

JUDGMENT OF THE COURT (Fifth Chamber)

14 September 1999 *

In Case C-275/97,

REFERENCE to the Court under Article 177 of the EC Treaty (now Article 234 EC) by the Finanzgericht Köln, Germany, for a preliminary ruling in the proceedings pending before that court between

DE + ES Bauunternehmung GmbH

and

Finanzamt Bergheim

on the interpretation of the Fourth Council Directive (78/660/EEC) of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies (OJ 1978 L 222, p. 11),

* Language of the case: German.

THE COURT (Fifth Chamber),

composed of: J.-P. Puissechet, President of the Chamber, P. Jann, D.A.O. Edward (Rapporteur), L. Sevón and M. Wathelet, Judges,

Advocate General: P. Léger,

Registrar: R. Grass,

after considering the written observations submitted on behalf of:

- the Finanzamt Bergheim, by A. Kohls, Regierungsdirektorin und Ständige Vertreterin des Vorstehers,
- the German Government, by A. Dittrich, Ministerialrat in the Federal Ministry of Justice, and C.D. Quassowski, Regierungsdirektor in the Federal Ministry of Economic Affairs, acting as Agents,
- the Netherlands Government, by A. Bos, Legal Adviser at the Ministry of Foreign Affairs, acting as Agent,
- the United Kingdom Government, by J.E. Collins, Assistant Treasury Solicitor, acting as Agent, and
- the Commission of the European Communities, by A. Caeiro, Principal Legal Adviser, and A. Buschmann, a national civil servant on secondment to the Commission's Legal Service, acting as Agents,

having regard to the report of the Judge-Rapporteur,

after hearing the Opinion of the Advocate General at the sitting on 26 November 1998,

gives the following

Judgment

- 1 By order of 16 July 1997, received at the Court on 30 July 1997, the Finanzgericht Köln (Finance Court, Cologne) referred to the Court for a preliminary ruling under Article 177 of the EC Treaty (now Article 234 EC) two questions on the interpretation of the Fourth Council Directive (78/660/EEC) of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies (OJ 1978 L 222, p. 11, hereinafter 'the Directive').
- 2 Those questions have been raised in proceedings between DE + ES Bauunternehmung GmbH (hereinafter 'DE + ES'), a German building company, and Finanzamt Bergheim (hereinafter 'the Finanzamt').

Relevant Community law

- 3 Article 2(1) of the Directive provides:

'The annual accounts shall comprise the balance sheet, the profit and loss account and the notes on the accounts. These documents shall constitute a composite whole.'

4 Article 2(3) of the Directive provides:

‘The annual accounts shall give a true and fair view of the company’s assets, liabilities, financial position and profit or loss.’

5 Article 2(5) provides:

‘Where in exceptional cases the application of a provision of this Directive is incompatible with the obligation laid down in paragraph 3, that provision must be departed from in order to give a true and fair view within the meaning of paragraph 3. Any such departure must be disclosed in the notes on the accounts together with an explanation of the reasons for it and a statement of its effect on the assets, liabilities, financial position and profit or loss. The Member States may define the exceptional cases in question and lay down the relevant special rules.’

6 Article 20 of the Directive provides:

‘1. Provisions for liabilities and charges are intended to cover losses or debts the nature of which is clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which they will arise.

2. The Member States may also authorise the creation of provisions intended to cover charges which have their origin in the financial year under review or in a previous financial year, the nature of which is clearly defined and which at the

date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which they will arise.

3. Provisions for liabilities and charges may not be used to adjust the values of assets.'

7 Article 31 of the Directive provides:

'1. The Member States shall ensure that the items shown in the annual accounts are valued in accordance with the following general principles:

...

(c) valuation must be made on a prudent basis, and in particular:

(aa) only profits made at the balance sheet date may be included,

(bb) account must be taken of all foreseeable liabilities and potential losses arising in the course of the financial year concerned or of a previous one, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up,

- (cc) account must be taken of all depreciation, whether the result of the financial year is a loss or a profit;

- (d) account must be taken of income and charges relating to the financial year, irrespective of the date of receipt or payment of such income or charges;

- (e) the components of asset and liability items must be valued separately;

- (f) the opening balance sheet for each financial year must correspond to the closing balance sheet for the preceding financial year.

2. Departures from these general principles shall be permitted in exceptional cases. Any such departures must be disclosed in the notes on the accounts and the reasons for them given together with an assessment of their effect on the assets, liabilities, financial position and profit or loss.’

8 The first paragraph of Article 42 of the Directive provides:

‘Provisions for liabilities and charges may not exceed in amount the sums which are necessary.’

Relevant national law

- 9 The Directive was transposed into German law by the Bilanzrichtliniengesetz (Law on Accounting Guidelines) of 19 December 1985 (BGBl. I, p. 2355). That Law was then incorporated in the Third Book (Paragraphs 238 to 342) of the Handelsgesetzbuch (Commercial Code, hereinafter 'the HGB') of 10 May 1897 (BGBl. III, p. 4100-1).

- 10 According to the Körperschaftsteuergesetz (Law on Corporation Tax, hereinafter 'the KStG'), corporation tax is determined on the basis of operating profits calculated pursuant to the Einkommenssteuergesetz (Law on Income Tax (hereinafter 'the EStG') BGBl. 1990, p. 1898, amended 1991 I, p. 808). According to the EStG, profits must be valued on the basis of accounts drawn up pursuant to the rules contained in the HGB.

- 11 In accordance with Paragraph 7 of the Gewerbesteuer-gesetz (Law on Trade Tax), the basis of assessment to trade tax is calculated pursuant to the EStG or the KStG and therefore pursuant also to the rules contained in the HGB.

The dispute in the main proceedings

- 12 In carrying out the building work entrusted to it, DE + ES uses subcontractors in addition to its own employees. When calculating the corporation tax and trade tax payable for 1993, it sought to make global provision for liabilities under warranties relating to particular works contracts as obligations arising in law before the date of the balance sheet but whose effects might emerge only after that date and which it valued at 2% of the turnover subject to warranties. It therefore sought tax relief equal to the amount of that valuation.

- 13 DE + ES claimed that such a provision was necessary in order to take account of defective performance of building contracts concluded during the previous year, which would probably give rise, in the following years, to claims for building defects and to warranty claims.
- 14 The Finanzamt did not deny that DE + ES was under an obligation to put right defects in work regarded as being covered by the provisions for warranty liabilities. Those provisions include assumption of the cost of repairs, reduction of the price paid or payment of damages. Nor did the Finanzamt challenge the creation of global provisions for debts arising after the date of the balance sheet but going back to the financial year concerned.
- 15 It refused, however, to accept the amount of the provision sought and proposed a provision corresponding to 0.5% of the turnover in the last two years. It considered that, if an undertaking claims a global provision which is higher than that usual in the sector concerned, it must prove that in the past claims against it have been above the usual level.
- 16 The Finanzgericht states that, in order for a global provision to be made under German law, the Einkommensteuer-Richtlinien (Income Tax Guidelines, hereinafter 'the EStR'), which are based on settled case-law, require that the cause of the obligation for which the provision was made must have arisen before the balance-sheet date and that there must be a serious expectation of that obligation materialising (Guideline R31c(2) of the EStR).
- 17 However, the Finanzgericht considers that the requirement that asset and liability items must be valued separately, contained in Article 31(1)(e) of the Fourth Directive, from which departures are permitted only in exceptional cases for which reasons must be given in accordance with Article 31(2), precludes global provisions for liabilities and charges from being entered on the 'Liabilities' side of the balance sheet.

18 In those circumstances, the Finanzgericht decided to stay proceedings and to refer the following two questions to the Court for a preliminary ruling:

1. Is it compatible with the accounting rules laid down by the Fourth Council Directive (78/660/EEC) of 25 July 1978 on the annual accounts of certain types of companies (OJ 1978 L 222, p. 11), under which:
 - the annual accounts are to give a true and fair view of the company's assets, liabilities, financial position and profit or loss (Article 2(3));
 - provisions are intended to cover losses or debts the nature of which is clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which they will arise (Article 20(1));
 - provisions are not to be used to adjust the values of assets (Article 20(3));
 - account is to be taken of all foreseeable liabilities and potential losses arising in the course of the financial year concerned or of a previous one, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up (Article 31(1)(c)(bb));

- the components of asset and liability items are to be valued separately (Article 31(1)(e));

- provisions are not to exceed in amount the sums which are necessary (first paragraph of Article 42),

if a building undertaking which, besides its own employees, uses subcontractors to perform its contracts does not make individual provisions, taking into account potential individual warranty liabilities inherent in particular contracts, for obligations under warranties not arising until after the balance-sheet date, but makes global provision, by way of a fixed percentage of the turnover subject to warranties?

2. If the first question is answered in the affirmative:

Subject to what conditions, in accordance with what valuation criteria and up to what percentage, on the basis, where appropriate, of an assessment by the business itself, may such global provision be made, regard being had also to any limited rights of recourse against the business's own employees and subcontractors, and, in the event of doubt as to the amount of the provision needed, who bears the disadvantage of the fact that the matter is not susceptible of proof?

- 19 It must be observed at the outset that in Germany corporation tax and trade tax are calculated on the basis of the balance sheet drawn up in accordance with the Law transposing the Directive into national law.

- 20 The questions submitted by the national court must be understood as raising the following issues which must be examined in turn.
- 21 First, it is necessary to determine whether the Directive precludes the creation of a provision for potential liabilities under warranties, such as those in question here, in respect of obligations which arise in law before the date of the balance sheet but whose effects will not become apparent until after that date.
- 22 If the Directive does not preclude such a provision, the second question to be examined is whether each potential warranty liability must be evaluated separately or whether a global provision for all such liabilities may, or even must, be made.
- 23 A third question to be examined is whether the making of such a provision may, as a matter of principle, be limited to a fixed percentage of the turnover subject to warranties.
- 24 Article 20(1) of the Directive lays down the obligation to enter provisions for liabilities and charges in the accounts under 'Liabilities'. It is clear from its wording that provisions for potential warranty liabilities must be entered under 'Liabilities' provided that those liabilities constitute charges the nature of which is clearly defined and which are likely to be incurred but are uncertain as to their amount or the date on which they will arise.
- 25 As the German Government has pointed out, the obligations arising under such warranties may involve an obligation for the company concerned to carry out repair work for no charge, to replace certain items or do certain work again, to reduce the price paid or to pay damages for failure to carry out certain work. Even if only some of these potential warranty liabilities materialise, they

constitute debts from which, if they materialise, the company cannot escape and which should therefore be entered under 'Liabilities' even if it is not yet possible to say whether and to what extent the company will be obliged to bear them or to quantify them precisely.

- 26 Any other interpretation of Article 20 of the Directive would mean that such potential debts would not be shown in the balance sheet, which would lead to an overestimate of the assets. Such a result would be incompatible not only with the principle of making valuations on a prudent basis, the observance of which is prescribed by Article 31(1)(c) of the Directive, but also with the principle of the 'true and fair view', compliance with which is the primary objective of the Directive (see Case C-234/94 *Tomberger* [1996] ECR I-3133, paragraph 17, rectified by order of the Court of 10 July 1997, not published in the ECR), and according to which the annual accounts of the companies to which the Directive applies must give a true and fair view of their assets and liabilities, of their financial position and of their profit or loss (see the fourth recital in the preamble to the Directive and Article 2(3) and (5) of the Directive).
- 27 The principle of a true and fair view requires that the accounts reflect the activities and transactions which they are supposed to describe and that the accounting information be given in the form judged to be the soundest and most appropriate for satisfying third parties' needs for information, without harming the interests of the company.
- 28 It is therefore necessary to examine whether potential liabilities under warranties, such as those in question here, must be valued separately so that separate provision must be made for each potential liability under a warranty.
- 29 In this regard, Article 34(1)(e) of the Directive provides that the components of asset and liability items must be valued separately. That provision also applies to the provisions referred to in Article 20(1) of the Directive.

- 30 The principle of separate valuation laid down in Article 31(1)(e) of the Directive is not, however, absolute. In exceptional cases, departures are permissible under Article 31(2).
- 31 Since the Directive does not define what is meant by ‘exceptional cases’, this expression must be interpreted in the light of the Directive’s aim, which, as indicated in paragraph 26 above, is that the annual accounts of the companies concerned must give a true and fair view of their assets, of their financial position and of their profit or loss (see, also, to this effect the judgment in *Tomberger*, cited above).
- 32 The exceptional cases referred to in Article 31(2) are therefore those in which separate valuation would not give the truest and fairest possible view of the actual financial position of the company concerned.
- 33 As already explained, the warranty liabilities in question constitute potential debts whose amount and the date on which they arise cannot be stated precisely. The creation of a separate provision for each potential liability under a warranty could produce a distorted view of the financial position of the company concerned, which would be contrary to the principle of a true and fair view.
- 34 It follows that a single provision for all such liabilities should be made where, as in the present case, a global valuation is the most appropriate way of ensuring that the expenditure to be shown under ‘Liabilities’ in the balance sheet represents a true and fair view of its amount.
- 35 As regards the actual calculation of the global provision, it must be observed, as the German Government has pointed out, that the Directive contains no indications as to the conditions under which global provisions may be made, as to

the valuation criteria to be applied or as to the percentage up to which they may be made. It follows that such provisions can be determined only under the conditions laid down by the national legislation of the various Member States.

- 36 However, the powers of the national authorities in this regard are restricted by the Directive. First, it is clear from the primary aim of the Directive that the annual accounts must give a true and fair view of the assets, financial position and the profit and loss of the company. Second, it is clear from Article 42(1) of the Directive that provisions for liabilities and charges may not exceed in amount the sums which are necessary. It follows that the valuation criteria laid down by the national authorities must comply with those two conditions.
- 37 The valuation criteria for global provisions laid down by national authorities must therefore allow account to be taken of the reporting company's previous experience, or that of other companies active in the same sector, with warranty claims relating to similar contracts. The relevant criteria here could be, in particular, the type of construction work in question, the likelihood of the liability materialising, its likely cost, the extent to which subcontractors are used, rights of recourse against such subcontractors and, finally, any other relevant criterion for arriving at the best possible valuation of potential liabilities.
- 38 The creation of a global provision for potential liabilities under warranties cannot therefore be limited by the national authorities, a priori and in the abstract, to a fixed percentage of the turnover subject to warranties.
- 39 However, the undertaking concerned may not set such a global provision above a reasonable level, having regard to the potential liability concerned.

- 40 The answer to be given to the questions submitted by the national court must therefore be that the Directive requires provision to be made for potential liabilities under warranties, such as those in question in the main proceedings, as obligations arising in law before the date of the balance sheet but whose effects will not become apparent until after that date. A single provision for all such potential liabilities must be made where, as in the present case, a global valuation is the most appropriate way of ensuring that the expenditure to be shown under 'Liabilities' represents a true and fair view of its amount. In the absence of Community rules specifically applying to the method and criteria for evaluating provisions for charges and liabilities, those provisions should be determined under the conditions laid down by the national legislation of the various Member States, on condition, however, that the annual accounts give a true and fair view of the assets, financial position and the profit or loss of the company and that the provisions do not exceed in amount the sums which are necessary.

Costs

- 41 The costs incurred by the German, Netherlands and United Kingdom Governments and by the Commission, which have submitted observations to the Court, are not recoverable. Since these proceedings are, for the parties to the main proceedings, a step in the proceedings pending before the national court, the decision on costs is a matter for that court.

On those grounds,

THE COURT (Fifth Chamber),

in answer to the question referred to it by the Finanzgericht Köln by order of 16 July 1997, hereby rules:

The Fourth Council Directive (78/660/EEC) of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies requires provision to be made for potential liabilities under warranties, such as those in question in the main proceedings, as obligations arising in law before the date of the balance sheet but whose effects will not become apparent until after that date. A single provision for all such potential liabilities must be made where, as in the present case, a global valuation is the most appropriate way of ensuring that the expenditure to be shown under 'Liabilities' represents a true and fair view of its amount. In the absence of Community rules specifically applying to the method and criteria for evaluating provisions for charges and liabilities, those provisions should be determined under the conditions laid down by the national legislation of the various Member States, on condition, however, that the annual accounts give a true and fair view of the assets, financial position and the profit or loss of the company and that the provisions do not exceed in amount the sums which are necessary.

Puissochet

Jann

Edward

Sevón

Wathelet

Delivered in open court in Luxembourg on 14 September 1999.

R. Grass

J.-P. Puissochet

Registrar

President of the Fifth Chamber