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Financial reporting: Commission welcomes adoption of fair value accounting Directive

The European Commission has welcomed adoption on 31 May by the EU's Council of Ministers and the European Parliament of a Directive to modernise EU accounting rules by introducing the "fair value" accounting method. The Directive amends the EU's Accounting Directives to take account of developments in markets (such as widespread use of so called derivatives), business and international accounting standards. It will make it easier for European companies raising capital worldwide to comply with the financial reporting requirements of international capital markets and thus compete on equal terms with non-European competitors. The fact that this Directive has been adopted only 15 months after it was proposed by the Commission (see IP/00/187) highlights the effectiveness of the extremely cooperative and productive approach that the Commission, Parliament and Council have taken to working together on this initiative. The Directive forms part of the Financial Services Action Plan (see IP/00/1269).

Internal Market Commissioner Frits Bolkestein, said: "This Directive will help European companies to prepare financial statements that are accepted and understood around the world. Aligning the provisions of the Accounting Directives with existing international standards on fair value accounting will help European companies compete in international capital markets on equal terms with their non-European competitors. The rapid adoption of this Directive provides a very positive example of the EU institutions working efficiently together to adopt legislation quickly. It is an example that could and should be followed for other legislative proposals. "

The Directive amends the 4th Directive on Annual Accounts, the 7th Directive on consolidated accounts and the Bank Accounts Directive to enable the valuation of certain financial instruments at fair value. The fair value of financial instruments is determined by the market value or generally accepted valuation models if there is not a reliable (liquid) market. Nearly all changes in fair value, even though not realised, need to be shown in the company's profit and loss account. Fair value provides a more accurate view of a company's financial position and performance.

The main objective of the Directive is to enable companies to fully apply International Accounting Standards (IAS), including IAS 39 on the valuation of financial instruments that is mandatory as of financial year 2001, within the framework of the Accounting Directives.

The Directive defines those financial instruments that can be fair valued in line with IAS 39. It also lays down rules for Member States to define the scope of companies that shall be permitted, or can be required, to use fair value. A Member State can, for example, permit or require fair value only for listed companies. The Directive requires that all companies disclose information on derivative financial instruments such as options, swaps, and futures in the notes on the accounts. However, small companies can be excluded from this disclosure.

The amendment will not replace historic cost as the basis of accounting valuation in the Accounting Directives but will complement it, particularly since there is no international consensus that fair value accounting is appropriate in all cases. For example, there is as yet no international agreement on whether a company should be required to fair value its own debt or whether such fair value should take account of the company's own credit risk. Fair value accounting will therefore not be permitted for balance sheet items such as fixed assets (for example land and buildings or plant and equipment). Similarly, certain financial instruments, such as long-term debt, will continue to be stated at historical cost.

Although banks are included in the scope of the Directive, it should be clear that this is not about the introduction of "full" fair value reporting, a concept raising concerns with the banking industry, which is presently being discussed at international level and which will be assessed on its own merits by the Commission.

Close co-operation between the Commission, Parliament and Council has allowed accelerated adoption of this Directive with only one Parliamentary reading, a possibility created by the Amsterdam Treaty and applied for the first time in the area of the Internal Market.

For further information on the Fair Value Accounting Directive, see the Europa internet site at: http://europa.eu.int/comm/internal_market (look under Accounting).