ICAEW representation

ICAEW REP 51/06

RESTATEMENT CLAUSES

Memorandum of comment submitted in September 2006 by the Institute of Chartered Accountants in England and Wales, in response to the Department of Trade and Industry's invitation to comment on the restatement clauses in the Companies Bill

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales ('the Institute') welcomes the opportunity to respond to the invitation to comment on the restatement clauses in the Companies Bill issued by the Department of Trade and Industry ('DTI') in July 2006.

2. The Institute has a public interest mandate and has been a leading advocate of company law reform over the last eight years. Accountants make up the largest professional group of FTSE 100 chief executives, with 24 of the UK's largest companies having an accountant as CEO, and over 60% of FTSE Finance Directors are members of the Institute. As the largest accountancy body in Europe, the Institute's 128,000 members run and advise businesses of all sizes across virtually every economic sector.

3. We set out below our general comments, and our specific comments on the restatement clauses as included in the Bill printed on 20 July 2006, PART 18 'A COMPANY'S SHARE CAPITAL' (except Clauses 574 to 593 and 643 to 654), PART 19 'ACQUISITION BY LIMITED COMPANY OF ITS OWN SHARES' and PART 24 'DISTRIBUTIONS'. We also comment on certain pre-existing clauses, in the same area as the restatement clauses, where we continue to have issues to discuss with the DTI.

GENERAL COMMENTS

4. In the absence of destination tables it is difficult to assess the extent to which existing Companies Act provisions have been reproduced in the Bill and therefore we think it would be helpful if destination tables are published by the DTI.

5. We note that a 'statement of capital' will replace authorised share capital and thus this term appears frequently in the Bill. This term is currently defined each time it appears, and we recommend it is instead included as a defined term.

6. In places it is not clear whether grandfathering in existing Companies Act legislation is preserved in the Bill. For example, Clause 625 does not appear to replicate the current grandfathering in s.132(7) of the Companies Act 1985.

SPECIFIC COMMENTS

PART 18 - A COMPANY'S SHARE CAPITAL

Clause 607

7. Clause 607 re-enacts s103 of the Companies Act 1985. That section has caused difficulties in cases of acquisitions of a company by means of a (1985 Act) s425 scheme. In such a scheme all of the shares of the target company are cancelled and then that company issues new shares (to the new holding company) paid up out of the reserve arising from the cancellation. Put simply, it is a bonus issue. However, following s103(2), clause 607(2) creates an exemption from its

valuation requirement only where the bonus issue is to members, whereas at the point of issue the company in question has no members. It is sometimes thought that such an arrangement thus requires a valuation report, an exercise which poses its own difficulties in view of the fact that fresh assets are not being contributed to the company.

Clause 616

8. We query why an accidental omission provision (eg the provision contained in Clause 611(5)) has not been included in Clause 616.

Clauses 625 and 626

9. It should be clear on the face of the Bill whether merger relief is optional or mandatory under these provisions, particularly as we understand that the existing equivalent provisions have been the subject of conflicting legal opinion. The majority opinion appears to be that existing s.131 relief is mandatory (eg, the view expressed in the FRRP 2005 report on Interim reports) and existing s.132 relief is optional.

10. See also the point on grandfathering in General Comments above.

Clause 627

11. In ss(1) the words "at least" should be inserted after the word "secured", and in ss(2) the words "at least" should be inserted after the word" has". We also query the inconsistency of language between these two subsections; the term "secured" is used in ss(1) but not in ss(2).

Clauses 636 to 642

12. We appreciate that this clause is not a restatement but a helpful reform that has been in the Bill before the 20 July print. We support the introduction of some simple facility to redenominate share capital and therefore welcome this and related clauses. We believe they will work very well where a company is redenominating share capital from sterling to a foreign currency. We do however believe that the DTI needs to give some consideration to the effect of the clauses, including in relation to the common law, when used to redenominate in the other direction - ie, from foreign currency into sterling (or, perhaps, into whatever is the functional currency for accounting purposes). For example, suppose that a company (with a functional currency of sterling) has in issue share capital with a nominal value in the *amount* of \$100. The capital was issued when the *value* of \$100 was, say, £175. Suppose, further, that the procedure in clause 636(2), (3) means that at the point of redenomination the *value* of \$100 was £150. What is the nature/ status of the £25 reduction in value since issue, which has now crystallised (and must be booked in the accounts now if not earlier) by means of the redenomination? Harman J's remarks in *Re Scandinavian Bank Group plc* ([1987] BCLC 220 at 231) may suggest that hitherto such an adjustment <u>(ie, a credit in reserves on the occasion of reflecting in the accounts the reduction in sterling value of the share capital)</u> was not distributable. The opposite situation, eg

where the value of $100 has risen to, say, £195 at redenomination, merits consideration also. In this example the value has risen by £20 (and must by booked at least by the time of redenomination) and would appear to constitute a capital increase. Harman J laid some emphasis on the fact that (taking these illustrative figures) the $100 was fixed in amount, and thus implying that it was this fixed $100 that creditors should look to as their security (quoting the dicta from *Ooregum Gold Mining Co of India v Roper*), but accepted that it could nevertheless vary in value; this may perhaps imply that for common law purposes the capital should anyway be regarded as having been increased in sterling terms. We urge the DTI to consider these matters with a view to providing certainty in the context of this important reform.

13. We note that Clause 642 introduces a new "redenomination reserve", and we query why reserves arising on a redenomination of capital cannot simply be credited to the capital redemption reserve (instead of creating such a new reserve).

14. Further, having restricted the uses of share premium, it would be ideal if there could be just one reserve (eg a "share capital reserve"), instead of separate share premium, capital redemption (CRR) and redenomination reserves. However, we assume that this would be difficult to achieve since the uses of the share premium account in article 39(g) of the Second Directive are slightly wider than those for CRR in article 39(e). Has the DTI considered this?

Clause 655

15. Whilst we welcome the Government's intention to consult on and implement more fundamental reform of the distributions regime for private companies, we suggest below a measure to allow distributable profits to be augmented in the meantime.

16. This would provide that any reserve arising from a capital reduction permitted by legislation (which would therefore be subject to the relevant legislative safeguards) falls to be treated as a realised profit and is thus distributable.

17. We note that an equivalent amendment was tabled during Lords' Committee Stage (Amendment No. A68), but was rejected by the Government as something best dealt with by Guidance issued by our Institute and the Institute of Chartered Accountants of Scotland (ICAS) (*20 Mar 2006 : Column GC8*). The Institutes' joint working party appreciates the acknowledgement the Government expressed for the guidance we issue on the determination of distributable profits, and proposes to continue issuing such guidance. However, we would like to pursue this amendment.

18. This measure would codify in Statute the approach taken in the existing guidance, with respect to court approved capital reductions and apply it to all capital reductions. We advocate such codification because we have viewed the existing guidance on this particular point as no more than a stop-gap measure and one, moreover, that has not been easily fitted into a framework of guidance on the accounting question of determining which profits are realised profits. Outside of court-approved reductions, the reserve thrown up by the reduction is not easily

viewed as a profit in accounting terms, and whether it is a realised profit is somewhat removed from normal accounting considerations as there is no fresh consideration (assets) received by the company in the course of the reduction. Our guidance reports the result of in depth discussion with legal advisers, rather than dealing with accounting matters. This is properly a question of law, the Bill is an ideal opportunity to codify the answer as statute law and we cannot see a disadvantage of clarifying this principle in the legislation.

19. We note the Government expressed reluctance to separate this one particular issue and deal with it in the law on the grounds that this could be potentially confusing for companies that currently look in one place for guidance on distributions - the technical releases issued by the Institutes. However, we do not think this would confuse readers/users who would always, we think, look first for a definitive answer in the statute; only if legislation does not address a particular issue should there be any need to look to our guidance. We also note that express legislative provisions have been used in the past, for instance, current section 162F of the Companies Act 1985 sets out the extent to which the proceeds of sale for treasury shares are to be treated as realised, and we think a similar course of action could be taken in respect of capital reductions.

20. We therefore suggest that the following subsection is added to Clause 655:

    "( ) Where the company has reduced its share capital, any reserve arising from the reduction shall be treated for the purposes of Part 24 as a realised profit of the company, except to the extent that the terms of the special resolution under this section, or of the court order confirming the reduction under sections 659 to 665, provide otherwise."

Clause 657

21. We note that the solvency test was clarified during the Lords' Committee Stage debate (*20 Mar 2006 : Column GC14*) in respect of assets, as the Government helpfully explained that **"***where the asset value is greater than the debts of the company, it is a matter for the judgment of the directors whether there are grounds on which the company would be unable to pay its debts. In the consideration of the value of the assets, a balance sheet would of course be a valuable piece of evidence for the directors of the company. However, it will not be the only evidence that they may be advised to use. We would not want to influence the evidence that the directors feel that they need to seek to make such a reduction of capital, such as asset/business valuations that they should obtain, by prescribing how the value of the company's assets should be determined when making the solvency statement*".

22. However, it is also important for it to be clear how liabilities should be taken into account.

23. In our view, the term "prospective liabilities" should be removed from this provision. Whilst "contingent liabilities" has a specific meaning in accounting terms, "prospective liabilities" does not. We understand it is not merely an alternative term for "contingent liability", and that it would include, for example,

all future rental payments on a company's leased premises. How would such liabilities be "take[n] into account" without making this snapshot test unfairly onerous by including liabilities arising from future operations?

24. We appreciate that the term "prospective liability" is in use in current statute law relating to companies. Firstly, it is included in the insolvency legislation, which the courts follow when deciding whether to wind up a company. However, we understand that insolvency practitioners would not in practice petition the court to wind up a company on the strength of prospective liabilities because it is felt that the court's approach, though uncertain, would be to look favourably upon the company, not least because to do otherwise could be to imply that any company with, say, leasehold premises could be liable to unjust winding-up.

25. This term has also been used in the "whitewash procedure" in section 156 Companies Act 1985, under which private companies can authorise financial assistance if supported by a director's declaration of solvency (in which directors must take account of prospective liabilities), but this procedure is being abolished in this Bill.

26. We acknowledge that removing the term "prospective liabilities" would result in the Bill using slightly different wording on solvency than that used in the Insolvency Act. However, we think this is appropriate because where the burden of proof is upon the directors, as to the ability to continue in business, they should not be required to deal with an unjustly onerous test that is never relied upon in practice in petitions for winding-up. Although the words remain in the Insolvency Act no mischief or uncertainty is likely to arise there since, first, the burden of proof is on the petitioner, as to the <u>in</u>ability to continue in business; and, second, the petition is to the court such that the test's bias against the company would be open to suppression by the court. Moreover, we think directors, under the Bill, should not be required to make a judgement as to what a court may consider to be 'prospective liabilities' when making a declaration of solvency, particularly as there are criminal penalties attached. We believe that this Bill presents a good opportunity to relieve directors of an existing area of unfair subjectivity and uncertainty, and that this is particularly important with the solvency-based capital reduction being seen as a major reform intended to give widespread effect.

27. Therefore, we think the wording "or prospective" should be deleted from ss(2). An equivalent amendment should be made to Clause 727(4).

28. We also think it is important for the DTI to clearly explain how contingent liabilities are to be taken into account (we believe this should be at a value having regard to the risk of crystallisation not merely automatically at the theoretical maximum exposure). These concerns could be addressed in the explanatory notes or by way of a Ministerial statement on contingent liabilities.

Clause 669

29. We query how the formula in ss(1) will apply to preference shares presented as liabilities. Such liabilities will reduce the net assets side of the equation, but will have no effect on called-up share capital (as this will be the legal share capital,

rather than that recorded in the accounts). We acknowledge this is an existing problem, but the Bill presents a good opportunity to iron out this issue that arose on implementation of IFRS.

Clause 670

30. We support the inclusion of this reform power.

PART 19 – ACQUISITION BY LIMITED COMPANY OF ITS OWN SHARES

Clause 682

31. The word "Accounting" should be deleted from the heading of this clause. The creation of the reserve corresponding to the value of the shares is not truly an accounting matter (albeit it might be visible in accounts).

Clause 683

32. This clause restates s.150 of the Companies Act 1985. We note that s.150(4) contains a carve out for re-registered companies but expressly states that this carve out does not apply to old (pre-1982) public companies. This exclusion for old public companies is not restated in the Bill and so we query whether this omission is intentional and/or significant.

Clause 690

33. There is scope for confusion as ss(3) includes the term "provision" and cross refers to provisions under Clause 402. However, Clause 402 contains the term 'provision' in two different senses; provision in the accounts and provision made by regulation pursuant to the Bill/Act.

34. The comment in paragraph 33 above also applies to Clauses 834(3)(a), 835(4)(a), 839(1)(b)(i) and 844(2)(a).

Clause 691

35. We very much support the intention of the Bill that private companies no longer be prohibited in any way from providing financial assistance. In terms of giving effect to that intention, we have become aware that there is uncertainty as to whether the Bill will succeed. We are given to understand that the legal uncertainty arises from the proposition that the common law has a similar effect to the 1985 Act prohibition but without (of course) any whitewash. The technicality of this uncertainty is very much a matter for the legal profession, but we must stress that it is vital for companies that the statute be drafted such that no uncertainty arises, otherwise a flagship reform of the Bill will be cast into doubt.

36. We therefore support the following amendment that was suggested by the Law Society in their June 06 Committee Stage briefing on the Bill.

Clause 694

37. We noted the Government's comments on (and rejection of) the Committee Stage amendment No. A77 in the House of Lords to change "dividend lawfully made" to "distribution lawfully made under Part VIII" (*20 Mar 2006 : Column GC26*). However, we would like to pursue an amendment to Clause 694 (restating s.153 of the Companies Act 1985) because, if a lawful dividend is not financial assistance, we can see no public policy reason as to why any other lawful distribution should not also be scoped out of the financial assistance rules. We are aware that our members frequently encounter transactions in group reorganisations that would not be covered by Clause 694 as currently drafted. For example, if a group includes company (X) that has a subsidiary company (Y), if the group wishes to dispose of X but wishes to retain Y, Y would be hived up or across to another group company prior to the transaction. Following the very welcome reform at Clause 848, this preparatory transaction involving Y can go ahead even if there is a gift element (eg at book value) provided there is no deficit of distributable reserves. However, for financial assistance purposes, this transaction would not be permitted because the gift element is not in the form of a "dividend" but is some other form of distribution (eg, as recognised by the language of Clause 848), notwithstanding that in substance they are the same. This restriction gives rise to additional costs and therefore we think Clause 694 should be amended to cover such transactions; moreover, there would not appear to be adverse consequences in making such an amendment.

38. We therefore suggest that Clause 694(2)(a)(i) and (ii) are amended to read as follows:

    "(i) a dividend <u>or other distribution</u> lawfully made, <u>including</u> a distribution made in the course of the company's winding up..".

39. We note from the Committee Stage debate in the Lords that the Government objected to the words "under Part VIII" in our original suggested amendment. These words were intended to clarify the meaning of distributions, rather than to scope out the common law rules for distributions. We therefore propose the above alternative drafting, which we hope addresses the Government's concerns.

40. We note that changes that will be necessary, in the early years of the new Act's life, as a result of recent changes to the Second Directive. Article 23 has been amended to require that a company "*shall include, among the liabilities in the balance sheet, a reserve, unavailable for distribution, of the amount of the aggregate financial assistance*". We note this new wording could raise a problem where the nature of the financial assistance is such that it needs to be charged against distributable profits, for example a gift. In these circumstances one possible reading of the amended Second Directive would require a transfer of the amount of the aggregate financial assistance to an undistributable reserve even though the gift has been written off (i.e. there is a double counting risk). We look forward to liaising with the DTI regarding implementation of these new EU requirements to try to avoid such issues arising.

Clause 699

41. We note the welcome innovation at clause 699(2) that a redemption payment may be on deferred terms; this will answer a need that arises on many occasions in relation to private companies. In terms of the detail of how this innovation will operate, the question is, first, the basis of determination of the amount of the redemption for the purposes of clauses 700 *et seq* and 722 *et seq*. For example, if a share is redeemed today for £100 payable in ten years' time, is the redemption price (which comes out of distributable profits or fresh issue proceeds, or is subject to the permissible capital payment rules): the £100, or the value today of a promise to pay £100 in ten years' time (which would be substantially less). In the related situation of the consideration for the subscription for shares, the rule is that the true value (eg, taking account of the time value of money) is the relevant figure; however, this arises from case law in relation to share subscription (*Shearer vs Bercain*). In the absence of specific provision in the legislation on redemption, there will be considerable uncertainty.

42. The second operational matter is the question of how the funding by fresh issue proceeds would operate. If the redemption price is payable in 10 years' time, do the issue proceeds have to come through now or in ten years' time also?

Clause 704

43. We note the discrepancy between this Clause and Clause 699. Clause 699(2) permits the company and investors to agree to defer payment of redemption monies (meaning redemption can be used to make a loan). We query why no such ability to defer payment is included in Clause 704 in respect of purchase of own shares. Whilst we would welcome the innovation of purchase of shares on deferred terms, the operation issues noted in respect of clause 699 need to be dealt with here too.

Clause 727(4)

44. We propose an amendment to ss(4), see Clause 657 above.

Clause 747

45. Given that the existing PCP regime in s171 *et seq* is now to be retained, we believe that private companies should be able to set the permissible capital payment against unrealised reserves generally rather than restricting this set off to unrealised profits in the revaluation reserve. Other reserves are explicitly required by the Act, such as the new fair value reserve, or otherwise can contain unrealised profits (eg, merger reserve) and we believe all such reserves should be available for this purpose. In principle, the unrealised profits in, for example, the merger reserve are exactly the same as those in the revaluation reserve. This simple amendment would not give rise to any mischief, and would put an end to an unnecessary and illogical restriction. Simply referring to unrealised profits, rather than listing specific reserves, would retain flexibility as the clause will not require amendment if new reserves are introduced in future.

46. We therefore recommend that the words “for the time being standing to the credit of any revaluation reserve maintained by the company” be deleted from Clause 747(3)(b).

Clause 750

47. We support the inclusion of this reform power.

PART 24 – DISTRIBUTIONS

Clause 834

48. The word “individual” should be added after “Companies Act” in subsection (3)(a) and after “IAS” in ss(3)(b).

49. Equivalent amendments should be made to Clauses 835(4), 839(1)(b), 844(2) and 847(3)(b).

50. See also Clause 690 above.

Clause 835

51. The amendments made to s.265 of the Companies Act 1985 by SI 2005/2280 are not reflected in this drafting. This clause should instead read “liabilities <u>to creditors</u>” in various places in ss(3) and (4).

52. See also Clauses 690 and 834 above.

Clause 836

53. In ss(2)(d) it may be more appropriate for the words “accounting reference period” to be replaced with “financial year” as accounts cover financial years.

Clause 837

54. The words “by value” should be added after “15%” in ss(3)(b).

55. Given the Bill now reproduces ICTA provisions rather than cross referring to them, we assume that systems will be put in place to ensure consequential amendments are made to these provisions should the relevant ICTA clauses in future be amended.

56. We also note that the derivations table appears to have a typographical error as in relation to Clause 837(2) it should refer to s843(1A) of ICTA (it currently refers to s242(1a) of ICTA, which has been repealed).

Clause 839

57. The words, “, and the amount of a distribution that may be so made,” in ss (1) sit oddly given the words that precede them. The reader may be left unclear as to whether the quoted words refer to the maximum amount that could be made by distribution (eg, distributions of up to £X could be made) or the amount to be attributed to a particular proposed distribution (the proposed distribution is £Y and the lawfulness of that £Y distribution falls to be assessed, ie under the earlier words “whether a distribution may be made”). The former is, we presume, the intention, given that it was the effect of the differently drafted 1985 Act s270(1), (2). This issue is in need of particular clarity since it is clause 848 that seeks to set a book value rule for distribution measurement (in certain cases), not this clause 839.

58. See Clauses 690 and 834 above.

Clause 844

59. The existing section 275(1), (4), (5) of the Companies Act 1985 permits the revaluation exercise to be a mixture of actual revaluations and directors' considerations of asset values without actually revaluing them (ie, without actually booking the revaluation). It appears, however, that clause 844(1), (5) takes a different approach. It states that there is treated as having been "a revaluation" if the directors have considered the value of the "fixed assets" - ie, all of them - without actually having revalued them. This does not appear to take into account any actual revaluations, but may require the revaluation exercise to consist entirely of considerations of the value of all of the fixed assets. This appears insufficiently flexible to cover possible practical situations. It also seems to call into question whether the deficit appearing on such a revaluation - and therefore covered by this provision - does not include an actual (ie, booked) deficit; if so, this would render the provision ineffective.

60. See Clauses 690 and 834 above.

Clause 847

61. The drafting of ss(3)(b)(i) assumes that a particular requirement will arise under regulations under clause 402. Given that the detail no longer appears in primary legislation, would it be clearer to refer simply to notes to the individual accounts (including without unnecessary distinction between Companies Act and IAS individual accounts)?

62. Does the effect of para 3(a) of Sch 11 to the 1985 Act need to be preserved, perhaps by uinserting “or included” after “shown” in ss (1)?

63. See also clause 834 above.

Clause 856

64. The concept of ‘realisation’ is becoming less relevant in an accounting context, particularly in light of the adoption of IFRS, for example, fair value accounting. We note that the authoritative guidance on determination of distributable profits is issued by our Institute and ICAS (see paragraph 17 above). This framework of guidance on determining whether a profit or loss is realised is becoming less dependent on accounting considerations, and therefore we suggest the words “for accounting purposes” are deleted after the word “determination” in ss(4).

Clause 857

65. We welcome the Government’s stated intention to consult on and implement fundamental reform of the distributions regime for private companies, and we support the inclusion of this reform power which will enable the Government to implement any such reform.

66. We reiterate our calls for the DTI to prioritise this fundamental reform of the distributions regime by introducing a solvency-based regime for private companies, which has worked well in other parts of the world.

67. The current regime imposes limits on company distributions by reference to the historical amounts of capital contributed by investors. These rules can fail to achieve the objective of protecting creditors, impose unwarranted burdens on business and impede the development of financial reporting. We believe a solvency-based regime, under which distributions would be determined by reference to the effect on company solvency and the need to preserve the company as a going concern, would be simpler and more cost effective, whilst (along with other safeguards, such as the UK’s wrongful trading provisions) protecting creditors and allowing investors appropriate returns.

68. We also urge the Government to continue to press the EU for changes to the Second Directive in relation to public companies.

LC, 11.9.06