Date

10 February 2004

Le Président

Fédération des Experts Comptables Européens AISBL

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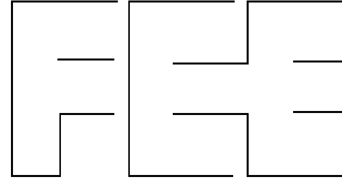

Mr Gianluigi Campogrande
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European Commission
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Dear Mr Campogrande,

Re: Capital Maintenance and the EC Communication "Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward"

FEE (Fédération des Experts Comptables Européens, European Federation of Accountants) read with interest the Commission's synthesis of the responses to the Communication on Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward.

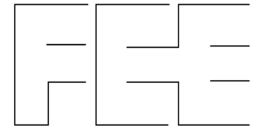
This letter addresses our immediate reaction to one particular aspect of the synthesis document, being the issues surrounding capital maintenance and an alternative regime that are covered in Section 4 of your document.

FEE, like many other respondents, welcomed the Commission's intention to launch a study into the feasibility of an alternative to the existing capital maintenance regime. In our comment letter dated 31 July 2003, FEE expressed strong support for accelerating the proposed timing of the study. We learnt from the synthesis that any idea about the possible introduction of an alternative regime in the Second Company Law Directive was not universally supported for various reasons.

We write to explain in more detail why FEE believes that analysing the feasibility of an alternative to the existing capital maintenance regime should be a high priority short-term matter. We believe the key matters can be summarised as follows:

- The shortcomings of the existing capital maintenance regime could give rise to the need to move to a more dynamic approach.
- The existing capital maintenance regime may lead to artificial restrictions on dividends for solvent companies when planned accounting changes come into force in 2005.
- In other countries there are other approaches that already have a track record of protecting creditors.

We address each of these points in turn below.



Shortcomings of existing capital maintenance regime

The Jaap Winter Group Report pointed to the weaknesses of the existing capital maintenance regime and called for modern solutions for creditor and shareholder protection within a framework of shareholder control fitting in the European company law structure.

We share the view that the existing regime does not always give security to creditors because the concept of legal capital is not directly linked to the liquidity of a company's assets and concentrates mainly on their book values. Diligent directors carry out an additional solvency check to avoid the situation where a company with sufficient distributable profits distributes assets to shareholders but prejudices the interests of creditors.

For a judgement regarding the ability of a company to pay back its debts, the legal capital of a company is, in practice, not high on the list of criteria. Typically, in considering lending decisions, creditors assess a company's cash flow, the liquidity of its assets and its financial flexibility rather than the nominal value of its share capital. These same criteria are of primary importance when directors are deciding on distributions to shareholders, and they are an important component in ascertaining that the interests of creditors will have been protected.

Impact of proposed accounting changes

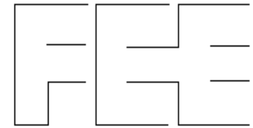
The IAS Regulation requires the use of IFRS by listed companies for their 2005 consolidated financial statements. The transition to IFRS will impact the financial information reported by companies and in particular their distributable profits. The principles underlying IFRS include a focus on data for predictive purposes and on fair value accounting. This leads to the inclusion of unrealised profits in the balance sheet and financial results when assets are revalued. The principles underlying the existing capital maintenance regime require that unrealised profits cannot be distributed. However, when liabilities are adjusted to fair values, for example in the case of pensions, the revaluation adjustment is not regarded as unrealised and therefore reduces distributable profits. This reduction of the amount of distributable profits disregards a company's ability to fund its long-term obligations from future cash flows.

The IFRS principles, and the wider objectives of global harmonisation of accounting standards, are therefore unlikely to be consistent with the measurement bases underlying the existing EU capital maintenance regime. With implementation of IFRS in 2005, the review of the capital maintenance regime should not be further delayed.

The transition to IFRS will affect such important matters as:

- Pensions and deferred tax (large deficits or provisions potentially inhibiting distribution of dividends);
- Share based payments (where charges for share options might have an impact on profits available for distribution); and
- Financial instruments (where fair value measurement is significant and the impact on distributable profits is very complex).

These changes will affect the group accounts of listed companies and, depending on the implementation of the options by Member States on the use of IFRS and requirements of the existing national accounting standards, the statutory accounts of individual companies. If statutory accounts are affected, under the existing capital maintenance regimes the changes will have a direct impact on distributable profits. Even in countries where statutory accounts continue to be prepared under existing national accounting standards, investors in many listed companies might be confused by the appearance in consolidated accounts of a breach of the distribution restrictions applicable to unconsolidated companies.



The major impact in the near future will most likely result from the revision of IAS 19 on pensions. The impact can be illustrated by the two examples, which are shown in the annex to this letter. While some companies clearly have a need to withhold dividends to allow them to fund their pension obligations, there are many other companies where the change in accounting will lead to a purely technical restriction on dividends. If companies are prevented unnecessarily from paying dividends, the result could be to depress share prices and potentially lead to a vicious circle of further deficits because so many pension funds are invested in equities.

The example in the Annex of pension funds illustrates that the problem is very immediate. One solution would be to abandon the proposed accounting change or continue the IAS 19 provision that allows pension deficits to be recognised over a period of years. We believe the further development of accounting should be based on transparency and usefulness to companies and investors, and not on the need to give a pragmatic fit with the existing capital maintenance regime.

As indicated, difficulties also exist in other areas where accounting changes are proposed, including the recognition of a profit and loss account charge for share options and the marking to market of financial instruments. In the latter case, there is great complexity in determining the amount of distributable profits under the requirements of the Second Directive. This complexity will extend into other areas of company financial reporting as accounting moves towards a fair value model in future.

We believe that in analysing the current capital maintenance regimes and the necessity for future changes it is essential to ensure that EU companies will not be at a disadvantage when compared to the US and other parts of the world in competing for investment funds.

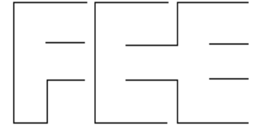
Alternative regime

At this stage we would not wish to prejudge the outcome of the proposed study of alternative regimes.

However, we draw attention to the fact that many states in the US and a number of other countries rely on a solvency test, sometimes with an additional net asset or fair value test. As solvency has to be considered for companies to assess their going concern status, such testing is not new. IAS 1, the applicable standard, recognises that the degree of consideration depends on the facts of each case. Companies with a history of profits and expectations of future profits will have little additional work to do. On the other hand, companies with poor track records or poor expectations of future profits will find it harder to justify making a dividend payment. The advantages and disadvantages of the methods for carrying out solvency tests will have to be discussed in detail.

The adoption of such a basis is complementary to what currently happens in practice as directors consider the ongoing solvency of a company when recommending a dividend payment. The feasibility study of a new system needs to take into account whether there is a practicable and reliable method for carrying out such a test. Management and those charged with governance are accountable for the implementation of such a test. If a solvency basis is considered it will also be fundamental that the roles and responsibilities of directors and auditors are clearly addressed and defined. It must be recognised that solvency projections rely on judgments for which the directors must have sole responsibility.

In addition, the study should consider the proposal of the Winter Group to introduce a Member State option to apply either the existing capital maintenance regime or a new regime.



Conclusion

In summary, FEE is very concerned that a deferral of the review of the EU capital maintenance regime will lead to unjustified and unnecessary restrictions on dividends and potential instability in the capital market**.**

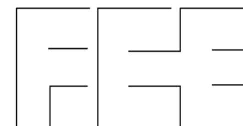
Therefore, we strongly recommend that you reconsider the phasing of the proposed study into capital maintenance and treat this as a high priority short term matter so that changes are made in good time. We would be prepared to provide any technical input deemed necessary.

We would be pleased to discuss any aspect of this letter you may wish to raise with us.

Yours sincerely

David Devlin
President

Copy to: Mr Erich Eggenhofer



ANNEX – Pension accounting change

The IASB has tentatively agreed that IAS 19 will be revised to require deficits on defined benefit pension schemes to be recorded in the balance sheet (similar to UK FRS 17). This change is expected when, or shortly after, IFRS becomes mandatory for listed companies in 2005.

If the proposed changes in pension accounting are implemented as expected, companies will be required to record the deficits on defined benefit pension schemes in their balance sheets from 2005.

The impact of such an accounting change is best illustrated by the examples of two different companies:

	Company A €m	Company B €m
Capital market capitalisation	2,000	20,000
Distributable profits before pension accounting change	1,000	1,000
Pension deficit to be recorded	2,000	2,000
Distributable profits after adoption	(1,000)	(1,000)
Annual free cash generation	200	2,000

It will be clear that Company A needs to take urgent action to reorganise its pension arrangements. Its annual free cash generation will not be sufficient both to fund the pension deficit and provide a return to its shareholders. Dividends should be suspended until the contractual obligation to employees and pensioners has been funded.

Company B is more complex. The free cash generation is sufficient to allow for gradual elimination of the deficit on the pension fund. There seems to be no reason to penalise the shareholders by stopping paying dividends until distributable profits are restored. In effect the capital maintenance regime is obliging Company B to allocate all its profits to the pension schemes until the distributable reserves position is restored.