



Accounting Standards Board

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Annette Grunberg
Corporate Law and Governance Directorate
Department of Trade and Industry
1 Victoria Street
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8 April 2005

Dear Ms Grunberg

Directive Proposals on Company Reporting, Capital Maintenance and Transfer of the Registered Office of a Company

- 1 This letter sets out the views of the Accounting Standards Board ('ASB') on certain of the issues raised in the above Consultative Document.
- 2 The ASB welcomes the Department's initiative in carrying out formal public consultation on proposals while they are still the subject of negotiation. This provides UK commentators with a structured and formal statement of what is or may be proposed on which they can form a considered judgement. We trust that the views of the Board and other commentators will be helpful to the Department in its further work on the relevant proposals. We hope that consultations will be carried out on future proposals at appropriate stages.
- 3 The Board's comments are set out below: these are followed by observations on the policy considerations that inform them. Responses to certain of the specific questions that the document raises are set out in the Appendix.
- 4 The Board does not wish to comment on the proposals for a Corporate Governance Statement discussed in Section 2 of the Consultative Document, nor on those in Section 4 (New Proposed Company Law (Transfer of Company Registered Office) Directive).

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Section 2: Draft Directive Amending the Fourth and Seventh Company Law (Accounting) Directives)

Main comments

- 5 The ASB regards the following points on the company reporting proposals as particularly important.
- (i) The proposals to require additional disclosures in the annual report and accounts do not fit well with our understanding of current European policy on financial reporting issues, which is centred on the adoption for use in Europe of International Financial Reporting Standards ('IFRS') and ensuring compatibility between the Accounting Directives and IFRS.
 - (ii) Any changes to the Accounting Directives should generally be limited to those necessary to remove inconsistencies with IFRS, and it is important that those changes should be made promptly, and swiftly reflected in UK legislation. Any other changes to the Directives should be limited to cases where their need can be clearly demonstrated and where new requirements are similar to, and wholly consistent with, those of IFRS. We accept that, in the climate created by recent corporate failures such as that of Parmalat, it is reasonable to propose amendments to the Directives to address perceived problems—but not that this should lead to requirements that are additional to those of adopted IFRS. Equally, it should be established that they do not set a precedent for future amendments to the Directives.
 - (iii) The proposals as drafted are too general to provide the legal certainty that is necessary for those preparing accounts.
 - (iv) We have particular concerns about the proposal that related party transactions are to be disclosed only if they are not 'concluded under commercial conditions'; the lack of an exemption from this requirement for subsidiary companies; and the focus on individual transactions rather than their effect in aggregate.
 - (v) To the extent that they are consistent with the above points, we agree that, in the present circumstances, amendments to the Directives in respect of off balance sheet finance and related party transactions are appropriate.



Policy considerations

- 6 European policy on financial reporting issues has long recognised that the Directives do not provide an adequate basis for the harmonisation of accounting requirements, and that this is particularly important in the case of companies that access the public capital markets. The EU Regulation, which requires EU listed companies to prepare their consolidated accounts in accordance with adopted IFRS (and allows Member States to require or permit individual accounts and accounts of other companies also to be prepared in accordance with those standards), recognises this.
- 7 One of the consequences of the EU Regulation is that the requirements of the Accounting Directives — and national legislation implementing those Directives — is not relevant to companies reporting under its requirements to the extent that they deal with matters within the scope of adopted IFRS. It can only create confusion to insert new requirements into the Directives that also apply to companies that prepare accounts under the EU Regulation. Where IFRS seem deficient, the right course is to make representations to the IASB to secure appropriate changes to IFRS.
- 8 There is no justification for imposing on companies that prepare their accounts under the Directives higher requirements than those that would apply under EU adopted IFRS. Any changes to the Directives should be limited to those necessary to enable companies reporting under the Directives to conform to the requirements of IFRS. In this context it would seem appropriate to consider likely changes to IFRS, including those that may emerge from the project on ‘Non-publicly Accountable Entities’. The extent to which national requirements are amended to reflect the requirements of IFRS may be best dealt with at the national level.

Section 3: Draft Directive Amending the Second Company Law (Capital Maintenance) Directives

Main comments

- 9 The ASB regards as important the following points relating to the proposals on capital maintenance:
 - (i) The ASB strongly urges consideration of wider reform, focussing on aligning any restrictions on distributions with their underlying purpose—the safeguarding of creditors’ interests. This seems most likely to be achieved by a solvency based approach.



- (ii) There is a legitimate interest in securing that no distribution of a company's assets to its members results in material prejudice to the interest of its creditors. It is also important that all holders of shares of the same class are treated equally, and that equitable treatment as between holders of different classes of shares is secured. Subject to this, however, there is no reason for the law to contain obstacles on the distribution of assets to members. To the extent that the proposals outlined in the consultative document would permit the abolition or relaxation of unnecessary restrictions they are, in principle, welcome.
- (iii) It is also desirable that there are adequate safeguards against the issue of shares (or instruments, such as share options, that convey the right to acquire shares) at an undervalue, as this prejudices the interests of shareholders.

Policy considerations

- 10 Current restrictions on distributions create a rigid link between the amount that may legally be distributed and a company's statutory accounts. This creates an unnecessary obstacle to the development of financial reporting which has adopted as its focus the provision of information that is useful to participants in the capital markets. It cannot be assumed that such information is necessarily appropriate for determining the amount that may be distributed consistently with legitimate public policy objectives. It is also the case that the present requirements are complex, irrational and in many cases fail to meet their objectives.
- 11 In short, the Board is firmly of the view that outmoded and costly company law rules must swiftly be brought up to date to facilitate continued improvement in EU financial reporting, in line with IFRS, and to remove unwarranted burdens on business. This view seems to be increasingly shared by others, for example in the Report 'Reforming Capital' produced under the aegis of the British Institute of International and Comparative Law (BIICL) in June 2004.



12 We would be pleased to expand on any of the points made in this letter, and hope you will feel free to discuss them with either Andrew Lennard (+44 (0) 20 7492 2430 a.lennard@frc-asb.org.uk) or myself.

Yours sincerely

A handwritten signature in black ink, appearing to read 'I. Mackintosh'.

Ian Mackintosh
Chairman



APPENDIX

ASB COMMENTS ON SPECIFIC QUESTIONS RAISED IN THE CONSULTATIVE PAPER

Section 2: Draft Directive Amending the Fourth and Seventh Company Law (Accounting) Directives)

A) Disclosure: New disclosure requirements on off-balance sheet arrangements, including Special Purpose Entities

Q4: Do you agree with the proposal in principle? If not why?

The ASB agrees with the proposal in principle only to the extent that it is consistent with the over-arching points made in the covering letter.

Q5: Do you think the proposal is clear enough to make it workable and capable of consistent application?

No. The meaning and scope of the proposal is wholly unclear. We share the view expressed in the Consultative Document that the present wording might be interpreted as including routine purchase and employment contracts, which we do not assume is intended. It would be wrong to try to address this concern by expanding the detail of the requirements; instead, the proposal needs to be clarified that it does not impose additional requirements on companies that prepare their financial statements in accordance with EU adopted IFRS.

Q6: If you draw up accounts, do you think that the changes to UK disclosure requirements set out in paragraph 3.4.2 will add significant burdens?

We do not believe that, if construed in accordance with their presumed intent, the proposal will impose any additional disclosure requirements on companies that prepare their accounts in accordance with UK accounting standards.

FRS 5 'Reporting the substance of transactions' limits the possibilities for 'off balance sheet' arrangements, including any 'Special Purpose Entities' that continue to fall outside the specific requirements for consolidation set out in FRS 2 'Accounting for Subsidiary Undertakings', as amended, reflecting the changes of the Modernisation Directive, in December 2004. FRS 5 also requires that:

"Disclosure of a transaction in the financial statements, whether or not it has resulted in assets or liabilities being recognised or ceasing to be recognised, should be sufficient to enable the user of the financial statements to understand its commercial effect."

(paragraph 30)



It should, however, be borne in mind that incorporation of requirements into the law will impose an additional burden on preparers and auditors, by increasing the volume, if not the content, of the requirements with which they have to comply.

Q7: If you are a user of company accounts, do you believe that this additional information will be useful, and, if so, what is the added value?

As stated in response to Q6 above, the ASB does not believe that the proposed requirements will secure the disclosure of any information additional to that provided under existing UK requirements. It is, however, possible that it will secure additional information in accounts prepared in conformity with the requirements of other Member States.

B) Disclosure: New disclosure requirements on related party transactions to enhance transparency

Q8 Do you agree with the proposal in principle? If not why?

The ASB agrees with the proposal in principle only to the extent that it is consistent with the over-arching points made in the covering letter.

Q9: If you draw up accounts, do you think that in practice it will increase your disclosure requirements?

The ASB believes that appropriate disclosures of related party transactions are secured by the requirements of FRS 8 and IAS 24 (both entitled 'Related Party Disclosures'). However, the following concerns should be highlighted.

- (i) The terms 'nature' and 'business purpose' are so vague that it is unclear what disclosure would meet the proposed requirement. Possibly a statement that the transaction is a sale and is deemed to be in the company's interest would suffice.
- (ii) It is, in the Board's view, very unwise to restrict the disclosure requirement to cases where the transaction 'has not been concluded under normal commercial considerations'. Often transactions between related parties would simply not take place between unrelated parties. This makes it impossible to judge whether the terms of those transaction reflect 'normal commercial considerations': this is not to suggest that there is anything improper in, or that should give rise to suspicion of, such transaction. The proposal as drafted might be interpreted as requiring companies to distinguish between those transactions that were concluded on normal commercial terms and those that were not: this would place directors in an invidious position and make the proposal unworkable.



- (iii) It is questionable whether the proposals should extend to the individual accounts of holding companies and subsidiaries where they are included in a set of consolidated accounts, as the volume of disclosure might result in a cost that is disproportionate to the benefit to users of the information.
- (iv) The proposals are framed in terms of individual transactions. It is, however, important that similar related party transactions should be aggregated where appropriate. Requirements focusing on individual transactions may result in unduly voluminous, burdensome and unhelpful disclosure. It is possible that each of a number of transactions is immaterial when considered individually, but may be material in aggregate.

The ASB's Technical Plan (available at www.frc.org.uk/asb/technical/techplan.cfm) envisages replacing FRS 8 with a standard based on IAS 24 in the near future. In finalising that standard, the ASB will have to consider whether the exemption for the individual accounts of group companies should be retained.

Q10: If you are a user of company accounts, do you believe that this additional information will be useful?

We question whether the proposal will secure the publication of any information additional to that of existing UK or IFRS requirements that will be useful.

Section 3: Draft Directive Amending the Second Company Law (Capital Maintenance) Directives)

Q5: Do you have any other comments on the drafting of Articles 10a or 10b?

Proposed new article 10a (3) seems to suggest that the value at which an asset is stated in statutory accounts should be taken as establishing its true value. This is mistaken: financial statements do not purport to place a value on a company's assets—and still less on the company as a whole.

Although it is understandable to suppose that the value of an asset should not be less than that which it is stated in the audited accounts, this is not necessarily true in all circumstances. For example, both FRS 11 'Impairment of fixed assets and goodwill' and its international equivalent, IAS 36, require impaired assets to be stated at the higher of value in use and net realisable value (the latter is described in IAS 36 as 'fair value less costs to sell'). Where value in use is used, the value of an asset as stated in statutory accounts may be significantly greater than the value of that asset to a company to which it is transferred.



Q29: Do you agree that a fundamental review of the capital maintenance system and of alternative approaches is a high priority for the EU?

As is made clear in the covering letter, the ASB's response to this question is, emphatically, yes.