European Commission

Accounting for the introduction of the euro

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EN

ACCOUNTING FOR THE INTRODUCTION OF THE EURO

CONTENTS

Foreword By Commissioner Mario Monti

The introduction of the euro will be a historic event in the true sense of the term. It is of great political as well as economic significance. As Commissioner responsible for the Single Market, I shall be focussing my attention on the contribution which the Single Currency will make in our continuing efforts to consolidate Europe's Single Market. The euro will contribute in a number of ways. It will in particular increase market transparency by making prices more easilycomparable and make cross-border transactions more attractive by eliminating the costs associated with currency conversion and by eliminating the exposure to exchange risks. All this will help create an environment that favours a steady and sustainable growth of the economy.

In turn, the Single Market underpins the Single Currency, or rather it underpins Economic and Monetary Union more generally. The operation of the Single Market is the principal vehicle of economic integration which makes EMU possible. In its recent Action Plan, the Commission is proposing an intensive effort between now and 1 January 1999 to ensure that the Single Market realises its full potential and thus provides the best possible conditions for the introduction of the euro on that date.

Of the many adjustments we shall all have to make when the euro is introduced, some important ones concern the financial reporting of businesses. The Commission recognised early on that there was a need to investigate the effects of the introduction of the single currency in this area. Together with experts from the Member States, we have prepared this document, which discusses accounting issues raised by the changeover to the single currency. Its purpose is to assist Member States and national standard-setting bodies as well as business and accounting professionals to achieve a smooth changeover. While providing wherever possible for the continuation of existing accounting practices, guidance is offered on major subjects such as currency translation, treatment of costs associated with the changeover, consolidated financial statements and comparative figures.

In the period up to the introduction of the euro, the Commission will continue to monitor the accounting issues that may arise. Where necessary, additional guidance may be provided. In the meantime, I hope that accountants and others involved in financial reporting will find this paper a practical and comprehensive answer to their needs.

INTRODUCTORY NOTE

This document exists in the eleven official Community languages and is available on request from DG XV/D3. The document can be obtained by:

- sending a letter to the:
  European Commission – DG XV/D3
  Rue de la Loi 200 – C100 03/133
  1049 Brussels
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- sending a fax to (+32-2)-299-4745; or

- downloading it from DG XV's website:
  http://europa.eu.int/en/comm/dg15/dg15home.html

I. Executive Summary

A. Principles underlying the paper

1. The introduction of the euro will change the currency in which many financial statements are prepared. It will also have practical consequences for many firms. Increasingly Commission services have been asked to clarify how these changes should be reflected properly in financial statements.

2. Commission services have studied how the existing framework of European accounting legislation could be used to account for the introduction of the euro in consultation with the Contact Committee on the Accounting Directives. To facilitate a smooth and orderly changeover to the use of the euro and to help national accounting authorities, firms and advisers across Europe the Commission services are publishing the results of their reflections. This paper is the result of a round of consultations, notably between Commission services, the Contact Committee on the Accounting Directives, and the Fédération des Experts Comptable Européens. They in turn consulted their respective constituencies. This paper reflects the broad agreement of the Contact Committee on the Accounting Directives on accounting issues arising from the introduction of the euro.

3. The key conclusions reached are threefold:

    a. The introduction of the euro can be treated within the existing framework of European accounting legislation;

    b. The introduction of the euro does not create a need for additional Community legislation, nor for amendments to existing Directives or for further harmonisation of standards; and

    c. Member States can use existing accounting practices which are allowed under current Accounting Directives to accommodate the changeover to the euro.

4. The Contact Committee on the Accounting Directives is a body that was set up, under the auspices of the Commission, under the Fourth (78/660/EEC) and Seventh (83/349/EEC) company law Directives. Its function is to facilitate harmonised application of the Accounting Directives through regular meetings dealing in particular with practical problems arising in connection with the application of these Directives. Furthermore, the Contact Committee advises the Commission, if necessary, on additions or amendments to the Accounting Directives. The Contact Committee is composed of representatives of the Member States and representatives of the Commission.

B. Structure of the paper

5. An introductory section provides the relevant background. It sets out the various phases for the introduction of the euro (paragraphs 13–14) and then describes the legal framework for the introduction of the euro, highlighting the elements of proposed Community legislation which are most relevant to accounting (paragraphs 15–23).

6. A large part of accounting for the euro is concerned with foreign exchange translation. Paragraphs 24 to 28 describe the context of existing EC rules for foreign currency translation. The issue is complex because different methods for foreign currency translation exist, the use of which varies between the Member States. This section also highlights the relevant articles in EC legislation and describes how in practice accounting principles are currently applied to foreign currency translations (paragraphs 31–43).

7. The paper then suggests how these principles might be used to account for the introduction of the euro (Section III). There are two key points to note:

a. First, in establishing annual accounts for financial periods ending on 31 December 1998, the fixed conversion rate should be used as the closing rate. Paragraphs 48 to 50 explain why; and

b. Second, in many cases the introduction of the euro will have an effect on the profit and loss statement. This is clearly an issue of importance to firms and their advisers, as well as to national authorities. In determining exactly how the profit and loss statement will be affected, the nature of the event is predominant (paragraph 68).

8. The paper discusses certain special cases, for example adherence to a strict interpretation of the historic cost convention (paragraphs 70–71), foreign exchange contracts (paragraphs 72–73) and different methods of consolidation (paragraphs 74–81).

9. When accounting for costs associated with the introduction of the euro, the underlying assumption is that most costs incurred are comparable to regular costs faced by companies (paragraphs 82–87). This means that most cannot be classified as extraordinary income or charges. Some, however, can be capitalised. The paper looks in particular at whether provisions can be made for costs. It sets out the relevant articles of the Accounting Directives and other papers.

10. Paragraphs 88 to 91 discuss how to present comparative figures for previous financial years in euro. It suggests using the irrevocably fixed conversion rate. Those that use and interpret the accounts will have to bear in mind any historic exchange rate fluctuations when comparing financial statements that were originally measured in different currencies.

11. The paper also discuss how companies with financial years which do not coincide with the calendar year (paragraph 92) should present their accounts. In some cases, the introduction of the euro will qualify as an important post-balance sheet event requiring proper disclosure (paragraph 93).

12. Section IV of the paper clarifies that national regulators may wish to give additional guidance and amend existing rules, but that they must work within the existing framework of Accounting Directives (paragraphs 95–96). It suggests some principles to help a smooth transition (paragraphs 97–100). Finally it identifies a particular area where some adjustment of Accounting Directives will be necessary, namely the thresholds for small and medium-sized enterprises.

II. Introduction

A. Phases

13. The transition to the single currency will take place in three phases, for which definite dates have been set:

    a. Phase A – Launch of economic and monetary union: In 1998, as soon as the group of countries taking part in EMU is known, the European Central Bank will be set in place. The conditions for conducting the single monetary and exchange-rate policy will be decided, and the production of euro banknotes can begin. Preparations in the participating countries will be stepped up throughout this phase, particularly in administrations, banks and financial institutions. The economy as a whole will continue to function as before, in other words on the basis of the national currencies;

    b. Phase B – Effective start of economic and monetary union: This phase, ending on 31 December 2001, begins on 1 January 1999 on which date the rates of conversion between the euro and the participating national currencies will be irrevocably fixed and the euro will become a currency in its own right. The currencies of the participating Member States will be replaced by by the euro which will be denominated both in its own unit (1 euro) and sub-units (100 cents) and in national currency units, i.e. the former national currencies of the participating Member States.

       Economic agents may also begin operating in the euro unit. Companies most heavily involved in international and European trade are most likely to opt for early conversion of all or part of their operations. Administrations will also continue to prepare actively for their own changeover where they have not already executed the changeover. They will provide operators and consumers with the necessary information on the introduction of the single currency;

    c. Phase C – Definitive changeover to the euro:

       i) After 31 December 2001, amounts which on 31 December 2001 are still expressed in national currency units of the participating Member States will be deemed to be expressed in euro units, converted at the official rates;

       ii) By not later than 1 January 2002, and over a short period (to be determined by each Member State but a maximum of six months), the new euro banknotes and coins will be put into circulation in substitution for banknotes and coins in the old national currency units. This phase should last no longer than is strictly necessary in order to minimise the complications for users that could be caused by national currency units remaining in circulation for an extended period alongside the single currency. The operation will end by 1 July 2002, (at the latest) when euro banknotes and coins will be the only banknotes and coins to have legal tender status in participating Member States.

14. The timing of these phases and the decisions which are made in each of these phases are of importance for financial reporting by companies.

B. Legal framework for the use of the euro

15. On 16 October 1996 the European Commission adopted two proposals to the Council on the legal framework for the use of the euro. They were, after discussion in a Council work group, politically endorsed by the European Council in Dublin on 12 December 1996. The two proposals are as follows:

    a. A Council regulation, based on Article 235 of the EC Treaty, covering those aspects which need to come into force as soon as possible to provide the market certainty for the early preparation of the changeover. This concerns, the one for one equivalence between the ECU basket and the euro, continuity of contracts, conversion and rounding rules; and

    b. A Council regulation, based on Article 109L(4) of the EC Treaty, is the legal base which allows the Council to adopt measures for the rapid introduction of the euro, which defines the monetary law provisions for participating Member States. However, it can only be adopted once the list of participating countries has been decided in early 1998.

    This legal framework confirms that the euro will be the single currency of the participating Member States from 1 January 1999 and provides the necessary legal certainty for all economic agents.

a. Principles

16. The two proposals presented by the Commission include several basic principles which are of importance for the financial reporting by companies:

    a. The euro will be substituted for the currencies of the participating Member States at the fixed conversion rates applicable from 1 January 1999 (Articles 2 and 3 of the 109L(4) Regulation);

    b. As from 1 January 1999 every reference in a legal instrument to the ECU is replaced by a reference to the euro at a rate of one euro to one ECU (Article 2 of the 235 Regulation);

    c. Where in a legal instrument reference is made to a national currency unit, this reference shall be as valid as if reference were made to the euro unit (Article 6 of the 109L(4) Regulation);

    d. The introduction of the euro shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance under any legal instrument, nor give a party the right unilaterally to alter or terminate a legal instrument. However, as the freedom of contract is respected, this provision remains subject to anything which parties may have agreed (Article 3 of the 235 Regulation); and

    e. Any amount denominated either in the euro unit or in the national currency unit of a given participating Member State and payable within that Member State by crediting an account of the creditor, can be paid by the debtor either in the euro unit or in that national currency unit (again, subject to anything that the parties might have agreed) (Article 8(3) of the 109L(4) Regulation).

17. In the explanatory memorandum of the Commission to the proposed Council regulations, it is stressed that the proposals strike a balance between “no compulsion” and “no prohibition” for the use of the euro unit as laid down in the reference scenario decided by the European Council of Madrid. The explanatory memorandum also confirmed that the EMU can qualify neither as an unforeseeable event nor as a severe disruption of circumstances. As the introduction of the euro does not justify invoking the principle of frustration, the legal framework confirms the continuity of contracts.

b. Freedom

18. For accounting purposes it is important to know what competences are given to the Member States as opposed to the freedom which is left to the companies in phase B (from 1 January 1999 to 31 December 2001) concerning the use of national currency units or euro units in the annual or consolidated accounts.

19. In the legal framework, the fundamental principle applicable during the transitional period is that acts to be performed under legal instruments stipulating the use of one of the units possible – the national currency unit or the euro unit – shall be performed in the stipulated unit unless otherwise agreed by the parties (Article 8(1) of the 109L(4) Regulation). This rule ensures that economic agents will only have to use the unit to which they have agreed. Exceptions from this principle are foreseen. Article 8(3) of the 109L(4) Regulation enables debtors to settle their debts in book money by making a payment in either the euro unit or in the national currency unit. Banks are under an obligation to convert such payments into the unit of account of the creditor. Article 8(4) of the 109L(4) Regulation enables Member States to take measures to allow redenomination of debt or the changeover of organised markets. Apart from these specifically mentioned exceptions of Article 8(3) and (4), Member States may allow the use of the euro unit but can only impose it on the basis of further Community legislation (Article 8(5) of the 109L(4) Regulation).

20. Annual and consolidated accounts of companies must be published in accordance with the national laws of the respective Member States (Article 47 of the Fourth Directive). National laws in certain Member States may not permit a free choice of reporting currency. In addition, the trade registers in certain Member States may not be able to accept annual and consolidated accounts, at the start of Phase B, that are not expressed in national currency units. Therefore, companies in these Member States can only publish their accounts in euro units when this is permitted by the Member State. Where this is not permitted, companies must continue to publish their accounts in the national currency unit.

21. Although Member States may allow companies to publish their accounts in the euro unit during Phase B, they cannot require this. The use of the euro unit can only be imposed on the basis of further Community legislation.

22. The principles of “no compulsion” and “no prohibition” concerning the use of the euro were laid down during the Madrid summit. These principles have to be respected both by economic agents and by the Member States themselves. Consequently, there is an inevitable trade-off between the freedom of the economic agents and that of the Member States.

23. Under Directive 90/604/EEC, companies in all Member States which publish their annual and consolidated accounts in national currency units, have the right to additionally publish their accounts in ECU. Therefore, with the effect from 1 January 1999 these companies will have the right to additionally publish their accounts in euro units.

III. Foreign Currency Translation

A. European Union legislation

24. This section gives an overview of the existing rules for foreign currency translation. First a summary is given of the European Accounting Directives. Thereafter, the different methods of currency translation are discussed under the headings of annual accounts, consolidated accounts and convenience translation.

25. A number of Accounting Directives has been adopted under the company law harmonisation program. These Directives are binding, as to the result to be achieved, upon each Member State to which they are addressed, but leave to the national authorities the choice of form and methods.

26. The accounting provisions for the annual and consolidated accounts are laid down in the Fourth Directive (78/660/EEC) and Seventh Directive (83/349/EEC), respectively. These Directives provide general and specific guidance on accounting issues and reporting formats, but do not specifically deal with foreign currency translation. However, Article 43(1)(1) of the Fourth Directive and Article 34(1) of the Seventh Directive do require disclosure of the method used for conversion of foreign currency amounts. Furthermore, the Fourth Directive establishes the prudence principle and the accruals principle, which are also of importance for currency translation (further reference is made to "Contact Committee on the Accounting Directives – An examination of the conformity between the international accounting standards and the European accounting directives", European Commission, Brussels/Luxembourg 1996, paragraph 37).

27. Article 39 of the Council Directive on the annual accounts and the consolidated accounts of banks and other financial institutions ("Bank Accounts Directive"; 86/635/EEC), establishes rules for foreign currency translation by banks and other financial institutions. This Directive requires assets and liabilities denominated in foreign currency to be translated at the spot rate of exchange on the balance sheet date. However, Member States may require or permit that assets held as financial fixed assets and tangible and intangible assets, not specifically covered by spot or forward markets, are translated at the exchange rates on the dates of their acquisition. Interest receivable and similar income and interest payable and similar charges shall include all income and charges resulting from covered forward contracts, spread over the actual duration of the contract and similar in nature to interest (Article 29(3) of the Bank Accounts Directive). Without prejudice to this provision the differences between the book values of the assets, liabilities and forward transactions and the amounts produced by the currency translation shall be shown in the profit and loss account. Member States may provide that certain positive exchange differences are not shown in the profit and loss account. The Member States may require or permit that translation differences arising on consolidation are included, in whole or in part, in the consolidated reserves.

28. In 1995 the Accounting Advisory Forum prepared a document on foreign currency translation. For a more detailed description of the subject reference is made to that document ("Paper on the Accounting Advisory Forum - Foreign Currency Translation", European Commission, Brussels/Luxembourg 1995).

B. Objectives of translation

29. The objective of currency translation is to incorporate foreign currency transactions and the accounts of foreign currency operations in the

annual or consolidated accounts of a company. Assets, liabilities, income, charges, profits and losses that are measured or denominated in a foreign currency must be translated to the reporting currency, because it is not possible to combine, add or subtract measurements in different currencies.

C. Definition of terms

30. The following terms are used in this document with the meanings specified. Whenever possible, definitions formulated by the Accounting Advisory Forum are used:

- The *reporting currency* is the currency used in presenting annual and consolidated financial statements;
- An *exchange rate* is the ratio for exchange of two currencies;
- The *closing rate* is the spot rate which exists at the balance sheet date;
- The *fixed conversion rate* is the irreversibly fixed exchange rate from the euro unit to the national currency unit of a participating Member State;
- A *foreign exchange contract* is an agreement, which gives the right or the obligation, to exchange different currencies at a specified rate at a certain date or during a certain future period;
- *Monetary items* are money held and assets or liabilities (including off-balance sheet items) to be received or paid in fixed or determinable amounts of money. All other assets and liabilities are non-monetary items;
- A *foreign operation* is a subsidiary, associated company, joint venture or branch, whose activities are based or substantially conducted in a currency other than the currency of the reporting company;
- The *net investment* which a company has in a foreign operation is its effective equity stake and comprises its portion of such foreign operation's net assets; in appropriate circumstances, intra-group loans and other deferred balances may be regarded as part of the effective equity stake;
- *Translation* is the process of expressing in the reporting currency of the company those amounts that are denominated or measured in a foreign currency. It includes both the expression of individual transactions in terms of the reporting currency and the expression of a complete set of annual accounts drawn up in a foreign currency in terms of the reporting currency;
- *Annual accounts* are defined in Article 2 of the Fourth Directive;
- *Consolidated accounts* are defined in Article 16 of the Seventh Directive;
- *Participating Member States* are the countries which, according to the legal framework for the use of the euro, adopt the single currency in accordance with the EC Treaty;
- *National currency units* are the units of the currencies of the participating Member States as those units are defined on the day before the start of the third stage of the Economic and Monetary Union;
- *Euro units* are units of the single currency as defined in the Regulation on the introduction of the euro which will enter into force at the starting date of the third stage of the Economic and Monetary Union.

D. Translation process

31. The process of foreign currency translation comprises two procedures. The first procedure is the translation of transactions, assets and liabilities denominated in a foreign currency into the reporting currency of a company. The second procedure is the translation of financial statements of foreign operations into the reporting currency of the parent company.

a. Annual accounts

32. Generally, all foreign exchange transactions entered into by a company are, subject to certain exceptions, translated into the local cur-

rency at the exchange rate ruling on the date the transaction occurs. Sometimes the use of an average rate for a period is acceptable if the exchange rate does not fluctuate significantly during the period.

33. At the balance sheet date, monetary assets and liabilities denominated in foreign currencies should be translated into the reporting currency. Three methods are commonly used in the European Union in order to achieve this:

   a. Monetary items are translated at the closing rate and the positive and negative exchange differences are recognised in the profit and loss account;

   b. Monetary items are translated at the closing rate. The negative differences are recognised in the profit and loss account. The positive differences are deferred under a separate heading in the balance sheet;

   c. Where there are negative exchange differences, the monetary items are translated at the closing rate and the negative difference is recognised in the profit and loss account. In case of positive exchange differences the monetary items are translated at the historic exchange rate, with the result that the positive exchange differences are not recognised.

   In all cases, non-monetary items remain translated at the rate ruling when they were originally acquired or last revalued.

34. It should be noted that there are modalities of the methods as described in the previous paragraph, in particular concerning the compensation of positive and negative differences on assets and liabilities denominated in the same currency, concerning the nature and the maturity of these assets and liabilities, and concerning hedged transactions. Notable exceptions are the translation rules as laid down in the Bank Accounts Directive. This Directive makes a distinction between "fixed assets" (these are assets held as financial fixed assets and tangible and intangible assets) and "current assets" for the purpose of currency translation.

35. Under certain conditions a special treatment is sometimes allowed for exchange differences on foreign exchange loans that serve as a hedge of an investment in a foreign operation. Depending on applicable national regulations, two different treatments are possible. The exchange differences on the loan and the investment are offset, or alternatively, the exchange differences on the loan are recognised in a separate line item in the balance sheet and subsequently amortised to the profit and loss account.

36. Exchange differences on foreign exchange contracts are normally recognised in the profit and loss account in the period in which they arise. In some cases, where foreign exchange contracts serve as a hedge of assets or liabilities or as a hedge of future transactions, these exchange differences may be deferred. In those cases the exchange differences are recognised in the profit and loss account at a later stage.

37. As a result of these foreign currency translation rules, not all monetary items are translated at the closing rate. In practice this can mean that, for example in the annual accounts of a company on 31 December 1995, not all monetary items are translated at the exchange rates on 31 December 1995. For instance, a foreign currency loan in these annual accounts could be translated at the historic exchange rate of 17 October 1987, the day on which the company received the loan. If the company would translate the loan at the exchange rate on 31 December 1995, then an exchange difference would arise.

b. Consolidated accounts

38. The financial statements of foreign operations must be translated into the reporting currency of the parent company, so that they can be included in the consolidated accounts. There are two generally accepted methods that are

used for consolidating foreign operations; the closing rate/net investment method and the temporal method.

39. The closing rate/net investment method views the balance sheet items of the foreign operation as a whole and translates them at the closing rate. The profit and loss account is translated at either the average exchange rate for the year or at the closing rate. The foreign operation is viewed as an independent separate entity, which is not integrated with the parent company. The exchange differences resulting from the application of this method are called translation differences. These translation differences are recorded directly in the equity of the consolidated group, because they only arise as a result of the translation and are not the result of operations. The cumulative amount of the translation differences should be recognised as a gain or loss in the profit and loss account in the same period as the sale or liquidation of the foreign operation.

40. Under the temporal method, the foreign operation is treated as if it were an integrated part of the parent company. This means that all individual items in the financial statements of the foreign operation are translated as if they were the result of transactions which the parent company itself had entered into. Thus, the assets and liabilities of a foreign operation are translated at the historic exchange rate at the date of their acquisition or latest revaluation. The items in the profit and loss account are translated, depending on their nature, at the spot, average or historic rate. A monetary item is translated, depending on the parent company's accounting policy for the item, at either the historic rate or the closing rate.

41. The temporal method is used when the trade of the foreign operation is more dependent on the economic environment of the parent company's currency than that of its own reporting currency. In preparing its consolidation, the parent company uses the historical costs, in its own reporting currency, for those assets and liabilities of the foreign operation that are not translated at the closing rate.

c. Convenience translation

42. A convenience translation is not part of the measurement of financial performance or the valuation of assets and liabilities. Instead, its purpose is to express financial statements in a currency with which the user is familiar. For instance, most German shareholders of a Mexican company would find it helpful when financial statements expressed in Mexican pesos are translated into Deutsche Marks. In this type of translation all amounts in the financial statements are converted at the same exchange rate, which is normally the year-end rate. In drawing conclusions from these financial statements the user still needs to take into account the particularities of the main currencies in which the company conducted its business and of the currency in which the financial statements were originally measured.

43. The preparation of financial statements in ECU, as allowed under Directive 90/604/EEC is an example of a convenience translation. As is already required by Directive 90/604/EEC, the exchange rate used in the translation should be disclosed in the financial statements.

IV. Effects of the Introduction of the Euro

44. The effects of the introduction of the euro depend on the particular circumstances of a company and its environment. The effects for companies whose reporting currencies are those of Member States who do not participate in the EMU is addressed in the paragraph on non-participating Member States. The effects on financial statements expressed in the currency of a participating Member State are described both for companies that never use foreign currencies and for companies that do have dealings in foreign currencies.

A. Domestic companies

45. Some companies never use foreign currencies in their operations. As a result these companies have never needed to perform a currency translation before, because it was simply not necessary. However, with the introduction of the euro these companies will now have to translate their accounts into euro units. This translation is not a remeasurement of the assets and liabilities of these companies. Instead, the assets and liabilities of the companies are simply expressed in a new currency, in the same way that this is done in a convenience translation, except in this case it is a one-off and irreversible exercise.

46. The translation procedure to be followed is relatively easy. It requires only that all assets, liabilities and equity are translated to euro units using the fixed conversion rate. The currency translation to be performed by these companies will, by definition, not result in any exchange differences.

B. Companies that have dealings in foreign currencies

47. Companies that have dealings in foreign currencies are companies that directly conduct part of their business in foreign currencies, or that have an interest in a foreign operation (branch or subsidiary). For these companies it is necessary to perform a currency translation in the preparation of their annual accounts and/or their consolidated accounts.

a. Realisation

Start date euro

48. The official start date of the euro is 1 January 1999. On this date (at the latest) the fixed conversion rates between the euro unit and the national currency units are announced. Independent from the exact date of their announcement, the fixed conversion rates should be used as the closing rate in establishing annual and consolidated accounts for financial periods ending on 31 December 1998 because:

   a. the decision on the fixed conversion rates will be taken in 1998. The subsequent announcement of this decision provides further evidence on conditions that existed at year-end and must be taken into account. The economic event, deciding on the fixed conversion rates, occurred in 1998 and should be accounted for in the corresponding financial period;

   b. all assets and liabilities of a company, which are denominated in another participating currency, that have not been sold or settled before the year-end at 31 December 1998, can subsequently only be sold or settled at the fixed conversion rates. Therefore, using the fixed conversion rates in establishing annual and consolidated accounts for financial periods ending on 31 December 1998 best reflects the economic reality at that date; and

   c. it is likely that the market exchange rates will have converged completely towards the fixed conversion rates because Article

109L(4) of the EC Treaty requires that the adoption of the irrevocably fixed conversion rates shall by itself not modify the external value of the ECU.

49. Not using the fixed conversion rates as the closing rate on 31 December 1998 would have several disadvantages:

    a. financial statements would not properly reflect the economic reality of the situation, if the fixed conversion rates have effectively been put into place on 31 December 1998;

    b. not using the fixed conversion rate as the closing rate at 31 December 1998 would have as a consequence that exchange differences between currencies of participating Member States have to be recognised in 1999 or later. Deferred recognition of exchange differences, over the remaining holding period or upon settlement or sale of the underlying items, could result in unpredictable fluctuations in the profit and loss account, which would reduce the usefulness of the financial statements. Especially, because these exchange differences are the result of past exchange rate fluctuations, but would be recognised in a year in which the exchange rates, by definition, cannot even fluctuate;

    c. recognition of negative exchange differences between currencies of participating Member States would be deferred at least until 1999, which is not in accordance with the prudence principle; and

    d. in many cases financial statements of companies are published six to twelve months after the end of the financial year. Financial statements reflecting the effect of the fixed conversion rates would be published as late as the second half of the year 2000.

50. There is no advantage to assuming that exchange differences are realised at a later date (for instance, in 1999) as this does not change or mitigate the effects of the introduction in any substantial way. In situations where accumulated exchange differences are of significance, more appropriate methods are available for reducing the effects of their realisation (further reference is made to paragraph 70).

Realisation of exchange differences

51. The exchange rates between the national currencies of participating Member States and the euro will be irrevocably fixed. In fact, after the introduction of the euro there will only be conversion rates between the national currency units. This means that there will not be an exchange risk between the participating currency units. All existing exchange differences between participating currencies will have become permanent, since a further increase or decrease of the exchange differences is impossible. Considering the general principles of the Fourth Directive, namely the prudence and the accruals principles, these exchange differences are realised.

52. The prudence principle requires that exchange losses on monetary assets and liabilities are normally taken into account immediately. Exchange gains on monetary liabilities should also be taken into account, as they reduce the amount which will ultimately be payable. There is no doubt about the realisation of the exchange gains on these liabilities, because financial statements are drawn up under the assumption that liabilities are settled upon maturity at face value.

53. In the case of monetary assets there is the possibility that a certain credit risk exists, and therefore it could be argued that exchange gains cannot yet be taken into account. However, allowances for credit risks have nothing to do with the question of recognition of exchange gains. Therefore, it can be said that the exchange gains on monetary assets must be taken into account, and allowances for credit risks should be set up separately.

54. In this paper a distinction is drawn between realisation and recognition. Realisation is the economic event that makes the exchange differences irreversible, while recognition refers to the accounting treatment of such differences.

55. The realisation of exchange difference between participating currencies is caused by the economic event of irreversibly fixing the conversion rate between participating currencies. The choice of reporting unit, euro unit or national currency unit, cannot change the fact that in the absence of exchange risks the exchange differences between currencies of participating Member States are realised. This is even the case for companies that continue to report in their national currency unit.

56. In the same way the exchange differences will be realised independent of whether they relate to a short term or a long term monetary item. The exchange rates are fixed for both long term and short term monetary items and therefore the exchange differences are realised for both types of items.

57. After the introduction of the euro it is unimportant for accounting purposes whether a company keeps its books in the euro unit or in the national currency unit. The outcome will be identical in both cases, because the exchange rate between the euro unit and the national currency unit is the same at all times.

58. The ECU has a special position because it represents a basket of Member State currencies. As the ECU is replaced by the euro at a ratio of one to one, the exchange rate between the ECU and the currencies of participating Member States will be fixed as well. Therefore, all exchange differences between the ECU and the currencies of participating Member States will also be realised.

59. The introduction of the euro does not alter the relationship between the currency unit of a participating Member State and a currency of a non-participating country. In these cases the currencies continue to fluctuate compared to each other and the exchange differences on these balances can be treated in the same manner as it was previously done.

b. Recognition in the profit and loss account

Monetary items

60. The assets and liabilities in the balance sheet of a company can be classified as monetary or non-monetary. Monetary items are money held and assets or liabilities (including off-balance sheet items) to be received or paid in fixed or determinable amounts of money. All other assets and liabilities are non-monetary items.

61. For companies that are covered by the Bank Accounts Directive the additional rules of Article 39 (86/635/EEC) regarding financial fixed assets, tangible and intangible assets, and the treatment of translations differences take precedence over the general rule.

62. Monetary items are sometimes denominated in a foreign currency, in which case they must be translated into the reporting currency. Fluctuations in the exchange rate of this foreign currency will lead to exchange differences on the monetary item. Non-monetary items, with the possible exception of investments in foreign operations, are denominated in the reporting currency, therefore, exchange differences will not arise on these items.

Recognition

63. Under existing accounting practices the fact that exchange differences are realised will in most cases require the recognition of exchange results in the profit and loss account. However, it may be necessary to consider whether an exchange result relates to the current year, or more appropriately to some future period.

64. In this context the provisions of the Accounting Directives should be kept in mind. Article 31(1)(d) of the Fourth Directive requires that account must be taken of income and charges relating to a financial year irrespective of the date of receipt or payment of such income or charges. Furthermore, Article 2(3) of the Fourth Directive states that the annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss.

65. Deferred recognition of exchange results in the profit and loss account may be appropriate when this leads to a better matching of income and expenses. In other words, exchange differences could be deferred when they have a direct relationship with offsetting future income or expense items. It is not appropriate to defer exchange results on foreign currency assets and liabilities to the date of their receipt or payment without such an offsetting relationship.

66. Normally all realised exchange differences on monetary items are recognised in the profit and loss account. Only when the offsetting exchange differences are taken to equity directly, can exchange differences on monetary items also be recorded in equity.

67. Some may hold the view that the exchange differences realised upon the introduction of the euro should be accounted for by restating the opening balance for the first year. However, this approach would have the same effect as the direct recognition in equity.

68. The magnitude of the realised exchange differences will depend on the particular circumstances of a company. However, in deciding on the accounting treatment of economic events, the nature of the event is predominant.

69. The exchange differences are caused by the fluctuation in the exchange rates to which the companies are exposed. As exchange risk exposures are part of the normal business of companies dealing with foreign currencies, they are included in the profit or loss account for the year but not as an extraordinary item. The exchange differences realised upon the introduction of the euro have, in all material respects, the same nature as other realised exchange differences. Therefore, in principle, the exchange differences that are realised as a result of the introduction of the euro should be treated in the same way as other realised exchange differences.

70. In situations where a company adheres to a strict interpretation of the historic cost convention in relation to long term monetary items (e.g. long term foreign currency loans), positive exchange differences are usually not recognised. These companies may have problems with the recognition of substantial exchange differences that are realised as a result of the introduction of the euro. The sudden recognition of positive exchange differences that have accumulated over a long period can affect the profit and loss account in such a way that problems might arise with taxation and profit distribution. There is no reason why the changeover to the euro should change accounting practices in the Member States that are allowed under the Accounting Directives. It is therefore possible for those Member States which give prominence to the prudence principle, to require or allow deferral of positive exchange differences after the introduction of the euro, to the extent that this is in conformity with the Accounting Directives. However, if negative exchange differences were to be realised, immediate recognition in the profit and loss account is required.

71. Article 31(2) of the Fourth Directive (further reference is made to paragraph 96) permits companies, in exceptional circumstances, to depart from the general principles of the Fourth Directive. A possible solution for these companies could be to place the exchange differences in a special line item on the balance sheet and use a systematic method to release this balance to the profit and loss account. Article 31(2)

of the Fourth Directive requires in this case that an assessment of the effect on the assets, liabilities, financial position and profit or loss is given.

c. Foreign exchange contracts

72. Foreign exchange contracts are often used to hedge foreign exchange risks. In many situations companies in the EU use foreign exchange contracts to reduce their exposure to fluctuations of the national currencies of other Member States. However, after the introduction of the euro the exchange risk on contracts between the currency units of two participating Member States will disappear. In the absence of exchange risks the outcome of a foreign exchange contract can be calculated with certainty and the exchange difference is realised.

73. While the legal framework for the use of the euro provides for the continuity of contracts, these foreign exchange contracts, which will have served their original purpose of reducing risk up to the date of the fixing of the exchange rates, will no longer have any risk reducing effect. Therefore, the question arises whether or not the exchange differences on the foreign exchange contracts should be recognised in the profit and loss account. This will depend on the purpose of the particular foreign exchange contract:

    a. Speculative contracts – The realised exchange differences on speculative foreign exchange contracts should be recognised in the profit and loss account immediately, because the exchange difference on the contract has no direct relationship with offsetting future income or expense items;

    b. Hedge of balance sheet items – If a foreign exchange contract is used as a hedge of a balance sheet item then the combined exchange difference on the foreign exchange contract and the balance sheet item should be recognised in the profit and loss account immediately;

    c. Anticipatory hedge – Anticipatory hedges are foreign exchange contracts that are used to reduce the exchange risk on future transactions or commitments. For instance a company that expects to receive a cash flow in a foreign currency next year, can enter into a foreign exchange contract in order to reduce the exchange risk exposure.

    Once the exchange risk between the currencies of participating Member States has disappeared the value of the foreign exchange contract used as an anticipatory hedge is a determinable amount of money that only changes because of the time value of money. As a result of the high liquidity of the foreign exchange markets most of these foreign exchange contracts will have all the characteristics of cash or near cash. Recognition of the related gains and losses in the balance sheet is necessary in most cases in order to provide a true and fair view.

    The exchange differences on these anticipatory hedges must be deferred when this leads to a better matching of income and expense items. Exchange losses on anticipatory hedges may not be deferred where this is in violation of the prudence principle, i.e. where this would result in losses in later periods. Conversely, exchange gains on anticipatory hedges should not be recognised in the profit and loss account where this would result in losses in later periods.

d. Consolidated accounts

74. This section addresses the consequences of the introduction of the euro on the different methods of consolidating foreign operations. The method most commonly used in the European Union for consolidating foreign operations is the year end/net investment method. The tem-

poral method is also used as an alternative, but to a lesser extent.

Year end/net investment method

75. Investments in foreign operations are generally not considered to be monetary assets, although the financial statements of these operations are denominated in a foreign currency. Under the year end/net investment method the translation differences arising on the consolidation of foreign operations are recognised in equity. The translation differences as calculated under this method are related to both the monetary and non-monetary assets and liabilities of foreign operations.

76. Once the fixed conversion rates between the national currency units of the participating Member States are in effect, the translation differences on foreign operations denominated in one of the other participating currencies will become fixed amounts. However, this does not mean that the fixed translation differences should be included immediately in the profit and loss account because:

    a. normally translation differences are not recognised in the profit and loss account for the period because they are reversible and the changes in the exchange rates have little or no effect on the present and future net cash flows of the foreign operation. As the translation difference is largely unrelated to the trading performance or financing operations of the foreign operation it should not be included in the profit and loss account;

    b. the fixed translation differences relate in part to non-monetary assets and liabilities. Recognising translation differences on non-monetary items in the profit and loss account is not an accepted accounting method; and

    c. immediate recognition of the cumulative translation differences in the profit and loss account would distort the true and fair view.

77. Therefore, it is not appropriate to recognise the cumulative amount of these translation differences as a gain or loss in the profit and loss account before the period in which the sale or liquidation of the foreign operation occurs.

Temporal method

78. The temporal method translates the assets and liabilities of a foreign operation at the historic exchange rate at the date of their acquisition or latest revaluation. The foreign operation is treated as if it were an integrated part of the parent company, and the assets and liabilities are valued accordingly. For the parent company the currency translation at the historic exchange rates is part of the valuation of the assets and liabilities.

79. The table below gives a brief example of the application of the temporal method, before and after the introduction of the euro.

	Subsidiary	Historic rate	Parent
a. Asset in national currency	**FRF 1200**	3.00	**DEM 400**
b. Fixed conversion rates	5.00	-	2.00
c. Asset in euro	**euro 240**	-	**euro 200**

80. In the set of accounts that the subsidiary keeps for local purposes, the asset is valued at euro 240. As the subsidiary needs to meet certain local reporting requirements, it is not possible to change the valuation of the asset. However, for the preparation of the consolidated accounts of the parent company, the same asset needs to be valued at euro 200. The introduction of the euro is in itself not a reason for the parent company to change the valuation of non-monetary assets held by its foreign subsidiaries. The difference of euro 40 reflects the effects of the exchange rate fluctuation in the period between the purchase of the asset and the introduction of the euro.

81. The subsidiary keeps a set of accounts that is necessary for local purposes, while at the same time a set of accounts is kept for consolidation purposes. The set of accounts kept for local purposes is based on the local valuation rules and reporting requirements, while the set of accounts for consolidation purposes is based on the accounting policies and reporting requirements of the parent company. The difference of euro 40 will disappear over time as the underlying asset is depreciated or sold.

e. Costs associated with the changeover

82. Companies will incur a variety of costs as a result of the introduction of the euro. These costs will range from administrative planning and changes in software to staff training, giving customers information and adaptation of vending machines. The difference in nature between conversion costs and regular costs is often only marginal, which can make the costs relating specifically to the changeover hard to identify.

83. As the costs of the changeover are comparable to regular costs, the normal rules of the Accounting Directives apply. This means that the costs of the changeover will normally be expensed in the year in which they are incurred. Companies are of course constantly adapting to the changing economic environment and technological progress. Therefore, most of these costs are part of companies' ordinary activities, which cannot be classified as extraordinary income or charges. Insofar as the changeover costs are substantial, adequate disclosure should be made so that the impact on the profit or loss of the company can be identified.

84. Some of the costs of the changeover may result in identifiable future benefits. In these cases, for instance when the costs result in identifiable benefits during the whole transitional period (Phase B), it is allowed to capitalise the costs of the changeover or to include them in the carrying amount of a fixed asset. In the banking industry it is generally recognised that the costs of the changeover can be very substantial. To the extent that these costs result in future economic benefits they might qualify for capitalisation. However, when costs are incurred in an effort to maintain an existing business they should not be capitalised. Capitalised costs will have to be amortised, according to the normal rules, over their useful economic life.

85. The question can be raised whether companies are allowed to provide for the costs of the changeover to the euro. Article 20 of the Fourth Directive allows two different types of provisions, both of which must meet the following conditions:

    a. their nature must be clearly defined;
    b. the liabilities or charges are either likely to be incurred, or certain to be incurred but uncertain as to amount or as to date on which they will arise.

    Article 20(1) refers to provisions for probable losses (arising from transactions in the course of settlement) and probable debts. The basic condition for setting up such a provision is the existence of a relationship to a third party (e.g. supply or service contract, legal proceedings, etc.). Article 20(2) contains an option for Member States to authorise the creation of provisions for charges which have their origin in the financial year under review or in a previous one, although there is no obligation to third parties in this case. This type of provision is meant to cover, for example, major and recurring maintenance costs and expenditure on major repairs ("The accounting harmonisation in the European Communities – Problems of applying the fourth directive on the annual accounts of limited companies", European Commission, Brussels/Luxembourg, 1990).

86. Setting up provisions for changeover costs under Article 20(1) is only possible in situations where a relationship with a third party exists.

However, it is not required that an actual commitment already exists on the balance sheet date. Under Article 20(2) provisions for changeover costs are only allowed when these costs arise in the financial year concerned, or a previous one. The decision by the Council of Ministers to introduce the euro or the ability of a company to identify reasons for expected future costs are in themselves not a sufficient reason for setting up provisions.

87. In certain cases the useful economic life of an asset is reduced as a result of the introduction of the euro, for example in the case of vending machines. It may therefore be necessary to depreciate these assets over a shorter useful economic life or to make another value adjustment.

f. Comparative figures

88. Article 4(4) of the Fourth Directive imposes the requirement of presenting comparative figures for the preceding financial year, which must be expressed in the same currency as the figures for the current year. For companies that change over to the euro unit in their financial reporting, it will be necessary to translate the comparative figures for the preceding financial year that were not expressed in euro units.

89. The only logical method for translating the comparative figures would be to translate them at the fixed conversion rate. This method effectively solves the problem which companies might experience if they start reporting in euro units in 1999.

90. Translation of the comparative figures using a historic exchange rate is not possible because the euro was not in existence before 1 January 1999. It is not appropriate to use the ECU as a surrogate for the euro, because the ECU's exchange rate to currencies of participating Member States will have fluctuated. Furthermore, using a historic exchange rate has added disadvantage that it would result in exchange differences in the case of a domestic company that did not have any balances denominated in a foreign currency.

91. By translating the comparative figures at the fixed conversion rate the historic comparability of financial statements that were originally expressed in the same currency is retained. However, in comparing financial statements that were originally measured in different currencies it is necessary to keep in mind the historic exchange rate fluctuation between these currencies.

g. Financial years not coinciding with the calendar year

92. For companies with a financial year not coinciding with the calendar year, the introduction of the euro will happen somewhere during their financial year. For these companies the introduction of the euro should be accounted for in the period in which contains 31 December 1998. However, it will not be possible to publish financial statements in euro units for financial periods ending before 1 January 1999, because the euro will only become the single currency of the participating Member States on that date.

h. Post-balance sheet events

93. For companies that end their financial year not on 31 December, but a few months earlier, the introduction of the euro is an event taking place after the balance sheet date which can still have an impact on the annual and consolidated accounts for that financial year. Companies are required by Article 46(2)(a) of the Fourth Directive to give an indication of any important event that has occurred since the end of the financial year. For instance, a company that ends its financial year on 30 September 1998, would have to disclose the effects of the changeover to the euro in its financial statements for that period if these are established after the announcement of the fixed conversion rates.

C. Non-Participating Member States

94. The effects of the introduction of the euro are limited for companies in non-participating Member States. As of 1 January 1999 (start of Phase B) the companies with cross-border, intra-EU transactions, will have to prepare themselves for dealing with transactions expressed in euro units. Furthermore, these companies might experience an indirect effect of the introduction of the euro through their subsidiaries in participating Member States.

V. European Requirements

A. Regulation at national level

95. Member States may want to give additional guidance or amend their existing regulations in order to deal with the unique introduction of the euro. In so doing, the national regulators will have to work within the existing legal framework of the Accounting Directives.

96. Article 31(2) of the Fourth Directive (further reference is made to paragraph 71), which permits departures from the general principles in exceptional cases, does not permit national regulators to prescribe special rules. This Article is addressed to companies preparing financial statements. Therefore, national regulators cannot use this Article as a legal basis for prescribing rules that are not in line with the Accounting Directives.

B. Transitional period

97. To facilitate a smooth transition during the transitional period (Phase B), Member States might consider applying the following principles to the preparation and publication of annual and consolidated accounts. These principles are possible under the present regulations:

    a. There should be sufficient flexibility on the part of Member States to allow companies to publish accounts in euro, including for administrative purposes such as for taxation, during Phase B. That would reduce the administrative burdens on businesses, especially SMEs who might be faced with conflicting demands to carry out their accounting operations in euro or in their national currency and hence be required to produce two sets of accounts.

    b. There should be neither compulsion nor prohibition for companies to use national currency unit or the euro unit;

    c. A legal framework should ideally be in place at the start of Phase B which allows companies to establish and publish their accounts exclusively in euro units; and

    d. Companies should not be treated more or less favourably depending on the date they change over to reporting in euro units. All relevant rules should be neutral and fixed clearly and sufficiently in advance.

98. There is no need to amend Article 50A of the Fourth and Article 38A of the Seventh Directive which allow the publication of additional accounts in ECU. From the beginning of Phase B, companies in participating Member States may use the euro unit instead of the ECU in addition to the national currency unit for publishing the accounts. Companies in the non-participating Member States may publish their financial statements in euro units in addition to the publication of these financial statements in their national currency units.

99. The early adoption of financial reporting in euro units is to be encouraged. However, apart from the 'additional' facility dicussed in paragraph 98, it will not be possible to publish financial statements in euro units for financial periods ending before 1 January 1999, because the euro will only come into existence as the single currency on that date. The exact timing for the transition to euro units will differ from company to company. It is generally assumed that large companies will first start using the euro unit, but depending on the circumstances small and medium-sized companies may also want to change over to the euro unit as early as possible. The last possibility to establish financial statements in the national currency unit will be for financial years ending, 31 December 2001 the last date by which changeover must be effected in the participating Member States.

100. Companies might be allowed, during the transitional period, to choose between preparing their accounts in national currency units or in euro units. It would be theoretically possible that companies publish their annual accounts in national currency units, while they publish their consolidated accounts in euro units, or vice versa. As accounts conforming to the Accounting Directives have to be drawn up clearly and have to disclose comparable and equivalent information, it does not seem desirable that annual accounts and consolidated accounts are published together but in different currency units.

C. Thresholds

101. Articles 11 and 27 of the Fourth Directive define the thresholds for small and medium-sized companies. These amounts are laid down in ECU. When translating these amounts to their national currency, Member States may increase these amounts by no more than 10% for the purpose of having rounded thresholds in their national currency. Every 5 years the ECU amounts of the thresholds are examined and if necessary revised.

102. Situations might arise, after the introduction of the euro, where the euro amounts of the thresholds in the Fourth Directive are not equal to the euro amounts in the national legislation. It is understood that companies will be allowed during Phase B to continue to use the thresholds as implemented in national currency units in their national legislation.

103. After Phase B the national currency units of the participating Member States can no longer be used. There will no longer be a need to translate the euro thresholds of the Fourth Directive into the national currency units of participating Member States. Therefore, when the thresholds will be adjusted after the end of Phase B the participating Member States will no longer be allowed to use the 10% rounding rule, while non-participating Member States can continue to use this rule. To ensure equal treatment of Member States, it must be ensured that at the next 5 yearly adjustment of the thresholds in 1999 a system will be introduced into the Directive which guarantees an equivalent treatment of SME's in both participating and non-participating Member States.