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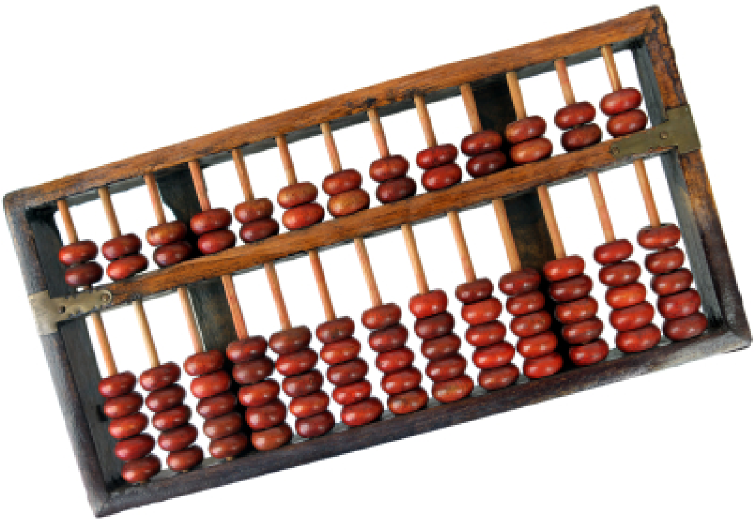

Law of 30 July 2013: Modernisation of accounting Law and reform of the CNC

One and a half years after the publication of draft law 6376 aimed at completing the modernisation of company accounting legislation following the entry into effect of the Law of 10 December 2010 introducing international company accounting standards, it was adopted by the Chamber of Deputies. The Law of July 30, 2013 (hereafter referred to as the "Law"), which also reforms the Commission des Normes Comptables (the Accounting Standards Commission, hereafter the “CNC”), was published in the Mémorial, Luxembourg’s official journal on 2 October 2013.

Modernisation of accounting law

Eight key changes could potentially impact your company:

1. The optional scope of the principle of “substance over form”

The Law introduces the optional scope of the so-called “substance over form” principle, as permitted by the 4th Directive 78/660/EEC. In the absence of clear rules and a consistent interpretation of the concept of “substance over form”, this option is certainly desirable.

2. Changes to the names of certain balance sheet headings

The designation of headings and items relating to securities that are fixed assets and to transferable securities has been changed to **include the broadest definition of financial instruments**, thereby covering all derivatives, money market instruments and, where applicable, other financial contracts that are neither transferable securities nor derivatives.

Subordinated debts are split according to their residual term. In addition, the maturity of **subordinated debts** (residual term of less than or more than one year) must now be disclosed. The distinction between subordinated debts owed to affiliated companies and companies linked by a participating interest may be disclosed in the notes to the annual accounts.

Article 63, paragraph (1), has been amended to remove the option whereby a company could create a separate item within balance sheet assets to recognise the **repayment premium linked to a debt**. From now on, the difference between the amount of debts repayable and the amount received must appear in an existing balance sheet item and must, where applicable, be explained in the notes to the annual accounts.

3. Changes to the names of certain income statement headings

Article 46 introduces a new income statement item, A.9 or B.9 “**Share of profits/losses of associates**”, in which profits resulting from applying the equity method to equity investments will be presented. Previously, income of this kind had to be recognised in the income statement under a separate item with a corresponding heading, which in practice was roughly equivalent.

The option of making **exceptional value adjustments** as a specific entry separate from the income statement item has been withdrawn. Such exceptional value adjustments must now be posted under an existing expense item, with a more specific explanation provided in the notes to the annual accounts.

4. Fixed balance sheet and income statement formats

As provided for by the Grand-Ducal Regulation of 14 December 2011[1], the collection of data using a fixed, standardised electronic form came into effect on 1 January 2012; the Law confirms this new practice for all the concerned entities. It is no longer possible to choose the

[1] Laying down the procedure for filing an accounting package with the administrator of the Commercial and Companies Register and the conditions for consistency and computation checks on the annual accounts.

presentation format of the balance sheet and income statement (regrouping, additions, changes of heading). However, any additional disclosures necessary for a correct understanding of the annual accounts may be provided in the notes. Furthermore, pursuant to Article 27 of the Law, individual derogation requests may still be submitted in the event of special circumstances.

Since the deletion of Article 29 (5), the balance sheet or profit and loss which has no numbers for both years must still be taken (as currently provided by the eCDF format).

5. Off-balance sheet review

As regards the definition of the term "**related party**", the Law of 10 December 2010 already aligned this definition with that of international accounting standards. Article 65 paragraph (1) 7 ter will permit the application of IAS 24 "Related party disclosures" as adopted by the European Union as an alternative to the disclosures required in point 7 ter in connection with related parties.

6. Simplification measures for medium-sized companies

Small and medium-sized companies will be eligible for the following simplified disclosure requirements in the notes to the annual accounts:

- nature, commercial objective and financial impact of transactions not recorded in the balance sheet (Article 65 (1) 7bis of the Law);
- amount and nature of transactions with related parties where material and not entered into on an arm's length basis (Article 65 (1) 7ter of the Law).

7. Different format options for consolidated accounts

As regards consolidated accounts prepared in accordance with Lux Gaap, which are not collected using a standardised form, the Law provides the option of using all the accounting formats provided for in the 4th Directive 78/660/EEC, thereby immediately offering more flexibility as regards the presentation of the balance sheet and the income statement.

8. Support FSPs : filing of the balance of accounts in accordance with the standard chart of accounts (PCN)

Support FSPs are now required to comply with the Standard Chart of Accounts. They must also file their accounting packages using the eCDF layout.

The other key amendments introduced by the Law solely concern companies adopting IFRS or applying the fair value option:

1. Overview of procedures governing the use of the fair value method

a) Limiting the fair value option for other asset categories

While, in theory, the Law of 10 December 2010 made it possible to measure all asset categories other than financial instruments at fair value, the Law limits the use of fair value measurement. Article 64 (sexies) states that fair value measurement is only **possible if it is authorised by IFRS** (such as investment real estate in accordance with IAS 40).

If a company chooses to measure certain assets other than financial instruments at fair value, **disclosures** with content similar to that required for financial instruments measured at fair value are henceforth required **in the notes to the annual accounts** on the assumptions made in determining fair value, changes therein and the risks linked to the non-recovery of this value.

b) Introduction of a new requirement: accounting for deferred tax liabilities

The Law introduces the requirement to recognise deferred tax liabilities, i.e. taxes that are recognised in the current financial year but will only fall due during a subsequent tax year, for companies making use of the fair value option referred to in Section 7 bis of the Law. This requirement applies “where applicable”, i.e. provided that the gain relating to the fair value recognition of an asset or due liability is taxable when it is realised.

All companies are subject to this requirement (no exemption available for small companies).

c) Tax implications of procedures governing the use of the fair value method

The use of fair value accounting has tax implications. This is important, as Luxembourg tax law is closely linked to accounting law pursuant to Article 40 of the Luxembourg law on income tax (LIR), which lays down the principle of linking the tax balance sheet to the commercial balance sheet.

If fair value accounting is used, the Law requires the recognition of deferred tax liabilities. This requirement is logical and necessary, as measuring an asset or liability at its fair value so that unrealised gains or losses can be recognised entails a de facto increase in company’s net assets.

Even if the comments on the Law indicate that it is “understood” that unrealised income and gains will “generally” be taxed only when they are realised, it is necessary to amend the tax legislation if we are to ensure the fiscal neutrality of the use of fair value.

Indeed, combining Articles 18 and 40 of the LIR, i.e. the calculation of taxable profit as the difference between net assets invested at the end of the financial year and net assets invested at the beginning of the financial year, and the principle of linking the tax balance sheet to the commercial balance sheet could automatically entail taxing unrealised income.

Without anticipating the position of the Luxembourg tax authorities, and unless tax legislation is amended, either by changing the rules for calculating taxable profit in order to deduct or ignore unrealised profits or by making the filing of Lux Gaap accounts mandatory for tax purposes (based on the historic cost valuation principle), the use of fair value accounting could result in the immediate taxation of unrealised profits, thereby creating a cash flow problem relating to tax payments.

Measures to amend tax legislation are currently being drafted.

2. Calculation of distributable reserves in the event of fair value measurement or if IFRS is adopted

The reform of the accounting law [2] and the law on commercial companies [3] seeks to allow flexible but fair accounting while offering companies the option of the fair value measurement method. The legislator played a dual role in this context:

- firstly, ensuring companies applying this option do not find themselves at an advantage over other companies in terms of their ability to distribute dividends, all other things being equal;
- secondly, ensuring an increase in the dividend distribution capacity is not the sole reason for applying the fair value option.

The provisions covering this method apply to companies [4] that prepare their accounts under Lux Gaap and exercise the fair value option, as well as companies that prepare their accounts in accordance with IFRS.

However, this reform does not apply to credit institutions or insurance and reinsurance companies, or to investment companies such as open-ended investment companies (SICAV), closed-ended investment companies

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[2] Amended Law of 19 December 2002 on the Commercial and Companies Register, accounting and annual accounts

[3] Amended Law of 10 August 1915 on commercial companies

[4] In this case, companies whose share capital represents a guarantee for third parties, i.e. limited liability companies, European companies, limited stock partnerships, public limited companies and cooperative companies.

(SICAF), venture capital companies (SICAR) or Specialised Investment Funds (SIF).

The solution proposed by the Law protects the interests of third parties and guarantees fairness between commercial companies irrespective of the accounting methods applied, without excessively increasing the administrative burden of companies applying the fair value option or preparing their accounts in accordance with IFRS.

The new concept enshrined in the Law is founded on two principles:

- authorising the distribution of realised and substantially-realised profits (or reserves);
- allocating to a non-distributable reserve unrealised profits and increases in shareholders' equity recognised in the opening balance sheet prepared on the first-time application of the fair value option or the first-time adoption of IFRS.

It is also necessary to neutralize the impact of retrospective application increasing the amount of unrealised reserves on the adoption of a new standard or a change in accounting measurement method under IFRS.

A number of derogations [5] to allocation to this non-distributable reserve nonetheless exist, such as (i) income from financial instruments held in the trading portfolio and (ii) changes in shareholders' equity following the reversal of provisions and value corrections (other than those calculated to systematically depreciate the value of asset items over their value in use) that cannot be retained in the balance sheet following the adoption of IFRS must be considered available.

This non-distributable reserve cannot be used for any other purpose, such as for a share capital increase through capitalization of reserves or as a charge to the legal reserve or any other reserve required by law.[6]

The principle of non-distribution of any unrealised or substantially-realised item increasing a company's shareholders' equity, either by recognition directly in equity or through the income statement, is thus introduced.

Companies should therefore be able to isolate – with a view to allocating profits and calculating distributable reserves – unrealised gains recognised in the income statement for the year or directly in equity, as well as the resulting tax implications.

Beyond this initial principle, the creation of non-distributable reserves can sometimes pose problems, particularly where unrealised income exceeds profits for the period (where the other activities of the company generate a loss). Existing distributable reserves shall be allocated in priority to the non-distributable reserve and where such reserves are insufficient, the difference shall be deducted from retained earnings[7].

For those cases not specifically covered, the principles of prudence and profit realisation should be applied.

Any distributions infringing these provisions will have to be repaid.

Some principles are clarified and some practices are confirmed by their inclusion in the Law:

1. Clarification of the no-netting principle

The **no-netting principle** is defined in the new Law as a generally applicable principle, but does not cover cases where there is a right to netting by virtue of the Law.

An interpretation was published by the European Commission (98/C16/04) in this

[5] Art 72ter (3)
[6] Art 72ter (2)

[7] i.e. by creating an accumulated deficits account that must be cleared prior to any subsequent distributions.

respect concerning the legal right to netting pursuant to law or contract.

2. Official authorisation of English and German as alternatives to French

Many companies already file their annual accounts in English or German. The new requirement introduced by the Law, which approves this practice, is that all the documents that must be filed for a given financial year must be provided in the same language.

However, although it is the usual practice, the statutory annual accounts and consolidated accounts need not be in the same language.

3. A formal extension of the exemption possibilities applicable under the specific regime for parent and subsidiary companies (Articles 70, 71 and 72)

The pre-amendment formulation had the disadvantage of limiting these exemptions to Luxembourg consolidations prepared in accordance with the Lux Gaap provisions.

From now on, the Law provides for the option of using the accounts/consolidated accounts prepared in accordance with IFRS or the Seventh Directive in order to qualify for the exemptions provided for in Articles 70, 71 and 72.

Entry into effect:

The amendments impacting balance sheet (Article 34) and income statement (Article 46) formats come into effect from January 1, 2014. Companies cannot therefore adopt these amendments for the current year[8].

The option to apply the other provisions introduced by the Law in the current year remains available to companies.

Reform of the CNC

The purpose of this reform is to align the CNC's function with that of accounting standardisation bodies in other European countries (Germany, Italy and the Netherlands in particular), by:

- structuring the CNC as economic interest grouping;
- providing it with 12 experts (instead of 9) appointed for a term of 4 years, renewable depending on their expertise/contribution;
- giving it the status of a consultative committee on company accounting (rather than an accounting standardisation body with regulatory powers);
- according it budgetary autonomy (primarily an annual State subsidy plus an initial State contribution and a tax on the filing of annual and consolidated accounts collected by the RCS[9]),and ;
- expanding its role to include advising the Government, contributing to the development of an accounting doctrine and participating in discussions on accounting and financial reporting at international, EU and national levels.

[8] The 2013 standardised online collection forms for balance sheets and income statements on the eCDF platform will remain unchanged.

[9] The amount of the tax payable by companies will be between €5 and €10 and will not increase the total filing costs of companies, which currently stand at around €30.

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