



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 27.10.2004
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Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Council Directives 78/660/EEC and 83/349/EEC concerning the annual accounts of certain types of companies and consolidated accounts

(presented by the Commission)

EXPLANATORY MEMORANDUM

1) CONTEXT OF THE PROPOSAL

- **Grounds for and objectives of the proposal**

The objective is to further enhance confidence in the financial statements and annual reports published by European companies. In this respect, shareholders and other stakeholders need reliable, complete and easily accessible information. This concern is shared by the European Parliament¹ and the Council². It should be addressed by amending the Accounting Directives to:

- **Establish collective responsibility of board members:** Confidence in the financial statements is linked to who has responsibility for drawing up and publishing them. In line with what is currently prevailing in Member States the responsibility should rest collectively with all board members.
- **Enhance transparency about related parties' transactions:** Companies' transaction with their managers, the latter's family members or other so-called related parties are often not carried out under normal commercial conditions. While satisfactory transparency is required for all listed European companies, under International Accounting Standards (IAS) more transparency is necessary for unlisted companies.
- **Enhance transparency about off-balance arrangements:** The disclosure requirements in the Accounting Directives for off-balance sheet commitments are not precise enough. Special Purpose Entities (SPE) is a prominent example: They are captured in the balance sheet if they qualify as a subsidiary but in many cases SPE's may be organised in a different way. Instead of developing complex definitions of an SPE (bearing the immediate risk of circumvention), disclosure should instead be improved by imposing a specific requirement in the notes to the accounts for material off-balance sheet arrangements, including SPE's.
- **Introduce a corporate governance statement:** Investors on European capital markets have a major interest in listed EU-companies' corporate governance practices. Accordingly, each listed company should – in a specific section of its annual report - disclose information about its practices in a "corporate governance statement".

- **General context**

On 21 May 2003, the Commission adopted an Action Plan for Modernising Company Law and Corporate Governance at EU level (Action Plan)³, announcing the

¹ P5_TA(2004)0096 – "European Parliament resolution on corporate governance and supervision of financial services - the Parmalat case"

² The ECOFIN ministers meeting in the Council in Oviedo in April 2002 invited the Commission to consider this issue.

³ Communication from the Commission to the Council and the European Parliament – Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to move forward COM(2003) 284 final.

	confirmation of the collective responsibility of board members, the improvement of information provided by groups and the introduction of a corporate governance statement as a short term priority, i.e. presentation of a proposal before the end of 2004. Recent corporate scandals have underlined that urgent action is necessary.
	<ul style="list-style-type: none"> • Existing provisions in the area of the proposal <p>The Accounting Directives are in this context understood as Directives 78/660/EEC⁴ and 83/349/EEC⁵.</p>
	<ul style="list-style-type: none"> • Consistency with other policies <p>The proposed amendment is consistent with other horizontal Community policies, in particular the Commission's Action Plan and the Financial Services Action Plan.</p>
2) RESULTS OF CONSULTATIONS OF INTERESTED PARTIES AND IMPACT ASSESSMENT	
	<ul style="list-style-type: none"> • Consultations of interested parties
	<p>Consultation methods and main sectors targeted.</p> <p>Two consultations were carried out: a consultation on the Company Law Action Plan (2003) and an on-line consultation (between April and June 2004) on this specific initiative. A summary of the responses to the Company Law Action Plan was published in November 2003; the responses to the second consultation were published in September 2004 on the Commission's web site.</p>
	<p>General profile of respondents.</p> <p>There was a wide geographical coverage, i.e. more than 200 responses from 18 Member States. Approximately half of the responses came from the business community; the other half came from other stakeholders.</p>
	<p>Summary of responses and how they have been taken into account.</p> <p><i>a) Collective responsibility of board members</i></p> <p>Generally, there was support for the Commission's intention to confirm the collective responsibility of board members towards the company in EU-legislation.</p> <p><i>b) Enhancing transparency on transactions with related parties' and on off-balance arrangements</i></p> <p>The business community was not in favour of solutions going beyond what is already required by International Accounting Standards (IAS) whereas other stakeholders in general support improved disclosure in order to restore confidence in a company's financial statements.</p>

⁴ OJ L 222, 14.8.1978, p 11. Directive last amended by Directive 2003/51/EC of the European Parliament and Council (OJ L 178, 17.7.2003, p16).

⁵ OJ L 193, 18.7.1983, p 1. Directive as last amended by Directive 2003/51/EC of the European Parliament and Council (OJ L 178, 17.7.2003, p16).

	<p>Given the increased use of off balance sheet arrangements, e.g. use of SPEs in order to remove assets and liabilities from the balance sheet, it is necessary to improve the disclosure of such arrangements which may serve useful business purposes. This will further promote public confidence in financial statements.</p> <p><i>c) Corporate governance statement</i></p> <p>The consultation showed support for limiting such a corporate governance statement to information on whether and to what extent a listed EU-company complies or not with a corporate governance code. While business was reluctant to go further other stakeholders favoured additional disclosure, in particular information about the risk management system applied by listed EU-companies.</p> <p>The Commission proposes a corporate governance statement for listed EU-companies along the lines set out in its Action Plan thereby limiting information requirements to what is strictly necessary, i.e. the reference to the corporate governance code, the extent of which this code is complied with, information about shareholders' meetings, the composition and operation of the board and its committees. The Action Plan included further items the publication of which is already mandatory under the Directive on Takeover Bids; these items should in future become part of the corporate governance statement.</p>
	<ul style="list-style-type: none"> • Collection and use of expertise
	<p>During the consultation more than 40 detailed written contributions was received.</p>
	<ul style="list-style-type: none"> • Impact assessment <p>A preliminary impact assessment was presented in the Commission's Legislative and Work Programme 2004 showing that increased transparency would contribute to ensuring that the functioning of groups remains compatible with the interests of shareholders and other stakeholders at the different levels of the group</p>
<p>3) LEGAL ELEMENTS OF THE PROPOSAL</p>	
	<ul style="list-style-type: none"> • Legal basis <p>Article 44 (1) of the Treaty.</p>
	<ul style="list-style-type: none"> • Explanation of the proposal <p style="text-align: center;">A. CLARIFICATION OF RESPONSIBILITY AND LIABILITY OF BOARD MEMBERS FOR FINANCIAL STATEMENTS AND KEY NON-FINANCIAL INFORMATION</p> <p>Recent corporate scandals have highlighted issues related to board members' misconduct and thereby underlined the need for the Commission to pursue its Action Plan and establish an EU-framework of collective responsibility for board members, including appropriate sanctions and liability. Hence the Commission proposes to ensure that Member States must guarantee that board members are collectively responsible at least towards the company.</p>

This does not prevent Member States from extending collective responsibility for board members directly to shareholders and other stakeholders. But EU legislation would confirm the system of collective responsibility and oblige Member States to have or introduce appropriate sanctions and civil liability rules for non-respect of the accounting rules by board members in order to underpin the collective responsibility

Accordingly, the Commission proposes in Article 1 to insert a new section containing Articles 50b and 60a in Directive 78/660/EEC and in Article 2 to insert a new section containing Articles 36(a) in Directive 83/349/EEC and inserting Article 48 under section 6 of Directive 83/349/EEC.

B. INCREASED TRANSPARENCY - RELATED PARTY TRANSACTIONS AND OFF BALANCE SHEET ARRANGEMENTS, INCLUDING THE USE OF SPECIAL PURPOSE ENTITIES AND OFFSHORE CENTRES

Related party transactions

In the Action Plan the Commission considered that additional initiatives aiming at improving the financial and non-financial information disclosed is desirable, even by non-listed companies.

The Accounting Directives provide for transparency about transactions with affiliated companies which are but one type of related parties. This concept is not as broad as under the International Accounting Standards (IAS 24) dealing with transactions with related parties that listed companies must, as of January 2005, apply when preparing consolidated accounts.

In order to determine who is a related party, the Commission proposes to integrate the definitions set out in IAS 24, as endorsed under the IAS-Regulation⁶. Using the definitions under IAS does not imply that non-listed companies would be subject to exactly the same disclosure requirements as listed ones. Unnecessary burdens should be avoided in two ways: the Accounting Directives already grant an option to Member States allowing small companies not to provide disclosure about transactions with affiliated undertakings – which is one type of related party; accordingly, this logic should also apply to other related party transactions. In addition, not each and every related party transaction should be disclosed if they are not carried out under normal commercial conditions (i.e. not at arm's length) and only if they are material.

Accordingly, the Commission proposes in Article 1 to add a new subparagraph to Article 43 (1) of Directive 78/660/EEC and in Article 2 to add a new subparagraph to Article 34 of Directive 83/349/EEC. In Article 2 the Commission also proposes to add a new paragraph 1a to Article 41 of Directive 83/349/EEC.

Transparency in the use of off-balance arrangements

Innovations in financial instruments have facilitated the allocation of risk among borrowers and investors in more efficient ways. However, certain financial

⁶ OJ L 243, 11.9.2002, p1

instruments may involve transactions the effect of which alters a company's accounts so they no longer reflect the true financial position. Consequently, there is a public policy issue to ensure that the "true-and-fair-view" principle is better and clearer implemented at European level. IAS and the Accounting Directives provide for some disclosure of off balance sheet arrangements.

Special Purpose Entities (SPEs) are captured in the balance sheet if they qualify as a subsidiary or as a company in which a participating interest is being held but SPE's can be organised to elude this. Disclosure should be improved by imposing a specific disclosure requirement in the notes for material off-balance sheet arrangements. To the extent that this disclosure goes beyond what is required under IAS, listed EU companies applying IAS would also have to comply with this disclosure through an amendment to the Accounting Directives.

Consequently, the Commission considers that the Accounting Directives should require all companies - whether listed or not - to disclose any off balance sheet arrangements and their financial impact if it can be material for an investor's assessment of a company's financial position. This is in line with the overarching principle that financial statements must present a true and fair view of a company's financial situation and the best way for ensuring transparency. Capturing for instance SPEs via specific definitions would be too easy to circumvent.

Accordingly, the Commission proposes that additional specific information on material off-balance sheet arrangements should be disclosed in the notes to the annual and consolidated accounts. The Commission proposes to add a new subparagraph to Article 43 (1) of Directive 78/660/EEC and in Article 2 the Commission proposes to add a new subparagraph to Article 34 of Directive 83/349/EEC.

C. DISCLOSURE ABOUT CORPORATE GOVERNANCE PRACTICES BY ISSUERS WHICH HAVE THEIR SECURITIES TRADED ON A REGULATED MARKET

Information about corporate governance structures in listed European companies are of crucial importance for European capital markets and European investors. For this purpose, all listed EU-companies should provide a specific "Corporate Governance Statement" in their annual report.

The Commission considers that the Corporate Governance Statement should become a specific part of the company's annual report and that it should also indicate certain information to be given in accordance with the Take Over Bids Directive as well as information about the risk management system, the operation of the shareholder meeting, the shareholders rights and the operation of the board and its committees.

Therefore, the Commission proposes to add a new section 9A to Directive 78/660/EEC. As for the consolidated annual report it is proposed to add a new subparagraph to Article 36 (2) of Directive 83/349/EEC limiting the information requirements to the applied risk management and internal control systems for drawing up the consolidated accounts and the consolidated annual report.

	<ul style="list-style-type: none"> • Subsidiarity principle <p>This proposal does not fall under the exclusive competence of the Community. The objective of the action is to improve public confidence in financial statements. A central element in this is that financial statements must be comparable across the EU to benefit integration of capital markets. In ensuring equivalent transparency and thereby contributing to completion of the internal market, the proposed measures are in line with the subsidiarity principle.</p>
	<ul style="list-style-type: none"> • Proportionality principle
	<p>The proposal continues the Community's principle based approach to EU-Accounting regulation. This ensures proportionality and leaves flexibility to authorities and economic operators on how to fulfil the objectives while minimising their financial and administrative burden.</p>
	<ul style="list-style-type: none"> • Choice of instruments
	<p>The proposed instrument amends existing directives and is therefore a directive.</p>
<p>4) BUDGET IMPLICATIONS</p>	
	<p>There are none for the Community budget.</p>

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amending Council Directives 78/660/EEC and 83/349/EEC concerning the annual accounts of certain types of companies and consolidated accounts

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 44 (1) thereof,

Having regard to the proposal from the Commission⁷,

Having regard to the opinion of the European Economic and Social Committee⁸,

Acting in accordance with the procedure laid down in Article 251 of the Treaty⁹,

Whereas:

- (1) On 21 May 2003, the Commission adopted an Action Plan announcing measures to modernise company law and enhance corporate governance in the Community. As a short term priority, for the Community was to confirm the collective responsibility of board members, increase transparency in transactions with related parties and off-balance arrangements and improve disclosure about corporate governance practices applied in a company.
- (2) Pursuant to that Action Plan, members of the administrative, management and supervisory bodies of a company were as a minimum to be collectively responsible towards the company for drawing up and publishing annual accounts and annual reports. The same approach was also to apply to members of the administrative, management and supervisory bodies of undertakings drawing up consolidated accounts. On the one hand, this would not prevent Member States from going further and provide for direct responsibility towards shareholders or even other stakeholders. On the other hand, Member States were to refrain from opting for a system of responsibility limited to individual board members. However, this should not prevent courts or other enforcement bodies in the Member States from being able to impose sanctions on an individual board member.

⁷ OJ C [...] [...], p.[...]

⁸ OJ C [...] [...], p.[...]

⁹ OJ C [...] [...], p.[...]

- (3) On 27 September 2004 the Commission adopted a Communication on preventing and combating financial and corporate malpractice outlining inter alia the Commission policy initiatives regarding internal control in companies and responsibility of board members.
- (4) At present Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies¹⁰ and Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts¹¹ only provide disclosure of transactions between a company and the company's affiliated undertakings. This should be extended to cover other types of related parties, such as key management members and spouses of board members. Disclosure of material transactions with related parties that are not carried out under normal commercial condition can assist users of annual accounts to assess the financial position of the company as well as, when the company belongs to a group, the financial situation of the group as a whole.
- (5) Definitions applicable to related party disclosures as set out in the International Accounting Standards adopted by the Commission under Regulation (EC) No 1725/2003 of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council¹², should be integrated into Directives 78/660/EEC and 83/349/EEC
- (6) Off balance sheet arrangements may expose a company to risks and benefits, which are material for an assessment of the financial position of the company and when the company belongs to a group, the financial position of the group as a whole.
- (7) Such off balance sheet arrangements could be any transactions or agreements companies may have with entities that are not included in the balance sheet. Such off balance sheet arrangements may be associated with the creation or use of one or more Special Purpose Entities (SPE's) and offshore activities designed to address *inter alia* economic, legal, tax or accounting objectives. Appropriate disclosure of such arrangements that are not included in the balance sheet should be set in the notes to the accounts or the consolidated accounts.
- (8) Companies, having their securities admitted to trading on a regulated market and which have their registered seat in the Community, should be obliged to disclose an annual corporate governance statement as a specific and clearly identifiable section of the annual report. This statement should provide shareholders with easily accessible key information about the actually applied corporate governance practices, including a description of any existing risk management systems and internal controls in relation to the financial reporting process. Furthermore, where relevant, companies may also provide an analysis of environment and social aspects necessary for an understanding of the company's development, performance and position. There is no need to impose a separate corporate governance statement on undertakings drawing up a consolidated

¹⁰ OJ L 222, 14.08.1978, p. 11. Directive as last amended by Directive 2003/51/EC of the European Parliament and of the Council (OJ L 178, 17.7.2003, p. 16).

¹¹ OJ L 193, 18.07.1983, p.1. Directive as last amended by Directive 2003/51/EC of the European Parliament and of the Council (OJ L 178, 17.7.2003, p.16).

¹² OJ L 243, 11.09.2002, p1

annual report, however, the information concerning the risk management system and the internal control system the group has should be presented.

- (9) The objectives of the action to be taken are, in particular to facilitate cross border investments and to improve EU-wide comparability and public confidence in financial statements and reports through enhanced and consistent specific disclosures. This cannot be sufficiently achieved by the Member States since national legislation differs. By amending the Accounting Directives and deepened harmonisation the objectives can be better achieved at Community level. Hence the Community may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve those objectives.
- (10) Directives 78/660/EEC and 83/349/EEC should therefore be amended accordingly.
- (11) This Directive respects fundamental rights and observes the principles recognised in particular by the Charter of the Fundamental Rights of the European Union,

HAVE ADOPTED THIS DIRECTIVE:

Article 1

Directive 78/660/EEC is amended as follows:

1. In Article 43 (1), the following points (7a) and (7b) are inserted:

(7a) the nature and business purpose of company's arrangements not included in the balance sheet, and the financial impact on the company of those arrangements, in so far as the information set out is material and of assistance in assessing the financial position of the company”

(7b) the nature, business purpose and amount of any transaction entered into by the company with related parties, where that transaction is material and has not been concluded under normal commercial conditions. The definitions of related party set out in paragraph 3 of the International Accounting Standard 24 on Related Party Disclosures as set out in Commission Regulation (EC) 1725/2003¹³ shall apply for the purposes of this Directive.”

2. The following Article 46a is inserted:

“Article 46a

A company whose securities are admitted to trading on a regulated market, within the meaning of Article 4(1)(14) of Directive 2004/39/EC of the European Parliament and of the Council¹⁴ shall include a corporate governance statement in its annual

¹³ OJ L 261, 13.10.2003, p. 1

¹⁴ OJ L 145, 30.4.2004, p. 1

report. That statement shall be included as a separate part of the annual report and shall contain at least the following information:

1. a reference to the corporate governance code the company decided to apply or is subject to under the law of the Member State where it has its registered seat, accompanied by an indication, where the text of the applied corporate governance code is publicly available;
2. an explanation as to whether and to which extent the company complies with the corporate governance code referred to under point (1).
3. a description of the company's internal control and risk management systems;
4. the information required by Article 10, paragraph 1, points (c), (d), (f), (h), and (i) of Directive 2004/25/EC of the European Parliament and of the Council¹⁵;
5. the operation of the shareholder meeting and its key powers, and a description of shareholder's rights and how they can be exercised;
6. the composition and operation of the board and its committees.

To the extent a company departs from the corporate governance code referred to under point (1), the company shall explain from which parts of the code it departs and the reasons for doing so.

3. The following Section 10A is inserted:

“SECTION 10A

Responsibility and liability for the annual accounts and the annual report

Article 50b

Member States shall ensure that the members of the administrative, management and supervisory bodies of the company are collectively responsible towards the company for ensuring that the annual accounts and the annual report are drawn up and published in accordance with the requirements of this Directive.

Article 50c

Member States shall ensure that their laws, regulations and administrative provisions on liability apply to the members of the administrative, management and supervisory bodies referred to in Article 50b of this Directive.”

4. The following Article 60a is inserted:

“Article 60a

¹⁵ OJ L 142, 30.4.2004, p. 12

”Without prejudice to Article 6 of Directive 68/151/EEC¹⁶ and to the right of Member States to impose criminal sanctions, the Member States shall lay down the rules on penalties applicable to infringements of the national provisions adopted pursuant to this Directive and shall take all measures necessary to ensure that they are implemented. The penalties and measures provided for must be effective, proportionate and dissuasive. The Member States shall notify those provisions to the Commission by 31 December 2006 at the latest and shall notify it without delay of any subsequent amendment affecting them.”

Article 2

Directive 83/349/EEC is amended as follows:

1. In Article 34 the following points (7a) and (7b) are inserted:

”(7a) the nature and business purpose of any arrangements not included in the consolidated balance sheet, and the financial impact of those arrangements, in so far as the information set out is of direct relevance and assistance in assessing the financial position of the undertakings included in the consolidation taken as a whole.”

“(7b) the nature, business purpose and amount of any transaction entered into by the parent undertaking, or by other undertakings included in the consolidation, with related parties, where that transaction is material and has not been under normal commercial conditions.”

2. In Article 36 (2), the following point (f) is added:

“(f) A description of the group’s internal control and risk management systems in relation to the process for preparing consolidated accounts. In case the consolidated annual report and the annual report are presented as a single report, this information must be included in the section of the report containing the corporate governance statement as provided by Article 46a of Directive 78/660/EEC”;

3. The following Section 3A is inserted:

“SECTION 3A

Responsibility and liability for drawing up the consolidated annual accounts and the consolidated annual report

Article 36a

Member States shall ensure that the members of the administrative, management and supervisory bodies of the undertaking drawing up the consolidated accounts and the consolidated annual report are collectively responsible towards that undertaking for

¹⁶ OJ L 065, 14.3.1968, p. 8. Directive as last amended by Directive 2003/58/EC of the European Parliament and of the Council (OJ L 221, 4.9.2004, p.13)

ensuring that the consolidated annual accounts and the consolidated annual report are drawn up and published in accordance with the requirements of this Directive.

Article 36b

Member States shall ensure that their laws, regulations and administrative provisions on liability apply to the members of the administrative, management and supervisory bodies referred to in Article 36a of this Directive.”

4. In Article 41, the following paragraph 1a shall be inserted:

“1a. The definitions of related party set out in paragraph 3 of the International Accounting Standard 24 on Related Party Disclosures as set out in Commission Regulation (EC) 1725/2003¹⁷ shall apply for the purposes of this Directive.

5. The following Article 48 is inserted:

“Article 48

Without prejudice to Article 6 of Directive 68/151/EEC and to the right of Member States to impose criminal sanctions the Member States shall lay down the rules on penalties applicable to infringements of the national provisions adopted pursuant to this Directive and shall take all measures necessary to ensure that they are implemented. The penalties provided for must be effective, proportionate and dissuasive. The Member States shall notify those provisions to the Commission by 31 December 2006 at the latest and shall notify it without delay of any subsequent amendment affecting them.”

Article 3

1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 31 December 2006 at the latest. They shall forthwith communicate to the Commission the text of those provisions and a correlation table between those provisions and this Directive.

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

2. Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive.

Article 4

This Directive shall enter into force on the 20th day following that of its publication in the *Official Journal of the European Union*.

¹⁷ OJ L 261, 13.10.2003, p. 1

Article 5

This Directive is addressed to the Member States.

Done at Brussels,

For the European Parliament
The President

For the Council
The President