



iGAAP Alert.

TECH 02/10 Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006

In a nutshell

Guidance on distributable profits has moved with the times. The revised guidance issued by the ICAEW and ICAS has been enhanced and expanded to address some new – and often complex – situations, including foreign currency share capital, use of a presentation currency and ‘cash box’ structures.

Discussion of the earlier guidance was included in our June 2010 Quarterly Newsletter and in our full iGAAP 2010 and ukGAAP 2010 manuals.

Introduction

The law about payment of dividends has remained substantially unchanged for thirty years. Financial reporting has, however, moved on a long way in that time. Law that seemed uncontroversial and easy to apply in the days of ‘prudent’ historical cost accounting has become much more difficult to apply today.

In 2003, the Institute of Chartered Accountants in England and Wales (ICAEW) and the Institute of Chartered Accountants of Scotland (ICAS) published guidance known as TECH 07/03. It ran to 25 pages. The latest successor to this guidance has recently been published and is now 168 pages.

TECH 02/10 *Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006* provides comprehensive and up to date guidance. It summarises the law on distributions and provides guidance on the meaning of ‘realised profits’ which, under the law, is a matter of generally accepted accounting practice. Distributions can be made only out of realised profits. The meaning of realised profits can evolve over time to cope with changing circumstances.

TECH 02/10 supersedes the previous guidance, TECH 01/09, with immediate effect. However, almost all of the guidance from TECH 01/09 has been carried forward. The changes, although extensive, are almost entirely concerned with addressing new issues or providing more detail in areas that were covered only briefly in TECH 01/09.

This iGAAP Alert addresses only the new and amended material. A discussion of the earlier guidance can be found in our publications *iGAAP 2010 IFRS reporting in the UK and ukGAAP 2010 Financial reporting for UK unlisted entities*. An article on practical issues about distributable profits appeared in the June edition of our iGAAP Newsletter.

TECH 02/10 can be downloaded from the ICAEW website at www.icaew.com

The additional guidance includes:

- how to apply the 'linkage' principle that requires a group or series of transactions to be viewed as a whole, particularly if they are linked or artificial or circular;
- the circumstances in which 'cash box' structures, sometimes used to raise equity finance, generate distributable reserves;
- the implications of foreign currency share capital;
- use of a presentation currency that is different from the functional currency of the company;
- the circumstances in which profits arising from a reduction in an acquired liability are realised profits;
- the application of section 846 of the Companies Act 2006, which deals with distributions in kind, to replacement assets and fungible assets;
- distributions settled by set off where an existing debtor balance due from the parent is reduced or eliminated by the distribution;
- clarification of the circumstances in which profits regarded as realised may subsequently become unrealised and vice versa;
- group treasury balances;
- goodwill written off to reserves and surplus shares held in an ESOP trust where existing guidance has been redrafted to eliminate references to superseded accounting standards;
- the circumstances in which profits arising on the construction of an asset for use in a service concession arrangement in accordance with IFRIC 12 will be realised profits;
- hedging relationships involving more than one company in a group; and
- IFRIC 5 and decommissioning funds.

Linkage

Transactions and arrangements should not be looked at in isolation when assessing whether profits are realised. The overall commercial effect of a group or series of transactions or arrangements should be considered, particularly if they are artificial, linked (legally or otherwise) or circular. TECH 02/10 provides guidance on the factors that should be taken into account when deciding whether transactions need to be assessed for their combined effect.

The principle of linkage is of particular relevance to intra-group transactions but is not limited to them.

Example: Steps in a group reorganisation plan

Group reorganisations often involve a series of interconnected steps which would not be undertaken in isolation. A profit may arise on step 1 which is represented by cash and therefore, in isolation, appears to be a realised profit. But if step 2 involves that cash being paid out again it is necessary to look at the combined effect because the profit may not be represented by 'qualifying consideration' and may therefore be unrealised.

Example: Transaction with a third party

A subsidiary is sold for cash to a third party on the condition that the cash is applied in subscribing for shares in the purchaser. The substance or overall commercial effect of the transactions is a sale with consideration in shares of the purchaser. The profit will be unrealised unless the shares of the purchaser are readily convertible to cash, for example because they are quoted on an active market.

These two examples illustrate clear instances of linkage. In practice, it may be far less clear, for example if there is a period of time between the two transactions and perhaps no legal obligation to complete the second one. Judgement will often be required. TECH 02/10 aims to achieve greater consistency in those judgements by setting out a series of principles that should be followed.

'Cash box' structures

The practice of raising equity capital by means of a 'cash box' structure has been around for many years but has recently become much more common. In brief, the proceeds of the share issue are parcelled into a 'cash box' company which is then acquired by way of share for share exchange in circumstances which qualify for merger relief. This avoids the need to recognise a share premium on the share issue.

In isolation, the profit is represented by the cash proceeds of the share issue once it has been extracted from the 'cash box' company (typically through redemption of preference shares). On this basis, the profit would be realised. However, TECH 02/10 explains that it is necessary to have regard to any linked transactions. For example, if the capital had been raised to finance the acquisition of a subsidiary, the company is not free to retain the cash and the overall effect is an acquisition by way of share for share exchange. The resulting profit is, therefore, unrealised. TECH 02/10 provides further examples of scenarios to help determine whether the profit is realised or unrealised.

Foreign currency share capital

Companies sometimes have shares denominated in a currency other than their functional currency. For example, a UK based company, with operations located in the UK and transactions mainly denominated in sterling, may have issued shares denominated in US dollars. TECH 02/10 provides useful clarification of the implications of such arrangements based on legal advice received by the Institutes.

Where a company's shares are denominated in a currency other than the company's functional currency, an adjustment arising on any retranslation for accounting purposes is not a profit or loss as a matter of law. The guidance refers to it as 'an arithmetical difference which does not spring from any substance in law'. This applies irrespective of whether the shares are classified as equity or debt for accounting purposes, although in the former case it is unlikely that an exchange difference would be recognised. Any 'profit' on retranslation cannot enhance a company's distributable reserves. A 'loss' on retranslation of shares presented as debt can, however, reduce the distributable reserves of a public company because of the additional requirement in law about net assets exceeding share capital and undistributable reserves.

The effect of exchange rate movements should be considered even if no retranslation is recorded for accounting purposes. The common law has the effect of restricting distributions where to do otherwise would result in the net assets falling below the functional currency worth of the share capital. There is a rule of law that where the share capital is denominated in a particular currency, the share capital is in fact fixed as an amount in that currency. Thus the current worth of the share capital in functional currency terms must be compared with the net assets in functional currency. To the extent that a distribution would result in the net assets falling below the functional currency worth of the share capital, the ability to make such a distribution is restricted (even though the company might have some accumulated realised profits otherwise available for distribution).

Use of a presentation currency

TECH 01/09 addressed the question of the exchange differences arising on the retranslation of a branch into the functional currency of a company. TECH 02/10 distinguishes this necessary retranslation from the use of a presentation currency as a matter of free choice under IAS 21 or FRS 23.

Realised profits and losses are measured by reference to the functional currency of the company. The accounting gain or loss arising upon the retranslation of the whole of the accounts from the company's functional currency to a presentation currency is not a profit or loss as a matter of law. Such an amount cannot therefore be a realised profit or loss. The position is therefore similar to exchange differences arising on foreign currency share capital as described above.

Example: Exchange profit on retranslation

Company A has UK based operations and most of its transactions are denominated in sterling. Its functional currency is sterling. However, it presents its financial statements in US dollars because it has US shareholders. During the year, there is a movement in exchange rates which results in a substantial exchange profit on retranslation of Company A's net assets. This profit is reported in OCI in accordance with IAS 21. The profit is not available for distribution for the reasons explained in TECH 02/10.

Conversely, an exchange loss would not necessarily reduce distributable reserves because it is not a realised loss. But it may have an impact on the ability of a public company to make a distribution because of the additional test that net assets must exceed share capital and undistributable reserves. The exchange loss will reduce net assets but have no effect on the amount of share capital and undistributable reserves.

This situation is, however, distinguished from that of a branch where the exchange difference arising on retranslation will be a realised profit or loss to the extent that the branch net assets were qualifying consideration when the profit or loss arose.

Profit on reduction of an acquired liability

Usually, a reduction in a liability will be a realised profit on the grounds that it is the reversal of a realised loss which was recognised when the liability was established. This is not always the case. For example, a liability may have been recorded for the deficit in a pension scheme when accounting for a business combination in the accounts of an individual company. If the deficit reduces, an actuarial gain will be reported. The question is whether that gain is a realised profit.

TECH 02/10 concludes that a realised profit will arise on remeasurement of an acquired liability only when the reduction in the liability is readily convertible to cash (as defined in the guidance). This is a very tough test and certainly would not be met in the case of the pension scheme liability mentioned above. However, this conclusion is in line with the principle that profits are realised only when realised in the form of cash or other assets the ultimate cash realisation of which can be assessed with reasonable certainty.

The application of section 846

Section 846 of the Companies Act 2006 is concerned with 'distributions in kind' in circumstances where part of the carrying amount of the asset is represented by an unrealised reserve. The section provides that the unrealised reserve may be treated as realised for the purposes of assessing the lawfulness of the distribution of the asset. In practice this means that only the historical cost of the asset – not its carrying value – has to be covered by other distributable reserves. TECH 02/10 provides guidance about the application of section 846 in two circumstances where conflicting views had previously been expressed.

The first situation is where the asset on which the unrealised reserve originally arose is exchanged for another asset, for example shares in a subsidiary that are transferred to another subsidiary by means of a share for share exchange. The guidance confirms that section 846 can be applied to the distribution in kind of the replacement asset. This may seem uncontroversial but has been disputed by some legal advisers in the past.

The second situation is concerned with the distribution in kind of fungible assets such as shares or loan notes. TECH 02/10 confirms that, for the purposes of section 846, any unrealised reserve becomes realised pro rata to the proportion of the asset distributed. So 50% of the reserve will be treated as realised for the purposes of the distribution if 50% of the asset is distributed. This again seems uncontroversial but does produce unexpected results in some cases. The maximum distribution possible as a distribution in kind may be less than would be the case if the asset was sold or redeemed for qualifying consideration. TECH 02/10 provides a numerical example to illustrate this.

Distribution by set off

An issue arises where a company has an unrealised profit which is represented, in whole or in part, by a balance due from its parent company. It would be possible to make a distribution in kind of the debtor balance by applying section 846 to treat the unrealised reserve as becoming realised for the purposes of the distribution.

However, there has been a difference of opinion about whether it is necessary to structure such transactions as distributions in kind or whether, alternatively, a dividend could be declared and settled by offset with the existing balance. Those opposed to the alternative point of view have seen a 'chicken and egg' problem in that there cannot be an expectation that the balance will be settled until the dividend is declared – and there cannot be any declaration of a dividend until there is a realised profit available for distribution. TECH 02/10 has amended the definition of qualifying consideration to remove this doubt and confirms that making a distribution by offset is acceptable in these circumstances.

Example: Distribution by set off

Five years ago, Subsidiary S transferred some shares in other group companies to its Parent P at fair value with the consideration left outstanding as inter-company debt. The balance did not meet the definition of qualifying consideration because there was no expectation that it would be settled. The profit on the transfer of the subsidiaries was therefore considered to be an unrealised profit.

To tidy up the group structure it is decided that it would be useful to eliminate the balance because there is no realistic possibility that it will ever be settled in cash. However, waiver of the loan would amount to a distribution by subsidiary S. So it is necessary to consider whether it has adequate distributable reserves to make this possible.

Subsidiary S has a small balance of distributable reserves which is insufficient to cover the book value of the balance. However, it is possible to make a distribution in kind of the balance by applying section 846 CA 2006 under which the related unrealised profit can be treated as realised for this purpose.

Under the new guidance in TECH 02/10, it is now clear that there is no need to legally structure the transaction as a distribution of the balance itself. It is simply possible to declare a dividend in the normal way, treating the unrealised profit as realised for this purpose, and settle it by set off with the existing balance.

Changes of circumstances

TECH 01/09 contained guidance on the circumstances in which an unrealised profit will become realised and vice versa. This is unchanged. However, TECH 02/10 make a distinction in the case of profits that were recorded (e.g. through fair value accounting) as realised because the assets in question were regarded as readily convertible to cash. In this case, the initial determination that a profit is a realised one is definitive and unchangeable. Thus, for example, if changes in the market for a financial asset mean that from a certain date the asset no longer meets the 'readily convertible to cash' test, then prior fair value movements – whether profits or losses – remain realised.

Group treasury balances

The section of TECH 01/09 dealing with cash pooling arrangements and group treasury functions has been revised to be clearer and more helpful. The guidance confirms that the normal considerations apply when assessing whether a realised profit arises from a transaction which results in an increase in a balance due from a group treasury company. That is to say that the balance must represent qualifying consideration and the profit must not arise from artificial, linked or circular transactions. The nature of such arrangements varies widely in practice. It is always necessary to have regard to the particular facts and circumstances of each case.

The new guidance does helpfully address the situation where there is a long-term core balance that does not meet the definition of qualifying consideration but there is a 'churn' on the account. The fact that there is no expectation that the core balance will be settled does not preclude transactions processed through the account being realised profits when they arise from normal trading transactions in the ordinary course of business. This is because the debit entries on the account arising from these transactions are expected to be settled by offset with credit entries on the account. However, large and unusual transactions that result in a 'permanent' increase in the core balance will require careful consideration.

Goodwill written off to reserves

This guidance applies to goodwill written off directly to reserves under SSAP 22 *Accounting for goodwill* in periods ending before 23 December 1998. In a change to previous guidance, the Institutes have concluded that it is appropriate to apply the principles of the accounting framework actually used to prepare the financial statements, to determine the extent to which the goodwill is a realised loss, rather than the framework in use when the goodwill was first recognised.

Example: Goodwill written off

In 1997, Company A wrote off £2,000,000 of goodwill to reserves. In accordance with generally accepted practice at the time, it treated this goodwill as becoming a realised loss over its estimated useful life of 20 years. By 2010, £1,400,000 of goodwill would have been treated as a realised loss under UK GAAP.

However, Company A transitions to IFRSs in 2010 and the goodwill remains eliminated against reserves in accordance with IFRS 1. Company A does not have to treat any of the goodwill as a realised loss provided that it is satisfied that it would not have to be written down for impairment if it was carried as an asset.

Company A may not want the burden of impairment testing goodwill which was written off many years ago. In this case, it can accept the worst case position of simply assuming that all of the goodwill written off in reserves is a realised loss.

Surplus shares held by an ESOP trust

The purpose of this change to the guidance is to eliminate the need to refer to realised profits being determined in accordance with UITF Abstract 13 which was withdrawn in 2003.

Where options have been granted over shares held by the trust but those options are 'out of the money' or where there are 'surplus' shares that have not been allocated to any particular share scheme, a realised loss may arise if the market value of the shares falls below the purchase price. TECH 02/10 states that a realised loss will have arisen to the extent that the fall in market price below cost is not expected to be reversed and thus that part of the cost incurred is not expected to be recovered.

IFRIC 12 Service concession arrangements

Where the operator in a service concession arrangement constructs an asset to be used to provide a public service, the arrangement is accounted for as a construction contract under IAS 11. The asset arising from the recognition of revenue in accordance with IAS 11 will be either a financial asset or an intangible asset, in accordance with IFRIC 12, depending on the terms of the arrangement. Where a financial asset is recognised, any profit arising from the construction phase will normally be a realised profit. However, where an intangible asset is recognised, any profit will initially be unrealised. It will become realised as the intangible asset is amortised or impaired over the life of the arrangement.

Hedging relationships in group situations

Under a group's hedging strategy, different companies in the group may hold the hedging instrument and hedged item. In these cases, there is no hedge relationship within an individual company and thus the hedging principles in the distributable profits guidance do not apply. Accordingly, the general realisation principles apply to the hedged item and hedging instrument separately.

TECH 02/10 confirms this but also draws attention to the fact that the freedom of the companies involved to dispose of the hedged item or hedging instrument may be constrained by the intra-group arrangements. This should be taken into account when determining whether the instruments are readily convertible to cash for the purposes of determining whether profits arising from fair value accounting for them are realised profits.

IFRIC 5 and decommissioning funds

IFRIC 5 requires changes in the carrying value of the reimbursement asset, other than contributions to and payments from the fund, to be recognised in profit or loss in the period in which the change occurs. TECH 02/10 concludes that the profit on remeasurement of the reimbursement asset will generally be a realised profit. It is not necessary to consider whether the underlying investments held by the fund are readily convertible to cash although this will often be the case.

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