

## Accounting Standards and Legal Capital in EU Law

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### 1. Introduction

Limited liability is an essential concept in understanding the function of business associations. It is the element that distinguishes unlimited partnerships from limited liability companies.<sup>1</sup> In the latter, corporate assets and liabilities are separated from those of the corporate owners, and the corporate owners have no exposure to the claims of creditors. Nevertheless, companies are not only viewed as the property of their owners, but as a *nexus of contracts* between various actors, which can give rise to agency conflict between them.<sup>2</sup> Both shareholders and creditors have claims against the firm: dividends and the repayment of corporate debts. The fact that both claims can be satisfied from the pool of corporate assets means that shareholders and creditors are in conflicting positions. Shareholders are the owners of the company and enjoy an advantage, contrasting with the creditors concerning decision-making. For this reason, a jurisdiction may believe that a certain amount of value should not be transferred to them.<sup>3</sup> This is the rationale of *legal capital*, or *capital maintenance*, rules.

As Coase suggests, if economic theory attempts to find the most efficient way to organize business operations, then the technical means to achieve this depend on accounting.<sup>4</sup> Accounting primarily aims to *inform* capital providers, specifically shareholders and creditors.<sup>5</sup> Nonetheless, some jurisdictions extend the scope of accounting to include the *protection* of corporate stakeholders, especially creditors and tax authorities.<sup>6</sup> While Anglo-American jurisdictions lean towards the first model, Continental jurisdictions are the major representatives of the second. Since legal capital rules employ accounting figures, namely assets, liabilities, and equity, legal mechanisms cannot be separated from their accounting counterparts.<sup>7</sup> As discussed below, there are long-standing debates about the economic efficiency of mandatory legal capital rules and the differences between Anglo-American and Continental accounting systems. Since both debates influence each other, this paper will attempt to explore how they interact from a legal point of view.

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1 H. Hansmann & R. Kraakman, 'The Essential Role of Organizational Law', (2000) 110 *Yale Law Journal*, p. 395.

2 M. Jensen & W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure', (1976) 3 *Journal of Financial Economics*, p. 305.

3 L.A. Bebchuk, 'Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law', (1992) 105 *Harvard Law Review*, p. 1490.

4 R. Coase, 'Accounting and the Theory of the Firm', (1990) 12 *Journal of Accounting and Economics*, p. 11.

5 S. Cascino et al., 'The Use of Information by Capital Providers' (2013), in <<http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/January/AP13-The%20use%20of%20information%20by%20capital%20providers.pdf>> (last visited 5 September 2016).

6 R. Ball et al., 'The Effect of International Institutional Factors on Properties of Accounting Earnings', (2000) 29 *Journal of Accounting and Economics*, p. 15.

7 L. Handschin, 'Risk-Based Equity Requirements: How Equity Rules for the Financial Sector Can Be Applied to the Real Economy', (2012) 12 *Journal of Corporate Law Studies*, p. 256.

In the European Union (hereinafter EU) and the European Economic Area (hereinafter EEA) context, this discussion becomes even more relevant, because both legal capital and accounting rules are at the centre of company law harmonization efforts. European capital maintenance rules are considered to be more conservative; the same happens with Continental accounting. Recently, there has been a substantial movement towards introducing International Financial Reporting Standards (hereinafter IFRS), which are of an Anglo-American mentality, in Continental jurisdictions, which traditionally had conservative General Accepted Accounting Principles (hereinafter GAAP). This paper will address the effects of this *transplant* and will scrutinize the rationale that EEA States followed in the areas where they had discretion in implementation. The outcome will be twofold. Firstly, mandatory creditor protection can work better with mandatory conservative standards. Secondly, since the degree of dependence on debt financing varies among EEA States, conservative standards become more relevant for those states with a high degree of such dependence. Lastly, it should be noted that this paper will not discuss whether capital maintenance rules are economically efficient; rather it will research under which accounting regime they are more likely to be effective.

The paper will be organized as follows. Section 2 will study the classification of international accounting systems and the concept of accounting *conservatism*. Its conclusion will be that Anglo-American standards are more equity-oriented and neutral, while the Continental ones are more debt-focused and conservative. Section 3 will map the EU/EEA accounting regime and will focus on the function of the IAS Regulation.<sup>8</sup> It will claim that some EEA States have not used the options of the Regulation in an optimal way. Section 4 will discuss legal capital rules in EU law and how they interact with accounting, while Section 5 will focus on the agency costs created by the choice of a certain standard and the interaction between standards and incentives. At the end, in Section 6 the paper will advocate that mandatory legal capital rules can better protect creditors if they are combined with conservative rather than neutral accounting standards.

## 2. International accounting systems and accounting conservatism

This section will depict the classification of international accounting systems. Special focus will be given to the relation between accounting and legal families. Further, it will explore the concept of *accounting conservatism*, a mechanism associated with creditor protection. Lastly, it will show how accounting systems, legal families and accounting conservatism interact with each other.

### 2.1. The Nobes classification of accounting systems

There have been numerous attempts to draw borders between international accounting families.<sup>9</sup> One of the most recent is that of Nobes, which is particularly relevant for legal scholars, because his classification coincides to a great extent with the distinction between common and civil law.<sup>10</sup> Nobes' categorization derives from the main function of accounting, which is to provide information which is useful to the capital suppliers of the preparer.<sup>11</sup> Accounting systems around the world form two separate classes: one oriented towards external shareholders in countries with strong equity markets and one focusing on the needs of creditors and other stakeholders in countries with weak equity markets.<sup>12</sup> In a simplified model, the equity-oriented class corresponds to Anglo-American markets, while the debt-oriented equivalent corresponds to the Continental ones. Undoubtedly, the differences in accounting systems are closely associated with the divergence in corporate finance and governance models among different countries.<sup>13</sup> Anglo-American systems are dominated by equity financing which explains why they target the interests of shareholders.

8 Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, OJ L 243, 11.9.2002, p. 1.

9 C. Nobes & R. Parker, *Comparative International Accounting* (2012), p. 55.

10 C. Nobes, 'Towards a General Model of the Reasons for International Differences in Financial Reporting', (1998) 34 *Abacus*, p. 162.

11 See Cascino et al., *supra* note 5, p. 13.

12 See Nobes, *supra* note 10, p. 178.

13 H. Ben Othman & D. Zeghal, 'A Study of Earnings-Management Motives in the Anglo-American and Euro-Continental Accounting Models: The Canadian and French Cases', (2006) 41 *The International Journal of Accounting*, p. 410.

Continental systems are more stakeholder-oriented, since debt financing prevails. Debt-financed systems can also be sub-divided into institutionally and governmentally financed;<sup>14</sup> this explains why creditors and governments are considered to be the two most important stakeholders with interests in financial reporting.

The divergence in the financing models around the world has deep roots and can be characterized as path-dependent. Fear and KobraK state that the differences between American and German accounting and financing models trace their origins to the different degree of the involvement of equity investors and governments in the ownership of railroads in the 19<sup>th</sup> century, which were the most attractive investment of that period.<sup>15</sup> Further, when accounting rules were standardized during the Interbellum, legal and government professionals monopolized this process in Germany, while in the US only accountants undertook this task.<sup>16</sup> Thus, the leading representatives of each system adopted a different pattern of standardization, driven either by the markets or the state.<sup>17</sup> This path-dependence proves that legal tradition influences accounting practice and standardization.

Many scholars suggest that the differences between common law and civil law have a crucial impact on accounting standards.<sup>18</sup> Nobes observes a correlation between financing models and legal environments. Professional self-regulation, private enforcement and litigation prevail in common law countries.<sup>19</sup> Codification, governmental regulation and public disclosure and enforcement are the main features of the civil law jurisdictions. Thus, common law appears to be more adaptive to market practice, while civil law is more centralized and doctrinal. The same can be said about Anglo-American and Continental accounting rules. Although a relationship of co-existence between accounting systems and legal rules is observable, we should be cautious about inferring causality. Dutch GAAP (both DCC and DAS), which are equity-oriented despite the civil law background of the Netherlands, show that financing practice may be more relevant than legal origins.<sup>20</sup>

The main scope of Anglo-American systems is the information of equity investors, while the main scope of Continental systems is both the information and the protection of stakeholders.<sup>21</sup> The first are called 'neutral' and aim for the presentation of the 'true and fair value' (hereinafter TFV) of accounts, offering more discretion to the preparers.<sup>22</sup> On the other hand, Continental systems are 'prudent' in order to protect stakeholders by being biased in their favour.<sup>23</sup> They tend to report assets more conservatively by valuing assets at the 'lowest of cost or market rule' and by allowing the recognition of unrealized losses but not of unrealized profits.<sup>24</sup> This conservative treatment enables the creation of reserves, called 'hidden', that can be used in a future period when they become realized, even if the company has losses.<sup>25</sup> In reality,

14 J. Zysman, *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change* (1983), p. 55.

15 J. Fear & C. KobraK, 'Diverging Paths: Accounting for Corporate Governance in America and Germany', (2006) 80 *The Business History Review*, p. 10.

16 *Ibid.*, p. 46.

17 J. Tate, 'National Varieties of Standardization', in P. Hall & D. Soskice (eds.), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (2001), p. 443.

18 J. García Lara & A. Mora, 'Balance Sheet versus Earnings Conservatism in Europe', (2004) 13 *European Accounting Review*, p. 261; T. Jeanjean & H. Stolowy, 'Do Accounting Standards Matter? An Exploratory Analysis of Earnings Management before and after IFRS Adoption', (2008) 27 *Journal of Accounting and Public Policy*, p. 480; P. Joos & M. Lang, 'The Effects of Accounting Diversity: Evidence from the European Union', (1994) 32 *Journal of Accounting Research*, p. 141; B. Van Tanderloo & A. Vanstraelen, 'Earnings Management under German GAAP versus IFRS', (2005) 14 *European Accounting Review*, p. 159.

19 See Nobes, *supra* note 10, p. 172.

20 Both the Dutch Civil Code Standards (*DCC* or *BW Book 2 Title 9*) and the guidelines issued by the Dutch Accounting Standards Board (*DAS* or *Richtlijnen van de Raad voor de Jaarverslaggeving*) are considered as Dutch GAAP. The Dutch legal system is part of the Continental legal family. However, the Dutch accounting standards, which are the product of legislative and self-regulatory initiative, have followed the path of common law jurisdictions, being equity-oriented. Thus, it is the historically equity-oriented nature of the Dutch economy that has more influenced the Dutch accounting standards, rather than its legal system. See PricewaterhouseCoopers Accountants N.V., 'Similarities and Differences – Dutch GAAP vs. IFRS' (2013), p. 7, in <<https://www.pwc.nl/nl/assets/documents/pwc-similarities-and-differences-dutch-gaap-vs-ifrs.pdf>> (last visited 5 September 2016).

21 M. Arce & A. Mora, 'Empirical Evidence of the Effect of European Accounting Differences on the Stock Market Valuation of Earnings and Book Value', (2002) 11 *European Accounting Review*, p. 582.

22 See Joos & Lang, *supra* note 18, p. 142.

23 A. Haller & B. Eierle, 'The Adaptation of German Accounting Rules to IFRS: A Legislative Balancing Act', (2004) 1 *Accounting in Europe*, p. 37.

24 T. Harris et al., 'The Value Relevance of German Accounting Measures: An Empirical Analysis', (1994) 32 *Journal of Accounting Research*, p. 191; W. Mattli & T. Büthe, 'Global Private Governance: Lessons from a National Model of Setting Standards in Accounting', (2005) 68 *Law and Contemporary Problems*, p. 256.

25 Van Tanderloo & Vanstraelen, *supra* note 18, p. 161.

they undervalue assets in order to reduce the risk of overvaluation and they transfer this value to future accounts.<sup>26</sup> Continental accounting attracts a lot of criticism and is viewed as non-transparent and as a source of agency problems.<sup>27</sup> Indeed, hidden reserves and conservative bias are not very helpful for informational purposes; nevertheless, they have a central function in creditor protection, because they play a central role in dividend restrictions.<sup>28</sup>

Contrary to the above, neutral accounting allows for revaluations. However, this can be done only to the extent that they are justified by a reverse recognition in the previous accounts, achieving transparency and covering valuation risk.<sup>29</sup> Here, the recognition of unrealized profits is generally accepted, although there are exceptions, since their scope is to depict the value which is relevant for equity investors. In practical terms, Continental systems are more restrictive in good years, but they can become more permissive in bad ones, through the use of hidden reserves.<sup>30</sup> The restrictive outcome is driven by two factors: the undervaluation of assets and the link with taxation, which gives management an incentive to report lower profits. Hellman presents practical paradigms on how a prudent system can generate more profits than conservatively adjusted IFRS.<sup>31</sup> An example commonly referred to in the literature is that of Daimler-Benz AG, which reported profits under German GAAP, but losses under US GAAP, when listed on the New York Stock Exchange in 1993; this accounting divergence had negative implications after its merger with Chrysler.<sup>32</sup> Such outcomes have given Continental standards a poor reputation among Anglo-American scholars.

This sub-section examined the distinction between Anglo-American and Continental accounting standards and their distinct mechanisms. Moreover, the former are usually encountered in common law jurisdictions and the latter in civil law jurisdictions.

## 2.2. Accounting conservatism

One of the greatest risks in financial reporting is the overvaluation of assets, i.e. setting a book value higher than the market value.<sup>33</sup> The importance of the concept of market value has been emphasized by the 'Efficient Markets Hypothesis';<sup>34</sup> however, both of these concepts have received criticism from the literature, especially after the outbreak of the economic crisis of 2008.<sup>35</sup> For this reason, the reporting of past events should be reliable.<sup>36</sup> Reliability can be achieved through 'conservatism' or 'informational asymmetry' in the reporting of profits and losses. Conservatism is divided into 'unconditional' or 'balance sheet' or 'ex ante' conservatism and 'conditional' or 'earnings' or 'ex post' conservatism.<sup>37</sup> Unconditional conservatism focuses on the institutionally-driven procedure of valuing assets and liabilities, which is independent from the timeliness of reporting good and bad news.<sup>38</sup> It will be explained below that this is what happens in prudent systems. On the other hand, conditional conservatism means that there is an asymmetry in the timeliness and a higher degree of verification for reporting bad news rather than good news.<sup>39</sup>

It becomes apparent that conservatism is biased; the desirable outcome is the reduction of agency conflicts. The rationale behind conditional conservatism is that managers have incentives to be biased

26 See Handschin, *supra* note 7, p. 258.

27 P. Santella, 'Capital Maintenance in the EU: Is the Second Company Law Directive Really That Restrictive?', (2008) 9 *European Business Organization Law Review*, p. 441.

28 N. Hellman, 'Accounting Conservatism under IFRS', (2008) 5 *Accounting in Europe*, p. 97.

29 See Handschin, *supra* note 7, pp. 259-260.

30 See Ball et al., *supra* note 6.

31 See Hellman, *supra* note 28.

32 J. Coffee, 'Racing towards the Top? The Impact of Cross-Listings and Stock Market Competition on International Comparative Governance', (2002) 102 *Columbia Law Review*, pp. 1793-1974; D. Logue & J. Seward, 'Anatomy of a Governance Transformation: The Case of Daimler-Benz', (1999) 62 *Law and Contemporary Problems*, p. 92.

33 See Handschin, *supra* note 7, p. 257.

34 E. Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work', (1970) 25 *Journal of Finance*, pp. 383-417.

35 B. Malkiel, 'The Efficient Market Hypothesis and Its Critics', (2003) 17 *Journal of Economic Perspectives*, no. 1, pp. 59-82; R. Ball, 'The Global Financial Crisis and the Efficient Market Hypothesis: What Have We Learned?', (2009) 21 *Journal of Applied Corporate Finance*, no. 4, pp. 8-16.

36 See Hellman, *supra* note 28, p. 72.

37 W. Beaver & S. Ryan, 'Conditional and Unconditional Conservatism: Concepts and Modeling', (2005) 10 *Review of Accounting Studies*, p. 269; See García Lara & Mora, *supra* note 18, p. 263; See Nobes & Parker, *supra* note 9, p. 42.

38 See Ball et al., *supra* note 6, p. 2.

39 S. Basu, 'The Conservatism Principle and the Asymmetric Timeliness of Earnings', (1997) 24 *Journal of Accounting and Economics*, pp. 33-34.

towards revealing good news, because this will reflect a better image concerning their performance. By requiring a stricter degree of verification, conditional conservatism improves the quality of information required for contracting.<sup>40</sup> This is relevant for everybody who has claims against the company, thus both shareholders and creditors.<sup>41</sup> Another function of conservatism is to prevent the exploitation of creditors by making distributions to other claimants, such as equity-holders.<sup>42</sup> This outcome is achieved by decreasing corporate income and assets, through unconditional conservatism. The latter function resembles the restrictive function that legal capital rules have on distribution policy.<sup>43</sup> According to Basu, efficiency in contracting is achieved through the informational character of news-dependent conservatism, unconditional conservatism can only contribute to the behavioural restrictions in distributions and not to informational efficiency.<sup>44</sup> However, according to Watts, the distributional function of conservatism can also assist in contracting efficiency.<sup>45</sup>

From the above, we can deduce that unconditional conservatism mostly has a distributional function, while conditional conservatism mostly has an informational one. Indeed, the result of unconditional conservatism is not a lower valuation of assets and earnings, because through hidden reserves and earnings management the value not recognized in present accounts is transferred to future ones.<sup>46</sup> The concept that is affected by unconditional conservatism is the difference between assets and liability, which is equity. If the capital maintenance rules are applied, smaller equity is generated and, consequently, lower dividends are distributed. Thus, unconditional conservatism has a particular legal interest, especially for creditors.

There is a conflation between unconditional conservatism and prudence, or *Vorsicht* in German.<sup>47</sup> This is because many of the mechanisms used in Continental accounting are unconditionally conservative. García Lara and Mora have observed that Continental accounting systems are more unconditionally conservative than common law systems, while conditional conservatism appears more often in common law systems.<sup>48</sup> Besides, it has been noted that unconditional and conditional conservatism are negatively connected.<sup>49</sup> This means that firms that have adopted unconditional conservatism are more unlikely to adopt conditional conservative methods. Also, conditional conservatism has a higher quality of reporting while unconditional conservatism has a lower one, since conditional conservatism focuses on the timeliness of information.<sup>50</sup> This is connected to the fact that unconditional conservatism allows earnings management, i.e. the mitigation of income fluctuation from one year to another through hidden reserves, as happens with Continental standards.<sup>51</sup> On the contrary, conditional conservatism and income smoothing are negatively related and weakly connected.<sup>52</sup> From this it can be concluded that prudent systems concentrate on the distributional rather than the informational role of reporting, since they are non-transparent. The analogous mechanism employed by neutral systems usually influences the verification of news and not the balance sheet; thus they have solely an informational function.

### 2.3. Summary

This section presented the classification of international accounting families and the types of accounting conservatism. In a simplified scheme, Continental standards appear in civil law jurisdictions and they are

40 S. Ryan, 'Identifying Conditional Conservatism', (2006) 15 *European Accounting Review*, p. 513.

41 See Basu, *supra* note 39, p. 9.

42 R. Ball & L. Shivakumar, 'The Role of Accruals in Asymmetrically Timely Gain and Loss Recognition', (2006) 44 *Journal of Accounting Research*, p. 210.

43 See Bebchuk, *supra* note 3, p. 1490.

44 See Basu, *supra* note 39, p. 33.

45 R. Watts, 'Conservatism in Accounting Part I: Explanations and Implications', (2003) 17 *Accounting Horizons*, pp. 207, 214.

46 See García Lara & Mora, *supra* note 18, p. 262.

47 R. Ball & L. Shivakumar, 'Earnings Quality in UK Private Firms: Comparative Loss Recognition Timeliness', (2005) 39 *Journal of Accounting and Economics*, pp. 89-90; J. Gassen et al., 'International Differences in Conditional Conservatism – The Role of Unconditional Conservatism and Income Smoothing', (2006) 15 *European Accounting Review*, p. 559; See Nobes & Parker, *supra* note 9, p. 43.

48 See García Lara & Mora, *supra* note 18, p. 284; See Ball et al., *supra* note 6, p. 47.

49 See Ball & Shivakumar, *supra* note 42, p. 233; See Beaver & Ryan, *supra* note 37, pp. 301-302.

50 G. Iatridis, 'Accounting Disclosures, Accounting Quality and Conditional and Unconditional Conservatism', (2011) 20 *International Review of Financial Analysis*, p. 89.

51 See Beaver & Ryan, *supra* note 37, p. 302; See Hellman, *supra* note 28, p. 75.

52 See Gassen et al., *supra* note 47, pp. 557-558.

more conservative and debt-focused, while Anglo-American standards are associated with the common law, they are more neutral and they better serve the informational needs of equity investors. As will be examined below, this distinction has become less clear recently, after the transplantation of Anglo-American standards into Continental jurisdictions.

### 3. The accounting regime in the EU/EEA

This section will consider the regulation of financial reporting by EU Law. It will focus on the efforts for accounting harmonization and homogeneity through the introduction of IFRS for certain accounts. It will argue that the landscape of accounting standards in the EU and EEA is still heterogeneous, although in capital markets a relative convergence has been reached.

#### 3.1. Introduction

Since accounting cannot be separated from company law, EU company law harmonization has not ignored financial reporting. Accounting rules may have effects on corporate disclosure and accountability, capital maintenance, transparency, public trading or restructuring. They form an integral part of the regulatory nexus surrounding business corporations; thus, harmonization in accounting rules is a precondition for harmonizing the whole body of company law. Since financial reporting should serve the needs of capital providers, attempting to harmonize this field contrasts with the heterogeneity of capital sources in the EU.<sup>53</sup> Thus, the harmonization effort has led to an accounting regime that is mostly a product of *transplantation*, rather than *origination*; IFRS are exogenous to many European markets, compared to the local standards which were developed according to the particularities of Continental economies. While the scope of harmonization is market integration, there is the risk of giving birth to a legal regime that does not reflect the needs of the real economy.

The primary EU accounting law statutes are two directives and a regulation. First, Directive 2013/34/EU regulates the preparation of the annual financial statements and consolidated financial statements of limited liability companies.<sup>54</sup> This Directive replaced the Fourth Council Directive, which regulated the preparation of annual accounts by limited liability companies and the Seventh Council Directive governing the consolidated accounts of groups of companies.<sup>55</sup> Besides, the Eighth Council Directive<sup>56</sup> sets minimum standards for the accounting profession. Lastly, the IAS Regulation (a statute which is relevant for the EEA) introduced the application of IFRS for groups of companies with at least one listed member; until then this practice was exercised voluntarily by many companies.<sup>57</sup> Additionally, the Regulation enables national legislators to extend the application of IFRS to accounts governed by domestic law, an option that had been adopted by 21 Member States and the 3 EEA States.

#### 3.2. True and fair value versus prudence

A most fundamental characteristic of Directive 2013/34/EU is that it enables wide discretion for the Member States to preserve their own accounting philosophy, prudence or TFV principle.<sup>58</sup> The Fourth Directive was not clear concerning which should prevail and it introduced both philosophies. The TFV principle, as described

<sup>53</sup> See Cascino et al., *supra* note 5, p. 16.

<sup>54</sup> 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, OJ L 182, 29.6.2013, pp. 19-76.

<sup>55</sup> Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, OJ L 222, 14.8.1978, p. 11; Seventh Council Directive 83/349/EEC of 13 June 1983 based on Article 54(3)(g) of the Treaty on consolidated accounts, OJ L 193, 18.7.1983, p. 1.

<sup>56</sup> Eighth Council Directive 79/1072/EEC of 6 December 1979 on the harmonization of the laws of the Member States relating to turnover taxes – Arrangements for the refund of value added tax to taxable persons not established in the territory of the country, OJ L 331, 27.12.1979, p. 11.

<sup>57</sup> E. Jermakowicz & S. Gornik-Tomaszewski, 'Implementing IFRS from the Perspective of EU Publicly Traded Companies', (2006) 15 *Journal of International Accounting, Auditing and Taxation*, p. 174.

<sup>58</sup> L. Enriques, 'EC Company Law Directives and Regulations: How Trivial Are They?', (2006) 27 *University of Pennsylvania Journal of International Economic Law*, p. 26.

in Article 2(3) of the Directive, has a central importance and implies a retreat of prudence, and the situation has not changed after Directive 2013/34/EU.<sup>59</sup> Nevertheless, it has to coexist with prudence, according to Article 31(1)(c). The view extracted from the case of *Tomberger* (Case C-234/94) is a predominance of the TFV principle;<sup>60</sup> if a subsidiary's accounts comply with the TFV principle, it is not contrary to the prudence principle to include these accounts in the balance sheet of the parent company. However, EU linguistic politics are not helpful. All the linguistic versions of the Directive, apart from the English one, contain the words 'in any event/case' in the section on prudence.<sup>61</sup> This is explained by the impact of Roman law in all European languages apart from English, as well as by the translation procedures in European organs.<sup>62</sup> This means that there is no clear balance and that the Member States enjoy wide discretion in the application of the same concepts.<sup>63</sup>

### 3.3. IFRS in the EU/EEA

The IAS Regulation is much more radical than the Directives. It introduces the mandatory application of IFRS for the consolidated accounts of publicly traded companies, as they have been adopted by the European Commission pursuant to the (procedure of the) IAS Regulation. The mandatory application of IFRS for consolidated accounts of listed companies is justified by the fact that although there is a substantial divergence among the economic and financial systems of EEA States, there is a relative convergence of their capital markets.<sup>64</sup> IFRS are equity-focused accounting standards set by the International Accounting Standards Board (IASB), an international independent standard-setting body. Together with the US and UK GAAP, they are the most characteristic Anglo-American standards.<sup>65</sup> IFRS have a clear informational role in the context of capital markets and provide for informational comparability among different companies, something which is impossible if they are subject to different accounting regimes.<sup>66</sup> This is crucial for consolidated accounts, which treat a group of companies as a 'single accounting entity'.<sup>67</sup> Consolidated accounts are helpful in determining someone's investment strategy, while individual accounts can also be used for distributional and regulatory purposes, such as taxation.<sup>68</sup> Consequently, by mandating IFRS only for consolidated accounts, the Regulation draws a new dichotomy; now, accounting systems are not only determined by the financing systems they serve, but also by the type of accounts they bind. Even though the IAS Regulation introduces an Anglo-American transplant into Continental Europe, there is a homophony in favour of its provisions, because it regulates an environment that requires equity-oriented information. The standards used in individual accounts are still determined by national legislators; this is the cardinal compromise reached by the Regulation.<sup>69</sup>

For individual accounts, EEA States enjoy discretion. They can require, permit or prohibit IFRS. Additionally, their implementation can vary according to the following factors: (i) whether IFRS apply to individual or consolidated accounts, (ii) whether the covered companies are listed or non-listed, (iii) whether such an option applies to all firms or firms of certain industries, such as credit institutions, (iv) whether IFRS apply to some companies according to their size, and (v) whether accounts are used for distributional or only for informational purposes. The effects of requiring or permitting the use of IFRS on individual accounts are

59 S. Grundmann, *European Company Law: Organization, Finance and Capital Markets* (2012), p. 367.

60 Case C-234/94, *Waltraud Tomberger v Gebrüder von der Wettern GmbH.*, Judgment of the Court (Fifth Chamber) of 27 June 1996, [1996] ECR I-03133.

61 L. Evans & C. Nobes, 'Some Mysteries Relating to the Prudence Principle in the Fourth Directive and in German and British Law', (1996) 5 *European Accounting Review*, p. 368.

62 K. van Hulle, 'Prudence: A Principle or an Attitude?', (1996) 5 *European Accounting Review*, p. 375.

63 A. Haller, 'Financial Accounting Developments in the European Union: Past Events and Future Prospects', (2002) 11 *European Accounting Review*, p. 157.

64 See Arce & Mora, *supra* note 21, p. 595.

65 See Nobes & Parker, *supra* note 9, p. 72.

66 K. Schipper, 'The Introduction of International Accounting Standards in Europe: Implications for International Convergence', (2005) 14 *European Accounting Review*, p. 107; D. Street & R. Larson, 'Large Accounting Firms' Survey Reveals Emergence of 'Two Standard' System in the European Union', (2004) 17 *Advances in International Accounting*, p. 23.

67 See Nobes & Parker, *supra* note 9, p. 383.

68 T. Sellhorn & S. Gornik-Tomaszewski, 'Implications of the 'IAS Regulation' for Research into the International Differences in Accounting Systems', (2006) 3 *Accounting in Europe*, p. 188.

69 See Jermakowicz & Gornik-Tomaszewski, *supra* note 57, p. 181.

very important from a legal point of view. Firstly, wherever IFRS are adopted, individual accounts have to be separated from taxation, because they are incompatible.<sup>70</sup> Analogously, the influences that IFRS may have on national GAAP, as in the case of Germany, have led to a similar outcome.<sup>71</sup> Secondly, individual accounts continue to determine dividend distributions under IFRS, altering the whole discussion about legal capital, since assets, liabilities and equity are now calculated by a different method. In practical terms, under IFRS, assets can be valued higher and unrealized profits can be distributed, circumventing the restrictive nature of capital maintenance rules. Thirdly, accounting standards may influence contractual obligations between the company and third parties, such as debt covenants, if they are accounting-based.<sup>72</sup> An additional point of interest is auditors' liability; auditors traditionally have a 'watchdog' function over managers, resulting in a natural inclination towards conservative accounting.<sup>73</sup> Since Continental accounting is always conservative, the introduction of less conservative standards, without voluntary adjustments, is likely to create confusion and malfunctions.

A final remark should be made about the possible efficiency of adopting IFRS. As Ball et al. and Van Tanderloo and Vanstraelen have empirically observed, high quality standards are a pre-requisite for high quality reporting, but do not themselves guarantee such an outcome if the incentives of preparers are problematic.<sup>74</sup> Thus, IFRS may not work that well in economies characterised by close links between companies and stakeholders, because in those economies there is no demand for a high quality of reporting, due to this proximity.<sup>75</sup> In the EU context, the different degrees of enforcement effectiveness among the Member States play a central role, which also has an impact on the quality of the information produced.<sup>76</sup> Additionally, in those cases where IFRS are not mandated, but just permitted, the element of comparability is reduced. Further, companies bound by such a regime may decide to adopt IFRS not in order to enhance quality, but with the intention of increasing distributions. And in the same way, the mandatory application of IFRS in an economy with weak institutional features may not augment comparability, because it may not be easy to distinguish the genuine from the malign incentives. The long list of issues arising from the *IAS Regulation* shows the various legal implications of this statute.<sup>77</sup>

### 3.4. The State-level choices

EEA States have the option to extend IFRS application to individual accounts of listed companies and to all accounts of non-listed companies. For all of these accounts, national legislators can permit, require or prohibit the application of IFRS. Until 2013, 12 EEA States required the use of IFRS for the individual accounts of listed companies, 12 permitted their adoption and 7 prohibited this.<sup>78</sup> Additionally, some states that permit IFRS may require them for certain types of companies. If IFRS' application is extended to individual accounts, then distributions are made according to IFRS and not national GAAP. Thus, there is a small group of states that still consider that their national GAAP can better serve the interests of creditors and other stakeholders (Austria, Belgium, France, Germany, Hungary, Spain and Sweden). As shown by a study of the German KPMG, the decision of those states can be justified by the fact that their national GAAP are substantially divergent from the IFRS.<sup>79</sup> Also, apart from Hungary all the other economies are either

70 See Sellhorn & Gornik-Tomaszewski, supra note 68, pp. 195 et seq.

71 A. Hellmann et al., 'Continental European Accounting Model and Accounting Modernization in Germany', (2013) 29 *Advances in Accounting*, p. 127.

72 P. Ormrod & P. Taylor, 'The Impact of the Change to International Accounting Standards on Debt Covenants: A UK Perspective', (2004) 1 *Accounting in Europe*, p. 78.

73 P. Giudici, 'Auditors' Multi-Layered Liability Regime', (2012) 13 *European Business Organization Law Review*, pp. 522 et seq.; See Basu, supra note 39, p. 27.

74 R. Ball et al., 'Incentives versus Standards: Properties of Accounting Income in Four East Asian Countries', (2003) 36 *Journal of Accounting and Economics*, p. 235; See Van Tanderloo & Vanstraelen, supra note 18.

75 See Ball et al., supra note 74, p. 242.

76 See Haller, supra note 63, p. 177.

77 See Jermakowicz & Gornik-Tomaszewski, supra note 57, p. 193; See Schipper, supra note 66, p. 105; See Sellhorn & Gornik-Tomaszewski, supra note 68, p. 209; See Haller, supra note 63, p. 183.

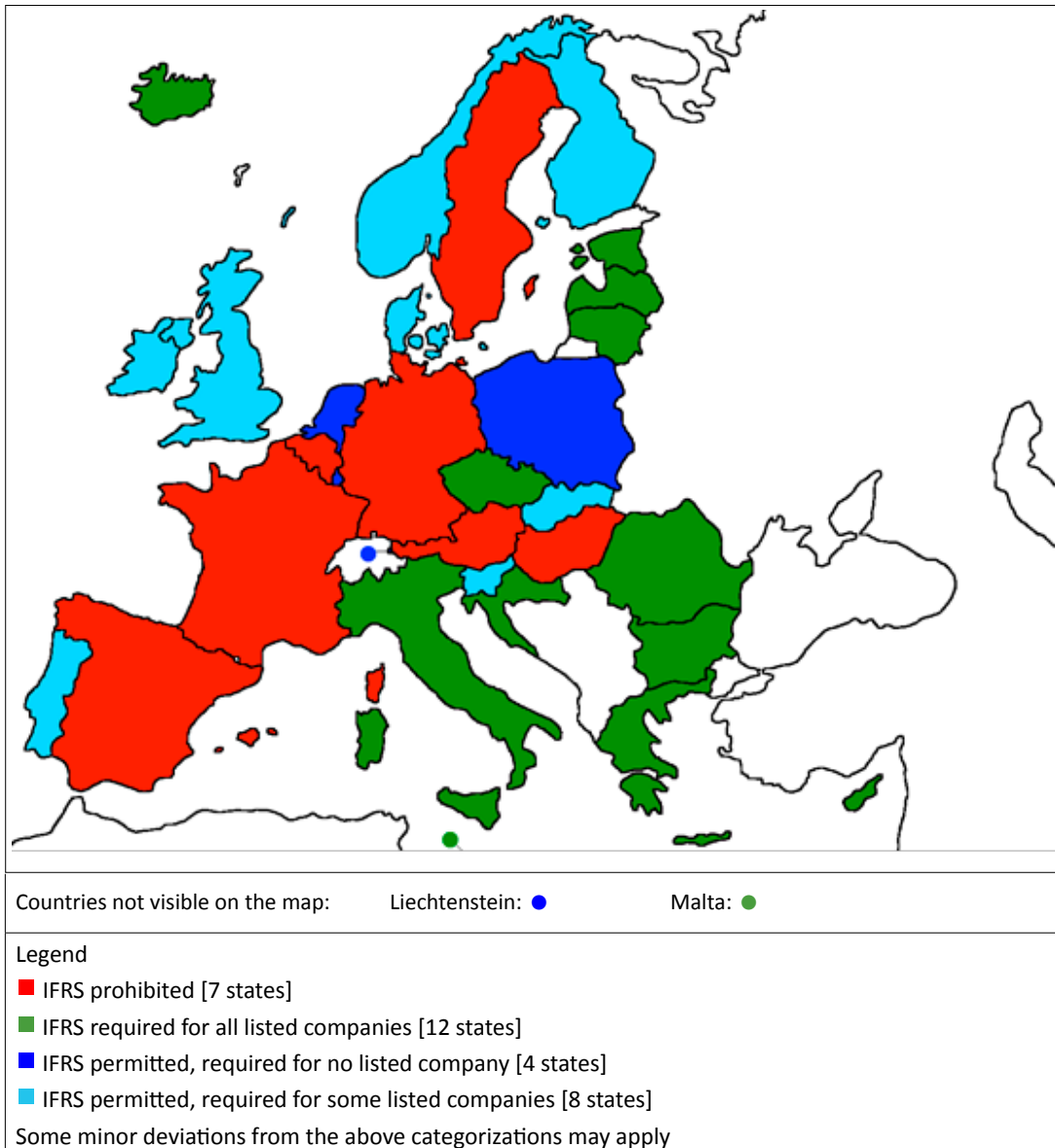
78 Detailed information on the application of IFRS by national jurisdictions is given in <<http://www.ifrs.org/use-around-the-world/pages/jurisdiction-profiles.aspx>> (last visited 5 September 2016).

79 KPMG Deutsche Treuhand-Gesellschaft Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, 'Feasibility Study on an Alternative to the Capital Maintenance Regime Established by the Second Company Law Directive 77/91/EEC of 13 December 1976 and an Examination of



coordinated market economies (Austria, Belgium, Germany, Sweden), or large economies of the Napoleonic tradition of standardization, namely France and Spain.<sup>80</sup> Their decision seems to be rational, given the strong economic and legal tradition that characterizes these countries.

*Adoption of IFRS for individual accounts of listed companies among the EEA States<sup>81</sup>*



From mapping the adoption of IFRS in the EEA, one can observe that IFRS are required in (a) ex-communist economies that are more willing to introduce new standards of high reputation and quality,<sup>82</sup> (b) small countries specializing in financial markets (Cyprus, Estonia, Iceland, Malta) and (c) some Mediterranean economies (Greece, Italy). The decision of the last group seems to be driven by the necessity to introduce

the Impact on Profit Distribution of the New EU-Accounting Regime' (2008), in <[http://ec.europa.eu/internal\\_market/company/docs/capital/feasibility/study\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/capital/feasibility/study_en.pdf)> (last visited 5 September 2016), p. 323.

80 P. Hall & D. Soskice, 'An Introduction to Varieties of Capitalism', in P. Hall & D. Soskice (eds.), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (2001), p. 20; See Tate, *supra* note 17, p. 443.

81 European Commission, 'Implementation of the IAS Regulation (1606/2002) in the EU and EEA' (2012), in <[http://ec.europa.eu/finance/accounting/docs/ias/ias-use-of-options\\_en.pdf](http://ec.europa.eu/finance/accounting/docs/ias/ias-use-of-options_en.pdf)> (last visited 5 September 2016); The IFRS Foundation and the IASB, 'IFRS Application around the World' (2013), in <<http://www.ifrs.org/Use-around-the-world/Documents/Jurisdiction-profiles>> (last visited 5 September 2016).

82 R. Larson & D. Street, 'Convergence with IFRS in an Expanding Europe: Progress and Obstacles Identified by Large Accounting Firms' Survey', (2004) 13 *Journal of International Accounting, Auditing and Taxation*, p.112.

high-quality standards in markets affected by major financial scandals.<sup>83</sup> However, what seems paradoxical for these countries is their dependence on debt financing and the divergence of their national GAAP compared to IFRS.<sup>84</sup> The same applies to the Eastern European states, although many of them already had equity-friendly standards before the IAS Regulation. In other cases, such as in Greece, the wide introduction of IFRS has led to the eventual reform of the domestic GAAP.<sup>85</sup>

There is another group of states that leave the decision about the adoption of certain standards to the companies themselves. A first group consists of Western and Northern European countries with strong equity markets, some of which traditionally have equity-driven standards. A second one is comprised of some Eastern European states and Portugal, which decided to implement an intermediate position between the two extreme ones. As was already discussed, this option offers flexibility, but also creates deficiencies in comparability and the opportunity for manipulation. Companies with discretion in applying IFRS can use standards that better fit their particular characteristics, in this way manipulating the interests of third parties. However, as was explained before, in many jurisdictions, such as the UK or the Netherlands, the differences between IFRS and local GAAP are not substantial;<sup>86</sup> thus the above-described flexibility is narrow in practice. Consequently, this intermediate option has many behavioural implications in those cases where national GAAP and IFRS are relatively distant. Thus, it should be noted that the wider the divergence between local GAAP and IFRS, the more important this discussion becomes. The decision to adopt IFRS is not an easy one to make; since the vast majority of Continental jurisdictions had a different accounting tradition to IFRS, the transition between the old and the new regime may not be simple. Yet, economies evolve and change; thus, the swift change from national GAAP to IFRS may reflect new market needs. In any case, an analysis of the economic teleology of adopting IFRS is beyond the scope of this paper.

### 3.5. Some final thoughts about the IAS Regulation

The IAS Regulation creates a bifurcated regime. Firstly, IFRS are made mandatory for consolidated accounts of listed companies, thereby compelling the harmonization of standards in this field. This intrusion is not unjustified, because it follows the informational needs of capital markets and the practice of the voluntary adoption of high-quality equity-focus standards by European firms prior to the enactment of the Regulation.<sup>87</sup> The success of the first stage is mirrored by the fact that all the 31 EEA States somehow allow or require the adoption of IFRS for the consolidated accounts of non-listed companies. The second point more controversially concerns what happens (a) with the individual accounts that impact distributions or taxation and (b) whether IFRS can be extended to non-listed firms. Both of these decisions lie at the discretion of national legislators and regulators. As noted above, there is a small group of states that rigidly reject any further application of IFRS. A second group of states require the adoption of IFRS for certain companies, while a third group permit them for certain or all companies. The stance of the first group seems rather conservative; however, it represents a devotion to another accounting philosophy that may better reflect the needs of local markets. The dangers of the decision of the first group are linked with the decision of the second group; mandatory IFRS application may or may not suit the characteristics of local economies. The third option is less paternalistic and more contractarian; companies can choose the standards they consider to be better. Here, the needs of outside parties are dealt with by the companies themselves and they are not centrally regulated.

Lastly, it was explained that IFRS are equity-focused and work well in capital markets. Nevertheless, they may prove burdensome for non-listed firms, since they are very complex. At the IASB level, there is a special form of IFRS which are especially designed for small and medium-sized enterprises (IFRS for SMEs). The text of the Regulation gives rise to questions as to whether new forms of IFRS, such as IFRS for SMEs,

83 See Sellhorn & Gornik-Tomaszewski, *supra* note 68, p. 199.

84 See KPMG, *supra* note 79, p. 323; See Cascino et al., *supra* note 5, p. 16.

85 Law 4308/2014 in <<http://www.enterprisegreece.gov.gr/files/Greek%20accounting%20standards%20-%20law%204308%20of%20%2024%20November%202014%20-%20-%20English.pdf>> (last visited 5 September 2016).

86 See KPMG, *supra* note 79, p. 323.

87 See Haller, *supra* note 63, pp. 168 et seq.

are compatible with the existing legal regime.<sup>88</sup> Until now, no state has adopted IFRS for SMEs, although four have adopted standards based thereon and some have indicated that they intend to adopt them, while others express concerns as to the compatibility of IFRS for SMEs with the IAS Regulation. Since IFRS for SMEs are especially designed for small and medium-sized companies with more concentrated ownership, they may seem preferable for non-listed companies compared to the normal IFRS, which are designed for bigger entities and are rather complex for smaller ones, although the image in the literature is not yet clear.<sup>89</sup>

### 3.6. Summary

The accounting regime in the EU cannot be characterized as being fully harmonized. This outcome derives from the existence of two conflicting accounting philosophies among the Member States, which has affected the wording of European statutes. The most substantial effort for harmonization comes with the introduction of IFRS, which has created a ‘two-standard’ system: some firms are using IFRS while others are using their national GAAP.<sup>90</sup> In the following sections it will be explored whether IFRS, as equity-focused standards, or Continental GAAP, as debt-focused standards, can better serve the scope of capital maintenance rules in order to protect creditors.

## 4. Legal capital and accounting rules in EU law

This section will give a brief synopsis of the discussion surrounding legal capital rules in EU Law. It will not compare the situation with alternative systems of creditor protection, but it will try to examine the reasons for adopting mandatory creditor protection instead of a voluntary system. Finally, it will test the interaction of legal capital rules with the accounting ones.

### 4.1. Limited liability and the protection of creditors

The fundamental function of limited liability is that shareholders are not liable against creditors with their own property for corporate debts.<sup>91</sup> Thus, limited liability is a mechanism of risk mitigation to protect shareholders against creditors.<sup>92</sup> Its concept is complemented by that of separate personality;<sup>93</sup> a separate group of assets, belonging to the company and not the shareholders, is created. The major risk for corporate creditors is that the assets of the company will somehow return to the shareholders, leaving nothing with the company in order to satisfy their claims.<sup>94</sup> All jurisdictions provide for rules that aim to prevent shareholders from obtaining a value that should be given to creditors.<sup>95</sup> However, there are different patterns in order to achieve this; the two conflicting models are the *contractarian*, which is voluntary, and the *paternalistic*, which is mandatory.<sup>96</sup>

EU and EEA jurisdictions, bound by the Second Council Directive,<sup>97</sup> have adopted the mechanism of legal capital, which includes a variety of mandatory rules that impose restrictions on shareholders concerning

88 A. Quagli & P. Paoloni, ‘How Is the IFRS for SME Accepted in the European Context? An Analysis of the Homogeneity among European Countries, Users and Preparers in the European Commission Questionnaire’, (2012) 28 *Advances in Accounting*, p. 152.

89 S. Fearnley & T. Hines, ‘How IFRS Has Destabilised Financial Reporting for UK Non-Listed Entities’, (2007) 15 *Journal of Financial Regulation and Compliance*, p. 405.

90 See Larson & Street, supra note 81, p. 115. See Street & Larson, supra note 66, p. 22.

91 See Hansmann & Kraakman, supra note 1, p. 394.

92 J. Benjamin, *Financial Law* (2007), p. 30; L. Enriques & J. Macey, ‘Creditors versus Capital Formation: The Case against European Legal Capital Rules’, (2001) 86 *Cornell Law Review*, p. 1168.

93 B. Manning & J. Hanks, *Legal Capital* (2013), p. 17.

94 J. Armour et al., ‘Transactions with Creditors’, in R. Kraakman et al. (eds.), *The Anatomy of Corporate Law* (2009), p. 116.

95 P. Mülbart, ‘A Synthetic View of Different Concepts of Creditor Protection, or: A High-Level Framework for Corporate Creditor Protection’, (2006) 7 *European Business Organization Law Review*, p. 373.

96 W. Bratton, ‘Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process’, (2006) 7 *European Business Organization Law Review*, p. 44.

97 Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, OJ L 315, 14.11.2012, p. 74. Before 4 December 2012: Second Council Directive 77/91/EEC of 13 December 1976.

distributions.<sup>98</sup> Part of this complex and broad concept is the narrower dividend distribution regulation, which restricts the most direct way of transferring value to shareholders: via a dividend distribution.<sup>99</sup> The mechanism employed by the Directive is a twofold test: one is assets-based and the other is profits-based.<sup>100</sup> Distributions cannot be higher than the difference between assets and liabilities plus share capital and undistributable reserves, as defined by national law. Also, distributions cannot be higher than the net profits of the company for the given financial year, plus any potential reserves from previous years, which are the hidden reserves. The most important concepts of this mechanism are the share capital and the undistributable reserves. These form the so-called ‘cushion’ of equity or legal capital.<sup>101</sup> This cushion is not to be given to the shareholders because it exists in order to pay creditors.<sup>102</sup> From this, we can derive that legal capital only exists for the interest of the creditors. In a hypothetical world where companies would not have creditors, there would be no need for capital maintenance rules, because they would serve no purpose.

EU Law uses this cushion as a means of mandatory creditor protection. However, the modern trend in the US is to disconnect dividend distribution from specific numerical calculations and to link them with corporate disclosure and the solvency of a firm.<sup>103</sup> Even those American jurisdictions that determine the distributions according to the relationship between assets and liabilities tend to employ much more flexible rules, while they lack the “cushion” function of the legal capital.<sup>104</sup> The restrictive function is here succeeded by private initiative, namely contract, and more precisely debt covenants. In the USA there is normally a test called the equity insolvency test. If it is not followed, directors might be liable. Furthermore, the fraudulent transfer law is applicable. Debt covenants can impose many restrictions on the debtor; one of those is a restriction in dividend distributions.<sup>105</sup> In practice, European and American companies may be subject to dividend restrictions of the same nature but of very different origin.<sup>106</sup>

#### 4.2. Path-dependence and regulatory patterns

It is rational to seek the roots of this transatlantic divergence. As in accounting standards, the explanation is path dependence. Historically, legal capital rules were present not only in Europe, but also in the US.<sup>107</sup> However, only in Europe was this concept maintained in its original form, while in the US the rules were gradually abolished.<sup>108</sup> The explanation seems to be the dominance of debt-financing and self-financing among European forms, while the American ones had greater exposure to equity markets.<sup>109</sup> This distinction justifies, in the eyes of European legislators, the recruitment of mandatory, rigid and conservative rules for the prevention of agency costs of the most important constituency; on the other hand, American firms could better achieve economic efficiency through flexible rules.<sup>110</sup> Subsequently, financing features have led European jurisdictions to be more focused on creditors.<sup>111</sup> An analogous explanation has been proposed for the divergence in accounting rules and corporate governance.<sup>112</sup> From this, it can be assumed that

98 P. Mülbart & M. Birke, ‘Legal Capital – Is There a Case against the European Legal Capital Rules?’, (2002) 3 *European Business Organization Law Review*, p. 700.

99 D. Kershaw, ‘Involuntary Creditors and the Case for Accounting-Based Distribution Regulation’, (2009) *Journal of Business Law*, no. 2, p. 146.

100 J. Rickford, ‘Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance’, (2004) 15 *European Business Law Review*, p. 962.

101 T. Bachner, *Creditor Protection in Private Companies: Anglo-German Perspectives for a European Legal Discourse* (2009), p. 114.

102 See Bebchuk, supra note 3, p. 1490.

103 A. Cahn & D. Donald, *Comparative Company Law: Text and Cases on the Laws Covering Corporations in Germany, the UK and the USA* (2010), p. 220.

104 Ibid., 227.

105 See Bratton, supra note 96, p. 54.

106 See Mülbart, supra note 95, p. 391.

107 See Bratton, supra note 96, p. 41.

108 C. Kuhner, ‘The Future of Creditor Protection through Capital Maintenance Rules in European Company Law – An Economic Perspective’, in M. Lutter (ed.), *Legal Capital in Europe* (2006), p. 359.

109 F. Kübler, ‘The Rules of Capital under Pressure of the Securities Markets’, in K. Hopt & E. Wymeersch (eds.), *Capital Markets and Company Law* (2003), p. 105.

110 W. Schön, ‘The Future of Legal Capital’, (2004) 5 *European Business Organization Law Review*, p. 432.

111 L. Enriques & M. Gelter, ‘How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law’, (2007) 81 *Tulane Law Review*, p. 612.

112 See Fear & Kobrak, supra note 15.

distribution reductions through capital maintenance rules are a protectionist tool that reflects the needs of a particular economy.

Consequently, we are inclined to draw a parallel line between prudence and capital maintenance: both systems are strict and restrictive in favour of creditors. Analogously, Anglo-American standards and distribution rules (outside Europe) are more flexible, but can become more conservative through voluntary means. This is a conflict between *empowering* rules, which are associated with the initiative of private parties leading to wealth creation, and *restrictive* rules, which are intrusive as regards the voluntary character of private transactions in order to protect a certain goal.<sup>113</sup> Another closely related dichotomy is that of *contractarianism* and *paternalism*. A paternalistic corporate law regime reduces corporate initiative with mandatory rules, whereas contractarian rules allocate the power to determine the essence of a contract to the private parties.<sup>114</sup> Under the second model, judges and legislators monitor only the procedure under which such an outcome can be achieved. Continental accounting and EU capital maintenance rules enact a more restrictive and paternalistic pattern, by intervening in the corporate nexus of contracts in order to promote the interests of certain stakeholders.<sup>115</sup> In Europe, legal and accounting rules were designed with the same philosophy in order to achieve the same scope. Common law jurisdictions are governed by more permissive rules, something that benefits incorporators and equity investors. Undoubtedly, the legal and accounting differences are interconnected and they are influenced by the dominant financing models and regulatory patterns in each jurisdiction. Section 5 will later analyze what happens when an accounting transplant is introduced in an environment with an opposite accounting tradition.

### 4.3. The criticism against legal capital rules

Legal and accounting literature divides creditors into two major classes: *voluntary*, or contractual, and *involuntary*, or non-contractual, such as tort victims. Voluntary creditors are further divided into *sophisticated* and *unsophisticated*, which are trade creditors. Involuntary and unsophisticated voluntary creditors are also called *non-adjusting*, because they do not have any contractual protection in terms of priority against other creditor claims in the case of insolvency.<sup>116</sup> Sophisticated or *adjusted* creditors are those that will take private initiatives to protect themselves, not only in the case of insolvency, but also against any kind of agency risks. For adjusting creditors, legal capital is not very helpful, for two reasons. First, legal capital rules do not determine the amount of legal capital that a particular company should have.<sup>117</sup> Apart from minimum capital rules, the amount of legal capital is determined by the contractual will of shareholders. Second, capital maintenance rules are not capital adequacy rules, in the sense that the company does not have to actually hold the amount of legal capital in its hands.<sup>118</sup> Thus, in most cases, legal capital rules do not preserve a sufficient amount for the benefit of non-adjusting creditors, who have no other means of protection. This is why mandatory insurance may be more beneficial for this constituency. On the other hand, legal capital functions as a behavioural rule that restricts the flow of value to the shareholders and reduces agency costs. From this perspective, it can be helpful for contractual creditors, particularly adjusting creditors.<sup>119</sup> Theoretically, these creditors can base their decision to establish a contractual relation on the protection given by legal capital. Nevertheless, they can achieve similar protection contractually.<sup>120</sup>

In order to assess whether legal capital rules are efficient, it is advisable to examine whether creditors actually rely on such rules. Easterbrook and Fischel suggest that the content of default rules should correspond with what the parties would have agreed on their own.<sup>121</sup> Functionally, mandatory distribution

113 F. Cross & R.A. Prentice, *Law and Corporate Finance* (2007), p. 8.

114 D. Sciulli, *Corporate Power in Civil Society: An Application of Societal Constitutionalism* (2001), p. 199.

115 See Jensen & Meckling, *supra* note 2.

116 L.A. Bebchuk & J. Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics', (1997) 82 *Cornell Law Review*, p. 1295.

117 See Kershaw, *supra* note 99, p. 145.

118 E. Ferran, 'Creditors' Interests and 'Core' Company Law', (1999) 20 *Company Lawyer*, p. 316.

119 See Kershaw, *supra* note 99, p. 164.

120 J. Armour, 'Legal Capital: An Outdated Concept?', (2006) 7 *European Business Organization Law Review*, p. 16.

121 F. Easterbrook & D. Fischel, *The Economic Structure of Corporate Law* (1991), p. 15.

restrictions in Europe resemble the American contractual practice.<sup>122</sup> Leuz et al. empirically support the fact that German and British creditors find statutory restrictions to be sufficient; covenants only have a complementary function in these jurisdictions.<sup>123</sup> Although many legal scholars have observed that the use of debt covenants in Europe is more limited than in the US, they hesitate to establish causality between legal capital rules and this outcome.<sup>124</sup> In a mandatory system, the protective buffer is determined by law and not by the parties; thus, a voluntary determination of the buffer is more adaptable to the will of the parties involved.<sup>125</sup> In a parallel way, mandatory protection is supposed to be generating lower transaction costs, because there is no need for a private agreement.<sup>126</sup> Nevertheless, mandatory protection, being inflexible, can prevent some economically efficient activities compared to contractual protection.<sup>127</sup> Analogously, mandatory protection can be beneficial, both for sophisticated and non-sophisticated creditors, while debt covenants primarily benefit the contracting creditor. This is particularly important for European firms, since trade creditors constitute a very important source of financing.<sup>128</sup> These creditors can free ride in voluntary protection, but still, covenants serve primarily individual and not collective interests.<sup>129</sup> Consequently, a covenant violation may lead to an outcome that benefits only one creditor at the expense of all the others.<sup>130</sup>

The use of covenants is not only affected by the existence of mandatory protection, but also by other characteristics of corporate laws. In the US, boards generally have greater discretion compared to European jurisdictions, and consequently it is easier for them to commit themselves in restrictive covenants.<sup>131</sup> Usually, the final decision about dividend distribution in Europe falls on the shareholders.<sup>132</sup> As will be explained in Section 5, corporate governance models, ownership structure and agency conflicts have a crucial impact on dividend policy and practice, which is highly relevant when we compare European with American firms. An additional factor is that many continental jurisdictions may hold creditors liable in case of insolvency if they had a significant impact upon the company.<sup>133</sup> All the above are indicators of the limited use of covenants in Europe and maybe an explanation as to why European jurisdictions have developed mandatory instead of contractual protection mechanisms.

The discussion on legal capital is long and has recently attracted particular focus. There is a significant part of the literature that advocates the abolition of the current regime in favour of a system determined by the solvency of a firm.<sup>134</sup> In a solvency test, creditor protection is achieved by ensuring that after the distribution, the company will still be solvent and the creditors' claims will not be at risk.<sup>135</sup> However, the purpose of this paper is not to assess the optimal nature of a balance sheet-based or a solvency-based regime. Its scope is to understand why and how capital maintenance rules operate and how they interact with the available accounting systems.

#### 4.4. The impact of accounting rules on capital maintenance

A balance sheet contains information about a firm's assets, liabilities and equity, which are all accounting concepts. Subsequently, from an accounting perspective, equity is the difference between assets and

122 See Kuhner, *supra* note 108, p. 362.

123 C. Leuz et al., 'An International Comparison of Accounting-Based Payout Restrictions in the United States, United Kingdom and Germany', (1998) 28 *Accounting and Business Research*, p. 126.

124 J. Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law', (2000) 63 *Modern Law Review*, p. 373; E. Ferran, 'The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union', (2006) 2 *European Company and Financial Law Review*, p. 185; See Mülbart & Birke, *supra* note 98, p. 716.

125 See Ferran, *supra* note 124, p. 186.

126 H. Merkt, 'Creditor Protection through Mandatory Disclosure', (2006) 7 *European Business Organization Law Review*, pp. 95, 108; Mülbart & Birke, *supra* note 98, p. 730.

127 See Ferran, *supra* note 124, pp. 189-190.

128 See Cascino et al., *supra* note 5, p. 45.

129 See Ferran, *supra* note 124, p. 193.

130 See Mülbart & Birke, *supra* note 98, p. 724.

131 See Cahn & Donald, *supra* note 103, p. 227.

132 S. Cools, 'The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers', (2005) 30 *Delaware Journal of Corporate Law*, p. 741.

133 H. Merkt, 'Creditor Protection and Capital Maintenance from a German Perspective', (2004) 15 *European Business Law Review*, p. 1050.

134 See Rickford, *supra* note 100, pp. 967 et seq.

135 B. Pellens & T. Sellhorn, 'Improving Creditor Protection through IFRS Reporting and Solvency Test', in M. Lutter (ed.), *Legal Capital in Europe* (2006), p. 380.

liabilities.<sup>136</sup> Accounting figures can take two forms of value: *real* or market value and *nominal* or *book* value.<sup>137</sup> Since the real value of an asset or a liability can never be definite (if it is not in cash), the function of accounting rules is to find the most appropriate way of valuing them. Anglo-American and Continental systems differ most in this respect: the first are equity-focused and concentrate on the effort of valuing assets and liabilities at their *true and fair value*, while debt-focused systems are *prudent*, or conservative in the same task, because they focus on the needs of creditors. Since dividends can only be distributed from the distributable part of equity, we can understand the significance of accounting rules for the legal procedure of distributing dividends.

It was mentioned that some accounting standards are biased conservatively in the valuation of assets and liabilities, and other are neutral in an attempt to reflect their real value.<sup>138</sup> In the EU context, this distinction is mirrored in the two prevailing accounting philosophies: the TFV principle and prudence. Common law GAAP, Dutch GAAP and IFRS are closer to the former, while Continental GAAP are closer to the latter. After the IAS Regulation, it is possible to apply IFRS to the balance sheet used for distributions if a Member State allows this. Generally, IFRS value assets higher and liabilities lower than Continental GAAP and allow the recognition of unrealized profits.<sup>139</sup> The outcome of such a regime is twofold: first, distributable amounts are higher and, second, it is possible to distribute profits that have not yet been realized. The balance sheet test is also associated with the creation of hidden reserves, which are not permitted under IFRS.<sup>140</sup> On the other hand, IFRS are more discretionary in the valuation of accruals, which are non-cash assets and liabilities. This is why IFRS will not produce high-quality reporting in the absence of high-quality incentives.<sup>141</sup> In practical terms, under IFRS, share capital and undistributable reserves play a lesser role, and a larger flow of dividends to the shareholders will be enacted. The previous section was inconclusive as to whether capital maintenance is more effective than alternative systems; however, if it has a protective function, the issue of whether IFRS offer less effective protection than the traditionally used Continental GAAP should be considered.

Opponents of IFRS point to their informational rather than distributional role, as well as the special focus on publicly traded companies.<sup>142</sup> The second point is important, given the fact that IASB has published a special form for IFRS for SMEs, which have not yet been accepted by any EEA State, apart from the United Kingdom.<sup>143</sup> A second argument is that creditors face an asymmetry in dividend distribution that has to be counterbalanced. A fundamental rule in dividend distributions is that dividends legally paid to the shareholders are never returned. If neutral standards are used instead of prudent ones, then the creditors bear the risk of an overvaluation of assets or an undervaluation of liabilities.<sup>144</sup> This asymmetry against creditors has to be corrected by another asymmetry, which is prudence. This rationale shows why the distribution of unrealized profits is contrary to the rationale of capital maintenance, since the latter attempts to prevent a distribution of profits that have not been valued with certainty. Prudent systems try to provide certain information to creditors in such a way that it cannot be misinterpreted.<sup>145</sup> Even strong opponents of the balance sheet test recognize that the application of IFRS in the balance sheet can prove problematic.<sup>146</sup> A third decisive point is the incompatibility of IFRS with taxation, which may force companies to suffer additional costs; on the other hand, managers have less incentives to manipulate individual accounts in order to have tax benefits, thereby increasing the quality of reporting.<sup>147</sup> A last remark concerns the fact that

136 P. Pope & A. Puxty, 'What is Equity? New Financial Instruments in the Interstices between the Law, Accounting and Economics', (1991) 54 *Modern Law Review*, p. 893.

137 See Handschin, *supra* note 7, p. 256.

138 *Ibid.*, p. 258.

139 See Merkt, *supra* note 126, p. 1046.

140 H. Boschma et al., 'Alternative Systems for Capital Protection' (2005), in <[https://www.wodc.nl/images/1190-full-text\\_tcm44-58735.pdf](https://www.wodc.nl/images/1190-full-text_tcm44-58735.pdf)> (last visited 5 September 2016), p. 7; See Van Tanderloo & Vanstraelen, *supra* note 18, p. 175.

141 *Ibid.*, pp. 175-176.

142 See Haller & Eierle, *supra* note 23, p. 37.

143 Detailed information about IFRS for SMEs is given in <<http://www.ifrs.org/Use-around-the-world/Pages/Analysis-of-SME-profiles.aspx>>, (last visited 26 May 2015).

144 W. Schön, 'Balance Sheet Tests or Solvency Tests – or Both?', (2006) 7 *European Business Organization Law Review*, p. 187.

145 See Kuhner, *supra* note 108, p. 347.

146 J. Rickford, 'Legal Approaches to Restricting Distributions to Shareholders: Balance Sheet Tests and Solvency Tests', (2006) 7 *European Business Organization Law Review*, pp. 168 et seq.

147 See Pellens & Sellhorn, *supra* note 135, p. 375.

IFRS can voluntarily become more protective towards creditors;<sup>148</sup> as was mentioned, this can be achieved through news-dependent conservatism. However, this proposition suffers from the same defects as IFRS in general. Conditional conservatism concerns the asymmetry in recognizing bad news against good news and does not serve the distributional purposes of prudence. The philosophy of capital maintenance rules is to restrict dividend distributions, as a means of agency cost reduction. This is why it should be supplemented by behavioural and informational conservatism.

#### 4.5. Summary

This section suggested that capital maintenance rules have a behavioural mentality. Accounting standards concentrated on the informational needs of equity holders may weaken this rationale. Thus, if there is any possibility that these rules can become effective, this can be achieved through the use of Continental standards. The following section will assess this proposal by examining the agency conflicts between corporate management, shareholders and creditors and the informational effectiveness of IFRS.

### 5. Accounting standards and the incentives of their users

This section will examine the agency costs created by the use of a certain accounting standard, between corporate managers, shareholders and creditors and will apply these findings to the particularities of European corporate governance systems. Also, it will test whether IFRS can work effectively enough in all Continental markets. The conclusion will be, firstly, that conservative accounting is favoured by creditors and should be mandatory when distribution restrictions are also mandatory. Secondly, some European markets have weak institutional features; in such an environment it is possible that IFRS will have no distributional use and will be ineffective in their informational scope. This is why such markets should have prudent rules, at least as a default rule, if not a universal requirement.

#### 5.1. Agency conflicts

It was already indicated that financial reporting should be helpful for its primary users, which are the financiers of a firm.<sup>149</sup> It equally has informational and strategic and even pecuniary implications for management.<sup>150</sup> Subsequently, the choice of a certain accounting standard may create three-dimensional agency conflicts: between shareholders, creditors and the management.<sup>151</sup> The most serious agency problems can be created when ownership is separated from control; there is a fear that the management, as an *agent*, will use corporate resources without taking into account the interests of the shareholders, as *principals*.<sup>152</sup> Dividend distribution is an area where agency conflicts may arise: shareholders pursue higher dividends, while managers and shareholders prefer to use the same resources for their own goals.<sup>153</sup> It was explained that mandatory legal capital rules are a mechanism aiming for a decrease in those conflicts. Further, the same can be achieved by voluntary debt covenants or conservative accounting rules.<sup>154</sup> Thus, in dividend distribution policies, it is possible to observe an occasional alignment of interests between management and creditors. However, if ownership is not separated from control, as happens in most European companies, then the situation becomes much less desirable for the creditors.<sup>155</sup> Now there is an alignment between shareholders and the management, which makes creditors the potential victims of expropriation, together with minority

148 Ibid., p. 377.

149 See Cascino et al., supra note 5, p. 13.

150 C. Armstrong et al., 'The Role of Information and Financial Reporting in Corporate Governance and Debt Contracting', (2010) 50 *Journal of Accounting and Economics*, p. 183.

151 Y. Qi et al., 'How Legal Environments Affect the Use of Bond Covenants', (2010) 42 *Journal of International Business Studies*, p. 235.

152 See Jensen & Meckling, supra note 2, p. 313.

153 S. Bank et al., 'Dividends and Politics', (2009) 25 *European Journal of Political Economy*, p. 210; B. Cheffins, 'Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in the United Kingdom', (2006) 63 *Washington & Lee Law Review*, p. 1305.

154 N. Boubakri & H. Ghouma, 'Control/Ownership Structure, Creditor Rights Protection, and the Cost of Debt Financing: International Evidence', (2010) 34 *Journal of Banking & Finance*, p. 2482; See Watts, supra note 45, p. 211.

155 L. Enriques & P. Volpin, 'Corporate Governance Reforms in Continental Europe' (2007), 21 *The Journal of Economic Perspectives*, p. 117.



shareholders and other stakeholders.<sup>156</sup> Consequently, there is a need for mechanisms that decrease these conflicts. From an accounting perspective, conservatism can serve this role, by being downward-prejudiced against the valuation of assets and earnings.<sup>157</sup>

The empirical evidence from Europe is that creditors prefer conservative accounting valuations.<sup>158</sup> Similarly, firms with stronger agency conflicts over distributions between shareholders and creditors are more likely to employ conservatism; lower agency and transaction costs will emerge in such an event.<sup>159</sup> However, the corporate governance model of a firm also plays a significant role in the reduction of those conflicts. In a model where shareholders prevail, there is a greater demand for news-dependent, or conditional, conservatism, whereas in stakeholder-centred models, the same information can be obtained through private channels of information.<sup>160</sup> This illustrates why Continental stakeholders may find prudence more relevant than conditional conservatism.

This shows that creditors will request dividend restrictions, if they can. Analogous restrictions can be achieved through debt covenants. Thus, in the absence of capital maintenance rules, creditors will agree such covenants with their debtors for their protection. In the same way, if creditors find that a particular accounting standard is not sufficient for them, they will request the use of a more conservative one. The potential adoption of conservative standards will have beneficial effects for the cost of debt.<sup>161</sup> In other words, if a firm uses accounting standards which are not favourable for its potential creditors, this will affect the terms or the final decision about contracting. Further, according to Nikolaev, there is a remarkable demand for conservative accounting even when debt covenants are used.<sup>162</sup> From the perspective of creditors, the use of conservatism is essential. Thus, the real debate is whether conservatism should be imposed on a mandatory basis instead of being contractual.

Continental GAAP are prudent, thus conservative in the valuation of assets and earnings. On the other hand, IFRS are neutral in their valuations; nevertheless, they can be adjusted to become conservative. Generally, a prudent/conservative system will generate lower dividends than a neutral one. In a system of mandatory capital maintenance, there is a possibility that creditors will consider such protection as sufficient. In reality, it is less likely that European firms will adopt debt covenants.<sup>163</sup> If creditors rely on the protection given by legal capital, they will logically prefer that the balance sheet should be calculated conservatively, in order to produce lower dividends. If a firm has the option to choose between conservative and neutral standards, the most desirable choice for creditors is the conservative one. If, however, a firm chooses neutral standards, the creditors are less protected than in a scenario where conservative standards would have been adopted. This evolution will create additional agency costs for the creditors; if they find them dangerously high, they will seek an additional protective mechanism; they may request the use of conservative standards, or they may impose a covenant, or both. Thus, the scope of capital maintenance has failed, since a sufficient solution will not be provided for agency conflicts created and the creditors will be forced to proceed to further action.

The determination of dividends with a certain standard can be seen simply as a policy decision, which favours a certain constituency.<sup>164</sup> Nevertheless, the jurisdictions that have adopted capital maintenance rules and debt-oriented accounting have done so because they took a policy decision to protect creditors. The prevalence of mandatory creditor protection through company law and accounting was not made at random; in those jurisdictions there was a greater demand for debt rather than equity investments. A jurisdiction will decide to favour equity investors more when it is judged that market needs are better

156 C. Salvato & K. Moores, 'Research on Accounting in Family Firms: Past Accomplishments and Future Challenges', (2010) 23 *Family Business Review*, p. 196.

157 See Watts, *supra* note 45, p. 215.

158 See Cascino et al., *supra* note 5, p. 45.

159 A. Ahmed et al., 'The Role of Accounting Conservatism in Mitigating Bondholder-Shareholder Conflicts over Dividend Policy and in Reducing Debt Costs', (2002) 77 *The Accounting Review*, p. 888.

160 See Ball et al., *supra* note 6, p. 47.

161 See Ahmed et al., *supra* note 159, p. 888.

162 V. Nikolaev, 'Debt Covenants and Accounting Conservatism', (2010) 48 *Journal of Accounting Research*, p. 166.

163 See Leuz et al., *supra* note 123, p. 126.

164 See Pellens & Sellhorn, *supra* note 135, p. 372.

served. However, in a market where capital maintenance rules may have a protective function, it will be more effective to tie them to prudent accounting. Therefore, states where businesses continue to have a strong reliance on debt financing have no reason to prefer equity-focused standards. Such a policy decision does not make sense from a distributional angle. In the next sub-section, it will be claimed that the informational contribution will also be limited.

## 5.2. Incentives versus standards

Someone may ask why the EU States, having mostly a conservative accounting tradition, have decided to introduce IFRS, which is an Anglo-American transplant. The reasons are threefold: the better operation of capital markets, the enhancement of accounting quality and the better comparability between different firms.<sup>165</sup> The focus of the IAS Regulation on the harmonization of the consolidated reporting of traded firms seems to serve these purposes.<sup>166</sup> There is a general assumption in the accounting literature that IFRS provide accounting information which is of better quality compared to the various national, non-US, GAAP.<sup>167</sup> Analogously, the mandatory application of IFRS is usually followed by encouraging signals from the capital markets.<sup>168</sup> The idea that IFRS can produce better accounting quality is very important. It is contended that if creditors have accounting information of better quality, even if it is more equity-relevant, this can have an overall positive effect for the formation of their business strategy.<sup>169</sup> Thus, in any case it is vital to understand whether IFRS can produce accounting information which is of better quality. If this statement is true, there is a strong counterargument against the absence of a distributive character of those standards.

It is advocated that high-quality standards cannot produce high-quality information if they are followed by poor incentives on the part of the preparers. Ball et al. have empirically supported this statement by looking into four East Asian markets, three of which have a weak institutional environment.<sup>170</sup> Analogously, Van Tanderloo and Vanstraelen have observed that German firms did not decrease the amount of their earnings management when they switched from the non-transparent German GAAP, where hidden reserves are allowed, to the transparent IFRS.<sup>171</sup> Further, Ball and Shivakumar have argued that UK private companies generally have worse quality reporting than public companies, despite being bound by the same auditing and financial reporting regulations.<sup>172</sup> Thus, institutional features such as capital markets, law enforcement and ownership structure shape the reporting quality.<sup>173</sup> Analogously, low accounting quality can be substituted by alternative, contractual means of protection, or it can be the outcome of insider access to the information of a firm.<sup>174</sup>

The above imply that the adoption of IFRS does not automatically lead to better reporting. Daske et al. divide IFRS adopters into 'serious' and 'label' adopters.<sup>175</sup> Serious preparers promise to embrace better incentives; label preparers do not. The adoption of high-quality standards may be attractive in markets with weak institutional characteristics; however, this is not always followed by cheaper financing.<sup>176</sup> As seen in Section 3, most states requiring IFRS for individual accounts of listed firms are Eastern European or Mediterranean countries with a weak institutional background. Even if the mandatory and universal

165 See Haller, *supra* note 63, p. 154; L. Márquez-Ramos, 'European Accounting Harmonization: Consequences of IFRS Adoption on Trade in Goods and Foreign Direct Investments', (2011) 47 *Emerging Markets Finance and Trade*, p. 55.

166 See Arce & Mora, *supra* note 21, p. 595.

167 M. Barth et al., 'International Accounting Standards and Accounting Quality', (2008) 46 *Journal of Accounting Research*, p. 496.

168 C. Armstrong et al., 'Market Reaction to the Adoption of IFRS in Europe', (2010) 85 *The Accounting Review*, p. 57; H. Daske et al., 'Mandatory IFRS Reporting around the World: Early Evidence on the Economic Consequences', (2008) 46 *Journal of Accounting Research*, p. 1131.

169 See Grundmann, *supra* note 59, p. 367.

170 See Ball et al., *supra* note 74.

171 See Van Tanderloo & Vanstraelen, *supra* note 18.

172 See Ball & Shivakumar, *supra* note 47.

173 D. Burgstahler et al., 'Importance of Reporting Incentives: Earnings Management in European Firms', (2006) 81 *The Accounting Review*, p. 1013; C. Leuz et al., 'Earnings Management and Investor Protection: An International Comparison', (2003) 69 *Journal of Financial Economics*, p. 505.

174 See Armstrong et al., *supra* note 150, p. 215; See Ball et al., *supra* note 74, p. 242.

175 H. Daske et al., 'Adopting a Label: Heterogeneity in the Economic Consequences Around IAS/IFRS Adoptions', (2013) 51 *Journal of Accounting Research*, p. 517.

176 *Ibid.*, pp. 533-534.

adoption of IFRS reflects a commitment by these states to the promotion of business-friendliness, it is doubted whether this is feasible under the given circumstances.

For those European countries without strong capital markets and institutional characteristics, it would be preferable to concentrate on correcting the malfunctions of their institutional environment and simply to permit serious adopters to apply IFRS, since these are the only firms that can truly benefit from these standards. This is a *contractarian* approach; the adoption of equity-friendly standards may or may not lead to better economic consequences and it is left to the individual parties to take this risk. If local GAAP are the default rule, then potential IFRS adopters risk being characterized as label adopters if their incentives are not genuine. Continental firms usually reflect a different corporate mentality system than British or American ones and their institutional characteristics may differ from those for which IFRS are designed.<sup>177</sup> A potential mandatory imposition of IFRS thereon can have disastrous effects: creditors do not receive the information and protection they may require and equity investors are not always offered high-quality reporting.

The default rule chosen by a jurisdiction should comply with the common characteristics of local companies. Most Continental markets are less equity-influenced than Anglo-American ones; there, the existence of mandatory restrictions in creditor protection should be accompanied by conservative accounting rules as a starting point, because this combination makes legal capital rules more likely to succeed in their scope. Requiring equity-focused rules makes sense in a market that is dominated by equity financing, where high-quality standards can flourish to the benefit of the dominant capital providers. In markets inclined towards debt financing, the optional application of IFRS seems to be preferable to a mandatory system. In such a case, a potential voluntary adoption of IFRS with an option to expropriate creditors will be received negatively and will prove unsuccessful. Thus, creditors will be protected by a conservative regime, unless companies are willing to seriously commit themselves to a better quality of information that can reduce the costs of capital and agency conflicts and enhance investor confidence.

### 5.3. Summary

This section recommended that mandatory creditor protection can better protect creditors if conservative standards are applied. Additionally, it claimed that the adoption of IFRS will not be effective where agency conflicts and a willingness to expropriate reign. On the contrary, transaction costs will remain high. Thus, if it is suspected that creditors can be easily expropriated, then mandatory IFRS adoption does not seem to be advisable.

## 6. Conclusion

This paper asked whether capital maintenance can work effectively with neutral accounting standards. It concluded that if a legal system wants to concentrate on creditors, then it is more meaningful to apply conservative standards. Moreover, the stronger the institutional features of a jurisdiction, the more probable it is that neutral standards will be efficient. However, this conclusion should not be misjudged. It was explained that both capital maintenance and conservative accounting trace their roots to the traditional reliance on creditors for capital. Accounting and legal rules are the offspring of particular factors that may still be present, or may have changed. In the case of the introduction of Anglo-American accounting standards in Continental legal systems, it seems that this evolution is a product of legal transplantation and not origination, a phenomenon that becomes more and more crucial in corporate law systems of Continental jurisdictions.<sup>178</sup> Thus, when the IAS Regulation came into force, it was not clear whether the new accounting regime reflected the true needs of many European markets. As was analyzed, IFRS were introduced in EEA jurisdictions in order to promote the efficiency of capital markets and equity investments, although it is not guaranteed that they can achieve this goal on their own. On the other hand, the impact that the legal capital

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177 L.A. Bebchuk & M. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance', (1999) 52 *Stanford Law Review*, p. 133; See Enriques & Volpin, *supra* note 155, p. 137.

178 J. Armour et al., 'How Do Legal Rules Evolve? Evidence from a Cross-Country Comparison of Shareholder, Creditor, and Worker Protection', (2009) 57 *The American Journal of Comparative Law*, p. 594.

rules have on creditors' decisions becomes less and less important under the new accounting law regime, thereby questioning the whole rationale of their existence.

Some may argue that the trend in EU company law rule-making is to promote Anglo-American transplants, instead of local backward ones. In the context we examined, however, this is not as problematic as it seems. What is problematic is the asymmetry between legal harmonization and market integration. Harmonization in accounting standards and legal capital rules is seen as a means to enhance and accelerate market integration, even though it is not definite whether all EEA markets' idiosyncrasies correspond to IFRS's characteristics. This means that certain markets may have to become more efficient in order to allow the IFRS to work efficiently. Following the same pattern, the sense that IFRS and legal capital rules do not fit well together, does not mean that accounting law reform was wrong. As Ferran has pointed out, if IFRS are optimal compared to Continental GAAP and they better reflect the modern accounting trends, the mere fact that they are not compatible with capital maintenance is not an argument against IFRS but further proof of the ideological deficiency of legal capital rules.<sup>179</sup> However, this statement cannot be true for all European jurisdictions. In other words, maybe the heterogeneity of European corporate financing models should not be combined with homogeneous financial reporting, if this is not imperatively necessary. ■

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<sup>179</sup> See Ferran, *supra* note 124, p. 207.