

Chapter 14
Accounting for Capital and Reserves, OCI and Profit Distribution
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Introduction

One of the discerning feature of the process leading to the passing of the Directive 2013/34/EU on ‘the annual financial statements, consolidated financial statements and the related reports of certain types of undertakings’ (i.e., the EU-D-34/2013 from now onwards) was the attempt to balance the need for a unified set of accounting rules and principles that would homogenize accounting practices of smaller and private firms in the EU, whilst allowing national legislators to exert enough flexibility to adapt the national general accounting principles to the specific features of the firms and the national economy (Andrè, 2017).

Such general trade-off subsumes most if not all the accounting issues analysed in this book and represent a key issue in relation to major changes in accounting rules and principles (Breuer, 2021). This is especially relevant regarding the accounting for equity, other comprehensive income, and dividend distribution (i.e., Capital and Reserves onwards). Notwithstanding the homogeneity in terms of the items constituting part of the section Capital and Reserves, as detailed in the Annex IV,¹ noticeable differences still feature across jurisdictions in terms of what affects equity composition and which transactions (and accounting items) lead to increases or decreases in equity and consequently the extent of distributable income and reserves. As a general tenet, the definition of equity and distributable income is still largely affected by the ‘prudence’ principle that continues to be a key attribute of financial statements according to the EU-D-34/2013. In fact, both the recognition and measurement of assets and liabilities, and changes thereof are largely affected by the degree of prudence thus bearing a direct effect on income and its volatility, equity, reserves, and dividend distribution.

¹ Annex IV details the structure of the Section L. Capital and reserves into the following: I Subscribed capital; II Share premium account; III Revaluation reserve; IV Reserves; V Profit or loss brought forward; VI Profit or loss for the financial year.

This chapter analyses how the accounting for Capital and Reserves and dividend distribution has been defined across different jurisdictions; in doing so, it offers three major contributions. First, it describes how the accounting for Capital and Reserves has been shaped by the adoption of the EU-D-34/2013 in the eight chosen countries (Denmark, France, Germany, Italy, the Netherlands, Spain, Sweden, and the United Kingdom). For the sake of conciseness, our focus will be primarily on financial instruments, given the prominence of fair value measurement therein. As a matter of fact, changes in the way standard setters allow (or not) to make fair value(s) relevant to income or OCI, largely affects capital, reserves, and dividend distribution.

Second, given the relevance of Capital and Reserves as a ‘contracting device’ among the enterprise and its stakeholders, we point out the close connection between a series of real economic decisions (e.g., financing, investor protection, etc..) and accounting for Capital and Reserves (Bischof and Daske, 2016). Indeed, although the measurement of equity stems from accounting rules, such a measurement has implications along two main dimensions. In most countries, especially with code law traditions, equity serves as a ‘third-party guarantee’ when other corporate governance mechanisms perform poorly (Leuz, Nanda and Wysocki, 2003; La Porta et al., 2008). For example, in countries like Italy or Spain, equity depletion (i.e., equity falling below a minimum threshold) triggers mandatory actions for board members and statutory auditors – such as calling on shareholders’ meetings or filing for bankruptcy – as well as for shareholders (e.g., through a request of replenishing capital). In these countries accounting rules tend to ‘preserve’ equity and limit dividend distribution, thus constraining the recognition of distributable income to stricter conditions. Next, most of the covenants in the private debt market rely on the book value of liabilities and equity (Beatty et. al., 2008). That is, the degree of “prudence” in measuring equity has direct implications on the breach of covenants and thus on the main financing terms (e.g., interest rates). In this light, we sought to analyse the underlying contextual conditions – at country-level – potentially explaining the different choices made by the national parliaments.

Third, we sought to pinpoint which accounting items and ‘areas of considerations’ (e.g., fixed assets, financial instruments, intangible assets), whose measurement and recognition criteria directly affect the measurement and representation of Capital and Reserves, drive the observable differences. For example, according to the EU-D-34/2013, Member States were offered the opportunity to opt for revaluation of fixed assets (Art. 7) and in the case they did, any revaluation should be booked in the balance sheet as part of the Capital and Reserves in which the higher value compared to the carrying amount should be part of the revaluation

reserve that is not available for distribution unless it represents a gain fully realized (Alexander & Fasiello, 2020).

Another major source of difference exists in terms of the fair value measurement: Member States are required to adopt it (Article 8 (1.a)) with the related changes in value to be included in the profit and loss account. The source of heterogeneity across Member States exists in terms of how to apply the prudence principle at the level of dividend distribution and the trade-off between a stricter adoption of the prudence principle and the accrual basis principle. For example, a key responsibility of the Member States relates to whether unrealised profits are accounted in the profit and loss or included in a reserve, whereas losses in value are recognised at once in the profit and loss, with the prudence principle constraining and reducing the operation of the accrual basis principle.

The rest of the chapter is structured as follows: section 2 discusses the nexus between the legal origin and background of a country/jurisdiction and the accounting for equity and reserves and dividend distribution. Section 3 analyses the differences across various jurisdictions in terms of specific accounting items playing a major role in affecting equity and dividend distribution. Section 4 concludes and offers avenues for potential future research.

Regulatory and Legal Background: impact on accounting for Capital and Reserves

The rules subsuming accounting for equity (i.e., Capital and Reserves) have two major economic implications typically disciplined by legal rules: limits to equity distributions and breaches of covenants. The heterogeneity across countries is highly significant on these matters.

Accounting based information is key in transactions between different providers of capital, labour and good and the firm. Most financial contracts rely on accounting information. The positive accounting theory is based exactly on the idea that the use of accounting information enhances the efficiency of contracting by minimizing contracting costs (Watts and Zimmerman, 1978; Holthausen and Leftwich, 1983).

The theory of incomplete contracts broadens this perspective on the role of accounting information in debt contracting (Christensen, Nikolaev, and Wittenberg-Moerman, 2016). The central tenet of this theory is that contracts are inherently incomplete, as the parties cannot negotiate all the possible future states of the world. When an unforeseen state occurs, incompleteness of contracts will inevitably trigger contract renegotiations, during which parties can behave opportunistically (e.g., borrowers may use asset substitution as a threat). Thus,

Commentato [PA1]: EDITORS:

Paragraph 1.a refers only to financial instruments, so if you are not dealing with other issues it maybe a better to edit it

Commentato [PA2R1]: Addressed above

Commentato [PA3]: EDITORS

The two examples in art. 7 and 8 are fine, but we would consider whether to include a more systematic mapping of the options offered by the directives that impact on capital and reserves.

Commentato [PA4R3]: In principle you are right but we deliberately chose to limit our analyses to the most relevant ones (ART 7 and 8) also for the sake of space and importance. Changing (and expanding) would entail a major reshuffling of the whole chapter.

Commentato [MG5]: EDITORS

The approach is OK, but we would reduce the reference to the theory already included in the introduction.

Commentato [MG6R5]: Addressed by coordinating with paragraph 1.

incompleteness leads to post-contractual opportunism and hold-up problems that adversely affect the incentives of the parties to enter contracts. Incomplete contract theory suggests that ex ante allocation of control rights alleviates hold-up problems in a contractual relationship. This happens because control rights determine the status quo in future renegotiations. Accounting information plays a determinant role within incomplete contract theory because the optimal allocation of control rights is contingent on a contractible signal (i.e. information) that reflects the underlying economics of the borrower (Zender, 1991; Aghion and Bolton, 1992; Hart and Moore, 1998). As accounting information produces summary measures of firm performance, accounting signals are primary candidates for governing the state-contingent allocation of control rights.

The seminal papers in the law and finance field have shown that differences in legal protections of investors help explain why firms are financed and owned differently in different countries (La Porta et al., 1997, 1998). In the context of investor protection rules are as important as the quality of their enforcement. Both the content of the law and its enforcement vary across countries and legal families (Djankov et al., 2008), explain the development of private credit markets (Djankov, McLiesh, and Shleifer, 2007), and are linked to differences across bankruptcy codes (Davydenko and Franks, 2008). Countries with poor laws or enforcement have other substitute mechanisms of corporate governance. These adaptive mechanisms may in fact be incorporated into the law, or they may lie outside the law. One adaptation is to legally introduce mandatory standards of retention and distribution of profits and reserve to investors, which limit the opportunities for managerial expropriation (La Porta et al., 1998). For example, mandatory dividends may protect minority shareholders from incumbent managers. In some countries, companies are mandated by law to pay out a certain fraction of their earnings as dividends. Mandatory dividends have been documented only in French civil-law countries, consistent with the evidence that these countries do not have a strong legal protection of shareholders (La Porta et al., 1998). Another remedial mechanism, it is the existence of a legal reserve requirement to protect creditors. This requirement forces firms to maintain a certain level of minimum reserve as a percentage of share capital before distributing dividends. Such a mechanism is often coupled with the requirement of a minimum share capital to avoid automatic liquidation. This protects creditors, who have few other powers, by forcing an automatic liquidation before all the capital is wasted by the insiders. The evidence on the legal reserve requirement shows that it is almost never used in common-law countries but is often prescribed in all civil-law families (i.e., French and German), which tend

to be less protective of unsecured creditors, and particularly in countries with German civil-law roots (e.g., Austria, Germany, Switzerland).

In this light we could interpret the different implementations of the EU-D-34/2013 with regard to accounting for equity. All legal rules that discipline retention or distribution of Capital and Reserve rely on financial statements and thus depend on the equity measurement and representation. Therefore, accounting for equity and its implications for distributions should be stronger in southern European countries adopting the EU-D-34/2013, whose laws were influenced by the Napoleonic codes. As shown in Table [1], French civil-law countries (e.g., France, Greece, Italy, Spain) have systematically a creditor protection lower than English common-law countries.

Table 1: Creditor Rights Index Across Time and Regions

Legal Origin	1978	1983	1988	1993	1998	2003
English	2.417	2.417	2.444	2.361	2.333	2.278
French	1.311	1.311	1.311	1.328	1.297	1.313
German	2.429	2.429	2.429	2.143	2.333	2.333
Nordic	2.250	2.250	2.500	2.000	1.750	1.750
Socialist	-	-	-	2.000	2.273	2.182
All	1.787	1.787	1.806	1.774	1.812	1.797
t-test English vs. French	4.664***	4.664***	4.719***	4.298***	4.364***	4.039***

Table 1 reports the Creditor Rights Index (La Porta et. al, 1998) by legal origins. Data are taken from Djankov, McLiesh and Shleifer, 2007. The Creditor Rights Index scores the level of creditor protection based on four legal rights. It ranges from 0 to 4, where an higher index means a stronger protection of creditors.

Financial covenants are a second important tool of financial contracting that relies on accounting for equity. Financial contracts use covenants to regulate state-contingent control allocation when firms access external finance (Christensen, Nikolaev, and Wittenberg-Moerman, 2016). Typically, accounting information is a signal of debtor financial performance that triggers the application of covenants: that is, accounting proves whether a covenant is fulfilled or breached. For example, the contract could impose explicit restrictions on borrowing whenever the leverage ratio exceeds certain thresholds, such as limits to distributions or the composition of the board of directors. The leverage ratio is an important covenant in financial markets (Nikolaev, 2010). Leverage computation is taken from financial statements; it thus depends on the measure of book value of equity.

Moreover, the link between covenants and accounting goes also in the direction of an increase in demand for accounting conservatism where there are covenants in financial contracts (Nikolaev, 2010). Therefore, country-level decisions about the adoption of the EU-

Commentato [MG7]: EDITORS:

We suggest trying which ones they are

Commentato [MG8R7]: Examples added

Commentato [MG9]: EDITORS:

We suggest trying which ones they are

Commentato [MG10R9]: Examples added

Commentato [MG11]: EDITORS:

While the topic is OK, we have some doubts about the inclusion of the table. Would it be possible to include more recent data, given the strong changes in these topics in recent years? [PA1]

[PA1] Difficile a mio avviso perché non ci sono aggiornamenti autorevoli recentemente

D-34/2013 concerning accounting for equity can have a direct effect on the implementation and usage of covenants in the credit market.

For example, following article 8 of the EU-D34/2013, member states can require or authorize to evaluate derivatives at fair value. If a state requires fair value accounting for derivatives while another state does not, the value of derivatives on the balance sheet will be different. In turn, this would lead to a different measurement of covenants, especially when derivatives are a liability like it is typically the case for interest rates swaps that are common for small and medium entities. Then, covenants are measured differently, and this affects financial contracts. Another example relates to the presence of micro firms in a state. Micro firms may avoid recognising derivatives on their balance sheet, while providing a minimum disclosure. If in each EU country, we have more micro enterprises than in another country, covenants measurement and comparability may be affected.

An analysis of the key accounting items affecting equity formation

Capital and Reserves incorporates values generated according to the recognition and measurement criteria stated for individual assets and liabilities. Consequently, values reported in the Capital and Reserves are likely to vary across the Member States in relation to the combination of the options allowed by the Accounting Directive EU-D-34/2013 matched with the options exerted by each Member State. Therefore, we focused on the effects on reserves of the accounting items whose treatments are more likely to be heterogeneous. This section shows the effects on reserves with reference to three specific accounting items: the revaluation of fixed asset, the change in fair value of financial instruments, and the capitalization of development costs.

Commentato [MG12]: EDITORS:

It seems to us that this part expands the concepts of the introduction, but without going well into the different countries. The initial theory should be reduced and more concrete examples should be included at country level.

Commentato [MG13R12]: Addressed with two examples

Table 2: Treatment of Accounting Items across Countries

Accounting items / Countries	Asset revaluation	Financial instruments	Development costs
Denmark	Revaluation amounts that are tied up and thorough explanations in the notes on revaluation amounts and the movements therein are required.	The Danish Financial Statements Act introduced a requirement for a fair value reserve on currency conversion (Section 39) and on accounting hedging (Section 49. PCS. 3).	An amount corresponding to the recognized development costs must be tied up in a special reserve under equity (§ 83, para. 2, cf. Act no. 738 of 1 June 2015).
France	Occasional revaluation admitted under conditions. There is no possibility to revalue an asset class in isolation. The revaluation gain is recognized in equity (Code de commerce L 123-18 and PCG art. 214-27)	France did not exert the option of fair value measurement, allowing financial instruments to be recorded only with the cost model. Financial assets are generally recognized at acquisition cost, and liabilities at amortized cost based on the contractual repayment schedule. Therefore, there are no changes in fair value to be tied up in the reserve.	Development costs can be expensed or capitalised (preferred treatment). When capitalised they are amortised over their useful life or over maximum five years if the useful life cannot be reliably estimated (Art. 214-3)
Germany	Revaluation of fixed assets is not allowed.	The fair value measurement is required for short-term financial instruments but forbidden for long-term financial instruments	Research costs are required to be expensed as incurred, while costs arising during development are allowed to be capitalised. When internally generated intangible assets are recognised, profits may only be distributed if the reserves available for distribution remaining after such a distribution are at least of the same amount as the recognised intangible assets.

Italy	Specific laws allow the revaluation of certain types of assets to consider their current value. OICs permit revaluations of assets if, and only if, these are authorised by special legislation. Fair value is permitted only if lower than cost and to measure the recoverable amount of a fix asset.	The Civil Code and then OIC 19 established amortised cost as the general method of measurement of receivables and payables. Fair value measurement is mandatory only for derivative financial instruments.	The Italian Civil Code allows entities to capitalise start-up and expansion costs and with development costs that generate economic benefits over several years subject to approval of the Board of statutory auditors. Start-up and expansion costs are amortised over a period not exceeding five years, development costs should be amortised over their useful life; absent reliable estimation they must be amortised over a period not exceeding five years. No distribution of profits take place unless the amount of the reserves available for distribution and profits brought forward is at least equal to that of the costs not written off.
Netherlands	The current value of fixed assets should be measured as the current cost, or lower recoverable amount. The measurement at current value is allowed for most investment properties.	There is no general fair value option, but fair value through profit or loss is allowed for all financial assets, except for loans granted and receivables. Other financial liabilities (except for trading portfolio and derivatives) are required to be measured at amortised cost. The decreases in value to below cost are required to be recognised in the statement of profit or loss: a negative revaluation reserve is not possible.	Development costs can be capitalised. In case their useful life cannot be reliably estimated they shall be written off within a period not exceeding 10 years (DL, article 396:3)
Spain	Cost model is required, and revaluation is not allowed.	The financial assets evaluated at fair value with changes in reserve is a residual category for investments in debt securities or equity instruments that cannot be either classified as held-for-trading nor considered an investment in associates.	Research expenditures: capitalization permitted when the company can properly justify technical, commercial, and financial success; amortization over a maximum of 5 years. Development expenditures: capitalization required when the company can properly justify technical, commercial, and financial success; amortization in a maximum of 5 years.

Sweden	Swedish GAAP allow companies to make revaluations of fixed assets if certain criteria are met. The unrealized gain is booked as restricted equity.	Only in the consolidated financial statements in privately held groups, fair value accounting for financial instruments was introduced by offering preparers a policy choice between historical-cost based accounting and fair value based accounting. Companies are not allowed to mix the two different choices.	Swedish GAAP does not allow for capitalization of development costs for small limited-liability legal entities, while large limited-liability legal entities are allowed to make a policy choice between the “expense model” and the “capitalization model”. Companies opting for the latter model had to apply the new EU requirement and create a development cost fund as part of restricted equity.
United Kingdom	Property, plant and equipment and intangible assets may be revalued. Changes in the fair value of investment properties will need to be recognised in the profit and loss instead of through reserves.	Initial measurement of financial instruments varies between transaction price (excluding transaction costs) for those held at fair value through profit or loss (FVTPL), present value of future payments for financing transactions, and transaction price for those that are not held at FVTPL or financing transactions. Many equity investments will need to be fair valued, with changes recognised through profit or loss.	Development costs and borrowing costs may be capitalised in certain circumstances

The first accounting item is the revaluation of fixed asset. The EU-D-34/2013 left the Member States the option to allow the revaluation of fixed assets (Article 7). In case Member State exerts the option, the Directive requires that the exceeding value over the asset's carrying amount is recorded in a revaluation reserve included in the Capital and Reserves and 'no part of the revaluation reserve may be distributed, either directly or indirectly, unless it represents a gain actually realised' (Article 7 (2)). The Member States may lay own rules governing the use of the revaluation reserve while respecting the provision that it must be tied up until it corresponds to a realized gain (Alexander & Fasiello, 2020). Therefore, the cross-countries differences are observable referring to whether they have opted for the fix assets revaluation, and the potential use of the revaluation reserve while respecting the provision that no part of the reserve may be distributed, directly or indirectly, unless it corresponds to a realized gain.

In most of the countries the local law sets strict conditions to be met for the entities to revalue fix assets.

In France the revaluation may be carried out occasionally either voluntarily or as required by the law, but it is admitted only for the entire class of assets, whilst it is not allowed in isolation (Le Manh, 2017). The revaluation gain is recorded in the revaluation Capital and Reserves (Code de commerce L. 123-18 and PCG art. 214-27). In Italy the revaluation of assets is allowed only in case of specific laws permitting the revaluation for anomalous loss in the purchase power. Accordingly, the Italian accounting standard setter (OIC) permits revaluations of assets only if these are authorised by special legislation (Provasi & Sottoriva, 2015). In the Netherlands the current value of fixed assets should be measured as the current cost, or lower recoverable amount (higher of value in use or realisable value). The measurement at current value is allowed for most investment properties, while agricultural products may be measured at fair value less costs of disposal (EY, 2020). In Sweden the revaluations of fixed assets are allowed if: i) there is a substantial value increase above the carrying amount; ii) the value increase is not temporary, and iii) there is a reliable measurement of the estimated fair value. The unrealized gain is booked as restricted equity (revaluation fund). The Danish Financial Statement Act (sections 58 and 53) did not set conditions for the revaluation, but it requires thorough explanations in the notes on revaluation amounts and the movements therein.

The change in the fair value of the fixed asset is mostly required to be recorded in the Capital and Reserve. An exception is the United Kingdom requiring the change in the fair value of investment properties to be recognised in the profit and loss instead of through reserves (PWC, 2013).

Commentato [FR14]: Consistent with Corinne Bessieux-Ollier, Véronique Blum, Elisabeth Walliser, p. 20.

Commentato [FR15]: Consistent with Giunta, Pisani, p. 9.

Commentato [FR16]: Consistent with Martin Hoogendoorn, p. 14

Commentato [FR17]: Consistent with Niclas Hellman and Tomas Hjelström, p. 14

Commentato [FR18]: Consistent with Frank Thinggaard, p. 11 e 17.

Commentato [FR19]: Consistent with Cascino Correia, p. 14.

Next, we turn our attention to the accounting for financial instruments. According to the Accounting Directive EU-D-34/2013, the adoption of the fair value measurement for financial instruments is optional for the Member States. If the Member States exert the option, the Directive requires that the change in fair value of hedging instruments under a system of hedge accounting (Article 8 (8.a)) the exchange difference on monetary items in investment in a foreign entity (Article 8 (8.b)) must be recorded in a tied reserve preventing the distribution of not realised gains (Alexander & Fasiello, 2020). With reference to available for sale financial assets, the Member States may permit or require that the change in fair value be recognized directly in reserve or, alternatively, in the income statement. The changes in the fair value of the other financial instruments must be included in the profit and loss account (Article 8 (8)) (Alexander & Fasiello, 2020).

Denmark has implemented the option in Article 8 (6) of the Directive and permits the recognition, measurement, and disclosure of financial instruments in conformity with international accounting standards adopted in accordance with Regulation (EC) No. 1606/2002 (Frank & Thinggaard, *supra*). The Danish Financial Statements Act introduced a requirement for a fair value reserve on currency conversion (Section 39) and on accounting hedging (Section 49. PCS. 3). The reserve must be dissolved or reduced to the extent that the change in the value is alternatively: i) realized or eliminated from the activity, ii) written down due to lower recoverable amount, iii) associated with deferred tax that must be provided for, iv) reversed due to a change in accounting estimates, or v) reduced due to depreciation. France did not exert the option of fair value measurement, therefore, there are no values to be tied up in the reserve. Germany exerted the option for fair value measurement of financial instruments with certain limitations. In Italy the fair value measurement is mandatory only for derivative financial instruments, and values to flowing into the reserves are limited to the variation in the fair value of some derivative financial instruments. Under Dutch laws and regulations there is no general fair value option, but fair value through profit or loss is allowed for all financial assets, except for loans granted and receivables. Other financial liabilities (except for trading portfolio and derivatives) are required to be measured at amortised cost. The decreases in value to below cost are required to be recognised in the statement of profit or loss: a negative revaluation reserve is not possible. If bonds are measured at fair value and the changes in value are accounted for via the revaluation reserve, Dutch laws and regulations do not permit a negative revaluation reserve. If investments in equity instruments are measured at fair value and changes in value are taken through other comprehensive income, they are transferred to profit or loss when realised. A negative revaluation reserve is not permitted (EY, 2020). The

current Spanish Plan General de Contabilidad is mostly aligned with IFRS 9 on Financial Instruments. The financial assets evaluated at fair value with changes in reserve is a residual category for investments in debt securities or equity instruments that cannot be either classified as held-for-trading nor considered an investment in associates (Gisbert & Mora, supra). In Sweden the historical cost has been dominating valuation approach, in fact Swedish Financial Accounting Standards Committee never issued Swedish standard corresponding to the fair-value standard IAS 39 (now IFRS 9). Only in the consolidated financial statements in privately held groups, fair value accounting for financial instruments was introduced by offering preparers a policy choice between historical-cost based accounting and fair value based accounting. Companies are not allowed to mix the two different choices.

In the United Kingdom the Financial Reporting Standard require financial instruments to be initially measured at the transaction price, in the case of the instruments held at fair value through profit or loss (FVTPL), present value of future payments for financing transactions, and transaction price for those that are not held at FVTPL. Many equity investments will need to be fair valued, with changes recognised through profit or loss (PWC, 2013).

The third accounting item we discuss is the capitalisation of development costs. The Accounting Directive state that national law may authorize the inclusion of costs of development under 'Assets'. Until those costs have not been completely written off, Directive EU-D-34/2013 further introduced a requirement that no distribution of profits take place unless the amount of the reserves available for distribution and profits brought forward is at least equal to that of the costs not written off. In Denmark the Section 83, para. 2, of the Act no. 738 of 1 June 2015 requires that an amount corresponding to the recognized development costs must be tied up in a special reserve under equity.

According to the French General Accounting Plan development costs can be expensed or capitalised, being the latter the preferred treatment. When capitalised they are amortised over their useful life or over maximum five years if the useful life cannot be reliably estimated (Art. 214-3) (Le Manh, 2017). German GAAP requires research cost to be expensed as incurred, while allowing capitalisation of costs arising during development. When internally generated intangible assets are recognised, profits may only be distributed if the reserves available for distribution remaining after such a distribution are at least of the same amount as the recognised intangible assets. The Italian Civil Code allows entities to capitalise start-up and expansion costs and with development costs that generate economic benefits over several years subject to approval of the Board of statutory auditors. Start-up and expansion costs must be amortised over a period not exceeding five years, development costs should be amortised over

their useful life; if this cannot be estimated reliably, they must be amortised over a period not exceeding five years (PWC, 2019). According to the Dutch Law, development costs can be capitalised. In case their useful life cannot be reliably estimated they shall be written off within a period not exceeding ten years (DL, article 396:3). According to the Spanish PGC-2021 the capitalization is, respectively, permitted for research expenditures and required for development expenditures, either way when the company can properly justify technical, commercial, and financial success. Once capitalised, the amortization is required over a maximum of five years (Gisbert & Mora, supra). Swedish GAAP does not allow for capitalization of development costs for small limited-liability legal entities, while large limited-liability legal entities are allowed to make a policy choice between the “expense model” and the “capitalization model”. Entities opting for the latter model had to apply the new EU requirement and create a development cost fund as part of restricted equity (Hellman, supra).

In the UK development costs and borrowing costs may be capitalised in certain circumstances (PWC, 2013).

Conclusions

This chapter overviewed and discussed the differences and similarities emerged in relation to the accounting for Capital and Reserves across Member States, following the adoption of the EU-D-34/2013. In fact, whilst the IASB neglected to devote a specific standard to discipline the accounting for Capital and Reserves, hence favoring homogeneity, the process through which the EU allowed Member States to retain a certain degree of autonomy in terms of tailoring the adoption of the Directive on their own companies’ needs, brought to significant differences in terms of the accounting rules and economic meaning of the Capital and Reserve items.

Interestingly, we started off our analysis based on the ex-ante assumption that Capital and Reserve is not like any other balance sheet item: in fact, it is affected by other recognition and measurement criteria in relation to several other individual assets and liabilities. Consequently, values reported in the Capital and Reserves are likely to vary across the Member States in relation to the combination of the options allowed by the Accounting Directive matched with the options exerted by each Member State. Therefore, the reasons why cross-country differences exist are three folded. Firstly, existing legal differences across jurisdictions, surfacing well before the adoption and transition to the Accounting Directive, map into the underlying role of equity as a ‘third-party’ protection for other stakeholders. Second, we argue that the ‘size’ and functioning of the Capital and Reserve accounts are mostly generated by the

changes in the assets and liabilities at fair value; the fact that the Accounting Directive left Member States with the option to embrace either cost measurement instead of the fair value, surfaced as a major trigger of differences. Third, we highlight that another major source of difference stems from – again the option left to member states – to account for changes in the fair value either in the income statement or in the reserves, depending on the existing accounting discipline in the first place and on the State Members option in the second place.

We believe this overview opens up several avenues for future empirical research; below we offer two examples: the heterogeneity in terms of possibility to revalue fixed assets may subsume a significant difference in terms of loan amounts and pricing. In fact, if accounting rules allow (do not permit) to revalue upward fixed assets, loan officers should (should not) be able to better assess the firm's ability to recover from missed loan payments if assets are reported at a value closer to current valuations. On the other hand, an implicit form of unconditional conservatism may serve as an ex-ante screening tool and offer a lower bound in terms of cash flow in the case of missed payments (Ryan, 2006). Second, the existing differences both across countries and within countries – due for example to different accounting rules applying to firms meeting size requirements, or being waived application of the EU-D-34/2013 – offer a nice setting to test whether governments react differently in terms of designing relief mechanisms in the aftermath of financial crisis.

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