FEE DISCUSSION PAPER ON ALTERNATIVES TO CAPITAL MAINTENANCE REGIMES

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The Fédération des Experts Comptables Européens (FEE) is the representative organisation for the accountancy profession in Europe. FEE's membership consists of 44 professional institutes of accountants from 32 countries. FEE Member Bodies are present in all 27 Member States of the European Union and three member countries of EFTA. FEE Member Bodies represent more than 500,000 accountants in Europe.

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1. EXECUTIVE SUMMARY AND KEY MESSAGES

1.1 Background and introduction

In its 2003 Communication and Action Plan on Company Law and Corporate Governance the European Commission (EC) announced that it planned to carry out a study into the feasibility of an alternative to the existing capital maintenance regime for public companies, as regulated by the Second Company Law Directive (Second Directive); FEE welcomed this commitment but, in letters dated 31 July 2003 and 10 February 2004, recommended that the proposed study be given higher priority and the timing of the research brought forward.

While the synthesis of responses to the EC's Communication did not indicate universal support for the creation of any new system, in May 2005, the Accounting Regulatory Committee[1] (ARC) and the EC announced that they had agreed to commission a feasibility study which would look into possible alternatives to the existing capital maintenance regime and also examine the implications of the EU's new accounting rules for companies' ability to distribute profits. This study, which is being undertaken by KPMG ('the KPMG study'), is expected to be published by the EC in the second half of 2007.

On 12 July 2007 the EC issued a Consultative Communication containing proposals for a simplified business environment for companies in the areas of company law, accounting and auditing[2]. The Communication is examining options for simplifying European law in these areas and invites comments from stakeholders by mid-October. The Communication addresses the Second Directive and indicates that "at least a review of the capital maintenance system should be considered in order to give companies more flexibility in the field of distributions to their shareholders." Stakeholders are in particular invited to "give their views on whether the rules on the capital of public limited companies or at least the capital maintenance system of the Second Directive should be repealed entirely or in parts". The KPMG study will provide additional information that should facilitate this assessment.

FEE has undertaken a parallel study which looks specifically at the impact of capital maintenance rules on the accountancy profession. The object of this study is to help in developing FEE's position on alternatives to the existing capital maintenance system, in providing input to the specific invitation to stakeholders to comment on the Consultative Communication on simplification, and in shaping FEE's response to the KPMG study.

The current capital maintenance system in all EU Member States is based on the requirements of the Second Directive. This Directive, which applies to all kinds of public limited liability companies (listed and unlisted), contains minimum provisions on minimum share capital requirements, distributions to shareholders and increases and reductions in capital.

1 http://www.ec.europa.eu/internal_market/accounting/committees_en.htm#arc
2 The communication can be downloaded from: http://ec.europa.eu/internal_market/company/simplification/index_en.htm

From a capital maintenance perspective, the Directive requires that the capital of every company is maintained in the interests of its creditors. Creditor protection is, in fact, an element of the concept of capital maintenance that has traditionally influenced European accounting rules, which are based on the principles of prudence and realisation.

The practical implications of the existing capital maintenance rules have become more apparent since the introduction of new rules on International Financial Reporting Standards (IFRS). The IAS Regulation of 2002 requires listed companies in the EU to prepare consolidated accounts in conformity with IFRS. Member States may also permit or require the individual accounts of listed companies, and the individual and consolidated accounts of non-listed companies, to be prepared in conformity with IFRS. IFRS allows the more extensive use of fair value accounting and has a significant impact on the determination of whether profits are to be regarded as realised or unrealised, and thus, under the rules of the Second Directive, on whether profits are available for distribution.

The introduction of IFRS, therefore, raises crucial questions concerning the continuing adequacy of the current capital maintenance system, Most importantly, it raises the question of whether there is a need to give companies more flexibility in deciding whether to make distributions to their shareholders and, if there is such a need, whether the current rules should be replaced by alternative checks such as checks on liquidity and future cash flows (the so-called ‘solvency test’). These questions are considered in this document.

1.2 Key messages

FEE welcomes the initiative taken by the EC to examine the possibilities for introducing alternatives to the current capital maintenance system, with a view to affording companies more flexibility in the making of distribution decisions.

FEE proposes the introduction of an alternative capital maintenance regime in the form of a solvency-based regime, which would involve both a “snapshot” test and a “forward looking” test. FEE envisages that this solvency-based regime would be introduced on a phased basis. This new regime would be optional at Member State level.

FEE believes that the structure of any new solvency-based regime should aim to meet the following objectives:

- It should aim to prevent companies becoming insolvent or over-indebted as a direct or indirect result of making distributions;
- It should aim to protect all stakeholders, especially creditors;
- It should be flexible, simple, effective and efficient and not cause any unnecessary burden to companies;
- It should require companies to take into account, in making individual distribution decisions, both their short and long term obligations; and
- It should incorporate the assumption that the longer the time horizon on which estimates of future solvency are based, the greater will be the level of uncertainty as to the reliability of such estimates.

FEE considers that the development of any new solvency-based regime will need to address the following elements:

The definition of 'profit distribution' and of 'solvency'

1. In an alternative, solvency-based regime, the meaning and scope of "profit distribution" would need to be re-defined. Restrictions on companies' ability to make distributions would be determined by reference to the effect that distributions would have on a company's solvency and over-indebtedness and to the need to preserve the company as a going concern. Distributions would no longer be restricted to profits only: the regime would permit any kind of capital to be distributed by the company to its shareholders - anything which is in substance repayment of equity, including e.g. acquisition of own shares - provided the solvency of the company could support such distribution. A common definition of solvency which could be used in this regard is the "ability to pay debts in the ordinary course of business when they fall due (without selling premises etc.)".

The solvency tests

2. A solvency-based regime should include both a "snapshot" test (i.e. a balance sheet or net asset test) and a "forward looking" test. The determination of distributable capital cannot be made on the sole basis of forecast liquidity, as it would take into account only payments and receipts which are anticipated within the time horizon used - long-term liabilities that fall due after the period of projection would not be covered. Creditors also have an interest in settlement of their long term liabilities. Therefore, a "snapshot" test would be necessary to outweigh the inherent uncertainties of the forward-looking test. If the snapshot test indicated that liabilities exceeded assets, a distribution to shareholders would not be permitted and the second step of the solvency test, i.e. the forward looking test would be irrelevant.

3. The "snapshot" test would help determine whether the proposed distribution would lead to a financial situation where liabilities exceeded assets, thus precluding the making of such distribution. This test would protect the interests of creditors since they are directly affected by the company's ability or otherwise to meet its long-term liabilities. A minimum requirement of the solvency-based system should be that distribution should not lead to a situation where liabilities exceeded assets under the measurement basis adopted. We consider that there are different options regarding the question of which values should be taken from the balance sheet or should be used for a net asset test:

   - Balance sheet test: values are directly derived from the balance sheet as drawn up under national GAAP or IFRS; and
   - Net asset test: the company could discharge its debts, i.e., the directors would need to compare the value of the company's assets and the amount of the company's liabilities at that date with assets stated at no more than fair value or value in use.

4. The forward looking test would supplement the findings from the "snapshot" test. This test should be based on the financial position of the company and enhanced by a liquidity plan which included payments and receipts that are expected as sufficiently certain within the selected time horizon. The test could take a number of different forms:

   - A simple cash flow test covering only cash receipts and payments over a certain period of time;

- A broader liquidity test, in addition, covering receivables and obligations that led to receipts and payments over a certain period of time; and
- A working capital test (including all short term assets and liabilities, such as inventories).

The time horizon

5. A crucial element of the forward looking test is the time horizon used in its calculation. The uncertainty of matters occurring or of the effects of payments in the future increases with the extension of the time horizon. However, a very short period may be of less or no protection for creditors of the company since they may also be directly interested in the company's ability to pay its debts later on in the future. FEE's view is that the proper length of the time horizon used for the forward looking test cannot be determined with a 'one size fits all' approach, but would have to be decided on a case by case basis. However a minimum time horizon could be put in place at EU level or Member State level. Should the EC set a minimum time horizon, this time horizon should be one year (which FEE considers the minimum level of protection for creditors). Individual Member States may set longer (than one year) minimum time horizons.

Directors' responsibilities

6. FEE considers that the decisions that directors make regarding distributions should be underpinned by general provisions in the criminal and civil law which call on them to act with due regard to the interests of their company's creditors and also to the long-term interests of their own company. In nearly every Member State there is already a general requirement that directors have a duty of care: In many Member States there are also measures which provide for directors to be made personally liable where there are distributions which are not in the company's best financial interests. FEE believes that measures of this kind are necessary to ensure that directors do not authorise a distribution of dividend in circumstances where the distribution could harm the interest of the creditors or other stakeholders.

The solvency statement

7. Directors (management) should be required to give their opinion on the solvency of the company in the form of a short solvency statement. This should be published in the official register of the Member State concerned; it could also be made available via the company's website. A solvency statement should be published in respect of every distribution made during the financial year, interim or final.

External assurance

8. We do not favour introducing legal requirements for external assurance, but it is for consideration whether the solvency statement should be capable of being subjected to some form of external assurance at the specific request of shareholders. The limitations of any such external assurance should be acknowledged. Since the solvency statement would include prospective information (in the form of the forward looking test), the statement could not be made subject to full audit requirements. The auditor or other practitioner will not be in a position to express an opinion as to whether the results shown in the solvency statement will be achieved. In particular, assurance could not guarantee that the company will continue to be liquid after profit distribution and throughout the period of projection. Any assurance provided/obtained should follow the IAASB pronouncements.

Application and scope of an alternative regime

9. The legal scope of any alternative capital maintenance regime would need to be settled. FEE envisages that the EC should introduce a regime giving the Member States the possibility to require or allow companies to follow an alternative system as well as the existing system. In terms of application of an alternative regime, it will be necessary to decide what range of companies should be allowed or required to use an alternative regime, and whether this issue should be determined at EU or national level. A minimum scope – e.g. listed companies using IFRS in their individual accounts following the IAS Regulation and those companies using IFRS in their individual accounts on a voluntary basis – could be defined in European legislation.

1.3 Invitation to comment

FEE would be interested to receive comments on any of the issues discussed in this document.

Please send comments to the FEE Secretariat e-mail: saskia.slomp@fee.be.

2. INTRODUCTION AND BACKGROUND

2.1 *Introduction*

The current capital maintenance system in the EU Member States is based on the Second Company Law Directive requirements. This Directive co-ordinates national provisions for all kinds of public limited liability companies (listed and unlisted) on the formation, minimum share capital requirements, distributions to shareholders and increases and reductions in capital.

From a capital maintenance perspective, the Directive aims to ensure that the capital of the company is maintained in the interests of creditors. Creditor protection is in fact one element of the concept of capital maintenance that has traditionally influenced European accounting rules, based on the prudence and realisation principles. Accordingly, hidden reserves, whilst not shown, may be kept in the balance sheet while profits are to be shown and free for distribution only when they are realised.

A frequent criticism of the Second Directive is that the current regime imposes limits on company distributions by reference to the historical amounts of capital contributed by investors and to those profits and losses shown in the annual accounts in accordance with provisions of the Fourth and Seventh Directives. It can be argued that these rules are not an appropriate basis for determining distributions, since these data are historical and not relevant to the question of whether or not a company is likely to be able to pay future liabilities when they fall due. The accounting rules stipulated in the Fourth and Seventh Directives are influenced by the principles of realisation and prudence and the historical cost convention; objectivity and reliability are important. In contrast, it can be argued that financial statements prepared under IFRS are more ‘relevant’ due to the fair value measurements they use, but are riskier and therefore less meaningful for creditors.

The principles underpinning the Second Company Law Directive are to some extent inconsistent with some of the IFRS concepts: IFRS is investor/shareholder oriented whereas the Directive embraces, in its capital maintenance requirements, creditor protection. The IAS Regulation[3] only requires listed companies[4] to prepare consolidated accounts in conformity with IFRS. Member States may also permit or require the individual accounts of listed companies, as well as the consolidated accounts and/or individual accounts of non-listed companies, to be prepared in conformity with IFRS. The use of IFRS allows a more extensive use of fair value accounting and has an impact on unrealised versus realised profits and thereby on profits available for dividend distribution. This raises several questions in relation to the appropriateness of the current capital maintenance system where the amount of distribution is determined on the basis of IFRS financial statements and on the need for additional checks such as on liquidity and future cash flows (the so-called ‘solvency test’).

FEE has carried out a survey on the existing capital maintenance regime in the EU Member States focusing on the accounting and auditing aspects. The survey covered the following areas:

- National capital maintenance regime;
- Funding of a company;
- Reserves requirements;
- Distribution of profit and increases in equity;

[3] Regulation no. 1606/2002 of 19 July 2002 on the application of International Accounting Standards.
[4] The Regulation considers companies whose securities are admitted to trading on a regulated market of any Member State within the meaning of Article 1(13) of Directive 93/22/EEC of 10 May 1993 on investment services in the securities field.

- Consequences of loss of equity;
- Return/ payment of capital to shareholders;
- Insolvency; and
- Implementation of IFRS.

The survey addresses public listed companies, public non-listed companies and private companies. Where the responses deviated for each of the categories this has been indicated. Based on the survey results an overview has been provided of the national situations in Chapter 3.

The overall aim of this document is to stimulate the discussion and to contribute to the debate on alternatives to the current capital maintenance regimes. The document explores whether there is a need for alternatives or additions (extensions) to the current EU capital maintenance regime and analyses the pros and cons. The document also hopes to provide an additional contribution to the study on alternative capital maintenance regimes commissioned by the EC (which is to be published after summer 2007) and to the invitation to stakeholders to give their views on the future of the current capital maintenance system as included in the July 2007 Consultative Communication on Simplification.

Section 4 of this document includes a description of possible alternatives to the existing capital maintenance regimes.

2.2 Impact of IFRS

The requirement of the IAS Regulation to use IFRS in the consolidated accounts of listed companies has implications for the financial information reported by companies depending on the extent to which the national GAAP used in preparing the previous financial statements differs from IFRS. In relation to capital maintenance requirements in particular the impact on distributable profits needs to be considered. The IFRS requirements may include a larger focus on data suitable for predictive purposes and on fair value accounting. This can lead to the inclusion in the financial results of what have historically been regarded as unrealised profits.

Some IFRS standards may not be consistent with the measurement bases which underlie the existing EU capital maintenance regime (e.g. fair value measurement). The accounting principles of the existing capital maintenance regime prohibit the distribution of unrealised profits (whether profits can be considered as being unrealised depends on the particular items: for example, in the case of assets available for sale, the valuation adjustment to reduce cost to net realisable value is not regarded as unrealised and therefore reduces distributable profits).

It must be remembered that Member States have the option to apply IFRS also to individual accounts. The implementation of IFRS affects important matters as:

- Goodwill;
- Impairment of assets;
- Pensions and similar obligations (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);
- Financial instruments (where fair value measurement is significant and the impact on distributable profits is highly volatile);
- Deferred taxes (where the impact can be positive as well as negative); and

- Classification of debt versus equity.

This has an impact on the consolidated accounts of listed companies and, depending on the implementation of the options by Member States on the use of IFRS, the options used included in IFRS and requirements of the existing national accounting standards, the annual (individual) accounts of listed companies and the consolidated and/or annual (individual) accounts of unlisted companies. If also annual (individual) accounts are affected, under the existing capital maintenance regimes the changes have a direct impact on distributable profits. Therefore, as individual rather than consolidated accounts are used for profit distribution, the question arises how the system of creditor protection in respect of company law can be modified for those companies that apply IFRS in their individual accounts, as discussed in this document.

2.3 Potential shortcomings of existing capital maintenance regime

Conflict of interests

One of the potential shortcomings of the current capital maintenance regime could be the conflict of interests between creditors and shareholders of the company.

It is in the interests of creditors that the company accumulates the maximum level of reserves in order to ensure that it will be able to meet its payments when they fall due. It therefore follows that it is in the creditors' interest that distributions to shareholders be as low as possible.

On the contrary, shareholders will usually strive to maximise the return of capital (particularly when anticipated returns from alternative investments are high). In some European countries national company law rules address this issue by giving shareholders the right to a minimum distribution but limiting the amounts that can be withdrawn.

However, in some European countries commercial law and company law address this conflict of interests by allowing shareholders a right to a minimum profit distribution, whilst at the same time, limiting these distributable amounts by means of accounting rules, rules on the determination of profits or by limiting the application of specific reserves precluding repayment of capital.

Accounting principles

According to the current capital maintenance regime, as mentioned before, only realised profits can be distributed. Such prohibitions to distribute unrealised profits lead to an accumulation of higher reserves within the entity and are in the creditors' interests. It can be questioned whether this reduction of the amount of distributable profits fully recognises a company's ability to fund its long-term obligations from future cash flows.

In its comment letter of 10 February 2004 FEE already outlined that there may exist situations in which the existing capital maintenance regime does not always give real comfort to creditors because the concept of capital maintenance as stated in the Second Company Law Directive is not directly linked to the solvency of the company 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 and other stakeholders.

In 2000 the EC set up the so-called "High Level Group of Company Law Experts" to develop recommendations on the modernisation of the European company law and on the enhancement of corporate governance. In 2002, this Group, known as the *Jaap Winter Group*[5] after its chairman published its recommendations which were mostly repeated in the EU Action plan "Modernisation of the company law and Enhancing corporate governance in the EU – A Plan to move forward" in 2003. The Jaap Winter Group pointed out 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.

The Jaap Winter report criticises the regime by stating *"it is argued that the legal capital regime fails to adequately protect creditors, who are not so much interested in the capital of the company (and certainly not in the minimum capital) but more in its ability to pay its short term and long term debts. It can also be said that the amount of legal capital as shown in the articles of association is a very primitive and inaccurate indication of the company's ability to pay its debts. There is an argument against the inflexibility and costs of the current regime that could hamper in some way the ability of companies to obtain equity funding. Finally, it is argued that the annual accounts have become an inadequate yard-stick for deciding whether the company has sufficient distributable reserves for it to make distributions to shareholders. As a result of changes in accounting standards, like standards on goodwill impairment and accounting for pension fund performance and costs of share and share option schemes, the accounts - and the reserves they show - become more and more volatile and less and less an indicator of the ability of companies to pay their current and future debts. Capital protection based on such accounts is becoming a delusion."*

Legal capital

For a judgement regarding the ability of a company to pay back its debts, the amount of 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 book value of its equity. These same criteria could be of primary importance when directors are deciding on distributions to shareholders, and they should be an important component in ascertaining that the interests of creditors are protected.

Any capital maintenance regime should be linked to the national insolvency rules. In most European countries there are two reasons for filing for insolvency:

- Illiquidity: the debtor is illiquid, i.e. is unable to honour payments when they fall due; and
- Over-indebtedness: the debtor's assets no longer cover existing liabilities. A valuation of the debtor's assets shall, however, be based upon a going concern.

In case of bankruptcy, a form of *solvency declaration* (i.e. a statement stating the solvency of the company) prepared by directors is relevant; evidence should be given that directors were prudent enough in asserting the solvency of the business before distribution.

This document does not address specifically contributions in kind other than as means to increase the capital of the company. The document is focussed on dividend distribution and also covers repayment of capital.

[5] Report of the High Level group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe of 4 November 2002, the so called "Jaap Winter Report".

3. CURRENT EU CAPITAL MAINTENANCE SYSTEM BASED ON THE SECOND COMPANY LAW DIRECTIVE

3.1 Capital Maintenance aspects in the Second Company Law Directive

The current Capital Maintenance system in the EU is based on the requirements of the Second Company Law Directive of 1977[6], amended in 2006 (Second Directive)[7]. This system is a minimum regime: EU Member States can add additional measures to safeguard creditor interests.

The aim of the Directive is to ensure minimum equivalent protection for both shareholders and creditors of public limited companies and to coordinate national provisions relating to the formation and to the maintenance, increase or reduction of their capital. The Directive considers in its preamble that capital constitutes the creditors' security, and aims at maintaining it by prohibiting any reduction thereof by distribution to shareholders where the latter are not entitled to it. To maintain the capital the Directive also imposes limits on the company's rights to acquire its own shares.

Based on the consultation results of the Jaap Winter Group regarding modernising company law and enhancing corporate governance in the EU a two-step approach was recommended:

- To reform the Second Directive based on the "SLIM plus approach" (evolution of the current regime to a more simplified and modern capital regime); and
- To conduct a review into the feasibility of an alternative regime, in order to explore further ways of increasing flexibility of public limited companies.

The Second Directive was amended in 2006 in order to implement some of the recommendations made by the SLIM Group in 1999 and by the Group of High Level Company Law experts in 2002. The modifications were aimed at allowing companies to adjust their capital size and ownership structure more easily, enabling them to react more promptly to market developments while maintaining protection to creditors and shareholders.

In parallel with the adoption of the 2006 Directive, the European Commission commissioned a feasibility study on alternatives to the capital maintenance regime as established by the Second Company Law Directive and the examination of the implications of the new EU accounting regime on profit distribution. The results of the study are not yet public at the time of the publication of this document.

Here follows an analysis of some of the concepts of capital maintenance related to creditor protection underpinning the Second Directive currently in force.

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6 Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent.

7 By Directive 2006/68/EC of 6 September 2006 amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital.

Distribution

Public limited liability companies cannot distribute share capital and undistributable reserves to shareholders, but must maintain them as a 'cushion' for the benefit of creditors. Art 15(1) of the Second Directive in fact imposes as a minimum rule a two-fold test for distributions:

- A balance sheet test in Article 15(1)(a) – i.e. prohibiting a distribution which reduces the assets below the amount of the "subscribed capital" and any reserves which may not legally be distributed. These are to be identified by reference to the last annual accounts; and
- An accumulated profits test in Article 15(1)(c), limiting distributions on the amount of profits at the last financial year plus profits brought forward, together with "sums drawn from reserves available for this purpose", less sums carried to reserves and accumulated losses.

Article 31(1)(c) of the Fourth Directive provides that "valuation must be made on a prudent basis, and in particular:

- Only profits made at the balance sheet date may be included; and
- Account must be taken of all foreseeable liabilities and potential losses arising in the course of the financial year…".

Article 33 of the Fourth Directive allows Member States to provide for valuation on the replacement value basis for certain tangible fixed assets, or by methods designed to take account of inflation, and for revaluations of tangible and financial fixed assets, rather than on the basis of purchase price or production cost. Differences arising are to be carried to a revaluation reserve. No part of this reserve may be distributed unless it represents gains actually realized. It may only be reduced by capitalisation or when it is "no longer necessary".

The Fair Value Directive[8] permits the inclusion of certain financial instruments at fair value. It achieves this by including a new Section 7a in the Fourth directive but makes no express provision as regards whether or not fair value gains might be distributable.

In Article 42(c) it does state "notwithstanding Article 31.1(c) where a financial instrument is valued in accordance with Article 42(b) (i.e. at a fair value) a change in the value shall be included in the profit and loss account. However, such a change shall be included directly in equity in a fair value reserve where:

a) The instrument accounted for is a hedging instrument under a system of hedge accounting which allows some or all of the change in value not to be shown in the profit and loss account; or
b) The change in value relates to an exchange difference arising on a monetary item that forms part of a company's net investment in a foreign entity.

There is also a provision enabling member states to permit a change in value on an available for sale financial asset other than a derivative financial instrument to be included directly in equity in a fair value reserve. The fair value reserve is to be adjusted when the amounts shown in it are no longer necessary for the purposes described above. There are similar provisions permitting banks to account for financial instruments at fair value.

[8] Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001 amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions.

Subscription for purchase and repurchase of own shares (indirect distributions)

Article 18 of the Second Directive generally prohibits a company from direct and indirect subscriptions for its own shares.

Article 19 of the Directive allows only repurchase of shares under certain conditions, the most important of which is the reference to the balance sheet test of Article 15(1)(a). Article 19(1)(c) imposes the Article 15(1)(a) balance sheet test; it does not also impose the accumulated profits test of Article 15(1)(c). The law of the Member States can provide that own shares may or are to be included among the assets shown in the balance sheet. In this case an additional undistributable reserve of the same amount has to be included among the liabilities. The other conditions are that general meeting authorization is required for repurchase of shares, except to prevent serious and imminent harm. The maximum duration of the authority is 18 months, the maximum aggregate nominal value of the shares is 10 % of subscribed capital and the net asset distribution rule must be satisfied. The acquisitions may therefore not have the effect of reducing net assets below the amount of the "subscribed capital" and any undistributable reserves.

Reduction of capital

Articles 30 and 40 of the Second Directive require a general meeting decision by qualified majority for a reduction of capital. Article 32 provides for creditor protection, with a minimum of a right to apply to the court where they do not have "adequate safeguards" for claims which have not fallen due by the date of publication of the decision. Article 33 provides that where a reduction is made to write off losses no creditor protection is required. According to Article 34 the subscribed capital may not be reduced to less than the amount of the minimum capital.

Support of third parties in acquiring shares

Article 23 of the Directive prohibits, subject to specified exceptions, a company from advancing funds, making loans or providing security, with a view to the acquisition of its shares by a third party.

Additional domestic considerations

It should be noted that in nearly every jurisdiction the general rule applies that directors have a duty of care. For example, in case of direct or indirect profits distribution this would mean that if a director is aware of the fact that a distribution would directly harm the interests of the creditors, for instance by causing a bankruptcy in the near future, he should prevent such distribution, even if it would be allowed based on the rules of Second Company Law Directive.

3.2 Overview of national situation

The survey FEE carried out provides a broad picture of the current capital maintenance situation in EU Member States. The questionnaire sent to the EU Member States covers three kinds of companies (following Article 1 of the Fourth Accounting Directive):

- Public listed companies;
- Public unlisted companies; and
- Private companies.

Answers were received from 23 EU Member States[9] including the five largest economies. A summary of the survey results by topic is presented below. The study is based on the responses to the questionnaire sent in May 2006[10].

3.2.1 General regime

The majority of EU Member States did not choose to require the application of IFRS for individual accounts on a mandatory basis for any of the 3 kinds of companies (public listed, public unlisted and private companies).

In five countries IFRS are mandatory for the individual accounts of both public listed and public unlisted companies, while in two countries IFRS are required for individual accounts of the public listed companies only. In 10 countries IFRS are applied on a voluntary basis for individual accounts of the 3 kinds of companies considered.

National GAAP is the basis for determining dividend distribution in the majority of Member States, while IFRS are used for that purpose only in some of the 12 Member States that joined in 2005 and 2007.

Capital Maintenance rules are primarily orientated towards creditor protection, although investor protection is also considered in some countries, either instead of or in addition to creditor protection. Both creditor protection and investor protection are primarily set forth in corporate/company law, followed by national accounting principles and commercial or trade law in some countries.

3.2.2 Founding of the company

Nearly all Member States stipulate a minimum capital requirement for founding all kinds of companies (such minimum ranges from approximately 7.000€ for a private company to 2.000.000€ for a public listed company). Only Ireland and UK do not require any minimum capital for private companies. The minimum capital requirements at foundation are in general not related to the future activities of the company.

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9 Answers were received from Austria, Belgium, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Malta, the Netherlands, Poland, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, and the UK.

10 The table presenting an overview of the detailed responses received is available on the FEE website: http://www.fee.be/publications/default.asp?library_ref=4&content_ref=702

A minimum amount or percentage of capital generally has to be paid in prior to the company being registered in the commercial register or equivalent in nearly all countries. A minimum amount has to be paid in before a public company is permitted to start business in the UK.

Contributions in kinds are allowed in all countries except from Cyprus, Lithuania and Latvia; percentages vary from 25% to 100%. It is obligatory to have an itemised description of the contribution in kind in all countries except Ireland. In the majority of the countries national legislation requires a report on the contribution in kind by an auditor. In some countries the report needs to be provided by another expert and in a few countries there is the choice between an auditor or another expert. Only in 3 countries there is no requirement to have any report on contributions in kind.

Regarding the other requirements for the foundation of a company, the most recurring is the approval from Court of the company registration. In founding a company in the majority of the countries it is necessary to have the legal entity's capital separated from founders' own capital (private equity).

In the countries where it is possible to contribute in kind, in most cases it is not allowed to make a contribution that does not qualify for recognition as an asset, neither under IFRS nor under national accounting rules (for example human resources, knowledge etc). In 8 countries only it is possible for the company to issue shares or options in consideration for labour or services only.

Only in 9 countries founders are in some way liable to third parties for transactions in the name of the company before it is registered or for a shortfall in equity.

Concerning the rules to found a company by contributing cash it seems that in several countries it is easier to set up the company than to start a non incorporated business.

3.2.3 Reserves requirements

In the majority of the countries, parts of annual net profits are required to be transferred to reserves[11] mainly as a result of corporate/company law and articles of incorporation/constitutional documents; only in some cases as a result of commercial/trade law.

In all the countries retained earnings are required for the three kinds of companies (amongst them revaluation and legal reserves are frequently required). Share premium reserves (paid in capital) are also frequently required. The original rationale behind legal reserves is creditor protection. Retained earnings and share premium reserves must in general be built up as required by law. Frequently other kinds of reserves can be built based on the company constitutional documents and voluntarily.

In the majority of the countries it is the shareholders' meeting/AGM which has the authority to determine which reserves will be created, while only in a few countries this can be done also by the board of directors/the executive directors. Only in the Netherlands and Slovenia can this power be attributed as well to the supervisory board/the non-executive directors.

In the majority of the countries there are restrictions for distributions from retained earnings and share premium reserves.

[11] In the survey reference was made only to reserves that are part of equity.

3.2.4 Distribution of profit and increases in equity

In nearly all countries there are no other bases for distribution of profits other than the individual accounts. In case of distributions, those individual accounts can be changed only in some countries and only under certain conditions. It is generally not possible in national legislation for the shareholders meeting to change the individual accounts prepared by management when shareholders and management disagree.

In some countries it is possible to distribute interim dividends, but only under certain conditions, one of the most frequent of which is that the interim balance sheet is audited.

The shareholders' meeting has the authority to determine the appropriation of the individual net profit in the majority of the countries. In some cases also the board of directors/the executive directors has this authority, while in two countries it is the only one which has this power.

As mentioned before, minimum legal capital is not available for distribution in any country, and specific reserves cannot be distributed in the majority of the countries. In all the countries there are specific requirements in relation to the restriction of distribution of reserves.

Shareholders are entitled to the remaining annual net profit after building up certain minimum reserves in all countries for the 3 kinds of companies considered.

The rules regarding the purchase of own shares are related to the rules for distribution of profit in nearly all countries (except for 3 countries). There is a direct relation between distributable reserves and profit in the majority of the countries; however there is no link in 8 countries. The rules (the conditions) differ regarding the class of shares (e.g. for ordinary shares and preference shares) in most countries.

The board of directors/the executive directors may be held liable in case of violation of the rules relating to distribution of profit in nearly all the countries, while the supervisory board/non executive directors may be held liable in 14 countries. In case the rules regarding distributions are violated, civil sanctions apply in all countries (amounts vary), while criminal sanctions are applied in some countries only. Third parties have possibilities for legal action against the company in all countries for all kinds of companies, and against the board of directors/the executive directors and the supervisory board/non executive directors in most countries.

In relation to increases in equity there are pre-emption rights (drawing rights) in all but two of the surveyed countries. Valuation concepts differ. In the majority of the countries a minimum amount or percentage of capital has to be paid in case of increase in equity.

In a case of a contribution of capital, dilutions of value are safeguarded in most countries via drawing rights.

In some countries there are some requirements to consider the solvency of the company in determining the profit available for distribution. These requirements are based on legislation or on case law depending on the system (i.e. case law in the UK, legislation in the other countries).

In the majority of the countries there are rules in the national requirements on individual accounts related to the ability to distribute increases in equity (excluding share capital). These rules are in some countries only related to the increase in equity caused by profit or amounts that are accounted for in the profit and loss account.

The question of realisation of profits is determined by accounting rules in the majority of the countries. For distribution purposes, according to the national requirements, it is generally not relevant that the amount of profit is available in the form of cash or cash-equivalents (liquidity principle). In nearly all countries it is a prerequisite in the national legislation that a distribution must not cause a decrease in equity/capital. It is not possible to pay dividends on preference shares if there is no profit or there are no distributable reserves in any country but Latvia.

It is possible to distribute in kind in the majority of the countries; the way of measuring distribution varies (e.g. book value, fair value or tax value). There are civil penalties in all countries (and in some cases also criminal penalties) as a consequence of violating these distributions in kind rules.

3.2.5 Consequences of loss of equity

In all countries management has the obligation to start certain procedures if the equity decreases under a certain level due to losses. The most common action to be taken is to call the Shareholders Meeting.

However, in nearly all the countries it is possible to continue operations even if all the equity has been lost. Civil penalties and sometimes also criminal penalties are foreseen for management in case of violation of rules on loss of equity. The auditor of the company takes a role in this respect in all countries but Cyprus, Malta, the Netherlands and UK.

As far as unrealised losses treatment is concerned, in many but not the majority of the countries unrealised losses are treated in the same way as realised losses.

3.2.6 Return / repayment of capital to shareholders

In all countries except from Latvia and Slovakia there are rules regarding return/repayment of capital in the case of winding up the company, as well as special rules for situations of return of capital other than winding up the company. Only in some countries do these rules differ regarding different classes of shares. In most countries it is the Shareholders Meeting which has the power to decide on the return/repayment of capital.

In most countries it is the board of directors who is liable in case of violation of the rules for returning capital to shareholders. In the majority of the countries insolvency practitioners (liquidators) have the same liability as directors in winding up the company.

Only in 5 countries and under certain conditions it is possible in situations other than in winding up the company to return to shareholders an amount equal to or greater than the capital paid in, if there are deficits in equity e.g. from loss carried forward.

3.2.7 Insolvency

The main reasons to file for insolvency under national legislation are over indebtedness and non-liquidity (when it is impossible to meet obligations when they come due). In all but one country it is possible to recover funds from directors in situations of insolvency (for example in cases of wrongful or fraudulent trading).

In all the countries there are civil liabilities for directors where they allow their company to trade with intent to defraud creditors. Such liabilities are generally imposed by legislation.

In nearly all countries there are laws or rules for wrongful and fraudulent trading that are of relevance to capital maintenance and creditor protection.

3.2.8 Other

In only 8 countries the meaning of equity for profit distribution/dividend distribution (individual accounts) is the same as for equity in the consolidated accounts. However this is not a recent change due to the introduction of IFRS.

There are in a few countries other areas of law or rules whereby the directors can incur personal liability for acts undertaken by the company, which threaten the company's solvency or violate the capital maintenance requirements. In few countries are there any specific requirements applicable to the Societas Europaea (SE) different from those for a public company as described above.

4. IDENTIFICATION OF CURRENT AND POSSIBLE ALTERNATIVE CAPITAL MAINTENANCE REGIMES

4.1 Overview of non-EU systems in place

Amongst others, the following kind of capital maintenance models can be identified:

- EU;
- US (Model Business Corporations Act, Delaware and California);
- Canada; and
- New Zealand.

Here follows a brief overview of the non-EU systems focussing on the payments and distribution aspects only[12].

US Model Business Corporations Act (MBCA), cumulative equity insolvency and "flexible" balance sheet tests

Payment

The Model Business Corporations Act (MBCA) makes no special provision about payment up of shares.

Distributions

Both of the following tests need to be satisfied:

a) An "equity insolvency" test – i.e. the corporation must be and remain after the distribution "able to pay its debts as they become due in the usual course of business"; and
b) A "net asset", or "balance sheet", test – i.e. the corporation's assets must not be, nor become as a result of the distribution, less than "the sum of its total liabilities" plus (subject to the articles, which may exclude this requirement) the sums necessary to satisfy any preferential rights in a winding up (in British terms).

US Delaware, optional par values and stated capital, net assets test, "nimble" dividends relaxation

Payment

Delaware corporations may issue stock with or without par value. Consideration for the issue of shares can be in any form and its value is a matter for bona fide business judgment of the directors. But the value of the consideration for shares with par value must be not less than that value.

[12] Information has been gathered from 'Reforming Capital: Report of the Interdisciplinary Committee on Capital Maintenance', J. Rickford, 2004 (the Rickford Report).

Distributions

Distributions may be paid:

a) Out of surplus; or
b) If there is no surplus, out of the "net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year".

The latter are known as "nimble dividends". However they may not be paid if the net assets are less than the capital "represented by the outstanding stock… having a preference on distribution of assets" and no such distribution may be made until "the deficiency" is "repaired".

US California, no par values, no stated capital but stricter distribution rules (retained earnings or net asset surplus)

Payment

Consideration for shares may normally be such as is determined by the board. Promissory notes and future services are not good consideration however. Shares may be "wholly or partly, partly paid" – i.e. they may be wholly unpaid up. There is no provision in the California code for par values or stated capital, "a statement of par value is not prohibited; it will simply have no legal significance". California thus has a purely no par values regime.

Distributions

Distributions may be made:

a) Out of "retained earnings"; or if
b) (i) The net assets (excluding goodwill capitalized R&D and deferred charges) are not less than 1.25 times liabilities (excluding deferred tax, deferred income and deferred credits); and
   (ii) Current assets are not less than current liabilities, or if earnings before tax for the preceding 2 fiscal years were less than average interest expense, then not less than 1.25 times current liabilities (special provision being made for:
      (aa) Profits derived from exchanges of assets – these must be currently realizable in cash; and for
      (bb) Repeated payments by customers under existing contracts – these can count as current assets net of related costs).

Canada (Canada Business Corporations Act and Ontario), no par value but strict stated capital with MBCA-type balance sheet distribution test – but easy redemption and capital reductions

Payment

Shares must have no par value, must be fully paid up and can be issued for any consideration the directors determine, subject to an express obligation on directors to acquire fair value, i.e. equivalent to the cash which would have been received, where non-cash assets are subscribed. The full amount (no more and no less) of the consideration received on issue of any share is to be credited to the appropriate "stated capital account" to be established for each class of shares. This account or

accounts is readily identifiable with the aggregate of share capital and share premium account under British law.

Distributions

Dividend declaration is a matter for the directors. To declare a dividend both of the following tests must be satisfied:

c) There must be no reasonable grounds for believing that after payment the corporation would be "unable to pay its liabilities as they become due"; and
d) There must be no reasonable grounds for believing that "the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes".

New-Zealand, no par value shares; no stated capital; MBCA-type distribution rule but with solvency certification

Payment

Shares are to have no nominal or par value. Shares are to be issued on terms that are "fair and reasonable" to the company and existing shareholders. The duty of loyalty applies but directors are expressly permitted to rely on properly appointed professionals. Where the consideration is not cash the board must consider and conclude that the cash value is no less than the amount to be credited for the issue.

Distributions

Distributions are authorized by the board which must be satisfied on reasonable grounds that the company will, after it is made, satisfy the "solvency test" – i.e. a twofold cumulative test:

a) The company must remain able to pay its debts as they fall due;
b) The value of the company's assets must exceed the value of its liabilities, including contingent liabilities; and
c) The directors authorizing the dividend must sign a certificate that this will be so, stating their grounds.

4.2 Alternative capital maintenance regime based on solvency test

4.2.1 Main characteristics of alternative regimes

Given the discussion of the capital maintenance system currently in force (see Chapter 2.3), it should be examined whether an alternative system for determination of profit distribution is possible and how it could be best designed and used. Taking into account that by nature shareholders normally bear more financial risk than other stakeholders (such as creditors and employees), an alternative system should provide appropriate protection to all stakeholders. An alternative system for determination of profit distribution should have relevance and reliability as objective characteristics. It is the responsibility of management to seek the balance between relevance and reliability within the respective legislation. It has to be considered that "relevance" in the context of the discussion of an alternative capital maintenance regime has not to be understood in a sense of decision usefulness for shareholders, but in a sense of protection of all stakeholders that do have interests in a company.

These characteristics can be used to determine the appropriateness of an alternative capital maintenance regime, including that a capital maintenance regime cannot be based solely on the intention or the discretion of management and/or shareholders, due to the relevant interests of the other stakeholders involved. On the whole, an alternative capital maintenance regime should at least reflect the following considerations:

- It should aim to prevent companies becoming insolvent or over-indebted as a direct or indirect result of making distributions;
- It should aim to protect all stakeholders, especially creditors;
- It should be flexible, simple, effective and efficient and not cause any unnecessary burden to companies;
- It should require companies to take into account, in making individual distribution decisions, both their short and long term obligations; and
- It should incorporate the assumption that the longer the time horizon on which estimates of future solvency are based, the greater will be the level of uncertainty as to the reliability of such estimates.

There is a wide range of different systems that could be taken into consideration when discussing alternative capital maintenance regimes. However, this discussion paper will focus on an alternative regime where distributions are based on solvency tests.

4.2.2 Considerations for solvency based regime

A common definition of solvency is the "the ability to pay debts in the ordinary course of business when they fall due (without selling premises, etc.)". Under an alternative solvency-based regime, the meaning and scope of "profit distribution" should be re-defined. Restrictions on distributions would be determined by reference to the effect on company solvency, over-indebtedness and the need to preserve the company as a going concern. The source of capital which is free for distribution would be irrelevant; distribution would no longer be restricted to profits only, but would permit any kind of distribution by the company to its shareholders (anything which is in substance repayment of equity, including e.g. acquisition of own shares) provided the solvency of the company could support such distribution.

Key elements of a solvency based regime: 'snapshot test' and 'forward looking test'

The purpose of making distributions dependent on a forward-looking test is to ensure that the company will be in a position to pay its debts in the ordinary course of business when they fall due. The determination of distributions solely on the basis of forecast liquidity (e.g. based on planning and budgeting values) takes into account payments and receipts only within a certain manageable period. Payments and receipts in the period of projection are uncertain (see 'considered time horizon' below). Long-term liabilities that fall due after the period of projection would not be covered. Since creditors also have an interest in settlement of their long term liabilities, some kind of snapshot test (net asset or balance sheet test) would be necessary.

As a result, the solvency test suggested should therefore include the two elements: a snapshot test (net asset or balance-sheet test) and a forward looking test. This two-step test would also be accompanied by formal procedures and sanctions.

Snapshot test

As explained above, the interests of the creditors of a company are affected by whether the company will be able to meet its long-term liabilities, and it is therefore necessary to base the determination of distribution not only on a forward looking basis, but also on a snapshot test, i.e. a net asset or balance sheet test. The snapshot test would help determine whether the proposed distribution would lead to a financial situation where liabilities exceed assets, which would preclude a distribution in such circumstances. If the snapshot test would indicate that liabilities exceed assets, distribution to shareholders should not be entered into and the second step of the solvency test, the forward looking test does not need to be considered. A snapshot test is necessary to outweigh the uncertainties inherent to forward-looking test. There are different possible solutions regarding the question of which values should be taken for the snapshot test.

The balance sheet test would be based on values derived from the balance sheet under national GAAP or IFRS. It is an advantage that these values are determined by appliance of standardised accounting rules, which are reliable and broadly accepted and which are subject to the audit of the financial statements. Furthermore, values derived from the balance sheet are available every time needed. Values derived from the balance sheet ensure a high level of objectivity and comparability between companies. In a balance sheet test the internally generated goodwill is not part of the balance sheet test for reasons of objectivity.

The ‘net asset’ test being a broader test than the balance sheet test would require the directors to assess that the company could discharge its debts, by comparing the value of the company’s assets and the amount of the company’s liabilities at that date. Directors may take into consideration the real value (often referred to in accounting terminology as either ‘fair value’ or ‘value in use’ where there is no fair value available) of the assets (where the real value is higher then the book value). This includes the value of any goodwill associated with the company’s businesses which is recognised under the accounting rules. Directors should also be aware of necessary future investments to sustain the cash flow and maintain the goodwill associated with the business in determining the value of assets. Liabilities (including long term liabilities such as pensions) should be considered at the amount required to settle the company’s liabilities at the date of a solvency statement (rather than the book value of the liabilities).

No matter whether values derived from the balance sheet or values determined in the net asset test are used for the snap shot test, some kind of uncertainty remains due to the measurement methods applied by the directors or the availability of observable prices, valuation techniques etc. if other than historical cost bases are used.

Forward looking test

As already mentioned above, the purpose of a forward-looking test is to assess whether the company will be in a position to pay its debts in the ordinary course of business when they fall due after distribution:

- A simple cash flow test, only covering receipts and payments in cash of the company in a certain period of time;
- A broader liquidity test, in addition, also covering receivables and obligations that lead to receipts and payments in a certain period of time; and
- A working capital test (including all short term assets and liabilities, such as inventories).

There should be two steps in a forward looking test. First, the financial position of the company should be derived from the financial records as a starting point: the company's free and available financial resources, arranged in the order of their liquidity, should be compared to liabilities, arranged in the order of their maturity. Liabilities should include all existing liabilities, including contingent liabilities.

As a second step, the liquidity of the company should be determined including expected payments and receipts which are sufficiently certain within the underlying (pre-fixed) time horizon. In the case of a group of companies, any payments which result from the group, e.g. funding for losses of subsidiaries (cash outflows), should be taken into consideration. The liquidity could be based on the company's internal budgeting and planning database and should be amended to take into account additional information relevant to company's financial resources (e.g. possibility of borrowing or shifting short- and mid-term liabilities into long-term liabilities), provided such information is reasonably reliable.

However, directors are expected to take all the necessary steps in order to the obtain information relevant to forming an opinion on liquidity in a certain period of time. Matters which the directors need to consider, whether relevant in the circumstances or not, could at least include, for example:

a) Profit and cash flow budgets (the latter including, where appropriate, any repayments of loans where no fixed repayment dates have been stipulated);
b) The ability to realise current assets, particularly inventories and receivables, and non current assets which are held for sale;
c) The ability to comply with normal terms of credit;
d) The possible cancellation of financial support by major lenders;
e) The material effect of any contingent liabilities;
f) The ability to raise alternative forms of financing as far as they are reasonable reliable; or
g) Any funding for losses of subsidiaries.

Should a liquidity test be prescribed in detail?

Regarding the question whether a liquidity test should be prescribed in detail or how to conduct a liquidity plan different views can be taken and Member States may vary on how flexible or prescriptive they choose to be when introducing a solvency-based regime.

On the one hand, it can be argued that there should be no detailed specifications or guidelines to leave flexibility for the directors of companies to reflect the individual circumstances of the company. On the other hand, it can be argued that some common minimum principles should be set to ensure minimum levels of objectivity and comparability between the companies in the interest of all parties affected by the distribution.

Even when common mandatory principles on liquidity plan would be set, the level of detail regarding the liquidity plan should be oriented towards the individual circumstances or industry sector of each company. However, in cases where directors can assume the going concern of the company, e.g. due to the fact that the company has gained sustainable profits in former periods, and have access to financial resources easily, it seems appropriate that the level of detail regarding the liquidity planning may be reduced.

Several elements of the alternative capital maintenance regime would need to be addressed by the legislator in this context: the minimum time period (for the forward-looking test), the formal procedures and the possible sanctions for directors.

Time horizon for forward looking considerations

An important element of the forward looking test is the time horizon. The significance and the reliability of the forward looking test is dependent on the time horizon considered.

As the uncertainty of the occurrence or the effects of payments in the future increases with the extension of the time horizon, the forward-looking test should be conducted for a certain time horizon that is appropriate in the circumstances. The question is, what is an “appropriate” time horizon? On the one hand, a very short period regarding the liquidity planning might have the virtue of bringing a high level of certainty, but it may be of little or no protection or produce no information benefit for creditors of the company, as they may also be interested in the company’s ability to pay its debts later on in the future. On the other hand, a very long period might meet the interests of creditors, but will increase uncertainty and reduce reliability.

Therefore, a trade-off between less uncertainty in the short term and a higher degree of uncertainty in the long term would have to be achieved. The associated snapshot test will help to out-weigh the uncertainties inherent in the forward looking test and to protect longer term creditors that fall outside the required time horizon. And the longer the time horizon for the forward-looking test is, the more important the snapshot test will be and vice versa. The appropriate time horizon in different Member States will depend on inter alia, how robust their associated snapshot test is, and on their domestic company law regimes. Therefore, it would not seem appropriate to impose an EU-wide ‘one size fits all approach’ in relation to the time horizon that directors should be required to consider. However a minimum time horizon could be put in place either at EU level or Member State level. Should the EC set a minimum time horizon, this time horizon should be one year (which FEE considers the minimum level of protection for creditors). Individual Member States may set a longer (than one year) minimum time horizons.

One possibility would be to have a time horizon of one year. The Jaap Winter Group, for example, recommended that, according to a liquidity test, the company must have sufficient liquid assets to make payments of the liabilities as they fall due in the following period, e.g. the forthcoming twelve months. Some argue that requiring a longer period is too onerous on the directors, as there would be so significantly more uncertainty beyond twelve months, especially if Member States implementing such forward looking tests would impose criminal sanctions. The snapshot test is used to protect creditors that fall outside the twelve month period.

Although financial statements are drawn up on a going concern basis it can be argued that a 12 month period from the date that the financial statements are approved for the forward looking test would still give additional protection to the creditors if a solvency statement would be explicit and publicly disclosed. The statement would be drawn up at the date of the proposed distribution, which may be significantly later than the most recent balance sheet date, so that the period covered is effectively anyhow longer than 12 months.

Another possibility would be to extend the time horizon to 24 months. A reason for this expansion of the time horizon is the inverse of the previous argument: as financial statements are prepared under the going concern principle and already cover the next 12 months of the financial year, one can argue that there is limited benefit in information for creditors that have longer interests in the company; therefore, it might be appropriate to expand the time horizon up to 24 months. This time horizon would also correspond with the time horizon that is used for the preparation of the annual report regarding the assessment of the material risks the company faces.

A third possibility could be to expand the time horizon up to five years. It can be argued that this time horizon could correspond to the period used by management for internal information and budgeting system and that the data is easily accessible in the company. But the amount, as well as the point of time of payments, are no longer determinable on a sufficiently reliable basis due to the increasing uncertainty of the longer time horizon.

In practice, it would seem to be appropriate for the time horizon actually used by the directors to match the industry standard business cycle, if that longer period exceeds any minimum set by the legislator. For instance, technology companies would be expected to have a shorter forecast period than traditional heavy industries, the directors of which would be likely to consider a longer period. However, whilst the directors may decide to consider longer time frames if appropriate in order to satisfy themselves against minimum criteria that the company can pay the dividend, only minimum time horizon requirements should be included in law. Member States that impose criminal sanctions may be more comfortable including a relatively short minimum time frame whilst at the same time, given more importance on the snapshot test and vice-versa (for the trade-off see above).

It should also be noted that in nearly every Member State there is a general requirement that directors have a duty of care: Many Member States also have in place measures which provide for directors to be made personally liable where there are dividend distributions which are not in the company's best financial interests. It should be fundamental to a solvency-based system that directors are expected to act with due regard to the interests of their company's creditors and also to the long term interests of their own company, so as to preclude them from authorising a distribution of dividends in circumstances where the distribution could harm the interests of the creditors, for instance if it is likely to lead to bankruptcy. Under these general duties, when considering a dividend the directors would be expected to consider creditors in exceptional circumstances that fall outside the minimum time horizon if appropriate to do so, for instance, if such liabilities are sufficiently foreseeable and probable and would (after payment of the dividend) endanger the solvency of the company.

4.2.3 Solvency statement and related assurance aspects

Solvency Statement

In the case of a solvency based regime directors (management) should include their opinion on the solvency of the company in a directors' statement, i.e. prepare a solvency statement. Then the question regarding the form and assurance provision of that solvency statement may arise. Any assurance provided/obtained should follow the IAASB pronouncements as discussed below.

A short solvency statement should be in the public domain. The solvency statement can be filed (electronically) at the official registry or alternatively made public on the website of the company. The solvency statement should be published in a timely context with the distribution in a similar way as the financial statements, e.g. upon approval of the dividend in the annual general meeting based on a resolution of the Board of directors when the dividend will be paid shortly after this point of time. This would also cover interim dividends (the Board can propose both interim and final dividends). For every distribution during the financial year, be it interim or final, there should be a published solvency statement.

Irrespective of how detailed or prescriptive the requirements for a solvency statement and the underlying forward-looking test might be, companies should not be obliged to publish sensitive data, details or underlying assumptions of the forward-looking test.

There is an example of the application of a solvency statement, implemented by New Zealand. The New Zealand approach requires that the directors should satisfy themselves on reasonable grounds in compliance with the appropriate standards of professional care that the company is, taking account of the distribution proposed (a hypothesis which must obviously apply to any solvency test), a going concern with a reasonable expectation of meeting its liabilities, and should publicly declare their satisfaction in a published certificate. Following this approach, liabilities should include all existing liabilities, including contingent liabilities.

Another example of a solvency statement is the new capital reduction solvency statement in the UK, which will require directors of private companies to file a short statement confirming that the directors have formed the opinion that:

1. As regards the company's situation at the date of the statement, there is no ground on which the company could then be found to be unable to pay (or otherwise discharge) its debts (the **snapshot test**); and
2. That the company will be able to pay (or otherwise discharge) its debts as they fall due during the year immediately following the date (the **forward looking test**).

Regarding the New Zealand approach, it can be questioned what is meant by "directors have to satisfy themselves on reasonable grounds…" on the companies liquidity and how the criterion "reasonable grounds" as a director's discretionary decision can be checked regarding the question on the legitimacy of a distribution. Regarding the UK example, it can be questioned which were the underlying criteria that the directors applied in forming their opinion that "there is no ground on which the company could then be found to be unable to pay (or otherwise discharge) its debts".

There are several possible approaches towards the need for dealing with directors' judgments about solvency and going concern:

a) Objective test with no specified underlying criteria: It can be argued that judgements about solvency and going concern are business judgements for directors that do not require them to follow any set criteria – the directors are simply required to satisfy themselves that they can make the required solvency statement, by looking at whatever criteria they deem suitable for purpose in the context of their specific company. For instance, some Member States favour a principles-based rather than a rules-based approach, and would argue that prescribing specific mandatory criteria for directors would be seen as a checklist, which can be detrimental. Such Member States may choose to leave it to the directors' professional judgement to identify suitable criteria to use in the context of their own company, such as those listed (a)-(g) in 4.2.2, and might instead issue non-mandatory guidance for directors on solvency judgements. Creditors would have annual comfort as the financial statements are drawn up on a going concern basis. It is also worth noting that making dividend payments without "reasonable grounds" in many jurisdictions constitutes a criminal offence and may involve criminal sanctions (see Section 4.2.4), and such jurisdictions may therefore be satisfied not to specify underlying criteria; or

b) Objective test with underlying criteria: It can be argued that whether the directors have "satisfied themselves on reasonable grounds" or "have no grounds on which the company could then be found to be unable to pay (or otherwise discharge) its debts" has to be decided on the basis of an objective test with underlying criteria, especially when the solvency statement is not only used for internal business purposes. It can be argued that, in the interests of all company's stakeholders, a distribution solely based on the directors' discretionary decision on the company's solvency might be regarded as subjective and inadequate. Therefore, some Member States would think it important that the legislator or standard setter should establish some set of

objective mandatory minimum criteria, setting out management's responsibilities in respect of distributions based on a forward-looking test, as a benchmark, against which third parties, e.g. creditors, can check such a decision and can prove the contrary in case they are of the opinion that a distribution has not been made on proper justification.

Assurance aspects

We do not call for legal requirements for assurance of solvency statements. However, in the future, third parties or directors may ask for some kind of *assurance* regarding the solvency statement. It should be left to market forces as to whether third parties such as banks, or the directors themselves, may wish to engage the auditors or other practitioners to consider the directors' solvency statement and provide an assurance report over e.g. the procedures the directors have undergone or assumptions made in carrying out the solvency test. The question is if and what kind of assurance can be given. Although auditors or other professional accountants in public practice ("practitioners") usually do not provide any public opinion on solvency statements they are often involved to privately report to the Board of Directors. The discussion below relates to the possibility of assurance resulting in a public practitioner's report or opinion, even though this may often not be made publicly available for example for liability reasons. Another possibility is to give public assurance on only certain aspects of a solvency statement.

Several factors play a role in providing/obtaining an assurance report on the solvency statement, not least the involvement of forward looking information. The snapshot test is less of an issue: in the balance sheet test the audited financial statements figures are used, whereas in a 'net asset' test the fair value or value in use needs to be determined. The latter figures may be more subjective where no observable market prices exist but pose no special difficulties different from a financial statement audit whereby the financial statements are based on fair value measurements.

A forward-looking test however is to a high degree based on predictions. The assumptions and intentions of the directors and conclusions drawn in order to assess the solvency of the company are therefore uncertain. When discussing assurance aspects on solvency statements, it should be considered that no new expectation gap will be created, therefore, it is important to make clear what a practitioner can do and what he can not do in this respect: The practitioner is not in a position to express an opinion as to whether the results shown in the solvency statement will be achieved. In particular, an assurance engagement cannot guarantee that the company will maintain its liquidity after profit distribution and throughout the period of projection or that the company will continue as a going concern. An assurance report provided/obtained by the practitioner on the solvency statement would not result in a shift of responsibilities between directors and the practitioner and would not absolve the directors from their responsibility regarding the solvency test and solvency statement.

A type of assurance different from the type of assurance provided when conducting an audit of the financial statements could be envisaged for the prospective information part of the solvency statement. The practitioner could evaluate whether management's assumptions and intensions are plausible and conclusive and not contradictory to their actual actions, or to other documents which are subject to the audit of the financial statements, and to the annual accounts or broadly known economic facts. A practitioner could also assess whether the conclusions drawn by management from the underlying assumptions are conclusive, i.e., factually accurate and not arbitrary.

While evidence may be available to support the intentions and assumptions on which the forward looking information is based, such evidence is itself generally future oriented, and therefore speculative in nature, as distinct from the evidence ordinarily available in an audit of financial information. Given the types of evidence available in assessing the assumptions on which the forward

looking information in based, it may be difficult for the practitioner to obtain a level of satisfaction sufficient to provide a positive assurance conclusion. As a result, when reporting on the solvency statement issued by the directors the practitioner would be in a position to provide/obtain a *limited level of assurance* only. It must be emphasised that in relation to solvency statement only a statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information would apply. Positive (reasonable) assurance could however be provided on certain aspects such as accounting policies compliance, underlying calculations, and consistency with assumptions as a separate engagement if market demand for external assurance on such information exists.

The following IAASB standards on prospective financial information are of particular interest for the limited assurance on the solvency statement, owing to the fact that the solvency test is based on prospective information:

- ISAE 3000, Assurance Engagements Other Than Audits or Reviews of Historical Financial Information; and
- ISAE 3400, The Examination of Prospective Financial Information (previously ISA 810).

ISAE 3000 as a generic standard provides the general principles that auditors should apply to assurance engagements other than audits or reviews of historical financial information where no specific ISAE has been developed. This ISAE is to be read in the context of the "International Framework for Assurance Engagements" (the Framework), which defines and describes the elements and objectives of an assurance engagement, and identifies those engagements to which ISAEs apply. This ISAE has been written for general application to assurance engagements other than audits or reviews of historical financial information covered by ISAs or ISREs. ISAE 3000 allows for two kinds of assurance, reasonable assurance and limited assurance. But when providing assurance on solvency statements, this standard does not provide sufficient specific guidance.

The purpose of ISAE 3400 is to establish standards and provide guidance on engagements to examine, and report on, prospective financial information, including examination procedures for best-estimate and hypothetical assumptions. Although this ISAE states that "it does not apply to the examination of prospective financial information expressed in general or narrative terms, though many of the procedures outlined in this standard may be suitable for such an examination", some parts of this standard provide helpful considerations. The reasons mentioned in ISAE 3400[13] why only limited assurance can be provided/obtained apply correspondingly for the solvency statement.

Based on the ISAE 3000, specific and appropriate procedures for providing assurance on solvency statements need to be developed. In doing so, it could be considered that – in addition to ISAE 3400 – the relevant parts of e.g. ISA 570 „Going Concern" or ISA 545 „Auditing Fair Values Measurements and Disclosures" or the principles of business valuation (e.g. discounted cash flow method) could be applied.

4.2.4 Sanctions

In the case of a solvency based regime, the question may arise of what happens if directors issue a "wrong" or "incorrect" solvency statement leading to improper distributions? Third parties that are harmed or have suffered damage resulting from such a distribution may ask for sanctions. Criminal and civil sanctions are principally stipulated in the jurisdiction of each Member State and therefore

[13] ISAE 3400 "The examination of prospective financial information", paragraph 8, 9.

differ. Member States would be expected to apply appropriate sanctions against directors taking account of their domestic company law framework. For example, some countries might impose civil and regulatory penalties against the directors (which could be limited to the board of directors/the executive directors, or also applicable to the supervisory board/non executive directors), for instance fines or disqualifications. Other countries may choose to impose criminal sanctions. For example, the UK would be likely to impose criminal sanctions akin to those attaching to the new UK solvency statement route for capital reductions, under which directors are punishable by up to two years' imprisonment and/or a fine if they make a solvency declaration without reasonable grounds.

Regarding national civil law, Member States would also need to consider whether there should be liabilities on shareholders to repay the company where distributions are made without proper justification or without taking into account the prescribed minimum criteria in the relevant Member State and where shareholders received the distribution not in good faith. In addition, it should be considered how and whether third parties should be able to take legal action against the directors.

For example, the existing regime in New Zealand imposes criminal liabilities for defective certification and a strict liability on shareholders to the company, with relief only where they show that they have received the distribution in good faith, and have changed their position, and that it would be unfair to insist on recovery.

The type and extent of sanctions imposed might influence the other aspects of the regime that countries introduce, such as the level of prescription as to what the directors must consider before making a solvency declaration. However, it can be questioned whether an alternative system based on repressive sanctions provides sufficient protection for third parties, e.g. creditors. The solvency test itself as well as the solvency statement should be developed in a way that provides sufficient protection for all parties in advance, that means before a distribution is made.

It should also be noted that in nearly every Member State there is a general requirement that directors have a duty of care, and that they could be liable for breach of any such duties if they authorise a distribution in circumstances where the distribution is likely to lead to bankruptcy. These duties are usually owed to the company, but (depending on the local legislation and case law) may be enforceable by the shareholders on behalf of the company.

4.2.5 Benefits and shortcomings of a solvency-based regime

It is not possible to provide absolute guarantees against insolvency. Any return of assets to shareholders increases the risk to creditors; but without a return for investors, companies could not perform and contribute to general welfare, and even creditors might not be in business. It is thus a question of reasonable balance, or proportionality. This balance must be struck taking account of the conditions in which modern business is conducted and all the other provisions of company law and practice which create risks or added security for creditors.

The benefits of a solvency-based regime might be:

- Company has more flexibility in dividend distribution in circumstances where dividend distribution would not be possible under the current capital maintenance regime;
- There can be a closer relationship between dividend distribution and real economic performance;
- Attaching higher importance to investors: more authority for capital markets and investors;
- Over capitalisation can be more easily avoided by distribution of profits not needed in the business situation; and

- No need to make extensive adjustments for individual IFRS accounts[14] (as would be the case under the current capital maintenance regime).

The main shortcomings of a solvency-based regime might be:

- Greater risk of paying future profits (including goodwill) to shareholders that may not crystallize;
- More subjectivity involved since there are less well defined criteria, inherent to forward looking information;
- More difficult and costly to apply; and
- More scope for ambiguity.

FEE is of the opinion that the introduction of an alternative capital maintenance regime in form of a solvency-based regime including both a "snapshot" test and a "forward looking" test should be considered.

4.2.6 Application and scope of alternative capital maintenance regimes

When discussing an alternative capital maintenance system, the issue of the application and scope of such systems needs to be addressed.

Scope

The current capital maintenance regime applies to all companies subject to the Second, Fourth and Seventh Directives. Should the alternative system equally apply to all these public and private limited liability companies or should its scope be narrower: for instance listed companies, or companies using IFRS? It should also be examined, whether companies in regulated industries such as banks, insurance undertakings and investment companies need be included in the scope since they are already subject to strict capital adequacy requirements.

A more limited scope will allow for gradual introduction of the alternative system but impairs the comparability. A minimum scope – e.g. listed companies using IFRS in the individual accounts following the IAS Regulation and those companies, which apply IFRS in their single accounts on a voluntary basis – could be considered to be defined in European legislation. In these cases, those companies could be given the possibility to use their IFRS accounts also for the purpose of distribution under the precondition that they perform the solvency test. However, each Member State will have to decide which would be the appropriate scope for the alternative regime given the national circumstances. Also it could be considered at European level to give Member States the possibility to require or to allow the alternative system for those companies that apply national GAAP in their individual accounts but wish to use the alternative system.

Application

It is for consideration how a new regime could be implemented. The EC could introduce a regime giving Member States the possibility to require or allow an alternative regime. However, in the long term it would be difficult to maintain two systems within the same scope of companies, for example it could be expected that interested parties in the companies would not accept two systems over an extended period of time due to lack of comparability between the companies.

[14] ICAEW Guidance TECH 21/05 Distributable Profits: Implications of IFRS, 3 June 2005.

The July 2007 Consultative Communication on Simplification considers as one option the entire or partial repeal of the Second Directive. A replacement or even a repeal of the Second Directive may suspend the close and harmonised relationship e.g. between commercial law and company law among and within the Member States which was built up and exists over many years. Harmonized regulation can bring benefits in avoiding a fragmentation or splintering in company law between the Member States which might impede comparability between companies having their seat in different Member States and lead to less transparency. Transparency is important to companies with cross-boarder activities as well for stakeholders that are in business relationship to companies in different Member States.

4.3 Should consolidated accounts be relevant in capital maintenance?

As capital maintenance is directed towards creditor protection, and the counterpart in a transaction with the creditor is the legal entity, the rules regarding creditor protection deal with the accounts of the legal entity. Normally the individual accounts are regarded as the accounts of the legal entity because they show the assets and liabilities of the legal entity itself.

The issue is can consolidated accounts also be relevant from a capital maintenance perspective?

The consolidated accounts show the assets and liabilities of all the group companies as if they were one legal entity. Creditors, however, have only a claim against the legal entity with which they entered into an agreement. Only the solvency or the ability to pay of this entity is relevant. The ability to pay will however, under certain conditions, depend on the relations with other group companies. In some countries the relation between group companies are regulated in special laws to groups of companies, other countries do not have such specialised laws.

Therefore, capital maintenance rules according the Second Company law Directive apply only to individual accounts and not to consolidated accounts.

As mentioned before, the actual capital maintenance system in Europe is static. It is based on a defined core equity that should not be distributed. Measurement of the total equity is based on the approved balance sheet at the end of a fiscal year (balance sheet approach). An alternative approach could be a more dynamic one which takes the expected future cash flows into account (solvency approach). From this latter perspective, consolidated accounts could be more relevant than in case of a more static approach.

In the balance sheet approach, the primary objective is to judge if there is enough cash available or profit that can be made available in cash in the legal entity to pay dividend.

In the balance sheet of the individual accounts, based on IFRS, the subsidiaries are accounted for at historical cost or fair value. In case of historical cost, the profit of subsidiaries has to be distributed before it is available for the shareholders of the holding company. This is in line with the underlying ideas of capital maintenance in the Second Directive. It could be argued that the holding company, in most practical cases, can decide on the cash flows of the subsidiaries, in which case consolidated accounts can better indicate the amount available. However the current company law rules include a test as to what extent the holding company can make decisions over the cash flows of its subsidiaries.

Fair value measurement of shares in subsidiaries leads to an increase in equity that is not necessarily realized. In the approach of the Second Directive non-realized gains (and other increases in equity) should not be made available to the shareholders. At least not without the possibility for third parties to object.

In the solvency test approach, the decisive criterion will be the possibility of the legal entity to dispose of enough cash flow to distribute dividend and continue its operations without a much higher risk. Both the individual accounts of the legal entity and the single accounts of the subsidiaries are relevant, as well as the forecasts of these companies. Under circumstances (e.g. where the holding company can dispose of the consolidated cash flow) the consolidated accounts could provide sufficient information together with the consolidated forecasts.

It should be noted that in the US the admissibility of dividends is judged on the basis of consolidated accounts. Probably this is based on the different view on the bases of consolidation in the US. Shareholders are considered as indirect owners of the assets and liabilities of the legal entity if they have power to control. In Europe the relationship between shareholder and company is not defined as a kind of ownership but as a kind of member relationship. The legal entity has an ownership interest in which the interest of all parties involved are balanced.

The basis for consolidation in the US seems to be the owner relationship, in Europe the responsibility of management of the parent company for the companies' interest as a whole. Control leads to the need to account for the decisions taken by the entity/person in control. From the idea that owners can dispose of the assets it is understandable that consolidated accounts are used in the US. Under the idea of a member relationship the shareholder can not dispose of the assets so consolidated accountants are only relevant to get insight into the future economic performance to be expected.

5. SELECTED FURTHER READING

- UK Companies Act 2006, sections 642-644, reduction of capital supported by solvency statement

- ICAEW Comments on Solvency test – TECH 22/05 Company Law Reform White Paper

- TECH 02/07 (ICAEW/ICAS) Distributable profits: Implications of Recent Accounting Changes (IFRS and converged UK GAAP)

- Implications of IFRS for Distributable Profits ICAEW Briefing Paper

- Going Concern and Financial Reporting – Guidance for Directors of Listed Companies registered in the UK

- Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance (European Business Law Review) by Jonathan Rickford

- TECH 21/05 (ICAEW/ICAS) Distributable Profits: Implications of IFRS, draft guidance

- FEE letter of 10 February 2004 to the EC on Capital Maintenance

- EC Call for Tender: feasibility study on alternative to capital maintenance regime as established by the Second Company Law Directive 77/91/EEC of 13.12.1976 and the examination of the implications of the new EU-accounting regime on profit distribution

- Symposium on Efficient Creditor Protection in European Company Law – Munich 1-3 December 2005

- Proposal for a Directive of the European Parliament and of the Council – amending Council Directive 77/91/EEC, as regards the formation of public limited liability companies and the maintenance and alteration of their capital

- Communication from the Commission to the Council and the European Parliament – Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to move Forward

- Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe

- IDW Presseinformation 8/2006: Vorschläge des IDW zur Neukonzeption der Kapitalerhaltung und zur Ausschüttungsbemessung and extracts of the press release of IDW's Position on Capital Maintenance and Profit distribution (in English language)

- Naumann, Fortentwicklung der handelsrechtlichen Rechnungslegung und Konsequenzen für die Kapitalerhaltung, in: Der Konzern 2007, pages 422 – 427

- Pellens: Kapitalschutz in Kalifornien – Vorbild für die europäische Gesellschaftsrechtsreform?, in: Der Betrieb 2006, pages 2021 – 2027

- Kämpfer: Solvenztest statt Mindestkapital – Was wird dann geprüft?, in: BetriebsBerater-Special, 5/2007, S. 1