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Accounting Harmonization and Market Conditions Under Impact of a European Company

Article Info:

Management Information Systems,
Vol. 3 (2008), No. 2,
pp. 003-009

Received 12 Jun 2008
Accepted 24 October 2008

UDC 347.72(4-672EU)

Summary

Legal form of an European company (SE) is a significant contribution to common European market. This legal form enables companies from different member states to operate under common rules, management and reporting system. In this time the great importance for provision of informations from the European company has the accounting harmonization in the European Union. SE can transfer its registered office within EU member states without ceasing to exist which creates a pressure on the member states to improve their market environment. Council Regulation No 2157/2001 on the Statute for an SE sets the ways of formation of an SE and also unifies different approaches to companies management structures and involvement of employees in SE. SE can be created by means of a merger of two or more public limited-liability companies; formation of a holding SE by public and private limited-liability companies; formation of a subsidiary SE; and transformation of a public limited-liability company into an SE. Formalities not laid down in the council regulation such as accounting and financial reporting, must SE conduct in accordance with national laws of EU member states.

Key words

European Company, IFRS 3, mergers, goodwill, holding, subsidiary

Introduction

The legal form of the European Company (Societas Europea – SE) was created on the 8th of October 2001, when the European Council issued a regulation no. 2157/2001/EC (further as "the regulation") on the statute for a European Company (further as "SE") which was consequently supplemented with a council directive no. 2001/86/EC regarding the involvement of employees (further as "the directive"). The aim was to create a European Company with its own legislative framework which would allow companies from different member states of the European Union (the EU) to operate within the EU under one set of rules, management and reporting. SE does not need to create an expensive network of subsidiaries where each would operate under different legal establishment. The subscribed capital value of an SE should be at least EUR 120 000 and the name shall be preceded or followed by the abbreviation SE. According to the regulation, an SE can be formed (European Council, 2001, p.2):

1. by means of a merger of two or more public limited-liability companies (including SEs), provided that at least two of them are governed by the law of a different Member States.
2. as a holding company of two or more public and private limited-liability companies, provided that each of at least two of them are governed by the law of a different Member States or has for at least two years had a subsidiary or a branch governed by the law of a different Member States,
3. as a subsidiary SE of two ore more companies (including SE), firms or other legal bodies, provided that each of at least two of them is governed by the law of a different Member States or has for at least two years had a subsidiary or a branch governed by the law of a different Member States,
4. by means of a transformation into an SE if for at least two years it has had a subsidiary company governed by the law of another Member State.

The regulation is legally bounding but in some areas, for example accounting, it only forms a framework and the practical legal attributes leaves for the rules applicable to public limited-liability companies under the law of the Member State in which the SE has its registered office. Upon this the SE shall be governed by (European Council, 2001, p.5):

1. the regulation,
2. by the provisions of its statutes if expressly authorized by the regulation,
3. in cases not regulated by the regulation:
   - by provisions of laws applied specifically due to SE,
   - by provisions of laws which would apply to a public limited-liability company of the Member state in which the SE has its registered office,
   - by provisions of its statutes in the same way as for a public limited-liability company in the country where the SE has its registered office.

According to article 2 of the regulation, only companies formed under the law of a Member State may form a European Company. Therefore companies from countries which are not members of the EU can not form or be a part of an SE.

The objective of our article is to outline the significance of the SE for the EU market, and to analyze attributes related to its formation and existence, mainly:

1. conditions under which an SE is formed,
2. accounting of formation of an SE by means of a merger
3. administration and management and involvement of employees on the management of an SE and protection of minority shareholders.

1. Formation of a European Company

1.1. Formation by means of a merger

Formation of an SE by means of a merger is determined in article 17 of the regulation. Formation can be carried out in accordance with the procedure for merger by acquisition or by the formation of a new company. In case of a merger by acquisition, one or more companies shall wind up without liquidation and transfer their assets and liabilities on another, acquiring company and the shareholders of the company being acquired become shareholders of the acquiring company or are paid cash which however shall not exceed 10% of the acquired shares (The Council of the European Communities, 1978, p. 37). In the case of a merger by acquisition, the acquiring company shall take the form of an SE when the merger takes place but it is not a newly formed company.

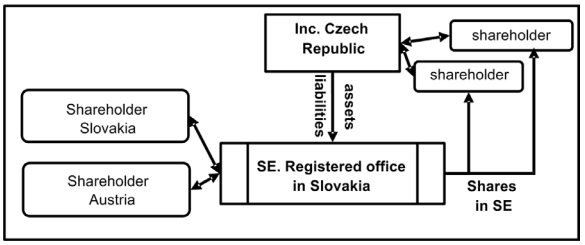

Figure 1 Merger by acquisition

In case of a merger by the formation of a new company, one ore more companies shall wind up without liquidation and transfer their assets and liabilities on a newly formed company. In return, the shareholders of the merging companies become shareholders of the newly formed company or are paid cash which however shall not exceed 10% of the acquired shares[7].

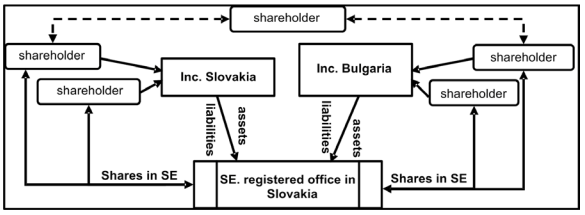

Figure 2 Merger by formation of a new company

According to article 20 of the regulation, the management or administrative organs of merging companies shall draw up the term of merger which shall include the following particulars:

a) the name and registered office of each of the merging companies and of the SE,
b) the share-exchange ratio and the amount of any compensation
c) the terms for the allotment of shares in the SE,
d) the date from which the holding of shares in the SE will entitle the holders to share in profits and any special conditions affecting that entitlement,
e) the date from which the transaction of the merging companies will be treated for accounting purposes as being those of the SE,
f) the rights conferred by the SE on the holders of shares to which special rights are attached and on the holders of securities other than shares, or the measures proposed concerning them,
g) any special advantage granted to the experts who examine the draft terms of merger or to members of the administrative,

management, supervisory or controlling organs of the merging companies,

h) the statutes of the SE,
i) information on the procedures by which arrangements. for employee involvement are determined pursuant to Directive 2001/86/EC.

1.2. SE formed as a holding company, subsidiary or by transformation from a public limited-liability company

When forming a holding SE, the management of the company promoting the formation shall draw-up draft terms for the formation, which shall include a report explaining and justifying the legal and economic aspects of the formation and indicating the implications for the shareholders and for the employees of the adoption of the form of a holding SE. The draft terms shall also set out the particulars provided for in Article 20, as mentioned above for to the formation of an SE by means of a merger, and shall fix the minimum proportion of the shares which the shareholders of the companies promoting the operation must contribute to the formation of the holding SE. One or more independent experts shall examine the draft terms of formation and draw up a written report for the shareholders of each company. Finally, the general meeting of each company promoting the operation shall approve the draft terms of formation of the holding SE.

The conversion of a public limited-liability company into an SE shall not result in the winding-up of the company or in creation of a new legal person. Also, the registered office may not be transferred from one member state to another at the time the conversion is effected. Similarly to the formation of a holding SE, when undertaking the conversion, management or administrative organ shall draw up terms of conversion and submit them to the general meeting for approval. An independent expert must be appointed to certify that the company has net assets at least equivalent to its capital and reserves which must not be distributed under the law or the Statutes.

2. Accounting for creation of a European Company

In line with the article 61 of the regulation, the preparation of annual and consolidated accounts including the accompanying annual report and the auditing and publication of those accounts of an SE shall be governed by the rules applicable to public limited-liability companies under the law of the Member State in which its registered office is situated. At the same time, the company which is taking part in the creation of an SE shall wind-up without liquidation in line with the legislation of the country of its registered office.

It is obvious that if and SE has offices in several EU countries, each with separate accounting standards, the consolidation of company branches' accounting might be difficult and time consuming task. The creation of the legal form of an SE thus stresses the need for accounting harmonization even more. This would support equivalence of accounting information and make them more comparable for accountants from different EU countries.

We believe that the best solution for harmonization of accounting standards in the EU would be application of the International Financial Reporting Standards (IFRS) to all EU member states accounting standards. Slovakia constantly approximates its accounting standards to IFRS. As of 1.1.2005, the companies which prepare consolidated financial statements must do so in line with IFRS. As of 1.1.2006, the individual financial statements will have to be prepared according to IFRS by all companies which fulfill at least two of the following parameters:

1. Their value of assets is larger than 166 billion EUR
2. Their turnover was larger than 166 billion EUR
3. The number of their employees in the last financial year was larger than 2000

Regarding IFRS, the creation of an SE by means of a merger shall be undertaken in line with IFRS 3 – Business Combinations. IFRS 3 defines a business combination as a transaction or event in which an acquirer obtains control of one or more businesses[1]. According to the IFRS 3, all business combinations must use the acquisition method which means that all identifiable assets and liabilities of the company, which is being wound-up without liquidation, are measured at their acquisition-date fair value. The total of the fair values at the day of the exchange of assets given, liabilities incurred and equity instruments[2] issued

[1] A business is defined as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return directly to investors or other owners, members or participants.

[2] Equity instrument: According to IFRS 7 Financial Instruments: Disclosures it is Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities

by the acquirer in the exchange of the control of the acquiree together with any costs directly attributable to the business combination incurred by the acquirer represent the cost of the business combination. Steps in applying the acquisition method are:

1. identification of the acquirer[3],
2. determination of the acquisition date[4],
3. recognition and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree,
4. recognising and measuring of goodwill or a gain from a bargain purchase.

IFRS 3 requires that, as of the acquisition date, the acquirer or the new company measure and recognise, separately from goodwill, all assets acquired, liabilities assumed and non-controlling interests in the acquiring company no matter if they were disclosed in the financial statements, if the following criteria are met:

- an asset, other than intangible asset should be recognised only when it is probable that future measurable economic benefits from this asset will flow to the enterprise,
- a liability, other than contingent liability should be recognised only when it is probable that its settlement will result in an outflow of measurable economic benefits from the enterprise,
- intangible asset and contingent liability should be recognised only when their fair value is measurable.

Creation of an SE by means of a merger and subsequent measuring for fair value can lead in creation of Goodwill. According to IAS/ per IAS 36 – Impairment of asset should be at least once a year tested for impairment[5]. To test for impairment, goodwill must be allocated to each of the acquirer's cash-generating units[6], or groups of cash-generating units and the carrying amount[7] of the unit/group of units, including the goodwill, shall be compared to the recoverable amount[8] of the unit/group of units. If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity must recognise an impairment loss and reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and then reduce the carrying amounts of the other assets of the unit (group of units) pro rata on the basis. The carrying amount of an asset should not be reduced below the highest of fair value less costs to sell, value in use[9], or zero. The negative goodwill, in contrary to goodwill, should be directly recognised in the statement of income and expenditures.

It is also necessary to realise that an SE will be created by means of a merger of companies from different member states of the EU, which have kept their book of accounts in their domestic currency. The succeeding company in Slovakia, for example, would therefore have to account for registered capital, debts receivable and debts payable, equity interests, securities, derivatives, valuables, cash as well as for any allowances, provisions for contingent liabilities, and technical reserves associated with property and debts denominated in foreign currencies in EURO and foreign currencies (The National Council of the Slovak Republic, 2002, p.1), if applicable, as thanks to the introduction of EURO in Slovakia, this duty is reduced to countries outside of the EURO zone only.

3. Contribution of SE to the EU market

Apart from the pressure on further harmonization of the accounting standards in the EU, as mentioned in the previous chapter, the creation of the legal form of an SE also contributes to improvement of the EU business environment, unified management structures of companies in the EU and creates provisions for involvement of employees in management and for protection of minority shareholders of an SE.

3.1. Improvement of business environment of the EU

The regulation and directive came into effect on the 8th of October 2004 finally allowing companies to plan and administer its reorganization[10] within

[3] Acquirer: the combining entity that obtains control of the acquiree.

[4] Acquisition date: the date on which the acquirer obtains control of the acquiree

[5] An asset is impaired when its carrying amount exceeds its recoverable amount

[6] The smallest identifiable group of assets.

[7] Carrying amount – the amount at which an asset is recognized in the balance sheet after deducting accumulated depreciation and accumulated impairment losses

[8] Recoverable amount – The higher of an asset's fair value less costs to sell (sometimes called net selling price) and its value in use

[9] The discounted present value of estimated future cash flows expected to arise from the continuing use of an asset, and from its disposal at the end of its useful life

[10] Reorganisation presupposes that existing companies from different Member States are given the option of combining

the whole business environment of the EU without being limited to legal form of one of the member states of the EU. With regard to the raising number of business activities, these forms are not sufficient enough for such a broad economic space and are a barrier to combination of companies from different member states.

The regulation allows for making business under laws directly applicable in all member states of the EU and in Norway, Iceland and Liechtenstein, hence avoiding legal and technical obstacles companies face when working under different legal systems of the EU. Under the regulation, the companies can make combinations, create holding companies or subsidiaries which would be capable of business activities within the whole EU market.

The regulation also puts pressure on the member states to simplify and improve their business environment. Areas such as company formation, administration, management and structure are governed by the regulation but issues of market regulation, bankruptcy and taxes are left for the regulation of the member states. As the companies with the legal form of an SE can freely move their registered office from one member state to another without moving their fixed capital, they would indeed always try to create their establishment in the country with the most attractive business environment.

Creation of this legal form is also of significance to companies from outside of the EU, in particular to companies from the USA where investors after the WorldCom and Enron scandals are more cautious about corporate governance and prefer legal system similar to the American. As the British system is the closest to the American, we can expect that some companies would register its offices in the UK and the production site in Slovakia, for example.

3.2. Unification of management structures of companies in the EU

Another contribution of the regulation is the provision for one-tier and two-tier systems which synchronizes different approaches to management structures in the EU. Every company having a legal form of an SE can choose a system that better suits its nature. Under the two-tier system, an SE shall comprise of a supervisory organ and a management organ and under the one-tier system of an administrative organ. To establish the legal form of the SE in Slovakia, act number 562/2004 on the European company (further as the SE act) was introduced. This act recognizes, under two-tier system, the board of directors and the supervisory board as set by the Slovak commercial code for the public limited-liability company; and makes provisions for the one-tier system so that companies in Slovakia can also operate under this governance. Slovak commercial code did not approve one-tier system in Slovakia before.

The statutory body under the on-tier system in Slovakia is the administrative board which manages activities of the SE, determines objectives of its business activities, supervises its performance, and acts in the name of the SE. Only individual persons can be member of the administrative board. If the statutes do not state different, the administrative board consist of at least three members, each of whom is entitled to act in the name of the SE. The administrative board can also appoint one or more executive directors to manage the company. These are consequently elected and withdrawn by the administrative board and can also be chosen from the members of the administrative board as long as the majority of the administrative board stays as a non-management executive position.

The supreme body of an SE is its general meeting. According to the SE act, the general meeting can be called by a shareholder or shareholders whose shares on the registered capital are at least 5% or less if stated in the statutes. Apart from the shareholders, the general meeting can also be called by the board of directors or administrative board in the manner and term stated in the statutes of the SE.

3.3. Creating provisions for involvement of employees in management of an SE

A group of experts tried to establish statutes for an SE already in 1965. These were however rejected for being too complicated and insufficient in provisions for involvement of employees in management of the company. Current regulation was therefore supplemented with the directive concerning the conditions for involvement of employees by means of information[11], consultation[12] and participation through which

their potential by means of mergers.

[11] Information means informing of the body representative of the employees by the board of directors or administrative board of the SE on questions which concerns the SE itself and any of its subsidiaries or establishments

[12] Consultation means the establishment of dialogue and exchange of views between the body representative of the employees and/or the employees' representatives and the competent organ of the SE, at a time, in a manner and with a

employees' representatives may exercise an influence on decisions to be taken within the company and in some cases their direct involvement in the supervision and strategic development of the company, especially formation and liquidation of an SE or its related subsidiaries, and in matters of employees number reduction. The employees have the right to elect or appoint, or the right to recommend and oppose some or all of the members of SE's supervisor and administrative board, if defined so in the Agreement on arrangements for the involvement of employees within the SE.

The Agreement on arrangements for the involvement of employees within the SE is negotiated by the Special negotiating body established to negotiate with the competent body of the participating companies directly involved in formation of the SE. For every 10% of employees there should be at least one member of the Special negotiating body. Agreement on arrangements for the involvement of employees within the SE shall be in writing and apart from the scope of the employees involvement it also establishes the Representative body of employees with the purpose of informing and consulting the employees and exercising participation rights in relation to the SE. The number of the members of the Representative body of employees, the way of their appointment or election and their right in relation to the Board of directors or Administrative board of the SE shall be set in statutes according to the negotiations on involvement of employees within the SE. It can also be negotiated that the involvement of the employees can be conducted in a different manner but it must be stated in the Agreement on arrangements for involvement of employees within the SE.

3.4. Transfer of a registered office of an SE

One of the objectives when the regulation was being prepared was to allow SE to freely transfer its registered office to a member state of more favourable environment in regard of the SE's activities. As an SE is governed by laws of the country where it is registered, the opportunity to freely transfer its registered office puts a pressure on the member states to constantly improve their business environment to prevent these companies from leaving for a better legal framework. The transfer of an SE's registered office is determined by article 8 of the regulation where it is stated that such transfer shall not lead to a liquidation of the SE or formation of a new company.

The management of an SE shall draw up and publicise a transfer proposal explaining the legal and economical aspects of the transfer and implication it may have on shareholders, employees, creditors and employees involvement within the SE. The shareholders and creditors are entitled, at least one month before the general meeting called upon to decide on the transfer, to examine the transfer proposal. The transfer proposal must be publicised for at least two months before a decision to transfer can be taken. The transfer shall take effect on the data on which the new registered office of the SE is registered.

3.5. Protection of the interests of minority shareholders and creditors

The regulation cedes the protection of the interests of minority shareholders and creditors to the legislation of the member states of the EU. Every minority shareholder who at the general meeting voted against proposals such as to transfer the registered office, form an SE by means of a merger or a holding SE has the right to request the company to buy back his shares for a proportionate price. A suggestion of a proportionate share should be publicized in the transfer proposal. In case the set price has not been found proportionate, every shareholder has the right to request an additional payment through a court.

With regard to creditors protection, the regulation again refers to application of laws of the Member states taking into account the cross-border nature of the merger. In Slovakia, the SE act states that appropriate protection of creditors' claims shall be ensured if, due to the transfer of the SE to abroad, these liabilities may become more difficult to settle. The SE act however does not determine any ways to asses the increase in difficulty to settle the liabilities nor does it state what should be understood under the „appropriate protection".

Conclusion

It is obvious that creation of the European Company should not have led to unification of EU standards or even to creation of a "super standard" for one company. On the contrary, the objective was to create a simple legal form that would be

content which allows the employees' representatives, on the basis of information provided, to express an opinion on measures envisaged by the competent organ which may be taken into account in the decision-making process within the SE

applicable in the legal system of every member state of the EU. SE stayed universal because the regulation focuses only on the practical issues of creation, governance and management structure and wind up/liquidation, eventually transfer of the registered office of the company, i.e. the issues, which from the point of view of a pan-European company, have to be regulated on the transnational level. Operatives such as accounting procedures are left for legislation of the member states. They should therefore create a business environment that would allow companies to create SEs in a transparent and hassle free manner. Necessity of the accounting standards harmonization is also on the forefront as well as is the precise compliance with all accounting principles and with the requirement for true and fair view of the financial statements.

From companies which have already been transformed to SE we can mention the insurance company Allianz and the chemical company BASF. Allianz has, due to the transformation, restructured its German insurance activities and integrated its Italian subsidiary RAS Holding to the group. It has also reduced its supervisory board and strengthen influence of its international branches on the management. BASF believes (BASF now a European company (SE), 2008, p.1) that the transformation will bring further development of its management structures optimize work of its divisions. Similarly to Allianz, BASF will also proceed with reduction of its supervisory board.

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