"Directive 34, the CJEU and the prudence principle: some reality behind the rhetoric".

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Much of this material is from joint ongoing work with Roberta Fasiello, University of Salento, and eventual publications in joint names are anticipated. This particular file is very preliminary.

The essential argument is that

1) fair value and unrealised profits are fully consistent with the prudence principle as contained in the new Directive,

2) the European Court is bound to accept this by its own previous decisions/cases (Gimle),

3) historical cost and the imparitätsprinzip are useless and dangerous (following but adding to Zappa),

4) fair value, as defined by IASB, is not much better.

The text for this sermon/homily is as follows. First the source, then the text in 3 languages (21 more are available). The proposition of the paper is that this text is nonsense in absolutely every respect.

P8_TA(2016)0248 International Accounting Standards (IAS) evaluation. European Parliament resolution of 7 June 2016 on International Accounting Standards (IAS) evaluation and the activities of the International Financial Reporting Standards (IFRS) Foundation, the European Financial Reporting Advisory Group (EFRAG) and the Public Interest Oversight Board (PIOB) (2016/2006(INI)) [The Stolojan report].

4. Emphasises that a core component of achieving the true and fair view of the figures set out in the accounts is prudent valuation, which means no understating of losses or overstating of profits, as described in Article 6(1)(c)(i) and (ii) of the Accounting Directive; points out that this interpretation of the Accounting Directive has been confirmed by numerous ECJ rulings;

4. souligne que l'un des éléments clés pour obtenir l'image fidèle des chiffres indiqués dans les comptes est l'évaluation prudente, ce qui signifie ne pas sous-estimer les pertes ni surévaluer les bénéfices, comme décrit à l'article 6, paragraphe 1, points c) i et ii, de la directive comptable; fait observer que cette interprétation de la directive comptable a été confirmée par de nombreux arrêts de la Cour de justice;

4. sottolinea che una componente essenziale per una rappresentazione veritiera e corretta delle cifre indicate nei conti è la valutazione prudente, il che significa che le perdite non vengono sottovalutate o gli utili sopravvalutati, come descritto all'articolo 6, paragrafo 1, lettera c), punti i) e ii), della direttiva contabile; sottolinea che tale interpretazione della direttiva contabile è stata confermata da numerose sentenze della Corte di giustizia dell'Unione europea;

THE ECONOMIA AZIENDALE TRADITION.

The doctrine propounded in Zappa ('due', 1927 and afterwards) is universally regarded as the basis, still accepted today in its theoretical essentials, of 'Economia Aziendale', i.e. firstly the various but always coordinated aspects of managing the 'azienda', and secondly the accounting-related question of valuation bases and performance measurement and reporting. These two key elements of 'Economia Aziendale' thinking are intimately linked together. A focus on income and the long-term maintenance of income is seen to necessarily follow from a properly rational analysis of the 'enterprise as a unitary and dynamic system aimed at economic production'. The key quotation from Zappa himself may be given as:

'Income available for consumption, or which is available for taxation or distribution, must not only not reduce the initial capital, but it shouldn't even damage the capacity of the capital to provide an income: income is essentially a surplus value, whose making leaves unimpaired the value which is the mechanism for its creation' 'Il reddito devoluto al consumo, o che si può prelevare o distribuire, non solo dunque deve essere tale da non diminuire il capitale iniziale, ma nemmeno dovrebbe intaccare l'attitudine del capitale a fornire un reddito: il reddito è essenzialmente un valore eccedente, che nel determinarsi lascia integro il valore che è mezzo di sua rilevazione'. (Zappa, 1946:267).

This is long-run capital maintenance. It is exactly consistent with the famous 'income number 3' definition of Hicks (1946): 'the maximum amount of money which the individual can spend this week, and still expect to be able to spend the same amount in real terms in each ensuing week'. It is about, and theoretically ensures, the capacity of the business ('azienda') to continue to operate for the indefinite future.

Historical cost fails to achieve the fundamental and rational and, paradoxically, prudent objective of long-run operational capital maintenance and therefore long-run entity survival. Consider the simplest of examples. An enterprise has a business model to buy and sell one item at a time. Capital is 100. Buy for 20 (historical 'actual/factual' cost). Buying price rises to 40. Sell for 50. Maximise distribution to owners. Replace for 40 and repeat the process to infinity. How much can be distributed?

Applying the Besta conservative model using historical cost, broadly supported by Zappa ('uno', 1910), supported also by Italian law, we have revenue of 50 and cost of 20. After the sale is made the difference of 30 is realized, so can safely be distributed. So cash, originally 100, becomes 100-20+50-30-40 = 60. So the opening 'patrimonio' when the business is first operational, of 80 plus physical sellable item, becomes closing 'patrimonio' of 60 plus physical sellable item. So the business is contracting and will eventually, if the process, the cost trend, and the accounting policy continue, become bankrupt. The conclusion is very simple: conservatism fails to conserve! Note that the problem is nothing to do with realization: the sales proceeds (revenues in the IASB sense) of 50, are indeed realized.

More formally, our little example ensures the maintenance of financial capital in nominal terms. The original 100, before purchase of the first unit, remains as 100, before the purchase of the second

unit. But the net cash inflow from the first unit, of 50 - 20, which under historical cost accounting is also the net income of revenues less expenses, of 50 – 20, needs to be regarded as two elements: the holding gain of 20 (40 - 20) and the operating gain of 10 (50 - 40). The holding gain of 20 needs to be retained ('permanently held') and is not available for distribution. Note also that the point, economically, operationally, and in terms of basic business common sense, is not that the income of 30 needs to be split into two parts. Zappa, quite correctly, disagrees with the 'Business Income' concept of Edwards and Bell (1961), which takes the 'Business Income' to be the 30. The point is that the income, Zappa's 'reddito' according to his own definition, is only 10 in the first place. The above quotation (Zappa 1946:267) makes this absolutely clear.

In a way, we can expose the required accounting and valuation treatment by taking the logic backwards. The 'answer' is that profit ('reddito') is 10. What are the assumptions and workings necessary to arrive at this answer? The key point is that the expense to be associated ('matched' in English, using the 'competenza' principle in Italian) with the revenue of today's sale is the expense of tomorrow's (replacement) purchase, not of yesterday's (historical) purchase. In other words, in the general case, a forward-looking replacement expense figure needs to be incorporated into the income calculation, not the historical purchase or production cost.

The final point to emphasise is that realisation is not relevant. If the cash from the sale of 50 has not come in, then 40 is not distributable. And if the cash from the sale of 50 has indeed come in then 40, not 20, of that cash is not distributable. The operating cash surplus from these events, of 10, is the maximum distributable, whether or not the sales proceeds are realised.

So a crucial point to be emphasised concerns the 'danger' of distribution of unrealised gains. It is important here to distinguish economic arguments and requirements and legal ones. Economically, much the greatest danger, as we have illustrated above, is to distribute *realised* gains when they are not surplus to the retentions necessary to ensure that the business 'leaves unimpaired the value which is the mechanism for its creation' (Zappa as already quoted). Economically the business can borrow cash against reliable (but unreceived) revenue flows to pay dividends early. This lacks prudence to some degree, and the law may, and in Italy usually does, prevent such a distribution. So this can be prevented by statute, but note that Italian statute is sufficiently stupid to allow distribution of the replacement cost increase (the additional 20 in our earlier example) after realisation, which fails to achieve the fundamental and rational and, paradoxically, prudent objective of long-run operational capital maintenance and therefore long-run entity survival. We do not imply that this legal problem is unique to Italy.

The configuration of income based on the historical cost adoption allows the exclusion of the gains not realized and only expected. This on the one hand, reduces the risk to distribute not yet realized profits, but on the other hand, it does not guard against the possibility to distribute all the gains of the accounting period, even if they are realized (see the example above presented). It is commonly known that the distribution of only realized profits does not guarantee a prudential behaviour in the capital maintenance perspective. Indeed, the generalized distribution of the profits, even if limited to the realized ones, can jeopardise the future profitability of the business.

The overall conclusion is very simple: 'Economia Aziendale' as developed by 'Zappa due' makes economic and managerial sense. For reporting purposes it theoretically makes complete sense too -

indeed it must do, because the job of external reporting is to give a transparent reflection of the economics of the 'azienda' and its relations with other economic players.

In operational terms, income available for distribution must not damage the capacity of capital to provide future income. In Italian legal terms, income available for distribution must not reduce the initial capital (in simplistic numerical terms). The II European Directive no. 77/1991 (named capital maintenance) fixed for joint-stock companies a minimum amount for 'social capital' as a guarantee for creditors. It stated rules claiming to preserve this measure of capital, allowing the distribution of only realized gains and also only provided that this distribution does not produce a decrease of capital below the stated minimum limit. The Italian Civil Code, for the safeguard of creditors, does not allow the distribution of unrealized gains, but does consider the losses, even if unrealized, in order to protect the capital. But of course this works in only nominal terms (as it does not consider adjustment of social capital amount for changes in the purchasing power, whether general or specific, of the currency) and above all only in the measure of the social capital, and as highlighted elsewhere (e.g. Fasiello, 2010:117) it is something very different from the capital maintenance as conceived under the 'Economia Aziendale' tradition and in economic theory. Economically the Italian Civil Code (and the II Directive) requirements are surely completely unnecessary, and logically irrational.

The historical cost adoption allows the maintenance of the financial capital in nominal terms (and, therefore, of the 'social capital') being, consequently, only a minimum guarantee for creditors, not sufficient to preserve the conditions for the future profitability and, therefore, the economic integrity of the capital, and of the entity itself. Of course, if the long-term economic integrity of the entity is not guaranteed, then the long-term economic integrity of the creditors cannot be guaranteed either. Claims that historical cost accounting is creditor-focused are invalid. Long-term survival of the 'azienda' as an operational entity able to satisfy all its stakeholders is ensured by the proper application of Zappa's 'reddito' principles, and nothing else is necessary. The lawyer is wrong again.

In terms of our earlier example explained above, views differ as to whether to go for the 30 and then restrict it to 10, or to define the profit, the 'reddito', as 10 in the first place. But the key point either way is that the 'resources renewal' to allow the permanent continued operation of the entity, in cognisance of the specific plans of the specific management at the specific time and in the specific place, must be ensured. 'Profit', using the word now in the general economic sense, is what has become available as a result of the activities of the reporting period after achieving this position.

This last conclusion is essentially what 'prudence' means under the 'Economia Aziendale' tradition, as created by the later Zappa and further refined by a long series of disciples. This extensive continuation is conveniently described and analysed in a forthcoming book (Alexander et al. (eds) 2017). As we have clearly but simply illustrated with our little numerical example, in this straight-forward case, the distributable profit, and Zappa's 'reddito', are both 10. We (and Zappa) arrive at that conclusion by strict logical analysis, not involving a subjective, arbitrary and 'negotiable' adjustment towards pessimism. Zappa, by his insistence on flexible valuations derived from the particular situation of a particular 'azienda' at a particular time, allows for any necessary adjustments to take account of the greater complexities (changing market expectation, changing

technical developments…..) which our simplified example excludes. The focus on the entity, the specific 'azienda', is the core of Zappa's theory (Zappa due that is!). It is the core of 'Economia Aziendale'. Under this conceptualisation of prudence, we can firmly support the prudence principle. But this prudence principle is far removed from that of IASB, that of traditional 'Continental' accounting, and that of current Italian practice. The issue of legal/lawyer thinking versus economic/Zapparian thinking very much remains on the table.

The Italian tradition, significantly though not exclusively, but very definitely including both Besta, and Zappa and his successors with 'Economia Aziendale', is entity ('azienda') specific. The business model concept is entity specific. So the Italian tradition and the business model go well together in this respect.

Besta's 'valore reale' in its theoretical manifestation (taken here as a given) is an exchange price ('valore di cambio'), and Fair Value as developed until the mid 2000s was explicitly an exchange price too. But there was and is an important difference between these two 'exchange prices' in that 'valore reale' was focused, both in its theoretically pure form and in its proxied applications, on entity specific considerations whereas fair value is, quite explicitly, not so focused. We have shown in several ways that entity specificity is required. It is tomorrow's cash outflows, which will arise because of today's consumption of prior purchases, which need to be linked with tomorrow's cash receipts. Fair value does not attempt to provide this information. More fully, following the issue of IFRS 13 effective from 2013, fair value is now explicitly a market-specific selling price concept, usually more-or-less gross of transaction costs. It is in essence an estimate of the cash flow which would result if the asset was sold today. But as such it has two theoretical flaws. The first is that it is not net of transaction costs, so it is an overestimate of expected cash flows. The second, perhaps partly related, is that it is market specific not entity specific. For both these reasons it is not a good estimate of the cash flows that the particular entity would receive if the asset were sold today. Further, of course, it wasn't sold today because it is still in the balance sheet. Fair value is not in general an estimate of the present value of the cash flows which will result when it is actually expected to be sold or used at some future time. So is it useful? Does it carry informational value? My answer would be that it is an opportunity cost concept. It is broadly (ignoring the two flaws mentioned above) an indication of the cash flows sacrificed by retaining the asset for its normal business use. The business had the opportunity to dispose of the asset before the balance sheet date, and did not do so. It has therefore lost, given up, and sacrificed, this possible cash flow. This is genuinely useful information. It is relevant to the appraisal of management competence and management decisions; did management act wisely by not selling? But is it a good measure of current performance, and therefore by extension a good indicator of future performance? Does it provide, as a measurement and reporting concept, the information that the explicitly declared chosen 'customers' of IASB, the particular epistemic community which they seek to serve, namely 'existing and potential investors, lenders, and other creditors', need for future decision-making, crucially and necessarily linked to expected cash flows? As the Framework states in para OB3, "existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity". Note that 'to an entity' is certainly entity-specific! So fair value is explicitly, as shown here for several reasons, not designed to provide the required information.

We have shown that the issue of realization is not relevant. The sales proceeds which need to be spent to replace consumed resources are not distributable if they have not been received. And they are not distributable if they have been received!

But there is hope. A major recent concern was the question of the endorsement by the EU of IFRS 9. We make no attempt at any broad summary of the complex issues, or any complete and rigorous exposition of the frequently confused, or simply invalid, arguments being put forward by a number of participants, including some in positions of some influence and authority, who should know better. We simply give two quotations. The first, Bischof and Daske (2015:18), is from an advisory report commissioned by the European Parliament's Committee on Economic and Monetary Affairs: '....this collective evidence convincingly suggests that the objectives behind the prudence principle outlined in the accounting Directives (e.g., financial stability) may rather be majorly achieved through fair value reporting. Vice versa, too strict of a historical cost regime potentially endangers these objectives to an even greater extent'.

The second is from a letter dated 1 December 2015 from Roger Marshall, as 'acting president of the EFRAG Board' to Olivier Guersent, the 'Director General, Financial Stability, Financial Services and Capital Markets Union' at the European Commission, paragraphs 4 and 5 on pages 4 and 5 (EFRAG 2015).

'The statement that financial statements should be prepared on a prudent basis and give a true and fair view of the entity's assets and liabilities, financial position and profit or loss does not automatically imply that the financial statements exclude unrealised gains and include all foreseeable losses. Recital 19 to the Accounting Directive clarifies that: 'systems of fair value accounting provide information that can be of more relevance to the users of financial statements than purchase price or production cost-based information. Accordingly, Member States should permit the adoption of fair value systems of accounting by all undertakings or classes of undertaking'. EFRAG also considered and assessed that IFRS 9 does not extend the use of fair value beyond what is allowed under the Accounting Directive. Under that Directive extensive options exists (sic) that permit or require fair value accounting for financial instruments and non-financial assets'.

Following on from this the current Directive 34 of 2013 explicitly requires fair value in certain circumstances and allows fair value or 'revalued amount' in many more (Articles 7 and 8). It also explicitly allows for the inclusion of unrealised gains in profit and loss (Article 8.9), which means in 'earnings' and not in 'other comprehensive income'. Article 8.9 reads in full as follows: "Notwithstanding point (c) of Article 6(1), Member States may permit or require, in respect of all undertakings or any classes of undertaking, that, where assets other than financial instruments are measured at fair value, a change in the value be included in the profit and loss account." It inevitably follows that such practices, in full accordance with the 2013 Directive, are consistent with the prudence principle (and also the true and fair view principle) as perceived in and required by that self-same Directive.

The Court of Justice of the European Union (EUCJ) is already committed by precedent to recognising these propositions. The Gimle judgement (C-322/12 of 2013) states in para 39 as follows:

‘The possibility that certain assets would be undervalued in company accounts where their acquisition value is lower than their real value is merely the necessary corollary of the choice made by the European Union legislator, in Article 32 of the Fourth Directive, to opt for a valuation method based not on the real value of the assets but on their historical cost’.

By direct extension, Articles 7 and 8 of the replacement 2013 Directive, which 'opt for a valuation method based not on the historical cost but on the 'real' (or in some sense current) value of the assets', give as a 'necessary corollary' that the European requirements of a true and fair view and of prudence, as designated by the legislator, are fully satisfied by such practices.

So our basic conclusion is simple and clear. EA, as developed by Gino Zappa, and further refined and developed by generations of disciples, places great emphasis on the long term operational survival of the entity, considered as a coherent unitary operation, and not as a collection of separate assets and liabilities. This requires the maintenance of long run cash flows, and this is turn requires the maintenance of the operational capacity/capital. The retention of the resources necessary to achieve this must be ensured BEFORE we can accept the existence of ANY profit. Profit is the surplus after this has been fully achieved. This is all essentially forward-looking, and requires forward-looking valuation concepts. But it is also very strongly related to the specifics of the individual entity, of its particular modus operandi at a particular time and in a particular place. It is this way of thinking which lies at the heart of the logic and the ethos of EA. Relevance, to potentially a wide variety of different users with a wide variety of sometimes incompatible needs, and appropriately focused flexibility to deal with these conflicts as well as possible, are needed at all times.

In a sense, of course, this is idealistic. The focused flexibility certainly allows financial reporting of greater informational relevance, useful to all stakeholders of any and every kind who have an interest in the development and continuation of the entity as an operational unit. It also makes ‘policing’ the validity of the financial reports more difficult. We remember the aphorism widely, and wrongly, attributed to Keynes: ‘it is better to be vaguely right than exactly wrong’. The source is in fact Read, (1898:351). The sentiment is absolutely correct, but there are tensions between flexibility/relevance on the one hand, and auditing/assurance on the other.

What we also show very clearly is that the ‘times they are a-changing’ (Bob Dylan, 1964; see Wikipedia). The EU Directive allows massive flexibility, especially if national governments give their optional support. The IASB standards (and Framework) allow massive flexibility and subjectivity too. And the European Court of Justice has explicitly signalled that ‘the European Union legislature’ must be assumed to always mean exactly what it said, and to always accept the necessary consequences. It is a well-established principle of legal interpretation that within any one specific document (such as Directive 34), any word or concept must hold the identical and unchanging meaning throughout the document. [PLEASE CAN I HAVE A PROPER REFERENCE/QUOTE FOR THIS (IN LATIN??)]

There is ‘all to play for’. EA gives no panacea and no instant solutions. But it provides a very valuable way of thinking, to help solve the absurdities, illogicalities and illusions of much 21st Century regulation and practice at all levels, national, European, and international.

So firstly we repeat our four-part ‘argument’ from page 1, and submit that these points are fully demonstrated by the above.

“1) fair value and unrealised profits are fully consistent with the prudence principle as contained in the new Directive,

2) the European Court is bound to accept this by its own previous decisions/cases (Gimle),

3) historical cost and the imparitätsprinzip are useless and dangerous (following but adding to Zappa),

4) fair value, as defined by IASB, is not much better.”

Secondly we repeat paragraph 4 of the Stolojan report:

“Emphasises that a core component of achieving the true and fair view of the figures set out in the accounts is prudent valuation, which means no understating of losses or overstating of profits, as described in Article 6(1)(c)(i) and (ii) of the Accounting Directive; points out that this interpretation of the Accounting Directive has been confirmed by numerous ECJ rulings.”

We have clearly shown that this is completely inconsistent with the current Directive (on which there have so far been no cases), both as regards wording (eg Articles 7 and 8), and as regards telos (eg Recital 19), and that when cases arrive the CJEU will inevitably follow the logic of the “choice made by the European Union legislature” (Gimle judgement para 39), in accepting and confirming our analysis.

References

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APPENDIX

The essential arguments and evidence of this Note finish here. Some more extensive quotations and comments are made available below. My own sources for the full documents are preserved for my convenience in these brackets, so if you want copies just ask.

[David work 11/09/15. Directive 34 (in 6 languages)

David work 26/2/16. Bischof and Daske (complete)

David work 13/05/16. Gimle (complete judgement)

David work 03/03/17. Stolojan (in 3 languages)]

Gimle. The findings of the Court were as follows.

25 By its question submitted for a preliminary ruling the referring court asks, in essence, whether the principle, set out in Article 2(3) to (5) of the Fourth Directive, that a true and fair view must be given requires that the principle of valuation of assets on the basis of their acquisition price or their production cost, contained in Article 32 of that directive, be departed from in favour of a valuation on the basis of their real value, where the acquisition price or the production cost of those assets is manifestly lower than their real value.

26 It is apparent from the order for reference that the main proceedings concern the treatment, for accounting purposes, of the acquisition of shares which were resold, one month after their acquisition, for a price 3 400 times their purchase price.

27 It is also apparent from that decision that the main proceedings are of a fiscal nature, in so far as an entry of shares in the accounts at their real value at the time of their acquisition would enable the Belgian tax authorities to tax the company concerned on the basis of the capital gain made on the difference between the real value of those shares and their acquisition price.

28 In this respect, the Court has already stated that the Fourth Directive is not designed to lay down the conditions in which the annual accounts of companies may or must serve as a basis for the determination by the tax authorities of the Member States of the basis for assessment and the amount of taxes, such as the corporate tax at issue in the main proceedings. However, it is in no way excluded that annual accounts might be used by Member States as a reference base for tax purposes (Case C 306/99 BIAO [2003] ECR I 1, paragraph 70), and no provision of the Fourth Directive precludes Member States from correcting, for tax purposes, the effects of the accounting rules in that directive, in order to determine a taxable profit closer to the economic reality.

29 The Court notes that the Fourth Directive is intended to ensure the coordination of national provisions on the structure and content of annual accounts and reports and methods of valuation, for the purposes of protecting members and third parties. To that end, according to the third recital in its preamble, it is designed only to establish minimum conditions as to the extent of the financial information to be made available to the public (BIAO, paragraph 69).

30 The Fourth Directive bases that coordination of the content of annual accounts on the principle that a true and fair view must be given, compliance with which is its primary objective (Tomberger, paragraph 17; DE + ES Bauunternehmung, paragraph 26; and BIAO, paragraph 72). According to that principle, contained in Article 2(3) to (5) of that directive, annual accounts must give a true and fair view of the assets, financial position and the profit and loss of the company.

31 Article 2(3) to (5) of the Fourth Directive, which lays down the principle that a true and fair view must be given, forms part of Section 1 of that directive, entitled 'General provisions'. Section 7 of that directive, entitled 'Valuation rules', defines the rules for valuation of the items shown in the annual accounts, among which are the general principles set out in Article 31 of the directive.

32 The Court has already had occasion to rule that the application of the principle that a true and fair view must be given must, as far as possible, be guided by the general principles contained in Article 31 of the Fourth Directive, within which the principle of making valuations on a prudent basis set out in Article 31(1)(c) is of particular importance (Tomberger, paragraph 18).

33 In accordance with the provisions of Article 31(1)(c) of the Fourth Directive, which states the principle of making valuations on a prudent basis, taking account of all elements – profits made, charges, income, liabilities and losses – which actually relate to the financial year in question ensures observance of the requirement of a true and fair view (Tomberger, paragraph 22, and BIAO, paragraph 123). In particular, Article 31(1)(c)(aa) provides that only profits made at the balance-sheet date may be included.

34 The principle that a true and fair view must be given must also be understood in the light of the principle contained in Article 32 of the Fourth Directive, pursuant to which the items shown in the annual accounts are to be valued based on the purchase price or production cost.

35 Under that provision, the true and fair view which the annual accounts of a company must give is based on a valuation of the assets not on the basis of their real value, but on the basis of their historical cost.

36 It is true that Article 2(5) of the Fourth Directive provides that where, in exceptional cases, the application of a provision of that directive is incompatible with the obligation laid down in Article 2(3), that provision must be departed from in order to give a true and fair view within the meaning of paragraph 3.

37 Under Article 2(5) of that directive, it is therefore possible that, in exceptional cases, Article 32 of the directive, which requires a valuation of the assets by acquisition price or production cost, must be departed from where the use of that method would give a distorted view of the companies' assets, financial position and profit or loss.

38 However, it must be stated that, as GIMLE, the German Government and the Commission point out, the undervaluation of assets in company accounts cannot, in itself, be considered to be an 'exceptional case' within the meaning of Article 2(5) of the Fourth Directive.

39 The possibility that certain assets would be undervalued in company accounts where their acquisition value is lower than their real value is merely the necessary corollary of the choice made by the European Union legislature, in Article 32 of the Fourth Directive, to opt for a valuation method based not on the real value of the assets but on their historical cost.

40 Furthermore, as the German Government states, the undervaluation of certain assets, such as shares, in a company's accounts, because of their valuation on the basis of acquisition price or production cost, is consistent with the principle of making valuations on a prudent basis laid down in Article 31(1)(c) of the Fourth Directive. In particular, the valuation of such assets at their real value would reveal a capital gain in the company accounts, corresponding to the difference between the real value and the acquisition value of those assets, contrary to Article 31(1)(c)(aa) of that directive, according to which only profits made at the balance sheet date may be included.

41 Furthermore, the Commission correctly points out that the État belge had not, at the time of the transactions at issue in the main proceedings, adopted the optional provisions under Article 2(5) or Article 33 of the Fourth Directive. The Commission also correctly states that a company which is certain to make a large profit due to commitments entered into regarding the future resale of an asset must, under Article 2(4) of that directive, give additional information in that regard.

42 In the light of all of the foregoing considerations, the answer to the question referred is that the principle that a true and fair view must be given, set out in Article 2(3) to (5) of the Fourth Directive, does not permit the principle of valuation of assets on the basis of their acquisition price or their production cost, contained in Article 32 of that directive, to be departed from in favour of a valuation on the basis of their real value, where the acquisition price or the production cost of those assets is manifestly lower than their real value.

FAIR VALUE

The term 'fair value' has been used with many meanings. In particular, on the one hand, it has been used as a 'catch-all' label for current values of more-or-less any kind (including in the past by Jacques), and on the other hand it has been used by regulators for a variety of specific proposals. Here I address purely the concept of fair value as used by IASB. Following certain changes of wording and punctuation in the 1980s, the IASC definition of fair value settled down to that in para 7 of IAS 18 as issued in 1993: "Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction". Whether the IASC thought they knew exactly what this meant at the time is an open question. In its then new quarterly newsletter, Insight, for October 2001 (IASB 2001:14), the newly created IASB stated: "At some stage, the Board will need to address other issues, for example: should fair value be considered to be an entry value (including buying costs), exit value (deducting selling costs) or something in between entry value and exit value?" This quotation obviously suggests that the IASB did not understand the definition they had inherited. An exchange price, by definition, must be the same for both parties in

the exchange. So, as then defined, transaction costs of both parties had to be excluded from the evaluations. In practice as required by particular standards, the logic of his argument was sometimes followed and sometimes ignored. But the definition is now changed. IFRS 13 'Fair Value Measurement' was issued by IASB in 2011, and is now fully operational. This, ignominiously following the coat-tails of a unilateral declaration by the US FASB (issued at a time of supposedly developing 'convergence'!), changed the definition of Fair Value to an explicitly exit (selling price) concept. Fair Value is now (IFRS 13 Appendix A) "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". This definition is automatically inserted into all standards referring to fair value, except, surely bizarrely, IAS 17 and IFRS 2, which retain the old (different and inconsistent) definition. As regards transaction costs, para 25 of IFRS 13 states that "The price...used to measure the fair value of the asset or liability shall not be adjusted for transaction costs". However para 26 states that transaction costs do not include transport costs. So fair value excludes transaction costs, but transport costs are excluded from the exclusion. This applies, for example, to IAS 40, which contains no mention of transaction costs (and investment properties are not transportable), so the IFRS 13 statements apply in full. 'Pure' fair value is to be used for the asset evaluation. But IAS 41 now states that a biological asset shall be measured...at its fair value less costs to sell, where 'fair value' is already net of transport costs to the market. The resulting number is of course lower than 'pure' fair value, so there is a clear inconsistency between the two standards. Both standards invoke fair value, one with option and one without, but they use fair value in different and quite incompatible ways. Returning to the basic principles as of 2013, fair value is a market-specific selling price concept, usually more-or-less gross of transaction costs. It is in essence an estimate of the cash flow which would result if the asset was sold today. But as such it has two theoretical flaws. The first is that it is not net of transaction costs, so it is an overestimate of expected cash flows. The second, perhaps partly related, is that it is market specific not entity specific. For both these reasons it is not a good estimate of the cash flows that the particular entity would receive if the asset were sold today. Further, of course, it wasn't sold today because it is still in the balance sheet. Fair value is not in general an estimate of the present value of the cash flows which will result when it is actually expected to be sold or used at some future time. So is it useful? Does it carry informational value? My answer would be that it is an opportunity cost concept. It is broadly (ignoring the two flaws mentioned above) an indication of the cash flows sacrificed by retaining the asset for its normal business use. The business had the opportunity to dispose of the asset before the balance sheet date, and did not do so. It has therefore lost, given up, and sacrificed, this possible cash flow. This is genuinely useful information. It is relevant to the appraisal of management competence and management decisions; did management act wisely by not selling? But is it a good measure of current performance, and therefore by extension a good indicator of future performance? Does it provide, as a measurement and reporting concept, the information that the explicitly declared chosen 'customers' of IASB, the particular epistemic community which they seek to serve, namely 'existing and potential investors, lenders, and other creditors', need for future decision-making, crucially and necessarily linked to expected cash flows? As the Framework states in para OB3, "existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity". Note that 'to an entity' is certainly entity-specific! So fair value is explicitly, as shown here for several reasons, not designed to provide the required information. A widely supported reaction to this conclusion seems to be that we should therefore stick to 'traditional' historical cost accounting and the good old 'prudence principle'. The

letter of comment from the ANC to the IASB, sent on 14 February 2014, in relation to the proposals for revising the Framework states inter alia that: ‘we are convinced that:

(i) The principle of prudence, which implies an asymmetry in the accounting of assets and liabilities, should be kept in the framework from which it was removed in 2010; (ii) The principle of reliability should equally be preserved contrary to the framework finalised in 2010 and to proposals in the DP’.

The ANC letter referenced above actually states on page 10 as follows: ‘At a time when the IASB reaffirms that the objective of accounting is to help users in assessing future cash-flows, the role of cash generation and capital maintenance in the determination of profit should not only be maintained in the framework but also reinstated in practice in standard setting’. Quite so! Therefore historical cost must be rejected, as our earlier example shows. But the new Directive, 2013/34/EU, issued on 26 June 2013 to replace the earlier 4th and 7th Directives, whilst certainly allowing both historical cost and fair value, has attempted to exclude the possibility of replacement cost accounting altogether. This is economic nonsense.

Here are some key extracts from this **new Directive**.

(Recital 19) The need for comparability of financial information throughout the Union makes it necessary to require Member States to allow a system of fair value accounting for certain financial instruments. Furthermore, systems of fair value accounting provide information that can be of more relevance to the users of financial statements than purchase price or production cost-based information. Accordingly, Member States should permit the adoption of a fair value system of accounting by all undertakings or classes of undertaking, other than micro-undertakings making use of the exemptions provided for in this Directive, in respect of both annual and consolidated financial statements or, if a Member State so chooses, in respect of consolidated financial statements only. Furthermore, Member States should be allowed to permit or require fair value accounting for assets other than financial instruments.

6. (c) recognition and measurement shall be on a prudent basis, and in particular:

(i) only profits made at the balance sheet date may be recognised,

(ii) all liabilities arising in the course of the financial year concerned or in the course of a previous financial year shall be recognised, even if such liabilities become apparent only between the balance sheet date and the date on which the balance sheet is drawn up, and

(iii) all negative value adjustments shall be recognised, whether the result of the financial year is a profit or a loss;

Article 8

Alternative measurement basis of fair value

1. By way of derogation from point (i) of Article 6(1) and subject to the conditions set out in this Article:

(a) Member States shall permit or require, in respect of all undertakings or any classes of undertaking, the measurement of financial instruments, including derivative financial instruments, at fair value; and

(b) Member States may permit or require, in respect of all undertakings or any classes of undertaking, the measurement of specified categories of assets other than financial instruments at amounts determined by reference to fair value.

Such permission or requirement may be restricted to consolidated financial statements.

8. Notwithstanding point (c) of Article 6(1), where a financial instrument is measured at fair value, a change in value shall be included in the profit and loss account, except in the following cases, where such a change shall be included directly in a fair value reserve:

(a) the instrument accounted for is a hedging instrument under a system of hedge accounting that allows some or all of the change in value not to be shown in the profit and loss account; or

(b) the change in value relates to an exchange difference arising on a monetary item that forms part of an undertaking's net investment in a foreign entity.

Member States may permit or require a change in the value of an available for sale financial asset, other than a derivative financial instrument, to be included directly in a fair value reserve. That fair value reserve shall be adjusted when amounts shown therein are no longer necessary for the imple-mentation of points (a) and (b) of the first subparagraph.

9. Notwithstanding point (c) of Article 6(1), Member States may permit or require, in respect of all undertakings or any classes of undertaking, that, where assets other than financial instruments are measured at fair value, a change in the value be included in the profit and loss account.