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ICAEW and ICAS publish updated guidance on realised and distributable profits under the Companies Act 2006

Contents

In a nutshell

- The ICAEW and ICAS have jointly issued TECH 02/17 to assist companies in determining whether profits made are realised and can be paid out as dividends.
- The guidance, which is equally applicable to companies applying IFRSS and UK GAAP, replaces TECH 02/10 which required significant updating following changes to IFRSs and UK GAAP and to reflect new issues that have arisen in practice. It takes effect immediately.
- New guidance on accounting for intragroup off-market loans has been added and the guidance on retirement benefit schemes has been rewritten. Clarity has also been provided on the application to long-term insurance businesses as a result of Solvency II.
- Investors are demanding greater disclosure around distributable reserves. While not changing the earlier guidance that disclosure is not required by law, TECH 02/17 refers to the report issued by the FRC's Financial Reporting Lab on this topic and notes that listed companies may wish to consider how to address the calls for greater transparency from the investor community.

For more information please see the following websites:

www.ukaccountingplus.co.uk

www.deloitte.co.uk

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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.

As a result of 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 published an exposure draft, in March 2016, of updated guidance on realised and distributable profits under the Companies Act 2006 ('the Act'). Following a period of consultation, the updated guidance in the form of TECH 02/17, has been published. 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.

In addition to updating references to the revised standards, removing obsolete material that had become outdated in TECH 02/10 and providing further clarity in certain areas, the updated guidance also contains a number of substantive changes to the requirements of TECH 02/10 which are discussed below.

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 02/17 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.

Companies intending to make a distribution have long been required to determine the sufficiency of their distributable profits prior to making a distribution. However, some investors are now calling for greater transparency 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 meet investor expectations based upon any voluntary disclosure they may make in the accounts.

TECH 02/17 carries forward the guidance from TECH 02/10 that disclosure of distributable reserves is not required by law. It also notes that, based on legal advice, the Institutes consider that this is a correct statement of the law. It does, however, draw attention to the November 2015 Financial Reporting Lab report *Disclosure of dividends – policy and practice* and the follow up publication in December 2016. Both of these highlight growing investor calls for greater transparency about distributable reserves. For more information on the Lab report see Deloitte's *Need to know* publication. TECH 02/17 notes that listed companies may wish to consider how to address the calls for greater transparency from the investor community.

What are the key changes from the guidance in TECH 02/10?

Guidance on accounting for intragroup loans on off-market terms

Additional guidance has been inserted regarding the distributable profits implications of loans made between group companies at below market rate. As a result of feedback during the consultation period, the material in the exposure draft was re-written although the overall conclusions reached, discussed below, remain the same.

Although the guidance is written in terms of intragroup loans, it is also relevant to loans made to or from shareholders (who may also be directors) in their capacity as shareholders. The guidance on intragroup loans on off-market terms is not applicable to FRS 105 reporters as FRS 105 does not require the FRS 102 accounting treatment for loans. However where an FRS 105 reporter makes such a loan to its parent or shareholder, there may still be a distribution as a matter of law if the transaction is at an undervalue and meets the definition of a distribution (see below).

TECH 02/17 provides examples 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 will have usually 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 guidance provides answers to these questions, which are summarised in the following table:

Loan from parent to subsidiary at below market rate that is not repayable on demand

	Parent	Subsidiary
Initial accounting	Cr Cash Dr: Debtor (present value) Dr: Cost of investment (remaining amount)	Dr: Cash Cr: Creditor (present value) Cr: Capital Contribution (remaining amount)
Is the capital contribution realised?	N/A	The credit to equity in the subsidiary's accounts for the capital contribution received is neither an accounting profit nor a profit in law because its legal form is a loan. 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. However directors should have regard to their fiduciary duties when considering whether it would be prudent to distribute such a profit. This conclusion assumes that the loan receivable meets the definition of qualifying consideration. For example, this will not be the case where the loan is expected to be rolled over at maturity.	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 that is not repayable on demand

	Parent	Subsidiary
Initial accounting	Dr: Cash Cr: Creditor (present value) Cr: Distribution received (remaining amount)	Cr: Cash Dr: Debtor (present value) Dr: Distribution (remaining amount)
Is the distribution a distribution as a matter of law?	N/A	Yes (see below).
Is the distribution received realised?	Yes. However directors should have regard to their fiduciary duties when considering whether it would be prudent to distribute such a profit.	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 provided that the receivable meets the definition of qualifying consideration.

Loan from subsidiary 1 to subsidiary 2 at below market rate

	Subsidiary 1	Subsidiary 2
Initial accounting	Cr: Cash Dr: Debtor (present value) Dr: Distribution (remaining amount)	Dr: Cash Cr: Creditor (present value) Cr: Capital contribution (remaining amount)
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.

Guidance on accounting for loans at above market rate and loans repayable on demand
Following feedback on the exposure draft, additional material has been added to explain the distributable profits implications for loans at above market rate and loans repayable on demand, which are summarised briefly in the table below:

Type of arrangement	TECH 02/17 guidance
Loan at above market rate	When a subsidiary agrees to pay an above market-rate of interest to its parent, there will be an unlawful distribution unless the amount of the distribution can be covered by the subsidiary's available distributable reserves.
Loans repayable on demand	An interest-free loan which is legally repayable on demand may also be a distribution as a matter of law if it is at undervalue even if there is no distribution for accounting purposes. There will be no distribution as a matter of law if the borrower is practicably able to repay on demand even if it has no intention to do so.

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 case law is clear 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 because it involves in substance an element of gift to the transferee.

This is relevant to intragroup loans on off-market terms (see above). The 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. The implication of this guidance is that a subsidiary cannot lawfully make a loan to its parent unless the amount of the distribution is covered by distributable reserves. The additional guidance about the definition of a distribution is based on legal advice and is not a question of generally accepted accounting practice. Therefore it is possible that some transactions previously entered into were distributions at the time they were entered into and would have been unlawful distributions in the absence of adequate distributable reserves.

Clarity has also been provided that a distribution can arise from the assumption, for example from a parent or fellow subsidiary, of a liability owed to a third party if the company does not receive consideration of the same value.

A section has also been added to illustrate other intragroup transactions such as assets received at undervalue and the transfer of a pension scheme surplus or deficit between group companies for a non arms-length sum, which may, as a matter of law, involve a distribution.

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 very outdated 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 which have moved from FRS 17 to IAS 19 or to Section 28 of FRS 102 may therefore have seen a change of accounting treatment, particularly when they were previously accounting for their participation in group defined benefit schemes as if they were defined contribution schemes. This may have affected distributable reserves.

Guidance on current and deferred tax

A new section on current tax has been added which clarifies that a current tax charge should be treated as a realised loss (even if it arises from the taxation of an unrealised profit) and a current tax credit will generally be treated as a realised profit to the extent that it represents a specific sum receivable in cash (or a reduction of a specific sum payable in cash) irrespective of the nature of the pre-tax sum to which it relates.

The guidance on deferred tax has been reorganised. It has been clarified that 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. However, a credit in profit or loss for deferred tax will often be attributable to a pre-tax realised loss and can be regarded as a reduction in that realised loss.

Observation

This clarification is unlikely to have much effect in practice because even when a deferred tax asset has been recognised, the resulting credit in profit or loss will usually be attributable to a pre-tax loss and therefore treated as a reduction in that loss. This will almost certainly be so under the timing differences approach of UK GAAP but may occasionally be an issue under IFRSs.

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

New sections have been added to address the distributable profits implications for long-term insurance businesses.

At the time of the exposure draft there was considerable doubt concerning the operation of the special rule in s843 of the Act for long-term insurance businesses, in relation to accounts for years ending on or after 1 January 2016, as a result of Solvency II.

A change in the law concerning distributable profits in relation to long-term insurance businesses was subsequently made by *The Companies Act 2006 (Distributions of Insurance Companies) Regulations 2016 (SI 2016/1194).*

This change in the law, which is now reflected within the guidance, clarifies that for long-term insurance businesses of authorised insurance and reinsurance companies (other than special purpose vehicles), special rules in S833A (for those subject to Solvency II) and S843 (for those not subject to Solvency II) apply to determine whether there is a realised profit rather than s853(4).

Other amendments

The more substantive changes to TECH 02/10 are summarised above but there are many other detailed amendments and clarifications. A mark-up comparing TECH 02/17 with TECH 02/10 is available on the ICAEW website for those interested in greater detail of the changes.

When are the changes applicable from?

The guidance does not contain an effective date but should be regarded as taking immediate effect. TECH 02/17 notes the revisions introduced now about the measurement of realised and distributable profits should not be used to question the lawfulness of distributions made at an earlier date. However, balances on reserves will need to be re-examined in the light of the Technical Release and the position should be re-assessed before a distribution is made.

However, the additional guidance about the definition of a distribution is based on legal advice and is not a question of generally accepted practice. Therefore, it is possible that some transactions previously entered into were distributions at the time they were entered into and would have been unlawful distributions in the absence of adequate distributable reserves. For example this may apply to some intragroup loans on off market terms. Directors may wish to take legal advice where they consider this might be the case and the amounts involved are material.

Further information

The updated guidance can be accessed on the ICAEW website, here.

The FRC Lab report Disclosure of dividends – policy and practice and the follow up publication in December 2016 are available on the FRC website.

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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