OPINION OF ADVOCATE GENERAL
delivered on 26 November 1998 *

1. Does 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 [1] (hereinafter 'the Fourth Directive') allow a global provision to be made, in the balance sheet of a limited liability company, for contingent liabilities under warranties? That, essentially, is the question which the Finanzgericht Köln (Germany) is referring to the Court for a preliminary ruling.

The relevant provisions of the Fourth Directive

2. The Fourth Directive is intended to coordinate national provisions relating to the presentation and content of annual accounts and annual reports, the valuation methods used therein and their publication in respect of certain companies with limited liability in order to protect members and third parties. [2]

3. To that end it lays down certain principles which must be applied when such accounts are drawn up.

4. For example, Article 2 (3) of the Fourth Directive provides that a company's annual accounts must give a true and fair view of its assets, liabilities, financial position and profit or loss (hereinafter 'the principle of a true and fair view').

5. Article 2 (5) provides that, where in exceptional cases the application of a provision of the Fourth Directive is incompatible with the principle of a true and fair view, that provision must be departed from in order to ensure that that principle is observed. Any such departure must first be disclosed in the notes on the accounts together with an explanation of the reasons for it.

6. Article 20(1) of the Fourth Directive defines provisions for liabilities and charges. They 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

* Original language: French.
1 — OJ 1978 L 222, p. 11.
2 — First recital in the preamble.

as to amount or as to the date on which they will arise'.

7. Article 31 of the Fourth Directive sets out the general principles with which the Member States must comply when valuing the items shown in the annual accounts.

8. Thus, Article 31 (1) of the Fourth Directive provides that:

'...

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

...

(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,

...

(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;

...'.

9. Furthermore, Article 31 (2) of the Fourth Directive permits departures from the principles set out in paragraph (1) only in exceptional cases.

10. Finally, the first paragraph of Article 42 states: 'Provisions for liabilities and charges may not exceed in amount the sums which are necessary'.

The relevant national provisions

11. The Fourth Directive was transposed into German law by the Bilanzrichtliniengesetz (Law on Accounting Guidelines) of 19 December 1985. [3] That Law was incorporated into the Third Book (Paragraphs 238 to 342) of the Handelsgesetzbuch (Commercial Code, hereinafter 'the HGB') of 10 May 1897. [4]

12. In accordance with Paragraph 243(1) of the HGB, 'annual accounts shall be drawn up in accordance with the principles of proper accounting'.

13. Paragraphs 249(1) and (3) stipulate that provisions may be made only where liabilities are uncertain and losses from pending transactions are imminent.

14. Paragraph 252(1)(3) and (4) and Paragraph 252(2) of the HGB essentially reproduce the provisions contained in Article 31(1)(c), (d) and (e) of the Fourth Directive. It provides that the asset and liability items must be valued separately at the date of the balance sheet, that valuation must be made on a prudent basis, in particular that account must be taken of all foreseeable liabilities and losses arising up to the balance sheet date, even if they become apparent only between the balance sheet date and the date on which the balance sheet is drawn up, and that only profits made at the balance sheet date may be taken into account. In addition, it also states that departures from the principles set out therein, for which particular reasons are to be given, are only possible in exceptional circumstances.

15. In accordance with Paragraph 253(1) of the HGB, which transposes the first paragraph of Article 42, 'provisions are not to exceed in amount the sums which, on the basis of a reasonable business assessment, are necessary'.

16. The Körperschaftsteuergesetz (Law on Corporation Tax, hereinafter 'the KStG') and the Körperschaftsteuer (corporation tax) take as their basis the trading profit which in turn is calculated in accordance with the Einkommensteuergesetz (Law on Income Tax, hereinafter 'the EStG'). [5] The EStG requires that profit must be valued on the basis of accounts drawn up pursuant to the HGB.

17. In accordance with Paragraph 7 of the Gewerbesteuergesetz (Law on Trade Tax), the basis of assessment to the tax levied

3 — BGBl. I, p. 2355.

4 — BGBl. III, p. 4100-1.

5 — BGBl. 1990, p. 1898, amended 1991 I. p. 808.

under that Law is to be calculated pursuant to the EStG or the KStG and, therefore, also pursuant to rules laid down in the HGB.

Facts and procedure

18. DE + ES Bauunternehmung GmbH (hereinafter 'the plaintiff'), a construction company incorporated under German law, performs building contracts using subcontractors as well as its own employees.

19. When the plaintiff calculated the Körperschaftsteuer and Gewerbesteuer (trade tax) for which it was liable for 1993, it sought to make a global provision liabilities under warranties which arose in particular contracts before the date of the balance sheet but whose effects were likely to appear after that date and which it valued at 2% of the turnover subject to warranties. Consequently, it claimed a tax exemption equal to the amount thus valued. It is not disputed that it is required to guarantee reparation of defective work that comes to light during the two to five years which follow the completion of that work or that the enforceability of any rights of recourse against employers or subcontractors is uncertain.

20. The Finanzamt Bergheim (hereinafter 'the respondent') does not dispute the regularity of the global provisions made to cover such liabilities but the amount of the provision which is being claimed in this case. It proposes a provision amounting to 0.5% of turnover for the previous two years.

21. The plaintiff brought an action before the Finanzgericht Köln and claimed that the contested notices of assessment should be amended to take account of a global provision for warranties amounting to 2% of turnover, or DEM 88 396.

22. The defendant considers that if an undertaking claims the benefit of a higher global provision than that which is usual in the trade concerned, it must prove that in the past the rate of warranty claims exceeded the normal rate. In this case, the defendant maintains that the evidence submitted by the plaintiff is insufficient to substantiate its claim and therefore contends that it should be dismissed.

23. The referring court states that, in order for such provision to be made under German law, the Einkommensteuer-Richtlinien (Income Tax Guidelines; 'EStR') and settled

case-law require that the obligation on which the provision is based must have arisen before the balance-sheet date and must give rise to a serious expectation of a claim (Guideline 31c(2) of the EstR).

24. The referring court considers that the requirement contained in Article 31(1)(e) of the Fourth Directive that asset and liability items must be valued separately, and from which departures are permitted only in exceptional cases for which reasons must be given in accordance with paragraph (2) of that article, precludes global provisions from being entered as liabilities in the balance sheet.

25. That is why, even though the principal proceedings relate directly to the calculation of the basis for assessment to two German taxes — Körperschaftsteuer and Gewerbesteuer — in an area outside the scope of Community law, the referring court considers that it is unable to resolve the case before it without first seeking clarification of the interpretation to be placed on certain provisions of the Fourth Directive and has therefore referred the two following 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 annual accounts (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),

for a building construction undertaking, which uses subcontractors in addition to its own employees to perform its contracts, not to make individual provision, taking into account individual warranty risks inherent in particular contracts, for warranty liabilities not arising until after the balance sheet date, but to make 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 preconditions, 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 also being had to any limited rights of recourse against the business, own employees and against 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?'

Preliminary remarks

26. The Commission and the German Government first raise the question whether it is within the Court's jurisdiction to reply to the questions referred, since the outcome of the main proceedings does not turn directly on the application of Community rules but on national legislation beyond the Court's jurisdiction — that is to say national rules of tax law relating to the determination of the basis for assessment to direct taxes — but go on to accept that it

has jurisdiction on the basis of the Court's judgment in the *Leur-Bloem* case. [6]

27. I share that opinion. According to that judgment, '[a] reference by a national court can be rejected only if it appears that the procedure laid down by Article 177 of the Treaty has been misused and a ruling from the Court elicited by means of a contrived dispute, or it is obvious that Community law cannot apply, either directly or indirectly, to the circumstances of the case...'. [7]

The Court considers that this is not the case with '... questions concerning Community provisions in situations where the facts of the cases being considered by the national courts [are] outside the scope of Community law but where those provisions had been rendered applicable either by domestic law or merely by virtue of terms in a contract... [T]he provisions of domestic law and the relevant contractual terms, which incorporated Community provisions, clearly [do] not limit application of the latter.' [8]

28. In this case, the referring court considers that the interpretation of the term 'provisions for liabilities and charges', taken in its Community context, is essential to resolve the case brought before it. That is because that term which appears in the Fourth Directive has been transposed in its entirety into national law and extended to situations similar to those purely internal situations envisaged by the Directive (that is to say, for the determination of the basis for assessment to direct taxes).

29. So, according to that judgment, '... where in regulating internal situations, domestic legislation adopts the same solutions as those adopted in Community law so as to provide for one single procedure in comparable situations, it is clearly in the Community interest that, in order to forestall future differences of interpretation, provisions or concepts taken from Community law should be interpreted uniformly, irrespective of the circumstances in which they are to apply ...'. [9]

30. The fact that the outcome of the main proceedings does not turn directly on the application of Community provisions does not, in the circumstance of the case, raise any doubts as to the Court's jurisdiction.

31. Therefore, my examination will deal with the question whether the Fourth

6 — Case C-28/95 *Leur-Bloem* [1997] ECR I-4161.

7 — Ibid., paragraph 26.

8 — Ibid., paragraph 27.

9 — Ibid., paragraph 32.

Directive precludes global provision from being made in the balance sheet for indemnity liabilities and charges which arise before the date of the balance sheet but whose effects may emerge only after that date and whether it lays down specific rules governing such provisions, in particular with regard to the burden of proof and the criteria for valuing their amount.

The first question

32. It is apparent from the grounds of the order for reference that, even though its first question is worded differently, the national court seeks to establish whether the principle of a true and fair view, the principle that valuation must be made on a prudent basis and the requirement that asset and liability items must be valued separately preclude a global provision for warranty liabilities in respect of particular contracts *which arise before the date of the balance sheet but whose effects may emerge only after that date* from being made in the balance sheet.

33. I consider not only that the Fourth Directive does not preclude such provisions from being made by way of a global valuation in a case such as that in the main proceedings but also that compliance with those principles requires that a company which finds itself in a situation like that of the plaintiff in the main proceedings must enter such provisions as liabilities in the balance sheet.

34. What we have here is a request by a limited liability building construction company to make provision in its balance sheet in order to cover the financial consequences which could result from warranty claims which may be made after building work has been performed in the course of a specific financial year but whose defects have not yet come to light or have come to light but have not yet given rise to an actual claim against the company. These claims are therefore liabilities or charges which will most probably materialise but whose precise valuation is difficult on account of the uncertainty as to date and amount of the actual claims.

35. These cases satisfy precisely the definition of provisions set out in Article 20 of the Fourth Directive.

36. It should be remembered that Article 20(1) defines provisions for liabilities and charges as being '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' and that Article 20(2) authorises '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'.

37. Therefore, there can be scarcely any doubt that the Fourth Directive entitles building companies such as the plaintiff to make such provisions.

38. Furthermore, I consider that observance of the principle of a true and fair view, which the Community legislature considers to be the primary objective of the Fourth Directive, requires such provisions to be entered as liabilities in the balance sheet and obliges companies to assess as accurately as possible their needs in this regard. To my mind, Article 20(1) of the Fourth Directive is not only based directly on the principle that valuation must be made on a prudent basis, to which I will return, but also constitutes an important application of the principle of a true and fair view.

39. The principle set out in Article 2(3) of the Fourth Directive requires Member States to coordinate national provisions relating to the presentation and content of a company's annual accounts so that those accounts give a *true and fair view* of the company's assets, liabilities, financial position and profit or loss. That principle is regarded as fundamental and, to make clear its primacy over the other principles set out in the Fourth Directive, Article 2(5) states that '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...'.

40. The Court confirmed that interpretation in its judgment in the case *Tomberger* [10], in which it ruled that 'the principle of the "true and fair view"... is the primary objective [of the Fourth Directive]'.

41. The partners and creditors of the company concerned must be able to ascertain its actual assets and liabilities, which they would be unable to assess if charges resulting from liabilities which arose before the date of the balance sheet but whose effects appeared after that date were not shown in the balance sheet. Therefore, where there is a strong possibility that a charge or a loss will be incurred, the principle of a true and fair view requires the company to enter it into its balance sheet. Furthermore, the primacy that the

10 — Case C-234/94 *Tomberger* [1996] ECR I-3133, paragraph 17.

Court confers on the principle set out in Article 2 (5) means that where it conflicts with other principles laid down in the Fourth Directive those principles must defer to it.

42. Let us therefore consider whether entering a global provision for liabilities and charges in the balance sheet breaches the principle that valuations must be made on a prudent basis and the principle that valuations must be made separately.

43. Observance of the principle that valuation must be made on a prudent basis is prescribed in Article 31(1)(c) of the Fourth Directive. It requires companies to present a balance sheet which takes account of any occurrences which could affect the financial security of the undertaking's creditors. That means that only profits made at the date of the balance sheet may be entered, and also that 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, of all depreciation, whether the result of the financial year is a loss or a profit, and of the income and charges relating to the financial year, *irrespective of the date of receipt or payment of such income or charges* [Article 31(1) (c)(aa), (bb) and (cc) and (d)].

44. Therefore, the costs incurred in performing contracts in the course of the financial year clearly include the amount of claims that would be due if the warranty given for such work were to be invoked. Consequently, the amount of that potential indemnity relates to the financial year at issue, even if the sums due in that respect are only likely to be paid in subsequent financial years.

45. Thus, the principle that valuation must be made on a prudent basis must be interpreted as requiring a company such as the plaintiff to enter in its balance sheet losses or liabilities resulting from warranty claims that may be made after building work has been performed in a specific financial year even if the defects have not yet come to light or have come to light but have not yet given rise to an actual claim against it.

46. In the Court's judgment in the *Tomberger* case, cited above, it made clear the proper application of the principle of a true and fair view also depended on observance of Article 31 of the Fourth Directive.

47. The Court ruled: 'With regard to Article 31 of the Fourth Directive, it should be borne in mind that the Fourth Directive seeks to coordinate national provisions concerning the presentation and content of annual accounts of certain types of companies... In order to coordinate the content of annual accounts, the directive lays down the principle of the "true and

fair" view, compliance with which is the primary objective of the directive...';[11] 'Application of that principle must, as far as possible, be guided by the general principles contained in Article 31 of the Fourth Directive. In this case, the principles set out in Article 31(1)(c)(aa) and (bb) and (d) are of particular importance';[12] and 'It is clear from those provisions that taking account of all elements — profits made, charges, income, liabilities and losses — which actually relate to the financial year in question ensures observance of the requirement of a true and fair view'.[13]

48. With regard to the requirement that separate valuations must be made, that requirement is contained in Article 31(1)(e) of the Fourth Directive, which states that 'the components of asset and liability items must be valued separately'.

49. The referring court and the Commission consider that the requirement that those components must be valued separately precludes a global valuation of provisions for liabilities and charges and that reasons must be given for exceptional circumstances in order that a departure may be made from it. However, the parties to the main proceedings and the intervening Member States take the view that the Fourth Directive authorises the making of a provision to cover several uncertain debts of the same kind, without it being necessary to give reasons for exceptional circumstances in accordance with Article 31(2) thereof.

50. In my view, the concepts 'separate valuation' and 'global valuation' neither preclude, nor are inconsistent with, one another. In other words, a separate valuation may be made globally or comprehensively.

51. That view is based on the wording of Article 20(1) and (2) and the first paragraph of Article 42 of the Fourth Directive. It follows from those provisions, read in conjunction, that the creation of provisions is authorised even if the amount of losses or debts is uncertain, provided that they do not exceed the sums which are necessary. A global valuation necessarily satisfies that definition. My reply would have been quite different had the Community legislature stipulated that all the components of asset and liability items had to be determined precisely.

52. In my view, by laying down the requirement that items be valued separately, the Community legislature is helping to ensure proper application of the general and mandatory rule prohibiting '[a]ny set-off between asset and liability items, or between income and expenditure items', which is set out in Article 7 of the Fourth Directive and reiterated in more precise

11 — *Tomberger*, cited above, paragraph 17.
12 — Ibid., paragraph 18.
13 — Ibid., paragraph 22.

terms, in relation to the making of provision for liabilities and charges, in Article 20(3), which states that: 'Provisions for liabilities and charges may not be used to adjust the values of assets'.

53. I must therefore conclude that the Fourth Directive does not preclude global provisions for risks of warranty claims from being entered in a company's balance sheet. [14]

The second question

54. It follows from the grounds contained in the order for reference that, in order to calculate the basis for assessment to the direct taxes for which the plaintiff is liable, the referring court seeks, by its second question, to ascertain whether the Fourth Directive lays down specific rules for provisions and whether, in particular it lays down the criteria for determining their amount.

55. It should be noted that the Fourth Directive contains no rule concerning the determination of the basis for assessment to direct taxes. Consequently, it lays down no rule for determining up to what amount, according to which criteria and under which rules a company may obtain tax deductions for provisions entered in its balance sheet. The reason for this is that there is no connection in the Fourth Directive between the contents of companies' annual accounts and assessment to tax, even though the existence of such a connection reflected in the accounts is permitted. [15]

56. As the Court recently stated in a judgment of 15 May 1997 in the case of *Futura Participations and Singer*, [16] '... no provision has been made for harmonising domestic rules relating to determination of the basis of assessment to direct taxes. Consequently, each Member State draws up its own rules governing the determination of profits, income, expenditure, deductions and exemptions as well as the amounts in respect of each of them which may be included in the calculation of taxable income or of losses which may be carried forward'.

14 — As far as I am aware, in the majority of Member States there are no express rules on the global valuation of provisions for charges and liabilities. However, they are clearly permitted in five States: in Austria (see, in particular, Geist, R. in: *Kommentar zum Handelsgesetzbuch*, p. 1593 et seq., and p. 1689 et seq.); in France (*Code général des impôts*, Article 39-1-5°); in the United Kingdom (*Statements of Standard Accounting Practice*, 18, rule 6) and, by way of exception, where reasons are given for them, in Germany (*HGB*, Paragraph 252(2)) and in Luxembourg (Conseil d'État, 7 February 1962, Comptoir des fers et métaux, No 5735, and Counseil d'État, 8 July 1953, Mayer-Reiffers, No 5015).

15 — See, for example, Article 30 of the Fourth Directive which provides: 'The Member States may permit taxes on the profit or loss on ordinary activities and taxes on the extraordinary profit or loss to be shown in total as one item in the profit and loss account before "Other taxes not shown under the above items". In that case, "Profit or loss on ordinary activities after taxation" shall be omitted from the layouts prescribed in Articles 23 to 26.
Where this derogation is applied, companies must disclose in the notes on the accounts the extent to which the taxes on the profit or loss affect the profit or loss on ordinary activities and the "Extraordinary profit or loss".'

16 — C-250/95 *Futura Participations and Singer* v *Administration des Contributions* [1997] ECR I-2471, at paragraph 33.

57. From that I must conclude that the rules relating to the determination of the basis for assessment to direct taxes, in particular with regard to the burden of proof and the criteria for valuing provisions for charges and liabilities, do not fall within the scope of Community law but within the exclusive competence of the Member States.

Conclusion

58. For the reasons set out above, I propose that the Court should reply as follows to the questions referred to it by the Finanzgericht Köln:

(1) 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 does not preclude a limited liability building construction company from making provision for risks of warranty liabilities which arise before the date of the balance sheet but whose effects will materialise only after that date, not separately, according to the specific risks residing in specific contracts, but globally, at a fixed percentage of its turnover subject to warranties.

(2) In the absence of harmonisation of national rules relating to the determination of the basis for assessment to direct taxes, the Member States alone are competent to lay down the rules relating to tax deductibility of provisions for charges and liabilities.