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Internal Market and Services DG

FREE MOVEMENT OF CAPITAL, COMPANY LAW AND CORPORATE GOVERNANCE

Accounting

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Subject: Simplification of accounting rules for small and medium-sized companies – Discussion of possible amendments to the Fourth and Seventh Company Law Directives

1. PURPOSE OF THIS DOCUMENT

- 1.1. The purpose of this document is to initiate an informal discussion regarding what could be done to reduce the administrative burden on small and medium-sized entities (SMEs) under the Fourth and the Seventh Company Law Directives (the “Accounting Directives”). The occasion could also be used to discuss whether there is a need for other improvements to the Accounting Directives.
- 1.2. The document outlines issues for consideration and discusses possible ways forward. At this time, the Commission Services are seeking input to the elaboration process, and no decisions have been made.

2. BACKGROUND

- 2.1. The Accounting Directives contain the basic accounting requirements for incorporated companies in the EU. Incorporation means that a company is a separate legal entity. Some Member States have expanded the scope of application of the Accounting Directives to other types of business, such as partnerships, which have a different legal form. Most companies that fall within the scope of these Directives are SMEs. The Directives already give Member States options to reduce the requirements for “small” and “medium-sized” companies.
- 2.2. The Accounting Directives define “small” and “medium-sized” companies where a company meets two of the following three criteria (thresholds after amendment by Directive 2006/46/EC). In this document, the notions "small" and "medium" sized-entities follow the Fourth Directive definitions:

	“Small” (Article 11 companies)	“Medium-sized” (Article 27 companies)
Turnover	€8 800 000	€35 000 000
Balance sheet total (i.e. gross)	€4 400 000	€17 500 000

assets)		
Number of employees	50	250

3. WHY DISCUSS NOW?

- 3.1. One key objective of the Barroso Commission is to ***simplify and reduce the administrative burden*** for companies in the EU. The Commission has set an overall goal of reducing the administrative burden on companies by 25%. This goal has been set for all areas of European legislation which affects companies, including the field of financial reporting and auditing.
- 3.2. For accounting, simplification means that we should reduce the administration surrounding the preparation of financial statements. This could also be achieved through introducing new more relevant rules to replace older, more complex or burdensome requirements.
- 3.3. Another key reason for the timing of this discussion is that ***Member States' accounting standard setters, the European Parliament as well as the IASB are showing an increased interest in SME accounting***. Several Member States are currently considering revisions to their accounting rules for SMEs, e.g. the UK has had a specific SME accounting standard for several years and is about to issue a further revision. The European Parliament will discuss SME accounting over the next few months in connection with the preparation of a report by MEP Mr Radwan on the issue. The IASB project on SME accounting is reaching the stage where an exposure draft is expected to be published in the next few months. This project is very controversial, and it is therefore important that there is a broad public discussion on the issues at an early stage.
- 3.4. There are also other reasons for discussing a possible ***review*** of the Accounting Directives.
 - It should be noted that whilst the Directives have served their purpose well in raising the quality of financial reporting in the EU, both were adopted many years ago, in 1978 and 1983, respectively. Many minor amendments have been made over the years, but it is now important that there is a discussion with Member States on the need for amendments in order to ensure their continued efficiency. It is important that the Directives provide an up to date framework for accounting for small and medium-sized companies in the EU.
 - The implementation of the IAS Regulation has required listed companies to prepare their consolidated financial statements using IFRS. This has highlighted a number of issues on the interaction between the Directives and IFRS. The modernisation of the Accounting Directives, in 2001 and 2003, tried to clarify these issues, but not all issues have been addressed.

4. CURRENT REQUIREMENTS IN THE ACCOUNTING DIRECTIVES

- 4.1. In brief, the Accounting Directives require companies to:

- prepare annual accounts;
 - prepare an annual report;
 - prepare consolidated accounts, where the company is a parent with subsidiary undertakings;
 - have these accounts audited; and
 - filed on a public register.
- 4.2. These overall requirements could be seen as the “administrative burden” put on companies by the requirements in the Accounting Directives.
- 4.3. The Accounting Directives are “minimum harmonisation” legal measures and together with the fact that accounting has substantially developed since their adoption, means that many Member States have supplemented these minimum requirements with additional requirements.

5. WHAT ACCOUNTING INFORMATION IS IMPORTANT FOR SMEs AND CURRENT DEVELOPMENTS IN SME ACCOUNTING

- 5.1. SMEs have different accounting needs than larger companies. SMEs are often managed by the people that own the company and they very rarely use the capital markets for their financing. These companies need to provide suitable information to their banks, as well as creditors, so that the credit standing of the company can be assessed. SMEs also need to have appropriate book-keeping and systems for internal control, which are closely linked to accounting.
- 5.2. The financial statements of SMEs should provide a good basis for simultaneously fulfilling a number of reporting purposes (banks, creditors, tax authorities, statistics collection, etc). Certain adjustments and additions are needed as the different external parties have different reporting needs, but the general aim should be to keep such amendments to a minimum.
- 5.3. The possible revision of the Accounting Directives must take as its starting point the actual needs of the SME and the users of their accounts, and thereafter determine what the most efficient and effective way is of providing this information.

The SME project of the IASB

- 5.4. The IASB is close to finalising its exposure draft on an accounting standard for SMEs. The current unofficial draft provides accounting guidance for those entities that do not have “public accountability”, and “publish general purpose financial statements for external users” (paragraph 1.1). The draft gives examples of external users including “owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies.” Furthermore, an often repeated phrase is that the IASB’s SME project is targeting entities with 50 (or so) employees.

- 5.5. There is consequently, an important difference in scope between the IASB exposure draft and the Accounting Directives, as the latter require all companies to prepare and file annual financial statements.
- 5.6. The focus on external users does not appear to address the needs of the “small” companies within the scope of the Accounting Directives, as they have less than 50 employees, and in many cases do not have external users. This illustrates that that the direction of the SME project is towards larger companies which are more likely to have investors that are not involved in the management of the company.
- 5.7. Although stakeholders in the EU have followed the project with interest, it is important to remember that accounting for SMEs is decided by the Accounting Directives. In this context it should be made clear that the IAS Regulation was specifically designed for listed companies and that it cannot be used for the adoption of a standard for SMEs. There is no commitment by the EU to adopt a future international standard on SMEs.
- 5.8. It is not evident that the current draft from the IASB will contribute to the Commission's objectives of simplification and reduction of the administrative burden for SMEs in the EU, in particular as IFRS are designed from the point of view of the information needs of external users which is different from that of managing owners.

6. WAYS OF ACHIEVING SIMPLIFICATION FOR SMEs IN THE ACCOUNTING DIRECTIVES

- 6.1. The Commission Services need input regarding the actual use of the Accounting Directives and SME accounting in their jurisdictions. This section discusses different ways of achieving simplification for SMEs. The following options are expanded upon:

1. **Raising the thresholds for small and medium-sized companies**
2. **Extending the exemptions for small and medium-sized companies**
3. **Amending and/or removing options**
4. **Simplification of accounting requirements for small and medium-sized companies**
5. **Reduction of disclosure requirements**

1. Raising the thresholds for small and medium-sized companies

- 6.2. The thresholds have been increased several times. The last time the current *thresholds* were discussed and increased was earlier in the year and the resulting increase is reflected in Directive 2006/46/EC. This last increase of 20% was much discussed in Council.
- 6.3. For many Member States the threshold amounts are quite high and result in over 95% of companies in their jurisdictions being SMEs.

6.4. However, Member States have not implemented the maximum thresholds and thereby reduce the number of companies that could benefit from these simplifications.

2. Extending the exemptions for small and medium-sized companies

6.5. At present, the ability to alleviate the administrative burden on SMEs is driven by options in the Accounting Directives that give Member States the ability to reduce the requirements for “small” and “medium-sized” companies.

6.6. Exemptions from the requirements of the Accounting Directives are available where a company is within certain size criteria. This is a very efficient way of ensuring that any simplifications of the requirements in the Directives reach the maximum number of companies.

6.7. In summary these options are as follows.

Small company options	Medium-sized company options
Publication of abridged balance sheet	Publication of abridged balance sheet
Publication of abridged notes to the accounts	-
Omit publication of profit and loss account	Publication of a partially summarised profit and loss account
No requirement to draw up consolidated financial statements	No requirement to draw up consolidated financial statements
No requirement for an annual report	Omit non-financial information from the annual report
No requirement for a statutory audit	-

6.8. It can be seen from the above table that the majority of the exemptions given are for small companies, with the removal of the requirement for an annual report, statutory audit and no requirement to publish a profit and loss account.

6.9. Concerning further *exemptions*, the following could be possible items for consideration:

- removal of the filing requirement for small companies;
- extension of the exemption from statutory audit to medium-sized companies;
- removal of the requirement for medium-sized companies to present an annual report, or extension of the exemption for these companies to omit also some financial information from the annual report.

3. Amending and/or removing options

- 6.10. The Accounting Directives contain a significant number of options, both at Member State level and at company level. For example, there are approximately 40 options at Member State level. Certain options were in the Directives from inception, others have been added in subsequent amendments, notably to enable Member States to apply IFRS accounting solutions also to unlisted companies.
- 6.11. These options provide flexibility for Member States to apply accounting solutions that are adapted to local conditions and traditions. However, options reduce accounting harmonisation and cloud the comparability of financial statements.
- 6.12. The current options cover many crucial elements of the Directives.
- The number of profit and loss layouts a company can choose from.
 - The number of balance sheet layouts a company can choose from.
 - Presentation and disclosure options.
 - Recognition and valuation options.
 - Options relating to reducing requirements for small and medium-sized companies.
 - Options relating to unlimited companies and investment companies.
- 6.13. In the context of the current simplification and clarification of accounting requirements for SMEs it may be appropriate to consider whether certain options could be removed, or whether further ones would be necessary.
- 6.14. For example, removal of the following options could be considered.
- Reduce the number of profit and loss account layouts from four to two (Articles 23 – 26).
 - Remove the options within the balance sheet layouts (Articles 9 – 10).
 - Simplify the profit and loss account and balance sheet layouts (Articles 9 – 10 and 23 – 26).
 - Removal of the option to permit rather than require the adjustment of comparative amounts (Article 4.4).

4. Simplification of accounting requirements for small and medium-sized companies

- 6.15. The Accounting Directives reflect numerous accounting models that have been used over the last 25 years. As a part of the current discussion of possible revisions, it may be of interest to look at a number of detailed accounting treatments and how they are, or how they should, be treated in the Directives. Certain material changes may be needed in order to ensure that the requirements are up-to-date and relevant.

- 6.16. One overall approach could be to align the accounting requirements with modern accounting principles. For example, the removal of the LIFO valuation option and change the basis of production cost to align with modern accounting practice.
- 6.17. In the long term, it could be considered whether a more substantial reformulation of the Accounting Directives could significantly simplify and clarify the accounting requirements for SMEs. Firstly, by reordering the Directives in such a way that that all requirements related to SMEs are contained in one section. Secondly, specific accounting requirements for small and medium-sized entities could be developed so that each Member State did not need to develop their own requirements.

5. Reduction of disclosure requirements

- 6.18. The Accounting Directives contain a large number of disclosure requirements. The number of requirements has increased each time the Directives have been amended.
- 6.19. The collection and presentation of disclosures could create a large administrative burden on companies, in particular SMEs. Furthermore, some requirements may only be of limited relevance for these companies. It is therefore important that the current disclosure requirements, particularly for SMEs, are looked at as a part of the current simplification exercise.
- 6.20. For example, deletion of the following disclosures could be considered.
- Disclosure of an explanation of formation expenses (Article 32.2).
 - Disclosure of the breakdown of net turnover into categories of activity and geographical markets (Article 43.8).

7. NEXT STEPS

- 7.1. The Commission Services plan to prepare a consultation document in spring 2007. Work on an impact assessment will start at the same time.