

Feasibility study on an alternative to the capital maintenance regime established by the Second Company Law Directive 77/91/EEC of 13 December 1976 and an examination of the impact on profit distribution of the new EU-accounting regime

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Executive Summary



Executive summary

The guiding objective of this study is to evaluate the feasibility of an alternative to the current regime of legal capital established by the 2nd Company Law Directive (CLD) and to examine the impacts of International Financial Reporting Standards (IFRS) on profit distribution. The study is intended to help the European Commission to evaluate whether an alternative regime would better support the efficiency and competitiveness of EU businesses. A particular challenge for the capital regime as currently embedded in the 2nd CLD is the introduction of IFRS in the European Union. Under the IAS Regulation (1606/2002), EU Member States may permit or require companies to use IFRS for their individual financial statements. This instantly raises the question whether IFRS as an accounting framework is adequate to be used as the basis for profit distribution under the current capital regime of the 2nd CLD when IFRS are not primarily designed for this purpose.

The decision on the introduction of an alternative to the current regime is a highly complex task. Several disciplines on which alternative regimes may have an effect or influence, will need due consideration. This primarily concerns the areas of company law and accountancy. Furthermore, certain aspects of insolvency and securities legislation or taxation may also come into play. For specific industries, such as the banking and insurance sector, certain regulations e.g. Basel II or Solvency II may also affect the capital regimes of the companies concerned. This study focuses on the core aspects of company law and accountancy as relevant for any company falling under the 2nd CLD, not making specific considerations for a particular industry. Taking into account the impact of IFRS on the current capital regime of the 2nd CLD, the study examines the feasibility of an alternative system by way of measuring the administrative burdens for EU businesses.

Overall, the cost analysis of the existing models adopted in the five EU Member States and five non-EU jurisdictions has shown that the compliance costs related to the capital regimes in all jurisdictions are generally not overly burdensome as by average they do not exceed €30,000 for a specific process. Comparative synthesis tables can be found in section 4.4 of this study report. A first conclusion of the study is that the reduction of compliance costs is unlikely to be a motivation for the transition to an alternative, solvency-based system.

Concerning the accounting aspects, EU Member States may require or permit the use of IFRS for individual accounts. As a consequence, IFRS individual accounts could also be used as a basis for profit distribution subject to Member States' legislation. This is currently the case in 17 of the 27 EU Member States. The practice on how IFRS are applied for distribution purposes shows a mixed picture throughout these 17 EU Member States. In 7 of these 17 Member States, the IFRS accounting profits are modified for distribution purposes. The basic modification consists in declaring certain "unrealised" profits resulting from IFRS individual financial statements as non-distributable.

Comparative cost analysis of capital regimes in selected EU/non-EU jurisdictions and in literature

Based on a legal analysis, the study conducts an economic analysis of the capital regimes of five EU Member States (France, Germany, Poland, Sweden and the United Kingdom) and of four non-EU countries (the USA, Canada, Australia and New Zealand) [for the legal analysis see Annexes - part 1, section 3]. Furthermore, four models which can be found in the literature (High Level Group, Rickford Group, Lutter Group and Dutch Group) are analysed. The aim of this economic analysis is the identification of the administrative costs, i.e. the

incremental burdens linked to company law provisions concerning the capital regimes in existence and the proposed models in the literature. The comparison of the administrative costs of different regimes may allow assessing whether a certain capital regime is more advantageous than another for EU companies from a cost perspective. In order to obtain comparable data throughout the various jurisdictions with different economic levels, we have employed standardised cost rates of €100/€70 per hour for the main cost factor of the provisions, the internal man hours spent on compliance. The basis for the economic analysis formed in-depth interviews with high-ranking representatives of 35 companies of different sizes in the five EU and the four non-EU countries. The interviews were complemented by the results of a CFO questionnaire sent out to 3,578 companies in these countries; thereof 157 companies have responded to the questionnaire which represents 4.39 percent of the 3,578 companies [for the CFO questionnaire, see Annexes - part 1, section 2.1].

Administrative costs in five EU Member States

A main building block of the current capital regime of the European Union is the concept of a subscribed capital which is protected from distributions. The concept of subscribed capital is extended to the 2nd CLD's approach to capital maintenance, which provides restrictions on share repurchases, capital reductions, the withdrawal of shares and financial assistance. Another building block is the use of balance sheet test to determine any distribution under the 2nd CLD. The balance sheet profit is the profit realised for the financial year after setting off losses and profits brought forward as well as sums in mandatory and optional reserves. The accounting framework from which the realised profits are derived is either national GAAP harmonised to a certain degree by the 4th CLD or IFRS. A third building block of the current regime of the 2nd CLD is the decision making authority of the general meeting concerning all matters relating to an amendment of the subscribed capital or fundamental decisions concerning transactions linked to capital maintenance issues.

The legal analysis of the company law regime adopted in five EU Member States showed that all of them closely follow the 2nd CLD. However, in some EU Member States there are a few significant additional protective measures in national legislation which partly concern profit distribution. This is the case, for instance, for national provisions concerning the protection of premiums and of certain reserves from distributions; the prohibition of transactions with shareholders that are not conducted at "arm's length"; the necessity of resolutions by the general meeting to distribute profits; different quorums for general meetings and additional rules regarding sanctions.

In implementing the 2nd CLD, the five EU Member States have set minimum subscribed capital requirements which in all cases exceed the minimum of €25,000 required by the 2nd CLD and extend up to €225,000 for French listed companies [see section 4.1.6]. In company practice, the subscribed capital regularly exceeds the minimum amounts by far. However, the interviews conducted with EU companies indicated that the practical relevance of the subscribed capital for the assessment of the viability of a company is seen as low. The companies as well as their peers like banks, rating agencies and analysts rather refer to other equity figures such as "net equity" and "market capitalisation". A comparison of the ratio of subscribed capital to the total shareholders' equity for the companies on the main stock exchange indices of the five EU Member States showed that due to the low percentage of subscribed capital, equity financing is not largely dependant on it and that there should be sufficient equity base for adequate distributions. In this context, it must be noted that the results of the CFO questionnaire underpin that the majority of the responding CFOs in all five EU Member States do currently not particularly question the distribution restrictions implied

by the concept of legal capital. The majority of the responding CFOs considered the subscribed capital to be necessary for equity financing and, in their opinion the subscribed capital does not constitute a barrier to the distribution of excess capital.

The general dividend policies of the companies interviewed differentiate from company to company as they depend on their individual circumstances. The level of dividends as such is a “political decision” of the parent company with a view to the share price. This includes aspects like dividend continuity or sending certain signals to the capital market. The starting point for the consideration of potential dividend levels is usually the consolidated financial statements and the cash flow situation of the group. The results of the interviews in this respect have been validated by the results of the CFO questionnaire. From an economic perspective, the reference to the group situation shows that the legal profit distribution concept which is based on the single legal entity, receives less consideration when discussing the actual level of dividends.

In general, all five EU Member States follow the requirements of the 2nd CLD in restricting profit distributions. The results of the CFO questionnaire showed that the responding CFOs considered legal requirements concerning distributions as well as possible violations of insolvency law as important deterrents regarding excessive levels of dividend payments; i.e. payments which endanger the viability of a company. Other market-led solutions such as bank covenants and rating agencies’ requirements play a less significant role.

To bring the parent company’s financial situation in line with the group perspective, a large part of the companies interviewed steer the profit and cash flow situation of the parent company. This is mostly done in a structured planning process over several years. This can entail significant costs for companies. However, as this process is mainly undertaken to achieve tax optimisation for intra-group distributions, we have disregarded the associated costs as incremental burdens stemming from company law.

Altogether, we have tried to assemble the administrative costs associated with key processes concerning compliance with the provisions of the implemented 2nd CLD. These processes included capital increases and profit distributions as well as certain aspects of capital maintenance such as the acquisition by the company of its own shares, capital reductions and redemption/withdrawal of shares. We have mainly been able to retrieve meaningful data for capital increases, profit distributions and acquisition by the company of its own shares as companies are regularly using these processes. The average costs for each process do not exceed €30,000. For capital reductions and the redemption/withdrawal of shares, there are no meaningful data as the sampled companies have not made use of these processes. For contractual self-protection such as covenants, we have found the use of such instruments but have not received associated cost data. Furthermore, we have not found that compliance costs vary according to the size of the company, in general.

In total, we conclude that the administrative costs concerning the 2nd CLD company law requirements are generally low for companies interviewed throughout the five EU Member States [for details please refer to section 4.1.6 of this study report]; more significant costs arise outside the area of the core company law requirements, specifically with regard to securities legislation (e.g. capital increases; acquisition by the company of its own shares).

In view of the most recent changes to the 2nd CLD in 2006, we have not been in a position to verify the cost implications of these measures as they have not yet been applied by the EU companies interviewed.

In addition, we have analysed the situation of private companies in four of the five EU Member States (Sweden has no separate legal form). In essence, the legal requirements related to the capital regime of private companies are less restrictive than the regime for the companies falling under the 2nd CLD [For an overview and further details, please refer to Annexes – part 1, section 4]. Private companies maintain the capital as contributions can usually not be distributed, although there is a trend at least to lower the amounts or de facto abolish the minimum capital. Capital increases and decreases require a resolution by the shareholder meeting. The basis for profit distributions are usually the net accounting profits as shown in the annual financial statements; the UK deviates by referring to “realised profits”, an approach also applied to UK companies falling under the 2nd CLD. The repurchase of own shares is generally not restricted, except for the UK where basically the same rules as for public companies apply.

Administrative costs in four non-EU countries

The four non-EU countries show different alternatives to the capital regime used in the EU. We have examined two US state laws (Delaware and California), the Canadian federal legislation as well as the company laws of Australia and New Zealand [for an overview see section 4.2.7]. Furthermore, we have outlined the provisions of the US Model Business Corporation Act (MBCA) which is a guideline for the company laws of a significant number of US states [see section 4.2.1].

With the exception of Delaware, none of the non-EU jurisdictions prescribe a subscribed capital or a minimum capital. In Delaware, the traditional capital system continues to be applied although it does not play an important role in practice. Because Delaware corporations usually issue shares with a very low par value (e.g. US\$ 0.01 and less), capital is negligibly low. As with EU companies, the equity figures “net equity” and “market capitalisation” are much more important to the companies interviewed.

Instead, the emphasis has shifted to increased testing procedures for dividend payments and other kinds of distributions such as the repurchase of the company’s own shares. This is achieved through various solvency and balance sheet tests. In some of the jurisdictions considered, the performance of the balance sheet test is based on audited consolidated accounts for legal or practical considerations (e.g. for the United States US GAAP). The results of the CFO questionnaire indicate that the responding CFOs of non-EU companies are satisfied with the concept of a balance sheet test and that they consider their audited accounts as a good starting point to determine the level of dividends. On the other hand, the majority of the responding CFOs, with the exception of Australia, believes that a solvency test taking into account future cash-flows better determines the ability to actually pay dividends than a balance sheet test.

In the non-EU countries, the distribution decision lies with the board of directors which has full discretion in this respect. The assessment by the company’s management about the adequate level of dividend payments results, as in the EU Member States, is a “political” decision driven by a share price objective. Aspects such as dividend continuity and other signalling effects to the capital market play a role. Again, these companies regularly refer to their consolidated accounts and cash flow position as a starting point for such considerations. This is reconfirmed by the results of the CFO questionnaire. One interesting fact in this context, however, is that the responding CFOs in the considered non-EU countries rank the issue of the compliance with covenants much higher than their EU counterparts.

One common feature of the non-EU capital regimes is that the increased responsibility of the board in this regard translates into a fiduciary duty or personal liability. Particularly in the United States, directors may also be subject to fraudulent transfer legislation.

As for EU Member States, we have tried to track the administrative costs associated with key processes for the non-EU jurisdictions. These processes included capital increases and profit distributions as well as certain aspects of capital maintenance such as the repurchase of shares, capital reductions, redemption/withdrawal of shares. We have been able to retrieve meaningful data only for capital increases, profit distributions and repurchase of shares as companies regularly use such processes. The average cost for each operation does not exceed €25,000. For capital reductions and the redemption/withdrawal of shares, there is no meaningful data available as companies have not made use of these options. With respect to contractual self-protection such as covenants, we found significant compliance costs amounting on average up to €90,000. However, the costs relating to covenants mainly depend on individual circumstances, especially how covenants are negotiated. Furthermore, we have not found that compliance costs vary depending on the size of the company, in general. However, it should be noted that the non-EU companies interviewed were all in good financial health. The compliance effort may, in these models, significantly increase once a company enters into a more difficult financial situation because the management assessment to justify a dividend payment would become much more detailed.

In total, we conclude that the administrative costs are also generally low for companies interviewed throughout the five non-EU jurisdictions [for details please refer to section 4.2.7 of this study report]; as market-led solutions, namely covenants, play a more prominent role, additional costs may arise in this respect. More significant costs rather arise outside the area of the core company law requirements, specifically with regard to securities legislation (e.g. capital increases; repurchase of shares).

Administrative costs of four models in the literature

All four proposals in literature (High Level Group, Rickford Group, Lutter Group, Dutch Group) consider possible changes to the current regime of profit distributions in the EU. These proposals vary from partial to full scale reform of the 2nd CLD capital regime. All systems differ as to how this affects the overall set-up of the capital regime.

The Lutter Group proposal [see section 4.3.3] to a large extent maintains the current system of the 2nd CLD and only changes provisions on the distribution of profits to accommodate the use of IFRS in the individual financial statements. To this end, the Lutter Group proposes a solvency test, in addition to the balance sheet test already foreseen by the 2nd CLD.

The other three models (High Level Group, Rickford Group, Dutch Group) discuss a fundamental change to the current capital regime by abolishing the concept of legal capital in favour of distribution testing by means of additional solvency tests. The latter goes hand-in-hand with the transition from a par value concept of shares to a true no-par value share concept. The High Level Group [see section 4.3.1] and the Dutch Group [see section 4.3.4] require the companies to meet both the balance sheet test as well as the solvency test. The High Level Group additionally discusses the introduction of a solvency margin. The Rickford Group [see section 4.3.2] ultimately only requires that a solvency test must be met to allow for distributions.

The solvency margin proposed by the High Level Group is an instrument which can only be used in the context of a balance sheet test and may replace the concept of a fixed legal capital. It ensures that the assets, after the distribution, exceed the liabilities by a certain margin. In this respect, it is decisive to determine an appropriate margin level to avoid excessive restrictions for companies to distribute dividends. In California, which is the only jurisdiction under consideration which embeds a solvency margin in law, the margin only needs to be met if a company does not have sufficient retained earnings for a distribution. We have not encountered any practical case of a California incorporated company where such a margin test has been actually performed.

The economic effects of these models are not fully clear, as they leave the most burdensome administrative aspects of the 2nd CLD intact. This specifically concerns the preparation of the general meeting in the case of capital increases, dividend distributions and the repurchase of shares. This is the reason why we have used the EU average administrative cost as a starting point for cost considerations. Presumably, this would also be true for capital reductions and redemptions/withdrawals. However, as specified above, we have not been able to gather reliable EU data in this regard.

All four models are, in differing degrees, incomplete in their suggestions on how to exactly conduct changes to the 2nd CLD. One important example is the impact of different designs of solvency tests. The existing gaps in these models partly allow for a wide interpretation and can immensely influence the associated burdens for the companies concerned. For the High Level Group, it seems relatively easy to comply as a reference to current balance sheet ratios is proposed (current assets/current liabilities). For the Rickford and Lutter Group, cash-flow projections are required. The Dutch Group leaves the design completely open. Except for the reference to current ratios, we have not encountered a formalised detailed application of any of these design approaches in the five non-EU jurisdictions. Therefore, we have not been in a position to build on this experience and, thus, have not attempted to estimate the costs associated with the different formats of the solvency tests [see section 4.3.5].

Result of the comparative cost analysis

Overall, the cost analysis of the existing models in the five EU Member States and four non-EU countries has shown that the administrative costs of company law in this regard for the companies in all jurisdictions are generally not overly burdensome as by average they do not exceed €30,000 in a specific process. The comparative synthesis tables can be found in section 4.4 of this study report. Thus, such considerations do not seem to play a decisive role in determining whether the transition to an alternative system would actually benefit EU businesses by lowering administrative burdens. However, administrative burdens can be of significant relevance when considering the implementation of certain measures in a jurisdiction. This is especially true for the design of solvency tests. Moreover, we have considered qualitative aspects of shareholder and creditor protection within each model. Both the EU and non-EU jurisdictions have certain shareholder and creditor protection instruments in place. In particular, the EU jurisdictions generally require the involvement of the general meeting concerning capital measures, whereas non-EU jurisdictions more often rely on the board of directors to take decisions in this respect.

Impacts of IFRS on profit distribution

The primary objective under which the IFRS are developed is the decision usefulness of the information provided to the users of the financial statements. Accounting standards developed under the IASB Conceptual Framework are not intended to serve as a basis for a distribution policy which aims at warranting the future viability of a company. IFRS typically make use of different measurement models, but rely in some areas to a large extent on fair value measurements. As a consequence, re-measurements due to changes in relevant market prices or equivalent measurement references result in recognition of (unrealised) profit/losses or have a direct effect on equity. In this context there is a debate as to whether the 2nd CLD in its current format is sufficiently prepared for this challenge.

Although the European Union has only introduced IFRS as a mandatory accounting framework for the consolidated accounts of publicly traded companies, EU Member States may require or permit the use of IFRS for individual accounts. As a consequence, IFRS individual accounts may also be used as a basis for profit distribution subject to Member States' legislation.

This is currently the case already in at least 17 of the 27 EU Member States¹. In 7 of these 17 Member States², the net income presented under IFRS is modified for distribution purposes. The main objective of such modifications is to eliminate "unrealised" profits/losses from IFRS individual financial statements from the basis for distributions.

Concerning the impact of the transition from national accounting rules to IFRS, the analysis shows that it cannot be generally assumed that the application of IFRS will result in a major increase in profits or in equity. However, as specific circumstances at each company prevail, situations may arise where the transition may show major impacts. In this context, it must be kept in mind that when comparing different accounting frameworks, any difference impacting accounting profits in one period will usually be reversed in a later period.

The analysis of the largest deviations of IFRS from national accounting rules for all 27 EU Member States [see section 5.2] showed that the following standards are mainly concerned: IAS 19 (Employee benefits), IAS 29 (Reporting in Hyperinflationary Economies), IAS 39 (Financial Instruments: Recognition and Measurement), IAS 40 (Investment Property), IFRS 2 (Share-based Payments), IFRS 3 (Business Combinations) and IFRS 5 (Non-current Assets Held For Sale and Discontinued Operations). As a general rule, these are mainly accounting standards which require or permit fair value measurements. Assessed by EU Member State, the perceived deviation of IFRS standards from national accounting rules ranged between 1.6 and 3.8 on a scale between 1 (identical) and 5 (dissimilar).

For example, investment properties may be carried at fair value with an immediate impact on profit or loss or immediately on equity. The accounting for defined benefit plans shows differences in the methods of accounting and parameters utilised. Moreover, actuarial gains or losses may not be recorded immediately. Accounting for financial instruments is a complex task for derivative and non-derivative financial instruments. In several jurisdictions, the fair value measurement of certain financial instruments is permitted or required.

¹ Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, Greece, Ireland, Italy, Latvia, Lithuania, Malta, Netherlands, Poland, Portugal, Slovakia, Slovenia and United Kingdom..

² Denmark, Greece, Ireland, Italy, Malta, Netherlands and United Kingdom..

In this context, however, it must be noted that the degree of deviation is, by essence, determined by the national interpretation of the realisation principle as embedded in the 4th CLD. The differing degrees of deviation reveal a lack of harmonisation of the interpretation of basic accounting principles of the 4th CLD throughout the European Union. Under a national accounting framework which is guided by the idea of decision usefulness the realisation principle is differently interpreted than under an accounting framework which emphasises the idea of prudence, e.g. German GAAP. This is one of the main reasons why there is no clear-cut answer regarding the total effects of a transition to IFRS for the European Union as a whole.

The last part of the IFRS analysis [see section 5.3] concerns a detailed comparison of national accounting rules' effects in the five EU Member States on distributable profits with IFRS in distinct areas, namely investment properties, defined benefit pension plans and financial instruments. These accounting areas showed a lack of European harmonisation as the national accounting rules differ widely.

The analysis of the current legislative practices in the five EU Member States concerning the interaction of national accounting frameworks under 4th CLD and the distribution model of the 2nd CLD has revealed certain options for a single company to deal with excessive distributions. A balancing element can be introduced at different levels. A first option is the emphasis on prudence in the basic principles of an accounting framework, e.g. in Germany. This option is, however, not relevant for IFRS. As a second option, a reassessment of what profits are distributable or of what should be restricted, may also take place outside the core financial accounting process. In particular, in the UK there is a differentiation between accounting profits under UK GAAP and realised profits for distribution purposes; the UK institutes ICAEW and ICAS have developed authoritative accounting guidance in this respect. Certain accounting treatments are revised by means of an authoritative guidance of the Institutes ICAEW/ICAS and determined as "realised" profits/losses. For further details on the authoritative guidance, please refer to section 5.3.5 of this study report. Under such an approach, certain accounting treatments of IFRS would need to be assessed as unduly influencing the distribution capacity of the companies concerned. Companies are only affected if they use these specific accounting treatments. Experience from the interviews with UK companies shows a mixed picture: some UK companies were not at all affected and others suffered from the administrative burdens associated with these provisions [see section 4.1.5].

In Sweden, the management has to observe a "prudence rule" in addition to the balance sheet testing based on the 2nd CLD; Swedish company law obliges the management of Swedish companies to specifically review the financial situation of the company and, in a group situation, also of the group. This relates not only to the accounting results but also to the cash flow situation. Interviews with Swedish companies pointed to a moderate compliance effort in this regard. The "prudence rule" could also be applied to the determination of distributable profits based on IFRS individual accounts.

Both the UK and Swedish approaches go beyond a simple consideration of accounting frameworks and are rather embedded in company law.

Even though the direct use of IFRS for profit distribution purposes potentially allows for excessive distributions, it must be acknowledged that IFRS as such may not necessarily cause problems for companies in their capacity to distribute profits. For example, the experience with the Polish companies interviewed did not point to major problems in the use of IFRS for

distribution purposes. However, they were not subject to excessive fair value measurements compared to a historical cost approach. They only reported issues concerning the transition to IFRS with regard to the treatment of hyperinflationary effects [see section 4.1.3]. To this end, potentially critical situations did not arise with the Polish companies interviewed.

Assuming that IFRS represents a uniform accounting framework throughout the European Union, it could be argued that any solution concerning the flexibility for the use of IFRS would need to be determined at EU level, also in view of warranting a comparable minimum protection to creditors in all EU Member States. Another argument for an EU solution could be that any further reaching reform which alters the current capital regime of the 2nd CLD would at least require European consensus. On the other hand, it could be argued that individual EU Member States may be best positioned to individually determine the necessary changes to their national company law framework to achieve the flexibility in an effective and efficient manner, especially when the capital regime as embedded in the 2nd CLD remains untouched.

Finally, it must be noted that IFRS are still developing and it seems that the development tends – although not finally decided - towards an increasing use of fair values as a measurement basis. Such element should be kept in mind within the debate as to how IFRS accounting profits should be relevant for profit distribution and whether modifications – such as the introduction of non-distributable profits or reserves or additional solvency requirements – ought to be permitted or required at EU or Member-State level.

Introduction of a new regime

As part of this study project, we have been specifically asked to explain the effects of the introduction of a new regime. To this end, the study elaborates an array of options on how the system of the 2nd CLD could be adjusted in order to introduce an alternative to the current regime. This elaboration is based on capital regimes already existing in EU and non-EU practice as well as the models in literature. The presentation of these options is designed to find a competitive solution which will not overburden EU companies. However, this study is not intended to recommend a single model to be implemented as an alternative. The determination of such a model is the task of the institutions of the European Union in their role as legislator. At the same time, such consideration will need to include shareholder and creditor protection aspects.

To achieve flexibility regarding the implications of the use of IFRS for distribution purposes, it is intended to present the different degrees of reform to the 2nd CLD structured into different dimensions which provide basic lines of thinking. The dimensions discussed are possible amendments to the basic model of legal capital of the 2nd CLD and the design of solvency tests. Finally, there is a discussion concerning the introduction of true no-par value shares.

The potential amendments to the basic model of legal capital range from a limited change to the distribution rules via the introduction of a specific fiduciary duty in company law up to a full-scale reform of the 2nd CLD with the abolition of legal capital and the predominance of solvency tests in determining dividend levels [see also section 6.2.1].

Reform of the basic model of capital

Model 1a “Company option” – Based on a general fiduciary duty to be embedded in company law, the board of directors could decide whether the balance sheet test prepared under a certain accounting framework such as IFRS is adequate to present the basis for distribution. If necessary, the board is entitled to make adjustments in view of a realised profit for distribution purposes. The exercise of the fiduciary duty should also include a duty to review whether the current or prospective cash flow situation allows for such distributions. Such approaches can be found in the current practice of Delaware corporations and in Sweden, where a separate “prudence rule” is introduced in company law. Such fiduciary duty could be introduced at the EU or only Member State level.

Model 1b “Regulator option” – A central authority determines mandatory adjustments for certain accounting treatments under a specific accounting framework such as IFRS as they are considered as not adequate for distribution purposes. Such an approach can be currently found in the United Kingdom where the Institutes ICAEW and ICAS have issued various pieces of authoritative accounting guidance. Mandatory adjustments could be determined either at EU or Member State level.

Model 2 “IFRS solvency add-on” – An additional mandatory solvency test is introduced for all EU companies using IFRS for their individual financial statements. The remaining elements of the 2nd CLD are kept intact. This approach is favoured by the Lutter Group. Such an approach requires the introduction of a solvency test format at EU or only Member State level.

Model 3 “On equal terms” – A full scale reform abolishes the legal capital of a company and introduces a two-stage distribution test consisting of a balance sheet and solvency test which have the same importance as they must both be met. This basic approach is suggested by the High Level and the Dutch Group. An additional protective element could be a solvency margin as discussed by the High Level Group. Concerning the balance sheet test, the buffer of the legal capital of at least €25,000 would either fall away or be replaced by a solvency margin. The solvency test is introduced as a balancing element.

Model 4 “Solvency test predominance” – Again, a full scale reform abolishes the concept of legal capital. Within a two-stage distribution test, a solvency test must be met in any case. The balance sheet test does not constitute any restriction on distributions as long as the solvency test is met. In essence, this approach reflects the proposal of the Rickford Group. As a consequence, distributions based on a negative balance sheet test would be permitted if the cash situation allowed for this.

The design of solvency tests is for nearly all potential changes to the basic model of capital a crucial feature of a reform of the 2nd CLD. It determines to a large extent the economic burdens associated for companies. To this end, the options range from a fiduciary duty for directors to adequately determine the format of a solvency test up to a prescribed mid-term projection of future cash flows up to five years taking into account further future commitments [see also section 6.2.3]. The responsibility of the directors for this solvency assessment could be demonstrated to the general public via a solvency certificate. In this context, it must be noted that we have not included as another option a solvency test based on a long-term projection period. The reason for this is the fact that experience from the interviews conducted in all nine EU and non-EU countries has shown that reliable forecasts cannot usually be produced for time periods exceeding five years.

Solvency test models

Model 1 "Leave it to the companies" – A general fiduciary duty could require the board of directors of a company must justify a distribution from a cash flow perspective. As it is not exactly prescribed how the solvency test will have to be performed, companies can flexibly adapt the method to their financial situation. A company in good financial health with a comfortable cash position will not need to perform detailed testing in this regard; a company in financial distress may have to intensify its efforts in this regard. This approach has been particularly found with Delaware corporations.

Model 2 "Current ratios" – A comparison of current assets to current liabilities based on audited financial statements could be an easy way of fulfilling this requirement. This has been suggested by the High Level Group. It does not take account of a prospective look into the future where certain obligations may already be known.

Model 3 "Short-term projection" – A short term projection would cover at least the next twelve months of a company's life. Another important element is the inclusion of longer term commitments. This is the basic approach of the Rickford and Lutter Group where the Lutter Group would also see a two year period as appropriate for the detailed analysis.

Model 4 "Mid-term projection" – A mid term approach would cover the next three to five years of a company's life and would also include longer term commitments. The projection period stretches to the boundaries of the current company's practices and ability to project cash flows in most cases.

Finally, possible ways are considered for the introduction of no-par value shares which do not refer to a nominal or fractional value [see also section 6.3]. The 2nd CLD at present only recognises par value shares and shares with an accountable par. The options discussed are solutions which keep the current 2nd CLD mainly intact up to solutions which require a fundamental reform as they allow that the proceeds contributed could be generally used for distributions if specific tests like the solvency test or margin do not prevent this.

True no-par value shares

Model 1 "Protection of all proceeds from share issues" – This model maintains, as far as possible, the provisions of the 2nd CLD and places all proceeds from the issuance of shares under protection under a new balance sheet item "equity capital" similar to that applicable to subscribed capital. Amendments would be necessary apart from the abolition of the prohibition on below par issues in particular because of the total binding of the proceeds from the share issues. However, it should be noted that this solution would, in some EU Member States, represent a considerably more onerous solution than the present one. The reason is that it is admissible in certain EU Member States that premiums be used to cover losses. This possibility would be lost if premiums were bound under the item "equity capital".

Model 2 "Variable capital" - This model is characterised by the fact that the proceeds of the share issue are not completely contributed to a protected equity capital item but to an only partially protected reserve. In this model most of the provisions of the 2nd CLD could remain intact. Amendments apart from the abolition of the prohibition on below par issues would be necessary in particular because of the different binding of the proceeds from the share issues. Furthermore, it should be noted that the reserves can be – under certain circumstances - reduced to zero.

Model 3 "Mixed model" - According to the mixed model, subscribed capital is formed on the foundation of the company, and the proceeds of the share issue are entered as such, until the minimum capital or a higher amount prescribed by the statutes is reached. Above that figure, the issue proceeds are no longer treated as subscribed capital but can be entered as reserves. This model leads to the necessity to have various procedures in place depending on whether the proceeds of the share issue are attributed to, or should be removed from, the subscribed capital or the reserves. Amendments to the 2nd CLD are – in addition to the introduction of the abovementioned different procedures and the abolition of the prohibition on below par issues – necessary as also this model leads to changes in the binding of the proceeds of the share issue. Furthermore, it should be noted that in this model less of the proceeds could flow to the subscribed capital than under the 2nd CLD.

Models 4 and 5 "Total abolition of legal capital" – These two models protect the proceeds of the share issue not by the prevention of distributions but by admitting its distribution under certain conditions, namely a balance sheet and/or solvency test or solvency margins. As, in this model, no-par value shares would be in a completely different environment, a full revision of the 2nd CLD would be necessary in practice, although this would not be due to the introduction of no-par value shares as such.

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