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ELI Guidance on Company Capital and Financial Accounting for Corporate Sustainability

Report of the European Law Institute

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Report of the European Law Institute

The European Law Institute

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Executive Summary

Environmental, social and governance (ESG) considerations rank high on the EU agenda. These considerations concern broad matters pointing to the sustainable and responsible long-term relationship of companies with stakeholders, society and nature. The EU has developed the European Green Deal, taking an active role in the global momentum towards fostering and facilitating sustainable business conduct.

In this context, an important and timely debate is ongoing as to how companies could and should be sustainable and responsible for the benefit of business and society at large. As a matter of fact, it is quite evident that only financially robust companies may be able to afford the pursuit of corporate sustainability over time and circumstances.

The present contribution to this debate draws upon this common sense assumption, pointing to the relationship between corporate sustainability, company law and financial accounting. Company law requirements concerning equity capital management could benefit from reform to facilitate corporate sustainability. Financial accounting and reporting further provide convenient legal-economic instruments to control company capital management and encourage sustainable business conduct over long-term horizons and planning.

On this basis, the ELI Guidance proposes a set of Recommendations on company capital and financial accounting for corporate sustainability aimed at: (i) providing a frame of reference and analysis to understand corporate sustainability in the context of business and law; (ii) pointing to specific issues which need to be addressed by European and national lawmakers and regulators; and (iii) establishing a set of company law instruments which set out possible solutions to cope with these issues.

The Recommendations aim at restating and modernising well-established principles of European company law on: (i) distributions; (ii) equity capital maintenance; and (iii) non-distributable reserves. Specific attention was paid to the enhanced controlling of new kinds of distributions such as share buybacks, as well as to limiting distributions of non-realised gains. The Project Team developed a comprehensive set of Recommendations aimed at fostering and facilitating sustainable business conduct through responsible company capital management and financial accounting adjustments. Further Recommendations were provided on related policy and regulatory matters concerning the EU framework for corporate sustainability.

As a whole, the Recommendations propose that companies commit to a prudent use of resources, by setting aside sufficient reserves to meet social and environmental commitments over long-term horizons, and establish a fair balance between these commitments and distributions to shareholding investors. Corporate sustainability may be enhanced by implementing controls over distributions while reinforcing reserve provisioning. This in turn will ensure company continuity and resilience, as well as financial stability and sustainable development for the benefit of business and society at large.

In conclusion, the Recommendations provide comprehensive guidance aiming at: (i) contributing to the regulatory and legislative work on company law at EU and Member State levels, especially on prudential capital management and distributions to shareholders; (ii) clarifying the duties of directors and auditors, and in so doing providing them with the legal certainty they need to discharge their obligations toward the company and society, while promoting the voluntary adoption of sustainable business conduct; (iii) clarifying key policy options for accounting law, while proposing specific accounting adjustments (similar to tax law), with a view to disclosing the financial impact of social and environmental commitments. Consequently, the Recommendations seek to enhance mutual trust across Europe by proposing a common basis for the convergence of national regulations, with a view to harmonising, clarifying and improving the implementation of company law, corporate governance and corporate reporting (both financial and non-financial) provisions dealing with sustainable business conduct. In particular, they aim at contributing to EU and national law on sustainable corporate governance, corporate sustainability due diligence, and non-financial reporting, while promoting sustainable business conduct by corporate management.

List of Abbreviations

CSER	Corporate, social and environmental responsibilities
CSRD	Corporate Sustainability Reporting Directive
DEBRA	Debt-Equity Bias Reduction Allowance
EFRAG	European Financial Reporting Advisory Group
ESG	Environmental, Social and Governance
ESRS	EU Sustainability Reporting Standards
IAS (see also IFRS)	International Accounting Standards
ICAEW	Institute of Chartered Accountants in England and Wales
IFRS (see also IAS)	International Financial Reporting Standards
NFRD	Non-Financial Reporting Directive
OCI	Other comprehensive income

ELI Guidance on Company Capital and Financial Accounting for Corporate Sustainability – Overview

P

Preamble

The ELI Guidance on Company Law and Financial Accounting for Corporate Sustainability aims to restate and modernise well-established provisions of European company law on: (i) distributions; (ii) equity capital maintenance; and (iii) non-distributable reserves, with a view to fostering and facilitating sustainable business conduct through responsible company capital management and financial accounting adjustments. Its overall aim is to secure company continuity and resilience, as well as financial stability and sustainable development for the benefit of business and society at large.

As a whole, it recommends that companies commit to a prudent use of resources, by setting aside sufficient reserves to meet social and environmental commitments over long-term horizons, and establishing a fair balance between these commitments and distributions to shareholding investors.

It aims at contributing to further harmonising, clarifying and developing European and national law on company law, corporate governance, and corporate reporting (both financial and non-financial).

It also aims at promoting sustainable business conduct by corporate management through voluntary adoption, while clarifying the duties of directors and auditors. By developing specific accounting adjustments (similar to tax law), the Recommendations facilitate the disclosure of the financial impact of social and environmental commitments, thus enhancing legal certainty for directors and auditors discharging their fiduciary duties toward the company and society.

1

Recommendation 1: Sustainable basis for distributions

Distributions (pay-outs), in whatever form (including dividends in cash, in kind or in shares, as well as share buybacks), should be submitted to a dual test:

(a) Before distribution: sufficient realised accumulated distributable profits, or net accumulated distributable reserves should exist; and

(b) After distribution: shareholder equity must equal at least legal paid-in share capital and accumulated non-distributable reserves.

2

Recommendation 2: Share premiums

Share premiums and related reserves should be treated as legal capital and subjected to the same rules, including restrictions on distributions and capital reduction.

3

Recommendation 3: Minimum equity capital protection

Equity capital maintenance:

(a) should include, but not be limited to, legal paid-in share capital and legal reserves;

(b) should comprise all reserves needed to facilitate corporate sustainability, including those needed for the discharge of social and environmental responsibilities; and

(c) may include all reserves defined as non-distributable under these Recommendations.

4

Recommendation 4: Legal reserves (prudential approach)

(1) Legal reserve requirements may be based upon total shareholder equity (including premiums) as defined by these Recommendations. The minimum annual allocation of net earnings to this legal reserve (share of net profits) may be prescribed by law (public order) or by the general meeting on the board's recommendation (private order).

(2) Minimum legal reserve requirements should be based upon total shareholder equity capital, not only legal share capital. Consequently, whenever a minimum level of legal reserve is required, it should be based upon at least the legal share capital plus premiums, and should be prescribed by law or the general meeting on the board's recommendation.

5

Recommendation 5: Restriction on distributions (prudential approach)

(1) Restrictions on distributions to shareholders (typically dividends and buybacks) may be established if reserves are below a certain threshold (as is the case in regulated sectors, such as banking and insurance).

(2) The maximum amount of annual distributions may be fixed either by law or the general meeting on the board's recommendation. This amount may be inferior to the total maximum amount that is permissible to distribute by existing company law provisions, thus establishing an ongoing general reserve provisioning mechanism.

6

Recommendation 6: Non-realised gains on certain accounting measurements

Non-distributable reserves should be established against non-realised gains arising from certain accounting measurements based upon current values. These measurements include:

(a) other comprehensive income (OCI) arising from the revaluation option for tangible assets (International Accounting Standards (IAS) 16) or intangible assets (IAS 38);

(b) unrealised gains on investment properties recognised in net income (IAS 40);

(c) OCI arising from the measurement at fair value of certain financial instruments and cash flow hedge instruments (IFRS 9/IAS 39);

(d) unrealised gains on certain financial instruments recognised in net income (IFRS 9);

(e) OCI arising from actuarial gains on a defined benefit plan (IAS 19); and

(f) OCI and net income arising from the effect of changes in foreign exchange rates (IAS 21).

7

Recommendation 7: Provisions

Non-distributable reserves should be introduced against the current value measurement of provisions, at least for those implied by social and environmental responsibilities. A more extensively prudent application may cover all the provisions.

8

Recommendation 8: Capitalised costs for start-up

Non-distributable reserves for capitalised start-up costs should be established.

9

Recommendation 9: Capitalised costs for development

Non-distributable reserves for capitalised development costs should be established.

10

Recommendation 10: Deferred tax assets

Non-distributable reserves should be established against non-realised gains recognised in either other comprehensive income or net income, arising from deferred tax assets.

11

Recommendation 11: Subsidiaries accounted for under the equity method

Non-distributable reserves may be established against initial investment and holding gains from investments in subsidiaries, which are accounted for under the equity method, net of actual paid dividends.

12

Recommendation 12: Sales and leaseback operations

Non-distributable reserves should be established against sale-and-leaseback and other operations which result in non-permanently accrued revenues.

13

Recommendation 13: Whole group sustainability

(1) The corporate group as a whole should provide a prudential guarantee and incur a related liability when resources are transferred between its dependent companies.

(2) This group guarantee and liability may not only cover the amount of transferred resources, but also the company's social and environmental obligations, which may become due over time and circumstances.

(3) The group guarantee and liability should be provided at least over the timeframe of related obligations.

14

Recommendation 14: Management of own shares

When own shares are acquired, regardless of the accounting representation used for their acquisition, the following should apply:

(a) the equity reserve matching own shares held outstanding should be non-distributable and based upon the acquisition value and holding gains at current values. The legal nominal value is not the basis to compute this reserve;

(b) any purchase of shares to be held in treasury has to be made out of distributable profits, which will be reduced by the amount of the purchase price; and

(c) when shares are sold, if the proceeds of the sales are higher than the purchase price, the positive difference should be held in the premium reserve.

15

Recommendation 15: Accounting for business combinations

A non-distributable reserve should be established against goodwill. Negative goodwill should not be distributable.

16

Recommendation 16: Sustainability in leveraged operations

In order to foster a level playing field concerning corporate sustainability with regard to national and cross-border operations, European and national law should introduce, or at least encourage Member States to introduce, legislation to ensure corporate sustainability of both national and cross-border leveraged operations to supplement the existing rules on financial assistance.

17

Recommendation 17: Content of the draft terms of cross-border operations

The European and national provisions on the draft terms of cross-border operations should be supplemented by adding an item concerning the likely repercussions of the operation on long-term corporate sustainability of the companies involved in the transaction.

18

Recommendation 18: Content of the report of the administrative or management body

With regard to cross-border operations, the European and national provisions on the report of the administrative or management body for members and employees should include, in the section for the members, an item outlining the implications of the cross-border operation for the corporate sustainability of the companies involved in the transaction.

19

Recommendation 19: Content of the independent expert report

With regard to cross-border operations, the European and national provisions on the independent expert report of the cross-border operation should be modified to include the expert's opinion as to whether, in view of ensuring the corporate sustainability of the companies involved in the transaction, the information the administrative or management body provided to the members in its report is reasonable and has been independently verified.

20

Recommendation 20: Scrutiny of the legality of cross-border operations

For the purposes of the application of the European and national provisions on the scrutiny of the legality of cross-border operations, in addition to verifying the respecting of the rules aiming at protecting members and creditors, among the abusive or fraudulent purposes that cross-border operations could be used for, the risk of circumvention or evasion of EU and national rules aimed at ensuring corporate sustainability should also be considered.

ELI Guidance on Company Capital and Financial Accounting for Corporate Sustainability

1 Introduction

1.1 The Report's Contribution to Fostering and Facilitating Sustainable Business Conduct in Europe

The EU has developed the European Green Deal,[1] taking an active role in the global momentum towards fostering and facilitating sustainable business conduct.[2]

In this context, the ELI Guidance lays down a set of company law Recommendations, which provide guidance on company capital management as well as its accounting and related reporting, disclosure and supervision, with a view to facilitating responsible company management and sustainable corporate governance. The Recommendations also include guidance on financial accounting adjustments needed for their application and enforcement.

According to Goode et al (2015, p 170),[3] 'guidance' constitutes a specific category of instruments, which international organisations have recently developed and put at the disposal of governments and businesses. Addressees are professional and trade associations, as well as governments and legislators, since the guidance may be understood as a repository of best practices for policy-making both at corporate, national and international levels. The term 'soft law' would be a misnomer in this context. Goode et al (2015: 170) state that 'a guide discusses in depth the structure of legal problems, including their economic, technical, and other factual background, outlines possible solutions and explains the underlying legal concepts and any interaction with existing regulatory frameworks, and ideally concludes by making recommendations'.

The Recommendations focus on three main areas of EU law that are currently at different levels of development: (i) company law provisions, including on cross-border transactions; (ii) non-financial reporting; and (iii) sustainable corporate governance.

Company law has a well-established history in EU law. In 2017, the Company Law Directive was updated and codified; its implementation by Member States is currently ongoing.[4] In this context, the ELI Guidance aims at providing regulatory and legislative bodies on company law an understanding of the need for responsible capital management and its implications for sustainable business conduct.

With sustainable business conduct in mind, non-financial reporting is a more recent development in EU law.[5] In April 2021, the European Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which amends the existing requirements for non-financial reporting covered by the Non-Financial Reporting Directive (NFRD). The CSRD was adopted by the European

[1] European Commission, 'A European Green Deal, Striving to be the First Climate-Neutral Continent' <https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en>.
[2] Hereafter, the notions of sustainable business conduct and corporate sustainability will be used interchangeably, referring to theory and practice of sustainable company management and sustainable corporate governance. ELI's working definition of corporate sustainability is provided by the section entitled: A Working Definition of Company Sustainability.
[3] Roy Goode, Herbert Kronke and Ewan McKendrick, 'Transnational Commercial Law: Texts, Cases and Materials' (2nd edn 2015) <https://global.oup.com/academic/product/transnational-commercial-law-9780198735441?cc=fr&lang=en&>.
[4] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law [2017] OJ L169/46 <http://data.europa.eu/eli/dir/2017/1132/2020-01-01> accessed 17 August 2022.
[5] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups [2014] OJ L330/1 <http://data.europa.eu/eli/dir/2014/95/oj> accessed 17 August 2022.

Parliament on 10 November 2022[6] and approved by the EU Council on 28 November 2022.[7] This Directive envisages the adoption of EU sustainability reporting standards (ESRS). The draft accounting standards are being developed by the European Financial Reporting Advisory Group (EFRAG).[8] In this context, the ELI project provides guidance to lawmakers and regulators on aspects of company capital maintenance and other areas that could be addressed in the non-financial reporting provisions currently underway.

This Report also relates to the European Commission's most recent initiative on sustainable corporate governance,[9] which was launched in July 2020 and is at an early phase of development. This initiative is complemented by the Corporate Sustainability Due Diligence (CSDD) proposal[10] launched in 2019. The European Parliament also issued its own resolutions on these matters on 17 December 2020[11] and 10 March 2021 respectively,[12] while the Council provided its conclusions on the latter in December 2020.[13] In this context, the Report provides additional and supportive insights from company law and financial accounting in order to achieve and implement sustainable corporate governance and improved corporate accountability on social and environmental issues. For example, the ELI Guidance helps explain directors' duties, while the accounting adjustments required to implement its Recommendations clarify both the application and discharge of those fiduciary duties that concern corporate sustainability.

In summary, the set of company law Recommendations addresses issues of corporate sustainability with a view to enhancing company capital management and facilitating better corporate governance, with implications for financial accounting, sustainable corporate governance, and extra-financial reporting.

The ELI Guidance draws upon the general principle of prudence, which should be pursued in company equity management. Prudence is meant to facilitate the autonomous existence of companies through time and circumstances. It goes hand in hand with the limited liability granted to company shareholding investors, as well as with fiduciary responsibilities to maintaining a sustainable company as a going concern. From this perspective, company equity capital is intended to be financially maintained over time and circumstances, while distributions to shareholders are expected to be taken out of realised profits and distributable reserves. Financial accounting instruments assist management in separating out accumulated distributable profits available for distribution, shareholder contributions to company equity, and non-distributable regulatory and prudential reserves. Thus changes in company equity capital are subject to specific controls to enhance capital maintenance.

The Recommendations aim at expanding and extending responsible company capital management with a view to fostering and facilitating corporate sustainability. For the sake of clarity, the ELI Guidance

[6] European Parliament, 'Sustainable Economy: Parliament Adopts New Reporting Rules for Multinationals' <https://www.europarl.europa.eu/news/en/press-room/20221107IPR49611/sustainable-economy-parliament-adopts-new-reporting-rules-for-multinationals> accessed 1 December 2022.

[7] Council of the European Union, 'Council gives final green light to corporate sustainability reporting directive' <https://www.consilium.europa.eu/en/press/press-releases/2022/11/28/council-gives-final-green-light-to-corporate-sustainability-reporting-directive/?utm_source=dsms-auto&utm_medium=email&utm_campaign=Council+gives+final+green+light+to+corporate+sustainability+reporting+directive> accessed 1 December 2022.

[8] European Commission, 'Corporate Sustainability Reporting' <https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en> accessed 1 December 2022.

[9] This initiative aims to improve the EU regulatory framework on company law and corporate governance. It would enable companies to focus on long-term sustainable value creation rather than short-term benefits. It aims to better align the interests of companies, their shareholders, managers, stakeholders and society. It would help companies to better manage sustainability-related matters in their own operations and value chains as regards social and human rights, climate change, environment, and so forth. European Commission, 'Sustainable Corporate Governance' (2022) <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance_en> accessed 1 December 2022.

[10] Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 COM/2022/71 final <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071> accessed 1 December 2022.

[11] European Parliament resolution of 17 December 2020 on sustainable corporate governance (2020/2137(INI)) <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020IP0372> accessed 1 December 2022.

[12] European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL)) <https://www.europarl.europa.eu/doceo/document/TA-9-2021-0073_EN.html> accessed 1 December 2022.

[13] Council of the European Union, 'Council Conclusions on Human Rights and Decent Work in Global Supply Chains' (2020) <www.consilium.europa.eu/media/46999/st13512-en20.pdf> accessed 1 December 2022.

does not profess to establish requirements for law, regulation and management concerning sustainable business conduct. It more modestly aims to provide an informed analysis of matters and issues of corporate sustainability which directly concern company law, and may offer further guidance concerning other areas of interest. The analysis in this Report points to matters and issues that deserve specific attention by legislators, regulators and companies committed to corporate sustainability. The Report aims to offer to the latter decision-makers an interdisciplinary study which sheds light on those issues with a view to better understanding how to achieve sustainable business conduct over medium- and long-term time horizons and planning. This Report addresses lawmakers and policy-makers at national and European levels, but also corporate management, which may refer to and voluntarily adopt these Recommendations.

The ELI Guidance does not require an amendment to existing rules on financial reporting,[14] although some accounting adjustments may be necessary to effectively implement these Recommendations both in company law, company management and corporate governance. Similar adjustments are already in place for tax purposes[15] as well as for specific industries, such as banking and insurance. As mentioned above, these adjustments may also provide guidance for developing non-financial reporting standards yet to be established by the EU. They are compatible with Article 4 of the EU framework for financial reporting, which stipulates that:

> [a]nnual financial statements pursue various objectives and do not merely provide information for investors in capital markets but also give an account of past transactions and enhance corporate governance.[16]

The need to enhance equity capital is set out in a recent proposal by the European Commission concerning a Debt-Equity Bias Reduction Allowance (DEBRA). This proposal appears in line with the ELI Guidance, which aims at fostering the establishment and maintenance of equity capital and equity capital reserves for the benefit of corporate sustainability and corporate resilience.[17]

1.2 Scope of Application of the ELI Guidance

Concerning the scope of possible implementation, the set of company law Recommendations is general in nature and may be universally applied to all companies. In fact, since the relevant EU frameworks, such as that for financial and non-financial reporting, are restricted to some companies, similar restrictions may be applied to their implementation. Table 1 summarises the scope of application for some relevant areas of EU law.

[14] European Commission, 'Financial Reporting' <https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/financial-reporting_en> accessed 1 December 2022.

[15] Concerning EU tax regulation, the EU is considering the introduction of a harmonised corporate tax framework through the European territories. This framework is expected to establish the definition of taxable corporate income by introducing tax accounting adjustments to the financial accounting income definition. See European Commission, 'Communication on Business Taxation for the 21st Century' (2021) <https://ec.europa.eu/taxation_customs/communication-business-taxation-21st-century_en> accessed 1 December 2022.

[16] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC [2013] OJ L182/19 <http://data.europa.eu/eli/dir/2013/34/oj> accessed 1 December 2022.

[17] EC Proposal for a COUNCIL DIRECTIVE on laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes, {SEC(2022) 204 final} - {SWD(2022) 144 final} - {SWD(2022) 145 final} - {SWD(2022) 146 final} <https://ec.europa.eu/taxation_customs/system/files/2022-05/COM_2022_216_1_EN_ACT_part1_v6.pdf> accessed 1 December 2022.

Table 1. Scope of Application for Relevant Areas of EU Law

Field	EU Law	Scope of Application
Company Law Codification	Directive (EU) 2017/1132 (as amended)[18]	The different chapters, sections, and provisions of Directive (EU) 2017/1132 are applicable to different sets of limited liability companies, as they are indicated in the three annexes of the Directive (Annex I, II and IIa). Although generalisations may be misleading, in essence, among the companies incorporated in the Member States, Annex I includes all private and public limited liability companies; Annex II lists public limited liability companies; and Annex IIa includes private limited liability companies together with some other legal forms that are not mentioned in either Annex I or Annex II. In light of this classification, Directive (EU) 2017/1132 requires Member States to harmonise, exclusively for the companies listed in Annex I (ie for public limited liability companies),19 the following aspects of company law: • several rules concerning incorporation; • capital maintenance and alteration; • national mergers; • national divisions (as long as these transactions are permitted by the relevant Member State). Conversely, Directive (EU) 2017/1132 requires Member States to harmonise for the companies listed in Annex II (ie for limited liability companies in general) the following aspects of company law: • nullity of the limited liability company and validity of its obligations; • online procedures (formation, registration and filing), disclosure and registers for companies and branches; • cross-border conversions; • cross-border mergers; • cross-border divisions. Finally, Directive (EU) 2017/1132 makes but a few references to the companies and legal forms indicated in Annex IIa, with regard to some specific provisions concerning online procedures and, in particular, with regard to the provisions on online formation, online filing and disclosure.
Financial Reporting	Directive 2013/34/EU (as amended)[20] and Regulation (EC) No 1606/2002[21]	Listed companies (those whose securities are traded on a regulated market) must prepare their consolidated financial statements in accordance with a single set of international standards, the International Financial Reporting Standards (IFRS). EU Member States can opt to extend the use of the IFRS to annual financial statements and non-listed companies as well.[22] Limited liability companies conducting business in the EU, regardless of their size, have to prepare annual financial statements and file them with the relevant national business register. Groups have to prepare consolidated financial statements. Directive 2013/34/EU also aims at reducing the administrative burden for SMEs. It allows a simplified reporting regime for small- and medium-sized enterprises and a very light regime for micro-companies (those with less than ten employees). The Directive includes a definition of micro, small, medium and large companies based on thresholds concerning turnover, total assets and number of employees. These thresholds are periodically updated to keep pace with inflation.

[18] EU Directive 2017/1132 as amended (n 4) accessed 18 August 2022.

[19] A public limited liability company is a limited liability company whose shares may be freely sold and traded to the public, although a public limited liability company may also be privately held. Its shares may be either listed or unlisted on securities exchanges.

[20] Directive 2013/34/EU as amended (n 16) <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013L0034> accessed 18 August 2022.

[21] Council Regulation (EC) 1606/2002 of 19 July 2002 on the application of international accounting standards [2002] OJ L243/1 <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32002R1606> accessed 18 August 2022.

[22] Implementing measures for Council Regulation (EC) 1606/2002 of 19 July 2002 on the application of international accounting standards, 28 November 2019, <https://ec.europa.eu/info/law/international-accounting-standards-regulation-ec-no-1606-2002/implementation/implementation-eu-countries_en> accessed 18 August 2022.

Field	EU Law	Scope of Application
Non-financial reporting Corporate sustainability reporting	Directive 2014/95/EU – also referred to as the NFRD – lays down the rules on disclosure of non-financial and diversity information by certain large companies (This Directive amended the Accounting Directive 2013/34/EU).[23] The EU adopted the Corporate Sustainability Reporting Directive (CSRD) on 28 November 2022.[24]	Large public-interest companies with more than 500 employees. This covers approximately 11,700 large companies and groups across the EU in 2021, including listed companies, banks, insurance companies, and other companies designated by national authorities as public-interest entities.

1.3 A Working Definition of Company Sustainability

For the purpose of this Guidance, company sustainability denotes *the capacity of a company to continue to exist into the future (the going concern principle), thereby continuing its business with a view to: (i) delivering satisfying products and services to customers; (ii) remunerating stakeholders including employees and shareholders satisfactorily; (iii) meeting creditor and liability obligations; (iv) and contributing to broader social and environmental benefits through the company's social and environmental responsibilities.*

This working definition highlights the close relationship between corporate sustainability, corporate social and environmental responsibilities (CSER), and ESG considerations as addressed by the EU and national legal frameworks. In this context, financially viable companies are those that can both sustain their stakeholder claims, and meet broader social and environmental responsibilities. However, the current practice in company management and corporate governance often focuses on and prioritises the primacy of shareholder value creation. This is noted in a recent study on 'Directors' duties and sustainable corporate governance' prepared on behalf of the European Commission.[25] This study revealed that many companies, in particular those listed on regulated exchanges, face pressure to both focus on generating financial return on equity capital invested over a short-term horizon, and redistribute a larger part of the income generated to shareholding investors. This may be to the detriment of the long-term continuity of the company, as well as of the sustainable development for society and nature.

The EU has developed the European Green Deal[26] through sustainable finance initiatives eventually backed by dedicated policies, including funding by the European Central Bank.[27] This strategy pursued by the European Green Deal focuses on the financial market dimension of sustainable development. It prompts investors to include sustainability matters in their portfolio strategies and their approach to companies.

[23] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups [2014] OJ L330/1 <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095> accessed 18 August 2022.

[24] EU Commission, 'Proposal for a Corporate Sustainability Reporting Directive (CSRD)' COM (2021) 189 final <https://ec.europa.eu/info/publications/210421-sustainable-finance-communication_en#csrd> accessed 18 August 2022. See also: <https://www.europarl.europa.eu/news/en/press-room/20221107IPR49611/sustainable-economy-parliament-adopts-new-reporting-rules-for-multinationals> accessed 1 December 2022.

[25] European Commission, 'Company Law and Corporate Governance' <https://ec.europa.eu/info/business-economy-euro/doing-business-eu/company-law-and-corporate-governance_en#studies> accessed 1 December 2022.

[26] See n 1 <https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en> accessed 1 December 2022.

[27] European Central Bank, 'Climate Change and the ECB' <www.ecb.europa.eu/ecb/orga/climate/html/index.en.html> accessed 1 December 2022. 28 Throughout this document, 'company' and 'corporate' are employed as equivalent adjectives denoting the business affairs pertaining to the whole company as a going concern. In its broadest meaning, the notion of the company refers not only to its legal structure (including its incorporation form), but also its economic substance as a business firm as an enterprise entity.

However, this strategy needs to be supplemented by considering the corporate dimension, which depends on corporate stewardship, management and governance. Companies themselves need to foster sustainable corporate strategies. They need to gather resources with a view to developing and implementing long-term corporate action plans that underwrite company sustainability, involving social and environmental responsibilities. Both the prudent management of resources and a fair balance between distributions and devoted resources to those action plans are required to meet these responsibilities.

The working definition of company sustainability (or corporate sustainability)[28] above draws upon the paradigmatic principle of the company as a going concern[29] and is based on the theory of the firm as an enterprise entity.[30]

The definition does not refer to the ambiguous notions of value and value creation, which may lead to misleadingly accounting for people and nature as economic assets expressed in monetary terms (for instance, by referring to shadow market prices), implying their equivalence with financial assets employed for financial returns.[31] This view would be consistent with a current value basis of accounting.

The Report's approach to corporate sustainability involves incorporating social and environmental responsibilities into the determination of those investments and costs that are needed to empower and protect people and nature. These investments and costs are incurred under the responsibility of company decision-makers. The company generates profits from its deployment of human and natural resources, and so, in return, the company must also empower and protect people and nature going forward for sustainability reasons. This view is consistent with a historical cost basis of accounting.[32] It further points to a prudent approach to resource usage and to the responsible management of productive power, which has to be maintained and renewed over time.

A recent important debate in company law and corporate governance raises the question of the company's purpose and the need to broaden company objectives beyond shareholder value and its primacy. This Report does not involve such opposition between purpose or profit, but it focuses on the accounting basis upon which profits are determined, especially distributable profits, and how much should be allocated between, on the one hand, distributions to executive management and shareholding investors, and, on the other hand, those investments and costs that are required to both sustain the company as a going concern and meet corporate social and environmental responsibilities. This Report does not uphold the dilemma between 'either profit or purpose', but rather considers the amount of profits accrued and their use for various purposes.[33]

The NFRD and the CSRD[34] refer to sustainability reporting as being on an equal footing with

[28] Throughout this document, 'company' and 'corporate' are employed as equivalent adjectives denoting the business affairs pertaining to the whole company as a going concern. In its broadest meaning, the notion of the company refers not only to its legal structure (including its incorporation form), but also its economic substance as a business firm as an enterprise entity.

[29] Alexia Autenne and others, 'The Current Challenges for EU Company and Financial Law and Regulation' [2018] 8(3) Accounting, Economics, and Law: A Convivium <https://doi.org/10.1515/ael-2017-0064> accessed 16 August 2022.

[30] Yuri Biondi and others, *The Firm as an Entity: Implications for Economics, Accounting and the Law* (1st edn, Routledge 2007) <https://www.routledge.com/The-Firm-as-an-Entity-Implications-for-Economics-Accounting-and-the-Law/Biondi-Canziani-Kirat/p/book/9780415493581> accessed 18 August 2022; Yuri Biondi and Stefano Zambon, *Accounting and Business Economics: Insights from National Traditions* (1st edn, Routledge 2012) <https://www.routledge.com/Accounting-and-Business-Economics-Insights-from-National-Traditions/Biondi-Zambon/p/book/9781138959873> accessed 18 August 2022.

[31] A Charles Littleton, 'Economists and Accountants' [2011] 1(2) Accounting, Economics, and Law: A Convivium <https://doi.org/10.2202/2152-2820.1038> accessed 16 August 2022; Yuri Biondi, 'The Problem of Social Income: The Entity View of the Cathedral' [2011] 34(4) Seattle University Law Review <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1854803)> accessed 16 August 2022.

[32] On alternative bases and models of accounting, see William A. Terrill, 'Cost Basis: Accounting's "*Samsons's Tresses*"' [2011] 1(1) Accounting, Economics, and Law: A Convivium <https://doi.org/10.2202/2152-2820.1013> accessed 17 August 2022; Yuri Biondi, 'The Pure Logic of Accounting: A Critique of the Fair Value Revolution' [2011] 1(1) Accounting, Economics, and Law: A Convivium <https://doi.org/10.2202/2152-2820.1018> accessed 17 August 2022.

[33] The notion of profit(s) is equivalent throughout this Report to that of income(s) to the business firm, reported by earnings in the income statement.

[34] European Commission, 'Corporate Sustainability Reporting' <https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en> accessed 1 December 2022.

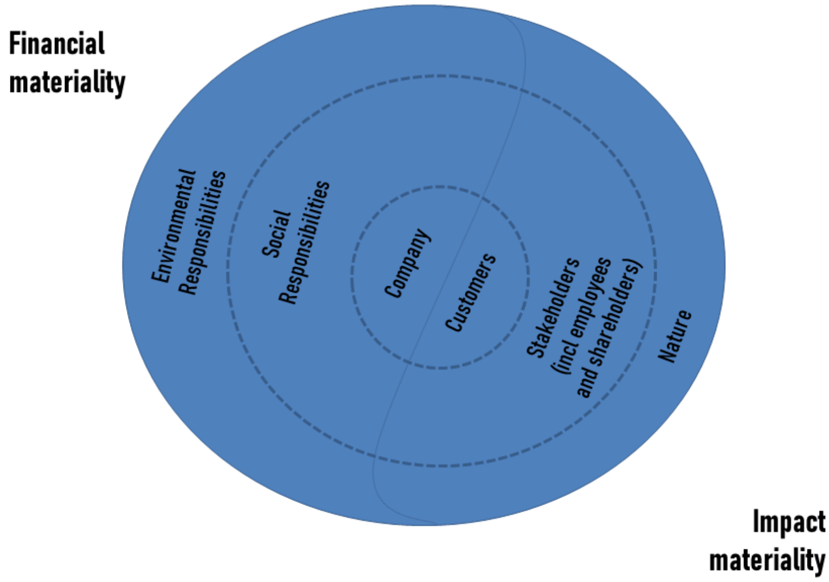
financial reporting, thus introducing a connectivity between these two pillars with a view to improving corporate reporting as a whole. Such comprehensive corporate reporting is expected to meet the needs of an inclusive range of stakeholders, including employees and shareholders, while upholding the EU's overarching goals concerning environmental and social considerations.

In the context of non-financial reporting, the principle of 'double materiality' is deemed to be fundamental, requiring both 'impact materiality' (external impacts of the company and its value chain) and 'financial materiality' (sustainability-related matters that financially affect the reporting entity). In this context, the 2021 EFRAG proposals for a relevant and dynamic EU sustainability reporting standard-setting argue that:[35]

> Double materiality requires that both impact materiality and financial materiality perspectives be applied in their own right without ignoring their interactions:
>
> a) Impact materiality: Identifying sustainability matters that are material in terms of the impacts of the reporting entity's own operations and its value chain (impact materiality) …
>
> b) Financial materiality: Identifying sustainability matters that are financially material for the reporting entity …

Corporate sustainability as defined by the ELI Guidance lies at the junction between these two dimensions of materiality. On the one hand, financial materiality points to the financial impact on the reporting entity; on the other hand, impact materiality points to the impact on stakeholders, society and the environment. According to ELI's notion of corporate sustainability, the financial dimension of impact materiality should be considered with a view to comprehensively reporting on the enterprise entity as a going concern. Indeed, the Report's approach builds upon a comprehensive notion of 'joint materiality', which combines impact and financial materiality, reporting on companies' financial obligations and commitments in their relationship with stakeholders (including customers, employees and shareholders) as well as social and environmental impacts. Figure 1 visualises this concept of joint materiality, which combines company impacts on people and nature with company responsibilities involving financial obligations and commitments to and by the company as a going concern. Table 2 further summarises the connection between impact materiality, financial materiality and related accounting elements according to notion of joint materiality in the ELI Guidance.

Figure 1. Joint Materiality (Company Impact) Combining Financial and Impact Materiality



[35] European Financial Reporting Advisory Group, 'Proposals for a Relevant and Dynamic EU Sustainability Reporting Standard-Setting, Final Report on behalf of the European Commission' (February 2021). <https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/210308-report-efrag-sustainability-reporting-standard-setting_en.pdf> accessed 1 December 2022.

Table 2. Correspondence between Impact Materiality, Financial Materiality and Accounting Elements

Impact Materiality	Financial Materiality	Accounting Elements
Company	Social and environmental risks	Financial liabilities
Customers	Product quality, including security	Product-related liabilities and commitments
Stakeholders (including employees and shareholders)	Social responsibilities	Social liabilities (including employee benefits) and commitments
Nature	Environmental responsibilities	Environmental liabilities and commitments

In this context, accounting should fulfil a joint role to inform about and control for the joint materiality of company impacts (Table 2). On the one hand, accounting may inform financial investors active in financial markets about the joint materiality. On the other hand, accounting may enhance managerial and social control over ESG concerns, which are of the utmost importance for business and society. From this perspective, the ELI Guidance aims at improving the financial information-provision role of accounting, while enhancing its complementary stewardship and sustainable governance role, in line with the concept of a company as a going concern.

1.4 The Quest for Sustainable Business Conduct in EU Law

The idea of sustainable development underlies the concept of a company as a going concern,[36] a high level of protection of employee and creditor rights, and the notion of sustainable investments that take into account social and environmental considerations. Background research on EU law concerning corporate sustainability conducted for the purposes of the present Guidance showed that, under EU primary and secondary law, there is a strong commitment to prioritising responsible and sustainable business conduct over short-termism driven by shareholder value and primacy.

However, the current EU company capital maintenance regime has certain limits and drawbacks, which could undermine corporate sustainability. The ELI project's regulatory overview, prepared as a background study to the present Guidance, shows that safeguards adopted by EU company law codification do not refer to long-term sustainability, while relying upon existing accounting measurements of assets and liabilities, on the one hand, and the share legal capital and non-distributable reserves, on the other hand. These accounting measurements are designed for financial reporting purposes and may not be the most appropriate for corporate sustainability purposes. Moreover, existing EU law is based on legal share capital and related non-distributable reserves, which were originally not designed to address corporate sustainability in its broader sense and its implications for business and society.

Concerning EU company law, since the rules of the Member State of incorporation cannot be overridden by more stringent mandatory capital maintenance rules of the Member State of the real seat, creditors, stakeholders and the natural environment in the country of the real seat will be mainly, if not exclusively, protected to the extent of the protection provided under the laws of the country of incorporation.[37] This may raise an issue at EU level, involving detrimental regulatory competition and a race to the bottom between Member States. This challenge requires EU harmonisation on these matters in the interest of long-term corporate sustainability, which includes corporate social and environmental responsibilities and obligations. The existing safeguards demonstrate

[36] Autenne and others (n 29).

[37] However, as the CJEU made clear in Kornhaas (Case C-594/14 *Simona Kornhaas v Thomas Dithmar als Insolvenzverwalter über das Vermögen der Kornhaas Montage und Dienstleistung Ltd* [2016] OJ C 48/5), it should also be emphasised that Member States still have the possibility of indirectly imposing some regulation on foreign companies that operate in their territory. From this perspective, under this judicial doctrine, the national regulations aimed at promoting corporate sustainability may arguably also be applied to companies incorporated in other Member States, and therefore also limit their ability to engage in detrimental regulatory competition.

that the EU capital maintenance regime already allows for the co-existence of EU mandatory share capital rules and private law arrangements – such as complementary regimes for potentially endangered creditors' claims and other obligations, including but not limited to cases of otherwise lawful distributions to shareholders.

1.5 The ELI Guidance on Company Capital and Financial Accounting for Corporate Sustainability

The ELI Guidance contributes to European and international debates on company capital management and corporate sustainability. In particular, it aims at providing European lawmakers, policy-makers and managers with a set of Recommendations capable of contributing to the positive development of a comprehensive and consistent body of company law instruments that facilitate sustainable business conduct by European companies. The Recommendations aim not only at creating wider public awareness of issues to be addressed to achieve corporate sustainability, but also at fostering harmonisation and mutual trust among Member States, levelling the business playing field across the EU. They may further foster sustainable business conduct through voluntary adoption by company management.

It is widely recognised that the time has come for legislative and policy proposals setting out common standards of corporate sustainability. The Recommendations propose common standards, which may facilitate the convergence of national regulations concerning sustainable business conduct, as well as the harmonisation of company law and sustainable corporate governance arrangements. These Recommendations were developed with a view to striking a balance between generality and specificity, ensuring that they are general and abstract enough to be acceptable by all Member States, while remaining specific enough to promote a common background that allows for the enhancement of harmonisation and mutual trust. They point to the role that company law, corporate governance and corporate reporting (both financial and non-financial) may play in the pursuit of sustainable business conduct by European companies. Therefore, they constitute a soft law instrument with a view to facilitating sustainable business conduct, harmonising the company law framework, and enhancing mutual trust across Europe. While the set of Recommendations as a whole is self-contained and self-consistent, the Recommendations may also be implemented in part or separately. They provide overall guidance on developing and implementing corporate sustainability measures at EU and national level, including measures relating to company capital management, sustainable corporate governance, and corporate reporting.

The Recommendations also provide an informed analysis and guidance on how to improve existing company capital management standards (including with regard to capital maintenance). These improvements are intended to foster and facilitate corporate sustainability as defined above. Figure 2 summarises the set of company law Recommendations.

The following preamble provides an introductory statement to the set of Recommendations and summarises the general purpose, scope and addressees thereof.

Preamble

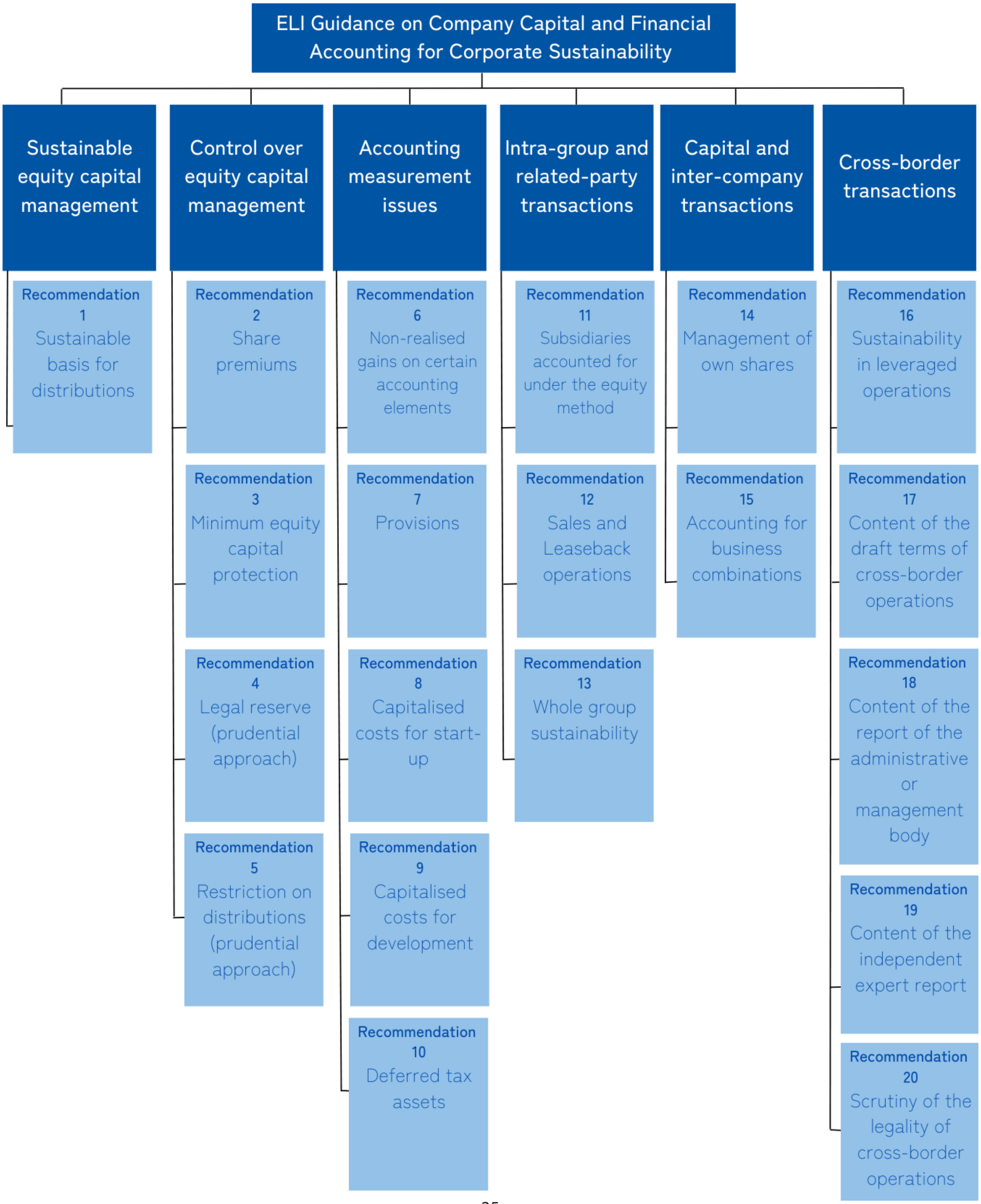
The ELI Guidance on Company Law and Financial Accounting for Corporate Sustainability aims to restate and modernise well-established provisions of European company law on: (i) distributions; (ii) equity capital maintenance; and (iii) non-distributable reserves, with a view to fostering and facilitating sustainable business conduct through responsible company capital management and financial accounting adjustments. Its overall aim is to secure company continuity and resilience, as well as financial stability and sustainable development for the benefit of business and society at large.

As a whole, it recommends that companies commit to a prudent use of resources, by setting aside sufficient reserves to meet social and environmental commitments over long-term horizons, and establishing a fair balance between these commitments and distributions to shareholding investors.

It aims at contributing to further harmonising, clarifying and developing European and national law on company law, corporate governance, and corporate reporting (both financial and non-financial).

It also aims at promoting sustainable business conduct by corporate management through voluntary adoption, while clarifying the duties of directors and auditors. By developing specific accounting adjustments (similar to tax law), the Recommendations facilitate the disclosure of the financial impact of social and environmental commitments, thus enhancing legal certainty for directors and auditors discharging their fiduciary duties toward the company and society.

Figure 2. ELI Guidance on Company Capital and Financial Accounting for Corporate Sustainability



The first Recommendation defines a sustainable basis for distributions, based on the approach to responsible company capital management described above. Recommendations 2 to 5 provide general purpose instruments to enable such management. Recommendations 6 to 10 address accounting measurement issues mainly raised by current value measurements (fair value accounting). Recommendations 11 to 13 address some group transactions which deserve specific attention to discharge ESG commitments and obligations. Recommendations 14 to 20 address the main issues raised by capital, inter-company and cross-border transactions.

The following sections explain the Recommendations' approach in further detail. Chapter 2 (A Taxonomy for Company Equity Capital) introduces a novel functional distinction between shareholder equity and company equity, inspired by the enterprise entity theory of accounting and by Japan's accounting framework.

Building upon this taxonomy, the Report introduces some general principles for equity capital management in Chapter 3 (Recommendations on Equity Capital Management), in line with the spirit of the existing EU framework and with the principle of prudence (as described in the introduction).

In order to strengthen the accounting framework upon which the EU regulation on company capital maintenance regime[38] relies, the Report further introduces specific Recommendations concerning accounting for distributable profits in Chapter 4 (Recommendations on Accounting Measurements).

Company capital management, including capital maintenance, is not simply about the determination of the profit available for distribution to shareholders. It has broader foundations that can have a material impact on corporate sustainability. Therefore, the Report pays specific attention to relevant transactions, events and circumstances, including: intragroup and related party transactions (Chapter 5: Recommendations on Group and Related-Party Transactions, Including with Special Purpose Entities); own share management and accounting for business combinations (Chapter 6: Recommendations on Capital and Inter-Company Transactions); and cross-border transactions such as mergers, divisions and conversions (Chapter 7: Recommendations on National and Cross-Border Mergers, Divisions and Conversions).

In order to implement these Recommendations, further complementary instruments to bolster sustainable company capital management are suggested. These are in respect of: (i) board and auditor duties; (ii) additional reporting and disclosure; (iii) and policy options for the EU accounting framework (Chapter 8: Complementary Instruments for Better Enforcing Sustainable Equity Capital Management).

An Annex provides an illustrative numerical implementation of each Recommendation, showing the effect of additional disclosure and the impact on accounting representations made with respect to company capital management.

[38] Directive 2017/1132/EU (n 4).

2 A Taxonomy for Company Equity Capital

Companies are required by law to prepare and publicise financial statements, including accounting information on their equity position. Generally speaking, company financial reporting takes the following format, which is prescribed under the IFRS and adopted by the EU for consolidated statements of all company groups listed on EU exchanges:[39]

Assets = Liabilities + Company Equity Capital (Net Worth)

Assets – Liabilities = Company Equity Capital (for company capital maintenance)

Company equity capital as represented by this balance sheet equation includes cumulated profits and losses as determined by the income statement, providing the baseline connection between the two financial statements.[40] Table 3 provides an illustration of an elementary balance sheet statement consistent with this formula.

Table 3. Existing Company Equity Capital Statement

Assets	**Liabilities**
	Total Equity Capital (Net Worth)

According to this format, accounting information on company equity brings together two distinctive equity capitals:[41] that provided by shareholding investors (shareholder equity as net paid-in equity capital); and that provided by the company itself and put in reserve for prudential and regulatory purposes (company equity). Drawing upon Japan's accounting framework,[42] the Report recommends distinguishing shareholder equity from company equity as follows:

- Shareholder equity (or shareholder capital) – including legal share capital and share premiums (if applicable) – is the cumulated sum of transactions with shareholders, including contributions provided by shareholders to the company in exchange for equity share securities, on a continuing basis and announced to the public. It also includes retained earnings available for distribution to shareholders and may include some regulatory reserves (when taken from shareholder funds).
- Company equity is the residual accounting elements, which comprise all the elements on the liability side of the balance sheet which are not included as liabilities or in shareholder equity as defined above. Company equity may include some regulatory reserves (when taken from retained earnings and entity funds) as well as non-distributable retained earnings and other non-distributable reserves, including those identified under these Recommendations.

Table 4 sets out the taxonomy for company equity capital as proposed by ELI Guidance.

[39] This was established when conducting background research on Member States' practice in the course of the ELI project. Regulation (EC) No 1606/2002 requires all EU listed companies to use IFRS for their consolidated financial statements. EU Member States can opt to extend the use of IFRS to annual financial statements and non-listed companies as well. European Commission, 'Implementation by EU Countries. Implementing Measures for Regulation (EC) No 1606/2002 on International Accounting Standards' <https://ec.europa.eu/info/law/international-accounting-standards-regulation-ec-no-1606-2002/implementation/implementation-eu-countries_en> accessed 1 December 2022.

[40] The statement of comprehensive income for sake of simplicity was ignored.

[41] Yuri Biondi, 'What Do Shareholders Do? Accounting, Ownership and the Theory of the Firm: Implications for Corporate Governance and Reporting' [2012] 2(2) Accounting, Economics, and Law: A Convivium, <https://doi.org/10.1515/2152-2820.1068> accessed 16 August 2022.

[42] Clemence Garcia, 'From Financial to "Sustainable" Capital Maintenance' [2020] 7(2) InterEULawEast <https://doi.org/10.22598/iele.2020.7.2.9> accessed 16 August 2022.

Table 4. Total Equity Capital Statement Based on ELI's Taxonomy

Shareholder Equity (A)	Non-distributable elements:	Legal capital Legal reserve and other regulatory reserves (if any) Share premium reserves
	Distributable elements:	Retained earnings – realised but accumulated as reserves – for the sake of distributions to shareholders
Company Equity (B)	Non-distributable elements:	Non-distributable reserves, including those under these Recommendations, such as retained earnings set aside for prudential reasons and revaluation reserves that are unrealised holding gains
Total Equity Capital (A+B)	Non-distributable elements:	Total non-distributable equity capital
	Distributable elements:	Total distributable equity capital

Table 4 Note: The distinction between distributable and non-distributable elements draws upon the ELI Guidance as developed in this Report.

3 Recommendations on Sustainable Equity Capital Management

Recommendation 1 provides a general frame in order to define and facilitate a sustainable basis for distributions, which lie at the core of sustainable equity capital management. Recommendations 1 to 4 provide general purpose instruments for enabling such sustainable equity capital management.

The EU and its Member States may consider introducing prudential principles establishing general control over equity capital management.[43] The Report proposes a general principle in line with EU law, along with four general prudential principles concerning share premiums, minimum equity capital, legal reserve requirements, and restrictions on distributions.

3.1 Recommendation 1: Sustainable Basis for Distributions

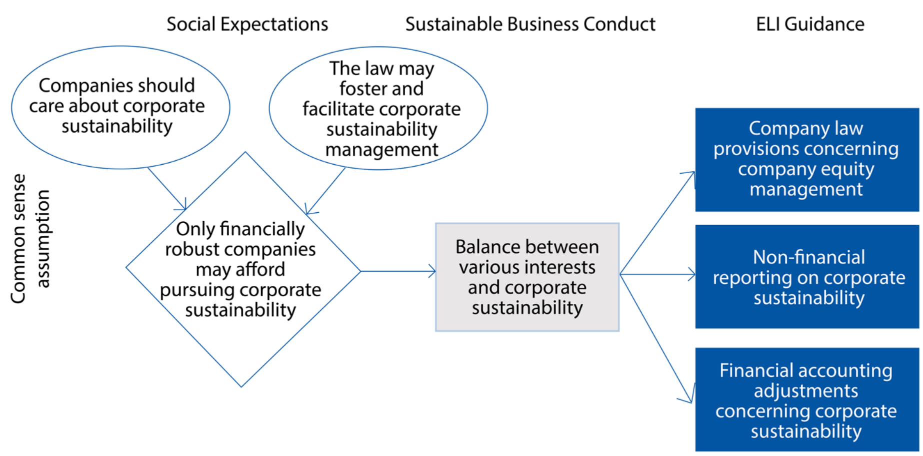
The board of directors should commit to, and disclose, a clear policy on the company's approach to equity capital management, including distributions and reserve provisioning.[44] Equity capital is understood here as a financially robust basis for long-term corporate sustainability. Accordingly, equity funds constitute an essential buffer against financial uncertainty and thereby underwrite the company as a going concern. Indeed, they represent shareholders' invested equity capital commitment to the company's viability over time and circumstances. Satisfying shareholder expectations for remuneration depends upon, and is proportionate to, this investment.[45]

The equity capital management policy should clarify how a sustainable balance is achieved among different and competing company, shareholder, creditor, and stakeholder interests, and obligations and ongoing commitments to social and environmental responsibilities. The latter obligations and commitments respond to social expectations concerning corporate sustainability and related sustainable business conduct. In this respect, the management policy should ensure a sufficient level of equity capitalisation (financial capital maintenance) is maintained to cushion against foreseeable expenditures with a view to ensuring these company obligations and commitments can be discharged over time and circumstances.

Figure 3 illustrates the rationale of sustainable business conduct embedded between social expectations of corporate sustainability and the regulatory framework and related instruments. In this context, the ELI Guidance on Company Capital and Financial Accounting for Corporate Sustainability aims at providing convenient instruments for management, gatekeepers and regulators with a view to fostering and facilitating sustainable business conduct.

Figure 3. Rationale of Sustainable Business Conduct Embedded Between Social Expectations and Regulatory Frameworks and Instruments

Corporate sustainability denotes the capacity of a company to continue to exist into the future (the going concern principle), thereby continuing its business with a view to: (i) delivering satisfying products and services to customers; (ii) remunerating stakeholders including employees and shareholders satisfactorily; (iii) meeting creditor and liability obligations; (iv) and contributing to broader social and environmental benefits through the company's social and environmental responsibilities.



[43] It is acknowledged that 'prudential' usually refers to financial industry regulations. Hereafter, 'prudent' and 'prudential' are used as equivalent, both referring to prudent behaviour, attitude, and orientation.
[44] This disclosure is already covered by the IAS 1(134) concerning presentation of financial statements, and it may be incorporated by the EU framework.
[45] Biondi (n 41).

A specific statement for equity capital management should be prepared and audited prior to distributions and other equity capital operations. In this context, clarifying the definition of realised and distributable profits through specific accounting adjustments may facilitate the equity capital management policy, as well as the allocation of these profits among competing corporate purposes. At present, this definition is not covered by the IFRS and is only implemented by the Member States' accounting frameworks for company law purposes.

The board of directors is in the best position to provide comprehensive information – including financial impact determination and accompanying notes and explanations – about the entity's current and prospective corporate sustainability management scheme, covering corporate viability and capacity to discharge corporate social and environmental responsibilities. A financial impact determination may require accounting adjustments and pro-forma financial statements, which restate the financial statements prepared for financial reporting purposes. The financial impact determination includes, but is not limited to, equity capital management.

Similarly, the financial impact determination may include, but not be limited to, the present risk assessment concerning outstanding liabilities to preserve corporate sustainability. This determination should be expanded to include company commitments and action plans relating to long-term corporate sustainability.[46]

The financial impact determination should include specific disclosure concerning equity capital management (including distribution of and retained earnings) for both distributions (pay-outs) to shareholding investors, and funding provisions for sustaining action plans concerned with corporate social and environmental responsibilities.

Hence, company equity capital management would be extended to include provisions for the latter action plans. Company policy would then better identify and balance these provisions with planned distributions to shareholders, with a view to securing the implementation of those action plans over time and circumstances.

Generally speaking, *distributions are regulated at the single company level*, although many companies nowadays are involved in intra-group and related-party transactions. In this context, decisions on distributions would be taken at group level, and based upon consolidated financial statements.

It is generally accepted that distributions should be generated out of realised profits (and losses) as distinguished from the equity capital provided by shareholders (net paid-in shareholder equity capital). The first Recommendation arises directly from this consensus:

Recommendation 1: Sustainable basis for distributions

Distributions (pay-outs), in whatever form (including dividends in cash, in kind or in shares, as well as share buybacks), should be submitted to a dual test:

(a) Before distribution: sufficient realised accumulated distributable profits, or net accumulated distributable reserves should exist; and

(b) After distribution: shareholder equity must equal at least legal paid-in share capital and accumulated non-distributable reserves.

From a financial accounting perspective, this Recommendation may be formulated as follows:

> Distributions (pay-outs), in whatever form (including dividends in cash, in kind or in shares, as well as share buybacks), should be limited to sufficient realised accumulated distributable profits, and net accumulated distributable reserves, after all non-distributable (prudential) reserves were provisioned.

[46] Yuri Biondi, 'Better Accounting for Corporate Shareholding and Environmental Protection' [2014] 11(2) European Company Law <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2471519> accessed 16 August 2022.

This dual test ensures that all distributions are made out of current and accumulated *realised* profits as determined on an accrual basis of accounting.[47] These profits arise from actual transactions which have occurred (no close-out) under normal business terms and conditions, and settled against cash and credit instruments: (i) which can be readily converted into cash, both without a period of marketing or negotiation, and without material costs or losses; and (ii) which are not held for strategic or regulatory reasons.[48]

This general principle is already embedded in EU company law and appears in line with Article 56 of Directive (EU) 2017/1132:[49]

> (Article 56(1)) 'Except for cases of reductions of subscribed capital, no distribution to shareholders may be made when on the closing date of the last financial year the net assets as set out in the company's annual accounts are or, following such a distribution, would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes of the company.'
>
> (Article 56(3)) '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.'
>
> (Article 56(4)) 'The term 'distribution' used in paragraphs 1 and 3 includes, in particular, the payment of dividends and of interest relating to shares.'
>
> (Article 56(6)) 'Paragraphs 1 to 5 shall not affect the provisions of the Member States as regards increases in subscribed capital by capitalisation of reserves.'
>
> (Article 56(7)) 'The laws of a Member State may provide for derogation from paragraph 1 in the case of investment companies with fixed capital.'

Generally speaking, the ELI Guidance aims to clarify and extend the existing EU framework to cover specific needs arising from corporate sustainability, including corporate social and environmental responsibilities. In particular, the purpose and scope of non-distributable reserves should be expanded to cover these needs, with a view to protecting the company as a going concern and making it capable of meeting its social and environmental responsibilities over time and circumstances, while it continues to provide satisfying remuneration for its stakeholders, including shareholders.

To this end, the financial capital maintenance regime remains a fundamental instrument to achieve and balance these objectives. According to the ELI Guidance, this regime is based upon an accrual basis of accounting, excluding cash-based tools such as solvency tests. The latter tests – which have been claimed to be alternative instruments, as shown by background research on EU law conducted in the course of this ELI project – may be insufficient since cash availability is not an actual constraint when a company can access financial markets by either bank borrowing or issuing debt and equity instruments. When applied to near-expiration liabilities only, solvency tests also divert attention from long-term corporate sustainability to immediate or foreseeable short-term cash-flow based ability to pay.

[47] An accrual basis of accounting recognises transactions when they occur, independently of the time of actual payment. This accounting basis differs from a cash basis of accounting which reports upon cash flows and funds from operating, financing and investing transactions.

[48] The latter assets received for payment would not be disposable and easily convertible in cash and cash equivalents. See also Institute of Chartered Accountants in England and Wales, *Guidance on Realised and Distributable Profits Under the Companies Act* (Technical Release, ICAEW Tech 02/17BL, 2017).

[49] Directive 2017/1132/EU (n 4).

3.2 Recommendation 2: Share Premiums

Companies often issue equity instruments including ordinary shares, which are sold at a premium above their nominal value (sometimes in line with current market prices for them), thus collecting amounts which go beyond the nominal legal value of each share. While it is a normal business practice to issue new shares at a premium above their nominal value, if this premium is distributable, management may engage in agiotage (stockjobbing). This means that share premiums are distributed as paper profits, implying a system that may overstate earning capacity and facilitate pyramid schemes (so-called Ponzi schemes). A Ponzi scheme is a fraudulent financial arrangement in which invested cash payments from new entrants are used to pay distributions to existing members even though no net profit is accrued from investments.[50] To be sure, existing shareholding investors may be willing to obtain such premiums by selling their own shares on the market, but it does not appear to be sound practice for company equity management to take premiums from new shareholders and distribute them to existing ones. This situation justifies the following Recommendation restricting distribution of share premiums and related reserves:

Recommendation 2: Share premiums

Share premiums and related reserves should be treated as legal capital and subjected to the same rules, including restrictions on distributions and capital reduction.

This Recommendation is based upon an interpretation of the EU framework for own share management and appears in line with the following EU provisions:[51]

> (Article 56(4)) 'The term 'distribution' used in paragraphs 1 and 3 includes, in particular, the payment of dividends and of interest relating to shares.'
>
> (Article 63(1)(b)) '[I]f the shares are included among the assets shown in the balance sheet [alternatively, they should be deducted from equity], a reserve of the same amount, unavailable for distribution, shall be included among the liabilities [then excluded from shareholder equity].'

To be sure, this matter is currently not harmonised across EU Member States, as demonstrated by background research reviewing national practices conducted in the course of the ELI project.[52] Some authorise the distribution of the share premium reserve under some conditions. Other jurisdictions are silent on this or forbid it, making this reserve an integral part of legal capital, which is not distributable. In fact, it is generally possible to incorporate this reserve into legal capital, thus proceeding to the reduction of the latter by reducing the nominal value of shares and creating a distributable reserve based upon the residual value. The latter reduction is then subjected to the restrictions imposed upon legal capital reduction according to the EU law framework and its implementation by EU Member States.

3.3 Recommendation 3: Minimum Equity Capital Protection

Historically speaking, company law has required maintaining legal share capital to ensure creditor protection in light of shareholder limited liability.[53]

At present, some EU Member States allow the establishment of limited liability companies with symbolic legal capital, if any, as shown by background research reviewing national practices conducted for this ELI project.[54] If minimum legal capital is immaterial, the legal rules concerning its maintenance (capital maintenance regime) are

[50] According to Marcus Lutter (ed), *Legal Capital in Europe* (De Gruyter 2011), 166-231 <https://www.degruyter.com/document/doi/10.1515/9783110926583/html> p 5, 'legal capital rules prevent the so called agiotage (stock-jobbing), i. e distributing share premiums as pretended profits, a system that simulates strong profits and facilitates pyramid schemes. (Footnote 11: This conclusion depends upon an interpretation of Art. 15 of the Second Directive. According to its purpose and its understanding in Germany, share premiums are bound in the same way as the capital).'

[51] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law [2017] OJ L169/46 <https://eur-lex.europa.eu/eli/dir/2017/1132/oj/eng> accessed 17 August 2022.

[52] Anne Le Manh, 'Accounting Policies and Dividend Limitation: A European Comparison' Accounting, Economics, and Law: A Convivium [2022] <https://doi.org/10.1515/ael-2021-0041>.

[53] Autenne and others (n 29).

[54] Le Manh (n 52).

ineffective for the purposes of creditor protection and corporate sustainability. However, for the sake of sustainable business conduct, some reserves should be constituted and maintained to protect the company as a going concern, notwithstanding the minimum amount required for legal capital.

Therefore, a company can be required to provide for these reserves, including by allocating profits (retained earnings) or issuing equity instruments. The capital maintenance regime should, therefore, be extended to include these reserves. Accordingly, minimum equity capital to be maintained should be at least equal to the amount of non-distributable reserves constituted for assuring corporate social and environmental responsibilities. A more exigent rule would require fixing a minimum equity capital proportional to total assets or another suitable threshold.

Recommendation 3: Minimum equity capital protection

Equity capital maintenance:

(a) should include, but not be limited to, legal paid-in share capital and legal reserves;

(b) should comprise all reserves needed to facilitate corporate sustainability, including those needed for the discharge of social and environmental responsibilities; and

(c) may include all reserves defined as non-distributable under these Recommendations.

Reserves listed in point (b) above generally result from provisions established by law, including financial accounting regulations. Equity reserves resulting from provisions are made non-distributable and should be maintained before distributions or equity capital reductions take place.

The allocation of net earnings (either positive or negative, that is, profits or losses) is critical here:

- In the case of positive net earnings (profits), they may be allocated between prudential reserves to ensure corporate sustainability, including social and environmental responsibilities, and distributions to shareholders, including retained earnings for future distributions to them.
- In the case of negative net earnings (losses), prudential reserves should be shielded from loss allocation to company equity. This implies that the obligation to maintain minimum equity capital is extended to include reserves, which are needed to ensure corporate sustainability, including social and environmental responsibilities.

Concerning the treatment of non-realised gains and losses, they should not be compensated with each other unless they are incurred on the same accounting element. Moreover, the valuation of assets for distributions-in-kind should be based upon their current values with a view to avoiding overpayment. This latter operation should be submitted to specific controls in transactions with related and dependent parties, since the latter transactions may result in appropriating unrealised gains.

Concerning minimum equity capital protection, operations on capital increase and reduction are critical. Consequently, non-distributable reserves should be excluded from these operations. In particular, accumulated unrealised profits should be excluded from capitalisation, while accumulated unrealised losses may be written off in a reduction or reorganisation of company share capital. In this context, the following exception made by the EU framework to the general rules on distribution (Article 56) could be revised to better protect non-distributable reserves for social and environmental considerations from appropriation:

> (Article 56(1)) 'Except for cases of reductions of subscribed capital …'
>
> (Article 56(6)) 'Paragraphs 1 to 5 shall not affect the provisions of the Member States as regards increases in subscribed capital by capitalisation of reserves.'[55]

[55] Directive (EU) 2017/1132 (n 51).

For instance, the following operations are not 'distributions' under EU company law: (i) an issue of shares as fully or partly-paid bonus shares; (ii) the reduction of share capital; (iii) extinguishing or reducing the liability of any of the members on any of the company's shares in respect of share capital not paid-up; (iv) reducing paid-up share capital; (v) redemption or purchase of any of the company's own shares out of capital.

Moreover, the company might have material share premium or merger reserves, which may be non-distributable. However, these reserves could be cancelled in operations involving equity capital reduction, such as: (i) capital reduction agreed and capital paid back to shareholders, treated here as a capital reduction, or re-purchase of shares; (ii) a capital reduction reducing the share premium or the merger reserve, then transferring it to retained earnings. Such operations may be especially problematic when carried out in intra-group and related-party transactions, including when special-purpose entities are involved.

In this context, the EU and national legislatures should consider strengthening the regime introduced by Articles 75 and 76 of Directive (EU) 2017/1132[56] concerning safeguards for creditors in the case of a reduction in the subscribed capital. Additional controls may be introduced when capital reduction operations over a certain timeframe exceed a certain threshold of non-distributable reserves. For instance, only a part of the latter reserves may be made available for capital reduction purposes with a view to offsetting losses, while at least a part of them may be excluded from capital reduction involving distributions to shareholders.

Last but not least, advance recognition of a future distribution or capital repayment should be deducted from current distributable profits.[57]

3.4 Recommendation 4: Legal Reserve (Prudential Approach)

Some EU Member States impose a legal reserve. This reserve fosters protection of company equity capital as well as the general protection of the company as a going concern. However, its amount is often based upon legal capital only. This basis may encourage companies to establish a lower amount of legal capital to have discretion on distributions, making the legal capital maintenance regime ineffective for the purposes of creditor protection and corporate sustainability enhancement.

A legal reserve implies a prudential cushion to be added to legal capital and maintained before distributions to shareholders may be carried out. The establishment of such a safeguard should be expanded to better meet social and environmental responsibilities.

Recommendation 4: Legal reserves (prudential approach)

(1) Legal reserve requirements may be based upon total shareholder equity (including premiums) as defined by these Recommendations. The minimum annual allocation of net earnings to this legal reserve (share of net profits) may be prescribed by law (public order) or by the general meeting on the board's recommendation (private order).

(2) Minimum legal reserve requirements should be based upon total shareholder equity capital, not only legal share capital. Consequently, whenever a minimum level of legal reserve is required, it should be based upon at least the legal share capital plus premiums, and should be prescribed by law or the general meeting on the board's recommendation.

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[56] Directive (EU) 2017/1132 (n 51).

[57] ICAEW 2017, *Guidance on Realised and Distributable Profits under the Companies Act 2006* (Technical Release, ICAEW Tech 02/17BL, April 2017). Guidance issued by the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland (the Institutes) in April 2017 <https://www.icas.com/__data/assets/pdf_file/0004/289075/TECH-02-17BL-Guidance-on-Distributable-Profits.pdf> accessed 1 December 2022; see also ICAEW (n 48) para 6.31.

3.5 Recommendation 5: Mandatory Restriction of Distributions (Prudential Approach)

Under EU law, some financial sectors, such as banking and insurance, already have in place regulatory instruments which control equity reserve requirements, including by restricting distributions to shareholders. Moreover, in several jurisdictions, general meetings are often required to approve an action plan for share buybacks.

These regulatory arrangements have been established to sustain financial institutions as going concerns and thereby also sustain financial stability and protect creditors (including depositors).

These regulatory and governance instruments are in line with the principle of prudence and the promotion of sustainable business conduct. Therefore, this principle of limiting hazards to stakeholders and society may be expanded to non-financial companies with a view to providing protection for corporate sustainability involving corporate social and environmental responsibilities.

Recommendation 5: Restriction on distributions (prudential approach)

(1) Restrictions on distributions to shareholders (typically dividends and buybacks) may be established if reserves are below a certain threshold (as is the case in regulated sectors, such as banking and insurance).

(2) The maximum amount of annual distributions may be fixed either by law or the general meeting on the board's recommendation. This amount may be inferior to the total maximum amount that is permissible to distribute by existing company law provisions, thus establishing an ongoing general reserve provisioning mechanism.

4 Recommendations on Accounting Measurements

Recommendations 6 to 10 provide solutions for accounting measurement issues mainly raised by current value measurements (fair value accounting).

Concerning the determination of distributable profits and distributable reserves for the sake of distributions, the EU and its Members States would need to address some specific issues relating to accounting measurements. In fact, EU Member states have been addressing these issues and implementing specific policies, but the EU response as a whole remains incomplete and un-harmonised, as demonstrated by background research reviewing national practices conducted for this ELI project.[58]

The identification of profits has traditionally been based upon the annual balance sheet and profit and loss statement of the company (annual accounts). Both financial statements are based upon an accrual basis of accounting. Historically, these financial statements were characterised by the principle of prudence and established according to the principles of realisation and conservatism. Today, the latter two principles have lost their importance with the EU's adoption of the IFRS. If distributions were to be judged on the basis of IFRS financial statements, there would be a serious danger that companies might pay distributions of mere book profits (unrealised profits).[59]

In this context, it should be recalled that the EU accounting framework is expected to remain aligned with the protection of company capital provision (italics added), pursuant to recital 7 of Directive 2013/34/EU:

> The provisions of this Directive should apply only to the extent that they are not inconsistent with, or contradicted by, provisions on the financial reporting of certain types of undertakings or *provisions regarding the distribution of an undertaking's capital* which are laid down in other legislative acts in force adopted by one or more Union institutions.[60]

The regulatory review conducted in the framework of this project showed that the EU capital maintenance regime is quite inconsistent with the EU accounting framework now dependent on the IFRS. Specific provisions should therefore be introduced to protect corporate sustainability and meet corporate social and environmental responsibilities.

4.1 Recommendation 6: Non-Realised Gains on Certain Accounting Elements

Some accounting standards, including the IFRS, allow for, or require, the recognition of non-realised gains, which are then recorded either as net income or as OCI. Non-realised gains mean that those gains are not accrued through arm's length transactions with customers or other independent parties, but due to certain accounting measurements, which involve the revaluation of book values to higher current values. This method applies a fair (current) value basis of accounting.

It is therefore appropriate to segregate these unrealised gains from shareholder equity and from distributable profits, establishing non-distributable reserves for non-realised gains arising from certain accounting measurements. For instance, the recognition of a change in fair value (current value) in financial statements is never a realised profit, nor is a foreign currency translation gain. The following Recommendation aims to address this issue:

[58] Le Manh (n 52).

[59] An ICAEW briefing paper noted that the adoption of fair value accounting challenges the existing profit distribution rules based on 'realised profits': 'The regime imposes a rigid link between company balance sheets and the amount of company distributions and, especially with the introduction of IFRS, is becoming increasingly flawed. This is because it is based on a supposition that realisation is a key driver of accounting profit recognition, and thus it bases distributions on realised profits as shown in the accounts; whereas accounts, especially under IFRS, are becoming less and less driven by realisation'. Institute of Chartered Accountants in England and Wales, 'Implications of IFRS for Distributable Profits. ICAEW Briefing Paper' <https://www.icaew.com/-/media/corporate/files/technical/legal-and-regulatory/modernising-uk-company-law/implications-of-ifrs-for-distributable-profits.ashx> accessed 1 December 2022.

[60] Directive 2013/34/EU (n 16). Emphasis added.

Recommendation 6: Non-realised gains on certain accounting measurements

Non-distributable reserves should be established against non-realised gains arising from certain accounting measurements based upon current values. These measurements include:

(a) other comprehensive income (OCI) arising from the revaluation option for tangible assets (International Accounting Standards (IAS) 16) or intangible assets (IAS 38);

(b) unrealised gains on investment properties recognised in net income (IAS 40);

(c) OCI arising from the measurement at fair value of certain financial instruments and cash flow hedge instruments (IFRS 9/IAS 39);

(d) unrealised gains on certain financial instruments recognised in net income (IFRS 9);

(e) OCI arising from actuarial gains on a defined benefit plan (IAS 19); and

(f) OCI and net income arising from the effect of changes in foreign exchange rates (IAS 21).

In this context, investment entities deserve specific attention. These entities qualify for exclusion from full consolidation by virtue of a scope exception. Under the IFRS, two accounting policies are available for investments in subsidiaries that are not classified as held for sale: (i) at cost; or (ii) in accordance with IFRS 9, which requires such investments to be maintained at fair value. All the non-realised gains on these investments – whether held for sale or not – should be accrued to a non-distributable reserve. For instance, as shown by background research on Italy in the course of the ELI project, Italian law (Article 6(1) of Legislative Decree 38/2005, concerning companies which adopt the IFRS) introduces some restrictions on distributions by establishing non-distributable reserves against certain fair value accounting gains and the consequent increase of company equity.

Moreover, unrealised losses should be recognised in net income or OCI without any reserve adjustments. In this context, the depreciation charge computation may result in enabling indirect recognition of non-realised gains. Under IAS 16 concerning property, plant and equipment, for instance, the residual value of an asset – that is, its yet unrealised liquidation value[61] – is deducted from the carrying amount upon which depreciation charges are determined.

> (IAS 16, 54) 'The residual value of an asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.'

In this case, asset residual value deduction may effectively reduce the depreciation charges on the basis of an unrealised gain, consequently increasing profits. For the sake of determining distributable profits which constitute the basis for distributions, asset residual value should not be deducted from the carrying amount unless the former is reliably measurable on a continuing basis and asset liquidation is feasible and likely to occur shortly. A more prudent approach would exclude deducting asset residual value when computing depreciation charges.[62]

4.2 Recommendation 7: Provisions

When a provision is recognised under the IFRS (IAS 37), some future cost exists that is likely to become due in time. Such future cost may be implied either by a regulatory obligation (such as future waste disposal[63] under the 'polluter pays principle' and the 'extended producer responsibility') or a constructive

[61] According to IAS (16(6)), 'the residual value of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.'
[62] See also IAS (38, 100) concerning residual value for intangible assets.
[63] See EU Waste Framework Directive, <https://ec.europa.eu/environment/topics/waste-and-recycling/waste-framework-directive_en> accessed 18 August 2022.

obligation (such as future expenditures committed under a publicly announced management plan to meet social and environmental objectives). Therefore, the establishment of an equity reserve to pay for that cost at its nominal amount is needed, and that reserve should not be distributable.[64] Establishing these provisions is in line with EU company law:[65]

> (Article 12(12)) 'Provisions shall cover liabilities the nature of which is clearly defined and which at the balance sheet date are either likely to be incurred or certain to be incurred, but uncertain as to their amount or as to the date on which they will arise.
>
> The Member States may also authorise the creation of provisions intended to cover expenses the nature of which is clearly defined and which at the balance sheet date are either likely to be incurred or certain to be incurred, but uncertain as to their amount or as to the date on which they will arise.
>
> At the balance sheet date, a provision shall represent the best estimate of the expenses likely to be incurred or, in the case of a liability, of the amount required to meet that liability. Provisions shall not be used to adjust the values of assets.'

Applying discounting to the estimated future nominal amount does certainly reduce the outstanding provision reserve, displacing the total provisioning through time, postponing its filling-up and thus potentially undermining protection from distributions. When discounting is applied, the future obligation would remain more exposed over time, especially in the case of financial distress occurring between the recognition of the discounted amount and its eventual future payment (full amount). Therefore, a reserve that equals the difference between the nominal and the discounted value should be maintained over time, enabling its progressive reduction over time. The following Recommendation addresses this issue:

Recommendation 7: Provisions

Non-distributable reserves should be introduced against the current value measurement of provisions, at least for those implied by social and environmental responsibilities. A more extensively prudent application may cover all the provisions.

These reserves may compensate for reductions in the total provisions outstanding due to the discounted value (at initial recognition), as well as prevent distributions based upon discounted unwinding gains (at re-measurement, due to a change in the discount rate of reference, for instance).

Moreover, re-measurement of a liability at its fair value – being often the reversal of a realised loss – cannot generate a realised profit.

When liabilities (eg, bank debts or bond issues) and derivative contracts are measured at fair value, their value may be affected by the reporting company's own creditworthiness. Consequently, a profit may arise in circumstances where the company's creditworthiness is deteriorating, that is, the fair value of the liability is decreasing. Even in this case, the holding gain on that liability is never a realised profit. According to IFRS 9, gains and losses on own creditworthiness are recognised in OCI. Therefore, they should be non-distributable.

More generally speaking, measuring current values under inflationary conditions and rapid technological changes may be quite challenging. These difficulties should not prevent management from establishing a prudent estimation of those future financial needs to be fulfilled with a view to implementing corporate social and environmental plans. This estimation complies with the EU law provisions quoted above.

[64] Biondi (n 41).
[65] Directive 2013/34/EU (n 16).

4.3 Recommendations on Capitalised Costs for Start-Up and Development

Both Recommendations on capitalised costs for start-up and development are in line with the EU Accounting Directive (Article 12(11)):[66]

> … Where national law authorises the inclusion of costs of development under 'Assets' and the costs of development have not been completely written off, Member States shall require that no distribution of profits take place unless the amount of the reserves available for distribution and profits brought forward is at least equal to that of the costs not written off.
>
> Where national law authorises the inclusion of formation expenses under 'Assets', they shall be written off within a period of maximum five years. In that case, Member States shall require that the third subparagraph apply mutatis mutandis to formation expenses. …

4.4 Recommendation 8: Start-Up Investments

When a company is established, some investments may be capitalised as assets to be amortised over time. This may increase the net earnings possibly available for distributions, relative to a full recognition of those investments as expenses of the period when they accrued.

For the sake of prudence, the distributable profit may then be limited to the amortised part of the capitalised parts or be limited by the full amount of them as if capitalisation had not occurred. The following Recommendation may then be applied:

> **Recommendation 8: Capitalised costs for start-up**
>
> Non-distributable reserves for capitalised start-up costs should be established.

According to the EU law mentioned above, 'where national law authorises the inclusion of formation expenses under "assets", they shall be written off within a period of maximum five years'. It is also specified that, in this case, Member States shall require dividend distribution restriction as for development costs.[67]

4.5 Recommendation 9: Development Costs

Moreover, when research and development processes reach the development phase, companies are likely to generate valuable resources from those processes (IAS 38). Contrary to research expenditures, which must be expensed in the period when they accrue, costs pertaining to the development phase may be capitalised and amortised over time. This would increase the net earnings possibly available for distributions, relative to a full recognition of those expenditures as expenses of the period when they accrued.

For the sake of prudence, the distributable profit may, in such cases, be limited to the amortised part of the capitalised development costs, or be limited by the full amount of these costs as if capitalisation had not occurred. The following Recommendation would then be applied:

> **Recommendation 9: Capitalised costs for development**
>
> Non-distributable reserves for capitalised development costs should be established.

For instance, as shown by background research on Germany in the course of this project, Germany's Commercial Code extends this principle to all internally generated intangible assets (section 268(8) GCC).

[66] Directive 2013/34/EU (n 16).
[67] Article 12(11)(4), Directive 2013/34/EU (n 16).

4.6 Recommendation 10: Deferred Tax Assets

Under IFRS (IAS 12) and several Member States' accounting frameworks, as demonstrated by background research reviewing national practices conducted for the ELI project,[68] companies recognise accrued rights to future tax benefits as deferred tax assets. A deferred tax asset arises when a reporting entity is expected to pay less tax in the future if it recovers the carrying amount of another asset or liability or if it has unused tax losses or unused tax credits. For instance, a deferred tax asset will arise and be capitalised when companies incur a loss which may be deducted from future profits with a view to reducing the corporate income tax basis over the next period(s).

Gains arising from these assets are recognised as either net income or OCI. However, these gains are not accrued through arm's length transactions with customers or other independent parties. Therefore, they should be excluded from distributable profits and held in a non-distributable reserve. The following Recommendation addresses this issue:

Recommendation 10: Deferred tax assets

Non-distributable reserves should be established against non-realised gains recognised in either other comprehensive income or net income, arising from deferred tax assets.

For instance, background research on Germany conducted for this project showed that Germany's Commercial Code (section 268(8) GCC) states that dividends can only be paid to the extent that the remaining profit reserves (+/- profit/loss carried forward) available for distribution correspond at least to the amount that the deferred tax assets exceed the deferred tax liabilities. In short: (unrealised) profits based on the recognition of deferred tax assets (minus losses from deferred tax liabilities) cannot be distributed. For the amount of this difference, the profit reserves (otherwise available for distribution) are blocked from distribution.

[68] Le Manh (n 52).

5 Recommendations on Group and Related-Party Transactions, Including with Special Purpose Entities

Recommendations 11 to 13 address some group and related-party transactions, which deserve specific attention to secure ESG responsibilities.

Factually speaking, in corporate practice, there is a fundamental disconnection between equity investment, enterprise management and corporate control. Over time, three main legal-economic innovations have featured this disconnection: (i) the very introduction of the corporate legal form as an autonomous legal person; (ii) the manner in which corporate groups and financial intermediaries work; and (iii) the overwhelming web of contractual arrangements and financial derivatives which characterise business affairs of listed companies and equity markets nowadays.[69]

This disconnection relates to the legal-economic existence of an enterprise group, which includes, but is not limited to, the corporate group defined by financial accounting consolidation provisions.[70]

Different approaches exist with regard to the identification of entities that belong to a specific group of companies. In general, legal and statutory presumptions are applied with judicial assessments in order to identify the parties which are involved in the group under a particular legal, judicial or regulatory procedure.[71] Important indications on group relationship identification are found in the parts of Directive 2013/34/EU[72] that deal with consolidated financial and non-financial statements (especially chapter 6),[73] as well as in Directive 2004/109/EC,[74] in particular with regard to the definition of 'subsidiary' as provided in Article 2(1)(f) of that Directive.[75]

Concerning enterprise groups, in business and financial affairs, various laws – including those covering competition, labour and pollution – have dealt with enterprise groups and the related need to bring clarity to relationships and responsibilities between business partners, with a view to enforcing the law and preventing abuse. The EU framework is currently evolving in order to better address these issues, including through Shareholder Rights (SRD II Directive),[76] Corporate Sustainability Due Diligence (CSDD proposal)[77] and CSRD proposal.[78] For instance, the SRD II Directive defines a 'related party' following the international accounting standards[79] as adopted in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council.[80] Accordingly, a related party may belong either to the corporate, or the enterprise group. The CSDD proposal defines both subsidiaries and established business relationships, the former pointing to the

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[69] Yuri Biondi, 'Ownership (Lost) and Corporate Control: An Enterprise Entity Perspective' (2019) 10(3) Accounting, Economics, and Law: A Convivium <https://doi.org/10.1515/ael-2019-0025> accessed 16 August 2022.

[70] Throughout this document, 'dependent' companies and entities point to the broader perimeter of an enterprise group, which includes the corporate group constituted by subsidiaries controlled by a parent company.

[71] For instance, concerning the existence of an employment relationship with a view to applying labour laws, see International Labour Organisation – ILO, Regulating the employment relationship in Europe: A Guide to Recommendation No 198, Governance and Tripartism Department International Labour Office, Geneva, European Labour Law Network (ELLN), March 2013.

[72] Directive 2013/34/EU (n 16) <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02013L0034-20211221> accessed 1 December 2022.

[73] Directive 2013/34/EU (n 16) <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02013L0034-20211221> accessed 18 August 2022.

[74] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L390/38 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32004L0109> accessed 18 August 2022.

[75] Directive 2004/109/EC (n 75).

[76] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (Text with EEA relevance) <http://data.europa.eu/eli/dir/2017/828/oj> accessed 1 December 2022.

[77] Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 COM/2022/71 final <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071> accessed 1 December 2022.

[78] European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting COM(2021) 189 final <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021PC0189&from=EN> accessed 1 December 2022.

[79] International Financial Reporting Standards, *IAS 24 – Related Party Disclosures* (IAS, 2022) 9.

[80] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02002R1606-20080410> accessed 1 December 2022.

corporate group, the latter to the enterprise group perimeter. Accordingly, a 'subsidiary' means a legal person through which the activity of a 'controlled undertaking' – as defined in Article 2(1)(f), of Directive 2004/109/EC of the European Parliament and of the Council[81] – is exercised. A business relationship means a relationship with a contractor, subcontractor or any other legal entities ('partner') either: (i) with whom the company has a commercial agreement or to whom the company provides financing, insurance or reinsurance; or (ii) that performs business operations relating to the products or services of the company for or on behalf of the company. An established business relationship means therefore a business relationship, whether direct or indirect: (i) which is, or which is expected to be, lasting, in view of its intensity or duration; and (ii) which does not represent a negligible or merely ancillary part of the value chain.

In the context of enterprise groups, transactions with and among dependent parties including subsidiaries (intra-group transactions), related party transactions and use of special-purpose entities may be concluded to facilitate structuring opportunities with a view to obtaining specific regulatory results. Striking cases such as *Metaleurop* in France[82] and *Wirecard*[83] in Germany show how corporate structures can be arranged to deceive the public while avoiding social and environmental responsibilities.[84] Some issues raised by structuring opportunities engineered through linked operations were acknowledged by the Institute of Chartered Accountants in England and Wales.[85]

Concerning equity capital management, examples of problematic intra-group transactions include:[86] (i) cash pooling arrangements and group treasury functions; (ii) dividend received or receivable on an investment in a subsidiary; (iii) accrual of intra-group dividends payable and receivable; (iv) dividend by a subsidiary to a parent which provides or reinvests the funds in the subsidiary; (v) sale of an asset by a parent to its subsidiary; (vi) sale of an asset by a subsidiary to a parent followed by a dividend to the parent of the resulting profit; (vii) sale of an asset by a subsidiary to a fellow subsidiary followed by a dividend to the parent of the resulting profit; (viii) dividend in kind between companies in the same group; return of capital contribution; (ix) transfer of an asset for consideration followed by waiver of the resulting inter-company debt; (x) intragroup loans including at off-market terms; (xi) debits within equity arising on group reconstructions (business combinations); (xii) merger relief and group reconstruction relief. To be sure, these transactions are problematic from the viewpoint of single financial statements, which constitute the basis for applying company law provisions, including rules on distributions. Even if distributions are decided based on consolidated financial statements, resources may be extracted from individual entities of the group, thereby undermining their individual capacity to meet social and environmental responsibilities.

Several ex-post liability regimes exist to cope with these structuring opportunities and related problems: (i) shareholder liability enforced through the existing piercing the veil doctrine; (ii) management liability due to a violation of duties; and (iii) the liability of counterparties due to fraudulent transfers. However, these ex-post liabilities are often insufficient to enforce the protection of corporate sustainability, especially when major liabilities for environmental damage and social obligations (such as employee

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[81] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (OJ L 390, 31.12.2004, 38) <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02004L0109-20210318> accessed 1 December 2022.

[82] Cour de Cassation, Chambre commerciale, 19 avril 2005, 05-10.094 <https://www.legifrance.gouv.fr/juri/id/JURITEXT000007050495> accessed on 2 December 2022. See also Olivier Mazade, 'L'affaire Metaleurop. Une dénonciation impossible?' [2013] *Terrains & travaux* 23.

[83] According to the Wirecard website, the Insolvency Court of the Local Court of Munich issued a ruling on 25 August 2020 to open insolvency proceedings over the assets of EUR 500 million bond (Ref 1542 IN 1308/20). Further information on the ongoing insolvency proceedings: <https://www.wirecard.com/> accessed on 2 December 2022. See also: <https://www.ft.com/wirecard> accessed on 2 December 2022.

[84] In order to cope with group structuring opportunities between parents and subsidiaries, Henry Hansmann and Reinier Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' [1991] The Yale Law Journal 1879 (<https://doi.org/10.2307/796812>) argued for unlimited shareholder liability with extraterritorial reach towards tort victims.

[85] ICAEW (n 48) 37.

[86] ICAEW (n 48) sec 9, 75.

pension benefits) are concerned. Moreover, ex-post liability claims in insolvency procedures increase litigation costs and undermine trust.

This overwhelming situation can make equity capital management regimes ineffective. Policy-makers should be aware of this limitation and seek remedies. For instance, background research showed that Germany's company law rules establish specific dividend controls when a subsidiary holds shares of its parent company.

Company operations which would require specific controls include:

- The recognition of non-realised gains through the equity method for investment in subsidiaries.
- Related party transactions with shareholders, including disguised value transfers by dependent companies.[87]
- Related party transactions with directors, including disguised value transfers by dependent companies.[88]
- Sale-and-buyback, sale-and-service, and sale-and-lease-back operations, including with related and intra-group parties: sale-and-buyback operations may disguise a borrowing operation and involve a factual transfer of assets, formally increasing revenues from the sale of assets which are not accrued substantially. A similar result may be obtained with synthetic lease operations involving special purpose entities.[89]

Problems with these transactions cannot be solved by taking into account consolidated statements. In order to cope with these operations, a suitable policy option would be to introduce specific principles, which enforce restrictions on distributions under these circumstances. The following sections recommend some of these principles.

5.1 Recommendation 11: Subsidiaries Accounted for Under the Equity Method

Recommendation 11: Subsidiaries accounted for under the equity method

Non-distributable reserves may be established against initial investment and holding gains from investments in subsidiaries, which are accounted for under the equity method, net of actual paid dividends.

5.2 Recommendation 12: Sales and Leaseback Operations

Recommendation 12: Sales and leaseback operations

Non-distributable reserves should be established against sale-and-leaseback and other operations which result in non-permanently accrued revenues.

In this context, as established during background research on Germany for this project, Germany's Commercial Code (section 272(4)) excludes from distributable profits the amount of investments in an ownership interest in a controlling enterprise or in an enterprise holding a majority ownership interest, by requiring companies to hold a specific reserve for this type of investment. This provision avoids redemption of shareholder contributions and circumventing dividend restrictions at the individual company level by means of buying shares of a parent company or subsidiary within the same corporate group. Since this reserve will be based on transfers from current profits

[87] Fleischer in Lutter and others (n 50) 94 ff.
[88] Fleischer in Lutter and others (n 50) 94 ff.
[89] Jan Friedrich, 'Regulatory Arbitrage in the Intersection of Accounting Standards and Tax Laws: The Case of Synthetic Leases' Accounting, Economics, and Law: A Convivium [2021] vol 11, no 2, 201–232 <https://doi.org/10.1515/ael-2020-0098> accessed 1 December 2022; Tessa Kunkel, 'Ambiguities in Accounting and their Impact on Regulatory Arbitrage: A Study on the Anchoring of the Rights and Obligations Approach in the IASB's Conceptual Framework' Accounting, Economics, and Law: A Convivium [2021] vol 11, no 2 161–199 <https://doi.org/10.1515/ael-2019-0049> accessed 1 December 2022.

or distributable profit reserves, it prevents 'double' shareholder remuneration (by both cash dividends and bought shares). The amount for this reserve can be taken from the current-year distributable profit, but also from existing distributable profit reserves.

5.3 Recommendation 13: Whole Group Sustainability

The problem with intra-group and related-party transactions is critical for liabilities concerning environmental protection and social obligations, such as pension benefits. They are exposed to the same situation that Stone[90] denotes in the case of the production and processing of dangerous goods:[91]

> This problem is more severe in the sphere of the production and processing of dangerous goods. For obvious reasons, the tendency to externalise the risk is particularly strong. The 'dirty business' is delegated to a company formed especially for this purpose and sparingly equipped with capital, or to so-called independent suppliers that are linked to the main enterprise not by a capital contributions but simply by a loan and general output contracts. This avoids legal liability responsibilities that usually characterise the relationship between the parent company and the subsidiary. In order to solve this dilemma, it is proposed that the shareholders should always pay such claims personally if the company cannot pay its liabilities itself. However, unlike the classic piercing of the corporate veil, the shareholders should not be liable in the same way as the partners of a general partnership, i.e. with joint and several liability. Instead, they would be liable as guarantors, i.e. each shareholder being liable for the amount not covered only up to his percentage of participation in the company.

In this context, a solution to prevent such cases would be to establish a solidarity fund concerning social and environmental responsibilities, as, for example, it exists for pension benefits in Germany and other countries. Accordingly, all companies promising pensions or facing social and environmental liabilities pay into that fund. In case of the company's financial distress, the fund covers pensions or disbursements.

Another policy option would be to introduce prudential general solutions involving guarantee and liability by controlling parties and directors, at least in the case of major social and environmental liabilities (such as pension benefit schemes and environmental impact management). Eligible future expenditures may be identified, for example, through the EU Taxonomy for sustainable activities.[92] This notion includes:

- Direct liability of the controlling parties (shareholders) in cases of failure to provide for the maintenance of company capital as expressed in these Recommendations (in line with 55 BGH, Urt v 10.7.2001 – VI ZR 160/00 NJW 2001, 3702, 3703[93]);
- Guarantee by/liability of the director in the case of transferring resources from the directed company. In fact, it would be unreasonable for a director to be able to cover for this amount;
- Guarantee by/liability of the controlling party (shareholder) in the case of transferring resources – in whatever form – from the controlled company;
- Guarantee by/liability of the whole group in the case of transferring resources – in whatever form – from its dependent companies, including subsidiaries and special purpose entities.

Drawing upon this background, the EU and its Member States should consider the following general Recommendation on group solidarity in terms of social and environmental responsibilities:

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[90] Christopher D Stone, 'The Place of Enterprise Liability in the Control of Corporate Conduct', [1980] 90(1) The Yale Law Journal 1, 68.
[91] Quoted by Merkt and Spindler in Lutter and others (n 50) 228, fn 295.
[92] European Commission, 'EU Taxonomy for Sustainable Activities' <https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en> accessed 1 December 2022.
[93] Quoted by Hanno Merkt and Gerald Spindler, 'Direct Liability of Controlling Parties (Piercing the Corporate Veil) and Related Legal Constellations' in Lutter and others (n 50) p 178 and fn 55.

Recommendation 13: Whole group sustainability

(1) The corporate group as a whole should provide a prudential guarantee and incur a related liability when resources are transferred between its dependent companies.

(2) This group guarantee and liability may not only cover the amount of transferred resources, but also the company's social and environmental obligations, which may become due over time and circumstances.

(3) The group guarantee and liability should be provided at least over the timeframe of related obligations.

From a financial accounting perspective, consolidated (combined) financial statements provide information on the corporate (enterprise) group's financial performance and position, helping assessing management's stewardship and ensuring accountability toward stakeholders including financial investors and society.[94] However, as a matter of law, corporate groups do not exist in the EU framework as overarching entities.[95] Only parent companies do. As such, groups do not have shareholders, employees, creditors and social and environmental obligations: only individual entities belonging or relating to the group do. In order to enforce this principle, the ultimate parent company may provide the guarantee, drawing upon the group resources to cover for it whenever necessary. Legal and statutory presumptions may be developed and applied together with judicial assessments in order to identify the group entities which will be involved in this enforcement.

This instrument of general guarantee and liability backed by group solidarity is inspired by the *Kommanditgesellschaft* (limited partnership), which allows for equity capital repayment.[96] While certainly true, repayment is, in this case, granted against the introduction of personal liability in the amount of the corresponding sum.[97]

This instrument is in line with the legal-economic theory of the enterprise entity.[98] The group is then understood as a single legal-economic unit, which acts in a coordinated way. This economic coordination involves a de facto mixing of assets and resources. It is intended to produce better results than single parties acting alone. It implies then that the group as a whole faces its social and environmental responsibilities.

This instrument is especially relevant when a company is materially undercapitalised. A similar shareholder guarantee is applied under Spanish law to protect creditors when a private company reduces its equity capital.[99] This is also the case for divisions at EU level.[100] Under Italian law, shareholder loans are subordinated when a limited liability company is undercapitalised;[101] this principle is extended to public companies[102] in the context of so-called 'directed and coordinated activities' (ie loans made by entities which directly or indirectly control the relevant borrower, provided the required legal conditions are met).[103]

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[94] See also IASB, 'Conceptual Framework for Financial Reporting' (2018) especially para 1.8, 1.12, 1.22 and para 3.10–3.18. <https://www.ifrs.org/issued-standards/list-of-standards/conceptual-framework.html/content/dam/ifrs/publications/html-standards/english/2022/issued/cf/> accessed 1 December 2022.

[95] To be sure, EU Regulation 2137/85 sets out a framework for a European Economic Interest Grouping (EEIG). This legal instrument constitutes a legal entity for a grouping formed by companies or legal bodies and/or natural persons carrying out economic activity coming from different Member States; the purpose of such a grouping is to facilitate and coordinate the cross-border economic activities of its members <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=celex%3A31985R2137> accessed 1 December 2022.

[96] § 172(4) German Commercial Code (Handelsgesetzbuch, HGB).

[97] Lutter and others (n 50) 9.

[98] Kurt A Strasser and Phillip Blumberg, 'Legal Form and Economic Substance of Enterprise Groups: Implications for Legal Policy' [2011] 1(1) Accounting, Economics, and Law: A Convivium <https://doi.org/10.2202/2152-2820.1000> accessed 17 August 2022.

[99] Art 331 Law of Capital Companies (LSC).

[100] Art 146 para 3 Directive 2017/1132 (n 4).

[101] Codice Civile, art 2467.

[102] ibidem, art 2497-quinquies.

[103] See also Italy's Supreme Court (*Corte di Cassazione*) decision no 16291 of 20 June 2018, identifying some additional elements to be taken into account when evaluating the application of the equitable subordination rule to shareholder loans made to a borrowing public company.

6 Recommendations on Capital and Inter-Company Transactions

Recommendations 14 and 15 address some extraordinary transactions such as capital and inter-company transactions. Moreover, Recommendations 16 to 20 address cross-border transactions.

6.1 Recommendation 14: Management of Own Shares

When a company acquires its own shares (so-called 'treasury shares'), it is generally accepted that the company should hold an equity reserve for the value of own shares held outstanding. This reserve should be made non-distributable.

The manner in which this reserve is represented may follow several accounting methods. Under IAS 32, two accounting methods coexist, either a negative reserve method (para 33) or a full fair value method (para 33A); disclosure is made either in the balance sheet or the notes (para 34):

> (Para 33) 'If an entity reacquires its own equity instruments, those instruments ('treasury shares') shall be deducted from equity. No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received shall be recognised directly in equity.'
>
> (Para 33A) 'Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund and recognise financial liabilities for the amounts to be paid to those investors. Similarly, some entities issue groups of insurance contracts with direct participation features and those entities hold the underlying items. Some such funds or underlying items include the entity's treasury shares. Despite paragraph 33, an entity may elect not to deduct from equity a treasury share that is included in such a fund or is an underlying item when, and only when, an entity reacquires its own equity instrument for such purposes. Instead, the entity may elect to continue to account for that treasury share as equity and to account for the reacquired instrument as if the instrument were a financial asset and measure it at fair value through profit or loss in accordance with IFRS 9. That election is irrevocable and made on an instrument-by-instrument basis. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. (See IFRS 17 for terms used in this paragraph that are defined in that Standard.)'
>
> (Para 34) 'The amount of treasury shares held is disclosed separately either in the statement of financial position or in the notes, in accordance with IAS 1 *Presentation of Financial Statements*. An entity provides disclosure in accordance with IAS 24 *Related Party Disclosures* if the entity reacquires its own equity instruments from related parties.'

When companies actively manage their own shares on financial markets, they may factually circumvent the capital maintenance regime. For instance, share buyback implies temporary capital reduction and a distribution to share-selling investors. If it is followed by share cancellation, it further implies permanent share capital reduction.

Moreover, pyramid schemes (Ponzi schemes) may be enabled if share premiums paid by new shareholders beyond the nominal value of the share are distributed to shareholders. More generally speaking, this distribution would breach equality between shareholders and enable the company to distribute profits made out of trading on own shares.

Last but not least, own share management was previously strictly restricted in many jurisdictions. Its deregulation has led to abuses and opportunities for market manipulation. This Report points to and draws upon this empirical evidence to recommend restrictions on this practice.[104]

[104] For empirical evidence and references to it, see Yuri Biondi, 'Hyman Minsky's Financial Instability Hypothesis and the Accounting Structure of Economy' [2013] Accounting, Economics and Law, vol 3, no 3, 141–166 <https://doi.org/10.1515/ael-2013-0045> accessed 1 December 2022.

Therefore, restrictions should be introduced on distributions made of own shares held and share premiums:

Recommendation 14: Management of own shares

When own shares are acquired, regardless of the accounting representation used for their acquisition, the following should apply:

(a) the equity reserve matching own shares held outstanding should be non-distributable and based upon the acquisition value and holding gains at current values. The legal nominal value is not the basis to compute this reserve;

(b) any purchase of shares to be held in treasury has to be made out of distributable profits, which will be reduced by the amount of the purchase price; and

(c) when shares are sold, if the proceeds of the sales are higher than the purchase price, the positive difference should be held in the premium reserve.

Concerning the management of own shares, one accounting method is to recognise holdings of own shares on the asset side with a positive reserve against own shares held (in treasury) constituted in the equity account. Alternative accounting methods exist, such as 'contraction of capital', the 'reduction-of-surplus method', or the 'unallocated deduction method'. These latter methods deduct the acquisition value of own shares held in treasury from the equity account. This deduction is required by IAS 32 quoted above.

In this context, EU company law codification[105] requires the acquiring and/or holding of own shares at all times to be subject to the following condition:[106]

> (Article 63(1)(b)) 'if the shares are included among the assets shown in the balance sheet, a reserve of the same amount, unavailable for distribution, shall be included among the liabilities.'

Premiums on options on own equity shares should be treated as premiums on share issuances.[107] Moreover, where a company enters into a forward contract to repurchase its own equity shares, the company should recognise a liability, at the outset, for the nominal value of the payment to be made, with a corresponding debit taken directly to equity. The accounting effect is as if the equity shares had been repurchased immediately.

For instance, as shown by background research on Germany, according to German law (section 71(2) of the German Stock Corporation Act (GSCA)),[108] the shares bought back for some authorised purposes may not, in the aggregate with the other shares bought back and still in possession, amount to more than 10% of the share capital. To ensure company capital maintenance and creditor protection even in these cases of authorised share buy-backs, a reserve requirement applies. Some authorised buy-backs are only allowed if the company is able, at the time of the purchase, to establish reserves equal to the amount of the expenditures incurred for the purchase, without reducing the share capital or any reserves that are required by law or in accordance with the byelaws, for the latter reserves cannot be employed to make payments to shareholders but must be retained by the company. Consequently, this provision ensures that buybacks do not lead to a distribution of otherwise non-distributable profits or reserves.

In fact, Directive (EU) 2017/1132[109] stipulates that Member States shall require conditions to be fulfilled when they permit own share acquisition.[110] In this context, the EU framework allows the establishment of a maximum holding rate for own shares, imposing a minimum threshold of 10% of the subscribed capital. It also allows Member States to impose restrictions

[105] Directive (EU) 2017/1132 (n 4) <http://data.europa.eu/eli/dir/2017/1132/oj> accessed 1 December 2022.
[106] See also Article 64(4) of Directive (EU) 2017/1132.
[107] Cf ICAEW (n 48), 6.16.
[108] German Stock Corporation Act (GSCA; *Aktiengesetz*, AktG) of 1965 (last amended in January 2018).
[109] Directive (EU) 2017/1132 (n 4) para 60.
[110] Directive (EU) 2017/1132 (n 4).

on dividends distribution when a company holds its own shares, in order to avoid double distribution of the same profits to shareholders. However, these recommendations are not followed by all Member States, undermining harmonisation and resulting in an uneven playing level field across the EU.

Furthermore, Member States may derogate from some company law codification[111] provisions concerning acquisition and/or holding of own shares to the extent that such derogations are necessary for the adoption or application of provisions designed to encourage the participation of employees, or other groups of persons defined by national law, in the capital of undertakings (Article 84(1)). In this context, distribution of own shares to employees and other qualified groups of persons may be treated in analogy with a company capital increase. Shares to be distributed shall then be issued or acquired against distributable resources. This approach is compatible with EU company law codification, which states in Directive (EU) 2017/1132 that:

> (Article 64(6)) '[Transactions effected with a view to the acquisition of shares by or for the company's employees or the employees of an associate company] may not have the effect of reducing the net assets below the amount specified in Article 56(1).'

6.2 Recommendation 15: Accounting for Business Combinations

Business combinations are major company events. They may occur between independent parties or among related parties (under common control).

Under the IFRS (IFRS 3), goodwill capitalises a residual payment to shareholding investors in the acquired company. The latter investors are paid to authorise the business combination.[112] By construction, this payment is therefore not covered by revaluated net assets. Its capitalisation depends, therefore, on expectations of future economic benefits flowing to the reporting entity.[113]

> Goodwill = Consideration paid for the acquired company minus revaluated net assets of acquired company

From a conservative viewpoint, goodwill should be recorded as an immediate loss and eventually recovered through future earnings. Historically, it was written off as an immediate loss.[114] Indeed companies may prudently opt to regard the entire amount of goodwill written off to reserves as a realised loss.

Under IFRS 3, goodwill is instead capitalised and allowed to stand on the asset side indefinitely, to be submitted to an impairment test. The latter test is regularly required but is subjective.

Alternative accounting treatments exist beyond immediate write-off and indefinite capitalisation submitted to regular impairment testing. If capitalisation has to be maintained, goodwill may be amortised under a short time window of several years. In this way, it would be transformed into losses if future economic benefits do not materialise in due course. This treatment is consistent with the fact that shareholding investors of the acquired companies were already paid up-front. The future economic benefits – which the goodwill payment has been based upon – should then likely occur.

Since a goodwill reserve is not based on anything but computed future economic benefit expectations which are not yet realised and easy to manipulate, it seems reasonable to exclude it from distributions. A goodwill reserve may be made non-distributable, since it is not covered by the acquired company's

[112] Paid consideration may be by cash or other assets, including own shares. Cash and cash equivalents employed to pay for the business combination may have been obtained by borrowing or issuing financial securities including own shares.

[113] According to the IFRS 3 Basis for Conclusions (BC323), 'goodwill represents resources from which future economic benefits are expected to flow to the entity. … goodwill meets the conceptual definition of an asset.'

[114] Ding Yuan Ding, Richard Jacques Richard and Stolowy Hervé, 'Towards an Understanding of the Phases of Goodwill Accounting in Four Western Capitalist Countries: From Stakeholder Model to Shareholder Model' [2008] 33(7–8) Accounting, Organizations and Society (AOS) <https://doi.org/10.1016/j.aos.2007.07.002> accessed 17 August 2022; Università degli Studi di Brescia, 'Should Merger Accounting be Reconsidered?: A Discussion Based on the Chinese Approach to Accounting for Business Combinations' (Working Paper No 91, 2008) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1303636> accessed 17 August 2022.

resources but is merely based on expected future economic benefits. The following Recommendation addresses this issue:

Recommendation 15: Accounting for business combinations

A non-distributable reserve should be established against goodwill. Negative goodwill should not be distributable.

This Recommendation is relevant for Member States that either allow the use of consolidated financial statements as a basis for distributions, or the application of the IFRS – as adopted by the EU framework for financial reporting – to single financial statements.

In the context of business combinations, the combination of capital reduction and acquisition reserves may be especially problematic. For instance, a company may issue new shares to acquire another company in a business combination or an acquisition of assets. This operation is accounted for as newly issued share capital and an associated goodwill (business combination) or share premium (acquisition of assets) reserve. The new shares and those reserves have the potential to be cancelled in a capital reduction, resulting in a capital repayment or a transfer into distributable reserves, which facilitate distribution. This operation would be particularly problematic in intra-group and related-party transactions, including those involving special-purpose entities. Therefore, acquisition reserves should be submitted to special controls when involved in capital increase and reduction operations.

7 Recommendations on National and Cross-Border Mergers, Divisions and Conversions

Within the European Union, national and cross-border conversions, mergers and divisions are mainly governed by national legislation that derives from Directive (EU) 2017/1132 as amended.[115] At present, this Directive, which codified almost all company law directives enacted since 1968, makes few references to the possibility of using company law to promote corporate sustainability.

It is worth noting that, among the few references to the need to ensure sustainability of companies, Directive (EU) 2019/2121 on cross-border conversions, mergers and divisions, which amended Directive (EU) 2017/1132, clarifies in its recital 32 that the 'involvement of all stakeholders in cross-border operations … contributes to a long-term and sustainable approach being taken by companies across the internal market'. Moreover, in its recital 39, this Directive also states that the competent authority designated by each Member State to scrutinise the legality of the cross-border operation 'should be able to check whether the company is the subject of any ongoing court proceedings concerning, for example … environmental law, the outcome of which might lead to further obligations being imposed on the company, including in respect of citizens and private entities'.

With regard to cross-border operations, the need to ensure the advancement of policies aiming at promoting corporate sustainability should not come at the detriment of freedom of establishment. Moreover, the wider the effective harmonisation achieved in the field of corporate sustainability at European level, the lower the need to ensure that cross-border mobility transactions run counter to the goal of ensuring that companies adopt a long-term and sustainable approach across the European Union.

In light of these considerations, it is suggested that European and national law with regard to cross-border operations be reformed. More precisely, with a view to enhancing corporate sustainability, including long-term financial sustainability, the introduction of the following Recommendations devoted to leveraged operations (Recommendation 16), content of the draft terms (Recommendation 17), content of the report of the administrative or management body (Recommendation 18), content of the independent expert report (Recommendation 19), and scrutiny of the legality of cross-border operations (Recommendation 20) is proposed.

7.1 Recommendation 16: Sustainability in Leveraged Operations

Recommendation 16: Sustainability in leveraged operations

In order to foster a level playing field concerning corporate sustainability with regard to national and cross-border operations, European and national law should introduce, or at least encourage Member States to introduce, legislation to ensure corporate sustainability of both national and cross-border leveraged operations to supplement the existing rules on financial assistance.

Recommendation 16 suggests that both EU and national legislatures introduce legislation to complement the rules currently existing on financial assistance,[116] addressing the sustainability problems deriving from leveraged operations. Leveraged operations (eg leveraged mergers) may create serious risks to the financial sustainability of companies, putting in jeopardy their long-term existence. For this reason, it is important that the financial suitability of these transactions – within a reasonable time

[115] In addition to the rules provided in Directive (EU) 2017/1132, cross-border mergers are also directly regulated by other EU legislation, like Council Regulation (EC) No 2157/2001 and Council Regulation (EC) No 1435/2003, which, among other things, provide regulation on those cross-border mergers that may result in the creation of a European company or of a European cooperative society. Furthermore, these Regulations also govern other cross-border mobility operations, like the transfers of registered offices that may involve these legal entities.

[116] The reference is to the existing rules on financial assistance, with particular regard to those adopted with a view to implementing Article 64 Directive (EU) 2017/1132 (n 4).

horizon – is verified or externally checked before their completion.

This assessment may take different forms (eg a mandatory section of the independent expert report, or a control on the merits performed by national authorities which verify the legality of the operation), and legislatures should be left free to address this issue as they deem most appropriate to better detect those transactions that are unreasonable with a view to preserving the financial sustainability of companies.

7.2 Recommendation 17: Content of the Draft Terms of Cross-Border Operations

Recommendation 17: Content of the draft terms of cross-border operations

The European and national provisions on the draft terms of cross-border operations should be supplemented by adding an item concerning the likely repercussions of the operation on long-term corporate sustainability of the companies involved in the transaction.

This Recommendation endorses the introduction of an item in the draft terms of cross-border operations that refers to the likely repercussions of the cross-border operation on the long-term corporate sustainability of the companies involved in the transaction. With a view to preserving the financial sustainability of companies, it is important to assess whether cross-border operations may result in the application of a legal framework after the transaction, which could be less protective of companies as going concerns. For this reason, this Recommendation is mainly concerned with cross-border and not with national operations.

This item should be prepared and disclosed not only in the interests of shareholders, creditors, and employees, but also, as is normally the case for the items included in the draft terms of operations, in the interest of the general public.

7.3 Recommendation 18: Content of the Report of the Administrative or Management Body

Recommendation 18: Content of the report of the administrative or management body

With regard to cross-border operations, the European and national provisions on the report of the administrative or management body for members and employees should include, in the section for the members, an item outlining the implications of the cross-border operation for the corporate sustainability of the companies involved in the transaction.

Recommendation 18 refers to the content of the report of the administrative or management body in cross-border operations, recommending the introduction of a section addressed to the members, outlining the implication of the cross-border operation on the corporate sustainability of the entities involved in the transaction.

7.4 Recommendation 19: Content of the Independent Expert Report

Recommendation 19: Content of the independent expert report

With regard to cross-border operations, the European and national provisions on the independent expert report of the cross-border operation should be modified to include the expert's opinion as to whether, in view of ensuring the corporate sustainability of the companies involved in the transaction, the information the administrative or management body provided to the members in its report is reasonable and has been independently verified.

Recommendation 19 addresses the content of the independent expert report in cross-border operations, recommending an evaluation by the independent expert of the information provided by the administrative or management body.

The emphasis of both Recommendations 18 and 19 is placed again on the risks associated with the cross-border element of cross-border operations, and, for this reason, they do not concern national operations. The report of the administrative or management body should be prepared in the interests of the members, without prejudice to the information addressed to other stakeholders (eg employees). Similarly, the independent experts should evaluate the reasonableness of the information provided, in their assessment, mainly from the members' perspective regarding the long-term sustainability of companies.

7.5 Recommendation 20: Scrutiny of the Legality of Cross-Border Operations

Recommendation 20: Scrutiny of the legality of cross-border operations

For the purposes of the application of the European and national provisions on the scrutiny of the legality of cross-border operations, in addition to verifying the respecting of the rules aiming at protecting members and creditors, among the abusive or fraudulent purposes that cross-border operations could be used for, the risk of circumvention or evasion of EU and national rules aimed at ensuring corporate sustainability should also be considered.

Recommendation 20 deals with the scrutiny of the legality of cross-border operations, suggesting the introduction of legislation that would enable competent national authorities to evaluate whether cross-border operations could result in a circumvention or evasion of EU and national rules aimed at ensuring corporate sustainability.

Obviously, the broader the effective harmonisation of EU law on the rules on the long-term sustainability of companies as going concerns, the less likely cross-border operations – at least within the EU – could result in the evasion of these rules. However, in the presence of diverse legal frameworks, and in light of the existence of more stringent national rules on corporate sustainability, it cannot be excluded that companies engage in cross-border operations to attempt evading or circumventing optional EU or national legislation in this field.

This Recommendation therefore clarifies that the already existing provisions concerning the scrutiny of the legality of cross-border operations should also consider the possibility of an elusion or circumvention of EU or national law on corporate sustainability.

8 Complementary Instruments for Better Enforcement of Sustainable Equity Capital Management

8.1 Directors' Duties

Directors' duties may be extended to cover equity capital management for the sake of corporate sustainability as established by these Recommendations.

Directors' duties may also be extended to include specific obligations concerning disclosure on equity capital management for the sake of corporate sustainability as established by these Recommendations. This disclosure would be in line with the IFRS.[117]

From this perspective, corporate governance codes may be instrumental to extending directors' duties for the sake of corporate sustainability as established by these Recommendations. This extension may also help to reinforce the need for comprehensive audits covering corporate social and environmental plans and obligations as addressed by these Recommendations.

8.2. Auditors' Duties

Auditors' duties may be extended to include auditing on a specific equity capital management statement – and accompanying disclosure on it – prepared with a view to making distributions, in line with the going concern opinion that auditors should already prepare. Currently, when a reporting entity has a history of profitable operations and ready access to financial resources, preparers and auditors may reach a conclusion that the going concern basis of accounting is appropriate without detailed analysis. This assumption may be reconsidered in order to include a wide range of factors relating to social and environmental plans and obligations before the conclusion is reached that the going concern basis is appropriate.[118]

8.3 Additional Disclosure

Specific disclosure on equity capital management may be added in the managerial report, the non-financial report, or the notes to the financial statements. This disclosure may introduce the distinction between shareholder equity and company equity, as established by the taxonomy overarching these Recommendations (Chapter 2: A Taxonomy for Company Equity Capital).

Such disclosure should include a financial impact determination – accompanied by notes and explanations – on the current and prospective corporate sustainability management and corporate social and environmental responsibilities.

The financial impact determination should include, but not be limited to, the present risk assessment concerning outstanding liabilities regarding corporate sustainability. This determination should be expanded to include company commitments relating to corporate sustainability and corporate social and environmental responsibilities.

The financial impact determination should include specific disclosure concerning equity capital management (including distribution of, and retained earnings), distinguishing both distributions (payouts) to management and shareholding investors, and funding provisions for corporate sustainability and action plans with respect to corporate social and environmental responsibilities.

8.4 Policy Options for Accounting Law

The ELI Guidance draws upon the emergent needs concerning information on ongoing and prospective corporate sustainability, as well as further issues which have emerged from the adoption of the IFRS as Europe's accounting framework, thus weakening

[117] IAS 1(134)–(136).
[118] Cf IAS 1(26).

the principle of prudence in the EU accounting framework.

Implementing the ELI Guidance does not require abandoning the legislative delegation to the International Accounting Standards Board (IASB) with a view to establishing a set of EU accounting standards, following the examples of US and Japan, among other jurisdictions.[119]

To be sure, a set of EU accounting standards could include provisions for defining realised revenues and distributable profits. In general, such provisions would require prioritising the historical cost accounting basis over the fair value accounting basis. However, notwithstanding the EU adoption of IFRS, the EU and its Member States have less far-reaching options than establishing EU accounting standards in order to implement these Recommendations.

For instance, under the current accounting framework, the EU could introduce an accounting standard for equity capital, a matter which is not currently covered by the IFRS, for both consolidated and single financial statements. Or it might introduce an accounting standard for equity applicable to single companies only, since single company financial statements are not currently required to comply with the IFRS-based framework at EU level, although Member States may extend the latter to single company financial statements.

In fact, implementing the Recommendations would not require an amendment of the EU financial accounting framework. Specific accounting adjustments and disclosures may be added without affecting financial reporting. Either the EU, the Member States or the company preparers may introduce additional disclosure on equity capital management. This disclosure would involve an accounting process similar to the reports already prepared for corporate income tax purposes. Such corporate sustainability reports would also provide the legal basis for distributions to shareholding investors under company law provisions.

Moreover, additional disclosure on equity capital management could introduce financial impact assessments of corporate sustainability in line with these Recommendations, and be included in the non-financial statement (or sustainability report), which is now compulsory under EU law. In particular, climate change-related reporting may be extended to include not only climate change financial materiality, but also a financial impact assessment of corporate sustainability involving corporate social and environmental responsibilities.

[119] Yuri Biondi, 'Accounting for Europe's Economy and Society: Considerations for Financial Stability, Economic Development and the Public Good' [2017] 7(2) Accounting, Economics, and Law: A Convivium, 65–77 <https://doi.org/10.1515/ael-2017-0018> accessed 17 August 2022.

Annex: Illustrative Numerical Examples

This Annex illustrates the implementation of the ELI Guidance on Company Capital and Financial Accounting for Corporate Sustainability by means of numerical examples. It introduces the Sustainable Conduct Company (SCC), which undergoes every accounting treatment concerned, applying each Recommendation, one after another.

For each Recommendation, some elementary accounting treatment is explained and illustrated by a numerical example. For each example, the current accounting treatment (either under IFRS if indicated, or according to general accounting principles without indication) and the proposed treatment according to the ELI Guidance on Company Capital and Financial Accounting for Corporate Sustainability are compared.

The aim of the ELI Guidance is to ensure that payments made to shareholders, primarily in the form of dividends but also share buybacks, do not worsen the financial situation of companies and, therefore, endanger their continuity and resilience through time and circumstances, undermining their long-term capacity to cope with social and environmental commitments.

Example 1: Share Premium

SCC is established by issuing 10 shares at 10 units of nominal (par/legal) value each in a private allotment immediately paid by cash for a total payment of 100 units by initial shareholders (1).

Immediately after its establishment, SCC issues 10 more shares at the same nominal (par/legal) value on the market, collecting 25 units each. Total payment is then 250 units (2) immediately paid by cash, 100 of which are recognised as share capital (representing the nominal value of issued shares) and 150 of which are accounted for as share premium (representing the amounts that shareholders may pay above the nominal value).

Because of the application of the ELI Guidance, the share premium is labelled within shareholders' equity as non-distributable amount. This ensures that the corresponding resources (150) remain in the company. In some EU countries, the distribution of share premium is already prohibited by company law (eg, Bulgaria, Germany) but in the majority of countries (18 out of 27, including Denmark, France120), their distribution is authorised or at least not prohibited. In the former countries, the ELI Guidance would have no impact; in the latter countries, the ELI Guidance would lead to a better maintenance of the financial sustainability of companies.

[120] See Le Manh (n 52).

Current Accounting
BALANCE SHEET

Assets		Equity & Liabilities	
Cash	+100 (1)	Share capital	+100 (1)
	+250 (2)		+100 (2)
		Share premium	+150 (2)
TOTAL	350	TOTAL	350

Proposed Accounting (ELI Guidance)
BALANCE SHEET

Assets		Equity & Liabilities	
		Shareholders' equity	
Cash	100 (1)	Share Capital (ND)	100 (1)
	+250 (2)		+100 (2)
		Share premium (ND)	+150 (2)
		Company equity	0
TOTAL	350	TOTAL	350

ND: non-distributable

INCOME STATEMENT

Expenses	Revenues
NO IMPACT	NO IMPACT

INCOME STATEMENT

Expenses	Revenues
NO IMPACT	NO IMPACT

Example 2: Legal Reserve Requirement

Following its foundation and the first share issuance on the market, SCC starts its operations, generating sales revenues for 950 units and incurring expenses for 320 units, resulting in a net profit of 630 units (630 = 950 – 320) for the year. For the sake of simplicity, income taxes are not considered, and all revenues and expenses are assumed to be immediately cashed in and out.

As a result of the implementation of the ELI Guidance, the legal reserve requirement is based upon total shareholders' equity. Thus, SCC recognises a legal reserve of 10% of its nominal legal share capital plus its non-distributable share premium (35 units = 10% of 350 units from the issuance of 20 shares in total).

The legal reserve basis then comprises not only legal share capital but **also share premiums** as recommended by the ELI Guidance. As a result, the (non-distributable) legal reserve is higher compared to the current situation, fewer dividends can be distributed to shareholders and more resources remain in the company.

Under Current Accounting and Legal Reserve Requirements	Accounting for Legal Reserve Requirements Under the ELI Guidance
Distributable profit = Total profit (630) – allocation to legal reserves (min of 5% of profits until the legal reserve equals at least 10% of share capital) = 630 – 20 = 610 In the example, the company allocates only the legally necessary amount to retained earnings, ie, 20 (= 10% of share capital of 200).	Distributable profit = Total profit (630) – allocation to legal reserves (min of 5% of profits until the legal reserve equals at least 10% of share capital <u>and share premium</u>) = 630 – 35 = 600 In the example, the company allocates only the legally necessary amount to retained earnings, ie, 35 (= 10% of share capital of 200 and share premium of 150).

Current Accounting

BALANCE SHEET

Assets		Equity & Liabilities	
Cash	350	Share capital	200
	630	Share premium	150
		Legal reserve (ND)	20
		Distributable profit	610
TOTAL	980	TOTAL	980

Proposed Accounting (ELI Guidance)

BALANCE SHEET

Assets		Equity & Liabilities	
		<u>Shareholders' equity</u>	
Cash	350	Share Capital (ND)	200
	630	Share premium (ND)	150
		Legal reserves (ND)	35
		Distributable profit	595
		<u>Company equity</u>	0
TOTAL	980	TOTAL	980

ND: non-distributable

INCOME STATEMENT

Expenses		Revenues	
Expenses	320	Sales revenue	950
Profit	630		

INCOME STATEMENT

Expenses		Revenues	
Expenses	320	Sales revenue	950
Profit	630		

Example 3: Non-Distributable Reserves for Gains Arising from Certain Accounting Measurements

During the current accounting period, SCC acquired financial assets of 100, immediately paid by cash (1). These assets are short-term investments and are therefore recognised as financial assets at fair value through profit and loss (according to IFRS 9). All fair value changes after acquisition are immediately accounted for in the income statement as profit or loss.

At the end of the period, held financial assets are valued at 135 (2) units, according to the current market price (fair value). In the current situation, the gain of 35 arising from fair value measurement can be distributed to shareholders (outflow of resources (cash) from SCC) although SCC did not earn cash in this situation since the financial assets were not sold. The ELI Guidance proposes that SCC allocates the accounting gain of 35 arising from fair value measurement in a non-distributable reserve, since this amount corresponds to an unrealised gain (also called: paper profit), ie, a gain that is not based on a transaction but on 'simple' accounting re-valuations and, therefore, exists only on paper. The corresponding amount is then taken out of distributable profits (or distributable reserves) and allocated to non-distributable reserves (3). Income taxes are not considered for the sake of simplicity.

As a result of the implementation of the ELI Guidance, distributable profit is limited to realised gains, while unrealised (paper) gains from certain accounting measurements at fair value are allocated to a non-distributable reserve within company equity. As a result, these unrealised (paper) gains are barred from distribution thus avoiding an outflow of resources from the company.

Current Accounting (IFRS)

BALANCE SHEET

Assets		Equity & Liabilities	
		Share capital	200
		Share premium	150
Financial assets: + 100 (1) + 35 (2) =	135	Distributable profit	35
Cash: 350 – 100 (1) =	250		
TOTAL	385	TOTAL	385

Proposed Accounting (ELI Guidance)

BALANCE SHEET

Assets		Equity & Liabilities	
		Shareholders' equity	
		Share Capital (ND)	200
		Share premium (ND)	150
Financial Assets: + 100 (1) + 35 (2) =	135	Distributable profit 35 – 35 (3) =	0
		Company equity	
Cash: 350 – 100 (1) =	250	Fair value reserve (ND)	+35 (3)
TOTAL	385	TOTAL	385

ND: non-distributable

INCOME STATEMENT (Current Accounting (IFRS))

Expenses		Revenues	
Profit	35	Fair value measurement gain	+35 (2)

INCOME STATEMENT (Proposed Accounting (ELI Guidance))

Expenses		Revenues	
Profit	35	Fair value measurement gain	+35 (2)

Example 4: Non-Distributable Reserves for Current Value Measurement of Provisions

During the current accounting period, SCC acknowledges that it is subject to environmental liabilities of 52 units for waste disposal to be payable in ten years. According to IFRS accounting (IAS 37), this long-term provision is recognised initially for its discounted value. Assuming a discount rate of 10% pa, the discounted amount for that liability today is 20 units (= $52{\cdot}(1+0.1)^{-10}$) which is recorded as a provision (1) and an expense (1) in the income statement. Income taxes are not considered for the sake of simplicity.

Provisions must be established for future losses to be incurred for legal or constructive obligations (IAS 37). For instance, environmental liabilities for legally required decontamination of production sites denote a legal obligation under the 'polluter pays' principle of environmental protection, while voluntary, but publicly committed environmental plans constitute a constructive obligation implemented by company management. The purpose of accounting for provisions is to retain resources in the company so that it can face the future losses. In this sense, accounting for provision (already) constitutes a limitation for the distribution of profits to shareholders.

The ELI Guidance proposes that SCC recognises the difference between the full nominal amount of 52 and the current book value (20) as a non-distributable reserve (= 32). For the sake of simplicity, both the loss from this waste disposal and the non-distributable reserve are taken from the distributable profits in year 1 (2) and from the distributable profit reserves in year 2 (2).

As a consequence of the implementation of the ELI Guidance, the full nominal amount of environmental liabilities (52) – not only their current value – is made non-distributable in the first year of measurement: 20 because of the provision and 32 because of the non-distributable reserve within company equity. As a result, the resources to cover the full nominal amount of these liabilities are retained in the company from the very beginning (instead of being built up over time). However, the non-distributable reserve becomes distributable progressively over future periods since IAS 37 requires accounting for interest expense in the income statement in the following years (see below year 2).

Current Accounting (IFRS)

BALANCE SHEET **YEAR 1**

Assets		Equity & Liabilities	
		Shareholders' equity	
		Share capital	200
Diverse assets	1,300	Share premium	150
		Distributable profit	930
		Liabilities	
		Provision	20 (1)
TOTAL	1,300	TOTAL	1,300

Proposed Accounting (ELI Guidance)

BALANCE SHEET **YEAR 1**

Assets		Equity & Liabilities	
		Shareholders' equity	
		Share Capital (ND)	200
Diverse assets	1,300	Share premium (ND)	150
		Distributable profit 930 – 32 (2)	898
		Company equity	
		Reserve for discounted provisions (ND)	+32 (2)
		Liabilities	
		Provision	20 (1)
TOTAL	1,300	TOTAL	1,300

ND: non-distributable

INCOME STATEMENT

Expenses		Revenues	
Provision expense	20 (1)	Sales revenue	950
Profit	930		

INCOME STATEMENT

Expenses		Revenues	
Provision expense	20 (1)	Sales revenue	950
Profit	930		

In year 2, the amount of the provision will increase because of the reduction of years to discount (9 years instead of 10). This effect is referred to as the un-discounting or unwinding effect. The corresponding amount is 2 = 20 (provision year 1) x 10% (or $52 \cdot (1+0.1)^{-9}$)= 22 – previous year provision of 20) and is recognised in the income statement as an interest expense (1). Since this interest expense decreases profits, it already constitutes a distribution restriction. To avoid double-counting of the same amount, the non-distributable reserve is therefore reduced by the same amount of 2 (2). Still, after this reduction, the full nominal amount of the environmental liabilities (52) is retained in the company: 22 in provisions and 30 in the non-distributable reserves.

The same treatment would be applied to the years 3 to 10 (maturity of the provision). It is assumed that all profits of year 1 have not been distributed to shareholders but retained in distributable profit reserves. Income taxes are not considered for the sake of simplicity.

Current Accounting (IFRS)

BALANCE SHEET **YEAR 2**

Assets		Equity & Liabilities	
		Shareholders' equity	
		Share capital	200
Diverse assets	2,250	Share premium	150
		Distributable profit reserves	930
		Distributable profit	948
		Liabilities	
		Provision: 20 + 2 (1) =	22
TOTAL	2,250	TOTAL	2,250

Proposed Accounting (ELI Guidance)

BALANCE SHEET **YEAR 2**

Assets		Equity & Liabilities	
		Shareholders' equity	
		Share Capital (ND)	200
Diverse assets	2,250	Share premium (ND)	150
		Distributable profit reserves: 898 + 2 (2)	900
		Distributable profit	948
		Company equity	
		Reserve for discounted provisions (ND): 32 – 2 (2)	30
		Liabilities	
		Provision: 20 + 2 (1)	22
TOTAL	2,250	TOTAL	2,250

ND: non-distributable

INCOME STATEMENT

Expenses		Revenues	
Interest expense	2 (1)	Sales revenue	950
Profit	948		

INCOME STATEMENT

Expenses		Revenues	
Interest expense	20 (1)	Sales revenue	950
Profit	948		

According to the ELI Guidance, every following year, the full amount of the environmental liabilities (52) is still excluded from distribution: one part because of the (increasing) provision (un-discounting or unwinding effect) and the other part because of the (decreasing) non-distributable reserve.

NB: In some cases (eg, an oil company which is required to remove an oil rig at the end of its exploitation), IFRS (IAS 16) require that, upon initial recognition of the provision in year 1, the corresponding amount is not immediately expensed but accounted for as part of cost of acquisition of the corresponding asset (here, the oil rig). Through the asset's depreciation, the initial amount is then expensed over the useful life of the asset. In this case, the determination of the non-distributable reserve has to be adjusted accordingly.

Example 5: Non-Distributable Reserve for Capitalised Costs

During year 1, SCC successfully completes the research phase of one project and incurs further costs for 150 units with a view to developing these results into a sellable product. It is assumed that the conditions of IAS 38 regarding the accounting of these costs as intangible assets are met. As a result, the development of 150 is capitalised (1), meaning that the amount is considered as an intangible asset and not as an expense. Since the result of the development is expected to produce benefits for two years, the development cost asset is amortised over two years, leading to an amortisation expense (2) for each period of 75 units for each year (allocating 150 over the two year time-window). The amortisation starts when SCC begins to produce (and sell) the developed product; it is assumed the latter operation is to occur throughout years 2 and 3. Income taxes are not considered for the sake of simplicity.

The fact that the development cost is capitalised as an intangible asset and not treated as an expense leads to a higher profit (in year 1) which can be distributed to shareholders. The distribution of this profit (increase) would worsen the financial situation of the company, given that this profit (increase) is artificial in the sense that it is not based on a better financial performance of the company but on the accounting capitalisation rule. Therefore, the ELI Guidance proposes that SCC establishes a non-distributable reserve for the total amount of capitalised development costs (intangible asset) in year 1 (3). The corresponding amount is taken out of distributable profits (or distributable profit reserves). When the development cost is amortised in years 2 and 3, the non-distributable reserve is released accordingly (4). This is to avoid double-counting of the same amount(s) given that the amortisation expense reduces profits and, hence, excludes the corresponding amount already from distribution.

Total profits are assumed to have been completely cashed in (all cash revenues and cash expenses, except for the amortisation of the development cost which is a non-cash expense). Distributable profits are considered to be fully paid out as dividends in the following year (annual dividends, no interim dividends).

Current Accounting (IFRS)

BALANCE SHEET **YEAR 1**

Assets		Equity & Liabilities	
		Share capital	200
Development cost (intangible asset)	150 (1)	Share premium	150
		Distributable profit	630
Cash: 350 + 630 – 150 (1) =	830		
TOTAL	980	TOTAL	980

Proposed Accounting (ELI Guidance)

BALANCE SHEET **YEAR 1**

Assets		Equity & Liabilities	
		Shareholders' equity	
		Share Capital (ND)	200
Development cost (intangible asset)	150 (1)	Share premium (ND)	150
		Distributable profit: 630 – 150 (3) =	480
Cash: 350 + 630 – 150 (1) =	830	Company equity	
		Capitalised development cost reserve (ND)	+150 (3)
TOTAL	980	TOTAL	980

ND: non-distributable

INCOME STATEMENT **YEAR 1**

Expenses		Revenues	
Expenses	320	Sales revenue	950
Profit	630		

INCOME STATEMENT **YEAR 1**

Expenses		Revenues	
Expenses	320	Sales revenue	950
Profit	630		

Current Accounting (IFRS)

BALANCE SHEET **YEAR 2**

Assets		Equity & Liabilities	
		Share capital	200
Development cost: 150 – 75 (2) =	75	Share premium	150
		Distributable profit	595
Cash: 830 (year 1) -630 (dividends) +670 (profit excl amort) =	870		
TOTAL	945	TOTAL	945

Proposed Accounting (ELI Guidance)

BALANCE SHEET **YEAR 2**

Assets		Equity & Liabilities	
		Shareholders' equity	
		Share Capital (ND)	200
Development cost: 150 – 75 (2) =	75	Share premium (ND)	150
		Distributable profit reserves	+75 (4)
		Distributable profit	595
		Company equity	
Cash: 830 (year 1) -480 (dividends) +670 (profit excl amort) =	1,020	Capitalised development cost reserve (ND): 150 – 75 (4) =	75
TOTAL	1,095	TOTAL	1,095

ND: non-distributable

INCOME STATEMENT **YEAR 2**

Expenses		Revenues	
Amortisation development cost	75 (2)	Sales revenue	1,150
Other expenses	480		
Profit	595		

INCOME STATEMENT **YEAR 2**

Expenses		Revenues	
Amortisation development cost	75 (2)	Sales revenue	1,150
Other expenses	480		
Profit	595		

Current Accounting (IFRS)
BALANCE SHEET **YEAR 3**

Assets		Equity & Liabilities	
		Share capital	200
Development cost: 75 – 75 (2) =	0	Share premium	150
		Distributable profit	615
Cash: 870 (year 2) -595 (dividends) +690 (profit exl amort) =	965		
TOTAL	965	TOTAL	965

Proposed Accounting (ELI Guidance)
BALANCE SHEET **YEAR 3**

Assets		Equity & Liabilities	
		Shareholders' equity	
		Share Capital (ND)	200
Development cost: 75 – 75 (2) =	0	Share premium (ND)	150
		Distributable profit reserves	+75 (4)
		Distributable profit	615
Cash: 1,020 (year 2) -670 (dividends*) +690 (profit excluding amortisation) =	1,040	Company equity	
		Capitalised development cost reserve (ND): 75 – 75= (4)	0
TOTAL	1,040	TOTAL	1,040

ND: non-distributable

* Assumed distribution of year 2 distributable reserves and profits

INCOME STATEMENT **YEAR 3**

Expenses		Revenues	
Amortisation development cost	75 (2)	Sales revenue	1,230
Other expenses	540		
Profit	615		

INCOME STATEMENT **YEAR 3**

Expenses		Revenues	
Amortisation development cost	75 (2)	Sales revenue	1,230
Other expenses	540		
Profit	615		

The effects of accounting under the ELI Guidance are visible in the cash position of years 2 and 3. The cash position (ie, the financial resources) of the company is higher when applying the ELI Guidance by 150 (year 2) and 75 (year 3) respectively. The ELI Guidance makes the amount of development cost available for distribution when the developed product is sold and corresponding profits are realised (profits of years 2 and 3, available for distribution in years 3 and 4). In current accounting the amount of development cost already increases profits of year 1 (before the sale of the developed product) which is available for distribution in year 2.

Example 6: Non-Distributable Reserve for Intra-Group Transaction

During the period, SCC invests 26 units (1) in a newly established subsidiary of which SCC (the parent company) holds all the equity shares. The subsidiary is then fully controlled by SCC as a parent company.

At the end of the period, the subsidiary recognises an increase in net equity of 2 units. It is assumed here that SCC uses the equity method to account for this investment in its individual financial statements. Hence, SCC will increase the book value of its investment by 2 units and recognise a gain of 2 units among its revenues (2). This accounting treatment is authorised in certain European jurisdictions (eg, France).

The ELI Guidance proposes that SCC establishes a non-distributable reserve (3) for the total amount of that gain from equity increase in a dependent company. The corresponding amount is taken out of distributable profits (or distributable reserves). Income taxes are not considered for the sake of simplicity. The ELI Guidance treatment excludes the equity method profits from distribution as those profits were not (yet) cashed in by the parent company, SCC. In that respect, they constitute unrealised (or paper) profits.

This proposal may also apply to consolidated financial statements in which investments in associated companies are accounted for using the equity method (under IFRS, for example). Although consolidated financial statements (consolidated profits) are not the legal basis for dividend distribution, for most companies they form the economic basis for dividend decisions. Once the economic dividend decision has been made, companies then ensure that the legal basis is aligned with that decision.

Current Accounting

BALANCE SHEET

Assets		Equity & Liabilities	
Investment in Subsidiary: +26 (1) + 2 (2)=	28	Share capital	200
		Share premium	150
		Distributable profit	2
Cash: 350 – 26 (1) =	324		
TOTAL	352	TOTAL	352

Proposed Accounting (ELI Guidance)

BALANCE SHEET

Assets		Equity & Liabilities	
		Shareholders' equity	
Investment in Subsidiary: +26 (1) + 2 (2) =	28	Share Capital (ND)	200
		Share premium (ND)	150
		Distributable profit: 2 – 2 (3) =	0
Cash: 350 – 26 (1) =	324	Company equity	
		Reserve for equity method gains (ND)	+2 (3)
TOTAL	352	TOTAL	352

ND: non-distributable

INCOME STATEMENT (Current Accounting)

Expenses		Revenues	
Profit	2	Profit from equity method investment	+2 (2)

INCOME STATEMENT (Proposed Accounting)

Expenses		Revenues	
Profit	2	Profit from equity method investment	+2 (2)

Example 7: Non-Distributable Reserve for Held Own Shares

During the period, SCC buys back from its shareholders, 1 share at 20 units (1), in an open market operation according to its own shares management plan.

Total profits are assumed to have been completely cashed in. Income taxes are not considered for the sake of simplicity.

The ELI Guidance proposes that SCC establishes a non-distributable reserve for the total amount of own shares held (2). The corresponding amount is taken out of distributable profits (or distributable profit reserves). Because in a share buy-back cash is returned to shareholders, the constitution of a non-distributable reserve according to the ELI Guidance avoids additional cash outflows to shareholders (for the same amount) via dividend payments.

Current Accounting (IFRS)

BALANCE SHEET

Assets		Equity & Liabilities	
Cash: 350 – 20 (1) + 630=	960	Share capital	200
		Share premium	150
		Treasury shares	(20) (1)
		Distributable profit	630
TOTAL	960	TOTAL	960

Proposed Accounting (ELI Guidance)

BALANCE SHEET

Assets		Equity & Liabilities	
		<u>Shareholders' equity</u>	
Cash: 350 – 20 (1) + 630=	960	Share Capital (ND)	200
		Share premium (ND)	150
		Treasury shares	(20) (1)
		Distributable profit: 630 – 20 (2) =	610
		<u>Company equity</u>	0
		Treasury share reserve (ND)	+20 (2)
TOTAL	960	TOTAL	960

ND: non-distributable

INCOME STATEMENT

Expenses		Revenues	
Expenses	320	Sales revenue	950
Profit	630		

INCOME STATEMENT

Expenses		Revenues	
Expenses	320	Sales revenue	950
Profit	630		

Example 8: Non-Distributable Reserve for Goodwill

During the period, SCC acquires an independent company for 46 units (1). Goodwill of 17 (1) units arises from the transaction, along with 29 re-valued net assets comprising 53 re-valued assets (1) and 24 re-valued liabilities (1):

> Goodwill (17) = Consideration paid (46) – Re-valued Net Assets {29 = Re-valued Assets (53) – Re-valued Liabilities (24)}.

Total profits are assumed to have been completely cashed in. Income taxes are not considered for the sake of simplicity.

The ELI Guidance proposes that SCC establishes a non-distributable reserve for the equivalent amount of goodwill (17) (2). The corresponding amount is taken out of distributable profits (or distributable profit reserves).

Since goodwill anticipates expected future economic benefits which are not yet realised and easy to manipulate, it seems reasonable to exclude it from distributions. Since goodwill is not based on realised profits of SCC and, hence, have not (yet) generated resources for SCC, the corresponding reserve should be non-distributable as there is nothing (yet) to distribute.

Current Accounting (IFRS)

BALANCE SHEET

Assets		Equity & Liabilities	
		Share capital	200
		Share premium	150
		Distributable profit	630
Goodwill	+17 (1)		
Other acquired assets	+53 (1)	Other acquired liabilities	+24 (1)
Cash: 350 – 46 (1) + 630=	934		
TOTAL	1,004	TOTAL	1,004

Proposed Accounting (ELI Guidance)

BALANCE SHEET

Assets		Equity & Liabilities	
		<u>Shareholders' equity</u>	
		Share Capital (ND)	200
		Share premium (ND)	150
		Distributable profit: 630 – 17 (2) =	613
		<u>Company equity</u>	0
Goodwill reserve (ND)	+17 (1)	Goodwill reserve (ND)	+17 (2)
Other acquired assets	+53 (1)	Other acquired liabilities	+24 (1)
Cash: 350 – 46 (1) + 630=	934		
TOTAL	1,004	TOTAL	1,004

ND: non-distributable

INCOME STATEMENT

Expenses		Revenues	
Expenses	320	Sales revenue	950
Profit	630		

INCOME STATEMENT

Expenses		Revenues	
Expenses	320	Sales revenue	950
Profit	630		

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