

Q&A CNC 20/021	<u>QUESTIONS / ANSWERS:</u> OPTIONAL PRINCIPLE OF SUBSTANCE (ART. 29 (3) LRCS): SCOPE OF THE OPTION, APPLICATION AND IMPLICATIONS FOR THE INFORMATION DISCLOSED IN THE NOTES TO THE ACCOUNTS AS WELL AS ON THE DETERMINATION OF DISTRIBUTABLE RESERVES
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Context:

The Luxembourg accounting model traditionally consists of a so-called “*patrimonial*” accounting model. This “*patrimonial*” principle generally implies that the accounting characterisation of a transaction follows its legal analysis, in accordance with the adage “*accounting, the algebra of law*”¹. According to this model, assets are generally recognised in the balance sheet when the undertaking legally owns them, and financing instruments are generally classified as equity or as debt depending on their legal analysis. Similarly, income and expenses are generally presented in the profit and loss account according to their legal nature. In addition, the principle of “*monetary nominalism*”² constitutes the general rule.

At all times, there have been exceptions to this “*patrimonial*” accounting model, in particular because of the inherent limitations of this model and of the objective of true and fair view associated with the accounting representation³.

As a result of the European accounting harmonisation and of the convergence of the accounting directives with the international financial reporting standards (IFRS)⁴, the optional principle of substance was explicitly introduced into Luxembourg accounting law applicable to undertakings (DCL) by the laws of 10 December 2010⁵ and 30 July 2013⁶. Following this perspective of primacy of substance over form, transactions and other events and conditions are recognised and presented on the basis of their economic and financial substance and not solely on the basis of their legal form, in order to enhance the relevance and reliability of accounting information.

However, unlike the IFRS framework, which is based on:

- a conceptual framework laying down the principle of representation of the substance of economic phenomena within financial reports and
 - standards that spell out, by type of contracts, transactions or instruments, the representation models to be used by the undertaking or the group (e.g. IAS 32 "Financial Instruments: Presentation", IFRS 16 "Leases")
- the approach adopted by the accounting directive 2013/34/EU⁷ and by Luxembourg accounting law applicable to undertakings is based on the articulation of a generic principle that undertakings have to implement and operationalise by category of transactions and contracts.

In this context, it appears that Luxembourg undertakings – the vast majority of which are small or even micro-undertakings in view of the criteria laid down by European law – generally do not exercise the "substance over form" option as set out in Article 29 para. 3 LRCS.

¹ See also the French book entitled: “*La Comptabilité, algèbre du droit et méthode d'observation des sciences économiques*”, Pierre Garnier, Dunod, 1947.

² According to the principle of nominalism, the monetary unit is considered to be a unit of measurement that is stable over time, regardless of variations in its purchasing power. In application of this principle, monetary units from different periods can be added together. As only the nominal value of the currency is taken into account, there is generally no need to discount sums payable or receivable, even when the maturity of such sums is remote and they do not bear interest. It should be noted that the accounting principle of monetary nominalism, which is enshrined in the Civil Code (art. 1895), has in the past and continues today to be subject to exceptions in European accounting law, particularly in case of the application of alternative measurement models to the historical cost convention (e.g. taking account of inflation, the revaluation model, the fair value model, etc.).

³ Since the 4th Directive 78/660/EEC and its transposition into Luxembourg law (Law of 4 May 1984), the annual accounts have to give a true and fair view of the assets and liabilities, financial position and results of the undertaking (now art. 26 (3) LRCS). This true and fair view objective – although not defined – refers to the idea of an accounting representation that reflects the reality of transactions and contracts in accordance with the chosen presentation framework.

⁴ See in particular: Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Council Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings (the “Accounting Modernisation Directive”).

⁵ Law of 10 December 2010 on the introduction of international accounting standards for undertakings (doc. parl. 5976).

⁶ Law of 30 July 2013 reforming the “Commission des normes comptables » or the Luxembourg accounting standards board (doc. parl. 6376).

⁷ Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of companies.

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However, for Luxembourg undertakings wishing to avail themselves of the "substance over form" option set out in Article 29 para. 3 LRCS, a number of issues of an interpretative nature arise which are of paramount importance both in terms of the need for legal certainty for undertakings and their legal representatives (i.e. preparers) and in terms of the creditors' protection's objective (i.e. users) by and through accounting information.

In this respect, it should be noted that recent case law of the Court of Justice of the European Union (CJEU judgment of 23 April 2020 in case C-640/18)⁸ has provided useful insight into the possible use, by Member States or directly by undertakings⁹, of an analysis of transactions and contracts, based on "substance" rather than "form", as a vehicle for a true and fair view, the primary objective of European accounting law.

Questions:

Since the introduction of the optional principle of "substance over form" in Luxembourg accounting law applicable to undertakings, a number of questions have arisen as to the interpretation to be given to this concept, including the following:

- The scope of the substance option (point 1);
- The modalities of application of the substance option (point 2);
- The implications with regard to the information to be disclosed in the notes to the accounts (point 3);
- The potential impacts regarding the determination of distributable reserves (point 4);
- Interpretative scope, first application and transition (point 5).

Answers:

1. The scope of the substance option

CNC is of the opinion that the concept of substance under LUX GAAP and LUX GAAP – FV constitutes – when the undertaking exercises the option referred to in article 29 para. 3 LRCS – a general principle of financial reporting affecting accounting information in all of its dimensions, namely: recognition, initial and subsequent measurements, presentation and information to be disclosed in the notes (cf.: point 1.1.).

In order to clarify the scope of the concept of substance and to promote the rise of harmonised interpretations, CNC plans to suggest a rewording of the optional principle of substance as part of the work on the overhaul of Luxembourg accounting law (see point 1.2.).

1.1. An optional general principle of financial reporting

Directive 2013/34/EU gives the concept of substance the status of a general principle of financial reporting in the same way as the principles of going concern, consistency, prudence, accrual-based accounting, non-offsetting, materiality and measurement at cost.

While there may be exceptions to these general principles, they share the common feature of being general in scope, affecting the various aspects of accounting information, i.e. recognition, initial and subsequent measurements, presentation in the balance sheet and profit and loss account, and disclosure in the notes to the accounts.

⁸ CJEU judgment of 23 April 2020 in Case C-640/18 in the proceedings Wagram Invest SA v Belgian State (curia.europa.eu).

⁹ Depending on the choices made by national legislators when transposing the Accounting Directive 2013/34/EU which remains, to a large extent and despite some advances, a minimum harmonisation directive like the former 4th and 7th Directives.

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In this context, CNC is of the opinion that an unduly restrictive interpretation should not be given – in the "LUX GAAP" and "LUX GAAP – FV" regimes – to the scope of the optional principle of substance, the wording of which is admittedly limited to presentation and recognition in the accounting directive 2013/34/EU¹⁰ and even to presentation alone within Luxembourg accounting law¹¹, but which in substance has clearly a general scope when the undertaking exercises the option.

The preparatory works at European and Luxembourg levels indicates indeed that the objective pursued by European and national legislators was convergence towards IFRS.

For example, the preparatory work on Directive 2003/51/EC, known as the "accounting modernisation" directive, which explicitly introduced the concept of substance into European accounting law, states that "*IAS recommends that certain contracts and transactions should be recorded in the profit and loss account or in the balance sheet under captions that express their substance, and not their legal form. Paragraph 2 expressly empowers Member States to permit or require that, in determining the line item under which an amount should be recorded, substance should be taken into account as much as form*"¹². The preparatory work on and recitals to the accounting directive 2013/34/EU confirm the earlier approach by stating that "*the presentation of items in financial statements should have regard to the economic reality or commercial substance of the underlying transaction or arrangement*"^{13/14}.

This same approach has been adopted in Luxembourg, where the parliamentary documents relating to draft bill of law 6376 state that "*after the entry into force of this legislative amendment, undertakings will therefore be able to refer voluntarily to the concept of substance by type of transaction or contract and will be able – for example – to refer to the approach adopted by IFRS as adopted by the European Union*"¹⁵.

However, it is clear that a representation of a transaction or contract in accordance with the concept of substance does not simply relate to the classification of the amount of said transaction or contract under a caption or sub-caption of the balance sheet or profit and loss account, but concerns all aspects of accounting information, i.e. recognition, initial and subsequent measurements, presentation and information to be disclosed in the notes. By way of illustration, the presentation of leases according to their substance affects not only the presentation of the rent expense in the profit and loss account, but also the accounting (e.g. recognising the right to use the leased assets as an asset and the lease obligation as a liability) and the initial and subsequent measurements of said assets and liabilities (e.g. discounting the payments to be made over the term of the lease, amortisation of the right of use, etc.), as well as the disclosure of information in the notes (see point 1.2. below).

¹⁰ Art. 6 para. 1 point h) dir. 2013/34/EU "*items in the profit and loss account and balance sheet shall be accounted for and presented having regard to the substance of the transaction or arrangement concerned*".

¹¹ Art. 29 para. 3 LRCS "*the presentation of amounts within the profit and loss account and the balance sheet may have regard to the substance of the relevant transaction or arrangement*".

¹² COM(2002) 259/2 final of 9.7.2002, p.5 - Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC, 83/349/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies and insurance undertakings.

¹³ COM(2011) 684 final of 25.10.2011, recital 8, p.18 - Proposal for a Directive of the European Parliament and of the Council on the annual financial statements, consolidated financial statements and associated reports of certain types of companies.

¹⁴ Dir. 2013/34/EU, recital 16, 4th sentence.

¹⁵ Doc. parl. 6376-0, comments on the articles, p. 26 – Draft bill of law reforming the "*Commission des normes comptables*" (Accounting standards board) and amending various provisions relating to bookkeeping and annual accounts of undertakings as well as consolidated accounts of certain types of companies.

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1.2. Guidelines considered by CNC as part of the overhaul of the DCL

Without prejudging the outcome of the legislative procedure, CNC has considered – as part of its work on the overhaul of the DCL¹⁶ – whether it would be useful to rephrase Article 29 para. 3 LRCS in order to clarify the scope of the optional principle of substance.

After careful consideration and review, CNC plans – as part of the overhaul of the DCL – to suggest a rewording of the optional principle of substance to ensure better alignment with both the accounting directive 2013/34/EU and IFRS, as well as greater legal certainty for stakeholders (preparers, auditors, users).

Such a rewording might read as follows:

"Income statement and balance sheet items may be recognised, measured and presented by having regard to the substance of the transaction or arrangement concerned. In such cases, the additional information necessary to comply with the requirement of a true and fair view is disclosed in the notes to the financial statements".

It should be noted that the optional principle of substance consists of an overall analysis of a category of transactions or arrangements, giving precedence to an economic and financial perspective over a legal and formal perspective. This optional principle of substance does not constitute a method for measuring assets and liabilities, and its use cannot in itself justify the application of an alternative measurement model to the principle of measurement at purchase price or cost (art. 52 LRCS). As the legislation currently stands, it should be noted that only the assets referred to in Section 7bis of Chapter II of Title II LRCS¹⁷ are eligible for measurement using the fair value model. It should also be noted that, as the DCL currently stands, the revaluation model under the LUX GAAP and LUX GAAP – FV regimes for the measurement of tangible and intangible fixed assets is unavailable¹⁸ unlike the existing option under the IFRS – EU regime.

2. Modalities of application of the substance option

CNC is of the opinion that, in the absence of a solution proposed by European and Luxembourg legislators, a Luxembourg undertaking exercising the substance option must necessarily refer to an existing national, European Union or international framework (see point 2.1.). Furthermore, if the substance option can be exercised on a non-general basis, it must target at least a whole category of transactions or arrangements in order to avoid selective or even abusive use of the substance option (see point 2.2.). Lastly, the principle of consistency of accounting policies should be applied in such a way that an undertaking exercising the substance option for a category of transactions or arrangements is durably committed by its choice of accounting policy (see point 2.3.).

¹⁶ For the record, the project to overhaul Luxembourg accounting law was announced in draft bill of law no. 6718, explanatory memorandum, point 2, p. 5:

"In a second stage - which will be the subject of a separate bill - a more comprehensive overhaul of Luxembourg accounting law will be carried out in order to incorporate the new bottom-up structure proposed by the new directive, as well as a modernised terminology more in line with current international accounting practice. In addition to this formal overhaul, a fundamental rethink is also required and has already been initiated on a number of key accounting law issues. This involves rethinking some of the choices made in 1984 when the 4th Directive was first transposed, and in 2002 when the reform linked to the introduction of a Luxembourg central balance sheet data office was implemented. These issues include – for example – the optionality of certain accounting provisions, the scope of undertakings subject to statutory audit, the extent of simplification for the smallest undertakings (e.g. micro-undertakings), the relationship between general accounting law and sector-specific accounting law or the question of standardising accounting information from a perspective guided by the needs of users of accounting information while respecting the constraints of preparing undertakings."

¹⁷ Without prejudice to the sector-specific accounting provisions applicable to certain undertakings in the regulated financial sector which are required to make a more widespread use of the fair value method to value / measure the securities in which they have invested their funds.

¹⁸ See: Q&A CNC 14/002 "Revaluation of fixed tangible assets" and Q&A CNC 14/003 "Revaluation of fixed intangible assets".

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2.1. The need to refer to an existing national, European Union or international framework

It should be noted that the accounting directive 2013/34/EU has not clarified the concept of substance by category of transactions or agreements in such a way as to give rise to a consistent interpretation.

In this context, Member States are entitled to articulate accounting frameworks by category of transactions or agreements applicable to undertakings under their jurisdiction.

In Luxembourg, in accordance with a certain tradition when it comes to transposing directives, the choice has been made – until now – not to articulate such frameworks. It is important, however, not to misinterpret this silence in the texts. For example, the absence of an explicit framework should not allow preparers of annual accounts to invent from scratch an accounting treatment that reflects the substance of a transaction or agreement. It should be borne in mind that the filing and publication requirements to which undertakings are subject are intended to provide relevant information to third-party users, in particular with a view to protecting them. However, the articulation by the undertaking of a discretionary or even arbitrary accounting treatment could undermine the objectives of information and protection intended by the legislator.

In view of the above, CNC is of the opinion that an undertaking wishing to exercise the substance option for a category of transactions or agreements must necessarily refer to an existing accounting framework. In the absence of explicit accounting frameworks under LUX GAAP and LUX GAAP – FV, CNC considers that it is up to the undertaking to **choose a national, European Union or international framework to rely on that is based on the concept of substance for the category of transactions or agreements concerned.**

In this respect, and as already indicated in the preparatory work¹⁹, **reference to the "substance" approach taken by IFRSs as adopted by the European Union is undoubtedly the most natural solution on which undertakings are encouraged to rely.** Nevertheless, given the current state of the texts and considering that other recognised national or international frameworks advocating a treatment based on "substance"²⁰ currently coexist, CNC is of the opinion that the sole use of the model retained by IFRS cannot be imposed at this stage.

Whichever national, European Union or international framework is chosen, it is important that the undertaking using such a framework to reflect the substance of a class of transactions or agreements makes explicit reference to the framework chosen in the notes to its annual accounts and that it applies the framework to the class of transactions or agreements concerned fully and fairly.

2.2. Exercising the substance option: a targeted or generalised scope?

As with other optional provisions, the question arises of the targeted or generalised scope of the substance option when exercised by the undertaking.

In this respect, CNC is of the opinion that, as European and Luxembourg accounting law currently stands, the substance option is essentially targeted in scope. While the substance option does not necessarily have to apply to all of an undertaking's transactions and agreements, it must be applied to the full category of transactions or agreements in order to avoid selective or even abusive use.

¹⁹ Parl. doc. 6376-0, comments on the articles, p. 26.

²⁰ It should be noted that beyond the explicit reference to the notion of "substance" by said accounting frameworks, it is the articulation by the latter – in a generalised manner or restricted to certain categories of transactions or agreements – of accounting treatments tending to dissociate and give precedence to an economic and financial analysis over a legal analysis, which constitutes the determining factor (e.g.: analysis of lease contracts, characterisation of financial instruments, monetary nominalism and consideration of the time value of money, etc.).

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A category of transactions or agreements is a grouping of items of a similar nature or function. For example, leases are a category of agreements that should be treated in a consistent and uniform manner in the undertaking's annual accounts.

2.3. The requirement for consistency of accounting policies

Although the general principle of substance is an optional principle under Luxembourg accounting law, the exercise of this option for a given category of transactions or agreements gives rise to a durable commitment on the part of the undertaking in application of the principle of consistency of accounting policies.

Article 51(1)(b) LRCS states that "*accounting policies and measurement bases may not be modified from one financial year to another*".

If changes in accounting policies are permitted in extraordinary cases, they must be disclosed in the notes to the accounts, together with an explanation of their impact on the undertaking's assets and liabilities, financial position and results (art. 51 para. 2 LRCS).

3. Implications in terms of disclosures in the notes to the accounts

CNC is of the opinion that, in application of the true and fair view principle (art. 26 (3), (4) and (5) LRCS), an undertaking exercising the substance option must disclose in the notes to the accounts the accounting policies applied to the category of transactions or arrangements by referring to the national, European Union or international framework on which it has relied on (point 3.1.) and by disclosing in the notes to the accounts the information required by said framework for the category of transactions or arrangements in question (cf. point 3.2.). This obligation applies to all categories of undertakings regardless of their size (see point 3.3.).

3.1. Disclosure in the notes to the accounts of accounting policies and measurement bases

In accordance with article 65 para. 1 point 1° LRCS, undertakings are required to disclose in the notes to the accounts the accounting policies and measurement bases applied to the various balance sheet and profit and loss account items.

In this context and in accordance with point 2.1, undertakings exercising the "substance" option for one or more categories of transactions or arrangements are expected to disclose the national, European Union or international framework on which they have relied on and to summarise the main characteristics of the accounting policies used. Without such information, the objective of protecting third-party users of accounting information – as intended by the legislator – cannot reasonably be achieved.

3.2. The content of the information to be disclosed in the notes to the accounts, as dictated by the chosen framework

In addition to the specification of accounting policies and the chosen framework referred to in point 3.1, the question arises as to the content of the information to be disclosed in the notes to the accounts, which supplements or details the information presented in the balance sheet and profit and loss account.

In this respect, and in accordance with point 2.1, CNC is of the opinion that the content of the information to be disclosed in the notes to the accounts by the undertaking should be that dictated by the national, European Union or international framework on which the undertaking has chosen to rely on.

Thus, if the company uses IFRS to represent a category of transactions or agreements based on substance, the content of the information to be disclosed in the notes to the accounts should be determined on the basis of the IFRS standard applied. An undertaking referring to another national or international framework should refer to that framework in order to determine the content of the information to be disclosed in the notes to the accounts.

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The objective is thus to promote – for the category or categories of transactions or arrangements concerned – a faithful and complete application of the chosen framework in its various accounting dimensions, including the information to be disclosed in the notes to the accounts. The aim here is to reconcile the objective of flexibility for preparers with the objective of protection for third-party users.

3.3. Content of the notes to the accounts: no simplification for small undertakings

Following the example of European accounting law, Luxembourg accounting law provides for a simplified content for the preparation of the notes to the accounts of small undertakings within the meaning of article 35 LRCS. The idea of simplification is justified by the limited administrative resources of small undertakings, the low complexity of their operations and accounting treatments and the small number of third-party users interested in their accounting information.

It should be noted that small undertakings are never exempt from the obligation to disclose in the notes to the accounts their accounting policies and measurement bases (art. 65 (1) 1° LRCS).

Furthermore, it should also be pointed out that small undertakings must always comply with the true and fair view principle (art. 26 (3) LRCS) and that, to this end, additional information must be disclosed in the notes to the accounts whenever the legal provisions are not sufficient to achieve this objective (art. 26 (4) and (5) LRCS).

Finally, it is noted that in Luxembourg, the application of the concept of "substance" is an optional mechanism and that its use is always voluntary by analogy with other optional mechanisms (e.g. the "fair value" option). Consequently, a small undertaking wishing to control the administrative burden of drawing up its annual accounts for legal / statutory purposes may choose – as is already often the case – not to exercise the "substance" option, which is more complex to implement and more demanding in terms of information to be disclosed in the notes to the accounts, and to stick instead to the classic "*patrimonial*" model.

In view of the above, CNC is therefore of the opinion that small undertakings exercising the "substance" option cannot benefit from simplification measures in the preparation of the notes to the annual accounts other than those already provided for by Article 66 LRCS.

4. Potential impact on the determination of distributable reserves

CNC also considers that it is necessary to remind of the principle of prudence and of profit realisation (art. 51 para. 1 point c) LRCS) which constitutes the basis for the determination of distributable reserves for undertakings subject to general accounting law.

CNC is of the opinion that – irrespective of the application of Article 72^{ter} LRCS relating to the limitation of the amount of distributable reserves in the event of the use of IFRS or of the fair value measurement basis – profits or reserves generated by an accounting treatment based on substance, the amount of which would significantly exceed that which would have been recognised in application of the traditional accounting model (e.g.: "*patrimonial*" principle, prudence, historical cost), should necessarily be neutralised for the purposes of determining distributable reserves and that – if this were not the case – the legal representatives of the undertaking in question would potentially be exposing themselves to the criminal sanctions provided for in Title XV LSC.

In view of the above, CNC urges undertakings and their legal representatives to exercise the utmost caution / prudence.

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5. Interpretative scope, first application and transition

In conclusion, it should be noted that the purpose of this Q&A is to provide Luxembourg undertakings wishing to exercise the "substance" option (art. 29 (3) LRCS) with useful clarifications on the scope of this option, its application and its implications on the information to be disclosed in the notes to the accounts as well as on the determination of distributable reserves. Through this interpretation, the scope of which is essentially interpretative, CNC is providing its opinion on the conditions for using the optional substance principle in a way that complies with the general principles of financial reporting and is faithful to both the objective of flexibility for preparers and the objective of protection for third-party users.

For undertakings that were already applying the "substance" option (art. 29 (3) LRCS) prior to the publication of this Q&A, CNC is of the opinion that this Q&A does not call into question the validity – within the limits permitted by law – of the accounting treatments previously used by these undertakings for the category or categories of transactions and arrangements concerned. These undertakings are invited to verify the conformity of the approach previously adopted and to incorporate the recommendations included in this Q&A from now on.

This Q&A applies to any set of annual accounts or consolidated accounts prepared under LUX GAAP or LUX GAAP – FV for a financial year beginning after the date of publication of this Q&A.

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Disclaimer

This document – provided as a courtesy – is an unofficial translation of the French original document entitled “Principe optionnel de substance (art. 29 (3) LRCS): portée de l’option, modalités d’application et implications sur l’information en annexe ainsi que sur la détermination des réserves distribuables”. In case of discrepancy in interpretation, the French version shall prevail.

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