OPINION OF ADVOCATE GENERAL TESAURO

delivered on 25 January 1996 *

1. By the question which forms the subject of these proceedings, the Bundesgerichtshof asks the Court to give a ruling on the interpretation of Articles 31(1)(c)(aa) and 59 of the 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 [1] (hereinafter 'the Fourth Directive').

The German court wishes to be informed, in particular, as to the compatibility with the abovementioned provisions of an interpretation of the national legislation implementing the Fourth Directive which requires those who draw up a limited company's balance sheet to carry out a particular accounting operation (hereinafter 'contemporaneous entering of profits'). That operation involves showing as an asset in the balance sheet for a given financial year (for example, 1989) of one company which wholly controls another company, as its sole shareholder, the accrued profits made by the subsidiary company in that period (again 1989), when the financial years of the two companies coincide and the subsidiary has approved the balance sheet and taken part in the resolution concerning the distribution of its profits in the form of dividends prior (for example, in May 1990) to the audit of the controlling company's balance sheet and its approval (July/October 1990).

The relevant legislation

2. Article 31(1) of the Fourth Directive requires the Member States to ensure that the items shown in the annual accounts are valued in accordance with certain general principles, including that of prudent valuation and the accruals concept.

According to Article 31(1)(c), 'valuation must be made on a prudent basis, and in particular:

(aa) only profits made at the balance sheet date may be included,

(bb) account must be taken of all foreseeable liabilities and potential losses arising in

* Original language: Italian.

1 — OJ 1978 L 222, p. 11.

the course of the financial year concerned or of a previous one, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up'.

The principle of prudent valuation, which is recognized more or less expressly in the accounting traditions of most of the Member States, thus obliges those who draw up balance sheets to value assets and liabilities in such a way as to ensure that they are financially reliable. In particular, it precludes the entry of unrealized profits and requires instead merely potential losses to be shown in the balance sheet (known as negative valuation asymmetry).

3. Article 31(1)(d) provides that 'account must be taken of income and charges relating to the financial year, irrespective of the date of receipt or payment of such income or charges'.

That is the accruals concept, which also forms part of accounting practice in most Member States, and which for the purposes of entry in the balance sheet of a given financial year requires the financial results achieved by the undertaking in the period covered by the financial year to be taken into account, regardless of the date of the actual receipts or disbursements; in other words, it lays down that in drawing up the accounts of assets and liabilities in the operating results, relevance for financial purposes takes priority over temporal or 'cash' relevance.

4. Both of those principles constitute a cogent enunciation of the more general principle of a 'true and fair view' ('quadro fedele'), [2] the actual guiding criterion of the Community rules as a whole, laid down in Article 2 of the Fourth Directive.

That principle requires the balance sheet to be drawn up so as to give not only a true (even in the relative sense in which that adjective is traditionally and necessarily used as regards balance sheets) but also a fair (essentially with regard to the good faith of the person drawing up the balance sheet) representation of the company's assets and liabilities, its financial position and its profit or loss.

2 — In the French version: 'image fidèle'; in the German: 'den tatsächlichen Verhältnissen entsprechendes Bild'. I would note that the expression 'rappresentazione veritiera e corretta' was preferred to 'quadro fedele' when the Italian Civil Code was amended in order to implement the Fourth Directive (Article 2423 of the Civil Code).

5. Article 59 of the Fourth Directive, [3] on the other hand, concerns the value of holdings held by companies in affiliated undertakings. In accordance with the first paragraph, the Member States may, pending subsequent coordination and subject to various conditions, permit 'the valuation of holdings in affiliated undertakings by the equity method'. [4]

6. The German legislation applicable to this case constitutes, according to the national court, a faithful transposition of the relevant principles laid down in Article 31. [5] In any event, the compatibility of that legislation with the directive has not been challenged.

It is apparent from the documents before the Court, however, that the option conferred on the national legislature of prescribing the 'equity method' referred to in Article 59 has not been exercised by the German legislature, at least not before the events material to this case.

3 — Amended by Article 45 of Seventh Council Directive 83/349/EEC of 13 June 1983 based on Article 54(3)(g) of the Treaty on consolidated accounts (OJ 1983 L 193, p. 1).

4 — According to that method, which is applicable when the holding company is capable of directly influencing the affiliated company's results, the value of the participating company's holdings corresponds to the value of the net assets and liabilities as they appear in the affiliated company's balance sheet, or to a percentage calculated on the basis of the share of capital held.

5 — In particular Paragraph 252(1)(4) of the HGB (Commercial Code).

The facts

7. Mrs Tomberger ('the appellant') holds shares in the limited company Gebrüder von der Wettern ('the respondent', or 'the holding company'); the latter in its turn holds 100% of the capital in two limited companies, Technische Sicherheitssystem and Gesellschaft für Bauwerksabdichtungen ('TSS' and 'GfB', or 'the subsidiaries').

The respondent's balance sheet for the financial year 1989, drawn to 31 December 1989, was audited on 18 July 1990 and approved by the shareholders' meeting on 19 October 1990. The balance sheets of TSS and GfB for the financial year 1989, also drawn to 31 December 1989, were approved by the (respective) shareholders' meetings on 29 June 1990, that is before the approval of the holding company's balance sheet. In addition, those meetings took decisions at the same time on the appropriation and distribution of the profits, in effect in favour of the holding company.

8. The directors included TSS and GfB's accrued and distributed profits for the financial year 1988, but not those for 1989, among the assets in the holding company's balance sheet for 1989.

Mrs Tomberger considered that in accordance with the rule of contemporaneous entries, the holding company ought instead to have shown in the assets in its own balance sheet for 1989 its subsidiaries' profits for that same financial year as well; she therefore brought an action for a declaration that the shareholders' resolution approving those accounts was void. In her opinion, the contemporaneous entry rule is consistent with the Fourth Directive in a case such as this.

The question

9. The claim, which was dismissed at first and second instance, was put forward again in the appeal on a point of law. The German Supreme Court deemed it necessary to stay the proceedings and ask the Court to give a preliminary ruling on the interpretation of Article 31(1)(c)(aa) and Article 59 of the Fourth Directive.

In that regard, it must at once be observed that, as is apparent from the order for reference, the Bundesgerichtshof had in the past already ruled in favour of permitting the contemporaneous entry of profits in a case similar to this. In a judgment given in 1975, that is prior to the entry into force of the Fourth Directive, the national court had declared that profits realized by a capital company in a given financial year *may* be entered (under the item 'Credits to affiliated undertakings') in the assets in the balance sheet for that same year of a company having a majority holding in the first company, where the subsidiary company's balance sheet has been approved before that of the holding company and where there is at least a corresponding plan to distribute the profits. [6]

10. Moreover, in its order for reference, that same court states that it now considers that contemporaneous entries are in fact *compulsory* in a situation which is in essence identical: where, that is, as in this instance, the holding company is the sole or majority shareholder in the subsidiary [7] and the latter has voted on the distribution of its profits before the approval of the holding company's balance sheet.

According to the Bundesgerichtshof, that fact makes it necessary to derogate from the general rule that the profits accruing to the subsidiary during a certain financial year can be entered in the holding company's assets only as from the time when the meeting of the members of the subsidiary adopts a resolution on the appropriation of those profits to dividends. Where there is a sole or majority shareholder, contemporaneous entry of profits accruing to the subsidiaries in a given financial year would help to provide to a

6 — Judgment of the Bundesgerichtshof of 3 November 1975, *H. and Others* v *W.A.G.*

7 — Which may accordingly 'be deemed to be dependent within the meaning of Paragraph 17(2) or to be affiliated to the same group of undertakings within the meaning of the third sentence of Paragraph 18(1)(3) of the Aktiengesetz'.

greater extent a 'true and fair' view of the holding company's assets and liabilities, financial position and profit or loss for the same period.

11. Such an interpretation would entail upholding the appellant's claim. The national court is, however, uncertain whether that interpretation is permissible, having regard to the relevant provisions of the Fourth Directive and the national implementing legislation; it therefore asks the Court to clarify the scope of the requirements laid down in Articles 31(1)(c)(aa) and 59 of the directive, in order to determine whether they preclude contemporaneous entry of the profits in circumstances such as those of this case.

12. With regard in particular to Article 59 of the Fourth Directive, it must be stated that although the national court has expressly referred to it in the question, that provision cannot constitute a relevant yardstick for determining whether it is permissible to enter the profits contemporaneously in the context now under consideration.

As I have pointed out, the German legislature has not exercised its option to prescribe or impose the equity method for valuing holdings in affiliated undertakings; it follows — and, what is more, all the parties are agreed on this point — that there can be no breach of Article 59 of the Fourth Directive. [8]

13. What is, on the other hand, relevant to this case is a provision which, while not mentioned by the national court, is undoubtedly capable of being applied in the circumstances: this is Article 31(1)(d), quoted above, which, as we have seen, embodies in unequivocal terms the accruals concept.

The question referred by the national court must therefore be decided solely in the light of Article 31(1)(c)(aa) and (1)(d) of the Fourth Directive.

14. One last detail concerns the facts of the case. It does not appear from the order for reference that the holding company is required to draw up consolidated group accounts. The question in fact makes express

8 — Here I might add that, as we have seen, Article 59 covers circumstances different from those at issue here, specifically the method of valuing the size of holdings in affiliated undertakings. In fact, the reference to Article 59 in the question can probably be explained by the fact that in the main proceedings the respondent gave an in-depth analysis when interpreting that provision, deducing therefrom a series of arguments in support of the view that contemporaneous entry of profits is unlawful.

reference only to the rules laid down by the Fourth Directive, on the individual accounts of capital companies.

The assumption, therefore, is that the balance sheets of the respondent and of its subsidiaries are 'normal' balance sheets, drawn up by separate individuals, and that the Community rules on consolidated accounts have no bearing on the case in any respect.

15. Now I come to the heart of the matter raised in these proceedings, which may be summed up in the following question: may profits made by subsidiary companies in the course of the financial year to 31 December 1989 be regarded as profits made by the parent company in the same financial year for the purposes of Article 31(1)(c)(aa) and (1)(d)?

In my view, the answer has to be in the negative. It is the resolution appropriating the profits for dividends and distributing them to the shareholders which confers on the holding company the right to those profits. Such a resolution may obviously be made only after the subsidiaries' balance-sheet date (31 December 1989). Before that, there is in fact no legal certainty as to the existence or the amount of such profits which *ex hypothesi* may not be made at all or may (even if only in part) be appropriated for a purpose other than distribution in the form of dividends.

16. It is quite true that in this case the fact that the subsidiaries are wholly controlled by the parent company may suggest that the distribution of profits as dividends is certain, inasmuch as it depends in any event on the will of the parent company. That is not, however, a sufficient basis for the assertion that the parent company is legally entitled, still less required, to enter those profits in its balance sheet for the year (for example 1989) in which they were made by the subsidiaries as profits; that right can arise only in respect of the following year (1990 in the same example) so far as concerns the parent company. In that connection it should be borne in mind that, notwithstanding the 'relationship between them', the parent and the subsidiaries are and continue to be formally separate legal persons, and the accounts which they are required to draw up are equally separate.

To maintain that profits made by subsidiaries in a given financial year may or must be regarded as the parent company's profits for that same year, even before they have been formally appropriated as dividends, would in a word be tantamount to stating that any profit made by subsidiaries *automatically* and *simultaneously* becomes the parent company's profit, which is not acceptable since they are legally distinct persons and their balance sheets are not consolidated.

17. The German and United Kingdom Governments ascribe considerable importance to the fact of sole control and maintain that an interpretation of the relevant provisions

which does not permit contemporaneous entry of profits in this case would be excessively restrictive and formalistic, especially since there is no real risk of imprudent valuation; the parent company's right to the profit must therefore be deemed to have come into existence, at least in financial terms, even if it has not been specified in legal terms, during the same financial year as that in which the subsidiaries made the profit.

The Bundesgerichtshof, for its part, considers that the parent company's entitlement to receive the profits constitutes a debt claimed from its subsidiaries, which at the balance-sheet date may be considered to be so well defined in financial terms that it *must* appear in the parent company's balance sheet as an addition to its assets in the same financial year as that of the subsidiaries.

18. It does not seem to me that the arguments of the German and United Kingdom Governments can be endorsed. Stressing the financial rather than the legal point of view does not alter the terms of the problem and of the answer to be given to the national court.

First of all, *the actual profit made by the subsidiaries*, in a situation where there are distinct legal persons and balance sheets drawn up not for the group but for the individual companies belonging to the group, can be recognized *as such* only at the end of the financial year and not before. Until midnight on 31 December, a profit of 100 could still be reduced to 50 or even vanish altogether.

19. In order, therefore, for subsidiaries' profits to be transformed into a *credit entry for the parent company* it is necessary:

(a) from the legal point of view

— for the subsidiaries' financial year to have come to an end;

— for the subsidiaries' balance sheets to have been approved and the profits appropriated and distributed as dividends;

(b) from the financial point of view

— (*at least*) for the subsidiaries' financial year to have come to an end.

20. The fact that subsidiaries are wholly controlled by the parent company, as is the case here, does not alter the terms of the problem. The subsidiaries' profits can be shown as assets of the parent company only in the financial year subsequent to that (1989) to which the subsidiaries' profits are attributed, since in any event it is only from 1 January following the end of the financial year in question (that is to say as from 1 January 1990 in this case) that profits can be deemed to exist and their appropriation for one purpose or another can be considered.

Sole control differs in only one respect: the parent company can, as of 1 January 1990, decide to appropriate the subsidiaries' profits as dividends and, consequently, to itself. But not before.

21. Therefore, it remains impossible in any event to show the profits made by the subsidiaries in 1989 as part of the assets in the same financial year as that of the parent company; that is precluded, to my mind irrefutably, by the need to comply with the principle of prudent valuation ('only profits made at the balance-sheet date may be included') and the accruals concept. It is precisely the correct application of those principles which, as I have said, helps to ensure that the balance sheet gives a 'true and fair' view of the company's assets and liabilities in the financial year to which the balance sheet relates.

On closer scrutiny, by the contemporaneous entering of profits in a case such as this, and thereby failing to ensure that items are valued on a prudent basis and that income and charges are shown for the year to which they relate, the directors of the parent company give the shareholders and third parties an 'untrue and unfair' view of the company's assets and liabilities in the financial year concerned, thus thwarting the essential purpose of the rules as a whole.

22. The German Government concludes moreover that under the system of cooperation established by the Community rules on balance sheets, Article 31(1)(c)(aa), under discussion here, is a provision specifying the result to be achieved, whose content may be supplied by each national legislature as it considers appropriate. More specifically, the German Government claims that the provision leaves the Member States a broad discretion in defining the 'profit made', with the result that every Member State is free to apply as a criterion the contemporaneous entering of profits, bringing them within the definition of 'profit made' in circumstances such as those of the present case.

That argument does not strike me as persuasive. In the first place, according to the actual wording of Article 31(1), 'the Member States *shall ensure* that the items shown in the annual accounts are valued in accordance with the following general principles'. [9]

23. Secondly, the directive, as I have already pointed out, does not merely require prudence in general terms but also takes care to define its substance with various detailed provisions which implement it, including the possibility of including in the balance sheet only profits actually made at the end of the financial year. In those circumstances, it seems to me that the rationale on which the provision is based would be undermined if it were possible to interpret it in the way suggested by the German Government.

But that is not all. However much the concept of 'profit made' may vary in the accounting traditions and practices of the different Member States, it cannot in any circumstances encompass a purely future profit, that is to say a profit as yet legally or financially non-existent. That is the case of profits made by an undertaking during a given financial year for its parent company, at least until the end of that year.

24. Finally, there is another provision of the Fourth Directive which also strikes me as significant, and is also an expression of the principle of prudent valuation and of the accruals concept. This is Article 31(1)(c)(bb), quoted above, in accordance with which 'account must be taken of all foreseeable liabilities and potential losses arising in the course of the financial year concerned or a previous one, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up'.

That provision, expressly referring only to losses and liabilities (which are moreover to be attributed to the financial year serving as reference period, even though they only subsequently become known), confirms *a contrario* that there can be no derogations from the requirement to include in the balance sheet only profits actually made *in the course* of the financial year.

25. In the light of the foregoing considerations, I therefore suggest that the Court should reply as follows to the question referred by the Bundesgerichtshof:

9 — Italics added.

Article 31(1)(c)(aa) and (1)(d) of 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 must be interpreted as precluding an accounting operation which involves showing as an asset in the balance sheet for a given financial year of a capital company which controls another capital company, as its sole shareholder, the accrued profits made by the subsidiary company in the same financial year, even where the financial years of the two companies coincide and the subsidiary has approved the balance sheet and adopted a resolution on the distribution of the profits before the controlling company's balance sheet has been approved.