Do Accounting Rules and Taxation Rules Hinder Corporate Social Responsibility?

A Historical and Prospective View from Switzerland: Hidden Reserves, Transparency and Sustainability

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ABSTRACT

The hidden reserves, practiced with passion by Swiss companies for more than a century, were motivated mainly by objectives that appear today to be fully in line with contemporary conceptions shaped by Corporate Social Responsibility thinking. The board of directors was essentially prudent and even pessimistic in presenting the accounts, so as to ensure an increased stability when the company had to face troubled times: in practical terms, the often very substantial hidden resources allowed to reduce volatility in results (and in dividends) and, at least in limited downturns, allowed the management to renounce practicing brutal disinvestments or lay-off of employees; the very prudent, systematically pessimistic way of presenting accounts protected also creditors' interests. In general, it gave rather good results, from the point of view of long-term entrepreneurial successes of companies. Also, this did not lead to significant misuses in terms of remuneration of top-managers: pessimistic presentations of annual results do not justify claims for excessive bonuses. It was not a perfect system: the hidden character of such reserves, quite typical for the Swiss cult of secret and confidentiality in business, does not comply with modern ideas on transparency. It is probably possible today to reach the same results as hidden reserves led to, if the boards of directors decide to build up *visible* (disclosed) provisions, what they should be allowed to do, for example, for contingent liabilities even of a low probability and for probable future expenses. Swiss accounting law permits such provisions as a principle.

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To the extent that "modern" accounting standards like IFRS and their followers do not allow such provisions, they are detrimental and dangerous, and should be rejected whenever possible; principles other than the principle of prudence, like the religion of an allegedly "true and fair view", are finally not scientific; they are largely illusory. Of course, building up visible provisions requires from the board – in contrast to hidden reserves – the courage to defend them towards impatient shareholders and tax authorities with their respective short-term appetites for high dividends and revenue. Prudence requires courage. This courageous prudence is a very practical and efficient instrument for companies that wish to implement the idea of Corporate Social Responsibility.

KEYWORDS
Reserves, Provisions, Hidden reserves, Under-evaluation of assets, Accounting, Principle of prudence, Cautiousness, True and fair view, Swiss law, IFRS, Stability, Lay-off of employees, Disinvestments, Dividends, Taxation, Agent theory, Long term, Balance sheet, Dissolution of reserves, Contingent obligations, Conditional obligations, Uncertainty, Crisis

Les règles comptables et fiscales entravent-elles la responsabilité sociale des entreprises ?

Vision historique et analyse prospective de la Suisse : réserves latentes, transparence et durabilité

RÉSUMÉ
Depuis la fin du 19e siècle, les réserves latentes ont connu un véritable engouement de la part des entreprises suisses. Les motivations avancées pour justifier cette ancienne pratique comptable frappent par leur adéquation avec un certain nombre de préoccupations contemporaines exprimées au titre de la responsabilité sociale de l'entreprise. Selon cette pratique, le conseil d'administration adoptait une prudence voire un pessimisme résolu en présentant les comptes annuels ; l'objectif était de constituer des réserves qui pouvaient être dissoutes dans les temps difficiles de façon à bénéficier d'une certaine stabilité. Les constitutions et dissolutions de réserves permettaient de réduire la volatilité dans les résultats (et les dividendes) et visaient aussi, du moins dans les crises

d'ampleur moyenne à renoncer à des désinvestissements brutaux ou à des licenciements. La présentation très prudente du bilan, systématiquement pessimiste, allait aussi dans le sens d'une protection des créanciers. En général, il peut être affirmé que cette pratique des entreprises a plutôt été corrélée avec des succès à long terme. Assurément, elle n'a pas été un facteur conduisant à des rémunérations excessives, puisque des comptes pessimistes ne justifient guère le versement de *bonus* extravagants. Ce système n'était cependant pas parfait : le caractère dissimulé des réserves, assez typique du culte helvétique pour la discrétion et la confidentialité en affaires, ne correspondait pas aux conceptions contemporaines en matière de transparence. Aujourd'hui, le rôle utile que remplissaient les réserves latentes peut probablement se réaliser par une pratique comptable par laquelle les conseils d'administration constituent des provisions visibles. À notre avis, ils doivent être autorisés à le faire pour couvrir les montants pouvant être dus au titre d'obligations conditionnelles (et ce, avant l'avènement de la condition) ou au regard de dépenses futures probables. Le droit suisse de la comptabilité permet ces provisions en principe. Dans la mesure où les standards comptables « modernes », comme les IFRS et les normes qui en sont dérivées, s'opposent à de telles provisions, ils sont néfastes et dangereux ; chaque fois qu'une entreprise aura le droit de renoncer à les appliquer, elle sera bien inspirée de le faire. Les principes comptables qui s'écartent du principe de prudence – telle la fameuse « image fidèle » (*true and fair view*) – ne sont, en fin de compte, guère scientifiques ; ils conduisent à des certitudes illusoires. Bien entendu, constituer des provisions visibles requiert du conseil d'administration – par contraste avec la constitution de réserves latentes – le courage de les justifier et notamment de les défendre face à l'impatience des actionnaires et des autorités fiscales et à leur appétit respectif pour des hauts dividendes et un important bénéfice imposable. Ainsi, la prudence réclame du courage. Le jeu en vaut la chandelle : cette prudence courageuse est assurément un instrument pratique et efficace qui permet aux entreprises de réaliser concrètement leurs objectifs de responsabilité sociale.

MOTS-CLÉS
Réserves, Provisions, Réserves latentes, Sous-évaluation des actifs, Comptabilité, Principe de prudence, Image fidèle (*true and fair view*), Droit suisse, IFRS, Stabilité, Licenciement d'employés, Désinvestissements, Dividendes, Imposition, Théorie de l'agence, Long terme, Bilan, Dissolution de réserves et de provisions, Obligations conditionnelles, Incertitude, Crise

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Section I. The hidden reserves; modern Corporate Social Responsibility as a reason to revisit the old Fortress of the Alps

This article is a reflection stimulated by the experience that an attentive corporate lawyer can repeatedly have in Switzerland and that is interesting in the present context of financial crisis: corporate accountants, managers and entrepreneurs frequently – if not constantly – recall "the good old times" in which the board of directors had an unrestricted possibility to build up so-called "hidden reserves" (also referred to "silent" or "undisclosed" or "latent reserves"[2] – in French "*réserves latentes*", in German "*stille Reserven*").

For their contemporary interlocutor, the term "hidden" is essentially inelegant: it goes against the cardinal principle of transparency; but the term "reserves" is acceptable and even seducing today, like the promise of an instrument of governance opposed to short-term approaches and

[2] Or the colloquial, more poetical, « *cookie-jar reserves* » (cf. YOUNG David, *Europe's transition to IFRS*, Financial Times 23.3.2006).

against excesses in maximization of returns on investment for shareholders – approaches that attempted to find their legitimacy in the agency theory. To some extent, the arguments of the Swiss entrepreneurs and accountants who long for traditional "hidden reserves" sound very modern and comply with quite several concerns expressed in contemporary corporate social responsibility reflections; they notably refer to the fact that the practice of hidden reserves ensured the ability of Swiss companies to, notably, resist efficiently in times of turmoil, in particular to renounce laying-off employees, and in general to ensure the continuity and stability of their activities in a *socially responsible* and *sustainable* way.

Swiss corporate law, which sets the rules of corporate accounting (today in a handful of barely more than 20 articles[3], previously in 10 articles), allowed until 1991 the board of directors to build up almost unrestrictedly hidden reserves[4], notably by under-evaluating massively (or even not disclosing at all) assets and by leaving unjustified reserves in the balance sheet[5]. This possibility was intensely used for approximately one century and became a noticeable characteristic of Swiss corporate practice[6]. This characteristic was criticized academically with a low intensity for a long time, and started to be efficiently mocked in the decade 1980-1990 by the diversified community of promoters of the agent theory[7] – corporate

[3] New rules, applicable as of 2015, are slightly more detailed (28 articles, numbered from 957 to 963b, replacing articles 662-671a CO); see *infra* ad n. 41.

[4] Article 663 subs. 2 and 3 aCO allowed latent reserves explicitly and without restrictions.

[5] About their practical importance and their extensive use, see for example the « Zurich Commentary » of the Code of Obligations by BÜRGI Wolfhart, *Zürcher Kommentar* ad article 662-663 CO (Zurich, Schulthess, 1957), N 70-89.

[6] As shown by MAZBOURI Malik, *L'émergence de la place financière suisse (1890–1913)*, Lausanne 2005, p. 253 ad n. 792, this practise was established in the end of the 19th century already, independently of tax purposes (see also BAUEN / BERNET / ROUILLER, *La société anonyme suisse*, Zurich, Schulthess 2008, N 341, n. 6).

[7] Leading scholars expressed firm hostility, cf. BÖCKLI Peter, *Schweizer Aktienrecht*, Schulthess, Zurich 2009, § 8, N 887 (with reference to other hostile opinions in n. 1440) and 889 ; DESSEMONTET François, *Le droit des sociétés* in: Europaverträglichkeit des schweizerischen Rechts, Zurich, Schulthess 1990, p. 5 : « *Le droit suisse des sociétés est fondé sur l'adage que la société anonyme a trois ennemis : ses actionnaires, ses employés et le fisc. Tout notre droit vise donc au maintien du* ***secret*** *[…] Il va de soi que l'encouragement législatif des réserves latentes à l'article 663 CO, unique en Europe, ne*

Switzerland was criticized as the "Fortress of the Alps"[8] *inter alia* because (international) investors complained being unable to determine the actual financial situation of Swiss corporations[9]. This strong criticism led the legislator in 1991 (after more than a decade of debates) to restrict to some extent the possibility to build up such reserves[10], creating also an obligation of disclosing them to the auditors[11] and, in some cases and to some extent, of disclosing their dissolution to the shareholders[12] (the

constitue pas seulement une règle comptable. Parce que [le conseil d]'administration de la société maîtrise son trésor, son cash flow et le gros de ses réserves, [il] maîtrise tout. Il est fréquent qu'on affirme que telle société de banque a réalisé un bénéfice net trois fois supérieur à son bénéfice publié. Vraies ou fausses, ces affirmations montrent que le droit suisse a failli à l'une de ses missions essentielles : créer la paix en suscitant la confiance des milieux intéressés » ; p. 11 : « […] la portée des réserves latentes dans l'équilibre des pouvoirs au sein de la société anonyme n'est pas une question technique. Il s'agit au contraire d'une option fondamentale du droit commercial. […] presque partout, cette liberté d'action comporte une obligation de rendre compte envers les actionnaires, dont le patrimoine est ainsi exposé. […] Le seul mandataire qui puisse rendre compte à moitié, c'est le conseil d'administration. Il y a là une inconséquence, explicable pour des motifs historiques, psychologiques, fiscaux, sociaux, mais une inconséquence grave pour le droit suisse, et insupportable en droit communautaire ».

[8] MACH / SCHNYDER / DAVID / LÜPOLD, *Transformations de l'autorégulation et nouvelles régulations publiques en matière de gouvernement d'entreprise en Suisse (1985-2002)*, Swiss Political Science Review 2006, p. 7, quoting DAVID Thomas et al., *Wirtschaft in soziologischer Perspective. Diskurs und empirische Analysen*, Münster, p. 151 sq.

[9] This was observed notably in the Message of the Federal Council of 1983 proposing considerable amendments to the rules on corporations, sociétés anonymes (the most widespread form of company in Switzerland), with relatively brutal words: « *l'admission sans limite des réserves latentes et le manque de principes concrets pour l'établissement du bilan ont conduit à l'anarchie dans l'établissement des comptes, anarchie qui ne permet que difficilement de se faire une idée précise de l'état du patrimoine et des résultats de la société, quand elle ne l'empêche pas* » (Federal Official Gazette [FF] 1983 II 779). ACHLEITNER Ann-Kristin wrote (*The History of Financial Reporting in Switzerland*, in WALTON Peter [ed.], *European Financial Reporting – A History*, Academic Press, London 1995, p. 241): « *International observers often perceive Swiss accounting and reporting to be a mixture between disclosing virtually nothing, hiding profits and creating or dissolving highly mysterious hidden reserves* ».

[10] Article 669 subs. 2 and 3 CO.

[11] Article 669 subs. 4, full disclosure to the auditors.

[12] Article 663b pt. 8 CO: disclosure is due to the shareholders by a mention in the annex to the annual accounts, provided the total amount of dissolved reserves exceeds the amount of newly created latent reserves *and* this difference substantially influences the annual result, letting it appear better than it is in reality; this last condition was decided by the Chambers of Parliament as a result of the debates of 1985-1991 (it was not in the project of the government, FF 1983 II 997).

content of these rules remained essentially unchanged in a comprehensive revision of accounting law in 2011[13]). This being said, latent reserves are much more radically endangered by the international accounting standards (IFRS) that are more and more implemented notably by auditors – and it is known that, following *inter alia* the British legislation of 1946-1947[14], the international standards have adopted more and more categorically the "principle" of "true and fair view"[15] that is considered incompatible with hidden reserves (and in fact with a considerable number of conceivable disclosed reserves)[16]. This tendency – a more and more radical refusal of hidden reserves, presented as incompatible with existing rules – seems constantly reinforced, in spite of a resistance that has again some voice and consistence since the financial crisis that started in 2007-2008[17]. While it is clear that this crisis was not due to an excess of reserves – rather the contrary is true –, it raises questions that allow reviewing deeply the state of questions - and more broadly reopening the debate.

[13] See *infra* ad n. 41 sq.

[14] The principle of « true and fair view » seems however considerably older (1844 – 1856), see CHAMBERS / WOLNIZER, A true and fair view of position and results: the historical background, in Accounting, Business & Financial History, I (1991) p. 197-214.

[15] The standard general approach of Swiss accounting law is not the « *true and fair view* » (although it is of course known – and translated as « *image fidèle* ») but a view that shall be « *as* ***secure*** *as possible* » (« *aperçu aussi sûr que possible* », « *möglichst zuverlässig* » Article 662a subs. 1 CO).

[16] If the probability of a risk is below 50%, the IRFS will not allow a provision (IAS 37 [1998] N° 23 – a provision can be built up so as to affect the profit only if the risk is "more likely than not", i.e. if "the probability that an event will occur is greater than the probability of not present in the future"), see from a Swiss perspective BÖCKLI Peter, *Schweizer Aktienrecht*, Schulthess, Zurich 2009, § 8, N 882 (also N 840 ad n. 1374 and N 842).

[17] In its edition of December 2007, the treaty La société anonyme suisse, of BAUEN/BERNET/ROUILLER was one of the relatively rare voices still presenting in a nuanced way also the positive aspects of hidden reserves.

Section II. The legislator's reflections on hidden reserves (1928-1975)

The arguments praising hidden reserves that can be heard today, often tinted with some nostalgia, are not new ones, but it is true that they sound strikingly modern and far from irrelevant with regard to corporate social responsibility and sustainability approaches.

It is interesting to lay chronologically the justifications that were expressed.

As early as February 1928, i.e. more than 18 months before the start of the financial crisis that led to the Great Depression, the Swiss Government, referring to the fact that crises can always be worse than even cautiously envisaged, proposed to enact a new law of corporations that would explicitly allow the board of directors of corporations to build up hidden reserves[18]. *Large* reserves were presented as an essential instrument of corporate governance, the usefulness and necessity of which had been demonstrated by experience accumulated to face the turmoil of First World War and the after-war troubles around 1920 (this

[18] FF 1928 I 267-268 : « *Le projet part du point de vue qu'une exploitation bien comprise doit avoir la possibilité de se créer d'importantes réserves. Les expériences réalisées durant la guerre et les années d'après-guerre ont démontré combien la réalité peut dépasser les prévisions de crise les mieux étudiées. Aussi notre projet permet-il d'assigner, dans le bilan, à des éléments de l'actif une valeur inférieure à celle qu'ils ont au jour où ce document est dressé, de même que de constituer d'autres réserves latentes, essentiellement pour assurer d'une manière durable la prospérité de l'entreprise. Dans la constitution de ses réserves, la société peut prendre en considération non seulement les risques immédiats, mais encore les perturbations susceptibles de découler de la situation économique ou politique en général, les conditions particulières de concurrence, etc. Le projet autorise l'administration* [i.e. board of directors] *à constituer des réserves latentes s'il paraît utile de le faire pour assurer la répartition d'un dividende aussi constant que possible. Et ceci est dans l'intérêt non seulement des actionnaires, mais de la collectivité en général. Les variations de cours occasionnées par la spéculation ne sont pas des phénomènes heureux. Il est hautement désirable que le développement de l'entreprise soit régulier, et seules les réserves latentes peuvent assurer cette régularité.*
Ces réserves doivent pouvoir être créées par l'administration, si l'on veut qu'elles atteignent leur but. L'assemblée générale a bien le droit d'ordonner de son côté, sous les mêmes conditions, qu'elles soient constituées. Mais elles n'ont plus alors le caractère de « réserves latentes ». Elles ne remplissent plus leur but essentiel qui est de couvrir les pertes sans ébranler le crédit de la société ».

impliedly referred to, notably, the large strikes across Europe including , the Russian revolution and German hyperinflation). It was needed to allow companies to constitute reserves by under-evaluating assets or by constituting other reserves, not only in order to take into account immediate risks, but also to face troubles arising from unexpected general evolutions. The Government mentioned specifically that hidden reserves (i.e. not only reserves) were the most appropriate tool to ensure the payment of a regular dividend, which was not only in the interests of all shareholders, but also of the collectivity in general (since such regularity would avoid strong variations of share prices, that would favor speculative behaviors).

The text proposed by the government in 1928 allowed the board of directors to constitute, without any control, such hidden reserves, provided the aim was to ensure prosperity of the company or the payment of a regular dividend[19]; this was accepted by the parliament (which held the final vote in 1936), but with a duty of the board to inform the auditors regarding hidden reserves[20]. Although some critical voices presented this as a "regression", contemporary writers presented the hidden reserves as "the quiet force" or "the secret force" of the Swiss economy[21] and the rule allowing (or *encouraging*[22]) the board to build them up as "the *pearl* of the new Company Act"[23].

[19] The entire content of Article 664 of the Project of 1928 was: « *Le bilan annuel doit notamment indiquer le rapport qui existe entre l'actif et les engagements de la société. Sont valables l'assignation, dans le bilan, à des éléments de l'actif, d'une valeur inférieure à celle qu'ils ont au jour où ce document est dressé, de même que la constitution d'autres réserves latentes par l'administration, s'il paraît utile de le faire pour assurer d'une manière durable la prospérité de l'entreprise ou la répartition d'un dividende aussi constant que possible* ».

[20] Article 663 subs. 3 aCO : « *L'administration est tenue de renseigner les contrôleurs sur la constitution et l'affectation de réserves latentes* ». See on the parlamentary procedure, BÜRGI Wolfhart, *Zürcher Kommentar ad articles 662-663 CO*, 1957, N 72.

[21] « *Die stille Kraft unserer Volkswirtschaft* » according to the Senator (*Ständerat*) WETTSTEIN, Bulletin of the Swiss « Senate » (Conseil des Etats) 1935 p. 91 (and 1931 pp. 389-399).

[22] See DESSEMONTET, *supra* n. 7.

[23] « Perle des Gesetzes », WIELAND Alfred, Minutes of the Commission of Experts, p. 256 (as enthusiastic in *Das Recht der Generalversammlung auf Überprüfung der von der*

After the Second World War, the Swiss companies appeared to be particularly successful in general. Many of them grew into multinationals. Among them, a large number became leaders in their respective field of activities (food industry, banking, insurances, pharmaceutical, machinery, watches, etc.)[24]. Accordingly, reluctance to make substantial[25] changes in corporate law – deemed to be one of the factors of this success – was considerable. However, the administration and various academic voices, pointing out notably the criticism abroad, advocated for changes. A project of 1975 proposed a general disclosure about constitution and dissolution of hidden reserves. It was however very strongly combatted by the industrial and business associations and finally abandoned. The argument prevailed that hidden reserves had been one of the key instruments enabling Swiss companies to overcome the crisis and in particular to abstain from laying-off employees[26].

Section III. Recognized merits of hidden reserves and nuances (1983-1991)

The message proposing the amendments of 1983 recognized the merits of hidden reserves as a useful and respectable tool for stability and durability of enterprises. Among the arguments, the Government

Verwaltung beschlossenen stillen Reserven nach dem Entwurf zum neuen Gesellschaftsrecht, RSJ/SJZ 1929 p. 53.

[24] See the complete fresco by LÜPOLD Martin, *Der Ausbau der « Festung Schweiz » : Aktienrecht und Corporate Governance in der Schweiz, 1881-1961*, Zurich 2010 ; see also summary (in French) of some data by ROUILLER Nicolas, *La prise du pouvoir dans les sociétés commerciales en Suisse*, Stämpfli, Berne 2012, pt. 2.2.3.3.1.

[25] It is unchallengeable that the ability to build up hidden reserves is a key characteristic of corporative law, as recognized notably by the scholars who criticized it (see DESSEMONTET, *supra* n. 7).

[26] See Message of the Federal Council FF 1983 II 791 : « *[…] la nouvelle réglementation des réserves latentes proposée [en 1975] fit aussi l'objet de sévères critiques. D'une part, on mit l'accent sur l'importance des réserves latentes pour l'autofinancement et la garantie de l'emploi. On avança que beaucoup d'entrepreneurs n'avaient pas dû recourir à des licenciements pour l'unique raison que les réserves constituées au cours des dernières années leur avaient permis de surmonter les difficultés engendrées par le brusque ralentissement de la conjoncture* ».

recognized that the "principle of particular prudence" had given good results[27]; it admitted thus the arguments of the defenders of hidden reserves, who insisted on their importance for the self-financing of the companies[28]. It also referred to other arguments of these "defenders", according to whom, notably, the fact that provisions had to be constituted to cover the numerous, considerable and complex risks to which a company is exposed and that it can be detrimental for it to publicly expose[29]; publishing hidden reserves might weaken the position of the company towards competitors[30]; regularity in dividends distribution, such as hidden reserves allow (by dissolving them in years of lower profits or of losses), avoids excessive speculation[31]; publishing the real profits may have as consequence that shareholders request excessively high dividends[32].

However, contrary to the enthusiastic, non-nuanced promotion of hidden reserves in 1928, the Government pointed out the problems raised by hidden reserves, notably as regards the disadvantages and risks for minority shareholders, but also for the company. To summarize, the minority shareholders (not represented in the board) were unable to know the real value of their shares; this affected their actual entitlement to

[27] FF 1983 II 833 : « *La prudence ainsi conçue est une particularité commerciale qui a donné de bons résultats* ».

[28] FF 1983 II 761 : « *[…] l'admission des réserves latentes, qui encourage fortement l'autofinancement* ».

[29] FF 1983 II 832 : « *la constitution de provisions nécessaires à couvrir les risques nombreux, considérables et complexes auxquels une entreprise est exposée n'a pas à être publiquement justifiée* » (arguments of defenders of hidden reserves).

[30] FF 1983 II 832 : « *la publication du montant des réserves latentes peut, entre autres désavantages, affaiblir la position de l'entreprise face à la concurrence* » (arguments of defenders of hidden reserves).

[31] FF 1983 II 832 : « *l'entreprise doit être en mesure de maintenir un niveau aussi constant que possible des bénéfices apparaissant au bilan, car des fluctuations importantes de ceux-ci peuvent entraîner de fausses spéculations* » (arguments of defenders of hidden reserves)

[32] FF 1983 II 832 : « *la publication du montant des bénéfices peut avoir pour conséquence que les actionnaires exigent la distribution de dividendes trop élevés* » (arguments of defenders of hidden reserves).

dividends as well as their ability to sell their shares[33]. The possibility of the board to dissolve (unlock) – without disclosure – accumulated hidden reserves in order to cover losses of a business year (and letting an annual profit appear instead of the losses actually incurred that year) might conceal the fact that the management of the company was defective, creating the danger that the company (i.e. here: the shareholders) be unable to react in time[34] (e.g. by revoking or not reelecting directors who had become ineffective managers[35]). The Government also mentioned the risk of misuses (significant information being available only to the "insiders" *lato sensu*)[36]. As regards the fundamentals in the structure of the company, the Government also noted the argument that, due to the board's unrestricted ability to build up hidden reserves, there was no balance between the shareholders and the board of directors, who was the real and sole master of the company[37]. As a result, the project of the Government proposed several restrictions as regards the maximal amounts of hidden reserves and an unlimited obligation to disclose the

[33] FF 1983 II 831 : « *le droit des actionnaires d'être renseignés est restreint ; il devient difficile, voire impossible, de juger avec certitude de la situation réelle du patrimoine ainsi que des bénéfices. Une estimation de la valeur réelle des actions devient dès lors aléatoire; l'actionnaire est privé des fondements nécessaires à l'exercice de ses droits, notamment de son droit de vote et de celui de vendre ses actions* » (arguments of the opponents to the hidden reserves).

[34] FF 1983 II 831 : « *Les objections auxquelles donne lieu le principe des réserves latentes portent essentiellement sur leur dissolution, ou plus exactement sur la possibilité ainsi offerte de ne pas mentionner, dans les livres, d'éventuelles pertes consécutives à la mauvaise marche des affaires, voire de transformer ces pertes en bénéfices* » ; and, quoting the arguments of the opponents to the hidden reserves : « *les administrateurs peuvent couvrir les pertes sans devoir en informer l'assemblée générale* ».

[35] Or by organizing an input of new capital before the situation of the company had too much deteriorated for investors to be convinced to put resources in it.

[36] FF 1983 II 831 : « *les réserves latentes accroissent le danger que les informations confidentielles auxquelles ont accès les initiés soient exploitées de manière indésirable* » (arguments of the opponents to the hidden reserves).

[37] FF 1983 II 831 : « *les réserves latentes réduisent à néant le partage des attributions établi par la loi, puisque ce sont pour une large part les administrateurs, et non l'assemblée générale, qui décident du montant des bénéfices à distribuer aux actionnaires; […] la possibilité de constituer et de dissoudre des réserves latentes renforce la position des administrateurs à tel point que ceux-ci deviennent les véritables maîtres de la société* ».

excess of dissolved hidden reserves over newly constituted hidden reserves.

The Parliament restricted considerably less than proposed by the Government the ability to build up hidden reserves; it also limited the disclosure as to dissolutions. The rules finally voted are:

- Article 669:
"*(1) Depreciations (write-downs), valuation adjustments and provisions must be made to the extent that they are required under generally recognised commercial accounting principles. Provisions must in particular be made in order to cover uncertain liabilities and potential losses from pending transactions.*
(2) The board of directors may make additional depreciations, valuation adjustments and provisions for replacement purposes; it may also refrain from cancelling provisions that have become unnecessary.
(3) Hidden reserves that exceed the foregoing are permitted to the extent justified with regard to the continuing prosperity of the company or to enable the payment of the most stable level of dividend possible, taking into account the interests of the shareholders.
(4) The creation and dissolution of replacement reserves and additional hidden reserves must be reported to the auditor in detail"[38].

- Article 663b:
« *The annex to the accounts contain:*
8. the total value of dissolved replacement reserves and additional hidden reserves in the event that this value exceeds the total value of newly created reserves of the same type if this results in a considerably more favourable presentation of the results achieved ».

Looking at these results, it is obvious that the legislator has opted for prioritizing the principle of prudence. There is first an obligation to make provisions to cover uncertain liabilities and potential losses (Article 669

[38] The text is a combination, by the author, of the unofficial translation by the Federal Chancellery and of the translation to be found in BAUEN/BERNET/ROUILLER, p. 557 sq.

subs. 1). *Above these compulsory provisions*, visible depreciations and visible provisions are *allowed* unrestrictedly for replacement purposes. *In addition*, provisions already made that have become unnecessary *may* nevertheless be kept (subs. 2); such provisions are fictitious liabilities – pure pessimism –, which lead the accounts to look worse than they are in reality. *Moreover*, *hidden reserves may* be constituted simply to allow corporate prosperity and stability of the dividend (subs. 3); these two alternative justifications are extremely broad any may justify more or less any constitution of hidden reserves[39].

If hidden reserves are dissolved in excess of newly made hidden reserves, a disclosure is needed only if this excess substantially[40] affects the accounts in a way that makes the annual results more optimistic. It means that the disclosure must happen when the yearly presentation of accounts is less cautious than the previous year.

This shows – considering also that the other rules of accounting only foresee maximum value (and never minimum ones (articles 664-667 CO) – that Swiss accounting law keeps as one of its prioritized characteristics the principle of prudence.

Article 662a subs. 2 CO sets forth:
« Proper accounting specifically requires compliance with the principles of:
1. completeness of the annual accounts;
2. clarity and materiality of information;
3. prudence;
4. continuation of the corporate activities;
5. consistency in presentation and valuation;

[39] Same opinion in MÜLLER Georges, Le droit comptable in « Le nouveau droit de la société anonyme, Cedicac, Lausanne, 1993, p. 98 ad n. 31 (« *c'est dire qu'il est loisible de justifier toute mise en réserve* »).
[40] BÖCKLI Peter, *Schweizer Aktienrecht* (2009), § 8 N 908 ad n. 1468 and N 920 ad n. 1482 – the leader of corporate doctrine who is the most hostile to hidden reserves (cf. supra n. 7) – considers that an influence of 10% or 20% on the profit is « substantial » (« *wesentlich* ») in the sense of Article 663b pt. 8 CO.

6. prohibition of offsetting assets and liabilities and income and expenditure ».

Interestingly, the law allows deviations (if explained) from the three last principles, but, *a contrario*, does not allow any deviation from the three first principles, among which the principle of prudence (Article 662a subs. 3 CO: « *Deviations from the principles of corporate continuity, consistency of presentation and valuation and prohibition of offsetting are permitted in justified cases, which must be set out in the annex* »).

Section IV. The un-debated survival of hidden reserves (2011)

New articles will replace the existing articles of the Code of obligations related to accounting, notably articles 662a, 663b and 669 CO (the new rules are planned to have effect as of the accounts to be closed in 2015 and 2016[41]). Interestingly, the issue of hidden reserves was this time barely uttered and not debated. The message of the Government insists notably on the purpose that the project shall be tax neutral and therefore not modify the regime of hidden reserves[42]. The new articles indeed appear to be identical to these articles[43]. Interesting changes, which will

[41] The rules were voted on 23rd December 2011; the time-limit for referendum elapsed in April 2012; the Federal Council announced on 16th August 2012 (*Rapport explicatif*, p. 4) that the new rules would apply 2 years (3 years for consolidated accounts) after their formal entry into force scheduled for 2013 (transitory rules, Article 2).

[42] Message of the Federal Council FF 2008 p. 1410 : « *le nouveau régime comptable est fiscalement neutre* » ; « *la relation coûts-avantages et des considérations propres à la planification fiscale individuelle portent à la conclusion qu'il faut autoriser la constitution de réserves latentes, dans la mesure où celles-ci ne sont pas arbitraires* » ; p. 1529 : « *[…] dans la perspective de la neutralité fiscale du projet […], il faut tenir compte de la pratique actuelle, qui permet de constituer des réserves latentes et de différer ainsi l'imposition des bénéfices pendant un certain temps* » ; p. 1534 : « *Le droit commercial permet ainsi toujours de constituer des réserves d'évaluation – connues dans le droit suisse comme «réserves latentes» (cf. art. 669 CO dans le droit actuel de la société anonyme)* ».

[43] Article 960a subs. 4 nCO will set forth (in addition to the compulsory depreciations) : « *Des amortissements et corrections de valeur supplémentaires peuvent être opérés à des fins de remplacement et pour assurer la prospérité de l'entreprise à long terme. L'entreprise peut, pour les mêmes motifs, renoncer à dissoudre des amortissements ou des*

be mentioned below, concern the explicitly admitted possibility to build up visible provisions[44].

Section V. Tax law and hidden reserves

Swiss corporate tax law is in general shaped by the principle according to which the commercial annual accounts established in compliance with commercial law are binding for the tax authorities[45]. In particular, *provisions* are recognized (as expenditure) in the same way as in commercial law. However, the tax law sets forth the qualification that provisions shall be justified "by the commercial usages"[46]. As a whole, this regime allows tax authorities to recognize the provisions decided by a company; but the qualification also allows them to challenge provisions that they would consider as excessively cautious, to the extent that they would consider that these provisions are not justified by the commercial usages.

The hidden reserves, not disclosed to tax authorities[47], have the practical effect that a company which has made such reserves does not have to

corrections de valeur qui ne sont plus justifiés », which is very close to Article 669 subs. 2 and 3 CO (the same results from the possibility not to dissolve visible provisions that are not anymore justified, Article 960e subs. 4 nCO). The importance of the principle of prudence is also repeated (Article 960 subs. 2 and 3 nCO). Article 959c pt. 3 nCO (« *le montant global provenant de la dissolution des réserves de remplacement et des réserves latentes supplémentaires dissoutes, dans la mesure où il dépasse le montant global des réserves similaires nouvellement créées, si la présentation du résultat économique s'en trouve sensiblement améliorée* ») is litterally identical to the current article 663b pt. 8 CO.

[44] These rules are quoted *infra* in n. 64-66.

[45] « Principe de déterminance » (Massgeblichkeitsprinzip), cf. for example GLAUSER Pierre-Marie, *IFRS et droit fiscal – Les normes true and fair et le principe de déterminance en droit fiscal suisse actue*l, in: ASA 2006 p. 530 sq. ; REVAZ Marie-Hélève / SCHMID Alessia, *Traitement fiscal des écarts de conversion*, in L'Expert-comptable suisse 2011 p. 537. The expression « principe d'autorité du bilan commercial » is also used (see Message of the Federal Council, FF 2008 p. 1420, 1443 sq., 1533).

[46] Article 59 subs. 1 lit. b of the Act on Direct Federal Tax.

[47] MÜLLER Georges (n. 39), p. 364 ; DESSEMONTET (n. 7, p. 11 : « *En permettant l'établissement de comptes amputés, le législateur permet en fait un report de la charge d'impôt; sous réserve d'un redressement fiscal, celle-ci ne sera jamais acquittée si les*

explain in practice to these authorities that they are "justified by the commercial usages". Only in case of particular inspection would a company possibly have to answer about the justification of a hidden reserve[48].

Section VI. Hostility of modern accounting standards (IFRS) to hidden reserves; constantly increased importance of these standards for Swiss companies

The international standards of accounting (in particular IFRS) do not, as a rule, tolerate hidden reserves[49]. To be listed in a stock exchange in Switzerland, the companies have to apply international recognized standards[50]. According to the regulations for admission of the Swiss stock exchange SIX[51], the IFRS shall be applied, or the US GAAP. For the domestic segment, a company may also apply the "Swiss GAAP FER" (a

réserves latentes viennent à être utilisées. C'est l'un des avantages essentiels du système »).

[48] See for example DESSEMONTET quoted supra n. 47.

[49] See, from a Swiss perspective, BÖCKLI Peter, *Schweizer Aktienrecht*, Schulthess, Zurich 2009, § 8, N 892, 901 and 935 (for the new articles 958 nCO) ; see also, from an international perspective, the concisely expressed view of YOUNG (supra n. 2), "*Provisions and hidden reserves. […] The standards clearly state that provisions cannot be recognised unless there is a legal or constructive obligation to transfer economic benefits to others in the future (for example, redundancy payments to former employees). The practice of taking provisions because something bad might happen is no longer permitted. The continued use of conservatism, or prudence, in financial reporting provides some modest ability to create hidden reserves, but it will clearly be much harder to do this in the future. For this reason alone, we should expect to see more volatile earnings […]*".

[50] Article 8 (subs. 3) of the Act on Securities sets forth that « […] *un règlement fixant les conditions d'admission des valeurs mobilières au négoce […] comprend des prescriptions sur la négociabilité des valeurs mobilières et les informations à fournir aux investisseurs pour leur permettre d'apprécier les caractéristiques des valeurs mobilières et la qualité de l'émetteur. Il prend en compte les standards internationaux reconnus* ».

[51] Article 6 of the Directive Financial Reporting of the SIX : « *(1) Where no alternative accounting standard is permitted below, issuers must apply IFRS.*
(2) US GAAP may be applied additionally in the following regulatory standards: Main Standard; Domestic Standard; Standard for Investment Companies.
(3) Swiss GAAP FER may be applied additionally in the following regulatory standards: Domestic Standard; Standard for Real Estate Companies ».

privately proposed standard, in force as of 2007, simplifying IFRS but still applying the "true and fair view" approach[52]); these regulation do not recognize hidden reserves (even if the Swiss GAAP FER give more weight to the principle of prudence than the US GAAP and allow thus the company to choose the less optimistic valuations[53]). The law applicable as of 2015 still allows hidden reserves in general, and does not itself require that large companies[54] apply "recognized standards" (that do not allow such reserves): if a listed company is listed in a stock exchange that does not require such standard, Swiss corporate law do not impose it[55]. However, the law entitles shareholders holding together 20% or more of the capital to request that the company apply a "recognized accounting standard"[56] – and thus normally renounce to hidden reserves.

Section VII. Prospective: prudence and visible reserves as the instrument for a honestly "true and fair view"

Swiss companies have loved hidden reserves for more than a century. In 1936, the Swiss legislator has encouraged this passion; it has benevolently tolerated it in its choice of 1991, repeated in 2011. Judging by economical results, this passion has clearly not been detrimental in general. It cannot be excluded that, as affirmed in 1936, this was the

[52] BÖCKLI Peter, *Schweizer Aktienrecht*, Schulthess, Zurich 2009, § 8, N 936.

[53] MEYER Conrad/TEITLER Evelyn, *Les Swiss GAAP RPC trouvent leur voie* in L'Expert-comptable suisse 12/2004, p. 7 : « *Une dotation aux ou une dissolution arbitraire des réserves latentes n'est pas tolérée. Cependant, 'choisir la variante la moins optimiste dans les cas d'incertitude ayant la même probabilité d'occurrence' correspond au principe de prudence. Cette affirmation présente un principe de prudence plus concret que les dispositions de l'IASB (F. 37 ou IAS 1.20). Les US GAAP ont laissé dépérir le principe de prudence lors de sa mise en pratique* ».

[54] That is to say: companies subject to complete (ordinary) audit. The ordinary audit is required by Article 727 subs. 1 pt. 2 CO (in force as of 1.1.2012) if a company does not reach two of the following thresholds (for at least 2 business years): total of assets of CHF 20 million; turnover of CHF 40 million; 250 (full time) employees, or if it must present consolidated accounts (the same thresholds apply, see Article 963 nCO).

[55] Article 962 subs. 1 pt. 1 nCO.

[56] Article 962 subs. 2 pt. 1 nCO. The choice among the recognized standards is made by the board of directors.

major force of Swiss companies (respectively the "pearl of the legislation"[57]) or, as defended in legislative debates from 1975 to 1991, a key factor of their ability to overcome crises and to act with (long-term) responsibility towards stakeholders (notably employees, but also creditors in general and long-term investors). And clearly, except where hidden reserves were used to conceal criminal actions[58], it was not an egoistic passion (or at least not a short-term egoism) of the directors: it was not used to obtain better personal remunerations or high bonuses based on an apparently high annual profit, since – exactly to the contrary – the effect was to under-evaluate the assets, over-evaluate the liabilities and thus decrease the apparent profit. However, with international accounting standards firmly hostile to hidden reserves and applying to a constantly increased number of Swiss companies – that cannot live their passion in splendid isolation –, it must obviously be contemplated that the practice of hidden reserves will continue to decrease.

As said in the preamble, nostalgia is a widespread reaction among Swiss entrepreneurs, managers and accountants; but it is probably not the only possible one. A prospective approach may take place, benefiting from the experience of the passion and its economic success. Considering the economic success together with the criticism, one can observe that the fact of building up reserves had not been *per se* the target of the argumentative gravity point in criticism. What was the core of legitimate criticism was the inability of shareholders – at least minority shareholders, not represented in the board – to determine how the board of directors actually managed the company; regarding the individual interests of the minority shareholders, this inability to know made it difficult to claim for an appropriate dividend distribution and, potentially, to sell their shares; and on the collective interest of all shareholders and of the company itself, the strongest argument consisted in pointing out

[57] *Supra* n. 23.

[58] E.g.: not disclosing an asset and transferring it to the majority shareholder (see DESSEMONTET, supra n. 7, p. 11-12 : « *par exemple, un bien non inscrit au bilan sera réalisé, et le produit de sa liquidation sera versé à l'actionnaire principal* », as in the case judged by the *Appelationsgericht* of Basel on 26.4.1963, BJM 1963 p. 163).

the danger resulting from the ability of directors to conceal – by dissolving hidden reserves – that the company had started to be currently poorly managed; this impossibility to notice poor management as long as hidden reserves were being dissolved, and thus to take timely measures to correct the poor management, was the largest danger resulting from the practice of hidden reserves (it was however quite reasonably cured by the obligation of disclosing important dissolutions[59]). Clearly, this criticism was linked with the fact that these reserves or provisions were *hidden*, and not by the fact that, as such, reserves had been constituted. The criticism against the fact that *reserves* or provisions are built up can be directed at an allegedly insufficient level of dividends – or at an allegedly insufficient level of distributions of resources or of use thereof (in salaries, bonuses, ventures). Tax authorities can also criticize reserves and provisions, since these reduce the taxable profit. But this criticism can only be addressed *at the short-term level* of dividends, of other distributions or of taxation; reserves and provisions mean only that dividends or taxes on profit are *postponed* to the extent of these reserves and provisions, until these are dissolved.

Accordingly, the interests that plead against reserves and provisions are only the interest for short-term dividends (or other distributions) or short-term taxation.

Intellectually, these interests are defended by the conceptual instrument of the "true and fair view", according to which "excessive" reserves and provisions are not justified since they would present the situation of the company in a way that does not correspond to "reality".

It is recognized that the so-called "true and fair view", hostile to reserves able to be dissolved, induces a considerably higher volatility for the company profit[60]: one or some profitable business year(s) – with considerable dividends distribution, considerable bonuses, considerable taxation – can be followed by a year of considerable losses. It is hard to

[59] Article 663b pt. 8 CO (and 959c pt. 3 nCO).
[60] See e.g. YOUNG, quoted supra in n. 49 *in fine*.

see a considerable advantage to this volatility as compared to a more stable evolution of a company's affairs: even shareholders (be they institutional investors or private holders) have in general some advantage to receiving stable rather than volatile dividends (especially pension funds, for example, that must plan their payments); the State, which has a budget, also has some advantage in having stable (more or less predictable) rather than volatile taxable substance. Except for some professionals of the finance industry, it is finally very hard to find any practical advantages to volatility. Volatility of companies' annual results (identified as a source for speculation, or for bankruptcy) is exactly what reserves "in the Swiss tradition" aimed to avoid[61] and, in general, were actually able to substantially avoid.

The question may therefore be whether, in addition to short-term interests, the satisfaction of having accounts presented in a "true and fair view" – a presentation that corresponds to "reality" justifies what should reasonably be understood as the disadvantages of volatility.

And here comes the more fundamental question, i.e. whether accounting standards like IFRS really provide the readers of yearly accounts with a "true and fair view" of the company's situation – so as to show "the reality".

Considered fundamentally, yearly (or quarterly) accounts have necessarily something artificial: they indicate a fixed value of assets and liabilities of a company on a fixed date, whereas this company continues its activities (in fact: *has continued* its activities when accounts are ready) and is thus exposed to constantly modified realities and risks (often partially perceived or not perceived at all). The only fully "true" accounts are the accounts at the moment of forming the company, and the closing accounts when the company has been entirely liquidated. *All* yearly or intermediary accounts in-between are approximate; they are mere attempts to give information about a reality that constantly varies and is

[61] Supra ad n. 18 ss.

essentially affected by factors of risk that cannot be precisely translated into fixed figures.

Determining the "true and fair value" of assets is unavoidably, to some extent, illusory; as long as an asset has not been sold, referring to its "market value" is not much more scientific than an act of faith[62]. However long the IFRS and IAS are and will become (i.e. how many thousands of pages they contain), the evaluations resulting thereof will *never* be scientific. For this only reason, the concept of "true and fair view" is probably a pretentious illusion. And this illusion may well have been a true disease of the management practices in the last two decades, leading to inappropriate approaches about the intensity of uncertainty and thus about the amounts of profit or resources able to be distributed (in dividends, bonuses, or new risks) – or taxed.

Without having necessarily to share to opinion expresses in the two paragraphs above, if one considers the reality as it is, the only scientific view is to accept that one cannot evaluate with certainty the assets: being aware (knowing) that one cannot know. Therefore, the most scientific approach is probably the one that results from the principle of prudence: it consists in accepting that uncertainty exists and is hard to ponder. Extreme events do have some likeliness and the limit when a prudent evaluation is not "true and fair" is, at least, to be considered as not easy to

[62] Using thus the "fair value" to evaluate one's own debt is expanding illusions: a worsened credit profile leads the debts of the debtor be valued at a lower level (which is indeed the "market price" or "fair value"). But the true reality is that a debt has always, for the debtor, the same amount. Allegedly applied "fair value" leads simply to an unfair and untrue view. This recent practices of the Barclays Bank PLC (in the UK) or of UBS AG (in Switzerland) have been criticized, although they clearly comply with IFRS (see opinion of the British governance institute PIRC [www.pirc.co.uk] : "*Taking account of this, and £2.7bn own credit gain, another discredited IFRS quirk, Barclays true profit for 2011 is only £2,914m rather not the £5,879m IFRS number, nor the group's own "adjusted" number of £5,590m […] We believe the IFRS model is fundamentally flawed, and Barclays' reporting provides a clear demonstration of why. Even now fundamental performance calculations are being carried out on the basis of misleading numbers, and bonuses are being paid out based on distorted profits […]*"; for UBS AG, see Q2-2012 report of 31.7.2012, p. 13 sq. and 44 (« *The second quarter included an own credit gain on financial liabilities designated at fair value of CHF 239 million* »).

reach. As a rule, a prudent evaluation is "true and fair", and it is hard to legitimately criticize an evaluation for being allegedly "excessively prudent".

Recent realities demonstrate that it would be very hard to legitimately criticize a board of directors that makes a provision of 30% for risk that real estate or 10-year government bonds would depreciate; one could also accept other percentages of provision or the absence of provision, but criticizing a prudent evaluation has in our opinion become clearly illegitimate, or irresponsible.

The same exists about creating provisions for conditional obligations (continent liabilities), like those arising out of guarantees. Mentioning them in the annex to annual accounts – as generally required[63] – is not always sufficient, since the accounts themselves are the basis for distributions. If a board of directors considers as prudent to create a provision in the amount of the income resulting of the transaction by which the company entered the contingent liability, it is impossible to criticize it (it just avoids the net income appear from potentially onerous operations); in our opinion, the board can neither be challenged if it creates a provision of the amount conditionally due pondered by the probability assessed by the board; and it is also admissible in our opinion to provision the entire amount of the conditional obligation, even if the probability is "deemed" as low. There is no really scientific way of evaluating such probabilities, neither the proper level of prudence (i.e. provisioning the entire amount conditionally due, or a proportion thereof). Nobody has the legitimacy to criticize a prudent, responsible, long-term oriented behavior of the board of directors in this regard.

As always, misuses shall not be allowed. If the continuing constitution of provisions leads to an absence of any profitability for a company that is able, over several years, to pay market-conform salaries, the legitimate

[63] In today's Swiss legislation, Article 663b pt. 1 CO (guarantees and assets pledged for third parties' debts ; debts arising certainly in future – like leasing – shall also be mentioned ; pt. 3 and 5) ; this remains substantially unchanged with the new legislation applicable as of 2015 (Article 959c subs. 2 pt. 8 nCO).

interests of the shareholders to receive some return (some dividends) out of their investment are probably not appropriately taken into consideration. But in the cases where considerable provisions are built up and the company regularly pays a dividend of e.g. 3 to 7% over inflation, it is very hard to criticize the board of directors for its decision of constituting provisions. If a majority of shareholders is unsatisfied with the policy of prudence, it may elect a new board of directors that will be "audacious" enough to dissolve provisions and pay out much higher dividends – at least in the short-run. Therefore, except in cases of misuses aimed to be detrimental to or to exclude minority shareholders (e.g. when the majority shareholder derives other advantages from the company, in form of high salaries or other lucrative contracts), building up considerable – visible – provisions out of prudent evaluations shall be considered as legal.

In our opinion, this is clearly allowed in Swiss law: in the current legislation as well as in the legislation applicable as of 2015, which includes explicitly two rules related to "visible" provisions, for uncertain debts (necessary provisions)[64] and for probable future expenses (optional provisions)[65], including (for the latter) "measures to ensure the long term prosperity of the enterprise"[66]. What may be delicate will be the practical implementation. Indeed, as long as the board of directors was building essentially hidden reserves – however large they might be –, this remained comfortable for the board of directors in the sense that it did not have to justify the principle of their constitution nor their size, neither to the shareholders[67], nor to the tax authorities[68], since none of them were

[64] Article 969e subs. 2 nCO: « *Lorsque, en raison d'événements passés, il faut s'attendre à une perte d'avantages économiques pour l'entreprise lors d'exercices futurs, il y a lieu de constituer des provisions à charge du compte de résultat, à hauteur du montant vraisemblablement nécessaire* ».

[65] Article 960e subs. 3 nCO : « *En outre, des provisions peuvent être constituées notamment aux titres suivants: 1. charges régulières découlant des obligations de garantie; 2. remise en état des immobilisations corporelles; 3. restructurations; 4. mesures prises pour assurer la prospérité de l'entreprise à long terme* ».

[66] See *supra* n. 65, quoting Article 960e subs. 3, pt. 4 nCO.

[67] They have to be communicated to the auditors, but these do not have to answer questions to shareholders, as long as the law is respected, see for example BÜRGI Wolfhart

able to know them. If the constitution of reserves evolves into a practice in which the reserves are essentially disclosed, the board of directors will obviously have the supplementary task of justifying its choices in favor of cautiousness and prudence. This will require from the board some ability to resist the short-term appetites of shareholders and of tax authorities.

The legal system gives to the shareholders who, in majority, have an appetite incompatible with the prudence of the board of directors the capacity to change that board, so that there is no need for any legal sanction or legal way to correct "excessively prudent" provisions; these will be dissolved by the newly elected board that is ready to obey the appetites or impatience of the shareholders for distributions. The legal system also allows the tax authorities to challenge "excessively prudent" provisions, which are "commercially not justified"[69]; in our opinion, this shall – with extremely few exceptions where the board would be unable to give any reasonable justification – nearly never be the case: the tax authorities shall, as a rule, not be allowed to challenge provisions resulting from the implementation of the principle of prudence. No taxation interests justify that, for example, a provision of 30% or 100% of the amount of a conditional obligation be not accepted if the board gives reasons explaining why it considers that this cautious appraisal shall prevail. Here also, the legal system shall protect the prudent choices of the board of directors; the short-term appetite of tax authorities to see a larger – taxable – profit shall also be refrained. Such appetite represents

(n. 5), N 73, 78, 85-89; BÖCKLI Peter, *Schweizer Aktienrecht* (2009), § 12 N 157 ad n. 462.

[68] See, for the tax authorities, for example MÜLLER Georges (n. 39), p. 364 (« *les autorités fiscales n'auront pas accès [au tableau des réserves latentes constituées et dissoutes] et n'auront pas le droit de le demander* »).

[69] See for example Article 59 subs. 1 lit. b, 2nd hypothesis, of the Act on Federal Direct Tax (« *Le bénéfice net imposable comprend: a. le solde du compte de résultats […] ; b. tous les prélèvements opérés sur le résultat commercial avant le calcul du solde du compte de résultat, qui ne servent pas à couvrir des dépenses justifiées par l'usage commercial, tels que: […] – les amortissements et les provisions qui ne sont pas justifiés par l'usage commercial* »).

only unjustified impatience, since constituted provisions do only postpone – and not suppress[70] – taxable profit and taxation.

Section VIII. The "courageous prudence" as an efficient practical instrument of corporate social responsibility

The hidden reserves, practiced with passion by Swiss companies for more than a century, were motivated mainly by objectives that appear today to be fully in line with contemporary conceptions shaped by Corporate Social Responsibility thinking. The board of directors was essentially prudent and even pessimistic in presenting the accounts, so as to ensure an increased stability when the company had to face troubled times: in practical terms, the often very substantial hidden resources allowed to reduce volatility in results (and in dividends) and, at least in limited downturns, allowed the management to renounce practicing brutal disinvestments or lay-off of employees; the very prudent, systematically pessimistic way of presenting accounts protected also creditors' interests. In general, it gave rather good results, from the point of view of long-term entrepreneurial successes of companies. Also, this did not lead to significant misuses in terms of remuneration of top-managers: pessimistic presentations of annual results do not justify claims for excessive bonuses. It was not a perfect system: the hidden character of such reserves, quite typical for the Swiss cult of secret and confidentiality in business, does not comply with modern ideas on transparency.

[70] From the point of view of tax authorities, one can understand that a particular attention is exercised when a company leaves their jurisdiction; the rule is that hidden reserves are taxed at that moment (as in a liquidation; see e.g. Article 80 subs. 2 of the Act on Federal Direct Tax). Even if one understands that tax authorities can feel necessary, from a taxation point of view, to dissolve the visible provisions, we think that they cannot go beyond exercising a particular attention as to whether there is a misuse and the absence of justification for provisions made in compliance with the principle of prudence; what can legitimately be done is a postponement of tax decisions as to whether provisions made to cover conditional liabilities appear justified, until the expiry of the exposure (accordingly, the company has to consider that the provision for a continent liability includes a – smaller – alternative provision as to the tax burden resulting for the potential dissolution of this provision).

It is probably possible today to reach the same results as hidden reserves led to, if the boards of directors decide to build up *visible* (disclosed) provisions, what they should be allowed to do, for example, for contingent liabilities even of a low probability and for probable future expenses. Swiss accounting law permits such provisions as a principle. To the extent that "modern" accounting standards like IFRS and their followers do not allow such provisions, they are detrimental and dangerous, and should be rejected whenever possible; principles other than the principle of prudence, like the religion of an allegedly "true and fair view", are finally not scientific; they are largely illusory. Of course, building up visible provisions requires from the board – in contrast to hidden reserves – the courage[71] to defend them towards impatient shareholders and tax authorities with their respective short-term appetites for high dividends and revenue. Prudence requires courage. This courageous prudence is a very practical and efficient instrument for companies that wish to implement the idea of Corporate Social Responsibility.

[71] BÖCKLI Peter, *Schweizer Aktienrecht* (2009), § 8 N 924, rightly points out that courage is needed when the board does not have *hidden* reserves at its disposal.