

MANDATORY RULES ON FINANCIAL SITUATION, DIVIDENDS DISTRIBUTION AND FAIR VALUE ACCOUNTING IN THE EU IRFS REGULATION

*Andrea Lolli**

Abstract

The objective of this work is to show that the financial situation of a company and its future evolution are legally relevant when the distribution of dividends are concerned and if the company wants to avoid –as an exception to the general rule- the application of fair value criteria. This I will argue is the case despite the fact that the EU has still not chosen to introduce a solvency test either as an alternative or as an additional system-to legal capital. The going concern principle as stated in Fourth Council Directive 78/660/EEC of 25 July 1978, and the financial information requested as part of the balance sheet by the EU Directive 51/2003, are the legal elements obliging the company to take into consideration the financial situation when the above mentioned decision is taken, in order to avoid liability for a decision which is inconsistent with the financial situation. The financial situation of the company is now particularly relevant for companies choosing to avoid the appliance of fair value criteria to financial instruments, as that choice presumes the ability to wait to sell that instrument on the market and that ability is very much dependent on the financial resources and the financial needs of the company.

Keywords: legal capital, financial situation, dividends fair value

**Associate professor of commercial and bankruptcy law in Ferrara University*

I. Financial (or solvency) test and legal capital

In the last years the EU has been considering the idea of reforming the legal capital system.

The discussion has its origins in the years leading up to the financial crisis, and was based on the belief that requiring a minimum amount of legal capital to start a business would needlessly prevent, some businesses from coming into existence¹.

The maintenance of a minimum capital amount during the life of a company could – according to this line of thinking - unnecessarily limit the distribution of dividends and impede the use of financial resources that could be put to better use².

¹ Doing Business Report. 2009, p.12. © 2008 The International Bank for Reconstruction and Development / The World Bank 1818 H Street NW Washington, DC 20433 One of the elements that contribute to the improvement of the legislation regarding starting a business is, from the doing business point of view, abolishing or reducing the requirement of legal capital.

² ENRIQUES MACEY, *Creditors versus capital formation: the case against the European legal capital rules*, 86, *Cornell l.rev.*, 2001, p. 1165 ss.

It is clear that this support for a change to the system of legal capital, by removing every mandatory rule, is very market-driven, in the sense that the amount of capital necessary for a company is determined by the market itself: if a company offers too low a capital to cover its obligation the market will judge that company to be untrustworthy, and will deny that company access to credit and commercial relations.

The theme of promoting company efficiency has already determined the setting of new rules from the EC, through the EC directive 2006/68, rules which are influenced by the view “that a simplification and modernization of directive 77/91 EEC would significantly contribute to the promotion of business efficiency and competitiveness without reducing the protection offered to shareholder and creditors”.

This was intended to be the first step towards a general examination of the feasibility of alternatives to the capital maintenance regime which would still adequately protect the interest of creditors and shareholders.

Following that line of thought, the EU commissioned KPMG to carry out a study to evaluate the feasibility of an alternative to the current regime of legal capital established by the 2nd company directive and to examine the impact of International Financial Reporting Standards on profit distribution.

The main report was delivered and published at the beginning of 2008, in a situation very different from the one in which the EU had commissioned the study on legal capital³.

The European Commission Directorate General for Internal Market and Services summarised the main findings of the KPMG Report as follows (EC 2008, p1-2):

a) The current minimum legal capital requirements and rules on capital maintenance do not constitute a major obstacle to dividend distribution.

b) As to dividend distributions, they are prohibited if the balance sheet test is negative. This leads to the question as to whether it would not be more appropriate to replace this test by a solvency one or at least to permit the application of a solvency test as an alternative. In this regard, the study shows that: EU Member States can introduce an additional solvency test. Most existing academic proposals to amend the 2nd Directive refer to the necessity to add a solvency test to a balance-sheet test.

Several Member States have required or permitted the application of IFRS for individual accounts without resulting any apparent difficulty in the distribution of dividends.

c) As to the problem if the balance sheet test (based on historical cost accounting in accordance with the 4th Accounting Directive) has become inadequate for deciding whether the company has sufficient reserves for it to make distributions to shareholders, following the adoption of International Financial Reporting Standards, from the results of the study it emerges that the 2nd Company Law Directive is a flexible instrument insofar as it requires a limited amount of legal capital. Moreover, under the Second Company Law Directive, Member States remain free to require or allow companies to prepare individual IFRS-based accounts for dividend distribution purposes.

d) Moreover, the Second Company Law Directive already allows Member States to adopt some of the solvency-based systems existing outside the EU as well as some of the alternative proposals for reform, except the possibility to distribute profits in the presence of a negative balance sheet. Finally, it appears from the study that the compliance costs of the 2nd Directive are rather limited, and no higher than those required by the alternative regimes outside the EU.

e) In the light of the conclusions of the external study, the view of DG Internal Market and Services is that the current capital market regime under the

Second Company Law Directive does not seem to cause significant operational problems for companies. “Therefore no follow-up measures or changes to the Second Company Law Directive are foreseen in the immediate future.” (EC 2008 p.2)

It is obvious that the world financial crisis, partially caused by an excessive use of debt by companies unable to pay back the money lent, and the consequent financial crisis that affected the financial system has completely changed the perspective on proposals for a reform of legal capital.

The problem seems no longer to be if legal capital is an unnecessary limit to distribution of dividends but, on the contrary, if the legal capital system is sufficient to protect shareholders and creditors.

From that new and - opposing - point of view, it becomes obvious that the problem is not whether to abolish the system of legal capital but how to complement that system with another, which will be more effective in preventing a distribution which could compromise the life of the company as a going concern.

The same change of opinion has taken place with regard to the effect of the IFRS on the account used to provide dividend distribution.

When the IFRS was introduced through Regulation (EC) No. 1606/2002, the problem seemed to be how to prevent the distribution of dividends by the application of the financial reporting standards which allow for the evaluation of assets through the fair value principle.

Up until the beginning of the financial crisis, in a context of rising prices and economic expansion, the application of the fair value principle was seen as a potential danger because of its influence on the determination of the profit and loss account, notwithstanding the fact that the increase in value determined by that criteria is not realized.

The start of the financial crisis, and the fact that the market value –or the fair value- of many assets has fallen dramatically has altered the problem, forcing us to consider how to prevent a devaluation of assets that may seem too punitive, when judged against an untrustworthy market situation in the throes of an exceptional financial crisis.

It is obvious that the market efficiency principle, the central dogma behind a call for a deregulation of legal capital rules, and which gave strength to the adoption of the fair market value criteria, is now up for discussion.

I have not come across any study on the effect of speculation on the financial market. However, I would argue that the unjustified growth in value creates both a speculative bubble and an unjustified drop in market value of enormous proportions. It was this which ultimately pushed the market to the edge of collapse, avoided only through huge State and central bank intervention, proving that the market is not able

³Contract ETD/2006/IM/F2/71. 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. Main Report.

to regulate itself and that the “greed is good” philosophy presents serious dangers for the market and tends to distort value.

Moreover, most of the problem was created by the same subjects – directors and managers of financial companies who controlled the financial market, but who, however, came through the storm with earnings as big as their mistakes.

This fact seems to completely contradict the concept of market efficiency, if by market efficiency we intend that the market rewards those who make the right decision and punishes those who make the wrong one.

II The EU rules that give a legal status to the financial situation of the company and its evolution

In view of recent happenings in the financial world, and with regard to the two problems referred to in our introduction we will now examine the following issues:

a) Apart from any change to the rules on legal capital, should the actual set of mandatory rules make it compulsory to take into consideration the overall financial situation, especially when distributions are concerned and whenever the directors have to deal with a decision that involves the maintenance of a going concern ?

b) How should we deal with the fair value principle, bearing in mind that the market and the values determined by the market cannot always be trusted.

I think that the answer to the first question is yes. The relevant data can be found both in the rules and in the accounting principle related to the going concern principle and in directive 51/2003.

The going concern principle⁴ is one of the basic assumptions that must be made in order to proceed with the preparation of the balance sheet of any company which is not deemed to be in liquidation.

The widely-accepted assumption that the legal entity is continuing its business activity, obviously justifies the evaluation of the company as one not in liquidation, but rather as an entity that is continuing to operate as a going concern.

The opportunity to continue the business activity is based on the assumption that the legal entity is in a financial condition to continue doing so, that, the company will be able to generate and/or raise enough resources to stay operational.

The lack of the financial resources necessary to cover one’s debt is a condition that, for most national EU legislation, as examined in KPMG Report on

capital maintenance, places the legal entity in a condition of insolvency which is –by definition– incompatible with the carrying on of business activity. The relationship between the going concern principle, the availability of the financial resources necessary to cover one’s debt and the solvency situation of the company seems to imply that at least once a year - whenever the company is required to produce a balance sheet- it should implicitly declare that it is in a condition to cover its own debt .

The declaration must obviously be true at the time it is produced but the object of the declaration should also necessarily take into account a successive period of time. The assumption that the company is able to pay its debt is based on the debt that exists when the declaration is made. The debt, however, must be paid at a future date.

So, that declaration, necessary implies that the company has or will have at the due date, the money necessary to pay its debt.

On that issue IAS 1 requires that in evaluating the existence of a going concern perspective, the directors must take into account all information available on the future of the legal entity, a future that should at least take into consideration the twelve month period following the day on which the balance sheet is closed⁵, .

The other legal source that confirms my belief that it is essential to take into account the future financial situation of the legal entity, is the EU Directive 51/2003, that states that the annual report must include at least a fair review of the development and performance of the company’s business and of its position, together with a description of the principal risks and uncertainties that it faces, that the review shall be a balanced and comprehensive analysis of the development and performance of the company’s business and of its position, and finally, that to the extent necessary for an understanding of the company’s development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including

⁵ IAS 1 PAR. 26 “In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, the entity may reach a conclusion that the going concern basis of accounting is appropriate without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate”.

⁴ That is part of the accounting EU legal system starting from art.31 Fourth Council Directive 78/660/EEC of 25 July 1978.

information relating to environmental and employee matters.

The reference to a necessary analysis of the development of the financial situation, and the further references to key performances indicators, confirm that the relevance of the future evolution of the financial situation of the company as an element that must be taken into account every time the balance sheet is prepared and that the nature of that evaluation is to be done with reference to some criteria that are not completely stated in accounting principle and rules.

First of all, it seems to me that the IFRS provision regarding the going concern principle, and the Directive provision requiring a description of the evolution of the financial situation as part of the balance sheet, further confirms the relevance of that situation in any related decision to distribute dividends, a decision that is usually taken immediately after the approval of the balance sheet.

I think that any distribution of dividends which can endanger the continuance of the company as a going concern is unlawful, as the dividends are determined according to a balance sheet that was prepared on the presumption of the existence and the continued maintenance of that position in the following 12 months.

The assumption which is made by directors at the time of preparing the balance sheet on the continuance of the company as a going concern in the following 12 months inhibits them –in my opinion– from taking a decision that would risk invalidating that assumption. If the directors were to generate a more negative future situation of the company, they to a certain extent undermine the current assumption that the company is a going concern.

On this point it seems clear to me, that the need to maintain the financial situation of the company as declared at the moment of the preparation of the balance sheet is certainly relevant from a liability perspective, since any decision taken that affects the maintenance of that situation must have wider legal implications.

Secondly, it seems to me that the IAS/IFRS and accounting legislation are solely focused on the actual situation of the company at the time of preparation of the balance sheet, and not on the future evolution of that situation. The key performance indicators are not, in fact, defined by accounting principles, and the accounting principles are not stated in terms of describing the future evolution of the company or taking into account the future evolution of the financial situation.

If –as is now the case– it is not only the current situation of the company that matters, but how that situation evolves, it will then be necessary to identify and adapt the rules which are necessary to make that prediction and to state what are the key performance indicators that must be taken into account. That means

using technical instruments and rules that are to be found, at the moment, outside the accounting discipline.

III. The evolution of the financial situation of the company and the suspension of the fair value principle

The above-mentioned doubt regarding the real trustworthiness of the values determined by the financial market justify, from my point of view, the consequent call for a suspension of the appliance of the fair value criteria on every occasion –and the financial context in which we now find ourselves is certainly one of those occasions – where it is clear that the value expressed by the market all too often does not represent the “true” value of the quoted financial instrument.

This position has already been taken under consideration by SEC on a mandate by the United States Congress⁶, which is considering suspending the application of the fair value principle, when markets are particularly depressed, taking the view that fair value understates the “true economic value” of financial instruments, leading to concerns regarding fair value accounting resulting in “procyclicality.

In October 2008, the IASB amended IAS 39, *Financial Instruments: Recognition and Measurement*, and IFRS 7, *Financial Instruments: Disclosures*.³²⁶ The amendments permit non derivative financial assets held-for-trading and AFS financial assets to be reclassified in particular situations. The amendments permit an entity to reclassify non-derivative financial assets out of the fair value (through profit or loss) category in particular circumstances. The amendments also permit an entity to transfer from the AFS category to the loans and receivables category a financial asset that would have met the definition of loans and receivables (if the financial asset had not been designated as AFS), if the entity has the intention and ability to hold that financial asset. The IASB noted that the reclassification of securities and loans under U.S. GAAP is available in certain circumstances and that entities applying IFRS did not have that option of reclassification. The amendments issued bring IAS 39 more in line with U.S. GAAP, particularly SFAS No. 115 and SFAS No. 65.

⁶ Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting office of the chief accountant division of corporation finance United States securities and exchange commission. Report by the Staff of the U.S. Securities and Exchange Commission.

This amendment was effective retroactively back to July 1, 2008 and that position was under discussion in the EU and in the area of application of the IFRS, on the double consideration that now not only has it been proved that market values are untrustworthy but that not inhibiting the application of that principle would put the EU companies in a worse position than that of enterprises subject to the US standards.

On November 30, 2009, Commission Regulation EU nr. 1171/2009 was approved, accepting amendments of IAS 39 and of IFRIC nr.9.

The disapplication of the fair value criteria when it is doubted that the value represented by the market is truly accurate, presumes that the assets involved in the disapplication are not to be sold or put on the market until the condition of the market changes.

This depends on –at least - two element, the first of which is the contents of the financial instruments, which must obviously be compatible with the continuance of the financial instrument in the ownership of the company.

The second element relates to the situation of the company, which must be in a position to maintain the financial instrument in its ownership. This is possible only if the financial situation of the company permits it to wait to sell the financial instrument until the market improves.

In conclusion. I would argue that thiis conclusively demonstrates the legal importance of taking into consideration the financial situation of the company, and particularly the ability of the company to maintain itself as a going concern in the longer term, that is, if the company is to avoid the application of the fair value criteria on financial assets in a depressed market situation.