PAPER 6.1

SERVICES ENTERPRISES IN THE FRAMEWORK OF EC ACCOUNTING DIRECTIVES

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Note: *EC means European Community, ECU is the unit of account used within the EC budget, it has an approximate value of 1,3 US $*

Abstract

The paper deals with the pertinence and harmonizing effect of EC accounting rules to service enterprises given their specificity in size and structure. It analyses the negative effect of the various thresholds, exceptions and options for implementation left to Member States. It evaluates the population and scope of service enterprises which are covered by the basic piece of legislation, the Fourth Directive.

Introduction

Statisticians have since a long time recognized the importance of accounting rules and disclosure provisions applicable to all of them for the collection process of business statistics. Characteristics contained in accounting provisions have the advantage to be available at prescribed and calculable times, to have a definition with somewhat compelling background and not to fall under confidentiality considerations. Together with the knowledge of the business population normally assured through business registers accounting rules form the heart of statistical business surveys.

If this is true for the statistical system of a given country an important advantage adds in the validity area of accounting rules going beyond a country: implicitly a harmonizing effect in availability and comparability takes place. The EC system of accounting rules is therefore of utmost importance.

As towards service enterprises the predominance of SME's (Small and Medium Enterprises) is well known. In a legal text of 3, April 1996 (96/280/EC) the European Commission recommends the following definition of SME's:

- Micro-enterprises: less than 10 employees;
- Small enterprises: less than 50 employees and one of the conditions 7 MECU turnover or 5 MECU balance sheet total;
- Medium-sized enterprises: less than 250 employees and 40 MECU turnover or 27 MECU balance sheet total.

It is clear that for services industry sectors there is a predominance of micro enterprises.

The purpose of this paper is to investigate the pertinence and harmonizing effect of EC accounting rules to service enterprises given their specificity in size and structure. It analyses the negative effect of the various thresholds, exceptions and options for implementation left to Member States. It evaluates the population and scope of service enterprises which are covered by the basic piece of legislation, the Fourth Directive.

Overview of the EC business accounts framework

Company law and its harmonization is since the early 60's recognized to be a cornerstone of the Internal Market the EC wants to be. Accounting rules fall into this framework and have thus a long history and numerous legal provisions exist with statistical implications. Historical differences in Member States have nonetheless led to a series of exceptions and options.
The most important legislative provisions are, apart from the so-called Fourth Directive (78/660/EEC) as subject of this paper, the following:

- Conventions on double taxation and recommendations on taxation of SME's;
- Disclosure requirements of branches in other Member States than the one of the head office;
- Publication requirements upon acquisition or disposal of listed companies together with provisions for mergers etc.
- The so-called Seventh Directive on consolidated accounts: being the necessary complement to the Fourth Directive it may though not be widely applicable in services industries (exceptions exist).

The system is constantly updated in adapting thresholds, values etc to economic realities.

Presentation of the fourth directive

The Fourth Directive on annual accounts of certain types of companies is the cornerstone of company law concerning annual accounts. Its mere existence has a huge harmonizing impact on those and thus indirectly as well on statistical data available in harmonized form in different Member States.

The directive contains very detailed provisions for the layout and content of both balance sheet and profit and loss account, valuation rules, content of the notes on the accounts etc. One of the alternative layouts of both pieces is shown in the annex hereto.

Unfortunately this directive is not a unique and one way collection of provisions but contains a number of exceptions.

The purpose of the subsequent chapter which forms the main body of the paper is to analyse all provisions of the Fourth Directive in so far as:

- they may have an impact on statistical data collections, e.g. in providing characteristics or breakdowns disclosed in the annual accounts which have statistical interest;
- they contain possible exceptions, normally under certain conditions, or options the application of which is left to Member States.

The following logic is often applied in EC company law when a choice is possible between two or more options:

- The Member State can prescribe any one of the options to be binding for all companies. This may restrict comparability between Member States but leaves national figures unbiased.
- The Member State may leave the choice to each single company which is of course the worst situation from a statistical point of view.

It is furthermore assumed the following hypothesis: if after the negotiating process which has led to the adoption of the directive a choice or option or exception is inscribed in it there is at least one Member State which makes use of it and creates thus the exceptional condition to comparability which is described in the next chapter. This is all the more likely as the directive was adopted at a time of nine Member States (with very long transition periods) and now it is applicable to eighteen of them.

Statistical analysis of the fourth directive

In this chapter the main provisions of the directive are analysed with respect to exemptions, options, thresholds etc. Each time is sought to evaluate the impact this has in the real population of service enterprises as a whole without distinguishing specific industry sectors. This can of course be done with much more accuracy provided the data on the respective
population is available. The statistical data used to evaluate henceforth can be found in the Eurostat publication "Enterprises in Europe Third Report". This data relates to 1990-1992 but structural changes with impact to the following considerations can be assumed to be very slow. In order to save space telegram style is applied, all figures given are rounded and estimated.

(1) **Article 1: Types of companies covered (national definition, capital societies)**
4 million out of 14,2 million, thus 27 % are incorporated; occurrence of non micro-enterprises double as high in manufacturing than in services (correlated with incorporation); in services not more than *10-15 % in number* of all enterprises fall under the directive, unless Member States provide for it explicitly. Estimation: virtually half of turnover is represented by those enterprises.

(2) **Article 4(3): Combination of items (where immaterial or clearer)**
Arabic numerals (see annexes) can be combined which may lead to *loss of isolated figures.* No numerical evaluation of the phenomenon possible.

(3) **Article 9 and 10 alternative layouts of the balance sheet:**
MS can prescribe both, may choose one, or allow companies to choose individually which is the worst case.

(4) **Article 11: Abridged balance sheets depending on thresholds**
Two of three criteria justify abridged sheets:
< 2,5 MECU balance total (no data accessible)
< 5,0 MECU net turnover (sharpest criterion)
< 50 persons employed (covers > 99% in number)
Data accessible (partly adapted to the criteria) for only some countries; approximately 98% in number representing 60% - 70% employment and turnover fall under criterion 2. *All Arabic items in the balance sheet may disappear for those.*

(5) **Article 17: Definition of participating interest**
The critical percentage is left to Member States to be fixed, but may not be higher than 20%. Serious drawback in *comparability of FDI (FATS) statistics* in the framework of business statistics.

(6) **Article 23-26: Four alternative layouts of Profit / Loss Account**
MS can prescribe one or more, may choose one, or allow companies to choose individually which is the worst case.

(7) **Article 27: Abridged profit and loss accounts depending on thresholds**
Two of three criteria (higher than those under 4) justify abridged accounts:
< 8,0 MECU balance total (no data accessible)
< 10 MECU net turnover (covers > 99 % in number)
< 250 persons employed (covers > 99 % in number)
The quasi-totality of enterprises in services industries fulfill those. *Arabic items A1, A2 and B1 to B4 in annex 2 may be combined, thus leading to loss of important items*

(8) **Article 30: Profit/loss ordinary and extraordinary activities**
Member States may allow, independent of size, to combine or split profit or loss between *ordinary and extraordinary activities*. This may have negative effects on compilation of value added generated in a given sector when it is calculated from the bottom of the accounts.

(9) **Article 31-42: Valuation rules**
These know a number of options, derogations and possibilities which may affect comparability. This subject is deemed to merit a special study with concrete situations in mind and probably confined to some industry sectors.

(10) **Article 43: Notes on the account**
Useful statistical information is contained in the notes on the accounts. Paragraph 8 of Article 43 prescribes a breakdown of turnover by activity and geographical market when they differ from one another. A Commission recommendation provides for the application of the activity nomenclature NACE rev. 1 to be used

to this extent. This is extremely important for *classification purposes and branch approach* in terms of secondary activities.

(11) **Article 44: Abridged notes on the accounts**
The thresholds in article 11 as set out under item (4) serve as well to allow for abridged notes. Unfortunately this concerns as well the one under item (10).

(12) **Article 47: Publication obligations**
Paragraph 2 provides for companies under article 11 as set out under item (4) to be relieved by Member States from publication obligations. This can create serious *access problems by statisticians.* Paragraph 3 provides for abridged balance sheet published for companies under article 27 as set out under item (7).

Special cases

The Fourth Directive is not valid for financial and insurance companies in most of its provisions. Special pieces of legislation apply to those which are often even more detailed and have thus more harmonizing effect. Large use is made of those in the Eurostat statistical system which has already been reported to the Voorburg Group in previous sessions.

Special situation exists as well for leasing companies where the distinction between operational and financial leasing leads to differences where some leases should be capitalized. Micro-economic accounting rules and macro-economic rules as laid down in the ESA do not seem to coincide perfectly.

Any of these special cases merits specific analysis which is not the subject of this paper.

Conclusion and Outlook to the Future

Limitations of the EC accounting provisions have been shown in the previous chapter. It shall however been stressed once more the very beneficial effect of standards in accounting even if there are a number of exceptions. Even if as an outcome of the analysis in chapter 4 only rather few businesses in service industries are fully covered by the provisions legally, it can though be assumed that common practices have an attraction effect (e.g. generated by requirements for credit granting purposes). The author is not fully aware on the current situation in all Member States (what options did they make use of) as it may even be a dynamic one. A study on accounting rules (legal, self-regulation, recommendations) applicable in Member States and beyond is an other one to be recommended.

As towards future developments the EC is of course not a closed economic area but its companies (normally major ones) operate worldwide. They do increasingly seek capital as well at places outside the EC (often in the US, where they are subject to the Securities

Exchange Commission rules). These standards seem to be more demanding (GAAP Generally Accepted Accounting Practices) and therefore companies prepare a second set of accounts.

The Commission has proposed to harmonize its provisions with International Accounting Standards in the relevant Committee which, once achieved, will have very beneficial effects on the international comparability of statistics too.

Annex 1

Balance Sheet in the Fourth EC Directive

<u>Assets</u>

A. Subscribed capital unpaid

B. Formation expenses

C. Fixed assets

I. *Intangible assets*

1. Costs of research and development, in so far as national law permits their being shown as assets.
2. Concessions, patents, licences, trade marks and similar rights and assets, if they (a) acquired for valuable consideration and need not be shown under C(I) (3); or
   (b) created by the undertaking itself, in so far as national law permits their being shown as assets.
3. Goodwill, to the extent that it was acquired for valuable consideration.
4. Payments on account.

II. *Tangible assets*

1. Land and buildings.
2. Plant and machinery.
3. Other fixtures and fittings, tools and equipment.
4. Payments on account and tangible assets in course of construction.

III. *Financial assets*

1. Shares in affiliated undertakings
2. Loans to affiliated undertakings
3. Participating interests
4. Loans to undertakings (with which linked by virtue of participating interests)
5. Investments held as fixed assets
6. Other loans
7. Own shares

D. Current assets

I. *Stocks*

1. Raw materials and consumables
2. Work in progress
3. Finished goods and goods for resale
4. Payments on account

II. *Debtors*

1. Trade debtors
2. Amounts owed by affiliated undertakings.
3. Amounts owed by undertakings (with which linked by virtue of participating interests)
4. Other debtors
5. Subscribed capital called but not paid
6. Prepayments and accrued income

III. *Investments*

1. Shares in affiliated undertakings
2. Own shares
3. Other investments

IV. Cash at bank and in hand

E. Prepayments and accrued income

F. Loss for the financial year

<u>Liabilities</u>

A. Capital and reserves

I. Subscribed capital
II. Share premium account
III. Revaluation reserve
IV. Reserves
1. Legal reserve, in so far as national law requires such a reserve
2. Reserve for own shares
3. Reserves provided for by the articles of association
4. Other reserves.

V. Profit or loss brought forward
VI. Profit or loss for the financial year

B. Provisions for liabilities and charges

1. Provisions for pensions and similar obligations
2. Provisions for taxation
3. Other provisions

C. Creditors

1. Debenture loans, showing convertible loans separately
2. Amounts owed to credit institutions
3. Payments received on account of orders in so far as they are not shown separately

as deductions from stocks
4. Trade creditors
5. Bills of exchange payable
6. Amounts owed to affiliated undertakings
7. Amounts owed to undertakings (linked by virtue of participating interests)
8. Other creditors including tax and social security
9. Accruals and deferred income

D. Accruals and deferred income.

E. Profit for the financial year

Annex 2

Profit and Loss Account in the Fourth EC Directive

A. Charges

1. Reduction in stocks of finished goods and work in progress:
2. (a) Raw materials and consumables
   (b) other external charges.
3. Staff costs:
   (a) wages and salaries
   (b) social security costs, with a separate indication of those relating to pensions
4. (a) Value adjustments in respect of formation expenses and of tangible and intangible fixed assets
   (b) Value adjustments in respect of current assets
5. Other operating charges
6. Value adjustments in respect of financial assets and of investments held as current assets
7. Interest payable and similar charges (separately those concerning affiliated undertakings)
8. Tax on profit or loss on ordinary activities
9. Profit or loss on ordinary activities after taxation
10. Extraordinary charges
11. Tax on extraordinary profit or loss
12. Other taxes not shown under the above items
13. Profit or loss for the financial year

B. Income

1. Net turnover
2. Increase in stocks of finished goods and in work in progress
3. Work performed by the undertaking for its own purposes and capitalized
4. Other operating income
5. Income from participating interests (separately that derived from affiliated undertakings)
6. Income from other investments and loans forming part of the fixed assets (separately that derived from affiliated undertakings)
7. Other interest receivable and similar income (separately that derived from affiliated undertakings)
8. Profit or loss on ordinary activities after taxation
9. Extraordinary income
10. Profit or loss for the financial year