.asp?id=548>.

dominantly from high income countries (e.g. Australia, Japan, the United States) and middle income countries (e.g. Brazil, China, India, Russia, Turkey). A significant proportion of these issuers are incorporated in offshore financial centers, such as Bermuda and the Cayman Islands.

152. As discussed in paragraph 122, the basic premise of the Directive on Statutory Audit is that auditors of a company which issues equity or debt in a Member State should be subject to an equivalent minimum level of regulation, regardless of whether the auditor is regulated by that Member State, by another Member State or by a third country. This is intended to give investors in the EU a similar level of confidence in the auditors of companies in whose securities they invest, regardless of the country of incorporation of the issuing company.

153. To achieve this objective, the directive introduces stringent registration requirements for third-country audit entities. However, the directive permits exemption (in whole or in part) from this regime if the third country's regulatory system is deemed equivalent to the EU regime.

154. A number of observers have argued that the directive's provisions have an "extra-territorial" effect, which has some similarity to the Sarbanes-Oxley Act and potentially presents serious risks to EU capital markets' competitiveness as international financial centers.

155. With a growing number of third-country issuers seeking to raise capital on international markets (e.g. companies from China, India, Russia), these provisions will no doubt attract considerable interest from EU international financial centers seeking to maintain their competitive edge against capital markets where regulation is sometimes perceived as more onerous. While not wishing to regulate risks out of capital markets, EU policymakers and regulators seek to exempt countries on grounds of equivalence, in a way that is consistent with the directive's underlying objective.

156. As discussed above (see paragraphs 140-142), cooperation with public oversight authorities of third countries is an important element of the system of investor protection on European regulated markets. The adequacy of third countries oversight authorities is assessed in the light of the competences exercised by these authorities in the country concerned, the safeguards against breaching confidentiality rules and their ability under their own laws and regulations to cooperate with the competent authorities of European Member States. Reciprocity is also considered and this, for instance, delayed recognition of the adequacy of the PCAOB in the US until the US Congress had approved some amendments to the Sarbanes-Oxley Act.

¹⁰⁸ The Eighth Directive uses the term "audit firm" when referring to a legal person or any other entity that is approved in accordance with the Directive by the competent authorities of a Member State to carry out statutory audits. The Directive uses the term "audit entity" when referring to an entity which carries out audits of annual or consolidated accounts of a company incorporated in a third-country, i.e. outside of the European Union (as well as Norway, Iceland and Liechtenstein).

E. AUDITOR LIABILITY

157. Auditor liability has become a major issue across the EU and the world. Responding to this, the Commission launched a study into systems of civil liability which was completed in January 2001. One of the conclusions of the study was that auditor liability is part of a broader concept of national civil liability systems and that differences in auditors' civil liability are derived from the basic features of national legal regimes. The study concluded that harmonization of professional liability would be very difficult.

158. Article 31 of the Statutory Audit Directive requests the European Commission to present a report on the impact of current national liability rules for the carrying out of statutory audits on European capital markets and on the insurance conditions for statutory auditors and audit firms, including an objective analysis of the limitations of financial liability. As a first preparatory step, the Commission Services commissioned the consultancy firm London Economics to study these issues on an EU-wide scale. The study concluded that "the level of auditor liability insurance available for higher limits has fallen sharply in recent years. The remaining source of funds to face claims may essentially be the income of partners belonging to the same international network. Constantly large claims might therefore put at risk an entire network."¹⁰⁹

159. Subsequently the European Commission launched a public consultation on whether there is a need to reform rules on auditors' liability in the EU and on the possible ways forward. All respondents belonging to the audit profession expressed the need for a Commission initiative on auditors' liability, whereas other contributors had divided views on the matter.¹¹⁰

160. As a result of this consultation, on 5 June 2008, the European Commission approved a recommendation to Member States concerning the limitation of the civil liability of statutory auditors and audit firms. Article 2 recommends that "The civil liability of statutory auditors and of audit firms arising from a breach of their professional duties should be limited except in cases of intentional breach of duties by the statutory auditor or the audit firm." However, in view of the considerable variations between civil liability systems in the Member States, each of them will remain able to choose the method of limitation which it considers to be the most suitable for its civil liability system.¹¹¹

F. COMMISSION ADOPTION OF INTERNATIONAL STANDARDS ON AUDITING (ISA)

161. Article 26 of the Directive on Statutory Audit allows, but does not require, the European Commission to adopt International Standards on Auditing (ISA) for statutory audits of annual and consolidated accounts. The Commission's decision on adopting

¹⁰⁹ See http://ec.europa.eu/internal_market/auditing/docs/liability/auditors-final-report_en.pdf

¹¹⁰ See http://ec.europa.eu/internal_market/auditing/docs/liability/summary_report_en.pdf

¹¹¹ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:162:0039:0040:EN:PDF>

ISA will be a regulatory procedure with scrutiny by the Audit Regulatory Committee. In contrast to the provisions of Regulation 1606/2002 on the use of IFRS, the directive does not set a target date for such adoption.

162. In cases where the Commission has not endorsed an ISA covering a specific subject, EU Member States are allowed to apply their national auditing standards. However, once an ISA has been endorsed, statutory audits will have to be conducted in accordance with the endorsed ISA. Member States may add audit procedures or requirements or carve out parts of an ISA only if this is needed to meet national legal requirements relating to the scope of statutory audits.

163. Article 26 sets out three preconditions for ISA to be adopted, i.e., whether the standards (1) have been developed with proper due process, public oversight and transparency, and are generally accepted internationally; (2) contribute to a high level of credibility and quality of the annual and consolidated accounts; and (3) are conducive to the European public good. The directive states the Commission should review ISA and report to the Audit Regulatory Committee as to whether the ISA meet these requirements. The adoption of ISA will require translation and publication in full in the Official Journal of the EU in each of the 23 official languages of the EU.

164. To inform its decision on whether to adopt ISA, the European Commission organized a public consultation and commissioned two pieces of research on the evaluation of the differences between ISA and the standards of the US Public Company Accounting Oversight Board (PCAOB), and on the costs and benefits of an adoption of ISA in the EU. The overall conclusions of the latter study was that "On balance, adoption of clarified ISAs through the EU would contribute to the credibility and quality of financial statements and to audit quality in the EU, and to a greater acceptance of audit reports outside of their home jurisdictions within and outside of the EU. There are significant net benefits expected from the EU's adoption of ISA adoption beyond those expected from their adoption by the international auditing networks (grouped together in the Forum of Firms - FoF) or individual EU member states."¹²

165. The result of the consultation was equally positive. "The overwhelming majority of respondents to the consultation favor an adoption of the International Standards on Auditing (ISAs) at EU level. A significant majority of the respondents support the application of the ISAs to the statutory audit of all companies, including small companies for which an audit is required. The international acceptance of ISA is widely accepted by the respondents. Any amendments to ISA by either the European Commission or the Member States should be very limited. The vast majority of respondents support the adoption of the Application and Other Explanatory Material with a special status, however, not as best practice."¹³ However, at the time of writing the European Commission had not made a decision on whether to adopt ISA.

¹² See http://ec.europa.eu/internal_market/auditing/docs/ias/study2009/summary_en.pdf


¹³ See http://ec.europa.eu/internal_market/auditing/docs/isa/isa-final_en.pdf

G. THE FUTURE ROLE OF STATUTORY AUDITORS

166. In 2010, the European Commission published for comment a Green Paper entitled "Audit Policy - Lessons from the crisis". The Green Paper raised a number of questions that could help the Commission to define its future strategy on auditing. In particular, it identified the clarification of the role of auditors concerning risk management and going concern problems in a company as major topics. The Green Paper also discussed rules to avoid conflict of interests and possible remedies to the problem of concentration and choice in the audit market. Finally, the European Commission raised the question of whether systems of oversight needed to be enhanced and mechanisms developed at the EU level, which would also allow strengthening international cooperation. A summary of the 700 responses to this consultation was released by the European Commission early in 2011 and EU Commissioner Michel Barnier announced at a European Commission conference on auditing in February 2011 that he would be making legislative proposals on the issues raised by the Green Paper by the end of 2011.

TABLE OF ACRONYMS

ARC	Accounting Regulatory Committee
AuRC	Audit Regulatory Committee
CEBS	Committee of European Banking Supervisors (EBA since 1 January 2011)
CEIOPS	Committee of European Insurance and Occupational Pension Supervisors (EIOPA since 1 January 2011)
CESR	Committee of European Securities Regulators (ESMA since 1 January 2011)
CLAP	Company Law Action Plan
COREPER	Committee of Permanent Representatives (part of the Council of the European Union)
Council	Council of the European Union
DG	Directorate General
EBA	European Banking Authority (CEBS before 1 January 2011)
EC	European Commission
ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council
ECSC	European Coal and Steel Community
EEA	European Economic Area
EEC	European Economic Community
EFrag	European Financial Reporting Advisory Group
EIOPA	European Insurance and Occupational Pensions Authority (CEIOPS before 1 January 2011)
ENP	European Neighborhood Policy
ESMA	European Securities and Markets Authority (CESR before 1 January 2011)



EU	European Union
FEE	Fédération des Experts Comptables Européens / Federation of European Accountants (representative organization for the accountancy profession in Europe)
FSAP	Financial Services Action Plan
HLGCLE	High Level Group of Company Law Experts
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee (transformed into IASB in 2001)
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
ISA	International Standards on Auditing
MEP	Member of the European Parliament
SAP	Stability and Association Process
SEA	Single European Act
SEC	US Securities and Exchange Commission
SME	Small and Medium-sized Enterprise
TEG	Technical Expert Group of EFRAG
TFEU	Treaty on the functioning of the European Union
US GAAP	United States Generally Accepted Accounting Principles

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