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GAAP: In depth

Need to know
ICAEW and ICAS publish exposure draft of updated guidance on realised and distributable profits under the Companies Act 2006

In a Nutshell

- Only 'realised profits' can be paid out as a dividend. Determining what is a realised profit can be tricky especially in an intragroup scenario and when using fair value accounting rules.
- To assist companies, the ICAEW and ICAS have jointly issued TECH 05/16 BL an exposure draft of revised guidance to assist companies in determining whether profits made are realised and can be paid out as dividends.
- The guidance will, when finalised, replace TECH 02/10 which requires updating following changes to IFRSs and UK GAAP and to reflect new issues that have arisen in practice.
- Substantive changes have been made to the guidance on accounting for intragroup off-market loans and on retirement benefit schemes. Other changes are in the nature of updating references to the revised standards and removing obsolete material.
- Investors are demanding greater disclosure around distributable reserves. Whilst not proposing changes to disclosure, the guidance will assist companies to meet investor expectations in this respect. It will also help to avoid the potentially serious consequences for companies and their directors of making an unlawful distribution.

For more information please see the following websites:

www.ukaccountingplus.co.uk

www.deloitte.co.uk

Background

Determining how much profit a company has available for paying dividends can be a challenge. TECH 02/10 *Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006* (TECH 02/10) was issued jointly by the Institute of Chartered Accountants in England and Wales (ICAEW) and the Institute of Chartered Accountants of Scotland (ICAS) ('the Institutes') in October 2010 to help companies with this issue. The Technical Release provides guidance on realised and distributable profits under the Companies Act 2006 ('the Act') and its purpose is to identify, interpret and apply the principles relating to the determination of realised profits and losses for the purposes of making distributions under the Act.

Following changes to International Financial Reporting Standards (IFRSs) and UK Accounting Standards (notably the introduction of Financial Reporting Standard (FRS) 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland)* and the need to provide additional guidance on a number of areas that have arisen in practice, the Institutes have issued for comment an exposure draft of updated guidance (TECH 05/16 BL). Some of the changes are in the nature of updating references to the revised standards and removing obsolete material whilst other changes, discussed below, are more substantive. Comments on the proposals are requested by 9 June 2016.

Observation

The core of the guidance in TECH 02/10 has stood the test of time but some of the material and references have become dated so this updating is welcome. The opportunity has also been taken to provide new guidance about intragroup loans on off-market terms which has become a topical issue arising from the adoption of FRS 102.

Why is the guidance important?

Under the law, to make a distribution, a company needs sufficient 'realised profits' as shown in its 'relevant accounts'. There is a number of areas including applying fair value accounting rules and transactions between group entities where determining whether a profit is realised can be tricky. TECH 02/10 provides a framework for determining whether a profit is realised and hence can be distributed. Making a distribution in the absence of realised profits may result in an unlawful distribution and potentially serious consequences for company directors and shareholders.

Need to know – FRC's Financial Reporting Lab issues report on disclosure of dividend policy and practice

Companies intending to make a distribution have always been required to determine the sufficiency of their distributable profits prior to making a distribution. However, investors are now demanding greater disclosure around distributable reserves. Companies should ensure that they fully understand the nature of their reserves and, in particular, those that are non-distributable. This will help them to meet investor expectations based upon any voluntary disclosure they may make in the accounts. TECH 05/16 BL does not propose any changes to disclosure but draws attention to the recent Financial Reporting Lab report *Disclosure of dividends – policy and practice* on the subject. For more information on the Lab report see Deloitte's *Need to know* publication.

What key changes are proposed in the exposure draft?

In addition to updating references to standards and removing any material that is now obsolete, the following key changes are being proposed by the Institutes:

Guidance on accounting for intragroup off-market loans

Additional guidance has been inserted regarding the distributable profits implications of loans made between group companies at below market rate. Examples are provided of an interest-free loan made from a parent to its subsidiary, an interest-free loan made from a subsidiary to a parent and an interest-free loan made from a subsidiary to a fellow subsidiary.

Under old UK GAAP (other than for the small number of companies that applied FRS 26 *Financial Instruments: Recognition and Measurement)* such loans usually will have been recognised based on the consideration paid or received. In contrast, under IFRSs and FRS 102 such loans must be accounted for initially at the present value of the future cash flows discounted at a market rate of interest unless they are repayable on demand. The accounting under IFRSs and FRS 102 therefore raises questions as to how to account for the difference between the value of the loan and fair value on initial recognition. Additionally, there are questions as to the distributable profits implications of the interest paid or received on the loan. The draft guidance provides answers to these questions, which are summarised in the following table:

Loan from parent to subsidiary at below market rate

	Parent	Subsidiary
Initial accounting	Dr: Cost of investment Dr: Debtor (present value) Cr: Cash	Dr: Cash Cr: Creditor (present value) Cr: Capital contribution
Is the capital contribution realised?	N/A	The credit to equity in the subsidiary accounts for the capital contribution received is neither an accounting profit nor a profit in law. It is therefore not a realised profit.
Interest income and interest expense treatment	The making of the loan by the parent and the capital contribution provided to its subsidiary are not considered linked transactions and the interest receivable by the parent is an accounting profit. As a result, the interest receivable by the parent is a realised profit. Note that this conclusion assumes that the loan has been entered into for genuine business purposes rather than with the specific intention of creating distributable reserves.	The interest expense recognised by the subsidiary is an accounting charge but not a legal loss. This expense does not therefore reduce distributable profits and it is available to offset the credit in equity for the capital contribution received.

Loan from subsidiary to parent at below market rate

	Parent	Subsidiary
Initial accounting	Dr: Cash Cr: Creditor (present value) Cr: Distribution received	Dr: Distribution Dr: Debtor (present value) Cr: Cash
Is the distribution a distribution as a matter of law?	N/A	Yes (see below)
Is the distribution received realised?	Yes	N/A
Interest income and interest expense treatment	The making of the loan and the distribution by the subsidiary are not considered linked transactions. The interest payable is a realised loss.	The making of the loan and the distribution by the subsidiary are not considered linked transactions. The interest received is a realised profit.

Loan from subsidiary 1 to subsidiary 2 at below market rate

	Subsidiary 1	Subsidiary 2
Initial accounting	Dr: Distribution Dr: Debtor (present value) Cr: Cash	Dr: Cash Cr: Creditor (present value) Cr: Capital contribution
Parent required to record entries?	No – it is not a party to the transaction	No – it is not a party to the transaction

No new issues arise from a distributable profits perspective in this scenario; all considerations are covered by the two examples above.

Definition of a distribution for Part 23 of the 2006 Act

Additional guidance has been inserted concerning the definition of a distribution. The guidance now highlights that, irrespective of what 'label' is put on a transaction, it is the purpose and substance of the transaction that matters in determining whether a distribution has been made. So where, for instance, a subsidiary knowingly transfers an asset at undervalue to its parent, the guidance makes it clear that this will be a distribution regardless of how it is described.

This is relevant to intragroup loans on off-market terms (see above). The draft guidance explains that in the case of a loan from a subsidiary to a parent, the transaction is not just accounted for as a distribution but is also a distribution as a matter of law because it is at undervalue.

Observation

This is something that may have been overlooked in the past because a distribution was not recognised for accounting purposes. However, the implication of this guidance is that a subsidiary cannot lawfully make a loan to its parent unless the amount of any distribution element is covered by distributable reserves.

Clarity has also been provided that a distribution can arise from the assumption of a liability if the company does not receive consideration of the same amount.

Guidance on retirement benefit schemes

The guidance on retirement benefit schemes has been rewritten in the context of IAS 19 *Employee Benefits* but is equally applicable to Section 28 of FRS 102. The previous material in TECH 02/10 was mainly concerned with transition from the old UK standard, SSAP 24 *Accounting for pension costs* to FRS 17 *Retirement Benefits* (issued in 2000) and therefore required updating. The underlying principles are unchanged but the opportunity has been taken to explain them more clearly and concisely.

Accounting for retirement benefits will virtually always result in a cumulative net loss within reserves and that loss will be a realised loss. No adjustment is therefore required in arriving at distributable profits. In rare cases, there may be a cumulative net credit in reserves (e.g. if there is a pension scheme asset which exceeds contributions paid to the scheme) and this will require further analysis in accordance with the guidance.

Observation

Under Section 28 of FRS 102 and under IAS 19, entities under common control that participate in a group plan can no longer claim exemption from defined benefit accounting in their individual financial statements. In the absence of a policy for allocation of the net defined benefit cost, the entity that is "legally responsible" will record the defined benefit liability. Companies moving from FRS 17 to IAS 19 or to Section 28 of FRS 102 may therefore see a change of accounting treatment, particularly when they were accounting for their participation in group defined benefit schemes as if they were defined contribution schemes. This may affect distributable reserves.

Guidance on deferred tax

The guidance on deferred tax has been reorganised. It has been clarified that, unless it is the reversal of a realised loss, a deferred tax credit which results in the recognition of a deferred tax asset will generally be an unrealised profit because a deferred tax asset does not usually meet the definition of qualifying consideration.

Application to long-term insurance business as a result of Solvency II

New paragraphs have been added to draw attention to the very considerable doubt concerning the operation of the special rule in s843 of the Act for long-term insurance business, in relation to accounts for years ending on or after 1 January 2016, as a result of Solvency II. The Institutes understand that the Government is actively considering changing the law to address this issue.

When are the changes applicable from?

The draft guidance deals with some issues about the interpretation of the law. Those aspects should be regarded as having immediate effect because they are based on the advice of Counsel. For example, this applies to the guidance on the definition of a distribution and its application to intragroup off-market loans (see above). Other aspects of the guidance may be amended in the light of comments received.

Observation

The question of whether the imputed interest receivable is a realised profit is a matter of generally accepted accounting practice rather than a matter of law. It is therefore a matter on which comments are invited. However, the views set out in the draft guidance appear to be widely supported.

Apart from the key changes discussed above and updated references to reflect FRS 102 and IFRSs, the remaining guidance in the updated draft Technical Release is consistent with that in TECH 02/10.

Further information

The exposure draft can be accessed on the ICAEW website **here**. The FRC Lab report *Disclosure of dividends – policy and practice*, is available on the FRC website **here**. Our *Need to know* publication on the Lab report is available on UK Accounting Plus **here**.

Information on other UK accounting, reporting and corporate governance news and publications, can be found at www.ukaccountingplus.co.uk.

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