

## **A PROPOSAL TO ALLEVIATE PROBLEMS WITH DISTRIBUTABLE PROFITS THROUGH AMENDMENTS TO THE FOURTH COMPANY LAW DIRECTIVE**

### **Introduction**

The ICAEW supports amendment of the Second Company Law Directive to permit Member States to implement an optional alternative solvency-based regime under which distributions would be determined by reference to the effect of distributions on company solvency and the need to preserve the company as a going concern. However, if this is not possible in the short term, it may be possible to alleviate many (although not all) of the problems of applying the current law on distributions through some simple changes to the Fourth Directive. This paper sets out proposals for such changes for further consideration.

In summary, the effect of these proposals would be that all profits recognised for financial reporting purposes would be distributable, without reference to any additional test of whether or not they are 'realised'. However, in the UK, existing common law duties of directors should prevent payment of dividends which are imprudent in terms of the company's ability to pay its debts when they fall due, and the recent FEE paper on Capital Maintenance suggests that similar duties apply in most EU Members States. The UK position is considered further below.

There is almost certainly significant divergence of practice within the EU concerning how the requirement that profits must be 'realised' is interpreted in practice. The Fourth Directive is a minimum harmonisation directive and therefore other Member States would be free to retain the existing requirements and interpret them as they have done in the past. For example, in France it isn't necessary to have a profit at all in some cases; rather, share premium may be distributed.

### **Explanation of the present law and proposed amendments**

Article 15 (1) of the Second Directive states that:

- c) The amount of a distribution to shareholders may not exceed the amount of the profits at the end of the last financial year plus any profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed to reserve in accordance with the law or the statutes.

The Article refers only to profits and does not impose any requirement that those profits should be 'realised' profits. Therefore, taken in isolation, the Second Directive appears to permit the distribution of any 'profits'. However, this requirement has been interpreted in the past to mean that only those profits which may be included in a company's profit and loss account are available for distribution. It is therefore

necessary to have regard to the requirements of the Fourth Directive which deals with the preparation of individual accounts.

The relevant requirement of the Fourth Directive is Article 31 (1) (c) which includes the following:

1. The Member States shall ensure that the items shown in the annual accounts are valued in accordance with the following general principles:

- (a) .....
- (b) .....
- (c) valuation must be made on a prudent basis, and in particular:
  - (aa) only profits made at the balance sheet date may be included,
  - (bb) .....

This paragraph appears to be dealing with the valuation of assets. However, (aa) is generally interpreted to mean 'only profits made at the balance sheet date may be included in the profit and loss account'. In particular, this is the way that it has been incorporated into UK company law in what is now paragraph 12 of Schedule 4 to the 1985 Act.

Also, the paragraph in the Directive refers to 'profits made' rather than 'profits realised' which is the expression used in paragraph 12 of Schedule 4. It is understood that the term 'realised' was used because it was thought to be closer in meaning to 'realise' which was the word used in the original French version of the Directive. This was clearly intended to be more restrictive than profits 'made' because the law makes reference to unrealised profits as well as realised profits.

Article 33 (2) (c) of the Fourth Directive also refers to realisation and provides that:

The Member States may lay down rules governing the application of the revaluation reserve, provided that transfers to the profit and loss account from the revaluation reserve may be made only to the extent that the amounts transferred have been entered as charges in the profit and loss account or reflect increases in value which have been actually realised. These amounts must be disclosed separately in the profit and loss account. No part of the revaluation reserve may be distributed, either directly or indirectly, unless it represents gains actually realised.

It is an anomaly that the Fourth Directive, which seeks to regulate financial reporting rather than distributions, includes this restriction on the distribution of the revaluation reserve. The requirement applies to all companies, even though EU law on capital maintenance in the Second Directive applies only to public companies. It is also inconsistent with the position of the fair value reserve which arises under the fair value accounting rules (see below) where no such restriction is imposed by EU law.

The Fourth Directive was amended in 2001 to include the fair value accounting rules which permit accounting in line with IAS 39, IAS 40 and IAS 41 although subsequent changes to IAS 39 have introduced some inconsistencies. Article 42c provides that:

- 1. Notwithstanding Article 31 (1) (c), where a financial instrument is valued in accordance with Article 42b, 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

Therefore, profits arising from fair value accounting may be included in the profit and loss account irrespective of whether they are realised.

It is therefore proposed that:

- Article 31 (1) (c) should be amended to delete the requirement that only profits made at the balance sheet date may be included [in the profit and loss account];
- Article 33 (2) (c) should be amended to remove the restriction on transfers out of the revaluation reserve and distribution of the revaluation reserve to amounts that are 'actually realised'; and
- the words 'Notwithstanding Article 31 (1) (c)' at the beginning of Article 42c (1) can therefore be deleted because they become redundant.

### **Further background to the current law**

The introduction of these requirements into UK company law in 1980 was probably not seen as contentious at the time. It went further than required by the Second Directive in that it applied the rule about realised profits to private as well as public companies. However, it replaced some conflicting and confusing case law on the subject and so it brought some welcome clarity without, in the context of accounting practice at the time (as explained below), imposing significant burdens on companies.

It appears that the intention at the time was that realised profits were those profits that would be recognised in the profit and loss account. Guidance issued by the Institute in 1982 (TR 481) stated in paragraph 10 that:

A profit which is required by statements of standard accounting practice to be recognised in the profit and loss account should normally be treated as a realised profit, unless the SSAP specifically indicates that it should be treated as unrealised.

Tolley's guide to the Companies Act 1980 provided the following explanation which is helpful to an understanding of how these requirements were understood when they were first introduced:

In all those circumstances that are not specifically covered by the Act, the determination of whether a profit or loss is realised or unrealised must be made in the light of best accounting practice. This means that only profits made at the balance sheet date should be included in the financial statements. They should not be anticipated and, therefore, in accordance with the prudence concept, they should be included in the financial statements only when they are earned and ascertained. Profits should be recognised by being included in the profit and loss account. Therefore, they will be available for distribution only when realised in the form either of cash or of other assets, the ultimate cash realisation of which can be assessed with reasonable certainty.

Therefore it can be seen that the current law was relatively easy to apply when it was introduced because the test of what one could distribute was framed in terms that matched the then current accounting practice as to what could be recognised in the accounts. A profit shown in the profit and loss account could be used to pay a dividend. TR 481 refers to an exception in those cases where an accounting standard

specified otherwise but there were no such instances at the time of its publication (SSAP 1 having been amended to remove one which did exist). The position is very different today and often imposes onerous burdens on companies.

### **Advantages and disadvantages of the proposed approach**

Although the objective of the proposed changes to the Fourth Directive is to simplify the law on distributions, they have a potential effect on financial reporting. The inclusion of unrealised profits in the profit and loss account will no longer be prohibited as a matter of law. However, this is not seen as a problem because:

- The principle has already been breached by the changes introduced by the Fair Value Directive and no such requirement is imposed on companies reporting under IFRSs. For example, if UK GAAP were converged with IAS 40, fair value gains on investment properties would be reported in the profit and loss account even though they would be regarded as unrealised;
- Member States can retain the more restrictive approach if they consider it appropriate in their own jurisdiction; and
- In the UK, accounting standards issued by the Accounting Standards Board regulate the reporting of profits and other gains so there is little scope for abuse through a relaxation of the law. Indeed, such a change may help to remove obstacles to the UK adopting standards that are converged with IFRSs.

Turning to distributions, it might be said that it is 'not prudent' to distribute profits that are unrealised. This has been the traditional point of view. However, when the current law was established, there was generally no difference between the profits that were reported in the profit and loss account and those that would be regarded as realised. This is no longer the case as shown by the extensive guidance that has become necessary on the interpretation of 'realised profits' under the current law. The fact that there is no longer a one for one correspondence between profits for financial reporting purposes and profits for distribution purposes imposes an onerous burden on many companies. This needs to be addressed.

The arguments that support a move to a solvency-related basis for the payment of dividends are not repeated here. However, those arguments also demonstrate that the protection of creditors afforded by the current statutory regime is somewhat limited; it may be argued that modifying the current regime to allow distribution of all profits, not just realised profits, would not make it significantly more limited, but would alleviate the operational problems.

For example, some might take the view that the distribution of the remeasurement gains on an investment property should not be distributable as a matter of prudence. However, few would question that a profit on the sale of the property for cash should be available for distribution (after taking into account the usual factors such as losses on other transactions etc). However, there is nothing to stop the company reinvesting the proceeds in another property (provided the linkage rules of TECH 7.07 are not breached) and subsequently borrowing money from a bank to pay the dividend. In terms of liquidity, the company is in the same position as if it had not sold the property. In this case the counter-argument might be suggested that at least in the re-investment case the amount of the profit/gain was measured by reference to a third party transaction. However, this is arguably a dated view. If assets (and in some cases

liabilities) can be measured with sufficient reliability to meet the requirements of accounting standards is there any need to differentiate the profits?

Directors would, of course, have to consider the solvency of the company before paying a dividend even if there was no formal requirement for a solvency statement. In the UK, the directors have a common law duty not to distribute capital. They also have a fiduciary duty to ensure that the company is in a position to settle its debts as they fall due. This is likely to be the case elsewhere in the EU but it would be open to a Member State to impose similar obligations as part of a package of reform if it did not already exist in their jurisdiction.

If the changes proposed in this paper are adopted, the question arises of whether they should be accompanied by the introduction of some form of solvency statement as a quid pro quo for the relaxation of the prohibition on distribution of unrealised profits. This does not appear to be appropriate. Rather what is proposed is a short term change to the current test of increases in net assets, so that all net asset increases are distributable and not just some; as a matter of principle this is neither better nor worse at protecting creditors, but it is simpler and therefore less costly to operate; accordingly, this isn't a fundamental shift of principle; and it would be inappropriate to attempt to introduce some element of a solvency regime into it both because it is only modification within the current regime, rather than a change in it, and because the effort required to build consensus in Europe on solvency needs to be spent with the longer-term fundamental change in mind and not hold up this short-term change.