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ACCOUNTING OF OWN SHARES IN FINANCIAL STATEMENTS IN VIEW OF DIRECTIVE 2013/34/EU IN ITALY: OUTLOOK OF LEGISLATIVE DECREE 139/2015

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ABSTRACT

Directive 2013/34/EU of 26 June 2013 is aimed at amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC. Such Directive will oblige all Member States to bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 20 July 2015.

Directive 2013/34/EU introduces new elements and principles related to the preparation of financial statements, both annual and consolidated, and related reports, and to the compliance with new audit requirements to all those companies that are not obliged to adopt the international accounting standard set.

The Directive focuses on small and medium-sized entities (SMEs) and pursues the objective of finding the right balance between the need of a transparent financial reporting and the related burden of administrative costs compared to the benefits received. The European Union has intensively analyzed the obligations and requirements posed on SMEs related to accounting and financial reporting, acknowledging that they often result burdensome and not appropriate for promoting and enhancing real development, internationalization and competitive advantage; however, it remains of primary importance to ensure that financial information is correctly and transparently presented to all those parties who have an interest in the Company, thus establishing a set of minimum requirements that need to be respected by all entities operating in the European territory.

One of the most innovative aspects of the Directive is based on the concept of materiality that, according to article 6.1.j), allows an exception to the recognition, measurement, presentation, disclosure and consolidation when the effect of complying is immaterial. In the Italian legislation, a similar concept is expressed by article 2423-ter of the Italian Civil Code, under

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which the grouping of certain values in the presentation of the financial statement is allowed if their amount is immaterial. The provisions of the Directive, which considers not only the presentation but also the recognition, measurement, disclosure and consolidation, appears far more extensive than the Italian discipline and might lead to excessive arbitrariness, thus having a negative impact on the general principle of true and fair preparation of the whole financial statement.

Another innovative aspect of the Directive is the acquisition of own shares shall be recorded in the accounting books by reducing the net capital of the corresponding amount and registering a negative amount in the balance sheet. This is the new requirement that modified article 2357-ter of the Italian Civil Code will impose, thus changing the existing discipline that allows the recording of own shares acquired in the fixed asset section of the balance sheet. Consequently, articles 2424 and 2424-bis will also be modified.

Keywords: 4th accounting directive, 7th accounting directive, new accounting directive, directive 2013/34/EU, accounting harmonization

JEL Classification: M40, M41, M48

Directive 2013/34/EU of 26 June 2013 is aimed at amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC[1]. Such Directive will oblige all Member States to bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 20 July 2015.

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[1] **The Fourth Council Directive** of 25 July 1978 , based on Article 54, paragraph 3, item (g) of the Treaty on the annual accounts of certain types of companies **(78/660/EEC);** and the **Seventh Council Directive** of 13 June 1983 based on Article 54, paragraph 3, item (g) of the Treaty on consolidated accounts (**83/349/EEC).**

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Shares are units of ownership of a share capital of a joint stock company, with a nominal value as per the share certificate which is calculated by dividing the share capital by the number of shares issued. A holder of even just one share is a shareholder for all purposes and by participating to ordinary and extraordinary meetings, the shareholder takes part in the company's policy making process. It may be that a company decides to allocate shares to shareholders after purchasing own shares using profit reserves as part of a shareholder remuneration policy.

Conditions set out by Italian law for a correct purchase of own shares are the following:

1. Authorisation by shareholders' meeting in which the purchase conditions are established, as well as, the number of shares and the respective sales price (see article 2357 paragraph 3 of the Italian Civil Code).;
2. Shares must be fully paid-up and their purchase can be made within the limits of distributable profits and available reserves as per the last financial statements duly approved (article 2357, paragraph 1 of the Italian Civil Code).;
3. the nominal value of the acquired shares cannot exceed one fifth of the share capital in case of companies that recourse to the risk capital market (article 2357, paragraph 4 of the Italian Civil Code). Failure to comply with said conditions will result in the obligation to sell the

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shares within a year after their purchase, otherwise shares will be cancelled and the company' share capital would be reduced accordingly (see article 2357, paragraph 5 of the Italian Civil Code). Such limitation do not apply in the event of special purchases envisaged in article 2357-bis of the Italian Civil Code.

Until the implementation of Directive 2013/34/EU, own shares in Italy had be stated under assets of the balance sheet, separately from other shareholdings, under:

- financial fixed assets;
- or financial activities that do not constitute fixed assets;

depending on the given allocation.

As offset value (of equal amount) a reserve was required (non-distributable reserve) and had to be kept until the shares were sold or cancelled.

Own shares have no real value for the company that buys them. In fact, from one part we have the company's assets and from the other own shares; therefore their recording in the financial statements does not refer to other assets. This reflects indirectly even on shareholders. For those who did not sell shares to the company (shareholders withdrawing from the company), own shares have no value at all. Own shares could also be cancelled, but this would not entail any actual reduction in the company's assets which in reality it already took place. With respect to a cancellation of shares and reduction of capital, there is a reduction of assets which is only apparent. Own shares do not express any "independent" value, in any case they are "adjusted" by a non-distributable reserve of equal amount.

It is worthy of mentioning that the nature of the reserve consists of an "adjusting entry under assets" and not an entry under net equity. Apparently, own shares seem to have an offset in own capital (profit reserve), in any case, article 2357 of the Italian Civil Code sets out that "*a company may not purchase own shares if not within the limits of the distributable profits and available reserves*". Even article 2375-ter, last paragraph of the Italian Civil Code seems to confirm the above and prescribes that "*a non distributable reserve equal to the amount of own shares under assets of the financial statements must be set up and kept until the shares are sold or cancelled"* (as for the amendments implemented by article 2375-ter during the transposition of Directive 2013/34/EU see hereafter).

As per legislation, the Legislator has allowed for the acquisition of own shares only against profits or other available reserves, as otherwise the purchase would be damaging to the integrity of share capital which would be used to purchase shares from the company itself without any value. By requiring for the purchase to be made only against distributable profits (or other

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available reserves) this prevents the share capital from being surreptitiously repaid to shareholders. As they are used to purchase own shares, they consist of available reserves. By purchasing shares (which takes place by using the sums of money corresponding to said reserves), the reserves are in fact utilised. In substance, the company uses the reserves to purchase the shares from the withdrawing shareholder without any actual offset. Own shares do not have any intrinsic value for the issuing company that buys them. The company purchases the "paper shares" formally and in substance returns the selling shareholder its own capital.

From the selling shareholder's point of view, the matter in hand is similar to a withdrawal, partial or total, where after selling the shares to the company, the shareholder still has an interest. The withdrawal, even if formally other than the purchase of own shares, is an institute or assimilated body given that article 2437-quater, paragraph 5 of the Italian Civil Code requires for shares that are not allocated by the withdrawing shareholders to be repaid through the purchase by the company using available reserves.

The purchase of own shares for the typical matter in hand (article 2357) or for the withdrawal cases described above, takes place using the net equity reserves. This means that said reserves are no longer with the company. Business scholars reached this conclusion a while back in which an adjusting entry under assets is recognised to the own shares reserves and hence deny its belonging to own capital. Buying own shares cannot be ascribable to a normal exchange between assets (cash) and other assets in the financial statements (shares). After the purchase and recording of "own shares" in the financial statements, there is a reduction in the company's net equity and the release of financial resources used in the purchase (bank or banks) are actually offset in a reduction of capital reserves, in such that the item "own shares" recorded under assets can consists of an "adjusting entry in net capital". According to this approach, at first during the purchase of own shares the following would take place:

- the recording of the repayment of the contributed capital (which for simplicity coincides with the share capital);
- therefore, the immediate "absorption of the reserve to purchase own shares in the share capital".

So, based on the accounting representation of this case, the purchase of own shares are "funded" by a repayment of contributions while the share capital remains unchanged thanks to the allocation to capital of the "purchase reserve for own shares".

So in this manner, the purchase of own shares are "broken up" into its basic components attributed to:

- a repayment of contributions;

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- absorption of a reserve in the share capital (assuming profits).

The purchase of own shares implies a repayment of contributions and is as if said shares are never subscribed or paid-up. Therefore, the accounting representation described above is entirely valid. After the purchase of own shares, the share capital remains unchanged, but only because its reduction (corresponding to the repayment of contributions) is exactly filled up by the presence of available reserves which are then transferred to the capital. The purchase of own shares results in a free increase in share capital.

The level of share capital can in fact remain unchanged, despite the repayment of the contributions with the purchase of own shares, solely because an available reserve is "absorbed" into the share capital.

The use of said reserve depends on events occurring after the purchase of the shares:

- if the shares are sold on the market, the initial level of contributions will be restored (the one before the purchase of own shares) and the available reserve that is momentarily "absorbed" in the share capital will resume its original regime (in this case, a profit reserve);
- in case of a free allocation to shareholders, said reserve will remain permanently allocated to the share capital (through a transaction entirely assimilable to that of a new contribution);
- with respect to this case, the cancellation of own shares results in a legal reduction in the share capital with a consequent "clearing" of the reserve.

As we can see, in both of these cases (allocation of own shares to shareholders or cancellation of shares), the company's net capital remains unchanged, however its composition and its "ideal entries" change. In the first case, allocation of shares to shareholders, the initial level of share capital remains unchanged as the available reserve "absorbed" therein produces an equal effect and contrary to that of the initial repayment of contributions it produces the same effects of a free increase in share capital. However, in case of cancellation of shares, the share capital is reduced accordingly by "breaking up" the available reserve that was utilised to keep it intact (temporarily).

In the balance sheet tables, Directive 2013/34/EU (horizontal and vertical structure as per Annexe III and Annexe IV thereof) there is no express recording of shares or own shares under financial fixed assets in the assets of the balance sheet whereas their recording is expressly required under current assets *"as long as national legislation authorises the recording in the balance sheet"*. In the balance sheet, the Directive requires a corresponding reserve for shares

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and own shares to be stated in the entries of net equity *"as long as national legislative prescribes said establishment, notwithstanding article 24, paragraph 1, letter (b) of directive 2012/30/EU"*.

Considering that in Italy the purchase of own shares by limited liability companies is not required, during the transposition of Directive 2013/34/EU in Italy, Legislative Decree 139/2015 amended article 2357-ter of the Italian Civil Code thereby prescribing in the third paragraph that "*The purchase of own shares results in a reduction of net equity of equal amount through the recording of a specific entry under liabilities in the financial statements (with negative sign)"*. Therefore, as of 1 January 2016, any own shares in the portfolio (or subsequent purchase) may not be accounted under assets of the balance sheet (namely under financial fixed assets or current assets under "financial assets that do not constitute fixed assets") but the value corresponding to the purchase must be accounted negatively under the entries of net equity.

According to the first analysts of the Italian Legislative Decree 139/2015, the new accounting treatment would be consistent with the representation of the economic substance of the purchase of own shares if said purchase is actually aimed at reducing own equity. However, the new accounting treatment would not be consistent with the economic substance of the purchase if the reasons behind the purchase of own shares would only be for investment purposes aimed at a sort of quick profit.

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