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The Accounting and Legal Issues of Capital Reserve, with Particular Emphasis on Capital Increase by Share Premium

SUMMARY: The type of capital market transaction in which external investors become the members of an undertaking through capital increase by share premium is frequent in everyday business life. We confirmed the significance of the use of the capital reserve for the purposes of maintaining the solvency of an undertaking by using a descriptive statistical analysis. Based on the interpretation of the legal regulation, and the analysis of the accounting and legal practice we found that the Hungarian accounting and legal regulation on capital reserve in force does not ensure sufficient protection and transparency, which weakens social and business trust in business associations. For this reason we would consider it useful from an accounting perspective if capital reserve, similarly to subscribed capital called but not paid, could be paid subsequently, and if it was shown in a separate line of the balance sheet as long as the payment is not made, and if the supplementary notes also contained an obligation to provide information in that regard. Legal risks can be reduced if the arbitral tribunal's clause is included in the memorandum of association or syndicate contract in the case of capital increase by share premium. The excessive length of proceedings and capital shortfalls may jeopardise the success of the undertaking as a whole. It would strengthen the operation of the economy and legal certainty if the Court of Registration registered capital increase by share premium only when the capital reserve has already been paid in a verified manner in addition to the subscribed capital.

KEYWORDS: capital increase by share premium, components of equity, capital reserves, startup

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Practical experience shows that the external financing of startups is almost exclusively through equity; debt financing is not viable for this group of undertakings (Bethlendi, 2019). A specific characteristic of venture capital market is that the capital contribution of the

two principal ownership groups, i.e. founders and investors, may differ considerably. The founders provide the idea and the know-how, and they carry out the operational management of the company, while the investors provide the financial resources for the operation. For this reason, in the majority of the cases, the investors (angel investors, incubators or capital funds) achieve membership as shareholders

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by using capital increase by share premium. Within the framework of capital increase by share premium a larger proportion of capital increase is placed into a capital reserve while the subscribed capital is increased by a minimum amount. This is because the initial losses are covered by the capital reserve. If capital increase was carried out fully or to a significant degree through the increase of subscribed capital, equity could easily fall to below the subscribed capital due to the losses. In order to ensure the true and fair view of the undertaking, we find it important that capital increase by share premium should provide appropriate security to stakeholders from both an accounting and a legal perspective. The study presents how much flexibility is given by the legislator to the manager of an economic entity where the capital reserve of the company is not paid and/or transferred as capital contribution.

Although the Accounting Act created the legislative background to ensure that the statements to be drawn up on an annual basis provide a true and fair view of the given undertaking, in our view it would be useful to give further consideration to the regulation in terms of equity.

THE METHODOLOGY AND STRUCTURE OF THE STUDY

In the course of our research we examined equity on the basis of the¹ 2018 statements of the business associations operating in Hungary. After data cleaning we analysed the capital structure of 316,605 undertakings. In addition to presenting the accounting and legal regulation, we paid particular attention to the statistical substantiation of the results. We examined the significance of capital reserve by using a descriptive statistical analysis, while focusing on the principle of going concern.

In case of the legal regulation we used classic techniques of interpretation (Coyne et al.; Stelmach, Brozek, 2006, 184), and due to the interdisciplinary nature of the topic, we also found that the application of the law and finance school (Schnyder, 2016; 2018) was justified. We supplemented the theoretical approach with the Hungarian accounting and legal practice. By reviewing the judicial case-law we intended to draw attention to the difficulties arising from the potential legislative gaps.

The structure of our paper is as follows. After presenting the items of equity and the information content of the supplementary notes relating to equity, we give priority attention to the balance sheet line of the capital reserve affected by capital increase by share premium. We examine the practical problem as to how much flexibility is given by the legislator to the economic organisation where the capital reserve of the company is not paid and/or transferred as capital contribution. In addition to describing the balance sheet items of equity, the study covers in detail the possible means of enforcing the unpaid capital reserve. We close the study by presenting the conclusions.

EQUITY BALANCE SHEET ITEMS

The undertakings show the subscribed capital (as decreased by the amount of subscribed capital called but not paid), the capital reserve, retained earnings, the tied-up reserve, the revaluation reserve and the profit after tax of the subject year as part of the equity balance sheet items.

The equity categories ‘retained earnings’ and ‘profit after tax’ appear in the case of each operating company. The other equity categories can be considered as more specific equity components.

Legal provisions relating to subscribed capital and subscribed capital called but not paid

The regulation of the prescribed minimum amount of subscribed capital at the time of the formation of companies has an impact on the functioning of the undertaking. The ‘protection’ of equity (equity/subscribed capital ratio, dividend payment limit) also strengthens the principle of going concern by going beyond the interests of creditors (Böcskei, Deres, 2015).

In the case of limited liability companies and companies limited by shares the minimum amount of subscribed capital is regulated by Act V of 2013 on the Civil Code (hereinafter referred to as the Civil Code) and is subject to an obligation of registration with the Court of Registration.² The initial capital can be provided by making monetary or in-kind contributions at the time of formation. The provisions relating to the transfer of in-kind contributions must be laid down in the memorandum of association or the deed of foundation. Apart from certain exceptional cases³ the capital contribution must be made fully available to the company until the submission of the application for registration (Böcskei, 2014a). And this brings us to the category of subscribed capital called but not paid.

Regardless of the form of company, the part of the capital registered with the Court of Registration which has not been paid by the shareholders or members yet, and in case of in-kind asset contributions the amount not made available must be shown in the balance sheet as subscribed capital called but not paid.

The rules relating to the payment of the subscribed capital called but not paid are quite strict compared to those relating to the capital reserve not paid, which will be presented later. If the provision of the capital

contribution undertaken in the instrument of incorporation does not take place until the date prescribed, and the capital contribution is not made within 30 days despite the notification, the membership of the member(s) terminates, and he/they will be liable for the damage caused to the business association (Civil Code, 3:98. §). In the case of limited liability companies further rules apply to the subscribed capital called but not paid, which limit the payment of dividend (Böcskei, 2014a).⁴

Legal provisions relating to capital reserve

At the time of the foundation of the company and at the time of capital increase or reduction, there is quite a close connection between the subscribed capital and capital reserve. The cases of increase and reduction of the capital reserve are specified in the Accounting Act (Section 36 of the Accounting Act).

■ Among other things the difference between the issue price of the shares (subscription price) and their face value (share premium), which forms part of the capital reserve, must be shown as an increase of the capital reserve. This may happen at the time of foundation or at the time of capital increase. However, the capital reserve may also increase if the subscribed capital is reduced against the capital reserve.

■ The re-allocated amount of the reserve tied up from the capital reserve must be shown as an increase in the capital reserve at the time of the release of the commitment (when the capital reserve was transferred into the tied-up reserve, the capital reserve decreased) [Subsection 36 (1) of the Accounting Act].

■ The value of the funds placed into the capital reserve and funds transferred according to the legislation simultaneously with the cash

flow or the asset flow increases the capital reserve, while the value of the funds and assets transferred against the capital reserve decreases the capital reserve [Subsection 36 (1-2) of the Accounting Act].

■ The capital reserve may also decrease when the subscribed capital is increased, but it is only possible if the untied capital reserve provides coverage for that. When the capital reserve is reduced, attention must be paid to the fact that it may only be reduced if the capital reserve does not become negative as a result.

■ In case of loss-making financial management the capital reserve also decreases when the negative retained earnings are compensated; however, attention must be paid here as well to the conditions presented previously (Böcskei, 2014a).

■ The amount transferred from the capital reserve into the tied-up reserve must also be shown as a decrease in the capital reserve [Subsection 36 (2) of the Accounting Act].

In contrast to the subscribed capital called but not paid, the legislation does not provide a specific possibility for the capital reserve to be paid at a later time. To be more exact, it can only be shown in the balance sheet if the financial settlement has taken place. That is, the joint financial settlement of the subscribed capital and the capital reserve, and the registration of the subscribed capital with the Court of Registration are assumed.

Where the payment of the subscribed capital (and the capital reserve) does not take place, the Court of Registration rejects the application for registration of change concerning the amendment *ex officio*. In this case a procedure for supervision of legality may also be initiated in connection with the non-payment of the capital reserve, because in such cases the company does not comply with the legal provisions relating to its organisation and functioning, as well as the provisions of the instrument of incorporation during its operation.

However, the regulation does not address the situation in which the subscribed capital is paid and registered with the Court of Registration, but the capital reserve is not paid.

Legal provisions relating to retained earnings

Retained earnings have a connection with all equity components except for the subscribed capital called but not paid and the revaluation reserve. Retained earnings means the cumulative amount of the after-tax profit from all the business activities pursued during the year(s) preceding the business year. The positive result of the retained earnings means that the undertaking carries/carried out a profitable financial management. How to use the thus generated (accumulated) profit is a serious strategic decision to make even in case of a profitable financial management. Of course, it is crucial to bear in mind the short-term and long-term strategic objectives. We would like to note as well that dividend can be paid from the ‘untied’ retained earnings; in other words, if it was not paid from the after-tax profit of the given business year, then these ‘untied’ retained earnings can be used for the payment of dividend or profit-sharing. Of course, in this case the profit reserve will decrease by the amount of the dividend or profit-sharing paid (Böcskei, 2014a).

If the given economic organisation continues loss-making operation even for several years (which is a typical situation, for example, in the case of start-ups), retained earnings will become negative, which will result in the diminution of assets. The diminution of assets may lead to a situation in which the equity is lower than the subscribed capital; in this case one of the possible solutions is the execution of capital reduction. Capital reduction is possible if the value of the subscribed capital does not fall to below the

minimum amount prescribed for the form of company, which we presented previously.⁵

The supplementary payments made to cover the losses – which increase the retained earnings simultaneously with the payment of the fund – are aimed at increasing the equity, that is, ‘restoring’ the statutory condition due to diminution of assets, and the equity will also increase as a result. Numerous legal provisions have been created to avoid the occurrence of the loss of assets itself. One of such provisions is the co-movement of retained earnings and the tied-up reserve. Retained earnings must be reduced if the legislation sets out that a tied-up reserve must be created at the expense of retained earnings (see in the next chapter). In this case only untied retained earnings may be used for the payment of dividend or profit-sharing. In such cases the amount re-allocated from the tied-up reserve at the time of the release of the commitment will increase the retained earnings (Böcskei, 2014a).

Legal provisions relating to tied-up reserve

The tied-up reserve shows quite a close correlation with the capital reserve and the retained earnings as it must be created for the ‘unavailable’ (tied-up) amounts of the balance sheet items mentioned above. The ‘unavailable’ funds cannot be used, so they must be shown separately.

■ A tied-up reserve must be created in accordance with the law after the amounts placed into the capital reserve which are subject to an obligation of repayment if the terms of the agreement or contract are not, or are only partially, fulfilled (Section 38 of the Accounting Act).

■ A tied-up reserve must be created from the capital reserve, in accordance with the legislative provisions and on own initiative, for

the funds created to cover liabilities (Section 38 of the Accounting Act).⁶

The capital reserve cannot be negative; therefore, if the capital reserve does not cover the tied-up reserve, it must be tied up from the profit reserve. The retained earnings may also have a negative value so tying up is feasible in all cases (Böcskei, 2014a).

Legal provisions relating to revaluation reserve

The following must be shown as a revaluation reserve:

① The amount of the value adjustment determined on the basis of the valuation of the fixed assets at market price (revaluation reserve of value readjustment). The amount of the value adjustment determined on the basis of the market value must also be shown as revaluation reserve (difference of market and book value). Other components of equity cannot be settled at the expense of the revaluation reserve.

② The amount⁷ of the valuation difference accounted against the equity based on revaluation at fair value (revaluation reserve of valuation at fair value).

We do not present the detailed provisions relating to the revaluation reserve, as it is not connected to capital reserve.

Legal provisions relating to profit after tax

Profit after tax corresponds to the amount shown in the profit and loss statement under such title.

The provision of the Accounting Act which lays down that the after-tax profit of the subject year can only be paid as dividend, profit-sharing, or interest to the owner of an interest-bearing share if the amount of the

equity reduced by the tied-up reserve and the revaluation reserve – after the payment of the dividend, profit-sharing or interest of an interest-bearing share – does not fall to below the amount of the subscribed capital aims at ‘protecting’ the equity (Subsection 39 (3) of the Accounting Act). So that dividend can be paid, the untied retained earnings can also be used for supplementing the after-tax profit, but only on the condition that the limit of the payment of dividend must be taken into account.

The information content of equity – in an international comparison

We would like to present briefly the international context of our research topic. The International Financial Reporting Standards (IFRS) regulated among the general principles (IAS 1) concerning the preparation of financial statements that, among other things, the information relating to the change in equity must be shown as part of the financial statement. While the balance sheet structure is fixed in the Hungarian accounting regulation – we previously presented the named items –, it is expandable at international level, depending on what sorts of equity components they have and how the change in stock evolves (<https://www.ifrs.org/>).

When talking about national and international regulations, we should note that in the national regulation the repurchased shares of ownership must be shown (at nominal value) within the balance sheet line of subscribed capital, and it also prescribes that the subscribed capital called but not paid must be shown in a separate balance sheet line. In case of IFRS the items described above are not shown in a separate balance sheet line; they are recognised as the decrease of subscribed capital.

It should, however, be emphasised that the presentation of the structure and changes of equity, regardless of the regulation of each country, is of particular importance. In order to make economic decisions it is indispensable that the users of the financial statements are provided with information about the value of the capital structure and the reserves of the economic organisation, as well as the changes occurred in them. We should bear in mind that the primary objective of the statements is to provide a true and fair view of the operation of the economic entity. At international level the content and presentation of financial statements are included in the regulation relating to the information to be disclosed, for which the standards make recommendations. Thus, the presentation and textual description of the capital reserve (its potential non-payment), the matters raised herein, should appear at international level.

The international literature usually discusses capital increase by share premium from a legal point of view in connection with share issue, and in the context of creditor protection interests, minority rights, changed voting percentages (Armour 2003, Hannigan, 2015, and international tax advisory companies: ABiLiTieS Trust, Croneri). They analyse primarily the changes occurred in the capital and the operation of companies limited by shares, and they do not cover limited liability companies. The novelty of this study is that it approaches the topic from a different perspective, and places the emphasis on the role of the capital reserve, its payment (contribution) or failure of payment, and enforceability.

THE PROTECTION OF EQUITY

The magnitude of the level of property loss is regulated by the law to protect equity. It is obligatory to convene the supreme body of

the company when in case of a limited liability company the equity decreased to half of the subscribed capital due to the losses, and in case of a company limited by shares – subject to the notification of the supervisory committee – when the equity decreased to two thirds of the subscribed capital [Civil Code 3:189. § (1); 3:270. § (1)]. A further statutory condition is that in the case where the value of the equity does not reach the value of the equity prescribed for the given form of company in two consecutive business years, then the equity must be ensured within three months from the adoption of the statement of the second business year. If the statutory conditions cannot be complied with within the deadline prescribed, the company is obliged to transform or make a resolution on termination without legal successor, or merge within sixty days from the expiry of the deadline [Civil Code 3:133. § (2)].

If the equity is lower than the subscribed capital due to the diminution of assets, capital reduction must be executed. Capital reduction is possible if the value of the subscribed capital does not fall to below the minimum amount prescribed for the form of company.⁸ When decreasing subscribed capital, the company's own shares (in case of companies limited by shares) must be cancelled first (Civil Code 3:310. § (2)).

THE INFORMATION CONTENT OF THE SUPPLEMENTARY NOTES FROM THE PERSPECTIVE OF EQUITY

The supplementary notes, going beyond the numerical data of the balance sheet and the profit and loss statement, form part of the statement of undertakings (in case of those subject to the obligation to draw up annual statements, simplified annual statements), and the undertakings preparing an annual

statement must also draw up the annual report.

The supplementary notes must present, among other things, the trends in the assets and liabilities and the actual financial position of the undertaking item by item, and the changes occurred in the financial and income situation must also be evaluated therein. When presenting the financial position, the items of the equity must be presented separately, according to the following criteria:

■ In case of companies limited by shares the number and face value of the issued shares must be presented broken down by share types (separately showing those issued in the subject year). The number and face value of the issued convertible or equity bonds must also be shown (Subsection 91.b of the Accounting Act).

■ The supplementary notes must present the name, registered seat, voting percentage of the members (shareholders) holding majority control or qualified majority control [Subsection 89 (2) of the Accounting Act].

■ The percentages of – and any variations in – the capital subscribed by the parent company, by subsidiary company(ies), jointly controlled entities, and by affiliated company(ies) must be presented [Subsection 90(6) of the Accounting Act].

■ In case of the repurchase of own shares, partnership shares the supplementary notes must present the fact of repurchase and specify the reasons for the acquisition.⁹ The repurchased own shares, own partnership shares, their quantity and face value, and their percentage in the subscribed capital must be disclosed [Subsection 90 (7) of the Accounting Act].

The regulation does not name specifically the obligation to provide information on equity, except for the case where the securities¹⁰ issued by the undertaking are listed on any stock exchange.

The undertakings drawing up annual statements must prepare their annual report as well, which aims at presenting the true property, financial and income position of the undertaking, while also describing the assessment of the risks that have actually arisen or will possibly arise in the future.

The annual report, therefore, not only provides information on the results achieved by the undertaking in relation to the closed business year (the past), but also contains the ideas for the future. It is obligatory to detail the events occurred between the balance sheet date and the date on which the balance sheet is drawn up, which have significant influence on the future operation of the undertaking (Böcskei, 2014b).

Overall, there is no obligation to provide information on unpaid capital reserve in neither the supplementary notes nor the annual report.

ENFORCEMENT AND LEGAL CONSEQUENCES OF UNPAID CAPITAL RESERVE

From a legal point of view capital increase by share premium belongs to the group of equity settlement options¹¹ in which the amount of the subscribed capital also changes, which also requires the amendment of the essential company instruments and the registration of the changes with the Court of Registration. The same applies if the (cash) funds thus made available are no longer needed in the future: the documents must be amended in this case as well, because they can only be paid back to the owners by the simultaneous and proportionate reduction of the initial capital and the capital reserve.

The institution of capital reserve, despite its everyday frequency, is quite mistreated by the law in force, although most of the times

the restoration of the percentage of equity/subscribed capital can only be carried out by using capital increase by share premium. It is not mentioned at all by, for example, the Civil Code, and Act LXXXI of 1996 on Corporate Tax and Dividend Tax only contains a few references of technical nature. The explanations, comments relating to the legal regulations, and the related judicial case-law do not address this topic either (Vékás 2013; Andor, Lakatos 2014; Sárközy 2014; Török 2015; Orosz, Pomeisl, Wellmann 2015; Gál, Juhász, Mika, 2018; Petrik, 2018; Vékás, Gárdos, 2018). The mandatory or maximum level of the share premium is not regulated by the Civil Code either; therefore, its determination falls within the competence of the owner(s). We have already presented the key relevant provisions of the Accounting Act. A few provisions can be found in the legislation¹² relating to financial markets, but they only mention (in one instance or two) that the capital reserve is part of the initial capital or the solvency margin. Besides these, a few other legal regulations concerning the records of targeted state subsidies contain some brief specific provisions relating to capital reserves.

When carrying out capital increase by share premium, the owner may only place property into the capital reserve by increasing the subscribed capital, so if the owner does not increase the subscribed capital, then he may not place property into the capital reserve either. As this also concerns the essential documents of the business association, the (even repeated) increase of the subscribed capital and capital reserve can be recognised simultaneously with registering with the Court of Registration. The same applies to the reduction of the subscribed capital and the capital reserve. In this process, the Court of Registration does not only examine the instruments, but also the settlement of the previous payments.

A special situation occurs if the part of the capital is contributed during the capital increase by share premium, but the payment of the capital reserve does not performed. This is detrimental for the undertaking from an economic point of view because the capital surplus necessary for the operation is not available; and it raises concerns from a legal point of view as well because the obligation(s) undertaken in the resolution or the contract has/have not been complied with. The unpaid capital reserve may cause a problem in the future, too, as the Court of Registration will (may) determine the non-contribution *ex officio*, and as a consequence it will (may) reject the application for registration of change relating to the amendment, thus preventing, for example, the further capital injection of the company.

In case of non-payment, the initiation of civil proceedings is the most plausible option among the legal possibilities available to the company; in exceptional cases, the exclusion of the member may also be initiated. Hereinafter, we will present these options in detail. In order to maintain the general social trust in legal certainty and the lawful operation of business associations, the prosecutor or the Court of Registration may audit the operation of the companies, compliance with the resolutions and the obligations within its power of supervision of legality.

Enforcement by judicial action

According to Subsection 3:92 of the Civil Code disputes between the company and its members or former members in connection with their legal relationship to the company, including the initiation of a judicial review of the resolutions adopted by the bodies of the company, and disputes between the members in connection with their legal relationship to

the company qualify as legal disputes under company law. As a result of capital increase by share premium a new member may be added to the company, therefore, after registration and by contributing the part of the capital, he will be deemed as a member from the perspective of the enforcement of a claim for the unpaid capital reserve. The action is initiated by the business association (represented by the executive officer) against the member not having paid or having paid partially the capital reserve.

The payment of the capital reserve is essentially a civil, contractual legal claim, the enforcement of which belongs to the jurisdiction of the civil courts. Pursuant to Act CXXX of 2016 on the Code of Civil Procedure (hereinafter: CCP Act) the jurisdiction of the court has a peculiar nature because it is the regional court that acts in actions concerning membership between the legal entities and its members, or its former members, and between the members or the former members themselves (regardless of the upper threshold of 30 million forints of district courts).

The value of the subject matter of the action corresponds to the value of the claim in the action, so the amount of the unpaid capital reserve. The value of the subject matter of the action must be determined in Hungarian forints, which might be of importance in the case of partially foreign-owned companies if they determined the capital increase by share premium between each other in foreign currency (for example, in case of EU projects, international partnerships). The value of the subject matter of the action must be determined, and substantiated at the same time by the plaintiff, i.e. the representative (executive officer) of the undertaking, on the basis of the time of enforcement of the claim.

Unless the parties provided for otherwise, jurisdiction will be adjusted to the domicile or registered seat of the defendant. It constitutes

a simplification that the plaintiff, subject to its choice, may initiate the action for the enforcement of the claim arising from the contractual relationship before the court of the place of the carrying-out of the transaction or the performance of the service instead of the court generally competent as regards the defendant. One of the conditions is, therefore, that the capital increase by share premium must be provided for by a contract, a typical form of which is the amendment of the deed of foundation. This way, jurisdiction can actually correspond to the registered seat of the company, which may decrease the costs of enforcement.

However, Section 3:92 of the Civil Code also allows that the instrument of incorporation or an agreement between the parties involved in the legal dispute prescribe that legal disputes related to company law are to be settled in arbitral proceedings. The proceeding is faster and more cost-effective because it comprises merely one instance; no appeal may be lodged against the judgment of the arbitral tribunal either before the ordinary courts or elsewhere; and no extraordinary legal remedies are available as per the Act on the Code of Civil Procedure. However, the invalidation of the judgment of the arbitral tribunal may be applied for within a limitation period of 60 days in single-instance, non-litigation proceedings at the regional court, on the extensively and narrowly-defined grounds specified in Section 55 of Act LX of 2017, which do not include the factual or substantive legal mistakes of the arbitral tribunal. The decision of the arbitral tribunal can be executed in a manner identical to that of the ordinary court's decision. What seems to be a disadvantage is, however, also an advantage because the single-instance nature of arbitration creates the possibility to settle the legal dispute faster, in the absence of the public and definitively (Czédli, 2014).

Exclusion of a member

In an exceptional and extreme case, the exclusion of the member not having paid the capital reserve can be initiated. The member of a business association may be excluded from the company by a court decision based on an action brought by the company against the member concerned if his remaining in the company seriously jeopardised the objectives of the company (Civil Code, 3:107. §). Accordingly, the company has to prove the following: the failure of the payment of the capital reserve is of such a high degree that the lack of resources thus occurred may lead to the company not being able to achieve its economic objectives. Judgment on this may be achieved by considering the relevant circumstances of the specific case. This phenomenon can be observed the most often in the case of project companies, where the conditions and results of the future operation are clearly and jointly defined in the syndicate cooperation agreement. The judicial practice is uniform in the sense that the actual occurrence of the damage is not necessary for the substantiation of the action, the fact of jeopardising is, however, necessary (PJD 2018. 18.), which in itself is sufficient for the exclusion of the member (Szakácsné, 2014).

It is an important rule that the proceedings for exclusion cannot be initiated in the case of a two-member company; furthermore, the shareholder of a public company limited by shares, and the member who holds at least three-quarters of the votes at the meeting of the supreme body cannot be excluded from the company.

The initiation of the action for the exclusion of the member requires the resolution of the supreme body of the company, indicating the reason for exclusion, which was made by a two-thirds simple majority of all the members. The member concerned cannot vote on the

matter. The business association is entitled to submit an application against the member concerned by the exclusion; therefore, the business association can be in the position of the plaintiff, and the member of the business association concerned by the exclusion can be in the position of the defendant. The application based on the resolution must be initiated within the limitation period of fifteen days from the making of the supreme body's resolution. Pursuant to the CCP Act the competence of the court is similar to the aforementioned; therefore, it is also the regional court that acts in the actions for the exclusion of members of business associations.

The court can suspend the membership rights of the member concerned, at request, until the final decision of the court if the exercise of the membership rights could entail serious harm to the company. The suspension does not, however, affect the claim of the member for profit. Any liability arising during the period of suspension will not be imposed on the member subject to the suspension in the relationship between the parties even if he is obliged to be liable for the debts of the company against a third party. A further restriction is that during the term of the suspension of the membership right the instrument of incorporation cannot be amended, the exclusion of another member cannot be initiated, and no decision can be made on the transformation, merger, separation and termination of the company without a legal successor.

The legal effect of the exclusion is that the membership of the member will be terminated. The membership is only terminated by the finality of the judgment. As a rule, the member remains the full member of the company until this time, unless his membership is suspended. Although the exclusion deprives the member of his partnership share in the company, it does not exempt the company from its ac-

counting obligation. The partnership must settle accounts with the former member or his heir or legal successor upon his membership being terminated, unless his partnership share has been transferred or his heir or legal successor has joined the partnership (Civil Code 3:150. §). When accounts are settled, the sales value of the assets of the company at the time of the termination of the membership must be determined, and from that value, the part proportionate to the capital contribution of the party must be paid to the former member or his heir or legal successor in the form of cash within three months from the termination of the membership. In the course of this process, the paid and unpaid capital components must be taken into consideration. The excluded member is protected by the fact that the provision of the memorandum of association which excludes or restricts the accounting obligation, or determines the rules of accounting applicable to the member in a more unfavourable manner than as specified in the law, becomes null and void. In case of a limited liability company if the court excludes the member from the company, or the membership of the member was terminated because of the non-performance of the capital contribution or the supplementary payment, the partnership share of the former member must be sold. The former member and the company must agree on the conditions and method of the sale within fifteen days from the termination of the membership. If no agreement is reached within the deadline or the sale does not take place within the deadline pursuant to the agreement, the company is obliged to sell the partnership share in the company by public auction within 45 days from the expiry of the deadline for the agreement or the sale. This can be beneficial to the former member, but it can often lead to unfair situations, as the settlement of accounts with the member is not immediate, and not

even complete in all cases; therefore, it can be rather considered as indemnification (Czédli, 2014; Metzinger, 2004).

Supervision of legality

As we have indicated previously, the unpaid capital reserve may cause a problem in the future, as the Court of Registration determines the non-contribution *ex officio*, and as a consequence, it rejects the application for registration of change relating to the amendment, and it may also initiate a procedure for supervision of legality.

The legislator lays down that the general supervision of legality over legal entities is carried out by the court operating the register at which the legal person is registered. (Civil Code 3:34. §). The supervision of legality may not be aimed at the supervision of the decisions of the legal entity in terms of economic efficiency and expediency.¹³

A procedure for supervision of legality may be initiated in connection with the non-payment of the capital reserve, because in this case the company does not comply with the legal provisions concerning its organisation and functioning, as well as the provisions of its instrument of incorporation during its operation. The supervision of legality can be started

- *ex officio* if the court itself becomes aware of the necessity of the procedure or a circumstance giving rise to the procedure during its own official procedure, or the procedure is initiated by another court;
- at request if the procedure is requested by the prosecutor, a public administrative body, the economic or professional chamber competent in the territory, or a person who has a legal interest in the procedure or substantiates this legal interest.

The case of the *ex officio* procedure occurs most frequently; as a result the initiation of a procedure for registration of change due to the increase or the reduction of the capital reserve. However, on the basis of the restriction under the Company Act, the procedure for supervision of legality can be initiated *ex officio* during the assessment of the application for company registration (registration of change), in connection with the subject matter of the application for registration, only for the purpose of clarifying the existence of the reason for exclusion that arises during the comparison of the data of the natural person requested to be registered in the business register and the data of the criminal records. At the same time, it should be noted that during the procedure for registration (of change) the Court of Registration becomes aware of the non-payment of the capital increase *ex officio*, therefore, it can be established during the assessment of a subsequent amendment that the provisions of the instrument of incorporation or the resolution or contract concerning the increase of the capital reserve were not complied with.

In order to restore the lawful status, the Court of Registration may take the following measures depending on the circumstance giving rise to the measure, or its gravity:

- it may impose a fine of 100,000 forints to 10 million forints on the company, or, if it can be established that executive officer gave rise to the procedure for supervision of legality, the executive officer,
- it may annul the resolution made by the company that infringes the legislation or is contrary to the instrument of incorporation of the company, and, where necessary, it provides for the adoption of a new resolution by setting an appropriate deadline,
- if the lawful operation of the company is expected to be restored by convening

the supreme body of the company, it may convene the supreme body of the company or appoint a suitable person or organisation to execute this task at the expense of the company,

- if the restoration of the lawfulness of the company's operation cannot otherwise be ensured, it may appoint an inspector for up to ninety days.

It is obvious that these sanctions are not always effective, therefore, Subsection 3:34 (2) of the Civil Code provides the acting court with the possibility as *ultima ratio* to ultimately terminate the legal entity if the other means did not bring results. By doing so the legislator ensures that the courts can cease the potential illegal situation in all cases (Gór, 2015).

It is rare in the procedures initiated at request – to avoid the sanctions listed above – that the executive officer or the other owners of the business association would initiate the procedure for supervision of legality due to the non-payment of the capital reserve. The prosecutor's inclusion in the list is somewhat disturbing. Act CLXIII of 2011 on Prosecution Service grants broad power to the organisation; therefore, in order to safeguard the public interest, the prosecutor's office contributes to ensuring that everyone, the companies and specifically those participating in the increase of the capital reserve, comply with the laws. In the case of business associations, however, the supervision of legality is carried out by the Court of Registration, and the prosecutor only has the right to initiate the procedure.

Finally, we briefly refer from the field of criminal law to the fact that Section 407 of Act C of 2012 on the Criminal Code regulates the impairment of own capital. Therefore, the executive officer or member of a company limited by shares or a limited liability company who appropriates the company's own funds in part or in whole is guilty of a felony punishable by imprisonment not exceeding

three years. The non-payment of the capital reserve does not, however, result in carrying out a criminal offence, as the impairment can only be committed to the detriment of the equity already made available, and the criminal conduct is the appropriation itself. It is also important to note that the criminal offence will be realised if the appropriation of the funds of the company results in the provable enrichment of either the offender or a third party (Horváth, 2015).

EXAMINATION OF CAPITAL RESERVES

After describing the theoretical background, we examined the significance of capital reserves in the case of operating companies.

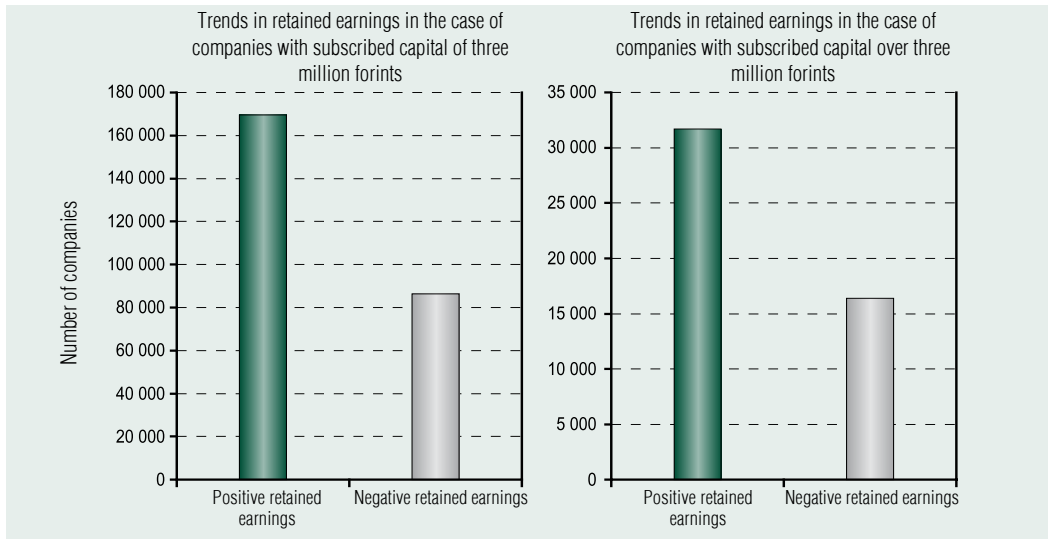
In our research we examined the own capital structure of 316,605 companies based on the data of the statements of the financial year of 2018 as a priority, as they had to comply with the minimum criteria relating to minimum equity, prescribed for the given form of company, until 15 March 2017 at the latest. 80 percent of the undertakings (255,690 companies) included in the sample had subscribed capital of three million forints, that is, they possessed the minimum amount of subscribed capital prescribed by the law for limited liability companies.

Before we start to focus on the role and significance of capital reserves, it is worth examining the trends in their retained earnings, which contain the cumulative amount of the after-tax profit from all the business activities pursued over the years preceding the business year.

In case of nearly 34 percent of the companies involved in the examination, regardless of the amount of the subscribed capital, the retained earnings were negative, which indicated cumulative loss, or the reduction of the equity. (See *Figure 1, 2*)

Figure 1

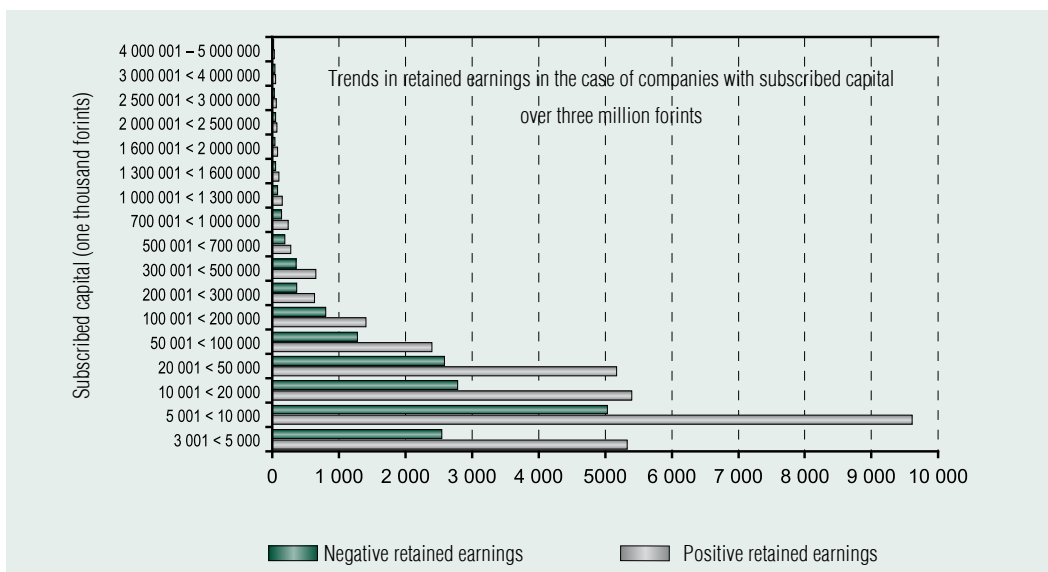
THE TRENDS IN RETAINED EARNINGS AS A FUNCTION OF THE LEVEL OF SUBSCRIBED CAPITAL (YEAR 2018)



Source: Own calculations based on Opten database

Figure 2

THE SIGN OF RETAINED EARNINGS AS A FUNCTION OF THE LEVEL OF SUBSCRIBED CAPITAL (YEAR 2018)



Source: Own calculations based on Opten database

The diminution of assets may result in the equity being lower than the subscribed capital; in this case the statutory conditions caused by the diminution of assets must be ‘restored’.

In the case of more than 13 percent of the undertakings (43,106 companies) the value of equity was lower than the value of the subscribed capital. Accordingly, if the subscribed capital/equity ratio is higher than 1, then there is diminution of assets. (See Figure 3)

In the case of more than 80 percent (80.84 percent) of the companies examined by us no capital reduction can be executed, as the subscribed capital of the company complied with the statutory minimum criteria.

The knowledge of these facts enhances the role and significance of the capital reserve, as

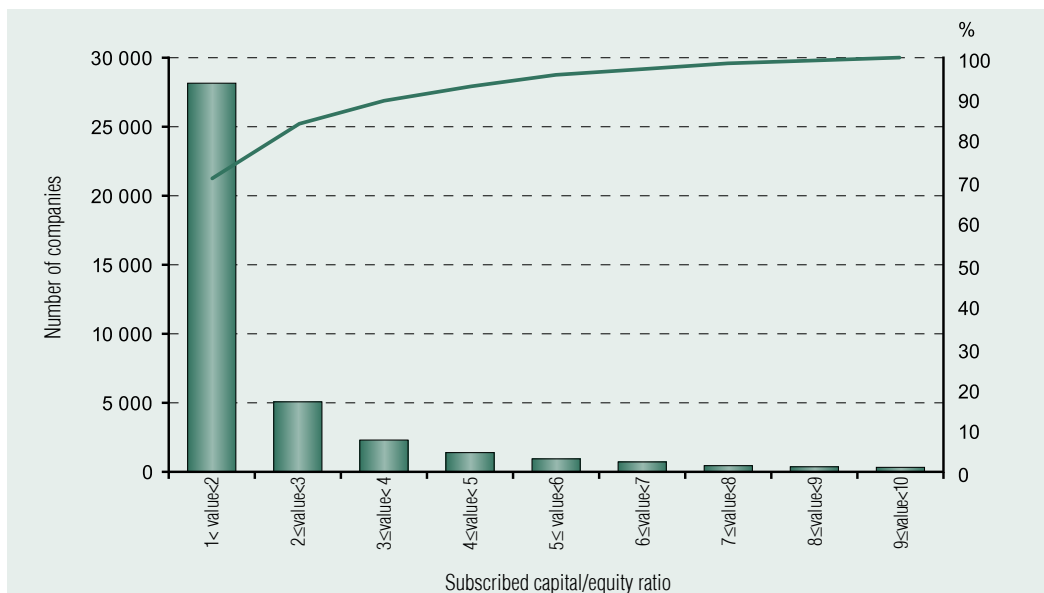
the capital reserve can be used (among other things) for compensating the negative retained earnings due to the losses.

Only 8.6 percent (27,279 companies) of the undertakings had capital reserves. When analysing the retained earnings of the undertakings with capital reserves, we found that the value was positive in case of 56 percent (15,397 companies), and negative in case of 44 percent (11,882 companies). The number of the undertakings with negative equity within this latter group of undertakings would be three fold if they did not use the capital reserve. Based on this, we consider the institution of the capital reserve and its use important in terms of maintaining the undertaking’s liquidity. (See Figure 4)

Only 11 percent (11,882 companies) of the companies with negative retained earnings

Figure 3

NUMBER OF COMPANIES AFFECTED BY DIMINUTION OF ASSETS – TRENDS IN THE SUBSCRIBED CAPITAL/EQUITY RATIO (YEAR 2018)

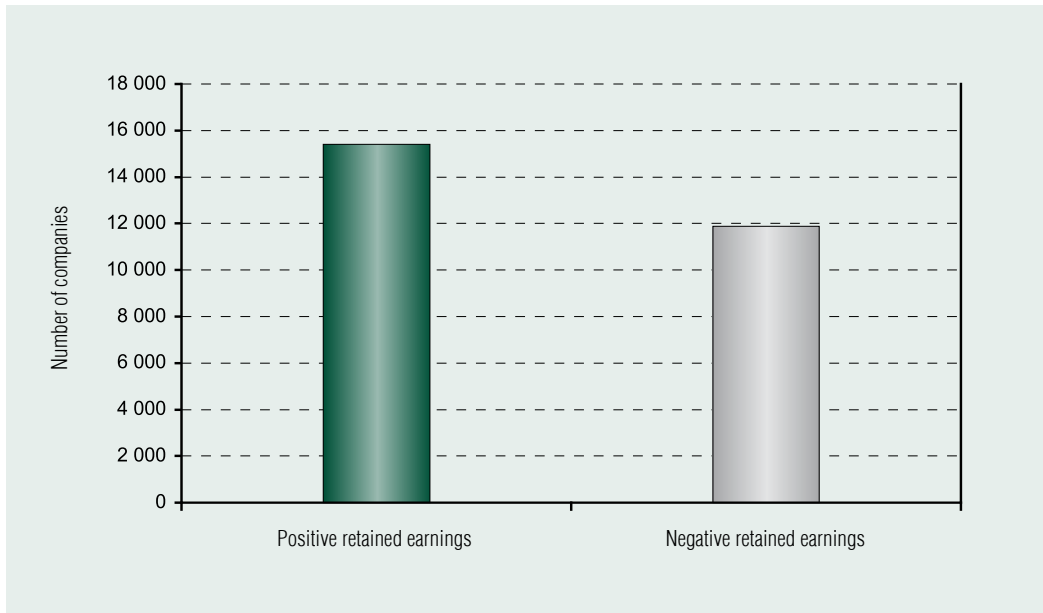


Comment: The Pareto line in the figure shows the distribution of the data in an order of decreasing frequency. The secondary axe demonstrates the percentage compared to all the companies with a subscribed capital/equity ratio over one.

Source: Own calculations based on Opten database

Figure 4

THE SIGN OF RETAINED EARNINGS OF UNDERTAKINGS WITH CAPITAL RESERVES (YEAR 2018)



Source: Own calculations based on Opten database

(107,486 companies) have capital reserves, therefore, 89 percent of the companies must cover the losses in a different manner (with supplementary payments).

SUMMARY, RECOMMENDATIONS

In our study we were seeking a solution to a practical problem: when the capital reserve is not paid by the external investor during capital increase by share premium. We examined what accounting and enforcement possibilities are available to address this problem.

We confirmed the significance of the use of capital reserves for maintaining the liquidity of a business by using a descriptive statistical analysis.

Based on the legislative interpretation of the items of equity and the informative

content of the supplementary notes relating to equity, and the analysis of the related accounting practice, we concluded that it would be useful from an accounting point of view to reconsider the regulation relating to capital reserves. It would be expedient if capital reserve, similarly to subscribed capital called but not paid, could be paid subsequently, and if it was shown in a separate line of the balance sheet as long as the payment is not made, and if the supplementary notes also contained an obligation to provide information in that regard.

According to the interpretation of the legal regulation and the legal practice, legal risks can be reduced if the arbitral tribunal's clause is included in the memorandum of association or syndicate contract in the case of capital increase by share premium. It would be all the more important since the excessive

length of proceedings and capital shortfalls may jeopardise the success of the undertaking as a whole. It would strengthen legal certainty if the Court of Registration registered capital

increase by share premium only when the capital reserve has already been paid in a verified manner in addition to the subscribed capital.

NOTES

¹ We examined undertakings operating in the form of limited liability companies and companies limited by shares, which prepare their statements properly. These two forms of business associations with legal personality are the ones relevant in terms of the involvement of external investors; for this reason, we focus on these company forms in the rest of the study.

² In the case of limited liability companies the minimum amount of subscribed capital (initial capital) is three million forint. The equity of a company limited by shares cannot be lower than five million forints in the case of private companies limited by shares, and it cannot be lower than twenty million forints in the case of public companies limited by shares.

³ In the case of limited liability companies if the amount of in-kind contribution exceeds half of the initial capital, it must be made fully available to the company until the submission of the application for registration.

⁴ If the conditions of the payment of subscribed capital, specified in the memorandum of association, set forth that one of the members is obliged to pay an amount smaller than half of their financial deposit until the submission of the application for registration, or determine a deadline for the payment of the unpaid monetary capital contribution which is longer than one year from the registration of the company, the company cannot pay dividend. The company cannot pay dividend

to the members as long as the retained profit and the profit accounted for the capital contribution of the members according to the rules of payment of dividend together with the monetary contribution made by the members does not reach the level of the initial capital (Civil Code 3.162. § (1)).

⁵ Decision on the reduction of the subscribed capital to below the minimum amount prescribed by the law can be made if the capital increase decided on simultaneously with the reduction of the subscribed capital also takes place. This is necessary, because thus the amount of the subscribed capital reaches at least the minimum amount of the initial capital or share capital prescribed for the form of company [Civil Code 3:202. § (4); 3:308. § (3)].

⁶ A tied-up reserve must be created for the book value of repurchased own shares, own partnership shares and redeemable shares, at the expense of the retained earnings. In case of formation/restructuring and experimental development if a decision is made on their capitalisation, and the costs arising in connection with foundation/restructuring and experimental development are not recognised under expenses. A tied-up reserve must be created for the capitalised value, the amount of which is not yet written off. Similarly, for the unrealised, deferred exchange losses of loan debts denominated in a foreign currency taken out for investment purposes and the issue of foreign exchange bonds, and the difference of the other provisions set aside for this purpose

(Róth et al., 2013 and Section 38 of the Accounting Act).

- ⁷ The amount for which an asset can be exchanged (sold or bought) or a liability can be settled between appropriately informed parties who express their intent to do business, within the framework of a transaction (contract) that was concluded (can be concluded) under the normal market conditions. The investments deemed as fixed assets, constituting ownership interest in an affiliated company, belonging to the category ‘sellable’ cannot be valued at fair value. In this case valuation at the market value at the time of the preparation of the balance sheet can be applied (Section 59/B of the Accounting Act, Róth et al., 2013).
- ⁸ Decision on the reduction of the subscribed capital to below the minimum amount prescribed by the law can be made if the capital increase decided on simultaneously with the reduction of the subscribed capital also takes place. This is necessary, because thus the amount of the subscribed capital reaches at least the minimum amount of the initial capital or share capital prescribed for the form of company [Civil Code 3:202. § (4); 3:308. § (3)].
- ⁹ Simultaneously with repurchasing the own shares and own partnership shares, a tied-up reserve must be created at the expense of the retained earnings, that will, therefore, also constitute a limit of dividend payment.
- ¹⁰ They constitute ownership interest, carry voting rights and their stock exchange trading is permitted in any recognised (regulated) market of any Member State of the European Union. In this case there is an obligation of detailed disclosure (Section 95/A of the Accounting Act).
- ¹¹ The options of equity settlement: supplementary payment; reduction of subscribed capital in favour of the equity beyond the subscribed capital; increase of subscribed capital by share premium; waiver of liability against the owner; final transfer of the fund; application of value adjustment; transformation into a different form of company, and as a last resort termination.
- ¹² Act XVI of 2014 on Collective Investment Trusts and Their Managers, and the amendment of certain financial laws; Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises. Act CCXXXV of 2013 on Payment Service Providers; Act CII of 2011 on Regulated Real Estate Investment Companies; Act CXXXVIII of 2007 on Investment Firms and Commodity Dealers, and on the Regulations Governing their Activities; Act CXVII of 2007 on Employers’ Pensions and its Institution; Decree No. 78/2014. (III. 14) on the rules of investment and borrowing of the collective investment undertakings; in all four cases the capital reserve is part of the initial capital; Government Decree No. 43/2015. (III. 12) on the solvency margin and technical provisions of insurers and reinsurers; Act XV of 2014 on Trustees and the Rules of their Activities.
- ¹³ Pursuant to Section 72 of Act V of 2006 on Public Company Information, Company Registration and Winding-up Proceedings (hereinafter: Company Act) the objective of the procedure for supervision of legality is to enforce the lawful operation of the company by the measures of the Court of Registration in order to ensure the authenticity of the business register.

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