# COMPARISON OF TECH 02/10 WITH TECH 02/17BL

## INFORMATION

The following document is provided for convenience only and is not to be relied upon. Reference should be made to the relevant Technical releases for a definitive view of their contents and the differences between them.

## KEY

Text that has been moved is identified in green.
Text that has been deleted is shown as struck through in blue.
Text that has been inserted is in red.

## GUIDANCE ON ~~THE DETERMINATION OF~~ REALISED AND DISTRIBUTABLE PROFITS ~~AND LOSSES IN THE CONTEXT OF DISTRIBUTIONS~~ UNDER THE COMPANIES ACT 2006

**Guidance on realised and distributable profits under the Companies Act 2006 issued by the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland (the Institutes) in ~~October 2010~~April 2017.**

~~**TECH 02/10 does not illustrate the application of its principles to accounting under FRS 102 or under changes to IFRSs since 2010. However, the application of TECH 2/10's principles to the revised financial reporting standards, which do not introduce any fundamentally new treatments, is not expected to raise any new issues of principle so far as realised and distributable profits are concerned. In addition, the TECH already sets out principles to be applied on a change in accounting policy. The TECH's references to lapsed financial reporting standards will be replaced in due course.**~~

This Technical Release provides general guidance and does not purport to deal with all possible questions and issues that may arise in any given situation. The Institutes ~~and the authors~~ do not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.



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**CONTENTS** **PARAGRAPH**

1.1 1.1 This Technical Release provides guidance on realised and distributable profits under the Companies Act 2006 (the Act).as amended) (the Act) and all relevant statutory instruments made under the Act. 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. It is based on the guidance originallypreviously issued as TECH 01/0902/10 in June 2009October 2010 but includes some significant additional material, the draft version ofhas been updated as proposed in TECH 05/16 which was issued for comment as TECH 03/09 in December 2009March 2016. For the convenience of users, paragraph numbering has been kept consistent with TECH 01/0902/10 so far as possible and consequently some paragraph numbers are not used where material has been deleted or moved. Versions of this guidance marked-up to show the changes from TECH 02/10 and TECH 05/16 are also available.

1.2 Comments received on TECH 03/09 were generally supportiveMost of the proposals and did not raise any major issues of principle. Some drafting improvements have been made comments received in the light of comments received.

1.3 The more significant changes made from the proposals in TECH 03/09 are as follows:

(a) for profits arising from remeasurement of acquired liabilities priorresponse to settlement, TECH 03/09 set out three options for consideration. None of the responses supported the approach in its paragraph 9.9 that such profits would be realised without any restrictions. Responses were divided between those supporting the 'readily convertible to cash' approach in its paragraph 9.7, which is consistent with the underlying principles of realisation established in previous guidance, and those supporting a departure from that approach in paragraph 9.8 which looked to whether qualifying consideration was received when the liability was assumed. The 9.7 approach is in effect an application of existing guidance and, as the Institutes have concluded that the level of support for the approach set out in paragraph 9.8 did not amount to sufficient to change 'generally accepted practice', this guidance therefore reflects the conclusion that a realised profit will arise on remeasurement of an acquired liability only when that profit is readily convertible to cash (as defined in paragraph 3.12);

(b) for goodwill written off to reserves, TECH 03/09 proposed a single approach to realisation which would have been independent of the accounting framework adopted. However, several of the responses suggested that it would be more appropriate to apply the principles of the accounting framework actually used to prepare the financial statements. This approach has been adopted in this technical release. A consequence of this decision is that in some cases goodwill written off to reserves that had been treated as a realised loss on the basis of notional amortisationTECH 05/16 focussed on the definition of a distribution and the consequences of accounting for off-market intragroup loans in accordance with SSAP 22 or FRS 10 will no longer be treated as a realised loss on transition to IFRSs, because the impairment model is applied and there has been no impairment;

(c) for distributions settled by set-off, TECH 03/09 proposed two possible approaches. The approach proposed in paragraph 8.12, which was to add a new paragraph 3.11(e) to the definition of qualifying consideration, received most support and has been adopted in this technical release; and

(d) 102. In the former case, additional guidance hasfootnotes have been added to make it clearer that the guidance reflects case law. In the latter case, the material has been extensively redrafted to address the treatment of reimbursement assets arising in connection with IFRIC 5 'Rights to Interests arising from Decommissioning, Restoration and

~~Environmental Rehabilitation Funds' (see 10.69 to 10.72).~~comments received but without changing the overall conclusions reached.

1.3 Some of the responses raised additional comments where the guidance could be expanded or made clearer. The opportunity has been taken to address some of these comments through improved drafting but they raise no new issues of substance.

1.4 This Technical Release also addresses the consequences of the change in the law concerning distributable profits in relation to long-term insurance business made by The Companies Act 2006 (Distributions of Insurance Companies) Regulations 2016 (SI 2016/1194) which were made on 7 December 2016.

1.5 The Institutes are aware of the calls by some investors for greater transparency about dividend policy and capacity including distributable reserves. The FRC's Financial Reporting Lab issued a report 'Disclosure of dividends – policy and practice' in November 2015 exploring how companies can make dividend disclosures more relevant for investors. An update to this was issued in December 2016. Paragraph 2.25 of this Technical Release states that there is no requirement under law or accounting standards for financial statements to distinguish between realised profits and unrealised profits or between distributable profits and non-distributable profits. The Institutes consider, based on legal advice, that this is a correct statement of the law. Listed companies may, however, wish to consider how to address the calls for greater transparency from the investor community.

1.6 This Technical Release reflects accounting standards in issue at ~~1 June 2010~~31 December 2016. It does not provide guidance on how transactions and arrangements should be accounted for. However, it has been necessary to make assumptions about accounting treatments while providing guidance on the impact on realised and distributable profits.

~~1.5 This Technical Release represents generally accepted practice at 1 June 2010. Whilst many of the revisions to TECH 01/09 made by this TECH 02/10~~1.7 Recent changes to accounting standards do not raise any fundamentally new issues in relation to realised and distributable profits. The application of new or revised standards may lead to changes in the timing and amount of profit recognised. This may occur due to changes in the recognition of revenue or in the recognition of costs. The effect of changes in an accounting policy are considered in paragraphs 3.28 to 3.40. The effect of changes in accounting policy may be to reduce or even eliminate a company's net realised profits. That would not render unlawful a distribution already made out of realised profits determined by reference to 'relevant accounts' which had been prepared in accordance with generally accepted accounting principles applicable to those accounts. However, for distributions made in the period in which a new or revised standard is to be adopted, the application of the common law capital maintenance rule in relation to distributions should be considered, as noted in paragraphs 3.30 to 3.37.

1.8 This Technical Release represents generally accepted practice at 31 December 2016 in relation to the meaning of realised profits. Whilst many of the revisions to TECH 02/10 made by this Technical Release represent principles that were generally accepted prior to that date, the revisions introduced now 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 ~~guidance~~Technical Release and the position should be re-assessed before a distribution is made.

1.~~6~~9 However, the additional guidance about the definition of a distribution in paragraphs 2.6A to 2.6D 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.

1.10 English and Scottish Counsel have confirmed that the guidance is consistent with the law at ~~1 June 2010~~31 December 2016. Counsel accept no responsibility (other than to the Institutes) in relation to advice ascribed to them in this guidance.

1.~~7~~11 The Act permits companies to prepare their individual accounts using UK GAAP or EU-adopted IFRSs. This guidance applies to companies reporting under both UK GAAP and EU-adopted IFRSs except where otherwise stated. The guidance has been written on the basis of ~~"full"~~'full' IFRSs as issued by the IASB ~~except where otherwise stated~~ but should be equally applicable to EU-adopted IFRSs. ~~No reference is made to IFRS 9 'Financial instruments', which has not yet been adopted by the EU. Similarly, no consideration has been given to issues that may arise from use of the IFRS for SMEs.~~

1.~~8 In the case of converged standards, reference~~12 Reference to an IFRS or IAS should be read as applying to the equivalent requirements of UK ~~standard~~GAAP unless the context requires otherwise. The guidance uses the ~~IFRS~~ terminology ~~"~~'in profit or ~~loss". In the context of UK GAAP, this should be read as~~ loss' which has the same meaning ~~"~~as 'in the profit and loss ~~account".~~account'. References to the 'Accounting Regulations' are to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) and to the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409) as appropriate. Where relevant, these take into account the amendments made up to 31 December 2016.

1.~~9 The revised version of IAS 1 issued in 2007 makes some changes of~~13 IFRSs and FRS 102 use terminology that is different from that in the Act, for example referring to a statement of financial position instead of a balance sheet. ~~It~~IFRSs also ~~introduced~~include a requirement for a statement of ~~comprehensive income which~~ profit or loss and other comprehensive income. FRS 102 refers to this statement as a statement of comprehensive income. Under IFRSs and FRS 102, this statement may be presented either as a single statement or as ~~an income~~two statements. The second statement ~~together~~starts with ~~a separate statement showing~~profit or loss and then shows the items of other comprehensive income. For simplicity ~~and consistency with UK GAAP, the previous~~, company law terminology has generally been ~~retained~~used in this guidance.

~~1.10~~1.14 FRS 101 *Reduced Disclosure Framework* generally requires recognition and measurement on a basis that is consistent with IFRSs as adopted by the EU. It does not, therefore, raise any new issues about realised and distributable profits and is not generally referred to separately in this Technical Release.

1.15 Certain companies are permitted to prepare their accounts in accordance with the micro-entities regime in company law and in accordance with FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. Accounts prepared in accordance with the micro-entities regime are 'presumed' to give a true and fair view if prepared in accordance with the applicable legal requirements (s393(2A)). Such accounts will be a company's 'relevant accounts' for the purposes of determining realised profits when it chooses to apply the micro-entities regime. The micro-entities regime does not raise any significant new issues in relation to distributable profits and is not generally referred to separately in this Technical Release. FRS 105 prohibits provisions for deferred tax and therefore a micro-entity's realised profits will not take into account any deferred tax which might have been provided under IFRSs or FRS 102. However, the directors of a micro-entity should have regard to the need to retain sufficient cash to pay the company's tax liabilities as they fall due in accordance with the guidance in paragraph 2.3A.

1.16 Companies should consider taking their own legal advice, particularly in relation to any matters not covered by this guidance.

# 2. THE LEGAL FRAMEWORK 2.1 – 2.53

## Introduction

2.1 The legal framework ~~relating to the determination of~~for determining realised profits and losses, and ~~of~~ profits available for distribution ~~consists of two elements:~~ , is contained in both the common law and the Act (including statutory ~~provisions.~~instruments made under the Act).

2.1AA Those aspects of the Act that deal with matters other than those relating to the form and content of accounts continue to apply ~~when~~irrespective of the accounting framework under which the accounts are prepared ~~under IFRSs~~. All of the rules on capital maintenance in the Act therefore continue to apply~~. That is to say, the~~ regardless of whether the accounts are prepared under IFRSs or UK GAAP. The legal rules regarding shares (and the share premium account) continue to control, for example, payments in respect of those shares even though the shares (and related share premium) may be presented as liabilities in the accounts. For example, the ability to pay dividends on preference shares is still determined by reference to the availability of distributable profits even if those dividends are reported as an expense ~~in accordance with IFRSs~~.

## The common law

2.1A The 2006 Act codifies the general duties of directors under common law. However, this does not render obsolete the rules in relation to capital maintenance or duties in relation to creditors of the company which remain relevant.

2.1B Under sections 851 and 852, any restrictions in common law or imposed by the company's articles on the sums available for distribution or the cases in which a distribution may be made, take precedence over the statutory provisions. Section 851(2) makes an exception to this rule. It provides that the amount of any distribution in kind is established by the statutory rules in sections 845 and 846 (see 2.9 - 2.9F below) and not by the applicable common law rules.

2.2 Under common law, a company cannot lawfully make a distribution out of capital. Thus, the directors must consider, both at the time of proposing the distribution and at the time it is made (see paragraph 2.10 below), whether the company, subsequent to the balance sheet date to which the 'relevant accounts' were prepared, has incurred losses that have eroded its profits available for distribution (the 'capital maintenance rule'). Guidance on the application of the capital maintenance rule to the introduction of a new accounting standard is given at 3.30 and 3.31 below. It is not practicable to give further guidance on the application of the capital maintenance rule in this Technical Release: appropriate advice will have to be taken to deal with specific circumstances.

## Fiduciary and other duties and volatility

2.3 In addition, directors are subject to fiduciary and other duties in the exercise of the powers conferred on them. The common law rule referred to at 2.2 above applies only to losses incurred up to the date of the distribution. An expectation of future trading losses after the date of distribution is a factor to take into account when making the assessment of future cash flows referred to at 2.3A below.

2.3A Examples of fiduciary and other duties include the obligation on directors to safeguard the company's assets and take reasonable steps to ensure that the company is in a position to settle its debts as they fall due. Directors must therefore specifically consider whether the company will still be solvent following a proposed distribution. Thus, directors should consider both the immediate cash flow implications of a distribution and the continuing ability of the company to pay its debts as they fall due. In reaching their decision they must take into account any change in the financial position of the company after the balance sheet date of the relevant accounts and the future cash needs of the company.

2.4 In the context of fair value accounting, volatility is an aspect where directors will need to consider their duties. The fair value of financial instruments may be volatile even though such fair value is properly determined in accordance with ~~IAS 39 *Financial Instruments: Recognition and Measurement* (subsequently referred to as IAS 39 for brevity).~~accounting standards. Directors should consider, as a result of their duties, whether it is prudent to distribute profits arising from changes in the fair values of financial instruments considered to be volatile, even though they may otherwise be realised profits in accordance with this guidance.

2.5 ~~Similarly, IAS 39 is~~Accounting standards are based on a ~~"~~'mixed measurement ~~model"~~model' whereby some financial instruments may be included at fair value while others may be included on an amortised cost basis. This may, in some cases, lead to volatility in the profit or loss for the period. For example, an asset and a liability may provide an economic hedge but if the asset is measured at fair value and the liability is not, a profit may be reported on one but a loss not reported on the other. Although such profits may be realised profits in accordance with this guidance, directors should consider, as a result of their duties, whether it would be prudent to distribute them.

## Definition of a distribution for Part 23 of the ~~2006~~ Act

2.6 A ~~"distribution"~~'distribution' is defined by section 829 as every description of distribution of a company's assets to its members, whether in cash or otherwise, subject to the following exceptions:

(a) an issue of shares as fully or partly paid bonus shares;

(b) the reduction of share capital;

(i) by extinguishing or reducing the liability of any of the members on any of the company's shares in respect of share capital not paid up; or

(ii) by repaying paid up share capital;

(c) the redemption or purchase of any of the company's own shares out of capital (including the proceeds of any fresh issue of shares) or out of unrealised profits in accordance with Chapter 3, 4 or 5 of Part 18; and

(d) a distribution of assets to members of the company on its winding-up.

2.6A The above statutory definition is wide. The case law, which is applicable both to the question of whether a distribution under section 829 has been made and the question of whether there has been a return of capital[1], is clear that it does not matter what label is put on a transaction[2]. It is its purpose and substance that matters[3]. In particular an undervalue transaction with a shareholder or sister company is capable of being a distribution, because it involves in substance an element of gift to the transferee[4]. However, the state of mind of those orchestrating an undervalue transaction may be relevant[3]. It would be necessary to consider what advice they took, how they tested the market and how the actual terms were

[1] *Progress Property Company Ltd v Moorgarth Group Ltd, citing Clydebank Football Club Ltd v Steedman.*
[2] Per Lord Mance in *Progress Property Company Ltd v Moorgarth Group Ltd*: 'there may come a point at which, looking at all the relevant factors, an agreement cannot be regarded as involving in substance anything other than a return or distribution of capital, whatever the label attached to it by its parties.'
[3] Per Lord Walker in *Progress Property Company Ltd v Moorgarth Group Ltd*: 'The court's real task is to inquire into the true purpose and substance of the impugned transaction. That calls for an investigation of all the relevant facts, which sometimes include the state of mind of the human beings who are orchestrating the corporate activity. … There may be questions to be asked as to whether the company was under financial pressure compelling it to sell at an inopportune time, as to what advice was taken, how the market was tested, and how the terms of the deal were negotiated. If the conclusion is that it was a genuine arm's length transaction then it will stand, even if it may, with hindsight, appear to have been a bad bargain. If it was an improper attempt to extract value by the pretence of an arm's length sale, it will be held unlawful. But either conclusion will depend on a realistic assessment of all the relevant facts, not simply a retrospective valuation exercise in isolation from all other inquiries.'
[4] *Aveling Barford Ltd v Perion Ltd.*

negotiated[3] – a relevant factor would be whether the transaction and terms were arrived at because the other party was a shareholder or sister company[5].

2.6B It should be noted that when considering the state of mind of those orchestrating the transaction, it is not a matter of whether they explicitly intended to effect a distribution, or knew it was a distribution at law[6], but whether the intended substance of the transaction is something that, regardless of its label, is a distribution. For the application of this principle to intragroup transactions see paragraph 9.68 to 9.70 below.

2.6C The definition of a distribution refers to distributions of assets, but it is clear that a distribution can arise from the assumption, from a parent or fellow subsidiary or similar, of a liability owed to a third party if the company does not receive consideration of the same value. That is because the liability commits the company to transfer assets at the due date and its assets are therefore reduced when entering into the commitment. A distribution can also arise from a subsidiary guaranteeing a liability of its parent or fellow subsidiary if the subsidiary does not receive a fee at market rates in consideration.

2.6D In October 2014, ICAEW issued TECH16/14 Guidance on donations by a company to its parent charity. This provides guidance on the status under company law of charitable donations made by a company to its parent that is a registered charity. It concludes, based on the illustrative circumstances which it describes, that such payments are distributions as a matter of law and therefore can be lawfully made only out of distributable profits.

## Profits available for distribution

2.7 A company may make a distribution only out of profits available for that purpose (section 830(1)) (the common law position is set out in paragraph 2.2). A company's profits available for distribution are its accumulated, realised profits (so far as not previously distributed or capitalised) less its accumulated, realised losses (so far as not previously written off in a reduction or reorganisation of its share capital) (section 830(2)). Thus realised losses may not be offset against unrealised profits. Section 831 imposes a further restriction on public companies (see paragraph 2.30 below).

2.8 Section 853(4) of the Act provides that references to realised profits and realised losses are to such profits or losses as fall to be treated as realised in accordance with principles generally accepted at the time when the accounts are prepared, with respect to the determination for accounting purposes of realised profits or losses. Section 3 below provides guidance on the application of this requirement.

2.8A In addition, The Companies (Reduction of Share Capital) Order 2008 SI 2008/1915 (~~"~~(‘the ~~Order~~Order’) specifies the cases in which a reserve arising from a reduction in a company's capital (ie, share capital, share premium account, capital redemption reserve or redenomination reserve)[7] is to be treated as a realised profit as a matter of law. The Order also disapplies the general prohibition in section 654 on the distribution of a reserve arising from a reduction of capital. The Order provides that:

(a) if an unlimited company reduces its capital, a reserve arising from the reduction is treated as a realised profit;

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[5] *Jenkins v Harbour View Courts Ltd* (a New Zealand case), cited in *Progress Property Company Ltd v Moorgarth Group Ltd*

[6] Per Lord Mance in *Progress Property Company Ltd v Moorgarth Group Ltd*: ‘The facts in that case [*Aveling Barford Ltd v Perion Ltd*] make it possible to speak of knowledge and intention to sell at an undervalue, but that does not mean that such knowledge or intention are always necessary factors.’

[7] The Order refers only to share capital but section 11 of the Interpretation Act 1978 makes it plain that where an Act contains power to promote subordinate legislation, words used in that subordinate legislation have the same meaning as in the main Act. Subject to certain exceptions, the provisions of the ~~Companies~~ Act ~~2006~~ relating to the reduction of a company's share capital apply to any share premium account, capital redemption reserve or redenomination reserve as if they were part of paid up share capital (sections 610(4), 628(3) and 733(6)).

(b) if a private company limited by shares reduces its capital and the reduction is supported by a solvency statement but has not been subject to an application to the court for an order confirming it, the reserve arising from the reduction is treated as a realised profit; and

(c) if a limited company having a share capital reduces its capital and the reduction is confirmed by order of court, the reserve arising from the reduction is treated as a realised profit unless the court orders otherwise.

These provisions are without prejudice to any contrary provisions of an order or undertaking given to the court, the resolution for, or any other resolution relevant to, the reduction of capital, or the company's memorandum or articles of association. These provisions came into effect on 1 October 2008. In accordance with The Companies Act 2006 (Commencement No.7, Transitional Provisions and Savings) Order 2008, they apply irrespective of when the reduction in capital occurred or when the reserve arose. They therefore apply to capital reductions made under the Companies Act 1985 (the 1985 Act) and those made by unlimited companies.

2.8B Section 654 and the Order are concerned with the status of any reserve arising from the reduction of a company's capital. They do not apply to the extent that a reduction of capital takes the form of a payment to shareholders so that no reserve arises.

2.8C Section 654 and the Order do not differentiate between a reduction of foreign currency share capital and other reductions. Thus the Order applies to such cases and the reserve arising in such cases will, subject to the requirements of the Order, be a realised profit. The amount of the realised profit arising may not be the same as the amount of the reduction due to exchange movements because the reduction is calculated by reference to rates of exchange at the date of the reduction. For example, where there is a reduction of capital with no payment to shareholders, although the reduction is calculated by reference to the exchange rates at the date of the reduction, the amount of the realised profit arising will be equal to the nominal value of the shares translated at the exchange rate ruling when the shares were issued. Section 11 explains the issues in detail.

2.8D Section 662 is concerned with the duty of a public company to cancel any shares in itself that it holds when shares are forfeited, or surrendered to the company in lieu of forfeiture, in pursuance of the Articles, for failure to pay any sums payable in respect of the shares (and certain other situations). Unless the shares are disposed of within three years of the forfeiture or surrender, the company must cancel the shares and diminish the amount of the company's share capital by the nominal value of the shares cancelled. Section 662(4) provides that the directors of a company may take any steps necessary to enable the company to comply with this requirement without complying with the requirements of chapter 10 of Part 17 of the Act in relation to reductions of capital.

2.8E A reserve arising from a capital reduction under section 662 will not be a distributable reserve because of the restriction imposed by section 654 (see 2.8A above). Section 654 is not disapplied by section 662(4) because ~~Section~~section 654 is not in chapter 10 of Part 17 of the Act, neither is it disapplied in these circumstances by the Order[8].

## Distributions in kind: Meaning

2.8F Sections 845 and 846 make provision for a distribution consisting of or including, or treated as arising in consequence of, the sale, transfer or other disposition by a company of a non-cash asset (referred to in this guidance as a 'distribution in kind'). ~~A waiver of an amount receivable from a parent is considered as a distribution in kind, being an "other disposition", of that receivable~~The transfer of an asset can be a distribution as a matter of law, and

[8] The Institutes believe that this may be as a result of an oversight in drafting the Order and ~~have drawn~~drew the matter to the attention of the Department for Business, Innovation & Skills~~.~~ (now the Department for Business, Energy and Industrial Strategy).

therefore within the scope of these sections, even if it has no accounting impact, for example an asset that was not recognised in the balance sheet transferred for no consideration.

2.8G Section 1163 defines a non-cash asset to mean any property or interest in property, other than cash. It also states that a reference to the transfer or acquisition of a non-cash asset includes:

(a) the creation or extinction of an estate or interest in, or a right over, any property; and

(b) the discharge of a liability of any person, other than a liability for a liquidated sum.

Therefore, a distribution which arises from the discharge of a liability for a liquidated sum is not within the scope of sections 845 and 846. The amount of such a distribution is the amount of the liquidated sum as stated in the relevant accounts, after any provision that has been made against it. This is because the amount of the provision has consumed distributable profits at the time it was made. To do otherwise would result in double counting the amount of the provision as a loss and as a distribution.

2.8GA For example, Subsidiary A has an amount of £100 due from Subsidiary B. Subsidiary A has made a provision of £40 against this balance which has been included in the profit and loss account as a realised loss. Subsidiary A makes a distribution in kind of this balance to its parent company. The amount of this distribution is £60 rather than £100 because £40 has already been treated as a realised loss.

2.8H A waiver of an amount receivable from a parent is a distribution but is not within the scope of sections 845 and 846. In contrast, a transfer to the parent of an amount receivable from a third party is within the scope of section 846.

### Distributions in kind: Treatment of unrealised profits

2.9 Section 846 provides that where a company makes a distribution in kind and any part of the amount at which the asset is stated in the accounts relevant to the distribution represents an unrealised profit, that profit is to be treated as realised for the purposes of the distribution. Thus if a company wishes to distribute in kind an asset with a historical cost of £100 and which is in the books at £130 (with the surplus in the revaluation reserve), the surplus of £30 is treated as realised for this purpose and only £100 of other realised profits are needed. However, if the surplus has been capitalised, it is no longer available for this purpose and other realised profits of £130 would be needed to cover the proposed distribution.

2.9A The application of section 846 to replacement assets is considered at 10.73 below. The application of section 846 to fungible assets is considered at 10.77 below.

### Distributions in kind: Determination of amount

2.9B Section 845 was a new provision in the ~~2006~~ Act (not in the 1985 Act) which removed doubts arising from the decision in *Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626 in relation to the amount of the distribution of a non-cash asset. Section 845 applies where:

(a) at the time of the disposition of the asset, the company has profits available for distribution; and

(b) if the amount of the distribution were to be determined in accordance with the section, the company could make the distribution without contravening Part 23.

2.9C Where section 845 applies, the amount of any distribution consisting of or arising from the sale, transfer or other disposition by the company of a non-cash asset should be calculated by reference to the value at which that asset is included in the company's accounts (ie, its book value) as follows. If an asset is transferred for a consideration not less than its book value, the amount of the distribution is zero, but if the asset is transferred for a consideration less than its book value, the amount of the distribution is equal to that shortfall, which will therefore need to be covered by distributable profits.

2.9D In determining whether a company has profits available for distribution for the purposes of section 845, section 845(3) provides that the company's profits available for distribution are treated as increased by the amount (if any) by which the amount or value of any

consideration for the disposition exceeds the book value of the asset. In this context, distributable profits may be 'treated as increased' from a negative starting point[9]. However, to apply section 845, a company must have profits available for distribution after any adjustment in accordance with section 845(3). This requirement is not met by a nil balance. There must be a positive balance, even if it is only 1p, immediately before the transfer of the asset. However, the balance may be nil after the transfer when the asset is transferred at below book value such as to eliminate the whole of the positive balance.

2.9E The references to consideration in section 845 are not restricted to consideration that would meet the definition of 'qualifying consideration' in this guidance.

2.9F Appendix 1 sets out illustrative worked examples of a transfer of an asset applying section 845.

2.9FA A transfer of assets may be lawful in accordance with the statutory provisions of section 845 but nevertheless be an unlawful distribution of capital contrary to common law (see 2.2 above). For example, this could occur as a result of an increase in the book value of an asset due to additional expenditure after the date of the relevant accounts but before the asset is transferred without any commensurate increase in consideration such that the company would be left with a deficit of distributable profits after the transfer.

**Distributions in kind:** ~~Effect of IFRIC 17~~**Interaction with accounting standards**

2.9G The amount of a distribution in kind for legal purposes will be the book value of the asset to be distributed, provided that this amount is available for distribution, because of the application of section 845 (see 2.9A to 2.9F above).

2.9H There are no requirements in ~~UK GAAP~~FRS 102 about accounting for distributions in kind but there is a requirement to disclose the fair value of any such non-cash assets distributed (FRS 102.22.18), except when the assets are ultimately controlled by the same parties both before and after the distribution. UK companies have almost invariably accounted for such distributions based on the book value of the asset in question. It has also been acceptable to account for such a distribution based on the fair value of the asset and recognise a profit on disposal. ~~This treatment has been used occasionally.~~

~~2.9I In December 2008, the IASB published IFRIC 17 *Distributions of Non-cash Assets to Owners*. It is to be applied prospectively (ie no restatement of prior periods is required) for annual periods beginning on or after 1 July 2009.The scope of IFRIC 17 excludes certain distributions, including those where the non-cash asset is controlled by the same party or parties before and after the distribution (e.g. intra-group transactions). It applies to a distribution that gives owners a choice of receiving either non-cash assets or a cash alternative. The ASB has stated (in UITF Information Sheet 88) that it has no plans to issue an Abstract based on IFRIC 17 because it has decided that the current accounting under UK GAAP is adequate.~~

~~2.9J IFRIC 17~~2.9I [Deleted]

2.9J Under IFRSs, IFRIC 17 Distributions of Non-cash Assets to Owners requires that, when accounting for a distribution of a non-cash asset, the distribution is measured at the fair value of the asset in question. The difference between the fair value of the asset and its book value is subsequently recognised in profit or loss when the distribution is settled. ~~This will be a significant change of practice and~~This may, in certain circumstances, have an adverse impact on the ability of a public company to make a distribution for the reasons explained below.

2.9K IFRIC 17 requires the recognition of a liability to make the distribution when it is appropriately authorised and no longer at the discretion of the entity. In most cases this means that the liability, which will usually exceed in amount the carrying value of the asset to be distributed,

[9] Legal interpretation of an amount being 'increased' in other contexts may be restricted to being increased from a lower amount but not from zero or below. However, in the context of section 845, such an interpretation would render sub-section (3) redundant and therefore this does not appear to be the intention of the legislation. Therefore, in this case, profits may be treated as increased from a negative starting point.

will be recognised before the distribution is settled. It will not be possible to revalue the asset to fair value prior to settlement in most cases. For example, investments in subsidiaries are usually carried on the historical cost basis and it would not be regarded as acceptable to revalue, in isolation, a particular investment. Nor is it possible to anticipate the 'profit' on disposal as this arises only on 'settlement' which must necessarily be later (if only momentarily).

2.9L If relevant accounts are drawn up after the liability has arisen but before settlement, they will include the liability for the distribution and consequentially reduced net assets. That reduction will be larger than that which will ultimately arise once the distribution is settled. The profit reverses some of the reduction to leave net assets reduced overall only by the book value of the distributed asset.

2.9M The debit entry arising from recognition of a liability in accordance with IFRIC 17 is ~~an advance~~the recognition of an unsettled distribution obligation and is not a ~~realised~~ loss. The fact that it is recognised at an amount greater than the distribution measured under section 845, therefore, does not affect the ability of a private company to make a distribution.

2.9N For a public company, the temporary adverse impact on the company's net assets will have an adverse impact on its ability to make a distribution which is based on those relevant accounts (~~e.g.~~eg, a proposed final dividend) because of the net asset test in section 831. However, it will not affect the company's ability to make the non-cash distribution in question because that distribution will have been made when it was approved (see 2.10 below) and is based on earlier relevant accounts.

2.9O The test in section 831 is a statutory one which applies to the amounts shown in the ~~"~~'relevant ~~accounts"~~accounts' for the purposes of the distribution. There is no need to update these amounts on an ongoing basis throughout the year other than for earlier distributions as required by section 840. Therefore, the issue arises only when the 'relevant accounts' are drawn up to a date between the date of approval of the distribution and when it is settled. Provided that the period between approval and settlement does not straddle the company's year ~~-~~end, this issue is thus unlikely to cause a problem in practice.

## Date of distribution

2.10 A distribution is made when it becomes a legally binding liability of the company, regardless of the date on which it is to be settled. In the case of a final dividend, this will be when it is declared by the company in general meeting or, for private companies, by the members passing a written resolution. ~~In the case of an interim dividend authorised under common~~It is not unusual for articles of association ~~(e.g. 1985 Act Table A),~~ to give directors the power to resolve to pay interim dividends (see for example Model articles for private companies limited by shares[10]). In such a case, normally no legally binding liability is established prior to payment ~~being made~~ of the dividend~~. In such a case,~~ , and a distribution is made only when the dividend is paid. However, in the case of an interim dividend, steps may be taken to establish a legally binding liability at an earlier date. See 9.6 to 9.18 below concerning how such a liability may be established. That guidance is written in the context of intra-group transactions. However, the guidance may also be relevant in other cases.

2.10A Distributable profits are consumed when a distribution is made in accordance with the previous paragraph. After that time, a shareholder's right to any unpaid dividend is as a creditor of the company rather than as a shareholder[11].

## Merger relief and group reconstruction relief

2.11 Where the company has entered into a transaction which gives rise to group reconstruction relief or merger relief under sections 611 or 612, it may choose under section 615 to

[10] As contained in Schedule 1 to the Companies (Model Articles) Regulations 2008, SI 2008/3229 (as amended).

[11] Section 74(2)(f) of the Insolvency Act 1986 provides that a sum due to a member in his character of a member by way of dividends etc is subordinated in a liquidation to the claims of other creditors.

disregard any amount that would otherwise have been included in the share premium account in determining the amount at which the acquired asset is stated in the company's balance sheet. Subject to the rules in accounting standards, the asset may therefore be stated at the nominal value of the shares issued together with any minimum premium value recognised when applying group reconstruction relief. However, it is also possible to record the asset acquired at fair value and to credit the amount of that relief to another reserve (often called a merger reserve)[12]. In such a case, that reserve is in law a profit and is initially treated as unrealised but becomes realised in a manner similar to a revaluation reserve. Thus, provided the merger reserve is not capitalised (by way of a bonus issue of shares), the decision as to whether or not to record the merger reserve should not overall have any effect on the level of the company's realised profits. The accounting choice referred to in this paragraph may be restricted by the application of accounting standards. This is considered further at 9.43 to 9.44D below.

## Relevant accounts

### General

2.12 Under both the Act and common law, distributions are made by individual companies and not by groups. The group accounts are therefore not relevant for the purpose of determining a company's profits available for distribution ~~(see 10.1 to 10.3 below).~~. The ~~status~~effect of ~~accounts prepared in accordance with IAS 28 or IAS 31 (ie using~~the inclusion of profits and losses arising from equity accounting~~) where a company has an associate or jointly controlled entity but has no subsidiaries~~ in individual accounts is considered at 10.~~4~~1 to 10.3 below.

2.13 Whether or not a distribution may be made within the terms of the Act is determined by reference to a company's 'relevant accounts'. Where it is proposed to make a distribution during the company's first accounting reference period or before any accounts have been circulated, initial accounts must be prepared. In all other cases the relevant accounts are its last annual accounts that were circulated to members[13] or interim accounts made up to a more recent date, if the proposed distribution cannot be justified by reference to the last annual accounts. In the case of a public company, these initial or interim accounts must be delivered to the Registrar of Companies before the distribution is made (see 2.20 below).

2.14 The items in these accounts to which reference is made in determining the amount of a distribution which may be made are listed in section 836(1) as profits, losses, assets, liabilities, provisions[14], share capital and reserves (including undistributable reserves). Thus, valuations or contingencies referred to in notes to the financial statements, but not incorporated in the balance sheet, do not affect the amount of realised profit calculated by reference to the relevant accounts. For example, if the relevant accounts record an unrealised profit but state in a note that, as a consequence of an event subsequent to the balance sheet date, the profit has become realised, interim accounts must nevertheless be prepared before a distribution can be made out of these profits.

2.15 Similarly, disclosures about the impact of future changes of accounting policy, such as those required by IAS 8(30), do not affect the amount of realised profit calculated by reference to the relevant accounts. However, they may be relevant to the application of the common law on capital maintenance where a distribution is to be made in the period in relation to which the change of policy will be implemented (see 3.30 and 3.31 below).

2.16 In practice it may not be sufficient to determine the amount of realised profits simply by examining the relevant accounts as further enquiries may be necessary as to the composition

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[12] As explained at 9.44B below, a third basis of measurement may be required when applying IAS 27 ~~as revised in May 2008~~.

[13] ~~Where a company circulates to members a summary financial statement, the relevant accounts are the full accounts from which the summary financial statement was derived.~~

[14] Provisions are defined for this purpose in section 836(1) as, in the case of Companies Act accounts, provisions of any kind specified for this purpose by regulations under section 396 and, in the case of IAS accounts, provisions of any kind.

of the various reserves included in the balance sheet. For example, certain reserves may include both realised and unrealised profits. As there is no legal requirement for a company to distinguish in its accounts between distributable and non-distributable profits as such (see 2.25 to 2.27 below), companies should keep sufficient records to enable them to distinguish between those profits which are available for distribution and those which are not.

2.17 Under section 395, a company's individual accounts must be prepared either as "'Companies Act individual ~~accounts"~~accounts' or as "'IAS individual ~~accounts".~~accounts'. Thus, the relevant accounts will be either its "'Companies Act individual ~~accounts"~~accounts' or "'IAS individual ~~accounts",~~accounts', depending on the choice made by the company. It follows that when a company elects to prepare its statutory individual accounts in accordance with EU-adopted IFRSs, it is the amounts stated in those accounts that are relevant for the purposes of justifying a distribution.

2.18 The detailed requirements for relevant accounts (annual, interim or initial) are summarised in the following paragraphs.

**Annual accounts – all companies**

2.19 If the company's last annual accounts constitute the relevant accounts they must be prepared under Part 15 of the Act (Accounts and Reports) and comply with the requirements of section 837. Such accounts may be either "'Companies Act individual ~~accounts"~~accounts' or "'IAS individual ~~accounts"~~accounts' (see 2.17 above). The requirements of section 837 are that:

(a) the accounts must have been properly prepared in accordance with the Act (including the requirement in section 393 that they must not be approved unless the directors are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss of the company), subject only to matters not material for determining the lawfulness of a distribution;

(b) the accounts[15] must have been circulated to members in accordance with section 423[16];

(c) the accounts must be accompanied, where applicable, by the report of the auditors under section 495; and

(d) if the report of the auditors is qualified, the auditors must state in writing whether in their opinion the matters in respect of which their report is qualified is material for determining the lawfulness of the distribution. The statement by the auditors, which can be subsequent to the report, must be laid before the company in general meeting in the case of a public company, or be circulated to members in accordance with section 423 in the case of a private company.

The last two sub-paragraphs do not apply where the directors of the company have taken advantage of ~~the audit~~an exemption ~~conferred by sections 477(1) or 480(1).~~from audit.

**Initial and interim accounts – public companies**

2.20 Sections 838 and 839 respectively provide that interim and initial accounts of a public company must have been 'properly prepared', or have been properly prepared subject only to matters that are not material for determining, by reference to those accounts, whether the proposed distribution would contravene sections 830 or 831. A copy of the interim and initial accounts must have been delivered to the Registrar of Companies before the distribution is made (ie, before the date of the distribution - see 2.10 above).

2.21 'Properly prepared' means that the accounts must comply with sections 395 to 397 which includes the true and fair requirement in relation to Companies Act accounts[17] and the

[15] When a company circulates to members its strategic report and supplementary information, the relevant accounts are the full accounts from which the strategic report and supplementary information were derived.
[16] ~~Where a company circulates to members a summary financial statement, the relevant accounts are the full accounts from which the summary financial statement was derived.~~
[17] There is no statutory requirement for interim and initial accounts to give a true and fair view when they are prepared under IFRSs because section 393, which imposes an overarching requirement for annual accounts

requirement to apply EU-adopted IFRSs in relation to IAS accounts. These requirements are to be applied with such modifications as are necessary because the accounts are prepared otherwise than in respect of an accounting reference period. In the case of interim accounts, the balance sheet must be signed in accordance with section 414. There is no equivalent statutory requirement for initial accounts to be signed in accordance with section 414 but, in practice, the auditors will require the accounts to be approved and signed by the directors before the report of the auditors can be signed.

2.22 In requiring the interim and initial accounts to be 'properly prepared', or to be properly prepared except for matters which are not relevant in determining whether a proposed dividend would be lawful under the Act, the legislation permits a public company to omit information which is not relevant in determining whether a distribution would be lawful under the Act. In practice, therefore, interim or initial accounts will consist of a balance sheet and profit and loss account but the notes may be restricted to those matters that are relevant to a distribution. Corresponding amounts for the previous financial year would not be relevant.

2.23 Interim accounts are not required to be audited. However, initial accounts of a public company must be accompanied by a report by the auditors stating whether, in their opinion, the accounts have been 'properly prepared'. If their report is qualified (which would be the case if the company chooses to prepare initial accounts which do not give a true and fair view, as described in paragraph 2.22 above), the auditors must make an additional statement which states whether, in their opinion, the matters in respect of which their report is qualified is material for determining, by reference to the initial accounts, whether the distribution would contravene sections 830 or 831. A copy of the auditors' statement must also have been laid before the company in general meeting and delivered to the Registrar of Companies.

2.23A If any of the requirements described in paragraphs 2.20 to 2.23 are not satisfied, the distribution is unlawful.

**Initial and interim accounts - private companies**

2.24 The requirements of sections 838 and 839 regarding the form and content of interim and initial accounts of public companies do not apply to private companies~~.~~, and such accounts do not need to be filed at Companies House. Instead, the only requirement for private companies flows from the general definition at the start of those sections of interim or initial accounts as those necessary to enable a reasonable judgement to be made as to profits, losses, assets and liabilities, provisions, and share capital and reserves. Reliable management accounts which deal with these matters will often satisfy this requirement. However, management accounts sometimes do not deal with all relevant matters. For example, they may exclude tax. In these cases, appropriate adjustments need to be made to the management accounts.

## Disclosure of distributable profits

2.25 There is no requirement under law or accounting standards for financial statements to distinguish between realised profits and unrealised profits or between distributable profits and non-distributable profits. Paragraph 2.16 above draws attention to the need for companies to maintain sufficient records to enable them to distinguish between those profits that are available for distribution and those which are not.

2.26 The guidance at 2.16 above is likely to be of greater significance when reporting under IFRSs or using the fair value accounting rules under UK GAAP than has previously been the case. One reason for this is that the restriction in the Accounting Regulations that only profits realised at the balance sheet date may be included in the profit and loss account does not apply in these cases.

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to give a true and fair view, does not apply for this purpose. However, the requirements of IAS 1 impose a similar requirement to 'present fairly'.

2.27 It may be thought helpful to users of financial statements if there is an indication of which reserves are distributable but, as noted above, there is no legal requirement to do so[18]. In some cases, there may be practical difficulties with providing such an analysis. For example, there may be uncertainties about whether certain profits are realised or unrealised. There is generally no need for directors to form a view on whether profits are realised unless they intend to utilise them to make a distribution.

## Subsequent events

2.28 Under common law, a company cannot lawfully make a distribution out of capital. Therefore it may be necessary to take into account losses incurred after the balance sheet date (see 2.2 above).

2.29 One or more distributions may already have been made by reference to a particular set of accounts; for example, an interim dividend or a purchase of own shares. In determining the lawfulness of any proposed further distribution by reference to the same accounts, the directors must take account of any such distributions (section 840(1)).

## Public companies

2.30 A further restriction is placed on distributions by public companies (section 831). A public company may make a distribution only if, after giving effect to such distribution, the amount of its net assets (as defined in section 831(2)) is not less than the aggregate of its called up share capital and undistributable reserves as shown in the relevant accounts.

2.31 Under section 831(4) the following are undistributable reserves:

(a) share premium account (see also section 610);

(b) capital redemption reserve (see also section 733);

(c) the excess of accumulated unrealised profits, so far as not previously utilised by capitalisation, over the accumulated unrealised losses, so far as not previously written off in a reduction or reorganisation of its share capital; and

(d) any other reserve which the company is prohibited from distributing by any enactment (~~e.g.~~eg, a redenomination reserve arising under section 628), or by its articles of association (or equivalent).

In relation to (c), the reference to 'excess' means that this amount can never be negative. Net unrealised losses cannot therefore be deducted from share capital and other undistributable reserves although net unrealised profits must be added to share capital and undistributable reserves. That is, (c) cannot reduce undistributable reserves to less than (a) plus (b) plus (d).

This means that, in calculating the amount available for distribution, a public company must reduce the amount of its net realised profits available for distribution by the amount of its net unrealised losses. The effects of this rule in relation to holdings of own shares through an ESOP trust and in relation to the presentation of shares as liabilities in the balance sheet are addressed at 7.12 *et seq* and 6.24 *et seq* respectively.

## Provisions

### The general rule and the exception

2.31A Section 841(2) states that for the purposes of Part 23, the following are treated as realised losses:

- in the case of Companies Act accounts, provisions of a kind specified for the purpose in regulations under section 396 (other than revaluation provisions); and

[18] On 24 November 2015, the FRC's Financial Reporting Lab issued a report 'Disclosure of dividends – policy and practice' exploring how companies can make dividend disclosures more relevant for investors. An update to this was issued in December 2016.

- in the case of IAS accounts, provisions of any kind (except revaluation provisions).

The Accounting Regulations[19] state that references to provisions for depreciation or diminution in value of assets are to any amounts written off by way of providing for depreciation or diminution in value of assets. It also states that references to provisions for liabilities (or, in the case of insurance companies to provisions for other risks), are to any amounts retained as reasonably necessary for the purpose of providing for any liability, the nature of which is clearly defined and which is either likely to be incurred, or certain to be incurred but uncertain as to the amount or as to the date on which it will arise.

2.32 The general rule is therefore that any provision (including one for depreciation or diminution in value as well as provisions for liabilities, charges or losses) is treated as a realised loss.

2.33 As an exception to the general rule, a 'revaluation provision' which is a provision for diminution in value of a fixed asset appearing on a revaluation of all the fixed assets (other than goodwill) (section 841(3)) is not treated as a realised loss. However, this exception would not apply where the fixed asset has been sold or scrapped, because in these circumstances any loss would need to be reclassified as realised. Furthermore, unrealised losses which exceed unrealised profits are relevant to a public company in determining the amount available for distribution as the requirements of section 831 (Restrictions on the distribution of assets) referred to at 2.30 above must be satisfied.

2.33A An example of applying section 841 is that an impairment write down of one subsidiary may be offset by an increase in value of another subsidiary for the purposes of determining profits available for distribution (although the impairment would still have to be recorded in the profit and loss account for financial reporting purposes). Another example is where financial assets are regarded as fixed assets, such as in the case of investment companies, and any decrease in the fair value of investments may be offset by any increase in the fair value of other investments for the purposes of determining profits available for distribution (even though certain increases in fair value might be treated as unrealised for the purposes of this guidance). However, as noted at 2.34AA below, the application of the exception in section 841 is not restricted to circumstances where there is an offsetting unrealised profit.

2.34 For the exception in 2.33 above to apply, it is not necessary for a revaluation of all the fixed assets to be recorded in the accounts. Section 841(4) provides that a revaluation of all the fixed assets is treated as having taken place if (1) the directors consider the value of any assets that have not actually been revalued, (2) they are satisfied that the aggregate value of those assets is not less than that stated in the company's accounts and (3) the notes to the accounts include a statement to that effect. The notes to the accounts should also state that amounts are stated in the accounts on the basis that a revaluation of fixed assets is treated as having taken place.

2.34AA Application of the exception in section 841 for revaluation provisions is not restricted to those circumstances where there is an offsetting unrealised profit (recognised or not). Where all of the assets are actually revalued, section 841 treats the provision as a revaluation provision without any additional restrictions.

2.34AB Where the assets, other than the impaired one, are not actually revalued but their value is 'considered' in accordance with section 841, the directors must be satisfied that the aggregate value of those assets (ie, the ones not actually revalued) at the time of their consideration was not less than the aggregate amount at which they were stated in the accounts. This does not impose any substantive additional restriction because financial reporting requirements ensure that an asset is not stated at a carrying amount which is higher than its value.

2.34AC An unlawful return of capital might arise if a company makes a distribution out of accumulated realised profits without deducting an impairment loss which is treated as a revaluation provision in circumstances where there is an absence of any upside on other

[19] Schedule 7 to SI 2008/409 and Schedule 9 to SI 2008/410.

assets. The company may have made a distribution which results in its assets being less than its capital under common law (see 2.2 above). In the case of a public company, a distribution would never be possible under the statutory provisions in these circumstances because of section 831 (see 2.30 above).

**Application of the exception under IFRSs and FRS 102**

2.34A Due to changes in accounting methods and choices as between cost and valuation, effected by the implementation of IFRSs and FRS 102, the question might arise as to whether the exception provided for by section 841(2) continues to be capable of use under IFRSs and FRS 102. The following paragraphs explain questions that might arise and the conclusion that the exception does continue to be capable of use under IFRSs and FRS 102.

~~2.34C For example, using section 841, an impairment write down of one subsidiary may be offset by an increase in value of another subsidiary for the purposes of determining profits available for distribution (although the impairment would still have to be recorded in the profit and loss account for financial reporting purposes). Another example is where financial assets are regarded as fixed assets, such as in the case of investment companies, and any decrease in the fair value of investments may be offset by any increase in the fair value of other investments for the purposes of determining profits available for distribution (even though certain increases in fair value might be treated as unrealised for the purposes of this guidance). However, as noted at 2.34AA above, the application of the exception in section 841 is not restricted to circumstances where there is an offsetting unrealised profit.~~

2.34B [Deleted]

2.34C [Deleted]

*Definition of "~~"~~fixed ~~assets"~~assets'*

2.34D The definition of a "~~"~~revaluation ~~provision"~~provision' (see 2.33 above) uses the term "~~"~~fixed ~~assets"~~assets' which are defined in section 853(6) as meaning assets of a company which are intended for use on a continuing basis in the company's activities. This term is not used in IFRSs. "~~"~~Non-current ~~assets"~~assets' as defined in IAS 1 will not correspond with "~~"~~fixed ~~assets"~~assets' as defined in section 853(6), for example because the former may include long term debtors.

2.34E For the purposes of applying section 841, fixed assets are those assets that meet the section 853(6) definition of "~~"~~fixed ~~assets".~~assets'. As noted above, in "~~"~~IAS individual ~~accounts",~~accounts', these will not necessarily correspond with those presented as non-current assets in the relevant accounts. However, there is nothing in section 841 that requires the fixed assets to be shown in the balance sheet as such for the section to be applied.

*Ability to revalue assets*

2.34F Investments in subsidiaries present a particular issue in the context of section 841 and IFRSs. Under IFRSs, ~~only two~~three accounting policies are available for investments in subsidiaries that are not classified as held for sale:

(a) cost (see 9.22 below); or

(b) in accordance with IAS 39, which requires such investments to be maintained at fair value~~.~~; or

(c) using the equity method as described in IAS 28.

In practice, fair value under (b) above may be precluded because the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot reasonably be assessed (see IAS 39, AG 80-81). IAS 39 requires such investments to be carried at cost. Even where a fair value policy is possible, it will require valuations to be obtained each time a balance sheet is drawn up. This is unattractive to most companies. Most companies, therefore, hold subsidiaries at cost. The issue that arises is whether it is

possible to apply the exception for ~~"~~'revaluation ~~provisions"~~provisions' in section 841 in circumstances where the accounting policy is cost (either through choice or because IAS 39 does not permit the assets to be revalued).

2.34FAThe same issue arises in connection with FRS 102 which permits a choice of accounting policy for investments in subsidiaries. These are cost, fair value through profit or loss and fair value through other comprehensive income.

2.34G Any assessment of the value of an asset can be described, for the purpose of the exception in section 841, as a revaluation, even if it is not in accordance with relevant accounting standards. In particular, the consideration of the value of an asset for the purposes of an impairment review could be described as a revaluation in this broad sense. Accordingly, section 841 does not use the term ~~"revaluation"~~'revaluation' as meaning a revaluation in accordance with relevant accounting standards. However, depreciation of an asset is not consideration of the value of an asset for the purposes of section 841.

2.34H It is also relevant that, for the purposes of a revaluation of all the fixed assets (or all other than goodwill) under section 841, the assets do not have to be included in the balance sheet at their revalued amounts nor do they have to be permitted to be included in the balance sheet at a valuation. In accordance with section 841(4), ~~"~~'for the purposes of sub-sections (2) and (3) any consideration by the directors of the value at a particular time of a fixed asset is treated as a ~~revaluation"~~revaluation' (subject to the requirements of sub-section (4)). Section 841(4) refers to ~~"~~'any consideration by the directors of the value ~~....."~~…' without any explicit requirement for that value to be determined on a basis that would be permitted for inclusion in the balance sheet.

2.34I In conclusion, it is possible to apply the exception for ~~"~~'revaluation ~~provisions"~~provisions' in section 841 in circumstances where the accounting policy is cost (either through choice or because IAS 39 does not permit the assets to be revalued).

**Asset revaluations**

2.35 Special considerations apply where a fixed asset has been revalued and an unrealised profit is recorded. Where a sum written off or retained for depreciation on or after the revaluation exceeds that which would have been charged if the unrealised profit had not been made, the excess does not give rise overall to a realised loss as there is a corresponding realisation of the related revaluation surplus, to the extent that that surplus has not previously been capitalised (section 841(5)). This means that the loss arising on the depreciation of revalued fixed assets is, in effect, calculated for distribution purposes by using historical cost principles, except to the extent that the surplus has previously been capitalised.

2.36 If an asset is revalued downwards below its recoverable amount, as defined in FRS ~~11~~102 or IAS 36, then the difference between that revalued amount and recoverable amount is treated as an unrealised loss as it reflects a revaluation adjustment rather than a provision as defined in section 841[~~20~~]. Such a loss would become realised in the event of a subsequent scrapping, disposal or impairment of the asset.

~~2.37 Under IAS 16, any revaluation loss that exceeds an existing revaluation surplus will be recognised as an expense in the income statement. Under FRS 15, such a loss would be recognised in the Statement of Total Recognised Gains and Losses to the extent that the asset's recoverable amount was greater than its revalued amount. Also, under FRS 15, where an impairment loss on a revalued asset is caused by a clear consumption of economic benefits, the loss will be taken to the profit and loss account. Under IAS 16, it will be taken to equity to the extent that there is a revaluation surplus relating to the asset. Consequently,~~

~~[20] FRS 15(70) states that where it can be demonstrated that recoverable amount is greater than the revalued amount, the difference between recoverable amount and the revalued amount is clearly not an impairment and should therefore be recognised in the statement of total recognised gains and losses as a valuation adjustment, rather than the profit and loss account.~~

losses may be reported differently under IFRSs and UK GAAP but the effect on accumulated realised profits will be the same.

2.37 For example, a property that cost £1m has been depreciated by £200,000 such that its book value is £800,000. It is revalued to its market value of £500,000. Its value in use is, however, greater than £800,000 and therefore no impairment provision would be required on an historical cost basis. The revaluation deficit of £300,000 is therefore an unrealised loss and may be recorded as a debit balance on revaluation reserve. However, to the extent that the value in use subsequently falls below £800,000 (ignoring further depreciation) the debit balance in the revaluation reserve will become a realised loss.

**Development costs**

2.38 Section 844 requires that development costs shown as an asset should be treated as a realised loss, except where there are special circumstances in the company's case justifying the directors justifyin deciding that the costs carried forward beingshould not be treated as an asset.a realised loss. This exception would be the case if the costs are carried forward in accordance with applicable accounting standards. The justification must be included in a note to the accounts (section 844(3)).

2.39 [Moved to 2.1AA]

**Treasury shares**

2.40 Sections 724 to 732 of the Act relax, in some circumstances, the requirement that when a company purchases its own shares they are automatically cancelled. They allow certain public companies that purchase their own "qualifying shares"' shares' out of distributable profits the option of holding them "'in treasury"treasury' (ie, un-cancelled) for sale at a later date (which must be for cash) or transferring them for the purposes of, or pursuant to, an employee share scheme. The treasury shares may also be cancelled at a later date. Only "qualifying shares" may be held in treasury. Qualifying shares are shares which are included in the Official List, traded on AIM, officially listed in another EEA[21] state or traded on a regulated market established in an EEA state. In all other cases, shares purchased are cancelled by the automatic operation of the law in accordance with section 706.

2.41 Any purchase of shares to be held in treasury has to be made out of distributable profits which will be reduced by the amount of the purchase price.[22].

2.42 The Act specifies how the proceeds of sale of any treasury shares for cash affects distributable profits. Where the proceeds of sale are equal to or less than the purchase price paid by the company for the shares, the proceeds should be treated as realised profits (ie, to reverse the original reduction in realised profits up to the purchase price paid). Where the proceeds of sale exceed the purchase price paid by the company for the shares, that part of the proceeds that is equal to the purchase price paid should be treated as a realised profit of the company. A sum equal to the excess should be transferred to the share premium account (ie, so that the purchase and sale of shares cannot create an overall increase in realised profits). For these purposes, section 731(4) provides that the purchase price paid by the company for the shares should be determined by the application of a weighted average price method.

2.43 Investments in own shares through an ESOP trust are not treasury shares as a matter of law. The distributable profit implications of shares held by an ESOP trust are considered in section 7 of this guidance. The purchase by an ESOP trust of shares held as treasury shares is considered at 7.33 to 7.35.

**Section 832 – Investment companies**

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[21] The European Economic Area (EEA) comprises the European Union together with Norway, Iceland and Liechtenstein.

[22] Section 724 was amended in 2013 to permit certain shares repurchased otherwise than out of distributable profits to be held as treasury shares but this amendment was reversed with effect from 6 April 2015 by The Companies Act 2006 (Amendment of Part 18) Regulations 2015 (SI 2015/532).

2.44 Investment companies are defined in section 833[23]. Under section 832[24] they are permitted, subject to meeting ~~certain requirements~~a requirement in section 832(5), to make distributions in circumstances, described in the following paragraph, which would not be permitted for other public companies under section 831. However, section 832 is an alternative rather than additional test for investment companies. Accordingly, an investment company may make a distribution in accordance with section 832 regardless of whether it would meet the tests in section 831 and, although possibly more rarely, vice versa. ~~However, an investment company's articles must prohibit the distribution of capital profits (see section 833(2)(c)) and the application of section 831 cannot override this.~~

2.44A An investment company may make distributions at any time out of its accumulated realised revenue profits, so far as not previously utilised by a distribution or capitalisation, less its accumulated revenue losses (whether realised or unrealised), so far as not previously written off in a reduction or reorganisation of capital duly made:

- if at that time the amount of its assets is at least equal to one and a half times the aggregate of its liabilities to creditors;
- if, and to the extent that, the distribution does not reduce that amount to less than one and a half times that aggregate; and
- the conditions set out in section 832(5) are met.

2.45 In most circumstances, these rules allow an investment company to ignore capital losses, whether realised or unrealised, when making a distribution.

2.46 As noted at 6.24 *et seq* in relation to section 831, the presentation of financial instruments in accordance with the substance of their contractual terms under IFRSs may affect the amount of a company's liabilities as stated in its relevant accounts. In particular, where all or part of the amount attributable to preference shares is presented as a liability, total liabilities will be increased by that amount. The amount of a company's assets is unaffected by the reclassification of shares as liabilities.

2.47 However, section 832 refers to ~~"~~'liabilities to ~~creditors".~~creditors'. Although ~~"creditors"~~'creditors' is not defined for this purpose in the Act, this amount excludes amounts in respect of share capital and share premium that have been presented as liabilities. It also excludes other amounts due to shareholders in their capacity as such including accruals for dividends and redemption premiums that have been presented as expenses in the income statement and liabilities in the balance sheet. It would not, however, exclude general accruals, deferred income or deferred tax.

2.47A Ordinary dividends are accrued in the balance sheet only in those rare cases where they are legally binding liabilities at the balance sheet date (see 2.10 above). However, a shareholder's right to any unpaid dividend is as a creditor of the company rather than as a shareholder (see 2.10A above). Therefore, any such liability is a liability to creditors for the purposes of section 832.

**~~Section~~ Sections 833A and 843 ~~–~~ Long ~~-~~term insurance business**

[23] As amended by The Companies Act 2006 (Amendment of Part 23) (Investment Companies) Regulations 2012 (SI 2012/952).
[24] As amended by The Companies Act 2006 (Amendment of Part 23) (Investment Companies) Regulations 2012 (SI 2012/952).

2.~~47B~~48 The normal rules of the Act (ie, the section 830 requirement for realised profits and the section 831 net assets rule for public companies) apply to insurance companies. However, for the purposes of determining whether there is a realised profit, the section 853(4) definition of realised profits, as being determined by reference to generally accepted accounting principles, is displaced in favour of special rules in the case of long-term insurance business as set out in sections 833A and 843. As described in paragraphs 2.50 to 2.55 and 2.56 to 2.60 below respectively, section 833A applies to insurance companies that carry on long-term insurance business and are subject to the Solvency II regulations (most insurance companies from 1 January 2016) and section 843 to those that are not.

~~2.48 Section 843 sets out special rules that apply to an authorised insurance company (as defined in section 1165), other than an insurance special purpose vehicle (as defined in section 843(8)), carrying on long-term insurance business.~~2.49 Much of the guidance in this Technical Release relates to the identification of generally accepted principles as to the determination of realised profits and losses in relation to section 853(4). To that extent, it is inapplicable to long-term insurance business of authorised insurance and reinsurance companies (other than special purpose vehicles) to which the above mentioned special rule applies instead. It should not be overlooked, however, that where such a company is a public company, it must also have regard to the section 831 net assets test.

**Section 833A – Insurance companies subject to Solvency II**

2.50 Section 833A sets out special rules for authorised insurance and reinsurance companies (other than insurance special purpose vehicles) that carry out long-term insurance business and are subject to Solvency II regulations. It came into force on 30 December 2016 and has effect for distributions made on or after that date by reference to relevant accounts (see paragraph 2.12 et seq) prepared for any period ending on or after 1 January 2016. However, as further explained in paragraph 2.54 below, a company's profits available for distribution are limited to an amount that does not exceed its accumulated profits less accumulated losses shown in its relevant accounts, whether realised or not.

2.51 The realised profit or loss of such a company for the period in respect of which its relevant accounts are prepared is taken to be the amount given by the formula A-L-D in subsection 833A(4). The formula is prepared using Solvency II based values (see section 833A(7)) as at the balance sheet date of the relevant accounts. A company's liabilities (L) are deducted from its assets (A), and a number of specific adjustments (D) are also made to recognise some differences between the bases of compiling Solvency II and Companies Act balance sheets. This is to advance section 833A's aim to recognise the special characteristics of such a company's long-term insurance business in determining its realised profit or loss.

2.52 The adjustments (D) comprise deductions for:

(a) Surpluses relating to a company's relevant interests in qualifying investment subsidiaries, defined benefit pension schemes and ring-fenced funds (see section 833A(5)(a)-(c))

(b) Deferred tax liabilities relating to surpluses included in 2.52(a) above (see section 833A(5)(d))

(c) Surplus assets held in a matching adjustment portfolio (see section 833A(5)(e))

(d) Specified capital items – including paid-in ordinary share capital, paid-in preference shares which are not liabilities of the company, any related share premium account and any undistributable reserves (see 833A(5)(f)).

So far as anything falls within more than one of the above subsections, its value is only to be taken into account only once.

2.53 In relation to section 833A(5)(a), the definition of a 'qualifying investment subsidiary' in section 833A(9) includes the phrase that it 'is not held by the company as part of its portfolio of investments'. This is to ensure that:

(a) investments backing long-term business and related liabilities are treated the same regardless of whether they are held directly or via entities that technically meet the definitions of subsidiary undertakings and other relevant participations, and

(b) interests in participations (eg, another insurance company, an asset management company or a service company) that are held for other purposes are treated as they would be by a company that is not a long-term insurer, where distributable profits take into account the receipt of dividends from the subsidiary rather than an appreciation in value of the investment in the subsidiary.

2.54 Subsection 833A(3) states that a company's profits available for distribution are limited to an amount that does not exceed its accumulated profits (whether realised or not) so far as not previously utilised by distribution or capitalisation, less accumulated losses (whether realised or not), so far as not previously written off in a reduction or reorganisation of capital duly made. The effect of this is that an insurance company's distributable profits are determined in two stages. In the first stage, accumulated realised profits or losses are calculated on a Solvency II basis unrelated to amounts in the relevant accounts as described in paragraphs 2.50 to 2.53 above. In the second stage, this amount is then capped at the amount of cumulative profits less losses shown in the relevant accounts. So an insurance company can never distribute more than the profits determined by reference to its relevant accounts but the extent to which that amount is realised, and therefore distributable, is based on a separate Solvency II calculation.

2.55 A company that carries out both long-term business and other business should apply section 833A only to the former, using apportionments between the two that are just and reasonable (see section 833A(8)).

**Section 843 – Insurance companies not subject to Solvency II**

2.56 Section 843 sets out special rules for authorised insurance and reinsurance companies (other than insurance special purpose vehicles (as defined in section 843(8)) that carry out long-term insurance business and are not subject to the Solvency II regulations. An amount included in the relevant part of the company's balance sheet is treated as a realised profit if it:

- represents a surplus in the fund or funds maintained by it in respect of its long-term business (as defined in sub-section (7) and which includes both with-profits life business and other life business); and
- has not been allocated to policyholders or, as the case may be, carried forward unappropriated in accordance with asset identification rules made under section 142(2) of the Financial Services and Markets Act 2000.

2.~~49~~57 For this purpose the relevant part of the balance sheet is ~~that~~the part of the balance sheet that represents accumulated profit or loss. A surplus in the fund or funds maintained by the company in respect of its long-term business means an excess of the assets representing that fund or those funds over the liabilities of the company attributable to its long-term business, as shown by an actuarial investigation.

2.~~50~~58 A deficit in the fund or funds maintained by the company in respect of its long-term business is treated as a realised loss. For this purpose, a deficit in any such fund or funds means an excess of the liabilities of the company attributable to its long-term business over the assets representing that fund or those funds, as shown by an actuarial investigation.

2.~~51~~59 Subject to this, any profit or loss arising in the company's long-term business is left out of account when determining realised profits and losses.

2.~~52~~60 For the purpose of these requirements, an actuarial investigation means an investigation made into the financial condition of an authorised insurance company in respect of its long-term business, by an actuary appointed as actuary to the company:

- carried out once every period of twelve months in accordance with Rules made under Part 10 of the Financial Services and Markets Act 2000; or

- carried out in accordance with a requirement imposed by section 166 of that Act.

~~2.53 Much of the guidance in this Technical Release relates to the identification of generally accepted principles as to the determination of realised profits and losses in relation to section 853(4). To that extent, it is inapplicable to long-term insurance business of authorised insurance companies (other than special purpose vehicles) to which the above mentioned special rule applies instead. It should not be overlooked, however, that where such a company is a public company, it must also have regard to the section 831 net assets test.~~

# 3. REALISED PROFITS 3.1 – 3.75

**General**

3.1 Section 830(2) of the Act defines a company's profits available for distribution as 'its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made'. Realised profits and realised losses are defined as 'such profits or losses of the company as fall to be treated as realised in accordance with principles generally accepted at the time when the accounts are prepared, with respect to the determination for accounting purposes of realised profits or losses' (section 853(4)). It is apparent from the use of the words 'at the time when the accounts are prepared' that the concept of a realised profit is intended to be dynamic, changing with the development of generally accepted accounting principles, as well as bringing within the definition profits which might not in ordinary language be called realised.

3.2 The determination of a company's profits available for distribution is derived from what is recorded in its accounts which are relevant for this purpose (see 2.12 above). It is fundamental for this purpose that the company's accounts have been properly prepared in accordance with the law and generally accepted accounting principles. Profits available for distribution may include amounts reported outside the profit and loss account (ie~~-~~, as other comprehensive income or in the ~~Statement~~statement of ~~Total Recognised Gains and Losses or Reconciliation of Movements~~changes in ~~Shareholders' Funds and their equivalents under IFRSs~~equity).

**Principles of realisation**

3.3 It is generally accepted that profits shall be treated as realised for the purpose of applying the definition of realised profits in companies legislation only when realised in the form of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty. In this context, ~~"realised"~~'realised' may encompass profits relating to assets that are readily realisable. This would embrace profits and losses resulting from the recognition of changes in fair values, in accordance with relevant accounting standards, to the extent that they are readily convertible to cash.

~~3.4 The principles of realisation set out in this guidance are consistent with the notion of realisation as expressed in FRS 18. They are, however, relevant irrespective of whether the relevant accounts are prepared under UK GAAP or under IFRSs. The guidance also recognises that certain amounts may, as a matter of law, be profits (see 3.8(b) below).~~

3.4 [Deleted]

3.5 In assessing whether a company has a realised profit, transactions and arrangements should not be looked at in isolation. A realised profit will arise only where the overall commercial effect on the company is such that the definition of realised profit set out in this guidance is met.

3.5A Thus, for example, a group or series of transactions or arrangements should be viewed as a whole, particularly if they are artificial, linked (whether legally or otherwise) or circular or any combination of these. The principle in paragraph 3.5 is likely to be of particular relevance for, but not limited to, intra-group transactions which are considered in section 9 of this guidance. Further guidance on the application of the principle in paragraph 3.5 is set out at 3.43 to 3.75 below. The specific circumstances of 'cash box structures' are addressed in section 12.

3.6 A profit previously regarded as unrealised becomes realised when the relevant criteria set out in this guidance are met (for example, a revaluation surplus becomes realised when the related asset is sold for 'qualifying consideration'). Similarly, a profit previously regarded as

realised becomes unrealised when the criteria set out in this guidance cease to be met. This is considered more fully at 3.28 to 3.29C below.

## Definitions

3.7 The definitions which follow should be read in conjunction with the principles of realisation as well as the guidance on their interpretation set out in this Technical Release.

### Profit

3.8 'Profit' for the purpose of section 853(4) comprises:

(a) ~~'gains', as defined in~~ the ~~Accounting Standards Board's 'Statement~~excess of income over expenses~~*Principles* for Financial Reporting' and 'income'~~ as defined in the ~~International Accounting Standards Board's 'Framework'~~IASB's Conceptual Framework and Section 2 of FRS 102 which ~~both convey (with different wording)~~conveys increases in ownership interest not resulting from contributions from owners. Such amounts may be included in profit or loss or in other comprehensive income or directly in equity in accordance with applicable accounting standards; and

(b) other amounts which are profits as a matter of law, or which are treated as profits, including:

(i) gratuitous contributions of assets from owners in their capacity as such; and

(ii) an amount taken to a so-called 'merger reserve' reflecting the extent that relief is obtained under sections 611 or 612 of the Act from the requirement to recognise a share premium account.

### Realised profit

3.9 A profit is realised, as a matter of generally accepted accounting practice, where it arises from:

(a) a transaction where the consideration received by the company is 'qualifying consideration'; or

(b) an event which results in 'qualifying consideration' being received by the company in circumstances where no consideration is given by the company; or

(c) the recognition in the financial statements of a change in fair value, in those cases where fair value has been determined in accordance with measurement guidance in the relevant accounting standards or company law, and to the extent that the change recognised is readily convertible to cash; or

(d) the translation of:

(i) a monetary asset which comprises qualifying consideration; or

(ii) a liability,

denominated in a foreign currency; or

(e) the reversal of a loss previously regarded as realised; or

(f) a profit[25] previously regarded as unrealised (such as amounts taken to a revaluation reserve, merger reserve or other similar reserve) becoming realised as a result of:

(i) consideration previously received by the company becoming 'qualifying consideration'; or

(ii) the related asset being disposed of in a transaction where the consideration received by the company is 'qualifying consideration'; or

(iii) a realised loss being recognised on the scrapping or disposal of the related asset; or

[25] Where the related profit has been capitalised, it will not be available for transfer from unrealised profit to realised profit.

(iv) a realised loss being recognised on the write-down for depreciation, amortisation, diminution in value or impairment of the related asset[26];

(v) the distribution in kind of the asset to which the unrealised profit relates; or

(vi) the receipt of a ~~dividend~~distribution in the form of qualifying consideration when no profit is recognised because the ~~dividend~~distribution is deducted from the book value of the investment to which the unrealised profit relates (~~e.g. as required by IAS 27 before its amendment in May 2008[27] in~~eg, a distribution which is credited to the ~~case~~cost of ~~dividends out~~investment because it is in substance a return of ~~pre-acquisition profits of subsidiaries) (see 9.22 *et seq* below~~capital),

in which case the appropriate proportion[28] of the related unrealised profit becomes a realised profit; or

(g) the remeasurement of a liability, to the extent that the change recognised is readily convertible to cash (see 3.9B below).

3.9A In addition, as explained at 2.8A, The Companies (Reduction of Share Capital) Order 2008 SI 2008/1915 specifies the cases in which a reserve arising from a reduction in a company's share capital is to be treated as a realised profit as a matter of law.

3.9B A profit arising on the remeasurement of a liability will often be the reversal of a realised loss, a foreign currency translation gain or a fair value gain, and may therefore be a realised profit in accordance with 3.9(c), (d) or (e), Paragraph 3.9(g) will be relevant in other cases such as that of a defined benefit pension liability assumed for consideration either in a separate transaction or as part of a business combination. In such a case the profit is only a realised profit in those rare cases where the change in value is readily convertible to cash as defined at 3.12 below.

### Realised loss

3.10 Losses should be regarded as realised losses except to the extent that the law, accounting standards or this guidance provide otherwise. The statutory position is set out in section 2 of this guidance.

3.10A The instances of unrealised losses referred to in this guidance are:

(a) 'revaluation provisions' as defined in section 841(3) which are an exception to the general rule that all other provisions are realised losses (see paragraphs 2.31A to 2.34I above);

(b) a downwards revaluation of fixed assets to below their recoverable amount (see paragraph 2.36 above);

(c) some losses arising from fair value accounting, but only when two criteria are met (see paragraph 4.31 below); and

(d) a provision for deferred tax when it relates to an unrealised profit in which case the deferred tax is treated as a reduction of the unrealised profit rather than as a separate realised loss (see paragraph 3.17(a) below).

### Qualifying consideration

3.11 Qualifying consideration comprises:

(a) cash; or

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[26] If the write down is subsequently reversed, an equal amount of profit should be regarded as becoming unrealised. In other words, the amount of profit regarded as becoming realised is equal to the *cumulative* amount of any write down treated as a realised loss.

~~[27] Amendments to IFRS 1 First-time Adoption of IFRSs and IAS 27 Consolidated and Separate Financial Statements: Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate.~~

[28] In the case of (iii) and (iv), the loss is treated as a realised loss under paragraph 3.15 of this guidance. However, part of this realised loss is compensated by a reclassification from unrealised to realised profit.

(b) an asset that is readily convertible to cash; or

(c) the release, or the settlement or assumption by another party, of all or part of a liability of the company; or

(d) an amount receivable in any of the above forms of consideration where:

(i) the debtor is capable of settling the receivable within a reasonable period of time; and

(ii) there is a reasonable certainty that the debtor will be capable of settling when called upon to do so; and

(iii) there is an expectation that the receivable will be settled; or

(e) an amount receivable by a company from ~~a~~its shareholder where and to the extent that[29]:

(i) the company intends to make a distribution to the shareholder of an amount equal to or less than its receivable from that shareholder; and

(ii) the company intends to settle such distribution by off-setting against the amount receivable (in whole or in part); and

(iii) within the meaning of paragraph 3.5 and 3.5A of this guidance, (i) and (ii) are linked.

3.11A For the purposes of applying paragraph 3.11 above, references to settlement include settlement by way of set-off with a liability to the same party.

### Readily convertible to cash

3.12 An asset, or change in the fair value of an asset or liability, is considered to be ~~"~~'readily convertible to ~~cash"~~cash' if:

(a) a value can be determined at which a transaction in the asset or liability could occur, at the date of determination[30] , in its state at that date, without negotiation and/or marketing, to either convert the asset, liability or change in fair value into cash, or to close out the asset, liability or change in fair value; and

(b) in determining the value, information such as prices, rates or other factors that market participants would consider in setting a price is observable; and

(c) the company's circumstances must not prevent immediate conversion to cash or close out of the asset, liability or change in fair value; for example, the company must be able to dispose of, or close out the asset, liability or the change in fair value, without any intention or need to liquidate or curtail materially the scale of its operations, or to undertake a transaction on adverse terms.

3.13 Further guidance on the application of ~~"~~'readily convertible to ~~cash"~~cash' is provided in section 4 of this guidance. The position regarding fair value losses is dealt with at 4.29 *et seq* below.

## Application

### Instances of realised profit

[29] In the case addressed by paragraph 3.11(e), it would be possible, in the absence of other accumulated realised losses, to distribute the receivable in kind under section 846. Paragraph 3.11(e) sets down generally accepted accounting practice that the receivable can be regarded as qualifying consideration in certain circumstances. The effect of this is that making a distribution settled by offset against the receivable is an alternative procedure to a distribution in kind of that receivable. ~~This is illustrated in the example in Appendix 9.~~

[30] The reference to the date of determination is subject to the limited exception in paragraph 4.17 below for the determination of the effect that any block discount on securities traded in an active market has on realised profits.

3.14 In addition to those instances which are readily apparent from the definition of realised profit, in applying the principles of realisation and the definitions set out above the following would constitute a realised profit:

(a) the receipt or accrual of investment or other income receivable in the form of qualifying consideration; or

(b) a gain arising on a return of capital on an investment where the return is in the form of qualifying consideration; or

(c) a gift ~~(~~such as a ~~'~~capital ~~contribution')~~contribution received in the form of qualifying consideration~~;~~. However, this does not apply when the legal form of the transaction is a loan even though it is accounted for as a capital contribution (see paragraph 6.20 regarding the proceeds of issue of convertible debt and paragraph 9.53 regarding intragroup off-market loans); or

(d) the release of a provision for a liability or loss which was treated as a realised loss; or

(e) the reversal of a write-down or provision for diminution in value or impairment of an asset which was treated as a realised loss.

**Instances of realised loss**

3.15 Realised losses will include:

(a) a cost or expense (other than one charged to the share premium account) which results in a reduction in recorded net assets;

(b) a loss arising on the sale or other disposal or scrapping of an asset;

(c) the writing down, or providing for the depreciation, amortisation, diminution in value or impairment, of an asset[31] , except as noted at 2.33 and 2.36 above;

(d) the creation of, or increase in, a provision for a liability or loss (other than deferred tax in the circumstances described at 3.17 below) which results in an overall reduction in recorded net assets;

(e) a gift made by the company (or the release of all or part of a debt due to the company or the assumption of a liability by the company) to the extent that it results in an overall reduction in recorded net assets; and

(f) a loss arising from fair value accounting where profits on remeasurement of the same asset or liability would be treated as realised profits.

~~3.16 [Deleted]~~

~~**Deferred tax**~~

**Current and deferred tax**

3.16 A current tax charge should be treated as a realised loss. This is so even if it arises from the taxation of an unrealised profit. This is because a provision for current tax represents a specific sum payable in cash that will arise irrespective of whether the related profit is realised or not. Similarly, a current tax credit should 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 item to which it relates. If the specific sum receivable is due from another group company in respect of group relief, it will be necessary to consider whether the balance is qualifying consideration (see 3.11(d) above).

3.17 A provision for deferred tax should generally be regarded as a realised loss~~. However,~~ except when ~~assets~~:

[31] Where the asset has been revalued or is otherwise represented to any extent by an unrealised profit, the appropriate proportion of the related unrealised profit becomes a realised profit, thus mitigating the effect of the realised loss - see paragraph 3.9(f) of this guidance.

(a) it relates to an unrealised profit (eg, a revaluation surplus – see 3.17A below); or

(b) it arises from a credit to equity which is legally a debt (e.g. initial accounting for convertible debt – see 3.17B below).

This principle applies to deferred tax provisions recognised in accordance with accounting standards, irrespective of whether profits are recognised in profit or loss, or in other comprehensive income.

3.17A An example of deferred tax arising on an unrealised profit is when an asset (eg, a property) is revalued to ~~their~~its fair value and the ~~gain~~profit is regarded as unrealised~~, the~~. The deferred tax arising on ~~that gain~~the profit should be treated as a reduction in that unrealised ~~gain~~profit rather than as a realised loss. For many financial instruments, profits arising from fair value accounting are realised profits (see Section 4 below). Any attributable deferred tax provision will be a realised loss.

3.17B For companies applying IFRSs, when a convertible debt instrument is accounted for using 'split accounting' (see Convertible debt at 6.19 and 6.20 below), a deferred tax provision may need to be established and debited against the initial carrying amount of the equity component in accordance with paragraph 23 of IAS 12. This occurs if the tax base of the debt is its full amount but the book amount is lower by the amount of the equity component. The deferred tax provision reverses through profit or loss over the life of the instrument as illustrated in Example 4 from the illustrative computations and presentation examples that accompany IAS 12. It does not represent a future cash outflow for payment of tax. The deferred tax provision should be treated as a reduction in the credit to equity rather than as a realised loss. The equity component of the financial instrument is not a profit at all and therefore does not fall to be classified as realised or unrealised (see Convertible debt at 6.59 *et seq* below). An adjustment to such an item does not affect realised profits. The resulting reversal of the deferred tax recognised in profit or loss is similarly not a realised profit. This issue does not arise under FRS 102 because initial recognition of a compound instrument does not result in any tax accounting.

3.17C A credit in profit or loss for deferred tax will often be attributable to a realised loss and can be regarded as a reduction in that realised loss. If this is not the case, and the credit results in the recognition of a deferred tax asset in accordance with accounting standards, the resulting profit will generally be an unrealised profit because a deferred tax asset does not usually meet the definition of qualifying consideration.

3.17D Under FRS 102, a credit for deferred tax in profit or loss should, as a result of the timing differences approach, generally relate to a realised pre-tax loss recognised in the profit and loss account. Such a deferred tax credit will therefore be a reduction in that pre-tax loss. However, under the temporary differences approach of IAS 12 there are more circumstances in which a credit will be recognised for deferred tax without a related pre-tax expense.

**Exchange of assets ('top-slicing')**

3.18 Where an asset is sold partly for qualifying consideration and partly for other consideration (for example, a mixed consideration of cash and a freehold property), any profit arising is a realised profit to the extent that the fair value of the consideration received is in the form of qualifying consideration. This approach is sometimes referred to as 'top-slicing'. (Example: fair value of consideration received is ~~10~~£10m, of which ~~4~~£4m is cash and ~~6~~£6m is freehold property. If the depreciated historical cost of the asset sold is ~~5~~£5m, the total gain is ~~5~~£5m but the realised profit is limited to ~~4~~£4m.)

3.18A The consideration received may comprise a combination of assets and liabilities. For example, this will often be the case on a transfer of trade and assets for no consideration (eg, a 'hive down' or 'hive across'). To apply the 'top slicing' rule in this case, any liabilities should first be deducted from the amount of qualifying consideration received. The profit will be realised only to the extent of any net balance of qualifying consideration received. For example, if a capital contribution received comprises investment property of £100,000 and

cash of £50,000 together with a bank loan of £70,000, none of the resulting profit of £80,000 is realised because the net amount of qualifying consideration received is negative.

### Hedging

3.19 Where hedge accounting is obtained in accordance with the relevant accounting standards, it is necessary to consider the combined effect of both sides of the hedging relationship to determine whether there is a realised profit or loss in accordance with the criteria in this guidance.

3.20 Application of this principle in the context of hedge relationships within the individual financial statements of a company is considered at 5.1 to 5.18 of this guidance. Consideration of the effects of hedge relationships where the hedging instrument and the hedged item are held by different group companies is considered at 5.19 to 5.22.

### Foreign exchange profits and losses

~~3.21 Paragraph 65 of SSAP 20 Foreign currency translation, which was issued in 1983, states that 'the application of paragraph 50 of this statement may result in unrealised exchange gains on unsettled long-term monetary items being taken to the profit and loss account'. Since then, however, the currency markets have become more sophisticated and companies have significantly more flexibility to crystallise exchange profits on long-term monetary items. Consequently, unless~~3.21 Unless there are doubts as to the convertibility or marketability of the currency in question, foreign exchange profits arising on the retranslation of monetary items are usually realised, irrespective of the maturity date of the monetary item.

~~3.21A~~ This ~~has become~~is generally accepted practice even though the exchange difference may not be 'readily convertible to cash' at the balance sheet date. However, a profit on retranslation of a monetary asset will not be a realised profit where the underlying balance on which the exchange difference arises does not itself meet the definition of 'qualifying consideration'. For example, this may be the case for some long-term ~~inter-company~~intra-group balances ~~within groups~~.

3.21A [Deleted]

3.21B The position regarding exchange differences reported in a separate component of equity (ie, not in the income statement) is considered at 5.7 below in relation to cash flow hedge accounting; and in relation to the translation of branches into the company's functional currency, the translation of the whole of a company's accounts from the company's functional currency to a presentation currency and questions of mismatch with the currency of denomination of shares are considered in section 11.

### Goodwill in an individual company

3.22 Where goodwill arises in a company's individual accounts (which would be the case, for example, where the company has purchased an unincorporated business) the goodwill will become a realised loss as the goodwill is amortised or written down for impairment in accordance with ~~relevant accounting standards~~applicable accounting standards. FRS 102 requires goodwill to be amortised over a finite estimated useful life, but IFRSs do not permit amortisation.

3.23 For periods ending before 23 December 1998, purchased goodwill may have been accounted for under SSAP 22 ~~"~~'Accounting for ~~goodwill"~~goodwill' by immediate elimination against reserves. Such goodwill may have remained eliminated against reserves under UK GAAP under the transitional provisions of FRS 10~~.~~ and will remain there on transition to FRS 102 or IFRSs. Such goodwill should be regarded as a realised loss to the extent that, had it always been recognised as an asset, it would have been amortised ~~or~~, impaired or disposed of in accordance with ~~FRS 10.~~

~~3.23A If the business to which the acquired goodwill relates is disposed of or closed, FRS 10 requires the profit or loss on disposal to include the goodwill previously taken to reserves to the extent that it has not previously been charged to the profit and loss account. Notional amortisation or impairment for the purposes of calculating realised profits does not affect this~~

financial reporting requirement. However, the effect of the disposal on realised profits is therefore net of any amount already treated as a realised loss in accordance with this guidance.

3.23B Goodwill may also have remained eliminated against reserves on transition to IFRSs in accordance with IFRS 1. Such goodwill should be regarded as a realised loss to the extent that, had it always been recognised as an asset under IFRSs, it would have been impaired in accordance with IFRS 3 and IAS 36. This is unaffected by any amounts of notional amortisation in accordance with FRS 10 that might have been treated as realised losses prior to transition to IFRSs.

3.23C When applying IFRSs, goodwill previously written off to reserves is not taken into account in any profit or loss on subsequent disposal. However, any goodwill written off to reserves that has not previously been treated as a realised loss will become realised as a result of the disposal.

3.23D applicable accounting standards. Companies not wishing to make these assessments may prudently opt to regard the entire amount of goodwill written off to reserves as a realised loss.

3.23A [Deleted]

3.23B [Deleted]

3.23C [Deleted]

3.23D [Deleted]

**Negative goodwill in an individual company**

3.24 The following guidance on negative goodwill applies under UK GAAP and IFRSs unless otherwise stated. Neither. IFRS 3 nor IFRS 3 Revised (subsequently together referred to as IFRS 3) usesdoes not use the term "'negative goodwill"goodwill' but instead they describedescribes that concept using different words. For simplicity, such an amount is described in this guidance as negative goodwill.

3.25 Negative goodwill up to the fair values of the non-monetary assets acquired should be treated as being realised in the periods in which the non-monetary assets are recovered, whether through depreciation or sale. Where the negative goodwill exceeds the value of the non-monetary assets, this excess should be treated as being realised in the periods expected to benefit. However, negative goodwill should not be treated as a realised profit in the case of a sale of the non-monetary assets where the consideration received is not qualifying considerationThis is consistent with the accounting treatment required under FRS 102.

3.26 Under UK GAAP, negative goodwill recognised in the profit and loss account in accordance with FRS 10 therefore represents a realised profit except in the case of a sale of the non-monetary assets where the consideration received is not qualifying consideration. 3.26 Where negative goodwill was accounted for under SSAP 22 in the accounts of an individual company, it would have been regarded initially as an unrealised profit. It will become a realised profit on the same basis as if it had been negative goodwill accounted for under FRS 1010102.

3.27 IFRS 3 requires the immediate recognition of negative goodwill as a profit for financial reporting purposes but this does not accelerate the realisation of negative goodwill which is as set out at 3.25 above irrespective of the accounting framework adopted.

3.27A However, negative goodwill should not be treated as a realised profit in the case of a sale of a non-monetary asset when the consideration received is not qualifying consideration.

**Changes in circumstances including changes in accounting policies and on the adoption of IFRSs and FRS 102**

**Introduction**

3.28 The treatment of a retained profit or loss as realised (or unrealised), or the recognition of an item as a profit or loss or an asset or liability, may change subsequent to its original recognition as a result of:

(a) a change in the principles of realisation; or

(b) a change in the law or in accounting standards or interpretations, either through an express reference to the realisation or otherwise of the profit or loss or, more commonly, through a change in the recognition or measurement of assets, liabilities, income or expenses. A company adopting IFRSs or FRS 102 for the first time will, in effect, be making a number of changes in accounting policies; or

(c) some other change in circumstance such that what was originally qualifying consideration under paragraph 3.11(d) is no longer so, for example, where a receivable was initially regarded as qualifying consideration but circumstances change such that there is now no expectation that the receivable will be settled in the form of qualifying consideration.

3.29 Although the effect of these changes may be to reduce or even eliminate a company's net realised profits, that would not render unlawful a distribution already made out of realised profits determined by reference to 'relevant accounts' which had been prepared in accordance with generally accepted accounting principles applicable to those accounts (this is subject to paragraphs 3.30 and 3.31 below). This is because the Act defines realised profits and losses for determining the lawfulness of a distribution as 'such profits and losses of the company as fall to be treated as realised in accordance with principles generally accepted **at the time when the accounts are prepared**, with respect to the determination for accounting purposes of realised profits or losses' (section 853(4), emphasis added).

3.29A The circumstances described in paragraph 3.28(c) do not extend to the case of "'an asset that is readily convertible to ~~cash"~~cash' (which is "'qualifying ~~consideration"~~consideration' under paragraph 3.11(b)). Such assets are, when received, regarded as being so highly liquid as to be treated as equivalent to cash. That is to say, the initial determination that a profit is a realised one is, if based on the qualifying consideration's being cash or "'an asset that is readily convertible to ~~cash",~~cash', definitive and unchangeable. Thus, for example, if changes in the market for a financial asset mean that from a certain point in time the asset no longer meets the "'readily convertible to ~~cash"~~cash' test, then prior fair value movements – whether profits or losses – remain as realised.

3.29B This would be relevant if, for example, the financial asset were reclassified out of a fair value category under ~~the amendment to~~ IAS 39 ~~of November 2008~~. To the extent that the last fair value includes amounts originally determined to be realised profits, they remain so. It is as if the profits were realised in cash and re-invested (outside of the principle in paragraph 3.5) into the financial asset in question. In such a reclassification case, it may of course be the case that the market changed, so as no longer to meet the "'readily convertible to ~~cash"~~cash' test, at an earlier date than the reclassification. In such a case the financial asset's carrying value may include realised profits and unrealised profits. Whilst the realised profits will retain that status going forward, the unrealised profits are capable at some future date of changing to realised profits under paragraph 3.9(f).

3.29C It would be open to a company, instead of splitting the fair value movement since inception into movements that were and were not readily convertible to cash, to make a shortcut, prudent assumption that if there are cumulative net gains since inception, they are regarded as unrealised.

### Timing of the effect of changes in accounting policies on distributable profits

3.30 The effects of the introduction of a new accounting standard or on the adoption of IFRSs or FRS 102 become relevant to the application of the common law capital maintenance rule only in relation to distributions accounted for in periods in which the change will first be recognised in the accounts. Where items will fall to be treated as liabilities under a new standard in a period after the period in which the dividend is accounted for, directors do not have to pay regard to such future liabilities merely because they are disclosed in the notes to the accounts.

3.31 Where the directors are considering the payment of an interim dividend in respect of a financial year, and a new accounting standard may, for example, lead to items being recognised as liabilities in the accounts for that year, the directors must, under common law, have regard to the effect of these liabilities on the expected level of profits available for distribution at the end of the financial year when determining the lawfulness of the interim dividend.

3.32 For example, for a company adopting IFRSs for the first time in its individual accounts in ~~2010~~2016 the position is as follows:

- any dividends accounted for in the 2015 accounts (eg, interim dividends paid during the year) do not have to have regard to the effect of adoption of IFRSs;
- any final dividend for ~~2009~~2015 will not be provided in the ~~2009~~2015 UK GAAP accounts and will first be accounted for in the ~~2010~~2016 accounts. Such a dividend would therefore have to have regard to the effect of adoption of IFRSs even though the ~~"~~'relevant ~~accounts"~~accounts' may still be those for ~~2009~~2015 prepared under UK GAAP;
- any interim dividend paid during ~~2010~~2016 would have to have regard to the effect of adoption of IFRSs even though the ~~"~~'relevant ~~accounts"~~accounts' may still be those for ~~2009~~2015 prepared under UK GAAP; and
- the ~~2010~~2016 accounts prepared under IFRSs would be the relevant accounts for the purposes of the final dividend approved by shareholders in ~~2011~~2017. The effect of a change in accounting policy known to be adopted in ~~2011~~2017 needs to be taken into account in determining the dividend to be approved by shareholders in ~~2011~~2017. The dividend will be recognised in the ~~2011~~2017 accounts.

3.33 The considerations set out above apply to all dividends whether in respect of shares classified as equity or shares classified as debt (or partly shares and partly debt as a compound instrument~~) under either IFRSs or UK GAAP.~~).

3.34 If the effect of a new accounting standard or guidance on profits which fall to be treated as realised is to increase the company's accumulated profits and the company wishes to distribute an amount in excess of that which could be determined by reference to what would otherwise constitute the company's 'relevant accounts', the company is required to prepare interim accounts complying with the new accounting standard or guidance. Where a public company is in this position, those interim accounts are required to be delivered to the Registrar under section 838.

3.35 For the purposes of a dividend made by reference, under statute, to ~~UK~~previous GAAP relevant accounts, but at a time when the foregoing guidance requires the effect of a current year changeover to ~~IFRSs~~a new GAAP to be considered, the directors will need to understand the consequences of adopting ~~IFRSs~~the new GAAP for the company's profits available for distribution. There is no statutory requirement to prepare interim accounts under section 836 (and section 838 in the case of a public company) if a proposed distribution can be justified by reference to the relevant accounts. However, under common law, a company cannot lawfully make a distribution out of capital. The directors may, for example, by reason of their duties to exercise appropriate skill and care, consider preparing interim accounts under ~~IFRSs~~the new GAAP, as of the date shortly before the time of paying the proposed dividend, to satisfy themselves that the accumulated realised profits shown in the last statutory individual accounts have not been eliminated, or reduced to such an extent that the proposed distribution would be unlawful. (It should be noted that these ~~"~~'interim ~~accounts"~~accounts' would not be interim accounts within the meaning of section 836(2) of the Act and section 838 would not therefore apply to them.) For a public company, the directors will also have to consider the impact of the restriction on distributions arising from section 831 (see 6.24 *et seq*). It may not always be necessary to prepare interim accounts, for example, in very straightforward cases where the directors are satisfied that no material adjustments arise from the transition to ~~IFRSs~~the new GAAP.

3.36 The directors of a company may not yet have decided whether to adopt ~~IFRSs~~a new GAAP for the current financial year. Similarly, they may not have decided whether to adopt early a

new accounting standard that has been issued but is not mandatory for the financial year. In these cases, the company's accounting policies are those that it has previously applied until a decision is made to change them. Therefore, in applying the foregoing guidance, it is not necessary to have regard to possible changes of policy that are being considered but have not yet been agreed.

3.37 Where a company believes that the implementation of ~~IFRSs~~a new GAAP will increase its balance of distributable profits, and it wishes to distribute those profits as increased, the guidance at 3.34 above will be relevant.

**Realised profits that have been distributed and are subsequently eliminated by a change of circumstances (including a change of accounting policy)**

3.38 Where the effect of a change in circumstance is that a profit previously recognised as realised either no longer exists or can no longer be regarded as being realised, the amount of that profit should either be eliminated through a prior year adjustment or be reclassified as unrealised (~~as appropriate~~respectively) in the relevant accounts in which the change in circumstance is first recognised.

3.38A Where a previously recognised realised profit is eliminated through a prior year adjustment, the adjustment should be treated as a realised loss. The effect is therefore to reduce accumulated realised profits by the amount of the adjustment. If the adjustment results in accumulated realised losses, further distributions will not be possible until the shortfall is made good. To make a distribution before the shortfall is made good would amount to an unlawful return of capital, contrary to common law.

3.38B The same approach is possible where the previously recognised realised profit is reclassified as an unrealised profit. However, as explained below, in certain circumstances, it may be possible to adopt an alternative approach and to treat the distribution as having been made, in whole or in part, out of the profit which has been reclassified as unrealised so that it reduces accumulated unrealised profits rather than accumulated realised profits. This alternative approach may reduce any adverse impact on accumulated realised profits but is more difficult to apply. Either approach is acceptable when realised profits are reclassified as unrealised profits.

3.38C Under the alternative approach referred to in 3.38B, as profits are fungible, unless there is evidence that the profit affected by the change in circumstances has been distributed, it should be assumed that the first distribution made after the recognition of the profit was made pro rata out of all available profits shown in the relevant accounts. Accordingly, the balance remaining after that distribution would include a proportionate amount of the affected profit. Similarly each subsequent distribution would reduce proportionately the amount of the affected profit.

3.39 For example, a company has accumulated realised profits of 40 brought forward at the beginning of Year 1. During that year it makes realised profits of 60 of which 40 arose from a specific transaction in that period, and distributes 70, leaving a balance of 30. In Year 2 it generates a further 170 of realised profits and distributes 150. A change in circumstances in year 3 leads to the 40 recognised in Year 1 becoming treated as unrealised. The amount of the original profit of 40 that would be regarded as having been distributed in Year 1 would be 28 (70% [ie, 70/100] of 40), leaving 12 of the original profit to be carried forward in the closing balance of 30 at the end of Year 1. In Year 2 the amount of this 12 that would be regarded as having been distributed in Year 2 would be 9 (75% [ie, 150/200] of 12), leaving 3 of the original profit to be carried forward in the closing balance of 50 at the end of Year 2. Thus the amount of profit to be reclassified as unrealised in Year 3 as a result of the change in circumstance would be 3.

| | | Total | Affected profit |
|---|---|---|---|
| YEAR 1: | Brought forward | 40 | - |

| | | | |
|---|---|---|---|
| | Profit for year | 60 | 40 |
| | Available for distribution | 100 | 40 |
| | Distributed | ( 70) | (28) |
| YEAR 2: | Brought forward | 30 | 12 |
| | Profit for year | 170 | - |
| | Available for distribution | 200 | 12 |
| | Distributed | (150) | (9) |
| YEAR 3: | Brought forward | 50 | 3 |

3.40 Where after making all reasonable enquiries it proves impracticable to obtain the information to make the allocation described at 3.38C, it would be appropriate to assume that the profit has been distributed (to the extent that there have been distributions).

**Effect of errors**

3.41 ~~Under UK GAAP, only changes in accounting policies and correction of *fundamental* errors are accounted for by restatement of comparatives. This means that errors that are material but not "fundamental" are accounted for in the year in which they are detected without any restatement. In contrast,~~ IAS 8 ~~requires~~and FRS 102 require all **material** errors to be corrected retrospectively through a restatement of comparatives. ~~Consequently, correction of errors by restatement is more common when reporting under IFRSs.~~ A distribution may have been made by reference to the original accounts which would not have been justified if the error had not occurred. The question arises of whether such a distribution would be rendered unlawful.

3.42 It is the error, rather than its correction, that may have the effect of making a previous distribution unlawful. ~~The effect of reporting under IFRSs is to make such errors more visible because of the requirement for retrospective restatement for all material errors. But whether~~Whether or not an error is corrected in this way does not, of itself, govern the lawfulness of a previous distribution. The effect of an error on the lawfulness of a distribution raises complex legal issues that are beyond the scope of this guidance.

**Application of the linkage etc principle in paragraph 3.5**

3.43 The principle in paragraph 3.5 above must be viewed from the perspective of an individual company to determine that company's realised profits. Therefore, if a company enters into a single transaction, that transaction cannot be linked because the concept of linkage requires the effect of two or more legally separate transactions of the same entity to be viewed as a single transaction in substance. The fact that a series of transactions is circular from the perspective of a group does not mean that an individual company in the group, for example that participates in a single transaction in that series, cannot realise a profit on that transaction. The normal test of realisation may be met when applied to that single transaction.

3.44 The fact that an individual company's transactions are linked for the purposes of paragraph 3.5 does not necessarily mean that a realised profit cannot arise. The normal tests of realisation may be met when applied to the overall effect of the series of transactions taken together.

3.45 For two transactions to be linked, the second transaction must have been contemplated when the first transaction was entered into. If the second transaction is entered into for genuine commercial reasons unconnected with the first transaction and was not part of a plan with the first transaction, the two transactions would not be determined as linked.

3.46 The following principles address the application of paragraph 3.5 and require the exercise of judgement.

**3.47 The application of paragraph 3.5 is not restricted to intra-group cash flows even though it is illustrated in the examples in section 9 solely in relation to intra-group situations.**

3.48 Paragraph 3.5 is also relevant to transactions with third parties. The examples in section 9 focus on intra-group transactions as these are the more common situations where the question of linkage arises. An example of a situation involving a third party where linkage must be considered is the sale of a subsidiary for cash to a third party on the condition that the cash is applied in subscribing for shares of the purchaser. The substance or overall commercial effect of the transactions is a sale with consideration in shares of the purchaser.

**3.49 The transactions do not have to be more than one of 'linked' or 'artificial' or 'circular' to fall within the principle in paragraph 3.5.**

3.50 Paragraph 3.5 states that ~~"~~'a realised profit will arise only where the **overall commercial effect** on the company is such that the definition of realised profit set out in this guidance is ~~met"~~met' (emphasis added).

3.51 Transactions need satisfy only one of the examples mentioned in paragraph 3.5A of being linked, artificial or circular, and furthermore these three cases are only particular instances of its application; that is to say, it is not limited to those cases. In practice individual transactions may fall within paragraph 3.5 because they are artificial or because collectively their effect is circular; but it is not necessary that a transaction be linked or artificial or circular for it to fall within paragraph 3.5.

**3.52 Splitting a transaction into separate steps would require consideration under the principle in paragraph 3.5.**

3.53 Taking the example discussed above of the sale of a subsidiary for shares; if this had been dealt with in one transaction it is obvious that the shares have to be evaluated to determine if they are qualifying consideration before concluding whether the profit on the transaction is realised. However, by splitting the transaction into two – a sale for cash and a subscription agreement – the commercial effect is obscured. Without proper analysis, the subscription agreement might have been overlooked and the profit determined as realised as the consideration was apparently cash. The transactions are linked. The transaction could be achieved by a single transaction of a sale for shares.

3.54 However, transactions may be linked without being artificial, or circular without being linked. Judgement is required in any determination of whether transactions fall within paragraph 3.5.

3.55 Other indicators of transactions that may fall within paragraph 3.5 include:

- the transactions being entered into at the same time (although see the discussion of time delays below) and in contemplation of each other;
- the transactions being with the same counterparty (which would include entities under common control and back-to-back arrangements); and
- transactions that are not in the ordinary course of business.

**3.56 Transactions may be linked ~~"~~'whether legally or ~~otherwise".~~otherwise'.**

3.57 Transactions will often be 'linked' when they form part of a single plan. For example, a so called 'steps plan' may exist in which a number of separate transactions are envisaged. It may be clear that the first step of the plan would never have been carried out unless there was every expectation that step two would also be carried out. In this case, it is appropriate to consider the combined effect of all of the transactions together.

3.58 However, this does not mean that transactions must be regarded as linked or circular just because they were planned together. For example, a company may sell some quoted investments for cash with the intention of using that cash to purchase stock. The fact that the company plans to use the cash to purchase stock does not prevent the profit on disposal[32] of the investments being a realised profit. Similarly, trading profits will be realised profits in accordance with the normal rules, even though the cash inflows are reinvested in stock or fixed assets.

3.59 One feature usually present for there to be linkage is that~~-~~:

- the cash ~~flow~~inflow has been generated with the intention ~~of,~~ or ~~for the~~ purpose of~~,~~ undertaking the linked ~~transaction.~~ cash outflow, or vice versa; or
- the cash outflow would not have occurred without the linked cash inflow, or vice versa.

Trading cash flows are generated as an end in themselves and thus do not possess this feature.

3.60 In relation to a sale and operating leaseback, the cash inflow arising from the sale transaction will ~~be~~, at least in part, be offset by the future cash outflows arising from the leaseback transaction. Therefore it might be queried whether they are linked. However, it is generally accepted that such arrangements do not fall within the scope of paragraph 3.5. A sale and leaseback transaction is not entered into for the purpose of financing the future operating lease rentals. To the extent that the apparent sale's profit exceeds arm's length terms (ie, the 'profit' is directly compensated for by high rentals) it is deferred anyway (under IAS 17 and ~~SSAP 21~~FRS 102).

3.61 Transactions may be linked legally by, say, being dealt with in the same contract or being in separate contracts but expressed to be inter-conditional. However, as made clear by the words ~~"~~'or ~~otherwise",~~otherwise', it is necessary to consider more than just the legal form of linkage of transactions to understand their substance collectively, as to do otherwise may not adequately express the overall commercial effect of the arrangements.

3.62 For example, in the case of the so called steps plan mentioned above, there may be no legal obligation to complete step 2 following step 1. However, this may, for example, be a commercial necessity because step 1 does not make sense without step 2 or because step 2 is necessitated by step 1.

[32] It is assumed for simplicity here that a profit is recognised on disposal of the investments, but companies ~~applying IFRSs or FRS 26~~ may have recorded a profit at an earlier stage because of the need to account for the investments at fair value.

**3.63 For a cash inflow and a cash outflow of a company to fall within paragraph 3.5, it is not necessary that the cash flows 'close the loop' by joining up at some other place in the group.**

3.64 A transaction is circular for a company if, for that company, there is a cash inflow and in another step in a series there is a cash outflow back to the same party. As discussed above, circularity is a sufficient but not a necessary feature for the application of paragraph 3.5. Another situation where paragraph 3.5 may apply is where the cash outflow at another step is to another party rather than the provider of the cash inflow. It is not necessary, for something to be linked, that the recipient of the onward cash flow passes the cash back to the original provider.

**3.65 Transactions are not linked merely because they are pre-planned but this may be evidence of linkage.**

3.66 Pre-planning (eg, by way of a steps plan) is evidence that the transactions are to be entered into in contemplation of each other and the overall outcome was pre-meditated. Evidence of pre-planning may indicate that those cash flows and the transactions from which they arise should be assessed as linked in order to understand their overall commercial effect. However, as explained in the example above at 3.58 concerning a disposal of quoted investments to finance a purchase of stock, this principle does not result in normal commercial transactions in the ordinary course of business being regarded as linked.

3.67 Taking this example further, the transactions are not linked because the vendor of the stock would normally require payment in cash and would not accept quoted investments in settlement. Therefore, the substance of the transactions taken together is **not** an exchange of quoted investments for stock.

**3.68 Where paragraph 3.5 requires a series of transactions to be viewed as a whole, the consequence is that a profit, to be realised, has to be represented by an increase in qualifying consideration between the start and end points of the series.**

3.69 If a series of transactions is viewed as a whole, then it is necessary to compare the assets and liabilities, and their amounts, at the start and end of the series to determine what transaction, in substance, has occurred (changes in assets and liabilities). The transaction thus identified is tested under the other principles set out in this guidance. Thus, where paragraph 3.5 applies, it is necessary to determine the amount of qualifying consideration involved at the start and end of the linked transactions to see if there has been an increase, decrease or a net nil position. Unless there has been an increase in the amount of qualifying consideration (in any of the forms defined in paragraph 3.11), ~~it~~there cannot ~~have~~be a realised profit from that series of transactions.

**3.70 If there is a new external cash flow somewhere in a chain of intra-group transactions to which the company is party, this cannot be associated with a portion of the gross cash flows of the company in question if, after considering a series of transactions that fall within the scope of paragraph 3.5 to which the company is party, the company does not have a net increase in cash or other qualifying consideration.**

3.71 A net nil cash position (as described at 3.69 above) cannot be broken into two gross components to assert that there has been an increase in qualifying consideration that will justify recognition of a realised profit. To do so would amount to dealing with such transactions as if they were independent and so would fail to treat them, as required by paragraph 3.5, as a series that is to be assessed as a whole. Thus, where a company's transactions, taken as a whole, do not increase its qualifying consideration, they do not generate a realised profit. This is the case irrespective of whether the cash inflow has been financed from new external cash receipts elsewhere in the group.

3.72 For example, consider a company that receives a dividend of 100 from one subsidiary and reinvests the same amount in another subsidiary as equity capital, both as part of a planned corporate restructuring. There is no net increase in qualifying consideration and therefore the receipt of the dividend is not a realised profit. It does not matter that the dividend of 100 was funded from external cash receipts elsewhere in the group.

3.73 However, paragraphs 3.71 and 3.72 above are concerned only with circumstances where the cash inflow and cash outflow comprising the net nil position fall within paragraph 3.5. For example, paragraph 3.72 is concerned with a planned corporate restructuring. The fact that dividends are received from some subsidiaries at or about the same time as investments are made in other subsidiaries as equity capital does not automatically prevent those dividends being recognised as realised profits. To be linked, there needs to be something more than juxtapositioning of transactions, such as the dividends being necessary at this time to facilitate the investment.

**3.74 Time does not necessarily matter when judging whether steps in a series of transactions need to be viewed as a whole. Inserting a pre-planned period of delay, for example, between intended steps will not generally break ~~"linkage".~~ 'linkage'.**

3.75 Time gaps in a series of transactions is a factor to judge as to whether this was an attempt to frustrate a series-of-transactions argument. Deliberate insertion of time delays is usually persuasive evidence of pre-planning and pre-meditation of the outcome. The length of the time period or periods between transactions is not, of itself, relevant. Thus, a time gap should not affect the conclusion. However, time may be a factor to consider if it gives genuine opportunity for a relevant change to occur in the series of steps. The more time that is to elapse between steps then the more time there is for commercial circumstances to change and thus for the subsequent steps, if not yet irrevocable, not to go ahead due to changed circumstances.

# 4. FAIR VALUE ACCOUNTING ~~4.1~~ – 4.33

## Introduction

4.1 The directors of any particular company need to consider their own company's facts and circumstances in determining whether an accounting profit arising through changes in fair value is readily convertible to cash in accordance with the definition and can therefore be considered as realised for distribution purposes. Consideration should also be given to 2.3 to 2.5 above regarding volatility and directors' duties. This section provides guidance on:

(a) the application of the definition of 'readily convertible to cash' to particular situations (see 4.2 *et seq*);

(b) available-for-sale investments under IAS 39 and the fair value reserve (see 4.23 *et seq*);

(c) the fair value option (see 4.26 *et seq*); and

(d) losses arising from fair value accounting (see 4.29 *et seq*).

4.1A The guidance in this section has been generally been written with reference to the requirements of IAS 39. However, the same principles are relevant to companies applying FRS 102 or IFRS 9. In particular, the determination of whether a profit is 'readily convertible to cash' applies regardless of the applicable accounting framework.

## Guidance on the application of ~~"~~'readily convertible to ~~cash"~~cash'

### Financial instruments

4.2 The definition of ~~"~~'readily convertible to ~~cash"~~cash' in paragraph 3.12 is closely but not completely aligned with the ~~measurement guidance in IAS 39. Necessary differences remain~~definition of Level 1 and Level 2 within the fair value hierarchy in IFRS 13 Fair Value Measurement. In particular, paragraph 3.12(c) imposes some additional restrictions so that not all Level 1 and Level 2 valuations will result in realised profits. Level 3 valuations will never meet the 'readily convertible to cash' test because they are based on unobservable inputs. The fair value hierarchy in IFRS 13 is the same as the one in paragraph 34.22 of FRS 102 as amended in March 2016.

4.3 In situations where:

(a) the financial instrument is traded in an active market; or

(b) the financial instrument is valued using a valuation technique whose variables include only data from observable markets,

it will generally be possible to enter into a transaction to convert the change in value to cash at short notice without any period of marketing and/or negotiation. Even when the instrument is not traded in an active market, there may be many institutions which will be prepared to quote a price based on observable market data at which a transaction could take place immediately. Such a change in value that is a profit would therefore, subject also to the test at 3.12(c) above, be regarded as realised.

4.4 However, a change in the fair value of a financial instrument that is a profit which is determined using a valuation technique where not all of the variables include data from observable markets would be regarded as unrealised. This would not be so where part of the profit can be closed out independently of the rest and that part may be realised pursuant to the guidance on close out at 4.5 and 4.6 below.

### Close out

4.5 A financial asset, financial liability or change in the fair value of a financial asset or financial liability may be capable of being readily convertible to cash for the purposes of applying condition (a) of the readily convertible to cash test at 3.12 above if it could be immediately closed out, meaning the relevant contract or underlying market risk position is capable of being immediately offset in the market and the normal market practice would be to close out the position in this way. For example, risks inherent in a derivative may be eliminated by taking out other financial instruments, including derivative contracts, with an offsetting risk profile. When it is possible under normal market practice to enter into such arrangements to ~~"~~'lock ~~in"~~in' any profit on the original contract, the profit that could be ~~"~~'locked ~~in"~~in' could be regarded as readily convertible to cash. It is not necessary for an actual transaction to have occurred.

4.6 4.5 above addresses the ability to close out in the context of condition (a) of 3.12. In relation to condition (a), consideration should also be given to whether the cash flows from the close-out instrument meet the definition of qualifying consideration, in particular the criteria set out at 3.11.

4.6A In addition, conditions (b) and (c) in 3.12 must also be considered. In the context of condition (b), consideration should be given to whether the valuation of the close-out instrument is based on observable market data.

4.7 The position regarding fair value losses is dealt with at 4.29 to 4.33 below.

### Embedded derivatives

4.8 ~~Unless~~Under IAS 39, unless the whole contract has been designated at fair value through profit or loss, an embedded derivative that is determined not to be closely related to the economic characteristics and risks of the host contract is required to be separated from its host for accounting purposes (bifurcation) and fair valued, as if it were a standalone derivative with the same terms. The same applies under IFRS 9 for financial liabilities and lease contracts. Changes in fair value of the embedded derivative are recognised in profit or loss. However, where a change in fair value is a profit it does not constitute a realised profit unless the embedded derivative can be closed out in the manner described above in ~~"~~'Close ~~out"~~out' or the host contract and embedded derivative together meet the ~~"~~'readily convertible to ~~cash"~~cash' test (including by reference to close-out if appropriate).

4.8A FRS 102 does not permit or require the separation of embedded derivatives (except when using its option to apply IAS 39 or IFRS 9 in place of sections 11 and 12 of FRS 102). However, non-financial contracts that include 'non-typical' features (which may be embedded derivatives under IAS 39 or IFRS 9) are accounted for in their entirety at fair value under FRS 102. They are likely to be non-basic financial instruments and accounted for at fair value through profit or loss. The existence of 'non-typical' features will generally mean that a valuation will involve unobservable inputs and therefore any profit will be an unrealised profit.

### Top-slicing

4.9. Fair value accounting under the relevant accounting standards involves the valuation of the whole item or, in the case of fair value hedge accounting, a particular risk and the recognition of the change in fair value in the financial statements. Where the change is a profit, it is not necessary to have completed a transaction to determine whether the whole of the increase in fair value is to be treated as realised. The criteria for determining whether an increase in fair value that is a profit could be readily converted to cash and thus be treated as realised are set out at 3.12 above. The concept of top-slicing a gain into realised and unrealised parts as envisaged by paragraph 3.18 arises when there has been a transaction involving qualifying and other consideration. On remeasurement there is no transaction involved in the recognition of a fair value profit, hence the question of top-slicing (ie, determining, by reference to mixed consideration receivable, whether part of the profit should be treated as realised as opposed to the whole of such profit) does not occur.

### Unquoted equity investments

4.10 Although increases in the fair value of many financial assets will meet the test of being ~~"~~'readily convertible to ~~cash"~~cash' at 3.12 above, this will not generally be true of unquoted equity investments. ~~The~~Under IAS 39, the measurement of such investments at fair value may be precluded because the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot reasonably be assessed. Even where the value can be estimated sufficiently reliably to meet the requirements of IAS 39 and an increase in fair value is recognised, it is unlikely that the amount would be readily convertible to cash at the date of determination. This is because, for example, a period of marketing and/or negotiation would generally be required to dispose of such an investment.

4.10A FRS 102 also requires unquoted equity investments to be accounted for at fair value through profit or loss unless their fair value cannot be measured reliably. For the reasons explained at 4.10 above, any profit on remeasurement of such investments is likely to be unrealised because it is not readily convertible to cash.

### Strategic investments

4.11 Under a company's business strategy it may hold investments for strategic purposes. Such investments are not readily disposable in the sense required to meet condition (c) of the readily convertible to cash test at 3.12 above, as a company's strategy cannot be readily changed so as to allow the investment to be realised immediately at the date of determination. For example, the company might have a strategic investment in a listed company that qualifies to be accounted for as an associate ~~under IAS 28.~~. It is possible for the company to elect ~~under IAS 28~~ to account for its associates (in its separate financial statements) at fair value under ~~IAS 39 (e.g. as an~~options available ~~for-sale asset, with fair value changes reported~~ in ~~equity).~~IAS 28 and FRS 102. Increases in fair value of such a strategic investment might be regarded as realised but for condition (c) of the test for readily convertible to cash. Thus the fair value increases are, consequently, unrealised.

4.12 A similar analysis may be made for a company's holding of other financial assets, such as government bonds, that are classified as available-for-sale and are thus remeasured at fair value but nevertheless are held to meet the company's business strategy or regulatory requirements. Any fair value increases of such assets are unrealised as the company cannot readily change its business strategy or regulatory compliance to allow the financial assets to be realised immediately at the date of determination.

### Hedge relationships in group situations

4.12A Under a group's hedging strategy, different companies in the group may hold the hedging instrument and the hedged item. ~~For example, in a net investment hedge as illustrated in IFRIC 16 Hedges of a Net Investment in a Foreign Operation.~~ The circumstances of each of the companies involved in the hedge relationship ~~needs~~need to be assessed at the date of determination, as the relevant company may not be in a position to realise an increase in fair value in the sense required to meet condition (c) of the readily convertible to cash test at 3.12 above. For example, the purpose of the company holding the hedging instrument is to hold it for the benefit of, or to assist, another group company, and accordingly it may not be able to dispose of or close out the hedging instrument, needing instead to seek that other company's concurrence. This is discussed further at 5.19 to 5.22 of section 5 Hedge accounting~~."~~.

### Investment properties

4.13 None of an increase in fair value of investment property is readily convertible to cash and is not therefore treated as a realised profit. This is because a period of marketing and/or negotiation would be required to dispose of such an investment and therefore it could not be converted to cash at the date of determination. This is not intended to preclude a profit being regarded as realised at the date of determination in those cases when the process of marketing and/or negotiation is complete at that date and legal completion occurs shortly after the date of determination.

### Own credit

4.14 When liabilities (~~e.g.~~eg, bank debt or bond issues) and over-the-counter derivative contracts are measured at fair value, their value may be affected by the reporting company's own creditworthiness. Consequently, a profit may arise in circumstances where the company's creditworthiness is deteriorating, that is, the fair value of the liability is decreasing. In such cases, it is necessary to consider whether the company would be able to realise the profit by settling the liability at its fair value. This may not be possible, particularly if the company is experiencing financial difficulties, and the relevant profit will therefore not be a realised profit. However, in most circumstances where a company is not in financial difficulties and it would be able to settle the debt at fair value, there will be no need to analyse the fair value changes between the amount attributable to marginal changes in the creditworthiness of the liability and changes due to movements in interest rates and other market factors.

4.15 It should be noted, however, that the tests set out at 3.12 above are wider than solely the ability to settle at fair value and must all be met. For example, the company must be able to settle on the date of determination without negotiation or marketing. Thus where a large volume of debt is under consideration, this is akin to a question of whether the company could refinance that large volume of debt on that date without negotiation, which would often not be the case.

**Block discounts for securities traded in an active market**

4.16 IFRS 13 taken together with IAS 39 or IFRS 9 requires certain financial instruments to be valued on a basis that does not take account of the size of the holding. That is to say that the valuation included in the accounts uses the published price quotation in an active market as the best estimate of fair value and does not reflect any ~~"~~'block ~~discount"~~discount' that might apply if the entire holding was disposed of at the date of determination. In the case of assets (~~e.g.~~eg, investments) that are traded on an active market, it may be possible to dispose of the entire holding at the date of determination but it is necessary to recognise that the proceeds may be less than the value recognised in the balance sheet in accordance with IAS 39 or IFRS 9.

4.16A FRS 102 does not include the same explicit requirements as IFRSs in this respect. However, assuming the accounting treatment adopted is the same as that required by IFRSs, the analysis set out in the following paragraphs will apply to the determination of realised profits.

4.17 Holdings in financial assets traded in an active market that might be regarded as relatively small (~~e.g.~~eg, less than 1% of a company's share capital) may nevertheless be large in relation to the volume of business done in that company's shares on a typical day in the market. For example, some such investments held by investment companies and other financial institutions fall into this category. Such investments are rarely, if ever, disposed of in a single block but are instead disposed of in a number of smaller blocks either all on the same day or over a short period of time, in accordance with normal market practice, to reduce or eliminate the effect of any block discount. In these limited circumstances, the effect of any block discount on realised profits may be calculated on the basis set out at 4.18 and 4.19 below rather than on the basis that the entire holding is disposed of in a single block on the date of determination. This is a limited departure from the principle established at 3.12(a) above.

4.18 Part 4 of the Statement of Recommended Practice ~~"~~'Accounting for Securities by ~~Banks"~~ ~~(~~"Banks' (~~'~~the ~~SORP")~~SORP') issued by the British Bankers' Association contained the following guidance:

> ~~"~~*'61. Where a holding of a quoted security (other than one to which paragraph [62] or [63] applies)[33] is so large that it could be disposed of only at an unfavourable price or over an extended period, it should be valued at an appropriate discount to the market price. The discount should be sufficient to reflect the reduction in price resulting from the size*

[33] Paragraph 62 dealt with instruments held for hedging and paragraph 63 dealt with investment securities stated at cost.

*of the holding or all future costs likely to be incurred in disposing of the interest over time in the ordinary course of business~~.”~~.’*

The SORP ~~has been~~was withdrawn because it ~~is~~was not applicable to banks reporting under IFRSs or applying FRS 26 under previous UK GAAP. It nevertheless provides an indication of generally accepted practice for the valuation of large holdings. Although this approach no longer applies for financial reporting purposes ~~for companies applying IFRSs or FRS 26~~, it continues to be relevant to the determination of realised profits.

4.19 Where it is determined that a block discount exists in relation to a holding of securities traded in an active market, only the part of the profit that may not be realisable over a short period of time in the ordinary course of business should be treated as unrealised[34]. This would not necessarily be the same as the block discount that may apply if the entity disposed of the entire holding in a single block at the date of determination (~~e.g.~~eg, in a forced sale), and which applies to situations other than those covered by the previous sentence for the purposes of determining the part of the profit that is unrealised.

4.20 Estimation of the unrealised profit referred to at 4.16 and 4.19 above will require the exercise of judgement. Directors of companies frequently have to exercise judgement in making accounting estimates. The position concerning block discounts is no different. Directors do not have to be able to quantify the unrealised profit referred to at 4.16 and 4.19 above precisely; an estimate is all that is required. It will often be clear that there is a sufficient margin of profit available for distribution (over and above the proposed distribution) to absorb a prudent assessment of the effect of any unrealised profit attributable to block discounts.

4.21 Directors should consider their common law duty to avoid an unlawful distribution of capital. If an investment is sold after the date of determination to finance a distribution, the impact of any resulting loss (whether due to the unrealised component of a block discount or otherwise) on profits available for distribution should be considered.

4.22 The case of a block discount can be distinguished from that of investment property and most unquoted equity investments when none of the profit is treated as realised due to the period of marketing and/or negotiation required to dispose of such investments, such that the profit could not be readily converted to cash at the date of determination.

**Available-for-sale financial assets and the fair value reserve**

4.23 Under IAS 39, profits and losses on ~~“~~‘available-for-~~sale”~~sale’ financial assets are recognised ~~directly in equity through the statement of~~in other comprehensive income (except for dividends, interest, impairment losses and foreign exchange profits and losses on monetary items). This applies until the assets are derecognised (~~e.g.~~eg, sold) at which time the cumulative profit or loss previously recognised in equity is recognised in profit or loss (ie ~~“recycled”)~~[35]~~.~~, ‘recycled’).

4.24 Profits and losses arising on the remeasurement of available-for-sale financial assets will be realised or unrealised according to the same principles that would apply if the same assets had been accounted for at fair value through profit or loss (see above). For example, it would be illogical if the question of whether a profit was realised or unrealised depended on whether the directors designated the particular assets ~~“~~‘at fair value through profit or ~~loss”~~loss’ on initial recognition, when using the fair value option in the circumstances permitted by the relevant accounting standards (see 4.26 below). However, profits on remeasurement of available-for-sale financial assets will be realised or unrealised in accordance with the

[34] A similar adjustment is not required when an overall (ie cumulative) loss is recognised on the remeasurement of a financial instrument in accordance with IAS 39. The potential additional loss, equivalent to the block discount, that would arise on disposal of the entire holding at the date of determination is not recorded as a loss in the financial statements. Consequently, the realised loss will equal the loss reported in the financial statements, which will exclude the effect of any block discount.

~~[35] Similar rules for “available-for-sale” financial assets apply for companies using FRS 26, where the profits and losses are recognised directly in equity through the statement of total recognised gains and losses. The amendment to FRS 3 for companies using FRS 26 clarifies the position for recycling the cumulative profit or loss on a sale of an available-for-sale financial asset.~~

principles described above, irrespective of whether they meet the requirements to be accounted for at fair value through profit or loss.

4.25 For companies reporting under IFRSs (ie, directly under the IAS Regulation), there is no requirement to credit profits included in other comprehensive income on available-for-sale investments to any particular reserve. ~~For~~FRS 102 does not have a category of 'available-for-sale' financial assets, nor does IFRS 9. However, for companies reporting under ~~UK GAAP (FRS 26),~~FRS 101 or applying the option in FRS 102 to apply IAS 39 recognition and measurement requirements, such profits ~~will~~may be taken to the fair value reserve in accordance with the requirements of the Accounting Regulations. There is no specific legal restriction on the distribution of profits included in the fair value reserve in either the Act or the EU ~~Fair Value~~Accounting Directive (~~2001/65/EC~~2013/34/EU) from which the provisions on fair value accounting in UK legislation are drawn. Therefore, there is no constraint on treating profits on remeasurement of available-for-sale financial assets as available for distribution if they are in all other respects realised profits in accordance with this guidance.

4.25A Similar considerations apply to investments accounted for at fair value through other comprehensive income in accordance with IFRS 9.

**Fair value option**

4.26 IAS 39~~, the EU adopted version of IAS 39 and FRS 26 contain the same~~ contains conditions regarding when it is permitted to use the fair value option to designate financial instruments ~~"~~'at fair value through profit or ~~loss"~~loss' on initial recognition. The conditions for using the fair value option are set out in paragraph 9 *et seq* of IAS 39. Similarly, paragraph 11.14(b) of FRS 102 allows debt instruments and loan commitments within the scope of section 11 to be designated on initial recognition as at fair value through profit or loss, provided they meet certain criteria.

4.27 Where the fair value option is used it is necessary to consider whether the changes in fair value of the relevant financial instruments that are recognised in the profit and loss account meet the conditions to be treated as realised. In this respect, the guidance above on ~~"~~'Financial ~~instruments", "~~instruments', 'Embedded ~~derivatives", "~~derivatives', 'Own ~~credit"~~credit' and ~~"~~'Block ~~discounts"~~discounts' will be most relevant in interpreting the ~~"~~'readily convertible to ~~cash"~~cash' criterion as defined at 3.12 above.

4.28 In addition, it is recognised that the use of the fair value option to eliminate or significantly reduce an accounting mismatch may validly be used in place of hedge accounting for hedges of fair value exposures. Consequently, where this is the case, although the designated financial instrument that is fair valued under the fair value option and the derivative that would otherwise give rise to the accounting mismatch are not in a formal IAS 39 or FRS 102 hedge relationship, consideration of the guidance in 5.2 to 5.6 ~~"~~'Fair value hedge ~~accounting"~~accounting' (which contain further guidance on the principle set out at 3.19 above) would be relevant in determining the effect on realised profits of the combined effect of the designated financial instruments and the derivatives concerned.

**Losses**

4.29 Losses arising from fair value accounting should be treated as realised losses where profits on remeasurement of the same asset or liability would be treated as realised profits in accordance with this guidance (see 3.15(f) above).

4.30 A loss that represents the reversal of an unrealised profit will not reduce cumulative realised profits. Even if the loss is treated as a realised loss, for example because it represents an impairment, the unrealised profit will become realised in accordance with 3.9(f)above.

4.31 Cumulative net losses arising on fair value accounting will be unrealised only if both:

(a) profits on remeasurement of the same asset or liability would be unrealised; and

(b) the losses would not have been recorded otherwise than pursuant to fair value accounting.

4.32 With reference to paragraph (b) above, absent fair value accounting a loss may need to be recorded for example, in relation to an asset, on the basis of historical/ amortised costs less impairment provisions; and in relation to a liability, under either an amortised cost basis of financial instrument accounting or as an onerous contract liability.

4.33 It is well established that the recoverable amount of tangible fixed assets (~~e.g.~~eg, properties used in a business) may exceed their fair value ~~(see paragraph 65 of FRS 15).~~. In the case of other assets (including investment property), it may be more difficult to justify a recoverable amount that is greater than fair value. Each case should be considered on its merits and, where there is doubt, losses should be treated as realised.

**Hedge relationships in individual companies**

5.1 As stated at 3.19 above, the principle to be applied to the determination of realised profits and losses when hedge accounting is used is as follows:

> ~~"~~"Where hedge accounting is obtained in accordance with the relevant accounting standards, it is necessary to consider the combined effect of both sides of the hedging relationship to determine whether there is a realised profit or loss in accordance with the criteria in this guidance~~"~~."

The application of this principle to different types of hedge accounting permitted by IAS 39 by companies holding both the hedging instrument and the hedged item is described at 5.2 to 5.18 below. The criteria for hedge accounting in FRS 102 are different from those in IAS 39, but the same three types of hedge accounting are permitted. This guidance is equally applicable to hedge accounting under FRS 102.

5.1A Where the hedging instrument and hedged item are held in different companies within the same group a hedging relationship is established only in the group's consolidated financial statements. The general realisation principles as set out at 3.3 to 3.12 apply to the individual companies. As the hedge relationship does not exist within a single company the principle at 3.19 is inapplicable in such a case. Instead guidance on the application of these principles is provided at 5.19 to 5.22 below to assist in determining in what circumstances any profits or losses on the hedging instruments and hedged items can be treated as realised for the individual companies concerned.

**Fair value hedge accounting**

5.2 In the case of fair value hedges under IAS 39, the gross profits and losses on remeasuring the hedging instrument and the hedged item for the hedged risk are both recognised in profit or loss. In many instances both the profit on one and the loss on the other will be realised by reference to the readily convertible to cash and other criteria. In such cases, no special consideration of hedging aspects is required (including hedge effectiveness or ineffectiveness).

5.3 In some cases, however, the profit on either the hedged item or the hedging instrument may, absent consideration of the hedging aspect, be unrealised (~~e.g.~~eg, if a fair value movement is not readily convertible to cash). The following paragraphs explain how the principle set out at 5.1 above should be applied in circumstances where the profit is not realised.

5.4 Where the hedge accounting relationship results in a net loss, this amount will generally be treated as a realised loss. For example, consider the situation where there is an unrealised profit on the hedged item of £90 and a realised loss on the hedging instrument of £100. The net loss of £10, which arises from hedge ineffectiveness, is recognised in ~~the~~ profit ~~and~~or loss ~~account~~ and is treated as a realised loss. Due to the hedge accounting relationship, the remaining £90 of the gross loss on the hedging instrument is not treated as a realised loss and is set off against the unrealised profit on the hedged item.

5.5 Where there is a net profit, it will be necessary to consider whether that profit is a realised profit. This will depend on the relationship between the gross components. For example, if there is an unrealised profit of £100 and a realised loss of £90, only the net profit of £10 will be treated as unrealised.

5.6 This approach applies irrespective of whether the profits or losses in question arise from changes in fair value of open contracts or from settled transactions. For example, the hedge accounting policy may designate a series of rolling derivatives as the hedging instrument, some of which have already been settled in cash, whereas there have been no past settlements in respect of the hedged item.

**Cash flow hedge accounting**

5.7 In the case of cash flow hedges under IAS 39, the portion of the profit or loss on the hedging instrument that is determined to be an effective hedge is recognised in other comprehensive income. Such profits and losses are unrealised and become realised only when the hedged transaction affects profit or loss (or IAS 39 otherwise requires the gain or loss to be recycled through profit or loss). This is based on the principle (set out in 5.1 above) that it is necessary to have regard to the combined effect of both sides of the hedge accounting relationship to determine whether there is a realised profit or loss. To the extent that the profit or loss is included in other comprehensive income (or, later on, added to the cost of a non-financial asset) in accordance with IAS 39, it must arise in connection with a valid hedge accounting relationship. It would therefore be inappropriate to consider this profit or loss in isolation from the hedged item. To the extent that any ineffective element of the profit or loss on the hedging instrument is recognised in profit or loss, that element should be assessed as to whether it is realised in accordance with normal principles (~~e.g.~~eg, the ~~"~~'readily convertible to ~~cash"~~cash' test).

5.8 The hedging principle at 5.1 above applies irrespective of whether the profits or losses in question arise from changes in fair value of open contracts or from settled transactions. The amounts taken direct to equity may, for example, include profits or losses on short-term derivative contracts that form part of a rolling-hedge strategy but which have matured. Such profits and losses should be treated as unrealised provided that IAS 39 requires them still to be deferred in equity as part of a cash flow hedge accounting relationship.

5.9 Accounting for a cash flow hedge in accordance with IAS 39 will affect net assets although the profit or loss is regarded as unrealised. Where the cumulative net amount on the cash flow hedge component of equity (cash flow hedge reserve) is an overall unrealised loss, this may additionally restrict the ability of a public company to make distributions because of the application of section 831 (see 6.24 *et seq*).

**Net investment hedge accounting**

5.10 Under IAS 39, net investment hedge accounting policies will generally arise only in the context of consolidated financial statements. Those financial statements are not relevant for the purposes of justifying distributions. However, it is possible that in some instances, in accordance with IAS 21, a branch may be treated as a foreign operation in the individual accounts of a company. In this case, net investment hedge accounting may be relevant to the individual accounts of a company. A net investment hedge under IAS 39 is accounted for similarly to a cash flow hedge.

5.10A However, in the case of a net investment hedge, the exchange differences on the hedged item are recognised in other comprehensive income together with the exchange differences on the hedging instrument. Therefore, the analysis in terms of realised profits for a net investment hedge is not the same as for a cash flow hedge. The analysis is similar to that described at 5.2 to 5.6 above for a fair value hedge insofar as it is necessary to consider whether the debits and credits within equity are realised or unrealised profits and losses, and the relationship between them.

5.10B So far as the hedge accounting is concerned, the question of whether the hedged item gives rise to realised profits is dealt with in section 11.

5.11 The circumstances where a company previously adopted hedge accounting for a foreign equity investment (ie, shares) in accordance with paragraph 51 of SSAP 20 ~~is~~are considered below.

**Transition from SSAP 20 - Hedge accounting for foreign equity investments**

5.12 Under old UK GAAP, SSAP 20 ~~permits~~permitted a form of hedge accounting for foreign equity investments, subject to certain conditions. Where a company ~~has~~had used foreign currency borrowings to finance, or provide a hedge against, its foreign equity investments, it ~~may~~could denominate those investments in the appropriate foreign currencies and translate the amounts at the balance sheet date at closing rate. Where this policy ~~is~~was adopted, the

resulting exchange differences ~~are~~were taken to reserves. The exchange differences on the related foreign currency borrowings ~~are~~were, subject to certain conditions, also taken to reserves. In some cases hedge accounting may be possible for such arrangements under IAS 39 or FRS 102 but as a fair value hedge through profit or loss. This is subject to more stringent conditions which ~~do~~did not apply under ~~UK GAAP~~SSAP 20. Therefore companies may not be able to obtain hedge accounting for such financing arrangements under IFRSs or FRS 102.

5.13 The hedge accounting for foreign equity investments under SSAP 20 described above is not restricted to investments in subsidiaries but this is its most common application. This guidance assumes, for simplicity, that the equity investment is in a subsidiary.

5.14 Where hedge accounting is not available under IAS 39 or FRS 102, the exchange differences on the borrowings will be included in profit or loss. Unless the equity investment is held at fair value under IAS 39 or FRS 102, there will be no offsetting difference on the investment and it is usually, in effect, frozen at its historical cost in the functional currency of the investor. It is then necessary to determine whether the exchange difference on the borrowings arising subsequent to the date of transition is realised or unrealised.

5.15 The exchange difference on the borrowings should be treated as realised in accordance with the general principles in section 3 where hedge accounting is not applied. This is irrespective of whether the purpose of the loan is for hedging an investment and of whether hedge accounting would have been permitted in the circumstances. This is the same as the position under SSAP 20 when the use of hedge accounting was optional.

5.16 It should be noted that even though hedge accounting is not available, the purpose of the loan may still be to provide an "'economic ~~hedge"~~hedge' against the related equity investment. As stated at 2.3 *et seq*, although profits on the borrowings will be realised profits, directors should consider, as a result of their fiduciary and other duties, whether it would be prudent to distribute them.

5.17 Where hedge accounting was used under SSAP 20 and is not possible (or is otherwise not used) under IFRSs or FRS 102, it will not usually be necessary~~, subject to IFRS 1,~~ to restate the investment to ~~either~~ cost ~~or fair value in accordance with IAS 27. On first-time adoption~~. Paragraph D15 of ~~IFRSs, paragraphs B5~~IFRS 1 and ~~B6~~paragraph 35.10(f)(ii) of ~~IFRS 1 will be relevant in these circumstances. They state that "if, before~~FRS 102 permit the use of a deemed cost based on the previous GAAP carrying amount at the date of transition ~~to IFRSs, an entity had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in IAS 39 the entity shall apply paragraphs 91 and 101 of IAS 39 to discontinue hedge accounting". Those paragraphs require hedge accounting to be discontinued prospectively.~~. The practical effect of this is that, if a policy of stating the investment at cost is adopted and the transitional exemption is used, the cumulative translation differences from applying SSAP 20 remain adjusted against the carrying value of the investment (ie, the investment in the subsidiary is frozen at the amount determined by translating the historic foreign currency cost of the investment at the spot rate prevailing at the date of transition).

5.18 When this treatment is applicable, the profits and losses taken to reserves under SSAP 20 will remain within equity under IAS 39 or FRS 102. In this case the assessment of whether those profits and losses are realised should continue to be made by reference to the net amount included within equity in accordance with the principle set out in paragraph 3.19 above.

**Hedge relationships in group situations**

5.19 Under a group's hedging strategy, different companies in the group may hold the hedging instrument and the hedged item. For example, in a net investment hedge as illustrated in IFRIC 16 Hedges of a Net Investment in a Foreign Operation. In these cases, there is no hedge relationship within an individual company and thus the hedging principle articulated at 3.19 and as expanded upon at 5.1 to 5.18 does not apply. Accordingly, the general realisation principles as set out at 3.3 to 3.12 apply as follows.

*Fair value accounting*

5.20 As referred to at 4.12A, a company holding a hedging instrument in a designated group hedge relationship cannot generally readily dispose of or close out the instrument in the sense required to meet condition (c) of the readily convertible to cash test at 3.12 above. This is because the company may not be able to act unilaterally to de-designate the hedging relationship that has been created by the group so as to allow it to realise the hedging instrument immediately at the date of determination. Consequently, any fair value increases of the hedging instrument are unrealised. Decreases in fair value will need to be considered carefully to determine the extent to which they are realised by applying the guidance at 4.29 et seq.

5.21 The company holding the hedged item may not be as constrained, if at all, as to its actions as the company holding the hedging instrument. Nevertheless, it should be considered whether the company has the ability to meet condition (c) of the readily convertible to cash test at 3.12 above. Disposing of or closing out the hedged item would involve breaking the group hedge relationship and this may have adverse consequences for the group. If the company has the ability to dispose of or close out the hedged item at the date of determination and thus meet condition (c), any fair value increases of the hedged item are realised. On the other hand, if it is determined that condition (c) cannot be met, then any fair value increases of the hedged item are unrealised. Decreases in fair value will need to be considered carefully to determine the extent to which they are realised by applying the guidance at 4.29 et seq.

~~*Historical cost accounting*~~

~~5.22 Companies not applying IAS 39 or FRS 26 but which have stand-alone derivatives or non-derivative financial instruments measure those instruments at historical cost and apply historical cost accounting. This is equally true for those that are held as part of a group hedging relationship. They could include, for example, accounting for foreign exchange differences under SSAP 20 or debtors and creditors for interest rate differentials in interest rate swaps. The general realisation principles as set out at 3.3 to 3.12 apply and normally these profits and losses are realised. Where profits on derivative and non-derivative financial instruments are realised, directors should consider whether from a group perspective it is appropriate to distribute them."~~

5.22 [Deleted]

# 6. ISSUES ARISING FROM IAS 32 ~~(AND ITS EQUIVALENT,~~AND SECTION 22 OF FRS ~~25)~~102

6.1 – 6.87

**Introduction**

6.1 Under IFRSs, financial instruments are presented according to the substance of the contractual arrangement, determined by the rules in IAS 32. This may differ from their legal form. For example, redeemable preference shares bearing mandatory dividends are presented as liabilities in the balance sheet and their corresponding distributions as interest charges in the income statement because the issuer has no ability to avoid payment in cash of either the principal or distributions. The substance of the contractual arrangement is therefore debt. Also, compound financial instruments are accounted for under the relevant standards using ~~"~~'split ~~accounting",~~accounting', whereby the proceeds of issue are split between a liability component and an equity component. Examples of compound financial instruments are convertible redeemable preference shares and convertible debt (assuming that the conversion feature itself meets the definition of equity in IAS 32).

~~6.2 Under UK GAAP, FRS 25's requirements on debt and equity presentation are the same as those in IAS 32.~~

6.2 Under UK GAAP, FRS 102's requirements on debt and equity presentation are very similar to those in IAS 32 in terms of underlying principles and terminology. However, IAS 32 contains more specific requirements in some areas (eg, puttable instruments) and as a result some classification differences may arise in rare cases. For simplicity, the guidance refers to the requirements of IAS 32 rather than those of FRS 102. However, it is equally applicable to the same accounting when applied under FRS 102. In that case, references to amounts presented as liabilities should be read as meaning those amounts presented as liabilities in accordance with FRS 102. One specific difference is that FRS 102 does not require recognition of a liability for the present value of the future cash outflow in the case of a forward contract or written option to purchase own equity shares.

6.3 The following guidance considers the implications for distributable profits of companies, for example, entering into contracts involving their own shares that may require classification in whole, or in part, as liabilities.

6.4 The guidance summarises the ten key principles in relation to determining distributable profits when dealing with such contracts. The guidance then applies the principles to some common scenarios ~~based on examples 1, 2, 4, 6 and 9 set out in the Illustrative Examples appendices to IAS 32 and FRS 25~~ involving contracts on own equity instruments. In addition, other scenarios are considered involving preference shares presented as liabilities, mandatorily redeemable preference shares and convertible preference shares.

6.5 Appendix 2 to the guidance provides illustrations of the accounting and capital maintenance book-keeping entries for the eight scenarios referred to above.

6.6 The ten principles underpinning the guidance in this section are set out below. The principles are split between those applying to all companies and those specific to public companies resulting from the application of the net assets test of section 831 of the Act. The principles are those underlying statute and common law in respect of distributions and capital maintenance.

**Assumptions**

6.6A The contracts described in this section and in Appendix 2 do not contain a cash settlement option.

6.6B Any redemption of the relevant shares will be made out of profits available for distribution and not out of the proceeds of a fresh issue of shares for the purpose of the redemption unless the text in this section or in Appendix 2 otherwise indicates. Payment of any dividends and redemption amounts are contingent upon such payments/redemption being lawful under the Act at the time of payment/redemption, with, where appropriate, the relevant amount being deferred until such time as the Act's restrictions fall away.

6.6C The shares, contracts and convertible instruments described in this section and in Appendix 2 are denominated in the issuer's functional currency, pay dividends and are redeemed in that currency, and, where convertible are convertible into shares denominated in that currency. It is also assumed that there are no contingent settlement provisions (see paragraph 25 of IAS 32 ~~and FRS 25~~) or alternate settlement options (see paragraph 26 of IAS 32 ~~and FRS 25~~). The effect of foreign currency, contingent settlement provisions and/or alternate settlement options can have an impact on the accounting to deny equity treatment in certain cases.

**Principles - General**

**6.7 Principle 1 - A distribution or a capital repayment is not as a matter of law a loss, notwithstanding that it may be presented for accounting purposes as an interest charge in the income statement**

6.8 Section 830(2) of the Act provides that, ~~"~~'a company's profits available for distribution are its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made~~."~~.' This is based on the premise that distributions are not losses. If distributions were losses they would be dealt with by the words ~~"~~'less its accumulated, realised losses~~,"~~,' and thus the words ~~"~~'so far as not previously utilised by ~~distribution"~~distribution' would be superfluous.

6.9 A distribution or capital repayment may on occasion be presented as an accounting loss. For example, in some cases dividends on a preference share are presented as interest charges in the profit and loss account. Notwithstanding the accounting presentation, such distributions or capital repayments remain, as a matter of law, distributions or capital repayments for the purposes of Part 23 of the Act. Accordingly, they are not counted as losses – and thus not as realised or unrealised losses – for the purposes of Part 23 of the Act.

**6.10 Principle 2 – An advance recognition of a future distribution or capital repayment is not a loss notwithstanding that it may be presented for accounting purposes as an interest charge in the income statement**

6.11 A distribution or capital repayment is not, as a matter of law, a loss. Thus the advance recognition of a future distribution or capital repayment is not a loss either. Hence, the accrual, as an interest charge, of a dividend, or a foreign exchange translation difference, in respect of a preference share presented as debt is an advance recognition of a future distribution or capital repayment but it is not a loss for distribution purposes even though the accrual is charged as interest the profit and loss account.

**6.12 Principle 3 - A distribution or a capital repayment consumes distributable profits when paid or when a dividend is declared by a company in general meeting**

6.13 An accounting liability recognised for accrued unpaid dividends or a capital repayment is an advance recognition of a future distribution or capital repayment and is not, as a matter of law, a loss.

6.14 A distribution does not consume distributable profits until such time as, as a matter of law, the distribution occurs, ~~e.g.~~eg, when paid under the authority of the directors, under common form articles of association, or when declared by members in general meeting, or at an earlier date on which a legally binding liability to pay the dividend is established (see 2.10 above).

6.15 The repurchase price for shares does not consume distributable profits until such time as, as a matter of law, the distribution and/or capital repayment comprised in the price occurs. In particular, notwithstanding that there are arrangements in place that will lead to repurchase, the company is not liable to pay the purchase price, and thus distributable profits are not consumed, until the shares are actually repurchased or redeemed. It should be noted that the holder of the shares cannot sue for damages in the event of failure by the company to repurchase those shares (see section 735 of the Act).

6.15A Section 691(2) provides that where a limited company purchases its own shares, the shares must be paid for in cash on purchase~~. However, in~~[36]. This restriction does not, however, apply when a private limited company is purchasing shares for the purposes of or pursuant to an employees' share scheme (section 691(3)). In the case of redeemable shares, section 686(2) provides that the terms of redemption may provide that the amount payable on redemption may, by agreement between the company and the holder of the shares, be paid in cash on a date later than the redemption date. ~~This is a change from the 1985 Act which required payment on redemption.~~ When payment on redemption is deferred, it is the current value of the redemption promise, at the redemption date, which determines the amount of distributable profits consumed. It is therefore the present value of the amount payable on redemption rather than its absolute amount which must be covered by distributable profits, at the redemption date, for the redemption to be permitted. The imputed interest expense arising from the use of the present value will, however, reduce distributable profits subsequent to the redemption date.

**6.16 Principle 4 - Premiums received by the issuer on written options to issue or repurchase own equity shares are profits when received**

6.17 A premium received by the writer of an option over its own equity shares is regarded as a profit at law. This is because it is value received by the company otherwise than in payment up of a share and otherwise than for taking on a liability. In particular, a written put option is not, as a matter of law, a liability of the company; for example, the holder of the option cannot sue for damages in the event of failure by the company to repurchase the shares (see section 735 of the Act).

6.18 Thus to the extent that the premium is received in the form of qualifying consideration, it is a realised profit at the outset.

**6.19 Principle 5 - When a company issues a compound financial instrument that is legally a debt, the original credit to equity determined using split accounting is not, as a matter of law, a profit; the original credit to equity is eliminated as accounting charges, which are not as a matter of law losses, accrue upwards the amount recorded as a liability**

6.20 The initial credit to equity is not an accounting profit because in accounting terms it is the equivalent of the issue of an equity instrument. As a matter of law there is not a profit either, because the proceeds received are in consideration for taking on a liability (in which respect

[36] Payment can include payment by set off against an amount due to the company.

it is distinctly different from a legally separate option contract addressed in Principle 4) albeit a liability that is not fully reflected as such in the accounts. The liability becomes fully reflected in the accounts through an additional interest charge that is not, as a matter of law, a loss because the full instrument that is legally a debt is reflected in the balance sheet at issue albeit in different places. Thus the cumulative debit in equity arising from these additional charges is available to eliminate the initial credit.

**6.21 Principle 6 - When a company issues a compound financial instrument that is legally a share, the original credit to equity determined using split accounting is share capital, and if applicable share premium; accounting charges made to accrue upwards the amount recorded for accounting purposes as a liability component, are not, as a matter of law, losses**

6.22 The initial credit to equity as a result of split accounting is share capital, and if applicable share premium, and is reflected as such. Subsequent accounting charges, to accrue upwards the amount recorded for accounting purposes as a liability component, are not, as a matter of law, losses because they are advance recognition of a future distribution or capital repayment.

6.23 In some circumstances, there may be a debit to be recognised in equity on an issue of shares to a parent company or fellow subsidiary, where the shares do not qualify to be classified in the accounts as equity of the issuer. The shares are recognised initially by the issuer as a liability at their fair value. However, the fair value may be greater than the proceeds received for their issue because the terms are off-market and, for example, involve redemption for significant amounts above the original proceeds and/or bear coupons that are substantial. In such circumstances, this difference between fair value and proceeds, a debit, is in effect advance recognition of future distributions and/or a future capital repayment and is recognised in equity. Consequently, this debit is not a loss at initial recognition. [Principle 2]. The debit will consume distributable profits either as dividends on the shares are made, which are distributions as a matter of law, or at the date of redemption (ie, when the payments are set against the liability over time or at the end~~).~~ [). [Principle 3]

**Principles - Impact of Section 831 for public companies**

**6.24 Principle 7 - The treatment of certain shares wholly as liabilities under IFRSs does not in itself affect the application of the section 831 of the Act net assets test for public companies and thus does not restrict distributable profits**

6.25 Section 831 states that a public company may only make a distribution at any time:

- if at that time the amount of its net assets is not less than the aggregate of its called-up share capital and undistributable reserves (as defined); and

- if, and to the extent that, the distribution does not reduce the amount of those assets to less than that aggregate.

6.26 Section 831 defines ~~"~~'net ~~assets"~~assets' for this purpose to mean the aggregate of the company's assets less the aggregate of its liabilities. By virtue of section 836, net assets for the purposes of section 831 are those shown in the ~~"~~'relevant ~~accounts"~~accounts' prepared in accordance with applicable accounting standards; that is, its ~~"~~'IAS individual ~~accounts",~~accounts', or its ~~"~~'Companies Act individual ~~accounts".~~accounts'. Therefore in the case of the issue of a financial instrument that is presented as debt in accordance with the substance of its contractual arrangements rather than their strict legal form, the company's net assets are unaffected for the purposes of section 831. This is because a liability is recorded (being in respect of the nominal value plus related share premium attributable to the shares) equal to the cash received as issue proceeds.

6.27 It is less clear from the drafting of section 831 whether there is any effect on the amount of a company's ~~"~~'share capital and undistributable ~~reserves"~~reserves' arising from the issue of shares for which the presentation of share capital and related share premium is as a liability. In legal form there will have been an increase in share capital and related share premium. However, in accordance with section 836, the amount of share capital and undistributable reserves is determined by reference to the amount as stated in the company's relevant accounts. Accordingly, it appears that any amount of share capital and related share premium that has been presented as a liability should be excluded from the amount of share capital and undistributable reserves for the purposes of applying section 831. This is because the amount of share capital and undistributable reserves as stated in the relevant accounts excludes this amount.

6.28 This interpretation of section 831 is consistent with the ~~"~~*Guidance for British companies on changes to reporting and accounting provisions of the Companies Act ~~1985"~~1985'* (originally issued by the DTI[37] in November 2004 and updated in August 2005[38]). The DTI's guidance states that ~~"~~'the interaction of section 264 and section 270(2) [of the 1985 Act, now sections 831 and 836(1) of the 2006 Act] is such that, where preference shares are classified as liabilities, they should be treated as such for the purposes of the net asset test, and should not be treated as part of called-up share capital and undistributable reserves for that ~~purpose" .~~purpose'.

6.29 Consequently the issue of shares with their nominal value and related share premium presented as debt does not result in an immediate restriction in the amount of profits available for distribution by a public company under section 831, because the issue leaves both net assets and share capital and undistributable reserves (as defined) unaffected.

6.30 When the section 831 test comes to be applied to the repurchase or redemption of the shares, it should be borne in mind that whilst the repayment of the nominal value and issue premium on the shares will leave net assets unaffected, ~~"~~'share capital and undistributable ~~reserves"~~reserves' will increase due to the recording of the capital redemption reserve and the inclusion in the share premium account within equity of the issue premium which has always existed and which is no longer required to be presented as a liability. Under section 831(1) the net assets must be at least equal to the ~~"~~'share capital and undistributable ~~reserves"~~reserves' both before (sub-section (1)(a)) and after (sub-section (1)(b)) the repayment for it to be lawful.

**6.31 Principle 8 - A debit to equity arising from an advance recognition of a future distribution or capital repayment does not form part of share capital and undistributable reserves (as defined) for the purposes of section 831 and thus restricts distributable profits for public companies under that section**

6.32 Despite not representing a realised loss or a consumption of distributable profits, nevertheless an advance recognition of a future distribution or capital repayment restricts distributable profits for public companies. This is due to the advance recognition of the distribution as a liability, reducing net assets, but the corresponding debit to equity (via the income statement/profit and loss account) not reducing ~~"~~'share capital and undistributable ~~reserves"~~reserves' as defined by section 831.

6.33 The above contrasts with Principle 1 because in the context of section 831, the Act gives precedence to the accounting presentation and this restricts the amount of the profits available for distribution.

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[37] Now the Department for Business, ~~Innovation & Skills~~Energy and Industrial Strategy.
[38] Guidance available from National Archives at:
http://webarchive.nationalarchives.gov.uk/+/http://www.berr.gov.uk/files/file21617.doc

6.33A The existence of any unrealised profits does not alter this situation (~~e.g.~~eg, such unrealised profits cannot be applied to offset the deduction, because the deduction is not an unrealised loss).

6.34 The question may arise as to whether this restriction might operate to prevent the distribution or capital repayment in question when it comes to be made, ~~e.g.~~eg, because the effect might be that the surplus of net assets over ~~"~~'share capital and undistributable ~~reserves"~~reserves' might be reduced to an amount less than the distribution or capital repayment to be made. However, there will be no restricting effect on the making of such amount of a distribution or capital repayment as has been recognised in advance, provided that immediately beforehand the net assets are not less than ~~"~~'share capital and undistributable ~~reserves".~~reserves'. This is because, accordingly, the company will meet the test in section 831(1)(a); and on the actual making of the distribution or capital repayment, which has previously been recognised as a liability, net assets are unaffected and thus remain no less than ~~"~~'share capital and undistributable ~~reserves",~~reserves', thereby meeting section 831(1)(b). If the shares in question were originally classified as debt, then the operation of section 831 in relation to the original issue price is as described at 6.30 above.

**6.35 Principle 9 - On initial recognition, split accounting for compound financial instruments does not restrict distributable profits for public companies under section 831**

6.36 If the compound financial instrument is legally a share (for example, a redeemable preference share with discretionary dividends) and is split into its debt and equity components, at the outset there is no effect on distributable profits. The initial liability is matched by ~~an equal amount~~a part of the cash proceeds equal to the liability and there is no effect on net assets~~.~~ in relation to the liability component. In respect of the equity component equating to the balance of the proceeds, the initial credit to equity is, at law, share capital (and share premium) and is included in ~~"~~'share capital and undistributable ~~reserves"~~reserves' for the purposes of the section 831 net assets test. This increase on one side of the net assets equation is balanced by the corresponding amount of cash proceeds which increases the company's net assets~~.~~ (ie, net assets increase by the amount of the equity component). Thus, ~~"~~'share capital and undistributable ~~reserves"~~reserves' do not exceed net assets and therefore there is no restriction on distributable profits at the outset.

6.37 If the compound financial instrument is legally a debt (for example, a convertible debt) and it is split into its debt and equity components, the initial liability is exceeded by the amount of cash proceeds, equal in amount to that of the initial credit to equity, and accordingly there is an increase in net assets. However, in respect of the initial credit to equity itself, this does not form part of ~~"~~'share capital and undistributable ~~reserves".~~reserves'. As a result, an increase in net assets is recorded (being the difference between the consideration received and the liability recognised) with no corresponding increase in ~~"~~'share capital and undistributable ~~reserves".~~reserves'. Thus the issue of this instrument contributes an excess of net assets over ~~"~~'share capital and undistributable ~~reserves".~~reserves'. This has the effect of reducing any pre-existing restriction on distributable profits under section 831. However, where there is no pre-existing restriction, or such a restriction is more than eliminated by the issue of this instrument, distributable profits are not created; this is because section 831 has effect only to reduce the ability to distribute realised profits.

**6.38 Principle 10 - The accretion of the liability component of compound financial instruments reduces distributable profits for public companies under section 831 unless the instrument is legally a debt**

6.39 Where the compound financial instrument is legally a share, the ~~"~~'interest ~~charge"~~charge' for the accretion of the liability component is not a loss as a matter of law [Principle 6] and

has no effect on the amount shown as ~~"~~'share capital and undistributable ~~reserves"~~reserves' in the relevant accounts. That is, the initial credit to equity (being share capital (and share premium)) cannot be used to absorb the accumulating ~~"~~'interest ~~charge"~~charge' debited to retained earnings (via the profit and loss account) due to the accretion of the liability. Hence, under the section 831 net assets test, the amount that a public company can distribute is restricted by the accumulated amount of the ~~"~~'interest ~~charge"~~charge' debit, which ultimately will be equal to the initial credit to equity. In other words, net assets are reduced but there is no corresponding reduction of 'share capital and undistributable reserves' and thus over time the cumulative restriction of distributable profits will equal the initial credit to equity.

6.40 Where a compound financial instrument is legally a debt, the accretion of the liability is an accounting loss (although not a loss as a matter of law [Principle 5]) that reduces net assets for the purposes of the section 831 net assets test (see paragraph 6.33). However this eliminates the initial increase to net assets recorded as a result of the split accounting and thus of itself does not restrict distributable profits.

**Examples**

6.41 The following examples illustrate the application of the ten principles described in 6.7 to 6.40 above. The first five examples addressed below are based on examples 1, 2, 4, 6 and 9 involving contracts on own equity instruments set out in the Illustrative Examples appendices to IAS 32~~ and FRS 25~~. Three further examples address preference shares presented as liabilities, mandatorily redeemable preference shares and convertible preference shares. The assumptions made at 6.6A to 6.6C above apply for the purposes of these examples.

6.42 Appendix 2 provides illustrations of the accounting and statutory capital maintenance book-keeping entries for the eight examples.

**[Assumptions]**

6.43 [Moved to 6.6A]

6.44 [Moved to 6.6B]

6.45 [Moved to 6.6C]

**Example 1 - Forward contract to repurchase own equity shares**

6.46 Where a company enters into a forward contract to repurchase its own shares that are equity shares under the relevant standard, the standards require the company to set up a liability, at the outset, for the present value of the payment to be made (ie, a discounted amount), with a corresponding debit taken directly to equity. The accounting effect is as if the equity shares had been repurchased immediately. This accounting entry is not required by FRS 102.

6.47 The initial debit to equity, for the present value of the consideration payable, is not a realised loss. This is because the eventual payment is not a loss, but is in fact a distribution (or a capital repayment to the extent not out of distributable profits) [Principle 2].

6.48 Over time the (discounted) liability is accreted up to the eventual repayment amount, with a corresponding charge to finance expense (interest) in the profit and loss account (income statement). The accretion of the liability over time up to full value of the eventual redemption amount is presented as an accounting loss – it is shown as part of the interest charge. Again, however, the ultimate payment of the full amount is either a distribution or a capital repayment and is not therefore, as a matter of law, a loss nor, therefore, a realised loss. [Principle 2]

*The effect on a public company*

6.49 For a public company the effect is to restrict distributable profits. [Principle 8]

*Combining the accounting and statutory capital maintenance entries to complete the repurchase of non-equity shares*

6.50 When payment is made to repurchase the shares, it is, for accounting purposes, set against the liability. To the extent that the payment must, in law, come out of distributable profits, the debit in reserves (ie, the initial debit to equity, together with the interest charge for the accretion) is set against and consumes distributable profits. To the extent that the payment must in law be charged to capital (~~e.g.,~~eg, funded by a fresh issue), then this debit is set against called-up share capital (and share premium as the case may be). Any necessary transfer from called-up share capital to capital redemption reserve is made in the usual way.

**Example 2 - Written option to repurchase own equity shares**

6.51 The accounting standards require the same accounting for a written option to repurchase equity shares as for a forward to repurchase equity shares (Example 1), save that in the case of the written option, any premium received at the outset is required to be taken directly to equity. So far as accounting for the repurchase price itself is concerned, the distributable profits considerations are the same as for the forward (see *Forward contract to repurchase own equity shares* at ~~6.46 *et seq* above).~~ paragraph 6.46 *et seq* above). As noted at paragraph 6.46 above, the initial accounting entry to recognise the present value of the future payments to be made is not required by FRS 102.

6.52 The option premium is regarded as a profit at law and, to the extent that the premium is received in the form of qualifying consideration, is a realised profit. [Principle 4]. As a matter of law, the repurchase price for the shares is a future distribution or capital repayment. [Principle 3]

*The effect on a public company*

6.53 For a public company the effect of the recognition of the liability for the present value of the payment to be made and the subsequent accretion of the liability to the payment amount, is to restrict distributable profits. [Principle 8]

**Example 3 - Forward contract to issue own equity shares**

6.54 A forward contract to deliver, through a fresh issue of shares, a fixed number of the company's own equity shares in exchange for a fixed amount of cash meets the definition of an equity instrument in the relevant standard because it cannot be settled otherwise than through the delivery of shares in exchange for cash (see assumptions in *6.6A to 6.6C* above). Consequently, the right to receive the cash in a future accounting period is not recognised by the company, and the standards do not require accounting entries to be made until the forward contract matures, when the company receives cash and issues shares to the contract's counterparty.

6.55 Assuming the fair value of the forward contract at inception is zero, no cash is paid or received at that date, and thus no accounting entries are required on inception. Therefore, where a company enters into a forward contract to issue equity shares, the required accounting for such an arrangement raises no issues of distributable profits.

*The effect on a public company*

6.56 There are no additional considerations for a public company.

### Example 4 - Written option to issue own equity shares

6.57 The relevant standards require the premium received on the writing of an option to issue own shares, that are presented as equity, to be credited directly to equity. The premium stays in equity regardless of whether the option ultimately is exercised or lapses, although it may be transferred between components of equity (ie, between reserves). The premium, to the extent that it is received in the form of qualifying consideration, is, in law, a realised profit at the outset. [Principle 4]

*The effect on a public company*

6.58 There are no additional considerations for a public company.

### Example 5 - Convertible debt

6.59 Under the relevant standards, an issuer of debt convertible into the issuer's own equity shares will use split accounting (see assumptions in 6.6A to 6.6C above). That is, part of the issue proceeds are recognised as a liability, with the balance recognised directly in equity at the date the convertible debt is issued, being the component deemed to relate to the written option to issue own equity shares (the equity conversion option). There is a correspondingly higher interest charge over the life of the debt because of the need also to charge the increase in the recorded amount of the liability as interest. That additional interest is an accounting loss but is not, as a matter of law, a loss. [Principle 5]

6.60 The initial credit to equity is not a profit but as the liability component is fully reflected in the accounts, it offsets the additional interest charge. [Principle 5]

*The effect on a public company*

6.61 There are no additional considerations for a public company. [Principle 10]

### Example 6 - Preference shares presented as liabilities

6.62 Where a company issues a class of preference shares that are redeemable at a specified date, or at the holders' option, and the dividends on the shares are non-discretionary and cumulative, IAS 32/~~FRS 25~~ requires that the company classifies this class of shares as a liability (ie, debt). Under IAS 39/~~FRS 26~~, the liability has to be carried at inception at its fair value, which will be the sum of the nominal value of the shares and any associated share premium where the shares have been issued at fair value. Over the life of the shares the non-discretionary dividend is accrued between each payment date and is presented in profit or loss as an ~~"~~'interest ~~charge"~~ charge'. A dividend when paid is set against the accrued liability.

6.63 To the extent that the preference shares are to be redeemed contractually at a premium, the liability will need to be accreted over time such that by redemption the carrying amount of the liability is equal to the redemption price. The accretion of the redemption premium attributable to an accounting period will be presented together with the accrued dividend as the ~~"~~'interest ~~charge"~~charge' for that period in profit or loss.

6.64 The presentation of the nominal value of, and any share premium associated with, the preference shares as debt has no effect on the determination of the company's realised profits and losses.

6.65 The accrued preference dividend (and any accrued redemption premium) that is presented as an ~~"~~'interest ~~charge",~~charge', and thus an accounting loss, is, as a matter of law, a distribution at the time of its making and not a loss. Thus such accruals do not affect the company's realised profits. [Principles 1, 2 and 3]

*The effect on a public company*

6.66 For a public company, the presentation of preference shares (ie, the nominal value and any associated share premium) as debt does not result in an immediate restriction in the amount of profits available for distribution by a public company under section 831. [Principle 7]

6.67 Nevertheless, the effect of the accounting for the dividends (and any redemption premium) on the preference shares should be considered. The accounting liability recognised for the accrued unpaid preference dividend (and any redemption premium) is an advance recognition for accounting purposes of the eventual distribution (and/or capital repayment) and thus does not consume distributable profits until it is actually made as a distribution (or capital repayment). [Principle 3] However, profits available for distribution by a public company under section 831 will be restricted due to the reduction in net assets. [Principle 8]

*Combining the accounting and statutory capital maintenance entries to complete the redemption*

6.68 When payment is made to redeem the preference shares, it is for accounting purposes, set against the debt.

6.69 However, at redemption the law requires the following, where the redemption is made out of distributable profits:

- the nominal value of the redeemed shares is added to the capital redemption reserve; and
- the redemption price consumes distributable profits equal to its amount.

6.70 Therefore to reconcile these positions, the nominal value of the redeemed shares should be credited to the capital redemption reserve. Any share premium on the original issue of the shares now being redeemed should be credited to share premium account in equity at the date of redemption. The sum of the amounts added to the capital redemption reserve and added to share premium account is applied against retained earnings; this sum combined with the accumulated ~~"~~'interest ~~charge"~~charge' in respect of any redemption premium (which has built up in retained earnings over time) is equal to the amount of the redemption price that the law recognises as consuming distributable profits. As established earlier, the debit that builds up over time in retained earnings in respect of the redemption premium is the advance recognition of part of the redemption price and is disregarded as to its effect on distributable profits until the actual redemption takes place. [Principle 3]

**Example 7 - Mandatorily redeemable preference shares**

6.71 Under IAS 32~~/IFRS 25~~, an issuer of mandatorily redeemable preference shares, which bear non-cumulative discretionary dividends, has a compound instrument and has to use split accounting (see assumptions in 6.6A to 6.6C above). That is, the standards require the company to set up a liability, at the outset, for the present value of the payment to be made on redemption of the shares. This will take into account any contractual premium to be paid on redemption. The difference between the proceeds received on issue of the shares and the net present value of the redemption amount is credited (or debited) directly to equity at the outset. Over time the (discounted) liability is accreted up to the contracted redemption price, with a corresponding ~~"~~'interest ~~charge"~~charge' being expensed in profit or loss.

6.72 As a matter of law, all of the nominal value and any associated share premium of the preference shares are share capital and share premium irrespective of where they may now be presented in the balance sheet. Consequently, the initial credit to equity is share capital/share premium, albeit that it is the only part that is allowed by the relevant accounting standard to be shown as such, and is not a profit. The presentation of shares

partly within liabilities and partly within equity has no effect on the determination of the company's realised profits and losses.

6.73 The interest expense from the accretion up to the full amount of the redemption price is, however, presented as an accounting loss – it is shown as an "'interest ~~charge"~~ charge'. Since the ultimate payment is either a distribution or a capital repayment, the interest charge is, as a matter of law, not a loss even though it is accounted for as if it were a loss. [Principle 2]

*The effect on a public company*

6.74 For a public company, the effect of this IAS 32~~/FRS 25~~ accounting is to restrict the maximum amount of profits available for distribution over time by the amount of the cumulative accruals for the redemption price. [Principle 10]

Combining the accounting and statutory capital maintenance entries to complete the redemption

6.75 For IAS 32~~/FRS 25~~ purposes, the payment to redeem the shares is set against the fully accreted liability.

6.76 However, at redemption the law requires the following, where the redemption is made out of distributable profits:

- no amount remains recorded in called-up share capital for the redeemed shares;
- the nominal value of the redeemed shares is added to the capital redemption reserve; and
- the redemption price consumes distributable profits equal to its amount.

6.77 Therefore to reconcile these positions, the nominal value of the redeemed shares should be credited to the capital redemption reserve in equity and the corresponding amount for this entry is used to eliminate the original credit to equity to the extent recorded as share capital (which is now cancelled share capital). Any share premium on the original issue of the shares now being redeemed, if hitherto presented as part of the liability, should be credited to share premium account in equity at the date of redemption. The sum of the amount added to the capital redemption reserve, but not used to make a corresponding elimination of the original credit to share capital, and that added to share premium account is applied against retained earnings; this sum, combined with the accumulated "'interest ~~charge"~~ charge' in respect of any redemption premium (which has built up in retained earnings over time) is equal to the amount of the redemption price that the law recognises as consuming distributable profits. As established earlier, the "'interest ~~charge"~~ charge' debit in retained earnings is the advance recognition of part of the redemption price and has no effect on cumulative realised profits until the actual redemption takes place.

**Example 8 - Convertible redeemable preference shares**

6.78 Under IAS 32~~/FRS 25~~, convertible redeemable preference shares are a compound instrument and an issuer of such instruments will use split accounting (see assumptions in 6.6A to 6.6C above). This is similar to debt convertible into an issuer's own equity instruments as described in 6.59 *et seq* above. That is, a liability is recognised for the debt component and a credit is recognised in equity for the equity component (the equity conversion option). However, the analysis for distributable profits purposes is more akin to that for the mandatorily redeemable shares with discretionary dividends described in 6.71 *et seq* above. This is because the initial credit to equity is share capital (and share premium).

6.79 It is assumed that the preference shares are convertible at any time by the holder into ordinary shares of the issuer and are mandatorily redeemed at the end of their term if not converted. The conversion feature cannot be settled other than by an exchange of the preference shares for a fixed number of the issuer's ordinary shares.

6.80 The presentation of the shares (inclusive of their share premium) as partly debt and partly as a credit in equity has no effect on the determination of realised profits and losses.

6.81 Any accrued unpaid preference dividends and the accretion up to the full amount of the redemption price, although presented as accounting losses through the profit and loss account, are disregarded in determining whether distributable profits have been consumed until their actual payment. [Principle 6]

*The effect on a public company*

6.82 At the outset there is no effect on distributable profits [Principle 9]. There will be a restriction for a public company on the maximum amount of profits available for distribution over time by the amount of the cumulative accruals for the redemption price. [Principle 10]

*Combining the accounting and statutory capital maintenance entries where the shares are redeemed*

6.83 The same analysis applies as given in 6.71 *et seq* in respect of the mandatorily redeemable preference shares with discretionary dividends.

*Combining the accounting and statutory capital maintenance entries where the shares are converted*

6.84 Under IAS 32~~/FRS 25~~, when the holders exercise their option to convert the preference shares into the issuer's ordinary shares, the amount of the liability at conversion is transferred to equity.

6.85 However, to establish the impact on profits available for distribution it is necessary to re-analyse the aggregate entries in equity to establish the amounts that represent:

- the nominal value of the ordinary shares issued on conversion;
- the relevant amount of share premium to be included in the share premium account; and
- the elimination of the ~~"~~'interest ~~charge"~~charge' debit in retained earnings.

6.86 This is achieved at conversion by crediting to retained earnings an amount equal to the accumulated ~~"~~'interest ~~charge"~~charge' in respect of accrued unpaid dividends and accretion to the issue price of the shares from the amount transferred from liabilities to equity. The aggregate of the balance of the transfer to equity and the initial credit to equity is equal to the total of the nominal value and share premium attributable to the ordinary shares issued on conversion.

6.87 The allocation of part of the transfer from liabilities equal to the accrued ~~"~~'interest ~~charge"~~charge' effectively reverses the ~~"~~'interest ~~charge"~~charge' accounting entries. At law the debit accounting entries had not consumed distributable profits and therefore the effective reversal of these entries has no effect on the quantum of distributable profits.

However, for public companies, the effective reversal of the ~~“~~‘interest ~~charge”~~charge’ debit at conversion removes the restriction under the section 831 net assets test.

# 7. EMPLOYEE SHARE SCHEMES 7.1 – 7.56

## ESOP trusts

### Introduction

7.1 Paragraphs 7.4 to 7.45 are concerned with the effect of a company's sponsorship of a trust (ESOP trust) that holds shares in the company, which may be delivered to the company's employees under an employee share scheme. This differs from the case of the direct holding of a company's own shares (treasury shares) which are addressed at paragraphs 2.40 to 2.43 above.

7.2 The practice of employing ESOP trusts evolved partly because of restrictions on a company acquiring its own shares (s658) or acquiring shares in its parent company (section 136). These restrictions ~~were~~have been eased ~~from 1 December 2003 when certain~~now that companies ~~were~~are permitted~~, subject to some restrictions,~~ to hold their own shares as treasury shares (see paragraph 7.1 above). The use of ESOP trusts has, however, remained widespread.

7.2A The provision of funds by a company to an ESOP trust to enable it to buy shares in the company or its parent company will generally fall within the definition of financial assistance for the acquisition of own shares (section 677). Such assistance is generally prohibited, subject to certain exceptions, for a public company or a subsidiary of a public company (section 678). ~~Under the 1985 Act, similar restrictions applied to all companies until 1 October 2008.~~ However, one of the exceptions to the general rules in section 682(2)(b) is 'the provision by the company, in good faith in the interests of the company or its holding company, of financial assistance for the purposes of an employee's share scheme'.

7.3 That exception is subject to a restriction in section 682(1) that the financial assistance may only be given if the company has net assets which are not thereby reduced, or to the extent that those assets are thereby reduced, the financial assistance is provided out of distributable profits. Although paragraphs 7.25 to 7.31 address the interaction of this restriction with the accounting for ESOP trusts, the general question of the lawfulness of financial assistance is not within the scope of this guidance and accordingly directors may wish to consider seeking legal advice.

### ESOP trusts under UK GAAP

~~7.4 Under UK GAAP, UITF Abstract 38 "Accounting for ESOP trusts"~~7.4 FRS 102 requires the sponsoring company of an ESOP trust to recognise the assets and liabilities of the trust in its own accounts whenever it had de facto control of those assets and liabilities. Where the trust purchases the company's own shares, the consideration paid for those shares should be deducted in equity until such time as the shares vest unconditionally in the company's employees. The effect of this deduction, which occurs in the individual accounts of the sponsoring company and not merely on consolidation, is considered below.

7.5 The sponsoring company of an ESOP trust may be a company other than the one whose shares are held by the trust. For example, a subsidiary may be the sponsoring company of an ESOP trust that holds shares in its parent. In this case the shares will not be "'own ~~shares"~~shares' from the perspective of the subsidiary's financial statements. The shares would be recognised as an asset in the subsidiary's balance sheet and the issues addressed in this guidance would not arise.

### ESOP trusts under IFRSs

7.6 The guidance set out below in relation to investments in own shares held through an ESOP trust will be relevant to companies reporting under IFRSs if they account for investments in

own shares in their individual balance sheets in a manner similar to that required by ~~UITF Abstract 38.~~FRS 102. However, published literature suggests that a different accounting treatment may be permitted in individual accounts under IFRSs. Whereas ~~UITF Abstract 38~~FRS 102 requires the assets and liabilities of the trust to be included in the individual balance sheet of the sponsoring company, under IFRSs it may be acceptable to account for the ESOP trust as an investment in a subsidiary. The IFRS Interpretations Committee was asked to address the question of which of these treatments is appropriate but declined to do so on the basis that it would be unable to reach a consensus on a timely basis given the different types of trusts and arrangements that exist in practice (see IFRIC Update, November 2006, for further details).

7.7 Where the ESOP trust is accounted for as a subsidiary, any loans to the trust by the sponsoring company, to the extent that they are regarded as recoverable, may therefore be recognised as assets in the individual balance sheet of the sponsoring company even though they have been used to finance an investment in own shares by the trust. If it is necessary to write the loan down for impairment at any time then that write down will represent a realised loss. The guidance set out below concerning the effects of a deduction within equity is not relevant when the loan is recognised as an asset because the deduction within equity will arise only in the consolidated financial statements.

~~**Note of legal considerations attached to Abstract 38**~~

~~7.8 A note of legal considerations attached to Abstract 38 sets out legal advice that the UITF received on the implications for distributable profits when the accounting treatment required by the Abstract is followed. The note of legal considerations is reproduced in Appendix 3 to this guidance for reference. This guidance is consistent with that note of legal considerations but additionally addresses some issues that were not covered in that note as well as considering some issues in greater depth.~~

~~7.8A The note of legal considerations attached to UITF Abstract 38 states that although the acquisition of shares by an ESOP trust will not, of itself, result in a realised profit or loss for the company concerned, "a company will still need to consider other transactions with the ESOP, for example a loan to the ESOP to fund acquisitions of shares, and these may affect the company's realised profits and losses". The reference to a loan to the ESOP might be read as implying that realised profits and losses should be determined by reference to "narrow entity accounting" (see 7.14 below). However, this is not the case; the UITF Abstract 38 note refers to the existence of a loan as only one of a number of factors that might be relevant. The assessment of realised profits and losses for the justification of a distribution is by reference to a company's "relevant accounts" and, as explained in paragraph 7.14 this means by reference to "extended entity accounting". However, see 7.25 to 7.31 regarding financial assistance by a public company.~~

7.8 [Deleted]

7.8A [Deleted]

**Effect of deduction within equity on realised profits**

7.9 A purchase of a company's own shares though an ESOP trust is not a distribution at law. This is because, at law, the shares have been purchased by the trust, notwithstanding that assistance may have been given by the company (by way of gift or loan, some or all of which may be ultimately irrecoverable, or by guarantee of the trust's borrowings that may ultimately be called upon to some extent). See 7.25 to 7.31 below for regulation of the transaction for a public company as financial assistance.

7.10 Neither does such a purchase, of itself, give rise to an immediate realised loss. Therefore, such an acquisition does not reduce the amount of profits available for distribution under section 830.

7.11 In addition, whilst the acquisition of shares will not, of itself, give rise to an immediate realised loss, the impact of other factors such as the granting of rights over those shares should be considered (see 7.37 to 7.41 below).

### Effect on section 831 restriction on purchase of own shares for a public company

7.12 The consideration paid on the purchase of shares by an ESOP trust sponsored by a public company will immediately restrict the profits available for distribution by virtue of section 831 by the amount of the consideration paid. As more fully explained below, there will be an immediate reduction in net assets but no change in share capital or undistributable reserves.

7.13 A public company may only make a distribution at any time:

(a) if at that time the amount of its net assets is not less than the aggregate of its called-up share capital and undistributable reserves; and

(b) if, and to the extent that, the distribution does not reduce the amount of those assets to less than that aggregate.

*Change in net assets*

7.14 Section 831 states that ~~"~~'net ~~assets"~~assets' means the aggregate of the company's assets less the aggregate of its liabilities. Under section 836, net assets are those as shown in the company's ~~"~~'relevant ~~accounts"~~accounts' which are normally the last annual accounts under Part 15 of the Act, properly prepared under the Act; in certain circumstances, the relevant accounts are initial accounts or interim accounts, which are prepared to a similar standard. Net assets for the purposes of section 831 should therefore be determined in accordance with accounting standards ~~and UITF Abstracts.~~. Accordingly, the relevant accounts and the net assets should include the assets and liabilities of the ESOP trust as reported under ~~Abstract 38 (~~"FRS 102 ('extended entity ~~accounting")~~accounting') rather than, for example, any loan between the company and the ESOP trust ~~("~~('narrow entity ~~accounting").~~accounting').

7.15 The effect of the accounting treatment required by ~~Abstract 38~~FRS 102 is that, in drawing up the relevant accounts, any own shares held by an ESOP trust would be recorded as a deduction in arriving at shareholders' funds rather than as an asset. Therefore, it follows that the relevant aggregate net asset amount for the purposes of the definition in section 831(2) would be reduced by the own shares held (being the consideration paid for the shares).

7.16 Disclosure by way of note that the company also has an ~~"asset"~~'asset' of own shares held through an ESOP trust would not restore the net assets for the purposes of section 831 (see 2.14 above). If the shares are not an asset for accounting purposes they cannot be an asset for the purposes of calculating net assets when applying section 831.

*Change in share capital or undistributable reserves*

7.17 A company's undistributable reserves are defined in section 831. In short, they include the company's unrealised profits less its unrealised losses, except that this amount is never less than zero (ie, net unrealised losses are not within the definition).

7.18 The correct characterisation, as a matter of law, of the deduction in equity is not straightforward. On the one hand the deduction should not be characterised as a loss at all (thereby rendering redundant questions of realisation) because from the point of view of the company's individual accounts (which are on an extended entity basis) the company has not lost control of the shares nor have these shares suffered any objectively measurable diminution in value. On the other hand, given that the applicable accounting treatment does not permit the company to treat the shares as an asset, some might argue that the deduction should be categorised as a loss, although the nearest equivalent could be said to be a return of capital. The characterisation which gives primacy to the substance rather

than presentation is the view to be preferred and accordingly the deduction should not be characterised as a loss.

7.19 Accordingly, the deduction for own shares in equity is neither a realised loss nor an unrealised loss and does not affect the balance of undistributable reserves.

### The effect on profits available for distribution under section 831

7.20 Thus with net assets reduced but share capital and undistributable reserves unaffected, the purchase of ESOP trust shares affects the maximum distribution permissible by virtue of the application of section 831 (the ~~"~~'maximum distribution ~~permissible").~~ permissible'). In other words, the effect of the section is such that the profits available for distribution are restricted by a reduction in net assets that is neither a realised nor an unrealised loss.

7.21 Furthermore, the existence of any unrealised profits does not alter this situation (~~e.g.,~~ eg, such unrealised profits cannot be applied to offset the deduction, because the deduction is not an unrealised loss).

### Effect on section 831 restriction on subscription for own shares for a public company

7.22 A subscription for new shares in a public company by its own sponsored ESOP trust will immediately restrict the maximum distribution permissible.

7.23 The application of section 831 is considered above. In the case of a subscription for new shares, there is no change in net assets. This is because the cash subscribed for the shares by the ESOP trust is recorded in the balance sheet of the sponsoring company both before and after the subscription in accordance with ~~Abstract 38~~FRS 102.

7.24 However, the amount of the company's called-up share capital is increased by the nominal value of the shares issued to the trust. The amount of the company's undistributable reserves is also increased to the extent of any share premium arising on the issue, for example where the ESOP trusts subscribes for the shares at market value which is at a premium to nominal value. There is no other effect of the subscription on undistributable reserves as defined in section 831. Consequently, any excess of the company's net assets over the aggregate amount of the company's called-up share capital and undistributable reserves is reduced and hence the amount of the company's maximum distribution permissible is restricted by the amount attributable to the share issue (ie, the proceeds of subscription for the shares by the trust).

### The effect of the financial assistance rules in relation to a public company

7.25 Assuming that the relevant assistance is permitted by virtue of section 682(2), in the case of a public company the assistance can only be given if the company has net assets which are not thereby reduced or, to the extent that those assets are thereby reduced, if the assistance is provided out of distributable profits.

*Net assets*

7.26 For the purposes of section 682, ~~"~~'net ~~assets"~~assets' are defined as the amount by which the aggregate of the company's assets exceeds the aggregate of its liabilities, taking the amount of both its assets and liabilities to be as stated in the company's accounting records immediately before the financial assistance is given. This is in contrast to section 831 where, by reason of section 836, net assets are the aggregate of the company's assets less the aggregate of its liabilities as shown in the company's relevant accounts.

7.27 Section 386 imposes a duty to keep accounting records which are sufficient to show and explain the company's transactions and to enable the directors to ensure that any balance sheet and profit and loss account prepared under Part 15 of the Act complies with the requirements of the Act. Thus the records must at least be consistent with accounting

standards and interpretations issued by the ~~UITF~~IASB or ~~the IFRS Interpretations Committee~~FRC as the case may be. However, this does not impose an obligation to maintain the entries in the accounting records fully in accordance with accounting standards and interpretations provided that it is evident from those records how to make suitable adjustments to prepare accounts in accordance with the requirements of the Act. Accordingly, section 386 does not require net assets for the purposes of section 682 to be determined by reference to ~~"~~'extended entity ~~accounting"~~accounting' (as described at 7.14 above).

7.28 Thus, in the absence of any such requirement, the company's assets and liabilities should be given their natural meaning, namely the assets and liabilities of the company as a legal person. In other words, the ~~"~~'narrow entity ~~accounting"~~accounting' basis is used for determining the net asset position of the company concerned and whether the financial assistance has reduced the company's net assets[39]. There is thus in this respect no change to the assessment of a company's net asset position as a result of applying ~~Abstract 38~~FRS 102.

*The effect of section 831 where financial assistance is provided out of distributable profits.*

7.29 Where a company has provided financial assistance out of distributable profits which has reduced its net assets and shares have been acquired by an ESOP trust, section 831 does not require a further restriction in the maximum distribution permissible equal to the amount of the reduction in net assets calculated under section 682.

7.30 Section 682 and section 831 are directed to different objectives. Section 682 determines the legality of the provision of financial assistance tested on a narrow entity basis. Section 831 determines the maximum distribution permissible tested on an extended entity basis. On the extended entity basis the assistance provided to the ESOP trust will not be treated as having been paid away until the shares are purchased at which point the net assets are reduced by the consideration paid for the shares (as described at 7.12 to 7.21 above).

7.31 Section 840 contains accumulation rules where distributions are proposed by reference to particular accounts and prior distributions have taken place. Section 840(2) makes it clear that financial assistance which is given out of distributable profits is taken into account in the accumulation rules. These rules continue to apply.

7.32 [Deleted]

**Purchase by an ESOP trust of shares held as treasury shares by a ~~listed public~~ company**

7.33 A purchase of treasury shares by an ESOP trust for cash will be a sale of treasury shares for cash for the purposes of section 731 (see paragraph 7.34 below). The proceeds will therefore increase distributable profits up to an amount equal to the original purchase price of the shares (ie, reversing the decrease that would have occurred at the time of purchase of the treasury shares). Any excess will be credited to share premium. At the same time, the former treasury shares, now shares held by the ESOP trust, will be accounted for and treated for distributable profit purposes just as if they had been purchased at the same price from a third party, ie, the entire consideration paid by the ESOP trust restricts the amount of profits available for distribution (see 7.12 to 7.31 above).

[39] More generally, the presentation of shares as liabilities reduces net assets as defined in section 682 for the purposes of financial assistance. The legislation refers to amounts stated in the accounting records rather than in the 'relevant accounts' because the test is a 'real time' one. However, subject to the use of 'narrow entity accounting' as described above, net assets as defined in section 682 for the purposes of financial assistance should generally be the same as net assets as defined in section 831 for the purposes of distributions by a public company. That is, the relevant shares should be treated as liabilities to creditors.

7.34 Section 727(1) states that where shares are held as treasury shares, a company may at any time ~~"(~~'(a) sell the shares... for a cash consideration or (b) transfer the shares ... for the purposes of or pursuant to an employees' shares ~~scheme".~~scheme'. Section 729(1) states that where shares are held as treasury shares the company may at any time ~~"~~'cancel the ~~shares".~~shares'. Section 731 deals with the treatment of the proceeds when shares ~~"~~'are ~~sold"~~sold' and requires any excess over the purchase price to be credited to share premium, with the remainder to replenish distributable profits. No treatment is otherwise specified for the proceeds when shares are ~~"transferred"~~'transferred' to an employee share scheme in accordance with section 727(1)(b). Section 731 does not apply exclusively to sales falling solely within section 727(1)(a) but applies to any sale of treasury shares to an ESOP trust notwithstanding that the sale might also be a transfer under section 727(1)(b).

7.35 The requirement in section 731 to transfer an amount to share premium when shares are sold for more than their purchase price applies only to treasury shares. Such a transfer is not required, or permitted, when shares held by an ESOP trust are sold in comparable circumstances. Whether or not the resulting surplus in the trust is a distributable profit from the perspective of the company is addressed at 7.42 to 7.45 below.

**Effect on distributable profits for a public company when proceeds are received for sale of shares by an ESOP trust**

7.36 In the case of a public company, the initial acquisition of the ESOP shares would have an immediate effect on distributable profits under section 831 because net assets were reduced without a corresponding reduction in share capital and undistributable reserves (see 7.12 to 7.21 above). However, if option holders then subscribe for the shares or the shares are sold in the market, the receipt of proceeds gives rise to an accounting entry (debit cash, credit shareholders' funds) that reverses the situation and restores distributable profits to the extent of those proceeds. That is, net assets are increased for the purposes of section 831 but there is no corresponding increase in share capital and undistributable reserves.

**Realised loss when shares held by an ESOP trust are transferred to employees - where shares originally acquired externally**

7.37 The purchase of shares by an ESOP trust does not, of itself, give rise to a realised loss (see 7.10 above) and, other than in the case of a public company, does not otherwise immediately affect the distribution of available profits. However, it is clear that if the shares are to be transferred to employees for less than their purchase price, the shortfall will at some time fall to be treated as a realised loss. In some cases options may be granted with an exercise price that is lower than the price at which the shares were purchased. In other cases shares may be transferred to employees for no consideration on the achievement of specified performance or service conditions. In all such cases, the difference between the purchase price of the shares and the proceeds received or receivable from the employee should be regarded as becoming a realised loss over the relevant amortisation or charging period as would be the case with a cash bonus that was contingent on future service.

7.38 [Deleted]

7.39 Where options have been granted over the shares in question but those options are ~~"~~'out-of-the-~~money"~~money' or where there are ~~"surplus"~~'surplus' shares that have not been allocated to any particular share scheme, a realised loss may also arise if the market value of the shares falls below their purchase price. 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.

7.40 [Moved to 7.8A]

### Realised loss when shares held by an ESOP trust are transferred to employees - where shares originally subscribed

7.41 The subscription for shares by an ESOP trust does not, of itself, give rise to a realised loss (see 7.10 above) and, other than in the case of a public company, does not otherwise immediately affect the distribution of available profits. However, as in the case of a purchase of shares described at 7.37 to 7.39 above, a realised loss may arise if the shares are subsequently transferred to employees for less than their subscription price. In all such cases, the difference between the subscription price of the shares and the proceeds received from the employee should be regarded as becoming a realised loss over the relevant amortisation or charging period.

### Whether a surplus on disposal of shares by an ESOP trust is a realised and distributable profit from the perspective of the sponsoring company

7.42 As explained at 7.44, a surplus on disposal of shares held by an ESOP trust is a realised profit. However, in respect of it being distributable, the directors should have regard to their wider common law duties as required by sections 851 and 852. As explained at 7.45, the profit therefore may not become distributable until some time in the future.

7.43 Under ~~Abstract 38~~FRS 102, a sponsoring company includes the assets, liabilities and transactions of its ESOP trust in its accounts as if the trust were a division or branch of the company. This is therefore not just a matter of including the trust in consolidated accounts. The assets, liabilities and transactions of the trust are included in the company's individual accounts. These are the ~~"~~'relevant ~~accounts"~~accounts' for the purposes of determining profits available for distribution. Where the trust has a surplus in the equivalent of its profit and loss account, the question arises of whether this should be reflected in the calculation of the company's realised profits.

7.44 Where the trust has a surplus (~~e.g.~~eg, from the sale of shares at more than their purchase price), it is arguable that, just as a parent would not treat a surplus in a subsidiary as a realised profit in its own individual accounts, the parent should not regard the surplus in the trust as increasing its realised profits. But there is a clear difference in that ~~Abstract 38~~FRS 102 requires the assets and liabilities of the trust to be included in the company's own individual accounts. ~~Also, Abstract 13, which was superseded by Abstract 38 and required own shares to be recognised as assets, made no mention of any legal difficulties about including any "profits" of the trust in the company's profit and loss account. Under Abstract 38, no such profits arise to be included in the company's profit and loss account but the issue is still relevant to the determination of the company's realised profits.~~ Where the consideration received by the trust for the sale of the shares is in the form of cash (or other ~~"~~'qualifying ~~consideration")~~consideration') that will be included in the company's balance sheet in accordance with the requirements of ~~Abstract 38~~FRS 102, the profit will be a realised profit from the company's perspective.

7.45 However, the directors should have regard to their wider common law duties as required by sections 851 and 852 (see 2.1 above). It would not be regarded as prudent to distribute an amount that represents assets that are retained in the ESOP trust and therefore not available for the general purposes of the company. If the assets of the trust are used in future to meet an expense, an equivalent amount of the gain should at that time be treated as distributable. Therefore to the extent that the realised loss arising from the expense does not exceed the previously recognised gain that was treated as undistributable, there will be no reduction in distributable profits.

### Expenses for share based payments ~~required by IFRS 2 and FRS 20~~

7.46 IFRS 2 ~~(~~and FRS ~~20)~~102 require expenses to be recognised in profit or loss for cash-settled share-based payment arrangements. The credit entry will be either a cash payment

or a provision. The expense recognised will therefore be a realised loss. The paragraphs which follow are concerned with equity-settled arrangements.

7.47 IFRS 2 ~~(~~and FRS ~~20)~~102 require expenses to be recognised in profit or loss for equity-settled share-based payment arrangements. The standard requires the credit entry arising from recognition of this expense to be credited within equity but does not specify any particular component of equity.

7.48 Any expense recognised in accordance with IFRS 2 or FRS 102 will be a realised loss. This follows from the principle that all losses should be regarded as realised losses except to the extent that the law, accounting standards or this guidance provide otherwise (see 3.10 above). However, the overall impact of the IFRS 2 or FRS 102 expense on distributable profits will depend on the status of the credit entry in equity.

7.49 If the consideration for an issue of shares is, as a matter of law, the provision of goods or services to the company, it will be necessary to credit share capital and share premium with the fair value of those goods or services. Similarly, if shares are, as a matter of law, issued in settlement of a monetary liability, it will be necessary to credit share capital and share premium with the amount of the liability discharged. Where this is so, the credit entry to equity required by IFRS 2 or FRS 102 cannot be a realised profit.

7.50 In the case of share options, the note of legal considerations appended to UITF Abstract 17 ~~(now~~is still relevant, despite that Abstract being superseded by FRS 20~~)~~ and FRS 102, and it provided the following guidance[40].

> ~~"~~'The UITF has received legal advice on the implications for share premium account when the accounting treatment required by this Abstract is followed. It has been advised that where new shares are issued in connection with an employee share scheme the share premium account will normally have to reflect only the cash subscribed for the shares (~~e.g.~~eg, by the employee or by an ESOP trust). In such cases, any difference between the cash subscribed for the shares (which must be at least as much as the nominal value, as shares cannot be issued at a discount) and the fair value at the date of grant of rights should be credited to reserves other than the share premium account. This is on the basis that the services of the employee do not, as a matter of law, form part of the consideration received for the shares issued, and the UITF has been advised that this would be the usual legal interpretation of such transactions. Exceptionally, however, the terms of a transaction might be such as to lead to the opposite interpretation, and companies may need to take legal advice on this point. In such a case, the operation of section 99(2) of the Companies Act 1985 [now section 585(1) of the Companies Act 2006] [prohibition of public company accepting undertaking to perform services in payment up of its shares] and section 103 [now section 593 of the Companies Act 2006] [non-cash consideration to be valued before allotment of shares] would also have to be considered~~."~~.'

However, the arrangements referred to in the last two sentences of the quoted paragraph are not typical. Instead, for example, in the case of share options, the credit to equity required by IFRS 2 or FRS 102 will usually be a credit to reserves other than share premium account.

7.51 The note of legal considerations does not, however, address whether the credit to equity in the case of options to subscribe for shares is a realised profit. However, an unrealised reserve will be treated as having become realised by the amortisation or writing down of the related asset (see 3.9(f) above). Therefore, assuming that the IFRS 2 or FRS 102 expense has been included in profit or loss (which would be the case except where the charge had

[40] The equivalent 2006 Act references have been added to the original note for ease of reference.

been capitalised as part of the cost of production of an asset) the credit entry in equity will be a realised profit. The IFRS 2 or FRS 102 expense will therefore have no net effect on distributable profits. However, when the expense is reduced by a credit for deferred tax which is represented by a deferred tax asset, the credit to equity will be realised only to the extent of the net of tax expense. In this case, any balance of unrealised reserve will become realised when the deferred tax asset is eliminated from the balance sheet.

7.52 The manner of settlement (~~e.g.~~ eg, subscription for new shares or purchase of shares in the market by an ESOP trust) does not affect the expense recognised under IFRS 2 or FRS 102 or whether this is a realised loss. However, it will be necessary to consider the effect on realised profits arising from any shares held by an ESOP trust (see 7.37 to 7.41 above).

**Intra-group recharges for share-based payments**

7.53 In November 2006, the IFRS Interpretations Committee issued IFRIC 11 "'IFRS 2 - Group and Treasury Share ~~Transactions"~~Transactions' which has subsequently been incorporated into IFRS 2. The Exposure Draft upon which this was based (IFRIC D17) included some material on the treatment of inter-company recharges made within groups in connection with share-based payment arrangements. The IFRS Interpretations Committee decided not to address these issues in IFRIC 11 because it did not wish to widen the scope of the Interpretation to an issue that relates to accounting for intra-group payments generally. The appropriate accounting for such recharges is thus a matter of developing practice, including that in some cases the treatment that was set out in the draft guidance in IFRIC D17, described below, may be appropriate.

7.54 The situation in question is one in which the company, being a subsidiary, makes a cash payment to its parent in relation to a share-based payment in favour of the company's own employees and where IFRS 2 requires an equity-settled share-based payment charge in the company's accounts. The proposals in IFRIC D17 envisaged that where a charge is made by the parent to the subsidiary which exceeds the expense that the subsidiary is required to recognise under IFRS 2, the excess is accounted for by the subsidiary as a distribution. For example, this may arise if a charge is made on the basis of intrinsic value at exercise date which will generally be higher than the grant date fair value recognised as an expense in accordance with IFRS 2. The accounting treatment of any such charge does not affect whether or not it is a distribution as a matter of law. In particular, if there is a commercial basis for such a charge, it will not be a distribution as a matter of law. An example of a commercial basis would be the expense that the subsidiary would have incurred if it had purchased shares in the market to satisfy the options. Consequently, it will not be unlawful for the subsidiary to make the reimbursement payment, even in the absence of distributable profits, provided that the payment is not a distribution as a matter of law.

7.55 However, the entire reimbursement payment will have the effect of reducing accumulated realised profits or increasing accumulated realised losses of the subsidiary. The debit to equity arising from the payment will first reduce the credit in equity arising from IFRS 2 which will no longer be available to offset the realised loss recognised as a result of the IFRS 2 expense. Any debit to equity in excess of this amount will be a realised loss even though it will not have been accounted for as a loss in the financial statements.

7.56 A liability may be recognised by the subsidiary where the parent has a contractual right to reimbursement at a future date. The amount of the realised loss at any date will generally be based on the amount of the liability recognised at that date but the particular facts of each case should be considered.

# 8. RETIREMENT BENEFIT SCHEMES 8.1 – 8.~~26~~15

## Introduction

8.1 The guidance in this section is written in terms of compliance with ~~FRS 17~~IAS 19 but is equally applicable ~~when the equivalent international standard IAS 19 'Employee benefits' is being applied. When IAS 19 is being applied, the guidance should be applied~~ to the ~~amounts reported under that standard. For simplicity, this guidance refers throughout to the relevant~~very similar requirements of section 28 of FRS 102. Companies transitioning from FRS ~~17.~~

~~8.2 The guidance set out below applies both to pension~~102 to IFRSs or vice versa should often see no change of accounting treatment and therefore no impact on distributable reserves. However, companies transitioning from FRS 17 to either IAS 19 or FRS 102 may see a change of accounting treatment, particularly when they were accounting for their participation in group multi-employer defined benefit schemes ~~acquired in a business combination and those that are started by the reporting company~~as if they were defined contribution schemes.

## Defined contribution schemes

8.~~3~~2 For defined contribution ~~retirement benefit~~ schemes, or those accounted for as defined contribution schemes, the cost charged to ~~the~~ profit ~~and~~or loss ~~account~~ under ~~FRS 17 is equal to the contributions payable to the scheme for the accounting period. The charge to the profit and loss account for the contributions payable~~IAS 19 is a realised loss.

~~**Multi-employer schemes**~~

~~8.4 Under FRS 17, some companies account for their participation in certain multi-employer defined benefit retirement benefit schemes as if they were defined contribution schemes. Where a scheme meets the criteria for this treatment in FRS 17, the position as regards realised profits and losses will be the same as for any other defined contribution scheme.~~

## Defined benefit schemes

*Principles*
~~**Summary**~~

~~8.5 In summary, what is required in relation to a defined benefit scheme is to identify whether any adjustment is required to reserves, to exclude unrealised profits, in arriving at the amount of distributable profits. To do so, it is first necessary to ascertain the cumulative amounts charged or credited in relation to the pension scheme, whether through the profit and loss account or through the statement of total recognised gains and losses (ie the total amounts taken to reserves). Paragraphs 8.11 to 8.13 determine whether that cumulative amount is realised or unrealised, with the test being different for cumulative net debits as against cumulative net credits. The cumulative net debit or credit will not be readily apparent from the accounts and so paragraphs 8.14 to 8.15 provide that it is determined from the movement in the pension scheme asset or liability on the balance sheet since inception of the scheme (ie when it is started by the company or when it was acquired in a business combination) and the cumulative net cash paid to the scheme. The cumulative cash flows may themselves be difficult to obtain and so paragraphs 8.16 to 8.17 provide a method of estimating the amounts. Paragraph 8.18 then describes some circumstances when it is possible to deduce easily, without working through these procedures, that all amounts accumulated in reserves are realised.~~

~~8.5A This calculation is unaffected by the date of adoption of FRS 17 and the accounting adopted previously (ie SSAP 24). A company may have established the cumulative amount in reserves for the pension scheme on adoption of FRS 17 in which case the amount can be rolled forward from year to year. However, the approach set out below will enable the position to be established at a particular date if no such calculation was performed.~~

**General principles**

8.6 It is the cumulative gain or loss credited or debited to reserves in respect of a pension scheme, rather than the existence of a surplus or deficit, that affects the realised profits and losses of a company. This principle is illustrated in Appendix 4.

8.7 The effect of FRS 17 on reserves must be calculated to identify whether any adjustment in respect of pensions is needed to reported reserves to arrive at realised reserves. No adjustment is required if a net cumulative loss has been taken to reserves. If a net cumulative gain has been taken to reserves, and under the guidance set out at 8.12 below that gain is in part or in full unrealised, a deduction equivalent to the unrealised element must be made to reserves in assessing the level of realised reserves.

8.8 In establishing the impact that a surplus or deficit under FRS 17 has on a company's realised profits, it is therefore necessary to:

(a) identify the cumulative net gain or loss taken to reserves in respect of the pension surplus or deficit; and

(b) establish the extent to which that gain or loss is realised.

8.9 Although the various elements making up the changes in the defined benefit asset or liability are disclosed separately in the performance statements (see paragraph 50 of FRS 17), it is the net amount that represents the cost to the company of the pension promise. Thus it is the cumulative net gain or loss taken to reserves that falls to be categorised as realised or unrealised. There is no need to distinguish that cumulative balance between amounts charged or credited in the profit and loss account and those recognised in the statement of total recognised gains and losses (STRGL). The entries in the STRGL are considered for this purpose as revisions of past estimates of the net pension cost and are not precluded from being treated as realised simply because they have passed through the STRGL rather than the profit and loss account.

8.10 The impact on reserves is not usually the same as the pension asset or liability recognised in the balance sheet. It will be different due to the net contributions paid to the scheme (see 8.15 *et seq*) and any asset or liability introduced as the result of a business combination (see 8.19 *et seq*).

8.11

8.3 For a defined benefit scheme, it is the cumulative amounts charged or credited to reserves which must be assessed as realised or unrealised. This is true irrespective of whether those amounts have been reported in profit or loss or in other comprehensive income. The assessment is as follows.

8.4 A cumulative charge is a realised loss.

8.5 A cumulative net debit in reserves in respect of the pension scheme constitutes a realised loss as it results from the creation of, or an increase in, a provision for a liability or loss resulting in an overall reduction in net assets. This follows from 2.32, 3.10 and 3.15(d) above.

8.12 A cumulative net credit in reserves in respect of the pension scheme constitutescredit is a realised profit only to the extent that it is represented by an asset that is to be recovered by refunds that have been agreed for a specific amount by the pension scheme trustees at the balance sheet date of the relevant accounts and the refunds will take the form of qualifying consideration. This follows from 3.9(a) above which refers to "a transaction where the consideration received by the company is 'qualifying consideration'". An asset that is recognised based on a reduction in future contributions or on expected refunds that are not

agreed at the balance sheet date will not meet the definition of 'qualifying consideration'cash or other qualifying consideration. Being eligible for a refund when the scheme is wound up would not be sufficient.

8.13 To the extent that a cumulative net credit in reserves exceeds any such agreed refunds it is unrealised, but it becomes realised in subsequent periods to the extent that it offsets subsequent net debits to reserves being recognised as realised losses in respect of the pension scheme (ie as the cumulative net credit reduces). This follows from 3.9(f)(iii) and (iv) above.

8.14 To establish the effect on realised profits at a particular date, a company must therefore establish the cumulative net credit or debit in reserves for the pension scheme at that date. This equals the amount of the surplus or deficit recognised before taking account of deferred tax, adjusted for:

(a) cumulative net contributions less refunds made in respect of the pension scheme; and

(b) in the rare cases in which the company has recognised a pension asset or liability in its individual accounts on the acquisition of an unincorporated business (in respect of the pension scheme of that business), the amount initially recognised (see 8.19 and 8.20 below).

An illustration of such a calculation is set out in *Application*

8.6 In most cases, there will be a cumulative charge and therefore no need to make any adjustment to what has already flowed through total comprehensive income (ie, that is already in reserves) in arriving at the amount of distributable profits (see paragraph 8.7 below). The few cases when adjustment may be required are when:

- the scheme is in surplus (see paragraphs 8.8 and 8.9 below); or
- the scheme was acquired as part of a business combination (ie, a trade and assets acquisition in individual accounts) (see paragraphs 8.13 and 8.14 below)

Appendix 4. As explained at contains numerical illustrations of the application of the principles in various scenarios.

*Application – originated scheme in deficit*

8.18 below, it7 It will often usually be obvious, without any calculations, that all of the amounts included in reserves arising from that there is a cumulative charge within reserves and it will not be necessary to quantify that cumulative charge. In the absence of a business combination (see paragraphs 8.13 and 8.14 below), it is only necessary to determine that the cumulative net contributions (ie, net of any refunds) to the scheme since its inception exceed any pension scheme accounting are realisedasset recognised in the balance sheet to be able to confirm that there is a cumulative charge within reserves. When this is the case, no adjustment will be required in arriving at distributable profits. It will not be necessary to quantify the cumulative charge.

8.15 Companies that are able to establish the precise amount of the *Application – originated scheme in surplus*

8.8 When a scheme is in surplus, this may be because there has been a cumulative net credit or debit in amount credited to reserves in respect of the pension scheme. In such a case, adjustment will treat it as realised or unrealised in accordance with 8.11be required to arrive at distributable profit, unless the cumulative credit meets the test at paragraph 8.135 above.

8.16 It may not be practicable8.9 A surplus might also arise if there has been a cumulative charge (ie, if contributions have been greater than that charge). No adjustment is required in this case.

*Application – practical identification of originated scheme cumulative charge / credit*

8.10 It may not be practical for companies with long-established schemes to ascertain the total cumulative net contributions less refunds made since the scheme commenced, to perform with precision the analysis in 8.13 above (although, in view of their rarity, it is likely that the company would be able to identify all refunds made and these should be included in the calculation). For such schemes the the calculation required by 8.7 to 8.9 above. In those rare cases where such a calculation is necessary, it is possible to use an estimated approach set out in this paragraph may be taken:

(a) the calculation set out in 8.14 above may be performed initially using only the amount of those cumulative net contributions the company has been able to identify; and

(b) that calculation may be revisited subsequently, as set out in 8.17 below, if further contributions are identified that were made priorthe company is able to the date of the assessmentidentify.

8.1711 A company adopting the estimated approach set out atin 8.1610 above might be able to revise that estimate subsequently by identifying additional contributions that have been made since the scheme was established or acquired. If so, it may be able to revise upwards the amount of a net cumulative realised loss in reserves and therefore treat as realised net credits arising in subsequent periods that would otherwise be treated as unrealised.

8.18 It will often be obvious, without any calculations, that all of the amounts included in reserves arising from pension scheme accounting are realised. Therefore, no adjustments will be required to the amounts stated in the accounts when determining the cumulative amount of realised profits available for distribution. Other than sometimes in those rare cases where a pension asset or liability has been recognised in the company's individual accounts on a past acquisition, no adjustment is necessary if a liability is recognised in the balance sheet (ie because the net cumulative contributions cannot be negative). Where a pension asset is recognised in the balance sheet, it is only necessary to determine that the cumulative net contributions exceed this amount to be able to confirm that no adjustment is necessary. The calculations are more complex when a past acquisition is involved.

**Acquisition of an unincorporated business**

8.19 Where part of a company's pension asset or liability arose on *Application – first time adoption of defined benefit accounting*

8.12 Companies transitioning to IAS 19 from FRS 17 may have to adopt defined benefit accounting for the first time if they previously were accounting for their participation in group multi-employer defined benefit schemes as if they were defined contribution schemes. Any such adjustment for financial reporting purposes will usually have an equal effect on the cumulative realised profits and therefore on distributable reserves. The exception is those rare cases referred to above when this would result in a restatement to a cumulative net credit within reserves, which will require more detailed assessment.

*Application – scheme acquired in past business combination*

8.13 The need for adjustment is more difficult to identify when the pension scheme has been acquired as part of a business combination. This is because the original business combination accounting will have involved the initial recognition of an asset or liability for

the pension scheme at the date of business combination. Whilst that initial recognition has no effect on accumulated reserves of the acquiring company, and hence no effect on distributable profits, it makes identification of potential cases of cumulative post-acquisition credits less readily apparent (eg, a year-end surplus might not be a result of a cumulative post-acquisition credit but of the acquired position).

8.14 Further, where there is a cumulative post-acquisition credit, it may be partly represented by (a) a pension scheme asset on that balance sheet and partly by (b) the ~~acquisition of an unincorporated business, it will have been recorded initially at fair value as required by FRS 7. That initial asset or liability will not have affected the company's reserves directly and must therefore be taken into account as part of the adjustment in arriving at the impact of FRS 17 on reserves.~~

~~8.20 FRS 17 did not change the requirement of FRS 7 to record the pension asset or liability at fair value, although it may have required fair value to be measured using a different method from that used when the~~ reversal of an acquisition ~~was first recorded. FRS 17 paragraph 97 notes that any difference between the FRS 17 measure of fair value and that originally used "should be treated as a change in assumptions (ie an actuarial gain or loss) arising since acquisition". Such a difference will therefore have given rise to~~date deficit. A credit represented by (b) is never a ~~gain or loss that falls to be categorised as realised or unrealised in accordance with the general approach noted above. As a result, it is the asset or liability recognised initially as part of the acquisition accounting that is taken into account (together with the net contributions paid since acquisition) in assessing the reserves position under FRS 17.~~

~~8.20A An actuarial gain arising from a reduction of a pension liability that was assumed in a business combination will result is an unrealised profit to the extent that it is not a reversal of post-acquisition pension expense. That is~~realised profit because such a reduction in a pension liability is not readily convertible to cash (see ~~3.9(g) and 3.9B).~~paragraphs 3.9(g) and 3.9B above). The credit represented by (a) is tested under the principles set out at paragraph 8.5 above.

~~**Deferred tax**~~

~~8.21 The deferred tax asset or liability arising from different treatments of pension costs for accounting and tax purposes generally relates to the pension asset or liability in the balance sheet and is not necessarily associated with the cumulative net debit or credit in reserves.~~

~~8.22 The cumulative debit in reserves in respect of a deferred tax liability relating to a pension asset should be treated as a realised loss. However, to the extent that there is an unrealised cumulative net credit in reserves in respect of the pension asset, then the amount of the debit in respect of deferred tax should be treated as a reduction in that unrealised profit rather than as a realised loss. It is not necessary to restrict the offset by applying the tax rate to the amount of the unrealised profit.~~

~~8.23 The cumulative credit in reserves in respect of a deferred tax asset relating to a pension liability should be treated as an unrealised profit. However, to the extent that there is a realised cumulative net debit in reserves in respect of the pension liability, then the amount of the credit in respect of deferred tax should be treated as a reduction in that realised loss rather than as an unrealised profit. It is not necessary to restrict the offset by applying the tax rate to the amount of the realised loss.~~

~~8.24 The approach set out above is consistent with 3.17 above.~~

~~**Companies with more than one scheme**~~

~~8.25 This guidance assumes the company has only one scheme. A company that operates more than one defined benefit scheme should assess separately for each scheme the impact of an FRS 17 asset or liability on its realised profits and losses. However, there may be situations where two schemes are to merge. In such situations a company may treat any net credit to reserves that has been recorded in respect of one scheme as a reduction in the realised loss caused by a net debit in respect of the other scheme from the point at which the trustees of the schemes have irrevocably agreed that they will merge and to extent that the surplus and deficit are permitted to be offset for funding purposes. A similar argument applies in cases where a transfer has been irrevocably agreed between different schemes.~~

~~8.26 A company that operates more than one defined benefit scheme may find that it can follow 8.11 to 8.13 above for schemes formed or acquired in an acquisition of an unincorporated business relatively recently but may need to follow 8.16 above for schemes operated by the company for a longer time. This guidance does not preclude such a mixed approach.~~

*Transfer of a pension surplus or deficit*

8.15 As mentioned at 9.69 below, the transfer of a pension scheme surplus or deficit between group companies for a non-arms-length sum may, as a matter of law, involve a distribution.

# 9. INTRA-GROUP TRANSACTIONS 9.1 – 9.44D71

**Introduction**

9.1 Under both common law and statute, distributions are made by companies and not by groups. The group accounts are therefore not relevant for the purpose of determining realisation or distributability; for example, realised profits which are reflected in a parent's[41] own accounts may be eliminated in the group accounts, and profits retained by subsidiaries are not distributable by the parent.

9.2 The ability of a parent to control the actions of its subsidiary must also be borne in mind when considering the substance of an intra-group transaction carried out by or with that subsidiary.

9.3 It is not practicable to attempt to illustrate every circumstance in which difficulties may arise in determining whether a profit is realised. The principles set out in this guidance should be applied in relation to the group company seeking to establish a realised profit. In particular, the principle in paragraph 3.5 (linkage etc) and the related guidance at 3.43 to 3.75 should be applied. The examples which follow are intended to illustrate the factors to be considered in determining whether intra-group transactions give rise to realised profits.

**Cash pooling arrangements and group treasury functions**

9.4 Groups of companies often operate cash pooling arrangements and group treasury functions. An example of such an arrangement is where a group company acts akin to a banker to other group companies by accepting funds and settling debts on behalf of those group companies. Group companies sometimes do not have their own bank accounts or have accounts which are cleared to a central account, in the name of one group company, at the close of business each day.

9.4A A group company may recognise a profit on a transaction which results in an increase in the balance due from the group treasury company. The normal considerations apply when assessing whether such a profit is realised. That is to say that the balance must represent qualifying consideration and the profit must arise from a transaction or arrangement that does not fall within paragraph 3.5 of this guidance (e.g. eg, artificial or linked or circular). The nature of such arrangements vary widely in practice. It is always necessary to have regard to the particular facts and circumstances of each case.

9.4B A group company may have a "'current account"account' balance with another group company through which many transactions, both debits and credits, are processed. There may be a considerable "churn"'churn' on the account even though a substantial balance remains outstanding. 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 to the account arising from these transactions are expected to be (ie, they are foreseen to be) settled by offset with credit entries on the account and therefore the criterion in 3.11(d)(iii) can be regarded as met. However, large or unusual transactions that result in a "permanent"'permanent' increase in the core balance will require careful consideration.

[41] The terms "parent"'parent' and "subsidiary"'subsidiary' refer respectively to a "'parent undertaking"undertaking' and a "'subsidiary undertaking"undertaking' as defined in section 1162 of the Act.

## Dividends

### Dividend received or receivable on an investment in a subsidiary

9.5 For a dividend received or receivable from a subsidiary to be treated as a realised profit, the consideration must be in the form of qualifying consideration. Accounting for dividends receivable and payable, including payment of intra-group dividends through inter-company accounts, is considered at 9.6 *et seq*. It will also be necessary to consider the effect any dividend has on the value of the investment in the subsidiary and, where its recoverable amount has fallen below its book value, to take account of the effect of any such impairment (and, where appropriate, any consequential release from revaluation, merger or other similar reserve).

### Accrual of intra-group dividends payable and receivable

9.6 The following paragraphs deal with income that is dividend income or appropriation for legal purposes and which for accounting purposes is dealt with as a dividend by the paying and receiving companies (rather than as interest under IAS 32 or FRS ~~25~~102).

9.7 A dividend payable is accrued in accordance with IFRIC 17 or FRS ~~21~~102 only when it is ~~"~~'appropriately authorised and no longer at the discretion of the ~~entity".~~entity'. This test will be met when a legally binding liability is established as described at 2.10 above. A dividend will be accrued as receivable by a parent company only when the subsidiary has a legally binding obligation to make the distribution. ~~IAS 10~~Paragraph 32.8 of FRS 102 refers to dividends ~~"declared"~~'declared' after the ~~balance sheet date~~end of the reporting period with the implication that those ~~"declared"~~'declared' before ~~the balance sheet date~~then would be accrued (by both the subsidiary and the parent). However, IFRIC 17 refers to dividends that are declared as those that are ~~"~~'appropriately authorised and no longer at the discretion of the ~~entity".~~entity'. A dividend may therefore have been 'declared' by the directors in the everyday sense of the term but not meet the requirements for recognition in financial statements.

9.7A [Deleted]

9.7B Paragraph 10(b) of IFRIC 17 states that a dividend is recognised on the date when it is declared by management or the board, if the law of the jurisdiction does not require further approval. This might have been seen as requiring a change of practice in relation to interim dividends on adoption of IFRIC 17. However, it is generally agreed that this is not so because the requirement to recognise a dividend only when it is no longer at the discretion of the entity takes precedence[42]. Also, it may be said that a UK interim dividend does require further approval by the directors immediately before it is paid because of the effect of their common law duties.

9.8 Companies may have to consider paying up (or establishing a legally binding liability to pay) interim dividends before the balance sheet date to ensure that the parent company has adequate distributable reserves to support the expected level of the proposed final dividend.

9.9 [Deleted]

9.10 [Deleted]

[42] Paragraphs BC18-20 of IFRIC 17 explain that the Interpretation does not change the principle on when to recognise a dividend payable. The principle was moved from IAS 10 into the Interpretation and clarified but without changing the principle.

9.11 This therefore raises the question as to what constitutes payment of an interim dividend and what steps may be taken to establish a legally binding liability. This will affect the timing of its recognition as a distribution by the paying company and as a profit by the recipient company. The question of whether a profit recorded by the recipient company is a realised profit falls to be determined under the general principles in this guidance, for example, whether it is qualifying consideration.

9.12 Where there is a transfer of cash the answer will be clear as payment has been received. This conclusion would not be affected by the cash being immediately or closely afterwards reinvested in the paying company either by way of loan or by way of capital investment, although the fact of such reinvestment will require consideration of the guidance at 9.19 below as to whether the profit is realised or unrealised in the parent company's hands.

9.13 Where the dividend is recorded on inter-company account and the effect of such an entry reduces the amount recorded as receivable from the parent to the dividend paying subsidiary, this would constitute settlement by way of set-off and would be equivalent to a payment in cash taking place at the date that the book entries were made by both companies (or the later of them if these should be different) to the extent that this does not reduce the amount recorded as receivable from the parent to the dividend-paying subsidiary below nil.

9.14 Where the dividend is recorded on inter-company account and the book entry creates or increases a liability of the paying subsidiary, the question arises as to whether the dividend falls to be treated as paid and received, or a legally binding liability is otherwise established.

9.15 Effecting the dividend via a group treasury function (see 9.4 above) where the subsidiary company instructs the group treasury function to debit the subsidiary's account and credit the parent's account, would constitute payment.

9.16 In other circumstances, more than just entries into the accounting records of the paying and receiving company are likely to be required. If there were no doubt as to the paying subsidiary's ability to pay the dividend, a legally binding liability in respect of an individual dividend could be established by the execution, as a Deed, of an acknowledgment of liability to pay the amount entered in the accounting records as a payable by the subsidiary and a receivable by the parent company or the constitution of such liability pursuant to an enforceable contract under Scots Law.

9.17 Any doubts about whether an interim dividend recorded by book entry is a legally binding liability can be removed by the conversion of the interim dividend into a final dividend before the year end. Under common form articles of association, this will require a recommendation by the directors and the declaration of the dividend either by approval by the members in a general meeting or, for private companies, by the members passing a written resolution.

9.18 In scenarios other than those discussed above, the position is more complex and dependent on the specific facts and circumstances and companies in doubt as to the position may wish to seek legal advice.

### Dividend by a subsidiary to a parent which provides or reinvests the funds in the subsidiary

9.19 Investment by a parent in a subsidiary which has paid a dividend in the form of qualifying consideration does not in itself preclude that dividend from continuing to be treated as a realised profit by the parent. However, if a subsidiary pays a dividend to a parent which directly or indirectly provides the funds for the dividend or reinvests the proceeds in the subsidiary in circumstances where the transactions or arrangements fall within paragraph 3.5 of this guidance, the dividend will not represent a realised profit for the parent if it does not receive in return for the provision of funds or their reinvestment an asset which is in the

form of qualifying consideration. Thus, in such a case, the profit will be unrealised if, for example:

(a) the provision or reinvestment of funds is in the form of:

(i) a subscription for shares, as the subsidiary is in effect capitalising its realised profits; or

(ii) a capital contribution (ie, a gift); or

(iii) a loan which does not meet the definition of qualifying consideration in the parent's accounts; or

(iv) a guarantee of borrowings used to fund the dividend (unless the likelihood that the guarantee will be called upon is remote); or

(b) the subsidiary is unlikely to be able to meet its obligations under any borrowings used to fund the dividend without recourse directly or indirectly to the parent.

~~**Dividends received out of pre-acquisition profits**~~

~~9.20 The Act does not deal specifically with the onward distribution by a parent of dividends out of the pre-acquisition profits of its subsidiaries. Under UK GAAP such dividends should be treated by a parent in the same way as any other dividend which it receives from a subsidiary, including taking account of any impairment in accordance with paragraph 9.5 (see 9.21 below). The position under IFRSs is considered at 9.22 *et seq* below.~~

~~9.21 Under UK GAAP, it has for many years been accepted that dividends received out of pre-acquisition profits of subsidiaries are treated as giving rise to a profit unless the dividend causes a diminution in the value of the investment below its book amount. This is separate from the question of whether or not such dividends are realised profits which will depend on whether they have been received in the form of qualifying consideration.~~

~~9.22 Under IAS 27, before its amendment in May 2008[43], when investments in subsidiaries were stated using the cost model, any dividends received out of their pre-acquisition profits were credited against the cost of investment.~~

~~9.22A In May 2008, the IASB issued an amendment to IAS 27 which removed this requirement. At the same time, it also issued an amendment to IFRS 1 which permits the use of the previous GAAP carrying amount of subsidiaries as their deemed cost on transition to IFRSs. When applying the amended Standards there will generally be no adjustment to the carrying amount of the investment in subsidiaries on transition to IFRSs so there is no effect on accumulated realised profits. This is applicable only to a parent that adopted IFRS after that amended version of IFRS 1 was applicable.~~

~~9.23 On transition to IFRSs, when applying the unamended IAS 27, companies had to determine the extent to which any dividends have been received out of the pre-acquisition profits of their subsidiaries. The May 2008 amendment has, on a prospective basis, removed this requirement and potential source of difficulty.~~

9.20 [Deleted]

9.21 [Deleted]

9.22 [Deleted]

~~[43] Amendments to IFRS 1 First-time Adoption of IFRSs and IAS 27 Consolidated and Separate Financial Statements: Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate.~~

9.22A [Deleted]

9.23 [Deleted]

9.24 [Deleted]

9.25 [Deleted]

9.26 [Deleted]

9.27 [Deleted]

**Sale of an asset by a parent to its subsidiary**

9.28 If a parent sells an asset to a subsidiary in circumstances where the transactions or arrangements fall within paragraph 3.5 of this guidance, any profit on the sale of the asset will not represent a realised profit for the parent if it does not receive an asset which is in the form of qualifying consideration. Thus, in such a case, the profit will be unrealised if, for example:

(a) there is an agreement or understanding regarding the repurchase of the asset by the parent; or

(b) the parent directly or indirectly provides the funds for the purchase or reinvests the proceeds in the subsidiary where the provision or reinvestment of funds is in the form of:

(i) a subscription for shares, as the subsidiary is in effect capitalising realised profits; or

(ii) a capital contribution (ie, a gift); or

(iii) a loan which does not meet the definition of qualifying consideration in the parent's accounts; or

(iv) a guarantee of borrowings used to fund the purchase (unless the likelihood that the guarantee will be called upon is remote); or

(c) the subsidiary is unlikely to be able to meet its obligations under any borrowings used to fund the purchase without recourse directly or indirectly to the parent.

**Sale of an asset by a subsidiary to a parent followed by a dividend to the parent of the resulting profit**

9.29 The subsidiary should apply factors similar to those in paragraph 9.28 in determining whether it has made a realised profit on the sale of an asset to its parent.

9.30 If a subsidiary sells an asset to its parent and pays a dividend out of the resulting profit in circumstances where the transactions or arrangements, from the parent's perspective, fall within paragraph 3.5 of this guidance, the dividend will not give rise to a realised profit for the parent unless the asset which the parent purchased meets the definition of qualifying consideration. This is because the overall commercial effect of such an arrangement for the parent is similar to a dividend in kind (see paragraph 9.33).

**Sale of an asset by a subsidiary to a fellow subsidiary followed by a dividend to the parent of the resulting profit**

9.31 The subsidiary should apply factors similar to those in paragraph 9.28 in determining whether it has made a realised profit on the sale of an asset to its fellow subsidiary.

9.32 If a subsidiary sells an asset to a fellow subsidiary and pays a dividend to the parent out of the resulting profit in circumstances where the transactions or arrangements, from the parent's perspective, fall within paragraph 3.5 of this guidance, the dividend will not give rise to a realised profit for the parent if, for example:

(a) the parent directly or indirectly provides the funds for the purchase where the provision of funds is in the form of:

(i) a subscription for shares, as the subsidiary is in effect capitalising its retained profits; or

(ii) a capital contribution (ie, a gift); or

(iii) a loan which does not meet the definition of qualifying consideration in the parent's accounts; or

(b) the parent directly or indirectly reinvests the dividend (or equivalent consideration) in the subsidiary which paid the dividend or the fellow subsidiary to which the asset was sold and the asset which the parent receives from this reinvestment is not in the form of qualifying consideration; or

(c) the parent directly or indirectly guarantees any borrowings used to provide either the fellow subsidiary with the consideration for its purchase of the asset or the vendor subsidiary with funds for its dividend (in either case unless the likelihood that the guarantee will be called upon is remote) or the subsidiary in question is unlikely to be able to meet its obligations under the borrowings without recourse directly or indirectly to the parent.

**Dividend in kind**

9.33 A dividend in kind from a subsidiary is an unrealised profit in the hands of the parent (even where there is a cash alternative) unless the asset distributed meets the definition of qualifying consideration. However, if the non-cash asset is distributed by the parent then, following section 846, that unrealised profit would be treated by the parent as a realised profit for the purpose of that onward distribution, provided that the profit was recorded in the relevant accounts.

**Return of capital contribution**

9.34 Where a capital contribution is returned directly or indirectly to the donor company in circumstances where the transactions or arrangements fall within paragraph 3.5 of this guidance, it will not give rise to a realised profit in the hands of the donor.

**Transfer of an asset for consideration followed by waiver of the resulting inter-company debt**

9.34A A group company may transfer an asset to another group company for consideration but subsequently waive the resulting inter-company debt. In such a case, if the purchase and release are part of a group or series of transactions or arrangements falling within paragraph 3.5 of this guidance, any profit will not represent a realised profit unless the asset originally acquired met the definition of qualifying consideration or has been disposed of for qualifying consideration. For example, where the substance of the arrangements taken together (~~e.g.~~eg, where the waiver is a step in the plan even if undocumented) is to transfer a fixed asset for no consideration, any profit recorded by the transferee company on the debt waiver will not be a realised profit. Instead, the profit is in the nature of a revaluation of an asset acquired at no cost.

**Debits within equity arising on group reconstructions**

9.35 Business combinations involving entities or businesses under common control are excluded from the scope of IFRS 3, ~~"~~'Business ~~combinations".~~combinations'. Typical examples include a group reorganisation involving either a transfer of a company within a group or the transfer of a business from one group member to another.

9.36 When a company carries out a ~~transaction~~business combination under common control[44] such as acquiring the business of another company within the same group, the directors may determine that it is not appropriate to recognise the net assets acquired at their fair values and that it is not appropriate to recognise goodwill. For example, a company may purchase the trade and assets of a division from its parent company, the consideration being ~~a combination of cash and shares.~~an intragroup loan. The directors may determine that the appropriate accounting is to recognise the net assets acquired at the transferor's book amounts. The consideration ~~paid, say, measured at~~payable, which may be based on the ~~nominal~~fair value of the ~~shares issued plus the value of the cash element~~business as a whole, may exceed the book amount of the net assets acquired ~~and this~~. This will leave a debit difference to be recognised. It is not goodwill. The debit is sometimes referred to as a ~~"~~'merger ~~difference"~~difference' and is recorded in equity.

9.37 A business combination involving members of the same group is completed under the direction of the controlling party, the common parent. Consequently, any excess paid by the acquirer over the book amount of the vendor's net assets is accounted for in a similar manner to a distribution or return of capital to the common parent. Distributions and returns of capital are dealt with through equity, and therefore it is logical also to recognise the debit in equity.

9.38 Such a debit directly to equity is not necessarily, however, a distribution as a matter of law. This is because the debit described above is determined on a book basis, whereas the question as to whether there would be an actual distribution is determined by whether the company gives consideration other than an issue of its shares, to its parent or a fellow subsidiary, with a fair value in excess of the fair value of the net assets and business acquired. Accordingly the debit may form part of an actual distribution or may not.

9.39 In a case where the debit in equity does not form part of an actual distribution, then at the date of acquisition the debit does not represent a loss; the acquiring company has purchased net assets worth at least the book value of the consideration given but, under the appropriate accounting, has recognised these at a lower amount. The difference between the two is the amount of the debit. As the debit is not a loss at all, it is neither realised nor unrealised. However, it can subsequently become a realised loss.

9.40 To the extent that the assets, if they had been recognised at the higher amount, together with any goodwill that would have been recognised, would have been written down, say, by depreciation or impairment, an equivalent amount of the debit becomes a realised loss. It is a realised, rather than unrealised, loss because, had the debit been carried as an asset, any write down for depreciation or impairment would be required, by section 841 and the principles of realisation (see section 3), to be regarded as realised.

9.41 The above guidance is written in the context of IFRS 3 but is equally applicable to a group reconstruction accounted for under FRS ~~6~~102.

*Additional consideration for a public company*

9.42 For a public company, the initial recognition of the debit will restrict the maximum amount of profits available for distribution to the extent the cash paid out (or the book value of other non-equity consideration given) is greater than the book value of the net assets acquired. This is because the acquirer's net assets as shown in the company's relevant accounts for section 836 purposes would be reduced as a result of paying out cash consideration but increased by a smaller amount by recognising the acquired net assets at a lower amount. Since the debit is neither a realised loss nor an unrealised loss it has no effect on the

[44] As defined in IFRS 3.

~~"~~'share capital and undistributable ~~reserves"~~reserves' part of the section 831 net assets test. Consequently, the maximum permissible distribution would be restricted.

### Merger relief and group reconstruction relief

9.43 As explained at 2.11 above, when shares are issued as consideration for the acquisition of a subsidiary, the issuing company may benefit from merger relief (section 612 of the Act) or group reconstruction relief (section 611 of the Act). In accordance with section 615 of the Act, under ~~UK GAAP~~FRS 102, such companies may state the cost of investment at the nominal value of the shares issued (for merger relief) or based on the minimum premium value (for group reconstruction relief). Under IFRSs, the interaction of these reliefs with the accounting for the acquired asset is complicated.

9.43A The IASB published amendments to IFRS 1 and IAS 27 in May 2008[45] that had implications for the treatment of merger relief and group reconstruction relief for accounting purposes. The amendments were effective for annual periods beginning on or after 1 January 2009. The effect of these amendments is described at 9.44A to 9.44D below.

9.43B Before the amendment in May 2008, IAS 27 was generally considered to require the acquired asset to be booked at fair value in some or all cases. Therefore, on transition to IFRSs, it was necessary to gross up the cost of investment to the fair value at the date of acquisition and to recognise a corresponding ~~"~~'merger ~~reserve".~~reserve'. Although different views were expressed on this financial reporting issue, the following paragraph deals with the treatment for distributable profit purposes when the merger reserve is recorded.

9.44 The adjustment to establish the merger reserve will have no direct impact on accumulated realised profits because the reserve will represent an unrealised profit. However, the reserve may become realised at a later date. This may, for example, occur on disposal of the investment for qualifying consideration or if the investment is written down for impairment.

9.44A In May 2008, the IASB issued an amendment to IFRS 1 which permits the use of the previous GAAP carrying amount of subsidiaries as their deemed cost on transition to IFRSs. If the exemption in the amended IFRS 1 is used, there is no adjustment to the carrying amount of the investment on transition to IFRSs and consequently no effect on accumulated realised profits. The amendment had no effect on a company that had already adopted IFRSs in a period before the amended standard was first applied.

9.44B In May 2008, the IASB also amended IAS 27 to insert a new requirement for the accounting treatment to be adopted by a new parent company (including an intermediate parent company) established as a result of a group reorganisation when certain criteria are met. When these criteria are met[46], the new parent accounts for the cost of its investment in the original parent ~~"~~'at the carrying amount of its share of the equity items shown in the separate financial statements of the original parent at the date of the ~~reorganisation".~~reorganisation'. In practice, this means that the new parent company will record the cost of its investment in the original parent at an amount equal to the IFRS net asset value of the original parent as shown in its separate financial statements at the date of the reorganisation. This will usually differ from both the fair value of the investment and

[45] Amendments to IFRS 1 First-time Adoption of IFRSs and IAS 27 Consolidated and Separate Financial Statements: Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate. These amendments are separate from the revision of IAS 27, which was published in January 2008, that has no effect on the accounting in the separate financial statements of a parent.

[46] The new requirement will not apply to all group reorganisations involving the establishment of a new parent company because it applies only if all of three specified criteria are met. Reorganisations may, in practice, fail one or more of the tests.

the amount that might have been recorded under UK GAAP taking into account merger relief or group reconstruction relief (see 9.43 above).

9.44C The amendment required only prospective application to reorganisations occurring in annual periods beginning on or after 1 January 2009. No restatement was required for past reorganisations although this was permitted provided that all subsequent past reorganisations meeting the relevant criteria are restated in accordance with the amended standard.

9.44D For future reorganisations, the application of the ~~new~~ requirement may have the effect of restricting the ability of a public company to make distributions because the net assets of the new parent company may (depending on the circumstances) be stated at an amount that is less than its share capital and undistributable reserves. However, for reorganisations not meeting the criteria in the amended IAS 27 and for other acquisitions, the guidance at 9.43B and 9.44 above continues to apply.

## Intragroup loans on off-market terms

### Introduction

9.45 The accounting treatment of some intragroup loans will change on adoption of FRS 102 compared with old (non-FRS 26) UK GAAP. The accounting treatment required by FRS 102 is the same as that required under IFRSs. This will apply to interest free loans and other loans not at a market rate of interest *unless they are repayable on demand.* In summary, this treatment results in initial recognition of capital contributions and distributions for accounting purposes together with the recognition of imputed interest income and expense over the life of the loan. Where the loans are at a market rate, no initial accounting issues arise as the initial carrying amount, being the present value of the future cash flows discounted at the market rate, will equate to the sum advanced.

9.46 Transactions affected by these requirements may take a variety of forms. They may involve taking on an obligation to pay or obtaining a right to receive interest at above or below market rates. They may take the form of loans from a parent to its subsidiary or from a subsidiary to its parent or from one subsidiary to a fellow subsidiary. For simplicity, the description at 9.50 to 9.64 assumes that the loans are interest free and not repayable on demand, but the same principles apply in other cases.

9.47 The arrangements considered in this guidance may be summarised as follows.

| Type of arrangement | Initial accounting | Paragraphs |
|---|---|---|
| Interest-free loan from parent to subsidiary | Parent makes a capital contribution to subsidiary | 9.50 to 9.59 |
| Interest-free loan from subsidiary to parent | Subsidiary makes a distribution to parent | 9.60 to 9.64 |
| One subsidiary makes an interest-free loan to a fellow subsidiary | First subsidiary makes a distribution and second subsidiary receives a capital contribution | 9.65 |
| Loans at above market rate | Not described | 9.66 |
| Loans repayable on demand | Loan at face value | 9.67 to 9.68 |

9.48 This guidance is written in terms of intragroup loans but will also be relevant to loans made to or from shareholders (who may also be directors) in their capacity as shareholders. Some loans to directors may be in their capacity as employees rather than as shareholders and therefore accounted for as an employee benefit. The particular facts and circumstances should be considered, for example whether similar benefits are provided to other employees (eg, season ticket loans).

9.49 FRS 105 does not require the FRS 102 accounting treatment for loans, which are simply measured at the amount advanced. This is also permitted by FRS 102 for public benefit entities as defined in that standard. However, when such a loan is from a company to its parent or shareholder, it may still be a distribution as a matter of law if it is at undervalue (see paragraph 9.62 below).

### Interest-free loan from parent to subsidiary

9.50 If a parent advances a cash sum as an interest-free loan to its subsidiary, and the loan is not repayable on demand, the accounting treatment may be summarised as follows:

- the parent recognises a loan receivable equal to the present value of the future cash flows discounted at the market rate of interest;
- the parent debits the cost of investment in its subsidiary with the amount of the capital contribution, being the difference between the above and the sum advanced;
- the subsidiary recognises a loan payable at the same amount as that recorded by the parent and credits equity with the amount of the capital contribution, being the difference between that and the sum advanced;
- over the term of the loan, the parent recognises interest income equal to the amount of the capital contribution; and
- over the term of the loan, the subsidiary recognises interest expense equal to the amount of the capital contribution.

9.51 As explained below, the impact on realised profits is generally as follows:

- the receipt of the capital contribution by the subsidiary is not a realised profit (see 9.53 below);
- the interest expense in the subsidiary is not a loss as a matter of law (and therefore not a realised loss) but is available to eliminate the initial credit to equity for the capital contribution (see 9.54 below); and
- the interest income recognised by the parent is a realised profit (see 9.57 below).

9.52 The parent's debit to the cost of investment in the subsidiary has no distributable profit implications, assuming that it does not result in a need to write down the investment for impairment.

9.53 The credit to equity in the subsidiary's accounts is not a realised profit because the credit is:

- not a profit for the purposes of 3.8(a) above; and
- not a profit as a matter of law because its legal form is a loan (see 3.14(c) above).

This conclusion is consistent with the guidance on a compound financial instrument at paragraphs 6.19 and 6.20 above.

9.54 The interest expense recognised by the subsidiary is an accounting charge, which is not, as a matter of law, a loss. The cumulative debit within equity arising from this additional charge is available to eliminate the initial credit to equity for the capital contribution (see paragraph 9.53 above). This conclusion is consistent with the guidance on a compound financial instrument at paragraphs 6.19 and 6.20 above.

9.55 The interest income recognised by the parent (ie, accruing the recognised asset up to the sum repayable at maturity) is, as a matter of principle, not considered a linked transaction for the purposes of paragraph 3.5 of this guidance. First of all, each cash flow is not being artificially split into two components but instead this accounting is necessary to reflect the substance of the transaction and give a true and fair view. The initial advance cash flow comprises a market rate loan and a capital contribution. The subsequent repayment cash flow comprises the repayment of the loan advanced and the settlement of accrued interest.

9.56 Second, although the capital contribution and interest accounting entries are related, in the sense that the one can be seen as the unwinding of the other, the sum advanced has not been paid over for the purpose of generating its repayment and is at risk of non-payment (although it is not lent with the expectation of loss).This is no different in principle from a loan bearing market interest, which would not ordinarily be said to have been advanced in order to facilitate the repayment of the same principal sum at maturity. Returning to the case of an interest-free loan:

- the capital contribution element of the sum advanced at the outset has not been made with the intention, or purpose, to facilitate the payment of the interest at a later date (see paragraph 3.59 above); and
- the time between advance and repayment is such that circumstances of the subsidiary may change and repayment will not be made, eg because of default (see paragraph 3.75 above).

9.57 If making the loan and making the capital contribution are not regarded as linked transactions, the interest income recognised by the parent, being a profit recognised under paragraph 3.8(a) above, will be a realised profit. This is because part of the cash received on settlement of the loan is to settle the balance of accrued interest (rather than being a return of the initial capital contribution). This is different from the treatment of the capital contribution (see paragraph 9.53 above) because that is not a profit as defined in paragraph 3.8 above.

9.58 The interest receivable by the parent will be a realised profit as set out above. However, directors should have regard to their fiduciary duties (see 2.3 to 2.5 above) when considering whether it would be prudent to distribute such a profit. For example, in the absence of other transactions, there may be no cash to pay a dividend.

9.59 The conclusion set out in 9.57 above assumes that the loan receivable meets all of the criteria in 3.11(d) above for qualifying consideration. There will not be any qualifying consideration if, for example, the loan is to be rolled over indefinitely.

**Interest-free loan from subsidiary to parent**

9.60 If a subsidiary advances a cash sum as an interest-free loan to its parent, and the loan is not repayable on demand, the accounting treatment may be summarised as follows:

- the subsidiary recognises a loan receivable equal to the present value of the future cash flows discounted at a market rate of interest;
- the subsidiary recognises a distribution made to its parent, being the difference between the above and the sum advanced;
- the parent recognises a loan payable at the same amount as recorded by the subsidiary and a distribution received from the subsidiary, being the difference between that and the sum advanced;
- over the term of the loan, the parent recognises interest expense equal to the amount of the distribution; and
- over the term of the loan, the subsidiary recognises interest income equal to the amount of the distribution.

9.61 Consistent with the analysis set out at paragraphs 9.55 and 9.56 above, making the loan and making the distribution should not be regarded as linked transactions. Therefore generally the effect will be as follows:

- the receipt by the parent of the cash distribution will be a realised profit;

- the interest expense recognised by the parent will be a realised loss in accordance with the principle at 3.10 above; and

- the interest income recognised by the subsidiary will be a realised profit provided that the receivable is qualifying consideration (see 9.59 above).

9.62 This transaction is accounted for as a distribution by the subsidiary. It is also a distribution as a matter of law because it is at undervalue. This is necessarily, and therefore intentionally, the effect of an interest-free loan. It is unrealistic to suppose that those terms arose other than as a result of the parent–subsidiary relationship (see paragraphs 2.6A and 2.6B above). A subsidiary cannot lawfully enter into a transaction involving it making a distribution unless the amount of the distribution as a matter of law is covered by distributable reserves.

9.63 The receipt by the parent of the distribution will be a realised profit. However, directors should have regard to their fiduciary duties (see 2.3 to 2.5 above) when considering whether it would be prudent to distribute such a profit. For example, in the absence of other transactions, the interest expense resulting from unwinding the discount on initial recognition will result in expected future losses which should form part of this assessment.

9.64 There may appear to be an inconsistency between the conclusion that the receipt by the parent of the distribution is a realised profit and the conclusion that the receipt of a capital contribution by a subsidiary is not a realised profit (see 9.53 above). However, whilst the parent's receipt of the distribution involves a profit for the purposes of 3.8(a) above, the subsidiary's receipt of a capital contribution does not (see 9.53 above). This results in a different outcome.

**Interest-free loan from subsidiary to fellow subsidiary**

9.65 When one subsidiary makes an interest-free loan to another subsidiary, the first subsidiary accounts for making a distribution and the second subsidiary accounts for the receipt of a capital contribution. This raises no new issues not already considered at paragraphs 9.50 to 9.64 above. The parent does not generally record any accounting entries.

**Loans at above-market rate**

9.66 The guidance at 9.62 above about distributions as a matter of law is also relevant in the case when a subsidiary agrees to pay an above-market rate of interest to its parent. It is unlawful for a subsidiary to agree to make such above-market interest payments to its parent unless the amount of the distribution can be made out of distributable reserves.

**Loans repayable on demand**

9.67 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. Whether such a loan is at undervalue will depend on the particular facts and circumstances. It may be helpful to consider the price at which the balance receivable could be sold to a third party or refinanced without undue delay, taking into account the borrower's financial position. 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.

9.68 A subsidiary cannot lawfully enter into a transaction involving it making a distribution unless the amount of the distribution as a matter of law is covered by distributable reserves. This is true even if the amount of the distribution for accounting purposes is nil. If a subsidiary does

not have positive reserves, entering into any transaction involving a distribution, however small, will be unlawful.

**Intra-group transactions that may involve a distribution**

9.69 Paragraphs 2.6-2.6C explain what is, in law, a distribution. Paragraphs 9.61, 9.65 and 9.67 above explain some particular cases when, in law, an intra-group loan can involve a distribution. However, there are other intra-group transactions that may, as a matter of law, involve a distribution, including for example:

- undervalue received for an asset (eg, property, shares in another subsidiary, intangible assets, debts receivable) transferred to a parent or fellow subsidiary;
- an over-payment made for an asset received from a parent or fellow subsidiary;
- undervalue received for services (eg, management services, use of company premises for inadequate rental) provided to a parent or fellow subsidiary;
- an over-payment for services received from a parent or fellow subsidiary;
- guaranteeing the debt of a parent or fellow subsidiary without receiving an appropriate fee;
- a charitable donation of profits to a parent or fellow subsidiary that is a charity (see paragraph 2.6D and TECH 16/14);
- acquisition or surrender of tax losses (group relief) for a non-arms-length sum (such as paying a parent or fellow subsidiary more than the tax relief that will be obtained); or
- the transfer of a pension scheme surplus or deficit between group companies for a non-arms-length sum.

Even when such a case involves a distribution, it may still be lawful, eg if it does not result in a diminution in recorded net asset value and the company does not have a deficit of profits available for distribution. On the other hand, even if there is no diminution in recorded net asset value – say, the transfer for no consideration of an internally generated intangible asset with no book value – if that involves a distribution then it would be an unlawful distribution if the company lacks profits available for distribution (see paragraphs 2.8F-2.9F).

9.70 Similar considerations may apply in transactions between companies under common ownership but not within a corporate group. One of the leading cases involved such common ownership.[47]

9.71 Sometimes a transaction will involve an unlawful distribution from the point of view of an intermediate holding company between the two transacting companies. Suppose that a subsidiary company (SCo), transfers an asset to its ultimate parent (UCo), at an undervalue. Even if that undervalue transfer is not unlawful for SCo, it may involve an unlawful distribution for the intermediate company (ICo), standing between SCo and UCo. The actual value of ICo's investment in SCo will be diminished by the transfer, and so it is possible that ICo's knowledge of the proposed transaction and passive acquiescence in it may result in its being, in law, a distribution by ICo. If so, and if ICo has insufficient profits available for distribution, then it will be unlawful.

47 *Aveling Barford Ltd v Perion Ltd*

~~**IAS 27, IAS 28 and IAS 31 – Separate financial statements**~~

**Profits and losses arising from equity accounting**

10.1 The balance of profits available for distribution is that available to the company, not to ~~its~~the group. The availability of such profits is to be judged by reference to accounts~~,~~ which must therefore be the company's individual accounts. ~~Except when initial or interim accounts are required, the "relevant accounts" for this purpose are the individual accounts forming part of the annual accounts, whether they are "Companies Act individual accounts" or "IAS individual accounts" (see section 2 above).~~

~~10.2 IFRSs do not use the term "individual accounts" but uses the term "~~10.2 IFRS permits the use of equity accounting for subsidiaries, associates and joint ventures in separate financial statements~~" which are defined in IAS 27 as follows:~~

> ~~"Separate financial statements are those presented by a parent, an investor in an associate or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interests rather than on the basis of the reported results and net assets of the investee."~~

~~10.3 Where a company prepares consolidated financial statements, these "separate financial statements" will be the company's "IAS individual accounts" for the purposes of section 395 and therefore the relevant accounts under section 836 for the purposes of justifying any distribution.~~

~~10.4 However, where a company has an associate or jointly controlled entity but has no subsidiaries, in some circumstances IAS 28 and/or IAS 31, when considered outside the EU legal framework, require the preparation of financial statements that are neither separate financial statements nor consolidated financial statements. In such financial statements, the investments in associates and jointly controlled entities are accounted for using the equity method or proportional consolidation as appropriate (see IAS 28(4) and IAS 31(5)). In these circumstances, the company is not required by IFRSs (when considered outside of the EU legal framework) to prepare separate financial statements. One point of view is that the financial statements including investments on the basis of equity accounting and/or proportional consolidation are not relevant for the purposes of justifying distributions and that the "separate financial statements" are the "IAS individual accounts".~~

~~10.5 Within the EU legal framework, an alternative point of view is that the financial statements required by IAS 28 and IAS 31 (ie those including investments on the basis of equity accounting and/or proportional consolidation) are a company's "IAS individual accounts". The Institutes have to date not been able to establish which view is the correct interpretation of the law and of EU-adopted IFRSs. The European Commission's Accounting Regulatory Committee has considered some related issues but has so far not provided clear guidance on this specific point.~~

~~10.6 Were the accounts including the equity accounting to be the "IAS individual accounts",~~ and thus a company's individual accounts. However, the share of ~~results~~profits of subsidiaries, associates~~/jointly-controlled-entities~~ and joint ventures is not a realised ~~save~~profit except to the extent that it is received as distributions in the form of qualifying consideration. Therefore, the amount of a company's accumulated realised profits will be the same irrespective of ~~which interpretation of~~whether equity accounting is used in the ~~law is correct~~IAS individual accounts.

10.3 Cumulative losses arising from equity accounting (ie, those that are not the reversal of profits from equity accounting) should be regarded as realised losses to the extent that a loss would be recorded for impairment of the investment had equity accounting not been used. However, an unrealised loss may restrict the ability of a public company to make a distribution as a result of the reduction in net assets (see 2.30 above).

10.4 FRS 101 also permits the use of equity accounting for participating interests in individual accounts when The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980) have been adopted. However, paragraph 29A(2)(b) of Schedule 1 to The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) (as amended in 2015) requires that where the profit attributable to the participating interest and recognised in the profit and loss account exceeds the amount of dividends, the excess must be placed in a reserve that cannot be distributed to shareholders.

[10.4 to 10.6 deleted]

[10.7 to 10.16 moved to 2.32 *et seq* and amended.]

### ~~IFRS 1 –~~ Fair value or revaluation as deemed cost on transition

10.17 Under IFRS 1~~,~~ (and FRS 102), a first-time adopter may elect to measure an item of property, plant and equipment at the date of transition to IFRSs at its fair value and to use that fair value as deemed cost. A first-time adopter may also elect to use a previous GAAP valuation of an item of property, plant and equipment subject to various conditions. ~~For example, it would be possible for a company that was carrying a property at a "frozen valuation" under the transitional provisions of FRS 15 to deem that valuation as cost on transition to IFRSs.~~ These elections are also available for investment property when a company elects to use the cost model under IAS 40 and also, in certain limited circumstances, for intangible assets.

10.18 IFRS 1 does not specify the treatment of any revaluation reserve existing under previous GAAP or of any excess of fair value over cost when the election is used to measure the asset at fair value at the date of transition. However, it is clear that this should not be presented as a revaluation surplus because the asset is regarded as held at cost (and, for example, any subsequent fall in value would have to be charged in the income statement rather than treated as a reversal of a revaluation surplus). In the absence of any other requirement in IFRS 1, the adjustment on transition may be reflected in retained earnings.

10.18A Similar considerations apply to the exemptions available on first-time adoption of FRS 101 and FRS 102. However, in those cases, the company will be applying the statutory alternative accounting rules and therefore the excess of the valuation over depreciated cost is presented as a revaluation reserve even though the assets are said to be at 'cost'.

10.19 Nevertheless, the treatment of a revaluation as deemed cost for the purposes of IFRSs does not alter the nature of the revaluation surplus which will usually be unrealised. Therefore, companies that elect for this treatment will have to keep an analysis of the balance of retained earnings to ensure that they can identify the amount of unrealised profit included. The unrealised profit will become realised as the asset is depreciated or written down for impairment, or is sold for qualifying consideration. This is consistent with the application of section 841(5) which is summarised at 2.35 above.

10.20 The assets that are included on the basis of fair value or revaluation as deemed cost may have been depreciated under UK GAAP. Consider a tangible fixed asset that cost £100 and, at the date of transition to IFRSs, had a net book value of £50. Suppose that the fair value at the date of transition is £120 and the company elects to use this as deemed cost. The excess above original cost of £20 is clearly unrealised. It might be argued that the other £50 of the adjustment is a realised profit because it reverses the depreciation that had previously been charged as a realised loss. However, this analysis is not appropriate because the restatement to fair value is in the nature of a revaluation and it is generally accepted that depreciation is not written back to the profit and loss account on a revaluation. ~~This is implicit in paragraph 63 of FRS 15.~~ Similarly, when a previous valuation is treated as deemed cost, nothing of substance has occurred to cause the previously unrealised profit to become realised. This situation may be contrasted with an adjustment to depreciation that arises from a change in accounting policy for depreciation to comply with IAS 16 (see *Changes to depreciation policies* at 10.21 below). It may be possible to argue that some component of the restatement to deemed cost relates to a reconsideration of residual values and is therefore a realised profit (see 10.22 below). But, in practice, it would not usually be practicable to distinguish this component.

### ~~IFRS 1 and IAS 16 –~~ Changes to depreciation policies on transition

~~10.21 Under IFRS 1, any change in estimated useful life or depreciation pattern is accounted for prospectively from the date that the change of estimate is made provided that the depreciation methods and rates under previous GAAP are acceptable under IFRSs.~~

However, in some cases, a company's depreciation methods and rates under previous GAAP may not be acceptable under IFRSs. If those differences have a material effect on the financial statements, the company adjusts the accumulated depreciation in its opening IFRS balance sheet retrospectively so that it complies with IFRSs (see IFRS 1 IG7).

10.21 Depreciation policies under FRS 15, FRS 102 and IAS 16 are likely to be similar and only rarely will adjustments be necessary to those policies on transition between these GAAPs. A potential exception to this rule relates to the basis of determination of residual value.

10.22 The requirements of IAS 16 and FRS 102 are, in general, similar to those of FRS 15 and so the depreciation methods and rates used for UK GAAP will usually be acceptable under IFRSs. However, a difference may arise because of the different way in which residual value is measured in the standards. Under FRS 15, residual values arewere based on the prices prevailing at the date of acquisition or revaluation of the asset. Under IAS 16 and FRS 102, they are based on prices prevailing at the balance sheet date. Therefore, in general, cumulative depreciation will be lower under IFRSsIAS 16 and FRS 102 assuming that prices are rising with inflation. Where such an effect is material, and an adjustment is made to reduce accumulated depreciation, the adjustment will be regarded as a realised profit because it represents the reversal of a previous realised loss.

**IFRS 1 – Deferred tax on business combinations**

10.23 The requirements of IFRS 1 and IFRS 3 for business combinations will generally be relevant only to the consolidated financial statements and therefore have no effect on distributable profits. However, in some cases it is necessary to account for a business combination in the individual accounts of a company, for example where it acquires an unincorporated business.

10.24 In some circumstances, IFRS 1 may require deferred tax to be provided in respect of assets or liabilities acquired through a previous business combination. For example, in many instances no deferred tax would have been provided on the revaluation of tangible fixed assets to fair value under old UK GAAP but such a provision would be required under IFRSs. When the company is not required to restate the business combination in accordance with IFRS 3 and uses this exemption, the deferred tax provision still has to be recognised but is adjusted against retained earnings rather than against goodwill.

10.25 The tax provision will reduce accumulated realised profits available for distribution where the transaction involved the acquisition of an unincorporated business by an individual company. It does not matter that the tax provision would not have been treated in this way had IFRS 3 been applied. It is the accounting that has actually been applied in the relevant accounts, in accordance with applicable accounting standards, which affects the amount of profits available for distribution.

IFRS 1 - 10.25A A similar issue can arise on transition to FRS 102 and similar considerations apply.

**Past capitalisation of revaluation reserve**

10.26 Under UK GAAP, someSome companies have revalued assets, in particular properties and investments in subsidiaries, and subsequently capitalised all or part of the resulting revaluation reserve through a bonus issue of shares. The issue that arises on transition to IFRSs or FRS 102 is the status of the debit entry in reserves if revalued assets are restated to a cost basis.

**Investment properties and property, plant and equipment**

10.27 Under SSAP 19, investment properties are required to be included in the balance sheet at their open market value. Under FRS 15, companies that chose to adopt a policy of

~~revaluation for classes of tangible fixed assets (property, plant and equipment) have to ensure that those assets are carried at their current value at the balance sheet date. On transition to IFRSs, companies are not required to continue to apply a revaluation policy for their investment properties or property, plant and equipment. In effect, IFRS 1 allows companies on transition to IFRSs to state their investment properties or property, plant and equipment at depreciated historical cost, or, in the case of property, plant and equipment, at a "deemed cost" that could be a previous valuation or fair value at the date of transition. This guidance addresses the position where a company chooses to restate to depreciated historical cost. In the case of a transition using a "deemed cost" the revaluation survives transition and there is no restatement to consider.~~

10.27 On transition to IFRSs or FRS 102, a company is permitted to make different accounting policy choices about the revaluation of certain assets. For example, a company that has previously had a policy of revaluing property, plant and equipment may decide to revert to historical cost accounting for those assets. Similarly, a company that has previously revalued its investment in subsidiaries may decide to restate them on the basis of cost less impairment.

10.28 Where the revaluation surplus has not been used at all for a bonus issue of shares and is still recorded in the balance sheet at the date of transition to IFRSs, the adjustment required will be simply to eliminate the revaluation reserve and reduce the revalued assets by the same amount to restate them to their depreciated historical cost. However, if the revaluation surplus has been capitalised, in full or in part, through a past bonus issue of shares, it will not be possible to reduce the reserve in this way. Neither is it possible to apply the debit to reduce share capital by the amount of the bonus shares. The question therefore arises as to the status of the debit entry in reserves arising from reversal of the past revaluation.

10.29 Paragraph 3.15(c) above states that, with two exceptions explained at 2.33 and ~~3~~2.36, realised losses will include the writing down, or providing for depreciation, amortisation, diminution in value or impairment of an asset. However, the entry to reverse the previous revaluation surplus is not depreciation or amortisation. It also does not relate to the diminution in the value of the assets or impairment but instead relates to a reduction in the amount at which those assets are recorded in the balance sheet. The actual value of the assets remains unchanged.

10.30 The exception described at 2.36 is as follows:

> 'If an asset is revalued downwards below its recoverable amount, as defined in FRS ~~11~~102 or IAS 36, then the difference between that revalued amount and recoverable amount is treated as an unrealised loss as it reflects a revaluation adjustment rather than a provision as defined in section 841~~.~~. Such a loss would become realised in the event of a subsequent scrapping, disposal or impairment of the asset.'

10.31 This principle may be applied to the restatement of a revalued asset to its depreciated historical cost. Therefore the debit entry to reserves arising from such a restatement (which equates to the revaluation element of the carrying value that is not yet depreciated) will be an unrealised loss provided that the recoverable amount of the asset is equal to or greater than the book amount prior to the restatement. To the extent that the revaluation surplus still exists as an unrealised reserve, the unrealised loss will simply eliminate that unrealised reserve. To the extent that the revaluation surplus has been utilised, in part or in full, for a bonus issue of shares, the resulting net debit entry will represent an unrealised loss.

10.32 The entry to reverse the previous revaluation surplus is not a provision for the purposes of applying section 841(2). In the case of Companies Act individual accounts, ~~"~~'provisions of a kind specified for the purposes of this paragraph by regulations under section 396 (except revaluation provisions~~)"~~)' are treated as realised losses. In the case of ~~"~~'IAS individual ~~accounts", "~~accounts', 'provisions of any kind (except revaluation provisions~~)"~~)' are treated

as realised losses. The entry to reverse the previous revaluation surplus is not a provision of the kind specified by the regulations under section 396 and is not a provision at all in the sense that the term is used for accounting purposes. On the restatement to historical cost there will be no provision deducted from the asset.

**Investments in subsidiaries**

10.33 Under the alternative accounting rules in the Accounting Regulations, investments in subsidiaries may be stated "at a market value determined as at the date of their last valuation" or "at a value determined on any basis which appears to the directors to be appropriate in the circumstances of the company". There is no obligation under the law or UK accounting standards to keep such valuations up to date although it is necessary to consider whether the assets have become impaired. Under IFRSs, two accounting policies are available for investments in subsidiaries. The first policy is that of cost, using the IAS 27 cost method. The second is to account for such investments in accordance with IAS 39. This would require such investments to be maintained at fair value. In practice, the measurement of such equity investments at fair value may be precluded because the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot reasonably be assessed (see IAS 39, AG 80-81). Even where such a policy is possible, it will require valuations to be obtained each time a balance sheet is drawn up. This is likely to be unattractive to most companies. Therefore, most companies hold subsidiaries at cost, as determined under IAS 27.

10.34 Hence the guidance on the effect of a restatement to depreciated historical cost of a previously revalued investment property or tangible fixed asset is equally applicable to a restatement of previously revalued investments in subsidiaries on to an IAS 27 cost basis.

**Effect of restatements for a public company**

10.33 [Deleted]

10.34 [Deleted]

10.35 For a public company, the restatement of a revalued asset (whether investment property, other property, plant and equipment or investment in subsidiaries) to a cost basis will restrict its profits available for distribution under section 831 to the extent that the revaluation surplus was capitalised. The effect of the unrealised loss on the restriction imposed by section 831 may be mitigated by the existence of recognised unrealised profits.

**IAS 11 - Accounting for construction contracts**

10.36 Under old UK GAAP (SSAP 9), accounting for profit on long-term contracts results in debtor balances described as "'Amounts recoverable on contracts".contracts'. This treatment was adopted when the standard was revised in 1988 because legal advice suggested that it was not possible to include the profit element in work-in-progress because of the requirement to state work-in-progress at cost.

10.37 The accounting required for construction contracts under IAS 11 and FRS 102 is broadly similar to that required by SSAP 9 (although the scope of the standardsrequirements is different). However, IAS 11 isand FRS 102 are not specific as to the nature of the asset to be recognised. In practice the item may simply be disclosed as "'construction contracts"contracts' although it may also be included within debtors or within work-in-progress.

10.38 Under old UK GAAP it iswas usually clear that the debtor balance for "'Amounts recoverable on contracts" meetscontracts' met the definition of "'qualifying consideration"consideration' (see 3.11 above). Therefore profit recognised on such contracts iswas regarded as a realised profit. On the basis that this treatment has been

generally accepted under old UK GAAP, any profits recognised in accordance with IAS 11 or FRS 102 should be regarded as realised profits, irrespective of how the asset is described in the balance sheet.

10.38A IFRIC 12 Service Concession Arrangements (and the equivalent requirements of FRS 102) may require a profit to be recognised by the operator ~~in accordance with IAS 11~~ in relation to the construction or upgrading of the infrastructure to be used to provide a public service. Whether any such profit is a realised profit will depend on whether a financial asset or an intangible asset is recognised in accordance with IFRIC 12 or FRS 102. This is more fully explained at 10.65 to 10.68 below.

~~**IAS 12 – Income taxes – Deferred tax**~~

~~10.39 As stated at 3.17 above, a provision for deferred tax should generally be regarded as a realised loss. However, when assets are revalued to their fair value, with any gain being recorded in the profit and loss account even though regarded as unrealised, the deferred tax on that gain should be treated as a reduction in that unrealised gain rather than as a realised loss (paragraph 14 of Appendix III to FRS 19 *Deferred tax*).~~

~~10.40 This principle is also applicable to deferred tax provisions recognised under IAS 12, irrespective of whether profits are recognised in profit or loss, or direct in equity. For many financial instruments, profits arising from fair value accounting are realised profits (see Section 4 above). Any attributable deferred tax provision will be a realised loss.~~

~~10.41 Deferred tax is more often recognised on unrealised profits under IFRSs than under UK GAAP. For example, the remeasurement of investment property at fair value will result in unrealised profits (see Section 4 above) on which deferred tax will have to be provided. Such a deferred tax provision is treated as a reduction in the unrealised profit rather than as a realised loss.~~

~~10.42 When a convertible debt instrument is accounted for using "split accounting" (see *Convertible debt* at 6.59 *et seq* above), a deferred tax provision is established and debited against the initial carrying amount of the equity component in accordance with paragraph 23 of IAS 12. This occurs if the tax base of the debt is its full amount but the book amount is lower by the amount of the equity component. The deferred tax provision reverses through profit or loss over the life of the instrument as illustrated in Example 4.~~ 10.39 [Deleted – see 3.17 to 3.17D]]

10.40 [Deleted]

10.41 ~~in Appendix B to IAS 12.~~ [Deleted]

10.42 [Deleted]

10.43 [Deleted]

~~It does not represent a future cash outflow for payment of tax. The deferred tax provision should be treated as a reduction in the credit to equity rather than as a realised loss. The equity component of the financial instrument is not a profit at all and therefore does not fall to be classified as realised or unrealised (see Convertible debt at 6.59 *et seq* above). An adjustment to such an item does not affect realised profits.~~

~~10.43 In some cases it may be necessary to provide for current tax on an unrealised profit. A current tax provision should be treated as a realised loss even if it arises from the taxation of an unrealised profit. This is because a provision for current tax represents a specific cash outflow that will arise irrespective of whether the related profit is realised or not.~~

**Property, plant and equipment – asset swaps**

10.44 One or more items of property, plant and equipment may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. IAS 16 requires the cost of such an item of property, plant and equipment to be measured at fair value unless the transaction lacks commercial substance or the fair value of neither the asset received nor the asset given up is reliably measurable. IAS 16 provides guidance on the circumstances in which the fair value of an asset is reliably measurable for this purpose.

10.45 A profit may therefore be recognised on such an exchange transaction in accordance with IFRSs. This profit is likely to be unrealised because an item of property, plant and equipment is unlikely to meet the definition of ~~"~~'qualifying ~~consideration"~~consideration' (see 3.11 above).

10.46 When a combination of property, plant and equipment and qualifying consideration (~~e.g.~~eg, cash) is received, the guidance at 3.18 above on ~~"~~'top-~~slicing"~~slicing' will be relevant.

10.47 Any profit treated as unrealised, becomes realised as the related asset is depreciated, written down for impairment or sold for qualifying consideration.

10.48 A loss arising on such a transaction is usually a realised loss. However, in some cases the loss may be similar in substance to an unrealised revaluation deficit (see 2.28 above).

10.49 For example, if a factory used in a business was exchanged for a similar factory and a loss recognised under IAS 16 by reference to the market value of the factories, the loss will be unrealised if there would have been no need to write down the original factory for impairment because its value in use was higher than its market value. It will also be necessary to consider the value in use of the new factory which might be different from the value in use of the old factory, even though their market value is the same (~~e.g.~~eg, because one is larger than the other).

10.50 IAS 38 provides for the same accounting treatment for swaps of intangibles as that under IAS 16 in respect of property, plant and equipment, and therefore the foregoing analysis also applies to intangibles under IAS 38.

10.51 ~~There are no specific~~FRS 102 includes similar requirements ~~in UK accounting standards dealing with such asset swaps~~to those of IFRSs. The above guidance is relevant to any profit recognised under UK GAAP although it should be noted that only profits realised at the balance sheet date may be included in the profit and loss account in accordance with the Accounting Regulations[48] (although the fair value accounting rules make an exception to this general rule).

**Revenue – Barter transactions**

~~10.52 When goods are sold or services rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction that generates revenue in accordance with IAS 18. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the fair value cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred.~~

10.52 Some barter transaction result in the recognition of revenue and profit in accordance with applicable accounting standards. The following guidance is applicable in such cases under IFRSs and UK GAAP. However, under UK GAAP it should be noted that only profits realised at the balance sheet date may be included in the profit and loss account in

[48] Paragraph 13 of Schedule 1 to SI 2008/409 and Paragraph 13 ~~to~~of Schedule 1 to SI 2008/410.

accordance with the Accounting Regulations[49] unless they arise from the use of fair value accounting.

10.53 When an asset is received, in determining whether any profit on such an exchange is realised or unrealised, it is necessary to determine whether such asset meets the definition of qualifying consideration. For example, when a property is received, it will be straightforward to assess whether or not it meets the definition of qualifying consideration. Any profit will not become realised until that property is depreciated, written down for impairment or sold for qualifying consideration.

10.54 Where services are exchanged, the effect of the accounting entries is to gross up the revenue and the costs by the same amount. Accordingly, there will be no effect on profit. When services are receivable but have not yet been received at the balance sheet date, a prepayment will be recognised. A prepayment does not meet the definition of qualifying consideration.

10.55 Where an exchange of services straddles the end of an accounting reference period, such that services are provided but not received before the balance sheet date, any profit at the year end would not be realised. Any such profit initially recognised will not become realised until the service has been received in exchange. That is, the profit will be realised by the prepayment being expensed to profit or loss when the service has been received.

~~10.56 There are no specific requirements in UK accounting standards dealing with barter transactions other than UITF Abstract 26 which is concerned with barter transactions for advertising. The above guidance will be relevant to any profit recognised under UK GAAP although it should be noted that only profits realised at the balance sheet date may be included in the profit and loss account in accordance with the Accounting Regulations[50].~~

10.56 [Deleted]

[10.57 to 10.64 withdrawn and replaced by section 11.]

**~~IFRIC 12~~ Service concession arrangements**

10.65 Service concession arrangements are addressed in IFRIC 12 Service Concession Arrangements ~~was issued in November 2006 and has subsequently been adopted by the EU. Service concession arrangements~~and are arrangements whereby a government or other public sector body ('the grantor') enters into a contract with a private sector entity ('the operator') for the construction / upgrade and operation of assets with which public services are supplied, such as roads, prisons or hospitals. Private Finance Initiative (PFI) arrangements are a common example of service concession arrangements in the UK.

10.66 The operator will often construct or upgrade the infrastructure to be used to provide the public service and the cost of this will be recovered over the life of the arrangement. This is accounted for as a construction contract under IAS 11 Construction contracts. 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.

10.67 When a financial asset is recognised in accordance with IFRIC 12, this will be an amount receivable from the grantor and therefore should normally meet the definition of qualifying consideration. Any profit arising from the recognition of revenue in the construction phase will therefore normally be a realised profit.

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[49] Paragraph 13 of Schedule 1 to SI 2008/409 and Paragraph 13 of Schedule 1 to SI 2008/410.

~~[50] Paragraph 13 of Schedule 1 to SI 2008/409 and Paragraph 13 to Schedule 1 to SI 2008/410.~~

10.68 When an intangible asset is recognised in accordance with IFRIC 12, this will not meet the definition of qualifying consideration. Any profit arising from the recognition of revenue in excess of cost in the construction phase will not therefore be a realised profit. Any unrealised profit arising in the construction phase will become realised as the intangible asset is amortised or impaired over the life of the arrangement.

10.68A FRS 102 includes similar requirements to those of IFRIC 12.

**IFRIC 5 Decommissioning funds**

10.69 ~~IFRIC 5 'Rights to Interests arising from~~Decommissioning funds are more fully described in IFRIC 5 Decommissioning, Restoration and Environmental Rehabilitation ~~Funds' was issued in December 2004 and subsequently adopted by the EU. Such funds are more fully described in IFRIC 5~~Funds but are typically established to provide a ring-fenced fund of assets to be used to pay for the decommissioning of an asset (~~e.g.~~eg, a nuclear power plant) at the end of its life. IFRIC 5 applies to the financial statements of a contributor to such a fund where the assets are administered separately (either by being held in a separate legal entity or as segregated assets within another entity) and the contributor's right to access the assets is restricted. The contributor retains the obligation to pay the decommissioning costs but is able to draw on the assets in the fund to finance such costs when they are incurred.

10.70 In accordance with IFRIC 5, the contributor recognises the right to receive reimbursement from the fund as a reimbursement asset in accordance with IAS 37~~-~~. The reimbursement is measured at the lower of the amount of the decommissioning obligation recognised and the contributor's share of the fair value of the net assets of the fund attributable to the contributor. Changes in the carrying value of the reimbursement asset, other than contributions to and payments from the fund, are recognised in profit or loss in the period in which the changes occur.

10.71 Paragraph 53 of IAS 37 states that a reimbursement asset is recognised when, and only when, it is virtually certain that the reimbursement will be received if the entity settled the obligation. An amount receivable which is regarded, for financial reporting purposes, as meeting this test will also generally meet the definition of qualifying consideration in paragraph 3.11(d).

10.72 That definition refers to the debtor being capable of settling the receivable within a reasonable period of time. What is a reasonable period of time is a matter of judgement and will depend on the particular facts and circumstances. Decommissioning funds may be established to pay liabilities that will not arise for many years. However, the nature of such funds is that they will generally be capable of settling the amount within a relatively short period of time if they were required to do so at the date of determination. The definition of qualifying consideration does not require actual settlement within any particular period of time.

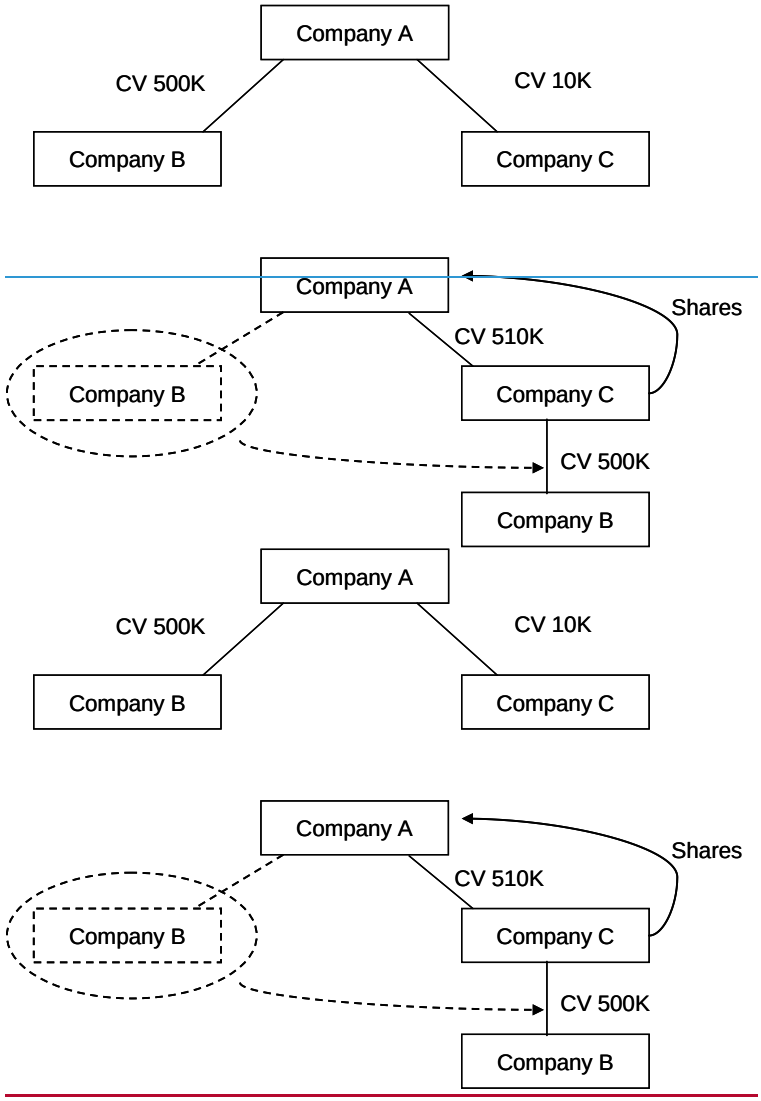
**Section 846 and replacement assets**

10.73 The following paragraphs illustrate how to apply s846 (see 2.9 above) where the asset to which an unrealised reserve relates has been replaced by a different asset.

10.74 Company A has brought forward realised profits of £75,000. It previously acquired an investment (in Company B) via a share for share transfer. This transaction qualified for merger relief in accordance with section 612 and the company elected to record a merger reserve in relation to this share issue. The aggregate nominal value of the shares issued was £50,000, compared with a fair value of £500,000 such that a merger reserve of £450,000 was recorded.

10.75 Subsequently Company A transfers that investment in Company B to another subsidiary company (Company C) in exchange for shares. As a matter of accounting practice, the merger reserve which initially related to Company A's investment in Company B is now attached to the investment in Company C, ie, part of the amount at which the investment in

Company C is stated represents the reserve. These transactions are illustrated in the diagram below (in which 'CV' means carrying value).




10.76 Therefore, if Company A wishes to distribute its investment in Company C to its shareholders, it can do so by applying section 846. This reserve (together with £75,000 of the brought forward realised profits) can be used to distribute Company A's investment in Company C to its shareholders. This is illustrated in the following memorandum balance sheet of Company A.

**Memorandum balance sheet of Company A**

| | Opening balance sheet | Share for share acquisition of Company B | After acquisition of Company B | Share for share transfer of Company B to Company C | After transfer to Company C | Distribution of Company C | After distribution of Company C |
|---|---|---|---|---|---|---|---|
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| Investment in Company B | | 500 | 500 | (500) | - | | - |
| Investment in Company C | 10 | | 10 | 500 | 510 | (510) | - |
| Other net assets | 90 | | 90 | | 90 | | 90 |
| **Net assets** | **100** | **500** | **600** | **-** | **600** | **(510)** | **90** |
| | | | | | | | |
| Share capital / premium | 25 | 50 | 75 | | 75 | | 75 |
| Merger reserve (Company B) | | 450 | 450 | (450) | - | | - |
| Merger reserve (Company C) | | | | 450 | 450 | (450) | - |
| P&L reserves (realised) | 75 | | 75 | | 75 | (60) | 15 |
| **Capital and reserves** | **100** | **500** | **600** | **-** | **600** | **(510)** | **90** |

**Section 846 and fungible assets**

10.77 The following paragraphs provide guidance on the distribution in kind of fungible assets such as shares or loan notes that have been received as consideration for the sale of another asset. For example, Company A has 1,000 £1 loan notes which are transferable in multiples of £1 and represent an unrealised profit of £900. If the company makes a distribution in kind of £500 of loan notes, the question is whether the unrealised profit might be regarded as becoming realised through the application of section 846 either:

- to the extent of £450 on the basis that the realisation of 50% of the asset results in the realisation of 50% of the profit; or

- to the extent of £500 through the application of a ~~"~~'top ~~slicing"~~slicing' rule similar to the one in 3.18 ~~below~~above for exchanges of assets.

10.78 The first (ie, pro rata) approach is correct. This is a matter of the statutory construction of section 846 rather than a matter of generally accepted accounting practice.

10.79 Section 846 is reproduced below for ease of reference.

***846 Distributions in kind: treatment of unrealised profits***

*(1) This section applies where—*

*(a) a company makes a distribution consisting of or including, or treated as arising in consequence of, the sale, transfer or other disposition by the company of a non-cash asset, and*

*(b) any part of the amount at which that asset is stated in the relevant accounts represents an unrealised profit.*

~~*accounts represents an unrealised profit.*~~

*(2) That profit is treated as a realised profit—*

*(a) for the purpose of determining the lawfulness of the distribution in accordance with this Part (whether before or after the distribution takes place), and*

*(b) for the purpose of the application, in relation to anything done with a view to or in connection with the making of the distribution, of any provision of regulations under section 396 under which only realised profits are to be included in or transferred to the profit and loss account.*

10.80 The profit that is to be treated as realised in accordance with sub-section (2) is the unrealised profit referred to in sub-section (1)(b). The reference in sub-section (1)(b) to 'that asset' means the asset to be distributed. Therefore, it is necessary to identify ~~"~~'that ~~asset"~~asset' which in the above example is not a single asset of £500 of loan notes but an aggregation of assets comprising 500 £1 loan notes. Naturally, if the loan notes were transferable only in units of £100 the distribution would consist of 5 assets. Therefore, in the above example, the distribution of £500 of loan notes results in the realisation of £450 of profit because that is the amount of unrealised profit attributable to those loan notes. In other words, the unrealised profit must be treated as spread evenly across each unit of the fungible asset and section 846 applied to each unit separately.

10.81 Paragraph 3.18 refers to the use of a top-slicing approach where an asset is sold partly for qualifying consideration and partly for other consideration and a realised profit falls to be assessed under generally accepted accounting principles. That

guidance is not relevant to the application of section 846 which is not concerned with the disposal of an asset for mixed consideration but with the ~~recharacterisation~~re-characterisation of an existing unrealised profit under that the specific provision of that section. In addition, that guidance is not relevant to the attribution of an unrealised profit, at the point of its arising, among one or more assets.

10.82 As illustrated in Appendix 8, this conclusion, may lead to unexpected results in some cases. In particular, the maximum distribution possible as a distribution in kind may be less than would be the case if all of the loan notes were redeemed or sold for qualifying consideration.

# 11. FOREIGN CURRENCY SHARE CAPITAL AND USE OF PRESENTATION CURRENCIES 11.1 – 11.38

## Introduction

11.1 The guidance in this section deals with matters arising from mismatches between any of the currency of share capital, the company's functional currency and the company's presentation currency. The accounting context in which this section is written is IFRS~~, ie IAS 21. So far as UK GAAP is concerned, if FRS 23 is applicable then this is converged with IAS 21; if SSAP 20 is applicable, the issues and principles are, however, the same because SSAP 20 differs only in minor details from IAS 21 for these purposes, although SSAP 20 does not include a free choice of presentation currency~~ but will also be applicable to companies applying FRS 102.

11.2. The main points at issue might be briefly put as follows: ~~what~~

(a) What is the effect of a translation of the whole of the accounts of a company into a presentation currency of free choice~~; and what~~?

(b) What is the effect of the retranslation of an autonomous branch from its functional currency into the functional currency of the company?

(c) What is the effect of the share ~~capital's~~capital being denominated in a currency other than the functional currency?

11.3 The first matter is similar to the ~~issue of translation of an autonomous branch which was previously addressed at paragraphs 10.57 -10.64 (which have now been withdrawn and replaced by the guidance~~second in ~~this section).~~accounting terms. However, ~~that~~the second case is not one of free choice of presentation currency. Rather, it is a necessity to translate the results of the branch into the functional currency of the company of which it is legally a part. In the case of use of a presentation currency, there is an arbitrary choice as to the units in which to show the accounts for mere presentation purposes. The legal analysis for the purpose of determining distributable profits is therefore different.

11.4 [~~Not used~~Deleted]

11.5 [~~Not used~~Deleted]

## Principles

11.6 Paragraphs 11.7 to 11.~~34~~38 set out ~~seven~~eight principles to be applied in relation to foreign currency share capital and the use of presentation currencies. Examples of the application of the principles are set out in Appendix 5.

**11.7 Principle 1: Realised profits and losses are measured by reference to the functional currency of the company.**

**11.8 Principle 2: An 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 a loss as a matter of law. Such an amount therefore cannot be a realised profit or loss.**

11.9 IAS 21 requires foreign currency assets, liabilities and transactions to be measured using a company's functional currency. This is defined as the currency of the primary economic environment in which the entity operates. Functional currency is a matter of fact and is not an accounting policy choice. However, IAS 21 also permits a company to present its financial statements in a currency other than its functional currency. Such a currency is referred to as a presentation currency and may be freely chosen.

11.10 The ~~"~~'relevant ~~accounts"~~accounts' for the purposes of justifying a distribution are determined in accordance with section 836 but will generally be the company's most recent statutory individual accounts. Although the face of those accounts shows amounts in presentation currency, the functional currency amounts underlie and form part of those relevant accounts. Realised profits and losses are determined by reference to these functional currency amounts. The functional-to-presentation translation gain or loss, which also appears in the relevant accounts, is not a profit or loss at law, for the reasons explained below.

11.11 The presentation currency is an arbitrary choice as to the units in which to show the accounts for mere presentation purposes. The functional-to-presentation translation is a book-keeping or accounting exercise. The accounting gain or loss arising from that process is an arithmetical difference which does not spring from any functional substance. There has been no profit or loss but merely a change in calibration. Thus such changes are not characterised as a profit or loss as a matter of law.

**11.12 Principle 3: The profit or loss arising upon the necessary retranslation of an autonomous branch, from its functional currency into the functional currency of the company, is a realised profit or a loss to the extent that the branch net assets were qualifying consideration when the profit or loss arose.**

11.13 A company has only a single pool of realised profits available for distribution, irrespective of its having one or more autonomous branches, with a functional currency different from that of the rest of the company. That single pool is measured by reference to the functional currency of the rest of the company. Thus in the case of a foreign operation (branch) with a functional currency that is different from the functional currency of the company, the translation is not an arbitrary one but one made of necessity to state the branch asset and results in the company's functional currency. It therefore has substance and is a profit or loss at law.

11.14 Whether that profit or loss is a realised one depends upon the nature of the assets and liabilities on which ~~they arise~~it arises. A profit that arises on retranslation of an asset which comprises qualifying consideration, or a liability, is a realised profit in accordance with paragraph 3.9(d) above. A profit arising on the retranslation of assets which do not comprise qualifying consideration (~~e.g.~~eg, property, plant and equipment) is an unrealised profit. A loss arising on retranslation of an asset or liability is a realised loss unless it is the reversal of an unrealised profit on that same asset or liability. The gross profits and losses on retranslation (rather than the net amount) should be assessed separately. It is therefore possible, for example, that there is a realised loss to be taken into account when determining profits available for distribution, even though the net amount taken direct to equity is a profit.

11.15 The analysis in the previous paragraph will apply only in straightforward situations where the composition of the company's assets has not changed significantly during the period. For example, it would not be appropriate to regard the exchange difference related to the amount of the opening cash balance (ie, the beginning to the end of year exchange difference computed in relation to that part of the opening net assets equal to the opening cash balance) as realised if that cash balance did not

exist throughout the period (eg, because it was invested in assets such as property, plant and equipment which would not comprise qualifying consideration).

11.16 The exchange difference taken to equity will also include the difference between the profit or loss for the period translated at actual (or average) rate and that profit or loss translated at closing rate. The profit or loss for the period arises on changes in the amounts and/or composition of the company's assets and liabilities (~~e.g.~~eg, on an exchange of stocks for cash).

11.17 Thus taking together the exchange differences on retranslation of the profit or loss for the period and on the opening net assets, the total amount arises in relation to an asset base that changes throughout the year. To establish whether this exchange difference is realised, partly realised or unrealised will require careful analysis of the facts. Appendix 6 gives two examples of this, illustrating why this calculation needs to be done. Ideally, it would be necessary to compute and assess exchange differences continually. In practice when conducting the analysis, reasonable approximations may be made. The approximations will depend on the facts of any case, for example the rate of change in the composition of the balance sheet between various asset/ liability categories.

**11.18 Principle 4: Where a company's shares, irrespective of whether those shares are classified as equity or debt for accounting purposes, are denominated in a currency other than the company's functional currency, the adjustment arising upon any translation for accounting purposes of the share capital is not a profit or loss at law. Such an amount therefore cannot be a realised profit or loss.**

11.19 Where shares are classified as equity under accounting standards and their currency differs from the company's functional currency, then the company will either retranslate those shares into functional currency at each balance sheet date or will leave them at their original historical amounts, although typically the latter is adopted in the case of ordinary shares. Accounting standards do not have anything to say about the translation of shares classified as equity, or at least not directly. In IAS 21 the requirement to accumulate the translation differences in the currency translation reserve rules out any question of allocating any of them against capital. In the case of retranslation the resulting difference does not pass through profit or loss and is not a gain or loss for accounting purposes. Where the shares are classified as debt (eg, certain preference shares), retranslation is mandatory and the resulting difference is an accounting gain or loss flowing through profit or loss.

11.20 In both cases, the shares remain share capital as a matter of law. Any retranslation of share capital for accounting purposes (whether equity or debt classified) is a ~~book-keeping~~bookkeeping or accounting exercise. The gain or loss arising from that process is an arithmetical difference which does not spring from any substance in law. There has been no profit or loss but merely a change in calibration. Thus such changes are not characterised as profits or losses as a matter of law.

**11.21 Principle 5: Where a company's shares, whether those shares are classified as equity or debt for accounting purposes, are denominated in a currency other than the company's functional currency, 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.**

11.22 Under statute, shares (whether of a private or a public company) must be of a fixed nominal amount (s542). There is a rule of law that where the share capital is

denominated in another currency (other than the functional currency) the share capital is in fact fixed as that other currency amount.

11.23 Further, the common law provides that a company may not distribute its capital (see 2.2 above). In relation to the currency of shares, this rule is not concerned with whether or not share capital has been retranslated in the accounts or with the nature of any translation adjustments. It is concerned with a question of fact as to value of the assets compared with the amount of the share capital. Since the amount of the capital is the currency amount, then for such a comparison to be effected the share capital must be stated in the same terms as value of the net assets. 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 current functional currency worth of the share capital, the ability to make such a distribution is restricted.

11.24 Thus an increase in the functional currency worth of the share capital may restrict distributions to less than the amount available under Part 23's statutory rules. On the other hand, a decrease will neither restrict nor augment the ability to make a distribution. The effect of a share capital decrease will be to increase the difference between net assets and share capital (assuming no other amounts within equity – see below for other cases) so as to exceed the Part 23 realised profits (and any unrealised profits). However, the maximum amount that may be distributed can never exceed the amount permitted by Part 23.

**11.25 Principle 6: Share premium account, and similar capital accounts, do not have a currency of denomination but are amounts of record in the books of account in functional currency.**

11.26 Share premium account is different from share capital in this context. Share capital is required by statute to be of fixed amount and therefore has a currency of denomination. Share premium account is not so required. Furthermore, share premium was, prior to the statutory requirement to treat it as if it were part of a company's capital, in law a profit. It is thus an amount of record arising on the occasion of a share issue. The amount is determined at that time and in the functional currency since that is the currency of substance for the keeping of accounts.

11.27 A capital redemption reserve is of the same nature as a share premium account. It is not required by statute to have a fixed amount. It is an amount of record arising on the occasion of a share redemption or repurchase. The amount is determined at that time and in the functional currency. It should be noted that the amount determined at that time will be by reference to the then functional currency worth of the shares redeemed or repurchased. This is because those shares, up to the moment of their redemption or repurchase, represent capital of that currency. Thus the nominal value of those shares, by reference to which the statutory rules for determining capital redemption reserve operate, is as a matter of fact a non-functional currency amount; its functional currency worth must be determined at the date of redemption or repurchase.

11.28 Principle 5 identifies a possible restricting effect upon distributions in relation to share capital where there is a mismatch between that capital's denomination and the functional currency. Since share premium and similar capital accounts do not have currencies of denomination, but are amounts of record in functional currency, no equivalent issue arises in relation to share premium and similar capital accounts; that is to say, there is no concept of variation in the worth of, eg, share premium to be concerned about.

11.29 It should be noted, however, that share premium is brought into the calculation of the restricting effect arising from a variation in the worth of the share capital under Principle 5. The common law prohibition on distribution of capital covers both share capital and share premium account. Thus, where a company has a share premium account, the restricting effect under Principle 5 is computed by comparison of the net assets with the aggregate of the functional currency worth of the share capital and the functional currency amount of record of the share premium account.

11.30 The common law principles of maintenance of capital apply to any reserve which the Act says must be treated as if it were part of the paid up share capital of the company. It therefore includes, in addition to a share premium account, a capital redemption reserve under section 733 and a redenomination reserve under section 626. The treatment of a share premium account described in 2.29 above therefore applies to any capital redemption reserve or redenomination reserve.

**11.31 Principle 7: The application of the s831 statutory net assets test operates by reference to amounts as shown upon the face of the accounts in presentation currency.**

11.32 The ~~s831~~section 831 net assets test (see 2.30 above) applies only to public companies. It is a statutory test formulated in terms of amounts set out in the relevant accounts required by the Act: net assets, share capital and undistributable reserves (as defined). It therefore operates by reference to whatever is shown in presentation currency in those accounts.

11.33 It may be noted here that s831 operates upon figures in presentation currency whereas, as described at Principles 1 and 2, s830's realised profits test draws upon functional currency amounts. This is because s830 deals with profits and losses and in law the functional-to-presentation translation does not yield a profit or loss. It is therefore necessary for s830 to begin with the amounts in the relevant accounts but to take from them only the amounts that are profits and losses in law. On the other hand s831 asks only that certain accounts figures be compared (eg, in a similar way to that described at 6.~~24ff~~24 to 6.30 above whereby shares classified as debt count as a reduction of net assets rather than an increase to share capital for the s831 test).

11.34 It should be noted that where share capital is retranslated, the amount within reserves arising as a result of the retranslation is not a profit or loss at law (see Principle 2). Nor is that translation difference presented as share capital. Thus the difference cannot be included, for the operation of the s831 test, as share capital or as undistributable reserves. Thus, in particular, any debit difference cannot be an unrealised loss to be deducted from the unrealised profits component of ~~"~~'undistributable ~~reserves".~~reserves'.

**11.35 Principle 8: A reduction of foreign currency share capital is calculated by reference to the rate of exchange at the date of the reduction.**

11.36 The amount of the reserve so arising is a matter of accounting practice. That reserve will be the functional currency amount (see paragraph 11.7) of:

(a) the amount previously recorded in relation to the now-reduced nominal value;

(b) plus or minus any amounts previously recorded for retranslation of the share capital (if it was retranslated – see paragraphs 11.18-11.20);

(c) less any amounts repaid translated at the rate at the date of repayment.

Put simply, the reserve is the aggregate net amount left over, in functional currency, after all of the share capital being reduced, any associated retranslation amounts and any repayment have been removed from the accounts. Appendix 7 contains illustrative examples of a company's position in several scenarios for capital reductions where there have been movements in the exchange rate between the functional currency and foreign share capital currency.

11.37 It should be noted that the amount of the reserve so arising is not the same as the amount of the reduction. In law the amount of the reduction would be the currency nominal value reduced at the functional currency exchange rate at the date that the reduction becomes effective. This is because the amount of the capital, and thus of the reduction, is the currency amount (see paragraph 11.22). It can be meaningfully stated at the effective date only at the rate applicable that day. For example, if the amount was repaid on reduction it would be that amount that would actually be repaid and accounted for as a cash payment. The realised profits arising on the reduction, on the other hand, are not determined by reference to the reduction amount but to the reserve arising, which is an accounting matter and may be a different figure.

11.38 The reserve may be thought of as comprising a number of components, one of which is the reduction amount, as follows, in the functional currency:

(a) a credit for the reduced nominal value, to the extent not paid out, at the reduction date exchange rate;

(b) a credit for any previously recorded balance, representing the reduced nominal value, that has not been eliminated by (a) above and/ or by any repayment;

(c) a debit for any previously recorded balance, representing the reduced nominal value, that has been over-eliminated by (a) above and/ or by any repayment; and

(d) a credit or debit, as the case may be, to replace any reserves entry for prior accounting retranslation of the reduced element of the shares since this is associated with the shares' nominal value that no longer exists.

In relation to the last component, such a prior reserves entry arises only where the shares were retranslated for accounting purposes; in effect it anticipated the reduction of the shares (it is the difference between the nominal value at historical rate and an amount equal to what is now the reduction amount) and so should be brought into account in reduction accounting.

# 12. CASH BOX STRUCTURES 12.1 – 12.35

**Introduction to the cash box share issue method**

12.1 The so-called "'cash box"box' method of effecting an issue of shares for cash has been employed from time to time over at least two decades. They have recently become commonplace. Whilst they have previouslymainly been seen in relation to acquisition funding, more recently they have also have been seen in connection with debt repayment or regulatory capital increases. Some companies undertaking such issues have been advised by their lawyers that the arrangement does not give rise to any share premium. As a consequence the question arises as to the status of the reserve recorded instead of share premium: is it a realised profit?

### Brief details

12.2 Although there are slight variations in the schemes put forward, a common case would be as follows (in this case a placing):

- There are four parties involved: the Company; NewCo, a newly incorporated non-UK subsidiary of which the company holds 89 of 100 ordinary shares (worth a trivial amount); a bank, that owns the other 11 shares (worth a trivial amount); and the placees who will put up a substantial amount of cash.

- The placees pay over the cash subscription amount to the bank, which, as principal, subscribes that cash amount for preference shares in NewCo.

- The Company allots ordinary shares (being equity shares under s548) to the placees, in consideration for which the bank transfers to it the 11 NewCo ordinary shares and the NewCo preference shares.

- NewCo redeems its preference shares (now held by the Company) in cash for the amount of the placing proceeds.

### No share premium account?

12.3 In relation to the penultimate bullet, it is assumed here, for the purposes of what follows, that there is merger relief under s612 and thus no share premium account falls to be recorded. That is a question of law, which will depend on the particular facts and circumstances of the case. Companies may wish to take legal advice. This Technical Release offers none.

### Accounting entries

12.4 In terms of accounting entries, where there is no share premium account there will instead be an other reserve. This would arise because either:

- the Company chooses to record a reserve at the point of acquiring the shares in NewCo in the same way that a company may choose to record a merger reserve in lieu of share premium in any case of the application of s612. This amount is a profit at law, in the same way as merger relief reserves generally (see paragraph 3.8(b)(ii)); or

- the Company could (under UK GAAP) choose to record its investment in NewCo at the nominal value of the shares and thus no reserve arises at this

point. However, once the investment in NewCo is redeemed for cash, the Company will record a profit on the redemption in the same amount.

12.5 Either way, the Company finds itself with a merger reserve or a profit reserve and the same question applies to them both: is the reserve realised? The method by which the reserve was recorded makes no difference to the question.

**The framework for considering whether the reserve is a realised profit~~?~~**

12.6 The reserve is akin to one arising where a company receives a capital contribution from shareholders. Paragraphs 12.7 to 12.15 below consider, in effect, whether the assessment of realisation of that reserve proceeds in any different fashion from that of a conventional capital contribution reserve.

### Prior to considering the use of the funds

12.7 Following redemption of the Newco preference shares, the cash proceeds thereof will, subject to the question of linkage set out below, fall to be treated as ~~"~~'qualifying ~~consideration"~~consideration' in the hands of the Company (see paragraph 3.9(a) or (f), depending on whether as an accounting entry the reserve arises on redemption by NewCo or on issue by the Company). *Prima facie*, and subject to what follows, the reserve would therefore be considered a realised profit.

### Questions of the use of the funds

12.8 Sometimes the reason for the placing or rights issue – and a reason will always be given to the market – is to obtain funds for an acquisition. The precise circumstances of the acquisition will vary. It is possible that the acquisition and placing/ rights issue are conditional upon each other; or they might occur on the same day; or the acquisition may be announced at the placing date but still itself be conditional; or there may in some industries be regulatory restrictions on the use of the cash proceeds.

12.9 In other cases the company may have raised the funds in connection with a need to recapitalise a subsidiary. For example, it is possible that the company may be compelled by regulatory requirements immediately to subscribe for equity share capital in a subsidiary; or it may be a commercial necessity to recapitalise a subsidiary. Other cases might include a capitalisation of the company itself for regulatory reasons; or to fund the repayment of the company's own debt.

12.10 In this context the question arises as to whether the reserve should therefore be deemed to relate to the intended application of the funds (ie, with the placing/ rights issue and the application of the funds being a series of related transactions) rather than to the immediate cash proceeds of the placing/ rights issue.

12.11 This can be split into two questions:

- Does the use of the funds need to be considered in terms of the ~~"linkage"~~'linkage' principle in paragraph 3.5?
- If so, will the use of the funds be found to be linked under that provision?

### Should linkage be considered?

12.12 Paragraph 3.5 is of general application and contains no exceptions. There is nothing in a cash box structure that marks it out as fundamentally different and warranting the

insertion of an exception to paragraph 3.5. The effect of the application of paragraph 3.5 has therefore to be considered.

12.13 Two other observations may be noted at this juncture. First, it would be unjustifiable to halt the analysis at the conversion of the NewCo preference shares into cash, and not to go on to consider whether there should be brought into the analysis the conversion of the cash into some other asset; it is a commercial reality that cash boxes are not carried out in a vacuum.

12.14 Second, if the question of linkage were not addressed, all manner of intra-group transactions might claim to result in realised profits.

### Conclusion as to framework to be employed in the assessment of realisation

12.15 Thus, all of the normal rules of realisation, including the effect of the application of paragraph 3.5 (linkage etc), apply. The assessment therefore proceeds in no different a way from that of the case of a conventional capital contribution.

## The effect of the application of paragraph 3.5

12.16 Paragraphs 12.7 to 12.15 above establish that a cash-box share issue and its wider context should be considered under the paragraph 3.5 principle of linkage etc. Paragraphs 12.17 to 12.35 look at the application of that principle to some scenarios detailing the use of the cash raised. The questions are: is the use of the funds linked; and if so, does the linked transaction, taken together with the equity issue, result in an increase in qualifying consideration for the company issuing the shares?

### Recapitalisation of the company for regulatory reasons

12.17 Suppose that the company is subject to a regulatory regime that requires it to maintain a specified level of net assets. The company's position and performance has deteriorated and it needs to raise funds, by an equity issue, to maintain its regulatory compliance and hence the continuation of its business. The cash received is employed as working capital.

12.18 Unless the company needs to hold the funds raised in some particular asset within its business, eg, if the regulatory requirement is to hold the funds in a particular type of asset, then there is no linked transaction. Accordingly, the profit is a realised one. Even so, it seems unlikely that in practice the company would make a distribution from it as to do so would reduce the company's regulatory capital again.

12.19 If there were a need to hold the funds in some particular asset category, then consideration would need to be given as to whether the specific asset meets the definition of qualifying consideration (see 3.11). To the extent that the asset is qualifying consideration the reserve that is created would be realised (albeit its distribution may not be a practical proposition from a regulatory perspective as noted above).

### Recapitalisation of a subsidiary company, with equity, for regulatory reasons

12.20 The company is a holding company that holds a subsidiary that is subject to a regulatory regime that requires it to maintain a specified level of net assets. The subsidiary's position and performance has deteriorated and the subsidiary needs to raise funds, by an equity issue, to maintain its regulatory compliance and hence the continuation of its business. The company (that is, the holding company of the

regulated subsidiary) raises the cash by an equity issue of its own and uses the cash to subscribe for equity in the subsidiary.

12.21 The regulatory necessity to recapitalise the subsidiary is enough for the company's onward investment of the funds to be linked. In this case the cash has been invested in equity shares in a subsidiary which will not be qualifying consideration (see 4.10), and thus the reserve is unrealised.

### Recapitalisation of a subsidiary company, with equity, out of commercial necessity

12.22 The case here is similar to that above save that the subsidiary is not regulated. It is, however, in financial difficulties and needs funds to continue in business. The company (that is, the holding company of the troubled subsidiary) raises the cash by an equity issue of its own and uses the cash to subscribe for equity in the subsidiary.

12.23 The commercial necessity to recapitalise the subsidiary is enough for the company's onward investment of the funds to be linked. As with the previous example the cash has been invested in equity shares in a subsidiary, which will not be qualifying consideration (see 4.10), and thus the reserve is unrealised.

### Recapitalisation of a subsidiary company, with inter-company debt, out of commercial necessity

12.24 Assume that the facts are the same as the previous example except that the cash raised by the company is lent to the subsidiary rather than the company's subscribing for subsidiary shares.

12.25 Again the commercial necessity to recapitalise the subsidiary is enough for the company's onward lending of the funds to be linked. In this case, the cash has been turned into an inter-company debt receivable. Whilst an inter-company debt receivable can be qualifying consideration (see 3.11(d)), where the funds have been lent to the subsidiary in view of, say, its troubled financial condition, then it is very unlikely that the debt would meet the tests necessary to be qualifying consideration and as such the reserve would be unrealised. A loan to a financially troubled subsidiary may also be on subordinated terms (such as a contingent loan) and so would make it even less likely that the definition of qualifying consideration would be met.

### Repayment of the company's own debt

12.26 In this scenario the cash raised as new equity is used to repay some of the company's debt. There might be a variety of reasons for this. For example, the company may be rebalancing its gearing ratio for the long term, say because credit markets will not enable it to sustain the previous high level. Or it might be that the company needs to repay that debt in order to survive and has no other sources of liquidity but an equity raising.

12.27 The commercial necessity to repay debt, or even the management intention to do so, is enough for the company's debt repayment to be linked. However, this does not prevent a realised profit arising. The reserve will in fact be realised as release or settlement of debt is itself a form of qualifying consideration (see 3.11(c)).

12.28 However, if the debt arose from the acquisition of an asset that does not meet the definition of qualifying consideration and the repayment through the equity issue was planned at the time of the acquisition of the asset, the reserve will be unrealised.

### Raising cash to be used to fund possible, unspecified acquisitions

12.29 In this scenario the company believes that there will be opportunities, in the medium term, to acquire some companies on favourable terms. It therefore raises cash now in order to move quickly if a target is identified.

12.30 There is not a strong enough nexus between the fund raising and an actual, specific acquisition. Acquisitions are the motivation, but there is not a specific target. In addition, a change in commercial circumstances is a realistic possibility (in a similar way to the sufficient time elapsing during in a planned transaction sequence such that commercial circumstances could change and the rest of the sequence not go ahead – see paragraph 3.74 above). The nexus is too weak for there to be linkage under paragraph 3.5.

12.31 Thus subject to any arrangement or intention to hold the funds in non-qualifying consideration form, here a realised profit will result.

### Using the cash received to fund a specific acquisition – where the placing and acquisition are inter-conditional

12.32 The company raises equity funds from placees and the placing and the acquisition are conditional upon each other.

12.33 The acquisition is linked (legally in this case). As the linked use of the cash is to acquire an equity investment that thereby becomes a subsidiary, the reserve will not be realised as the investment is not qualifying consideration as it is not readily convertible to cash (see 4.10).

### Other acquisition funding cases

12.34 Other acquisition funding cases will require careful examination to determine the level of linkage. The above two examples are at the opposite ends of the spectrum, one where the cash will be used to fund an acquisition, the other where it may or may not be used but in any event not immediately. Obviously there will be situations between these two extremes where judgement will need to be exercised. It should be recalled, however, that legal linkage is not a necessary test for linkage to exist. Simultaneously effecting a fund raising and an acquisition would also be very strong linkage; and few other types of circumstances are likely to be as non-specific and subject to change as the scenario involving possible but unspecified acquisitions.

## Disclosure

12.35 The July 2008 edition of the ASB newsletter *Inside Track* noted that the UITF had received a request for guidance about cash box structures. The UITF decided not to address this issue because it was a matter of the application of company law and was already being addressed by the Institutes. However, the issue reached the UITF agenda because some companies had failed to explain adequately, in their financial statements, why no share premium account arose on an issue of share at an apparent premium. When cash box structures are used, it is important that directors consider the adequacy of disclosures about their use and the consequential effect on items in financial statements.

~~LC, 29.10.10~~

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# APPENDIX **1**

## EXAMPLES OF THE APPLICATION OF SECTIONS 845 AND 846

### Example 1 - Transfer of an asset at book value applying section 845

A company has profits available for distribution of £10,000 on its profit and loss account. It sells a non-cash asset to its parent for a consideration of £20,000 which is equal to its book value. The market value of the asset is £60,000.

The company can apply section 845 in these circumstances and, as explained below, applying this section the distribution would be lawful. Section 845(2) provides that the amount of the distribution is taken to be zero because the amount of the consideration for the transfer is not less than the book value of the asset. Section 845(3) provides that, for the purposes of section 845(1)(a), the company's profits available for distribution are treated as increased by the amount (if any) by which the amount or value of any consideration for the transfer exceeds the book value of the asset. The adjustment in this case is therefore zero and the profits available for distribution in accordance with section 845(1)(a) are treated as £10,000. The company may therefore lawfully make the transfer of the asset because the distributable profits are treated as £10,000 and the amount of the distribution is treated as zero. Thus immediately after the transfer the company's distributable reserves remain £10,000.

| | |
|---|---|
| Realised profits brought forward | 10,000 |
| Adjustment for section 845(3) | - |
| Profits available for distribution | 10,000 |
| Distribution measured in accordance with section 845 | - |
| Balance carried forward on reserves | £10,000 |

Had the asset been revalued immediately before transfer to its market value of £60,000 the position (using section 846) would have been as follows:

| | |
|---|---|
| Realised profits brought forward | 10,000 |
| Unrealised profit arising from revaluation from book value (£20,000) to market value (£60,000) of the non-cash asset to be transferred to the parent | 40,000 |
| Profits treated as available for distribution in accordance with section 846 | 50,000 |
| Distribution measured as the difference between the ~~fair~~revalued book value of the asset (£60,000) and the consideration received (£20,000) | (40,000) |
| Balance carried forward on reserves | £10,000 |

Thus, it can be seen that, section 845 gives the same position before and after the transfer in this example as is given by revaluing the asset and using section 846.
The balance carried forward on reserves is a realised profit.

**Example 2 - Transfer of an asset at above book value applying section 845 where there is initially a positive balance of distributable reserves**

A company has profits available for distribution of £10,000 on its profit and loss account. It sells a non-cash asset to its parent for a consideration of £50,000 which exceeds its book value of £20,000. The market value of the asset is £60,000.

The company can apply section 845 in these circumstances and, as explained below, applying this section the distribution would be lawful. Section 845(2) provides that the amount of the distribution is taken to be zero because the amount of the consideration for the transfer is not less than the book value of the asset. Section 845(3) provides that, for the purposes of section 845(1)(a), the company's profits available for distribution are treated as increased by the amount (if any) by which the amount or value of any consideration for the transfer exceeds the book value of the asset. The adjustment in this case is therefore £30,000 and the profits available for distribution in accordance with section 845(1)(a) are treated as £40,000. The company may therefore lawfully make the transfer of the asset because the distributable profits are treated as £40,000 and the amount of the distribution is treated as zero.

| | |
|---|---|
| Realised profits brought forward | 10,000 |
| Adjustment for section 845(3): | |
| Increase in profits treated as available for distribution due to the consideration being in excess of the book value (£50,000 less £20,000) | 30,000 |
| Profits treated as available for distribution | 40,000 |
| Distribution measured in accordance with section 845 | - |
| Balance carried forward on reserves | £40,000 |

Whether or not the increase in reserves of £30,000 after the transfer is a realised profit depends on whether the consideration for the transfer is qualifying consideration.

If it is now assumed that the company revalued the asset to its market value of £60,000 it can again be seen that sections 845 and 846 give the same position after the transfer.

| | |
|---|---|
| Realised profits brought forward | 10,000 |
| Unrealised profit arising from revaluation from book value (£20,000) to market value (£60,000) of the non-cash asset to be transferred to the parent | 40,000 |
| Profits treated as available for distribution in accordance with section 846 | 50,000 |
| Distribution measured as the difference between the ~~fair~~revalued book value of the asset (£60,000) and the consideration received (£50,000) | (10,000) |
| Balance carried forward on reserves | £40,000 |

**Example 3 - Transfer of an asset at below book value applying section 845**

A company has profits available for distribution of £10,000 on its profit and loss account. It sells a non-cash asset to its parent for a consideration of £15,000 which is £5,000 below its book value of £20,000. The market value of the asset is £60,000.

The company can apply section 845 in these circumstances and, as explained below, applying this section the distribution would be lawful. Section 845(2) provides that the amount of the distribution is taken to be £5,000 because the amount of the consideration for the transfer is £15,000 and the book value of the asset is £20,000. Section 845(3) provides that, for the purposes of section 845(1)(a), the company's profits available for distribution are treated as increased by the amount (if any) by which the amount or value of any consideration for the transfer exceeds the book value of the asset. The adjustment in this case is therefore zero and the profits available for distribution in accordance with section 845(1)(a) are treated as £10,000. The company may therefore lawfully make the transfer of the asset because the distributable reserves are treated as £10,000 and the amount of the distribution is treated as £5,000. Thus immediately after the transfer the company's distributable reserves are £5,000.

| | |
|---|---|
| Realised profits brought forward | 10,000 |
| Adjustment for section 845(3) | - |
| Profits available for distribution | 10,000 |
| Distribution measured in accordance with section 845 (£20,000 - £15,000) | 5,000 |
| Balance carried forward on reserves | £5,000 |

The balance carried forward on reserves is a realised profit.

Again, if it is now assumed that the company revalued the asset to its market value of £60,000 it can be seen that sections 845 and 846 give the same position after the transfer.

| | |
|---|---|
| Realised profits brought forward | 10,000 |
| Unrealised profit arising from revaluation from book value (£20,000) to market value (£60,000) of the non-cash asset to be transferred to the parent | 40,000 |
| Profits treated as available for distribution in accordance with section 846 | 50,000 |
| Distribution measured as the difference between the revalued book value of the asset (£60,000) and the consideration received (£15,000) | (45,000) |
| Balance carried forward on reserves | £5,000 |

**Example 4 - Transfer of an asset at below book value applying section 845 in circumstances where distributable profits are zero immediately after the distribution**

A company has profits available for distribution of £5,000 on its profit and loss account. It sells a non-cash asset to its parent for a consideration of £15,000, which is £5,000 below its book value of £20,000. The market value of the asset is £60,000.

The company can apply section 845 in these circumstances and, as explained below, applying this section the distribution would be lawful. Section 845(2) provides that the amount of the distribution is taken to be £5,000 because the amount of the consideration for the transfer is £15,000 and the book value of the asset is £20,000. Section 845(3) provides that, for the purposes of section 845(1)(a), the company's profits available for distribution are treated as increased by the amount (if any) by which the amount or value of any consideration for the transfer exceeds the book value of the asset. The adjustment in this case is therefore zero and the profits available for distribution in accordance with section 845(1)(a) are treated as £5,000. The company may therefore lawfully make the transfer of the asset because the distributable reserves are treated as £5,000 and the amount of the distribution is treated as £5,000. Thus immediately after the transfer the company's distributable reserves are zero.

| | |
|---|---|
| Realised profits brought forward | 5,000 |
| Adjustment for section 845(3) | - |
| Profits available for distribution | 5,000 |
| Distribution measured in accordance with section 845 (£20,000 - £15,000) | 5,000 |
| Balance carried forward on reserves | - |

The balance carried forward on reserves is a realised profit.

Again, if it is now assumed that the company revalued the asset to its market value of £60,000 it can be seen that sections 845 and 846 give the same position after the transfer.

| | |
|---|---|
| Realised profits brought forward | 5,000 |
| Unrealised profit arising from revaluation from book value (£20,000) to market value (£60,000) of the non-cash asset to be transferred to the parent | 40,000 |
| Profits treated as available for distribution in accordance with section 846 | 45,000 |
| Distribution measured as the difference between the fair value of the asset (£60,000) and the consideration received (£15,000) | (45,000) |
| Balance carried forward on reserves | ~~£5,000~~ - |

**Example 45 - Transfer of an asset at above book value applying section 845 where there is initially a negative balance of distributable reserves**

A company has an accumulated deficit of £10,000 on its profit and loss account (ie, it has a deficit on its profits available for distribution). It sells a non-cash asset to its parent for a consideration of £50,000 compared with a book value of £20,000 and a market value of £60,000.

The company can apply section 845 in these circumstances although it starts with a negative balance of distributable profits. Section 845(3) provides that, for the purposes of section 845(1)(a), the company's profits available for distribution are treated as increased by the amount (if any) by which the amount or value of any consideration for the transfer exceeds the book value of the asset. The adjustment in this case is therefore £30,000 and the profits available for distribution in accordance with section 845(1)(a) are treated as £20,000. Section 845(2) provides that the amount of the distribution is taken to be zero because the amount of the consideration for the transfer is not less than the book value of the asset. The company may therefore lawfully make the transfer of the asset because the distributable reserves are treated as £20,000 and the amount of the distribution is treated as zero.

| | |
|---|---|
| Realised losses brought forward | (10,000) |
| Adjustment for section 845(3): | |
| Increase in profits treated as available for distribution due to the consideration being in excess of the book value (£50,000 less £20,000) | 30,000 |
| Profits treated as available for distribution | 20,000 |
| Distribution measured in accordance with section 845 | - |
| Balance carried forward on reserves | £20,000 |

Although the entire profit of £30,000 has been treated as realised for the purposes of the distribution, the balance carried forward on reserves falls to be treated in accordance with the normal rules. The analysis of reserves carried forward on reserves will depend on whether the transfer of the asset was for qualifying consideration. If the transfer was for qualifying consideration, the whole of the balance of £20,000 carried forward will be a realised profit. If the transfer was not for qualifying consideration, the profit arising on the transfer of the asset will be an unrealised profit and the analysis of reserves will be as follows:

| | |
|---|---|
| Realised losses | (10,000) |
| Unrealised profit | 30,000 |
| Balance on reserves | £20,000 |

The same position is achieved by revaluing the asset and applying section 846. The asset could be revalued from £20,000 to £60,000 (its market value) which results in an unrealised profit of £40,000. The distribution is measured at £10,000 being the difference between the ~~fair~~revalued book value of the asset and the consideration received on disposal. In accordance with section 846(2), the unrealised profit of £40,000 is treated as a realised profit for the purposes of determining the lawfulness of the distribution which consists of the sale of the non-cash asset. The profits treated as available for distribution under section 846 are

therefore £30,000 which is adequate to cover the distribution of £10,000. This may be summarised as follows:

| | |
|---|---|
| Realised losses brought forward | (10,000) |
| Unrealised profit arising from revaluation from book value (£20,000) to market value (£60,000) of the non-cash asset to be transferred to the parent | 40,000 |
| Profits treated as available for distribution in accordance with section 846 | 30,000 |
| Distribution measured as the difference between the ~~fair~~revalued book value of the asset (£60,000) and the consideration received (£50,000) | (10,000) |
| Balance carried forward on reserves | £20,000 |

The analysis of reserves carried forward will depend on whether the transfer of the non-cash asset was for qualifying consideration in the same way as described above under section 845.

The distribution in kind of the non-cash asset may therefore, in effect, be made out of unrealised profits without making good the shortfall on realised profits first. Whether or not the consideration for the transfer meets the definition of qualifying consideration has no effect of the lawfulness of the transfer but affects the disposition of the reserves following the transfer.

**Example 6 – Consideration of whether to transfer an asset at above book value where there is initially a negative balance of distributable reserves and where there are zero distributable profits after adjustment for section 845(3)**

A company has an accumulated deficit of £10,000 on its profit and loss account (ie, it has a deficit on its profits available for distribution). It sells a non-cash asset to its parent for a consideration of £30,000 compared with a book value of £20,000 and a market value of £60,000.

The company can begin to apply section 845 in these circumstances although it starts with a negative balance of distributable profits. Section 845(3) provides that, for the purposes of section 845(1)(a), the company's profits available for distribution are treated as increased by the amount (if any) by which the amount or value of any consideration for the transfer exceeds the book value of the asset. The adjustment in this case is therefore £10,000 and the profits available for distribution in accordance with section 845(1)(a) are therefore treated as zero. Although section 845(2) provides that the amount of the distribution is taken to be zero because the amount of the consideration for the transfer is not less than the book value of the asset, the company may not lawfully make the transfer of the asset under s845 because the distributable reserves treated as available are zero, which is not positive distributable reserves.

| | |
|---|---|
| Realised losses brought forward | (10,000) |
| Adjustment for section 845(3): | |
| Increase in profits treated as available for distribution due to the consideration being in excess of the book value (£30,000 less £20,000) | 10,000 |
| Profits treated as available for distribution | - |

Consequently the company may not lawfully transfer the asset.

The following shows the position had the company revalued the asset under s845 and applied section 846. The asset could be revalued from £20,000 to £60,000 (its market value) which results in an unrealised profit of £40,000. The distribution is measured at £30,000 being the difference between the fair value of the asset and the consideration received on disposal. In accordance with section 846(2), the unrealised profit of £40,000 is treated as a realised profit for the purposes of determining the lawfulness of the distribution which consists of the sale of the non-cash asset for less than its market value. The profits treated as available for distribution under section 846 are therefore £30,000, which is adequate to cover the distribution of £30,000. This may be summarised as follows:

| | |
|---|---|
| Realised losses brought forward | (10,000) |
| Unrealised profit arising from revaluation from book value (£20,000) to market value (£60,000) of the non-cash asset to be transferred to the parent | 40,000 |
| Profits treated as available for distribution in accordance with section 846 | 30,000 |
| Distribution measured as the difference between the fair value of the asset (£60,000) and the consideration received (£50,000) | (30,000) |
| Balance carried forward on reserves | - |

The distribution in kind of the non-cash asset may therefore, in effect, be made out of unrealised profits without making good the shortfall on realised profits first. Whether or not the consideration for the transfer meets the definition of qualifying consideration has no effect of the lawfulness of the transfer.

# APPENDIX 2

## NUMERICAL ILLUSTRATIONS FOR SECTION 6

The following are numerical illustrations of the eight examples discussed in Section 6 of the guidance. The illustrations reflect the application of the 10 Principles in 6.7 to 6.40 of Section 6. The assumptions set out in 6.~~43~~6A to 6.~~45~~6C of Section 6 apply to these numerical illustrations.

These illustrations are based on simple terms and conditions of the types of financial instruments concerned. Therefore, they cannot, and do not, purport to be representative of the accounting that may flow from more complex terms and conditions. Determining whether a financial instrument is debt, equity or is a compound instrument and/or contains embedded derivatives depends on a rigorous analysis of the relevant instruments' full terms and conditions.

~~IFRSs and converged UK GAAP (e.g. using FRS 26 'Financial instruments: Recognition and Measurement' and the fair value accounting rules in the Act)~~IFRSs do not distinguish between profits that are realised and those that are not. Under FRS 102 unrealised profits may be included in the profit and loss account when applying fair value accounting. Furthermore, as certain classes of share capital and their associated share premium have to be classified as liabilities and others split into debt and equity components, it is no longer possible to point to one place in the balance sheet that represents all of a company's share capital and share premium. Hence companies will need to maintain sufficient records to enable the tracking of their actual share capital and share premium and realised profits and thus their distributable profits. Companies may choose to do this in the form of memorandum accounts dealing with shares and options in relation to shares according to their legal form. Although, a company's annual statutory accounts prepared in accordance with IFRSs or ~~converged UK GAAP~~FRS 102 will form their relevant accounts for the purposes of section 836 of the Act, it will be necessary to reconcile these back to records such as these memorandum accounts to understand the legal position in respect of their share capital, share premium, realised and distributable profits. Such memorandum accounts are illustrated below in addition to the balance sheet position under IFRSs~~/converged UK GAAP~~ and FRS 102.

In the memorandum accounts, the realised profits available are shown for illustrative purposes as a separate component of equity.

In the IFRS/~~converged UK GAAP~~FRS 102 accounts, ~~"~~'Other ~~reserves"~~reserves' represent amounts taken to equity for accounting purposes but which do not form part of ~~"~~'share capital and undistributable ~~reserves".~~reserves'. For public companies in these illustrations, the expression ~~"~~'share capital and undistributable ~~reserves"~~reserves' for the purposes of section 831 comprises ~~"~~'Share ~~capital", "~~capital', 'Share ~~premium"~~premium' and ~~"~~'Capital redemption ~~reserve"~~reserve' . The P&L reserve is taken initially to be comprised wholly of realised profits.

For the avoidance of doubt, these illustrations do not purport to define the headings or reserve names within which amounts, thrown up only by IFRS/~~converged UK GAAP~~FRS 102 accounting, must as a matter of accounting convention be maintained within equity.

**Example 1 - Forward contract to repurchase own equity shares (Section 6, 6.46 – 6.50)**

A company has entered into a forward contract to repurchase 100 of its own equity shares from a third party in 5 years' time and the shares are to be cancelled on repurchase. These shares have a nominal value of £100 and are to be bought back for £100 (present value assumed to be £70). The company will buy the shares back, assuming it has sufficient distributable profits, and cancel them.

Under IAS 32~~/FRS 25~~, as the company will be required to deliver cash, the forward contract meets the definition of a financial liability.

**Journal entries for the IFRS ~~/ converged UK GAAP~~[51] balance sheet**

**On Day 1:**

| | |
|---|---|
| Dr Equity – Other reserves | £70 |
| Cr Liability | £70 |

Being the recognition of the liability under the forward contract.

Note that the liability amount is the discounted present value of the redemption amount and is assumed to be £70 in this example. This recognises that the company has purchased an interest in itself on day 1 with the consideration being deferred.

The debit of £70 that has been recorded in other reserves is not an accounting loss and does not affect distributable profits on day 1.

*Public company*
The recognition of the liability reduces net assets and hence restricts distributable profits for public companies as a result of the section 831 net assets test.

**During the 5 years:**

| | |
|---|---|
| Dr Profit & Loss - Interest expense | £30 |
| Cr Liability | £30 |

Being the accretion of the discounted liability to the redemption amount of £100.

Private company
Although the interest is charged to the profit and loss account, it is not a loss for the purposes of Part VIII of the Act. Thus it is not a realised loss.

Public company
However, for a public company, although realised profits have not decreased, net assets have decreased (as the liability has increased). Hence there is a restriction through the operation of section 831 on the profits available for distribution of £100 in total immediately prior to repurchase as a result of this transaction.

[51] FRS 102 does not require the recognition of the liability of £70.

**On settlement of the contract:**

| | |
|---|---|
| Dr Liability | £100 |
| Cr Cash | £100 |

Being the payment (or distribution) to settle the forward contract.

| | |
|---|---|
| Dr Equity – Profit & Loss reserve | £70 |
| Cr Equity – Other reserves | £70 |

Being the entry to reflect the consumption of distributable profits in the Profit & Loss reserve as a result of the payment to settle the forward contract.

| | |
|---|---|
| Dr Equity – Share capital | £100 |
| Cr Equity – Capital redemption reserve | £100 |

Being the transfer to maintain the capital of the company.

**Memorandum balance sheet**

| | **Before entering into forward** | **Enter into forward to repurchase shares** | **After entering into forward** | **Entries during the 5 years** | **Before repurchase** | **Repurchase entries** | **After repurchase** |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 100 | 0 | 0 | 0 | 100 | (100) | 0 |
| Assets | 200 | 0 | 0 | 0 | 200 | 0 | 200 |
| **Net assets** | **300** | **0** | **0** | **0** | **300** | **(100)** | **200** |
| | | | | | | | |
| Share capital | 200 | 0 | 0 | 0 | 200 | (100) | 100 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 100 | 100 |
| Realised profits | 100 | 0 | 0 | 0 | 100[+] | (100) | 0 |
| **Shareholders' funds** | **300** | **0** | **0** | **0** | **300** | **(100)** | **200** |

[+] £100 represents the maximum profits available for distribution but for a public company this will be restricted by £100, immediately prior to repurchase, through the operation of section 831, which is applied to the section 836 relevant accounts (ie, the IFRS ~~/ converged UK GAAP~~ balance sheet below) which show that net assets are equal to share capital and undistributable reserves.

For the purposes of section 831, in this illustration "'share capital and undistributable ~~reserves"~~reserves' comprise "'Share ~~capital", "~~capital', 'Share ~~premium"~~premium' and "'Capital redemption ~~reserve".~~reserve'.

## IFRS ~~/ converged UK GAAP~~ balance sheet

| | Before entering into forward | Enter into forward to repurchase shares | After entering into forward | Entries during the 5 years | Before repurchase | Repurchase entries | After repurchase |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 100 | 0 | 100 | 0 | 100 | (100) | 0 |
| Assets | 200 | 0 | 200 | 0 | 200 | 0 | 200 |
| Liabilities | 0 | (70) | (70) | (30) | (100) | 100 | 0 |
| **Net assets** | **300** | **(70)** | **230** | **(30)** | **200** | **0** | **200** |
| | | | | | | | |
| Share capital | 200 | 0 | 200 | 0 | 200 | (100) | 100 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 100 | 100 |
| Other reserves | 0 | (70) | (70) | 0 | (70) | 70 | 0 |
| P&L reserve | 100 | 0 | 100 | (30) | 70 | (70) | 0 |
| **Shareholders' equity** | **300** | **(70)** | **230** | **(30)** | **200** | **0** | **200** |

**Example 2 - Written option to repurchase own equity shares (Section 6, 6.51 to 6.53)**

A company writes an option to repurchase 100 of its own equity shares from a third party in 5 years' time. These shares have a nominal value of £100 and will be bought back for £100 (present value assumed to be £70). If the option is exercised by the third party, the company intends to buy the shares back out of profits, assuming it has sufficient distributable profits, and to cancel them. The company receives a premium of £5 on issue of the option.

Under IAS 32~~/FRS 25~~, as the company will be required to deliver cash on exercise of the option, the contract meets the definition of a financial liability. The premium received on the issue of the option is required to be taken directly to equity.

**Journal entries for the IFRS ~~/ converged UK GAAP~~[52] balance sheet**

**On Day 1:**

| | |
|---|---|
| Dr Cash | £5 |
| Cr Equity – Other reserves | £5 |

Being the recognition of the premium received.

The option premium is a realised profit because the premium is regarded as a profit at law and has been received in the form of cash. For the purposes of this illustration, the premium has been credited to other reserves on initial receipt and has remained there on exercise (but it could be taken to P&L reserve as illustrated in example 4).

| | |
|---|---|
| Dr Equity – Other reserves | £70 |
| Cr Liability | £70 |

Being the recognition of the liability under the written option.

Note that the liability amount is the discounted present value of the redemption amount and is assumed to be £70 in this example. This recognises that the company has purchased an interest in itself on day 1 with the consideration being deferred.

The debit of £70 that has been recorded in other reserves is not an accounting loss and does not affect distributable profits on day 1.

Public company
The recognition of the liability reduces net assets but not share capital and undistributable reserves and hence restricts distributable profits by £70 for public companies as a result of the section 831 net assets test.

**During the 5 years:**

| | |
|---|---|
| Dr Profit & Loss - Interest expense | £30 |
| Cr Liability | £30 |

Being the accretion over 5 years of the discounted liability to the redemption value of £100.

Private company
Although the interest is charged to the profit and loss account, it is not a loss for the purposes of Part VIII of the Act. Thus it is not a realised loss.

[52] FRS 102 does not require the recognition of the liability of £70.

Public company
However, for a public company, although realised profits have not decreased, net assets have decreased (as the liability has increased). Hence there is a restriction through the operation of section 831 on profits available for distribution of the amount recognised a liability as a result of this transaction (in this case £100).

**On settlement of the contract:**

| | |
|---|---|
| Dr Liability | £100 |
| Cr Cash | £100 |

Being the payment (or distribution) to settle the forward contract.

| | |
|---|---|
| Dr Equity – Share capital | £100 |
| Cr Equity – Capital redemption reserve | £100 |

Being the transfer to maintain the capital of the company.

| | |
|---|---|
| Dr Equity – Profit & Loss reserve | £70 |
| Cr Equity – Other reserves | £70 |

Being the entry to reflect the consumption of distributable profits in the Profit & Loss reserve as a result of the payment on exercise.

## Memorandum balance sheet

| | Before issuing option | Issue of option to repurchase shares | After issuing option | Entries during the 5 years | Before exercise | Exercise entries | After exercise |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 100 | 5 | 105 | 0 | 105 | (100) | 5 |
| Assets | 200 | 0 | 200 | 0 | 200 | 0 | 200 |
| **Net assets** | **300** | **5** | **305** | **0** | **305** | **(100)** | **205** |
| | | | | | | | |
| Share capital | 200 | 0 | 200 | 0 | 200 | (100) | 100 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 100 | 100 |
| Realised profits | 100 | 5 | 105 | 0 | 105[+] | (100) | 5 |
| **Shareholders' funds** | **300** | ~~0~~**5** | **305** | **0** | **305** | **(100)** | **205** |

[+] £105 represents the maximum profits available for distribution but for a public company this will be restricted by £100, immediately prior to exercise, through the operation of section 831, which is applied to the section 836 relevant accounts (ie, the IFRS ~~/ converged UK GAAP~~ balance sheet below) which show that net assets only exceed share capital and undistributable reserves by £5.

For the purposes of section 831, in this illustration "'share capital and undistributable ~~reserves"~~reserves' comprise "'Share ~~capital", "~~capital', 'Share ~~premium"~~premium' and "'Capital redemption ~~reserve".~~reserve'.

## IFRS ~~/ converged UK GAAP~~ balance sheet

| | Before issuing option | Issue of option to repurchase shares | After issuing option | Entries during the 5 years | Before exercise | Exercise entries | After exercise |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 100 | 5 | 105 | 0 | 105 | (100) | 5 |
| Assets | 200 | 0 | 200 | 0 | 200 | 0 | 200 |
| Liabilities | 0 | (70) | (70) | (30) | (100) | 100 | 0 |
| **Net assets** | **300** | **(65)** | **235** | **(30)** | **205** | **0** | **205** |
| | | | | | | | |
| Share capital | 200 | 0 | 200 | 0 | 200 | (100) | 100 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 100 | 100 |
| Other reserves | 0 | (65) | (65) | 0 | (65) | 70 | 5 |
| P&L reserve | 100 | 0 | 100 | (30) | 70 | (70) | 0 |
| **Shareholders' equity** | **300** | **(65)** | **235** | **(30)** | **205** | **0** | **205** |

**Example 3 - Forward contract to issue own equity shares (Section 6, 6.54 to 6.56)**

A company contracts with a third party that the latter will subscribe in one year's time for 100 of the company's £1 ordinary shares for a fixed price of £2 each. The contract cannot be settled other than by an exchange of the fixed amount of cash (£200) for the fixed number (100) of shares. It is assumed that the fair value of the forward contract at inception is zero and thus no cash is paid or received at that date. The functional currency of the company is pounds sterling.

No accounting entries are made on inception of the contract because no cash is paid or received since the contract's initial fair value is zero. This forward contract to deliver a fixed number of the company's own shares in exchange for a fixed amount of cash in the company's functional currency meets the definition of an equity instrument in IAS 32. There are no other settlement alternatives otherwise than through the delivery of shares in exchange for cash. Consequently, the right to receive the cash in one year's time is not recognised by the company. Therefore, where a company enters into a forward contract to issue ordinary shares, the IAS 32~~/IFRS 25~~ accounting for such an arrangement raises no issues of distributable profits.

No accounting entries are made until the forward contract matures in one year's time, when the company receives £200 in cash and issues 100 ordinary shares to the contract's counterparty.

**Journal entries for the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet**

**On settlement of the contract:**

| | |
|---|---|
| Dr Cash | £200 |
| Cr Equity – Share capital | £100 |
| Cr Equity – Share premium | £100 |

Being the issue of the shares at a premium of £1 per share for £200 in cash.

**Memorandum balance sheet**

| | Before entering into forward | Enter into forward to issue shares | After entering into forward | On settlement of the contract | After settlement |
|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ |
| Cash | 100 | 0 | 100 | 200 | 300 |
| Assets | 200 | 0 | 200 | 0 | 200 |
| Liabilities | 0 | 0 | 0 | 0 | 0 |
| **Net assets** | **300** | **0** | **300** | **200** | **500** |
| | | | | | |
| Share capital | 200 | 0 | 200 | 100 | 300 |
| Share premium | 0 | 0 | 0 | 100 | 100 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 |
| Other reserves | 0 | 0 | 0 | 0 | 0 |
| Realised profits | 100 | 0 | 100[+] | 0 | 100 |
| **Shareholders' equity** | **300** | **0** | **300** | **200** | **500** |

[+] £100 represents the maximum profits available for distribution. For a public company there is no restriction through the operation of section 831, which is applied to the section 836 relevant accounts (ie, the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet below) which show that net assets exceeds share capital and undistributable reserves by £100.

For the purposes of section 831, in this illustration "'share capital and undistributable ~~reserves"~~reserves' comprise "'Share ~~capital", "~~capital', 'Share ~~premium"~~premium' and "'Capital redemption ~~reserve".~~reserve'.

**IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet**

| | Before entering into forward | Enter into forward to issue shares | After entering into forward | On settlement of the contract | After settlement |
|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ |
| Cash | 100 | 0 | 100 | 200 | 300 |
| Assets | 200 | 0 | 200 | 0 | 200 |
| Liabilities | 0 | 0 | 0 | 0 | 0 |
| **Net assets** | **300** | **0** | **300** | **200** | **500** |
| | | | | | |
| Share capital | 200 | 0 | 200 | 100 | 300 |
| Share premium | 0 | 0 | 0 | 100 | 100 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 |
| Other reserves | 0 | 0 | 0 | 0 | 0 |
| P&L reserve | 100 | 0 | 100 | 0 | 100 |
| **Shareholders' equity** | **300** | **0** | **300** | **200** | **500** |

**Example 4 - Written option to issue own equity shares (Section 6, 6.57 to 6.58)**

A company issues an option allowing the holder to subscribe for 100 £1 ordinary shares for £1 each in one years' time. The functional currency of the company is pounds sterling. The option cannot be settled other than by an exchange of the cash in the functional currency of the company for the fixed number of shares. The holder makes an immediate payment of £5 to the company for the granting of this option.

The option is an equity instrument. Accordingly, the £5 received is credited directly to equity funds. The £5 is not an accounting profit. The £5 credit remains in equity funds irrespective of whether the option is exercised or lapses. If the option is exercised, the £100 is also credited directly to equity funds in the normal way.

**Journal entries for the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet**

**On Day 1:**

| | |
|---|---|
| Dr Cash | £5 |
| Cr Equity – Other reserves | £5 |

Being the receipt of the option premium.

In law the premium received is a profit at the outset, and a realised profit because it is received in cash. For the purposes of this illustration the premium has been credited to Other reserves on initial receipt and is transferred to the Profit & Loss reserve when the option is exercised.

**On Exercise:**

| | |
|---|---|
| Dr Cash | £100 |
| Cr Equity - Share capital | £100 |
| Dr Equity – Other reserves | £5 |
| Cr Equity – Profit & Loss reserve | £5 |

Being the entries for the issue of the new ordinary shares and receipt of the subscription monies and the transfer of the option premium to Profit & Loss reserve.

**Memorandum balance sheet**

| | **Before issuing option** | **Issue of option to issue shares** | **After issuing option** | **On exercise** | **After exercise** |
|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ |
| Cash | 100 | 5 | 105 | 100 | 205 |
| Assets | 200 | 0 | 200 | 0 | 200 |
| Liabilities | 0 | 0 | 0 | 0 | 0 |
| **Net assets** | **300** | **5** | **305** | **100** | **405** |
| | | | | | |
| Share capital | 200 | 0 | 200 | 100 | 300 |
| Share premium | 0 | 0 | 0 | 0 | 0 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 |
| Other reserves | 0 | 0 | 0 | 0 | 0 |
| Realised profits | 100 | 5 | 105[+] | 0 | 105 |
| **Shareholders' equity** | **300** | **~~0~~5** | **305** | **100** | **405** |

[+] £105 represents the maximum profits available for distribution. For a public company there will be no restriction through the operation of section 831, which is applied to the section 836 relevant accounts (ie, the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet below) which show that net assets exceed share capital and undistributable reserves by £105.

For the purposes of section 831, in this illustration "'share capital and undistributable reserves"reserves' comprise "'Share capital", "capital', 'Share premium"premium' and "'Capital redemption reserve".reserve'.

**IFRS / converged UK GAAP/FRS 102 balance sheet**

| | Before issuing option | Issue of option to issue shares | After issuing option | On exercise | After exercise |
|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ |
| Cash | 100 | 5 | 105 | 100 | 205 |
| Assets | 200 | 0 | 200 | 0 | 200 |
| Liabilities | 0 | 0 | 0 | 0 | 0 |
| **Net assets** | **300** | **5** | **305** | **100** | **405** |
| | | | | | |
| Share capital | 200 | 0 | 200 | 100 | 300 |
| Share premium | 0 | 0 | 0 | 0 | 0 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 |
| Other reserves | 0 | 5 | 5 | (5) | 0 |
| P&L reserve | 100 | 0 | 100 | 5 | 105 |
| **Shareholders' equity** | **300** | **5** | **305** | **100** | **405** |

**Example 5 - Convertible debt (Section 6, 6.59 to 6.61)**

A company issues a 5% £100 10-year convertible bond for £100. The bond is convertible, at the holder's option, into 100 £1 ordinary shares at the end of year 10. If not converted the bond is redeemable at the end of year 10 at par. The conversion feature cannot be settled other than by an exchange of the bond for the fixed number of shares. The company's functional currency is pounds sterling. There are no other features of the bond's terms and conditions that would deny equity treatment for the equity conversion option.

IAS 32~~/FRS 25 require~~ requires, where ~~their~~its conditions are met, that convertible debt is split into its constituent components of an unconvertible debt (assumed fair value, £60) and a written option to subscribe for ordinary shares (the equity conversion option). The latter component is accounted for in the same way as the stand-alone written option described in Example 4 above.

**Journal entries for the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet**

**On Day 1:**

| | |
|---|---|
| Dr Cash | £100 |
| Cr Liability | £60 |
| Cr Equity – Other reserves | £40 |

Being the recognition of the constituent components.

The split accounting is determined by computing the fair value of the debt component and assigning to the equity component the difference between the value of the debt and the proceeds of the bond issue. The fair value of the debt component is calculated as the present value of the repayment at maturity plus the present value of the future coupon payments (which are lower than those for an unconvertible debt due to the presence of the conversion opportunity). The discount rate used in calculating the present values is the prevailing market interest rate at the date the bonds were issued for a similar debt without the conversion option. For the purposes of this illustration, it is assumed that the split accounting is determined as £60 attributable to the liability component and £40 to the equity component.

The initial credit to equity is not a profit. It is not an accounting profit because in accounting terms it is the equivalent of an equity instrument. As a matter of law, it is not a profit either, because the proceeds received are in consideration for taking on a liability, albeit a liability that is not fully reflected in the accounts.

**Over the 10 year life of debt:**

| | |
|---|---|
| Dr Profit & Loss - Interest expense | £90 |
| Cr Cash | £50 |
| Cr Liability | £40 |

Being the recognition of 10 annual coupons of £5 each and the total additional interest of £40 to accrete the liability up to the redemption value. The allocation of the £90 among the 10 years' profit and loss accounts is determined using the appropriate method stipulated under the relevant accounting standard.

| | |
|---|---|
| Dr Equity – Other reserves | £40 |
| Cr Equity – Profit & Loss reserve | £40 |

As the change to the liability becomes fully reflected in the accounts as a loss by virtue of the initial treatment through the additional interest charge, then the portion of the proceeds

(£40) initially credited directly to equity offsets the impact of the initial treatment. For the purposes of this illustration, the amounts have been transferred from the Other reserves to the Profit &Loss reserve to reflect this.

**At maturity (if conversion occurs):**

| | |
|---|---|
| Dr Liability | £100 |
| Cr Equity - Share capital) | £100 |

If the debt converts, the £100 is credited direct to shareholders' funds.

**At maturity on redemption (if conversion does not occur):**

| | |
|---|---|
| Dr Liability | £100 |
| Cr Cash | £100 |

Recording the cash settlement of the liability.

**Conversion**

**Memorandum balance sheet**

| | **Before issuing convertible debt** | **Issue of convertible debt** | **After issuing convertible debt** | **Entries during the 10 years** | **Before conversion** | **Conversion entries** | **After conversion** |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 100 | 100 | 200 | (50) | 150 | 0 | 150 |
| Assets | 250 | 0 | 250 | 0 | 250 | 0 | 250 |
| Liabilities | 0 | (100) | (100) | 0 | (100) | 100 | 0 |
| **Net assets** | **350** | **0** | **350** | **(50)** | **300** | **100** | **400** |
| | | | | | | | |
| Share capital | 200 | 0 | 200 | 0 | 200 | 100 | 300 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other reserves | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Realised profits | 150 | 0 | 150 | (50) | 100[+] | 0 | 100 |
| **Shareholders' equity** | **350** | **0** | **350** | **(50)** | **300** | **100** | **400** |

[+] £100 represents the maximum profits available for distribution. For a public company there is no restriction through the operation of section 831, which is applied to the section 836 relevant accounts (ie, the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet below) which show that net assets exceed share capital and undistributable reserves by £100.

For the purposes of section 831, in this illustration ~~"~~'share capital and undistributable ~~reserves"~~reserves' comprise ~~"~~'Share ~~capital", "~~capital', 'Share ~~premium"~~premium' and ~~"~~'Capital redemption ~~reserve".~~reserve'.

**IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet**

| | Before issuing convertible debt | Issue of convertible debt | After issuing convertible debt | Entries during the 10 years | Before conversion | Conversion entries | After conversion |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 100 | 100 | 200 | (50) | 150 | 0 | 150 |
| Assets | 250 | 0 | 250 | 0 | 250 | 0 | 250 |
| Liabilities | 0 | (60) | (60) | (40) | (100) | 100 | 0 |
| **Net assets** | **350** | **40** | **390** | **(90)** | **300** | **100** | **400** |
| | | | | | | | |
| Share capital | 200 | 0 | 200 | 0 | 200 | 100 | 300 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other reserves | 0 | 40 | 40 | (40) | 0 | 0 | 0 |
| P&L reserve | 150 | 0 | 150 | (50) | 100 | 0 | 100 |
| **Shareholders' equity** | **350** | **40** | **390** | **(90)** | **300** | **100** | **400** |

## Redemption

## Memorandum balance sheet

| | Before issuing convertible debt | Issue of convertible debt | After issuing convertible debt | Entries during the 10 years | Before redemption | Redemption entries | After redemption |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 100 | 100 | 200 | (50) | 150 | (100) | 50 |
| Assets | 250 | 0 | 250 | 0 | 250 | 0 | 250 |
| Liabilities | 0 | (100) | (100) | 0 | (100) | 100 | 0 |
| **Net assets** | **350** | **0** | **350** | **(50)** | **300** | **0** | **300** |
| | | | | | | | |
| Share capital | 200 | 0 | 200 | 0 | 200 | 0 | 200 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other reserves | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Realised profits | 150 | 0 | 150 | (50) | 100[+] | 0 | 100 |
| **Shareholders' equity** | **350** | **0** | **350** | **(50)** | **300** | **0** | **300** |

[+] £100 represents the maximum profits available for distribution. For a public company there is no restriction through the operation of section 831, which is applied to the section 836 relevant accounts (ie, the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet below) which show that net assets exceed share capital and undistributable reserves by £100.

For the purposes of section 831, in this illustration "'share capital and undistributable reserves comprise "'Share ~~capital", "~~capital', 'Share ~~premium"~~premium' and "'Capital redemption ~~reserve".~~reserve'.

## IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet

| | Before issuing convertible debt | Issue of convertible debt | After issuing convertible debt | Entries during the 10 years | Before redemption | Redemption entries | After redemption |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 100 | 100 | 200 | (50) | 150 | (100) | 50 |
| Assets | 250 | 0 | 250 | 0 | 250 | 0 | 250 |
| Liabilities | 0 | (60) | (60) | (40) | (100) | 100 | 0 |
| **Net assets** | **350** | **40** | **390** | **(90)** | **300** | **0** | **300** |
| | | | | | | | |
| Share capital | 200 | 0 | 200 | 0 | 200 | 0 | 200 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other reserves | 0 | 40 | 40 | (40) | 0 | 0 | 0 |
| P&L reserve | 150 | 0 | 150 | (50) | 100 | 0 | 100 |
| **Shareholders' equity** | **350** | **40** | **390** | **(90)** | **300** | **0** | **300** |

**Example 6 - Preference shares presented as liabilities (Section 6, 6.62 to 6.70)**

A company issues for £110 (being fair value) in cash 100 of its 5% £1 preference shares which are mandatorily redeemable in 5 years' time for £125. The 5% coupons are non-discretionary, cumulative and payable annually. At redemption the company redeems them wholly out of distributable profits.

On issue of the redeemable preference shares the company is required to present these shares as a financial liability of £110, because the issuer has an obligation to transfer cash to the holder of the shares for both the principal and coupons and £110 is the fair value of the shares.

**Journal entries for the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet**

**On day 1:**

| | |
|---|---|
| Dr Cash | £110 |
| Cr Liability | £110 |

Being the recognition of the financial liability under IAS 32~~/FRS 25~~.

**Entries during the 5 years:**

| | |
|---|---|
| Dr Profit & Loss - Interest expense | £40 |
| Cr Cash | £25 |
| Cr Liability | £15 |

Being the recognition of the £5 annual non-discretionary dividends and the accretion of the liability over time, such that by redemption, the carrying amount of the liability is equal to the redemption price of £125. The allocation of the £40 among the 5 years' profit and loss accounts is determined using the appropriate method stipulated by the relevant accounting standard.

The presentation of the nominal value of £100 of, and the £10 of share premium associated with, the preference shares as a debt has no effect on the determination of the company's realised profits. The accrued dividend and the accrued redemption premium that is presented as an "~~'~~interest ~~charge"~~charge' in the profit and loss account, and thus an accounting loss, is not, as a matter of law, a loss, as it is a distribution at the time it is actually made as such in law. Hence it is not until dividends (and the redemption premium) take legal effect that distributable profits are consumed by the distribution.

Public company
Notwithstanding that there is no consumption of distributable profits until such time that the dividends (and redemption premium) have legal effect, the accounting liability recognised for accrued but unpaid preference dividends and the accreted redemption premium reduces net assets. Therefore under section 831 there is a restriction on profits available for distribution equal to the amount of the reduction in net assets. Just before redemption, and assuming that the preference dividends have been paid, the section 831 restriction will be equal to the reduction in net assets of £15. This can be observed by comparing the realised profits in the Memorandum balance sheet (£175) with the Profit & Loss reserve (£160) in the IFRS~~ / converged UK GAAP~~/FRS 102 balance sheet.

**Entries on redemption:**

| | |
|---|---|
| Dr Liability | £125 |
| Cr Cash | £125 |

At the end of year 5, the company delivers £125 in cash to the shareholder, who delivers 100 of the company's (£1) redeemable preference shares. The company sets its cash payment of £125 against the financial liability.

### Capital maintenance considerations

In addition, the company has to comply with the Act. Consequently, under section 733 of the Act there has to be a credit to capital redemption reserve equal to the nominal value of the preference shares redeemed that had been presented within liabilities. A corresponding debit is also made to distributable profits (the rationale for which is set out below).

At the same time the £10 of share premium, previously represented by the accounting liability, now falls to be included in the share premium account. A corresponding debit is made to distributable profits (the rationale for which is set out below).

**Additional entries required on redemption due to capital maintenance rules:**

| | |
|---|---|
| Dr Equity - Profit & Loss reserve | £110 |
| Cr Equity - Capital redemption reserve | £100 |
| Cr Equity - Share premium | £10 |

Being the entry to the Profit & Loss reserve which together with the debit for the accrued redemption premium (£15) ensures that £125 of distributable profits is consumed by the redemption price, as required by law. The entry to the Capital redemption reserve is the entry to reflect the legal preservation of the company's capital on redemption out of distributable profits. The £10 entry to the share premium account reflects the legal preservation of the initial share premium.

**Memorandum balance sheet**

| | **Before issuing preference shares** | **Issue of preference shares** | **After issuing preference shares** | **Entries during the 5 years** | **Before redemption** | **Redemption entries** | **After redemption** |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 100 | 110 | 210 | (25) | 185 | (125) | 60 |
| Assets | 300 | 0 | 300 | 0 | 300 | 0 | 300 |
| Liabilities | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **Net assets** | **400** | **110** | **510** | **(25)** | **485** | **(125)** | **360** |
| | | | | | | | |
| Share capital | 200 | 100 | 300 | 0 | 300 | (100) | 200 |
| Share premium | 0 | 10 | 10 | 0 | 10 | 0 | 10 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 100 | 100 |
| Realised profits | 200 | 0 | 200 | (25) | 175[+] | (125) | 50 |
| **Shareholders' equity** | **400** | **110** | **510** | **(25)** | **485** | **(125)** | **360** |

[+] £175 represents the maximum profits available for distribution but for a public company this will be restricted by £15 through the operation of section 831, which is applied to the section 836 relevant accounts (ie, the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet below) which show that net assets only exceed share capital and undistributable reserves by £160.

For the purposes of section 831, in this illustration ~~"~~'share capital and undistributable ~~reserves"~~reserves' comprise ~~"~~'Share ~~capital", "~~capital', 'Share ~~premium"~~premium' and ~~"~~'Capital redemption ~~reserve".~~reserve'.

**IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet**

| | Before issuing preference shares | Issue of preference shares | After issuing preference shares | Entries during the 5 years | Before redemption | Redemption entries | After redemption |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 100 | 110 | 210 | (25) | 185 | (125) | 60 |
| Assets | 300 | 0 | 300 | 0 | 300 | 0 | 300 |
| Liabilities | 0 | (110) | (110) | (15) | (125) | 125 | 0 |
| **Net assets** | **400** | **0** | **400** | **(40)** | **360** | **0** | **360** |
| | | | | | | | |
| Share capital | 200 | 0 | 200 | 0 | 200 | 0 | 200 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 10 | 10 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 100 | 100 |
| P&L reserve | 200 | 0 | 200 | (40) | 160 | (110)* | 50 |
| **Shareholders' equity** | **400** | **0** | **400** | **(40)** | **360** | **0** | **360** |

* Redemption price consumption of distributable profits of £125 = £110 debit at redemption + £15 debit over period to redemption as the additional interest charge (£40-£25).

**Example 7 - Mandatorily redeemable preference shares (Section 6, 6.71 to 6.77)**

A company issues £100 nominal value of its £1 preference shares for £110 in cash. These shares are redeemable in 5 years' time for £125. Dividends are discretionary and non-cumulative. Under IAS 32~~/IFRS 25~~ paragraphs 28 and AG37, these shares contain both a liability (assumed fair value, £90) and an equity component. Hence the instrument is classified as debt with an equity component for the dividend feature. It is assumed that over the five years, a total of £50 of discretionary dividends are paid. The accounting is set out below:

**Journal entries for the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet**

**On Day 1:**

| | |
|---|---|
| Dr Cash | £110 |
| Cr Liability | £90 |
| Cr Equity – Share capital | £20 |

Being the cash receipt on issuing the shares and recording of the appropriate liability and equity components.

Note that the fair value of the liability amount is the discounted present value of the redemption amount and is assumed to be £90 in this example. The balance (£20) of the proceeds is allocated to the equity component. For ease of this illustration, it is assumed that the entire share premium (£10) is included in the liability and that the credit to equity (£20) is all share capital.

The £20 credit to equity is not an accounting profit and as a matter of law forms part of share capital. This applies irrespective of the allocation of the £20 between share capital and share premium.

Public company
For the purposes of section 831, there is no restriction on profits available for distribution on issue of the preference shares as share capital and undistributable profits have increased by £20 and this is equal to the increase in net assets. The presentation of the balance (£90) of the shares and share premium has no impact on the section 831 calculation.

**During the 5 years:**

| | |
|---|---|
| Dr Profit & Loss - Interest expense | £35 |
| Cr Liability | £35 |

Being the accretion of the discounted liability to the redemption amount of £125.

*Private company*
The presentation of the discounted present value of the redemption amount of the preference shares as a liability has no effect on the determination of the company's realised profits. The interest expense from the accretion up to the full amount of the redemption price is presented as an accounting loss - as it is shown as an ~~"~~'interest ~~charge"~~charge'. Since the ultimate payment is either a distribution or a capital repayment, the ~~"~~'interest ~~charge"~~charge' is, as a matter of law, not a loss even though it is accounted for as if it were a loss.

Public company
However, for a public company, although realised profits have not decreased, net assets have decreased (as the liability has increased) over the 5 years. Hence, through the operation of section 831, there is a restriction on distributions of the amount recognised as a

liability, £35 in this case, by the redemption date. This can be observed by comparing the realised profits in the Memorandum balance sheet (£200) with the Profit & Loss reserve (£165) in the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet.

**During the 5 years:**

| | |
|---|---|
| Dr Equity – Profit & Loss reserve | £50 |
| Cr Cash | £50 |

Being the payment of the discretionary dividends during the term of the instrument.

**On redemption:**

| | |
|---|---|
| Dr Liability | £125 |
| Cr Cash | £125 |

Being the payment to redeem the shares.

**Capital maintenance considerations**

The company has to comply with the Act. Consequently, under section 733 of the Act there has to be a credit to capital redemption reserve equal to the nominal value of the preference shares redeemed that had been presented within liabilities. A corresponding debit is also made to distributable profits adjusted for the £20 originally taken to share capital (the rationale for which is set out below).

At the same time the £10 of share premium, previously represented by the accounting liability, now falls to be included in the share premium account. A corresponding debit is made to distributable profits (the rationale for which is set out below).

**Additional entries required on redemption due to capital maintenance rules:**

| | |
|---|---|
| Dr Equity – Profit & Loss reserve | £90 |
| Cr Equity - Capital redemption reserve | £100 |
| Dr Equity – Share capital | £20 |
| Cr Equity – Share premium | £10 |

Being the entry to the Profit & Loss reserve which together with the debit for the accrued redemption premium (£35) ensures that £125 of distributable profits is consumed by the redemption price, as required by law. The entry to the Capital redemption reserve is the entry to reflect the legal preservation of the company's capital on redemption out of distributable profits. The £20 debit to share capital is to eliminate the £20 originally recorded in respect to the shares which are now cancelled as a result of the redemption. The £10 entry to the share premium account reflects the legal preservation of the initial share premium. This share premium credit (£10), taken together with the capital redemption reserve credit, to the extent not matched by the elimination of share capital (£100 – 20 =£80), gives rise to a corresponding £90 debit to the profit and loss reserve, as referred to above.

## Memorandum balance sheet

| | Before issuing preference shares | Issue of preference shares | After issuing preference shares | Entries during the 5 years | Before redemption | Redemption entries | After redemption |
|---|---|---|---|---|---|---|---|
| | £ | | £ | £ | £ | £ | £ |
| Cash | 100 | 110 | 210 | (50) | 160 | (125) | 35 |
| Assets | 250 | 0 | 250 | 0 | 250 | 0 | 250 |
| **Net assets** | **350** | **110** | **460** | **(50)** | **410** | **(125)** | **285** |
| | | | | | | | |
| Share capital | 100 | 100 | 200 | 0 | 200 | (100) | 100 |
| Share premium | 0 | 10 | 10 | 0 | 10 | 0 | 10 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 100 | 100 |
| Realised profits | 250 | 0 | 250 | (50) | 200[+] | (125) | 75 |
| **Shareholders' funds** | **350** | **110** | **460** | **(50)** | **410** | **(125)** | **285** |

[+] £200 represents the maximum profits available for distribution but for a public company this will be restricted by £35 through the operation of section 831, which is applied to the section 836 relevant accounts (ie, the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet below) which show that net assets only exceed share capital and undistributable reserves by £165.

For the purposes of section 831, in this illustration ~~"~~'share capital and undistributable ~~reserves"~~reserves' comprise ~~"~~'Share ~~capital", "~~capital', 'Share ~~premium"~~premium' and ~~"~~'Capital redemption ~~reserve".~~reserve'.

## IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet

| | Before issuing preference shares | Issue of preference shares | After issuing preference shares | Entries during the 5 years | Before redemption | Redemption entries | After redemption |
|---|---|---|---|---|---|---|---|
| | £ | | £ | £ | £ | £ | £ |
| Cash | 100 | 110 | 210 | (50) | 160 | (125) | 35 |
| Assets | 250 | 0 | 250 | 0 | 250 | 0 | 250 |
| Liabilities | 0 | (90) | (90) | (35) | (125) | 125 | 0 |
| **Net assets** | **350** | **20** | **370** | **(85)** | **285** | **0** | **285** |
| | | | | | | | |
| Share capital | 100 | 20 | 120 | 0 | 120 | (20) | 100 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 10 | 10 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 100 | 100 |
| P&L reserve | 250 | 0 | 250 | (85) | 165 | (90)* | 75 |
| **Shareholders' equity** | **350** | **20** | **370** | **(85)** | **285** | **0** | **285** |

* Redemption price consumption of distributable profits of £125 = £90 debit at redemption + £35 debit over period to redemption as the additional interest charge.

**Example 8 - Convertible redeemable preference shares (Section 6, 6.78 to 6.87)**

A company issues for £100 in cash a non-cumulative 10% £100 10-year preference share. The 10% coupons are non-discretionary. The preference share is convertible at the holder's option at any time into 100 £1 ordinary shares. If the holder does not exercise its option to convert, the preference share is mandatorily redeemable for £100 at the end of year 10. The company's functional currency is pounds sterling. There are no other features of the preference share's terms and conditions that would deny equity treatment for the equity conversion option.

Under IAS 32~~ and FRS 25~~ paragraph 28, the convertible redeemable preference share is a compound instrument. The preference share has to be split accounted to separate the debt and equity components. The liability component comprises the host redeemable preference share and the non-discretionary coupons (assumed fair value, £60) and the equity component comprises the equity conversion option. The accounting is set out below:

**Journal entries for the IFRS~~ / converged UK GAAP~~/FRS 102 balance sheet**

**On Day 1:**

| | |
|---|---|
| Dr Cash | £100 |
| Cr Liability | £60 |
| Cr Equity – Share capital | £40 |

Being the recognition of the constituent liability and equity components.

The split accounting is determined by computing the fair value of the debt component and assigning to the equity component the difference between value of the debt component and the proceeds of the preference share issue. The fair value of the debt component is calculated as the present value of the repayment at final maturity (the only date at which cash could be paid) plus the present value of the future coupon payments (which are lower than those for an unconvertible preference share due to the presence of the conversion opportunity). The discount rate used in calculating the present values is the prevailing market coupon rate at the date the preference shares were issued for a similar preference shares without the conversion option. For the purposes of this illustration, it is assumed that the split accounting determined that £60 is the fair value attributable to the liability component and £40 to the equity component.

The £40 credit to equity is not an accounting profit and as a matter of law forms part of share capital.

**During the 10 years:**

| | |
|---|---|
| Dr Profit & Loss - Interest expense | £140 |
| Cr Cash | £100 |
| Cr Liability | £40 |

Being the recognition of the 10% coupon on the preference shares and the accretion of the liability component up to the redemption value.

Private company
The presentation of the discounted present value of the redemption amount of the preference shares as a liability has no effect on the determination of the company's realised profits. The interest expense from the accretion up to the full amount of the redemption price is presented as an accounting loss - as it is shown as an ~~"~~'interest ~~charge".~~charge'. Since the ultimate

payment is either a distribution or a capital repayment, the ~~"~~'interest ~~charge"~~charge' is, as a matter of law, not a loss even though it is accounted for as if it were a loss.

Public company
However, for a public company, although realised profits have not decreased, net assets have decreased (as the liability has increased) over the 5 years. Hence, through the operation of section 831, there is a restriction on distributions of the amount recognised as a liability, £40 in this case, by the redemption date. This can be observed by comparing the realised profits in the Memorandum balance sheet (£150) with the Profit & Loss reserve (£110) in the IFRS~~ / converged UK GAAP~~/FRS 102 balance sheet.

**On conversion (if conversion occurs):**

| | |
|---|---|
| Dr Liability | £100 |
| Cr Equity – Share capital | £100 |

Being the recognition of the equity issued to settle the liability.

In addition, the company has to respect the fact that as a matter of law there is only £100 of share capital in issue (not £140 taking this journal together with the original issue journal).

**Additional entries on conversion**

| | |
|---|---|
| Dr Equity - Share capital | £40 |
| Cr Equity - Profit & Loss reserve | £40 |

Being the entries to reflect the elimination of the prior accumulated debits to the profit and loss reserve in respect of the redemption price, with the corresponding adjustment taken to share capital leaving the balance there correctly representing just £100 of share capital, wholly classified as equity, post-conversion.

**On redemption (if conversion does not occur):**

| | |
|---|---|
| Dr Liability | £100 |
| Cr Cash | £100 |

Being the recognition of the settlement of the liability in cash.

**Capital maintenance considerations**
In addition, the company has to comply with the Act. Consequently, under section 733 of the Act there has to be a credit to capital redemption reserve equal to the nominal value of the preference shares redeemed that had been presented within liabilities. However, only £40 of this is matched by a corresponding debit to eliminate the share capital now cancelled on redemption. The balance of £60 is debited to the profit and loss reserve (see below).

**Additional entries required on redemption due to capital maintenance rules:**

| | |
|---|---|
| Dr Equity - Profit & Loss reserve | £60 |
| Dr Equity - Share capital | £40 |
| Cr Equity - Capital redemption reserve | £100 |

Being the entries required to reflect the cancellation and preservation of the company's capital on redemption and the charging of the balance of £60 against realised profits; together with the £40- already charged to the profit and loss reserves, which now consumes realised profits, this brings the total consumption of realised profits, on redemption, to the £100 redemption price in accordance with law.

## Conversion

### Memorandum balance sheet

| | Before issuing preference shares | Issue of preference shares | After issuing preference shares | Entries during the 10 years | Before conversion | Conversion entries | After conversion |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 200 | 100 | 300 | (100) | 200 | 0 | 200 |
| Assets | 250 | 0 | 250 | 0 | 250 | 0 | 250 |
| Liabilities | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **Net assets** | **450** | **100** | **550** | **(100)** | **450** | **0** | **450** |
| | | | | | | | |
| Share capital | 200 | 100 | 300 | 0 | 300 | 0 | 300 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other reserves | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Realised profits | 250 | 0 | 250 | (100) | 150[+] | 0 | 150 |
| **Shareholders' equity** | **450** | **100** | **550** | **(100)** | **450** | **0** | **450** |

[+] £150 represents the maximum profits available for distribution but for a public company this will be restricted by £40, immediately prior to conversion, through the operation of section 831, which is applied to the section 836 relevant accounts (ie, the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet below) which show that net assets only exceed share capital and undistributable reserves by £110.

For the purposes of section 831, in this illustration "'share capital and undistributable ~~reserves"~~reserves' comprise "'Share ~~capital", "~~capital', 'Share ~~premium"~~premium' and "'Capital redemption ~~reserve".~~reserve'.

### IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet

| | Before issuing preference shares | Issue of preference shares | After issuing preference shares | Entries during the 10 years | Before conversion | Conversion entries | After conversion |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 200 | 100 | 300 | (100) | 200 | 0 | 200 |
| Assets | 250 | 0 | 250 | 0 | 250 | 0 | 250 |
| Liabilities | 0 | (60) | (60) | (40) | (100) | 100 | 0 |
| **Net assets** | **450** | **40** | **490** | **(140)** | **350** | **100** | **450** |
| | | | | | | | |
| Share capital | 200 | 40 | 240 | 0 | 240 | 60 | 300 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other reserves | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| P&L reserve | 250 | 0 | 250 | (140) | 110 | 40 | 150 |
| **Shareholders' equity** | **450** | **40** | **490** | **(140)** | **350** | **100** | **450** |

## Redemption

### Memorandum balance sheet

| | Before issuing preference shares | Issue of preference shares | After issuing preference shares | Entries during the 10 years | Before redemption | Redemption entries | After redemption |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 200 | 100 | 300 | (100) | 200 | (100) | 100 |
| Assets | 250 | 0 | 250 | 0 | 250 | 0 | 250 |
| Liabilities | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **Net assets** | **450** | **100** | **550** | **(100)** | **450** | **(100)** | **350** |
| | | | | | | | |
| Share capital | 200 | 100 | 300 | 0 | 300 | (100) | 200 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 100 | 100 |
| Other reserves | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Realised profits | 250 | 0 | 250 | (100) | 150[+] | (100) | 50 |
| **Shareholders' equity** | **450** | **100** | **550** | **(100)** | **450** | **(100)** | **350** |

[+] £150 represents the maximum profits available for distribution but for a public company this will be restricted by £40 through the operation of section 831, which is applied to the section 836 relevant accounts (ie, the IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet below) which show that net assets only exceed share capital and undistributable reserves by £110.

For the purposes of section 831, in this illustration ~~"~~'share capital and undistributable ~~reserves"~~reserves' comprise ~~"~~'Share ~~capital", "~~capital', 'Share ~~premium"~~premium' and ~~"~~'Capital redemption ~~reserve".~~reserve'.

### IFRS ~~/ converged UK GAAP~~/FRS 102 balance sheet

| | Before issuing preference shares | Issue of preference shares | After issuing debt | Entries during the 10 years | Before redemption | Redemption entries | After redemption |
|---|---|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ | £ | £ |
| Cash | 200 | 100 | 300 | (100) | 200 | (100) | 100 |
| Assets | 250 | 0 | 250 | 0 | 250 | 0 | 250 |
| Liabilities | 0 | (60) | (60) | (40) | (100) | 100 | 0 |
| **Net assets** | **450** | **40** | **490** | **(140)** | **350** | **0** | **350** |
| | | | | | | | |
| Share capital | 200 | 40 | 240 | 0 | 240 | (40) | 200 |
| Share premium | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Capital redemption reserve | 0 | 0 | 0 | 0 | 0 | 100 | 100 |
| Other reserves | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| P&L reserve | 250 | 0 | 250 | (140) | 110 | (60)* | 50 |
| **Shareholders' equity** | **450** | **40** | **490** | **(140)** | **350** | **0** | **350** |

* Redemption price consumption of distributable profits of £100 = £60 debit at redemption + £40 debit over period to redemption as the additional interest charge.

# APPENDIX 3

## ~~NOTE OF LEGAL CONSIDERATIONS REPRODUCED FROM UITF ABSTRACT 38~~

~~The equivalent 2006 Act references have been added to the original note for ease of reference.~~

~~FRS 5 is not intended to affect the legal characterisation of a transaction, or to change the situation at law achieved by the parties to it (paragraph 46). Shares acquired by ESOP trusts and included in the balance sheet under this Abstract are not treasury shares as defined in the Companies Act 1985 (as amended by the Companies (Acquisition of Own Shares) (Treasury Shares) Regulations 2003) [s724 of the 2006 Act] or as defined by the Companies Act 1990 in the Republic of Ireland. Nor does the inclusion of the shares in the company's balance sheet as a deduction in arriving at shareholders' funds imply that they have been purchased by the company as a matter of law or that they are required to be cancelled, which would be the consequence of such a purchase except for shares held as treasury shares (in Great Britain sections 162(2) and 160(4) of the Companies Act 1985) [s706 of the 2006 Act].*~~

~~The UITF has received legal advice on the implications for companies' distributable profits when the accounting treatment required by this Abstract is followed. It has been advised that in Great Britain:~~

~~(a) Section 264 of the Companies Act 1985 [s831 of the 2006 Act] provides that a public company may only make a distribution if, and to the extent that, this will not reduce the company's net assets to less than an amount equal to the aggregate of its called up share capital and undistributable reserves. Section 270 [s836 of the 2006 Act] applies for the purposes of determining whether a distribution can be made without contravening sections 263, 264 or 265 [s830, s831 and s832 of the 2006 Act]. It provides that the amount of a distribution which can be made is determined by reference, inter alia, to the company's assets and liabilities as stated in the company's accounts. These are normally the company's last annual accounts (but may be initial or interim accounts). As the effect of the accounting treatment required by this Abstract would be that, in drawing up the accounts in question, any shares held by an ESOP would be recorded as a deduction in arriving at shareholders' funds rather than as an asset, it follows that the relevant aggregate asset value for the purposes of the definition of net assets in section 264(2) [s831(2) of the 2006 Act] would be reduced by a corresponding amount.~~

~~(b) In calculating a company's distributable profits, it is necessary to determine its "accumulated, realised profits so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made" (section 263(3) of the Companies Act 1985) [s830(2) of the 2006 Act].~~

~~The acquisition of shares by an ESOP does not, of itself, affect the company's realised profits or realised losses. The accounting treatment required by this Abstract, which requires a deduction in arriving at shareholders' funds and that no gain or loss should be recognised in the profit and loss account, is consistent with this analysis. This analysis holds good notwithstanding that an acquisition of treasury shares, with which an acquisition of shares by an ESOP has similarities, involves a deduction from distributable profits.~~

~~Although the acquisition of shares by an ESOP will not, of itself, result in a realised profit or loss for the company concerned, a company will still need to consider other transactions with the ESOP, for example a loan to the ESOP to fund acquisitions of shares, and these may affect the company's realised profits and losses.~~

~~(c) In determining whether a company has sufficient distributable profits and net assets in order lawfully to pay a dividend to its shareholders, under section 270(2) of the Companies~~

~~Act 1985 [s836(1) of the 2006 Act] the relevant accounts are the company's own individual accounts and not its consolidated accounts.~~

~~* The corresponding references in Northern Ireland are to articles 172(2) and 170(4) of the Companies (Northern Ireland) Order 1986 and in the Republic of Ireland to sections 211(2) and 208(a) of the Companies Act 1990. The corresponding references for the Republic of Ireland indicate the provisions dealing with the same topic as the sections in the Companies Act 1985 and are not identical in all cases. The Republic of Ireland references should be consulted for further information.~~

[Deleted]

# APPENDIX 4

## NUMERICAL ILLUSTRATIONS FOR SECTION 8

**Distinguishing the cumulative gain or loss in reserves from the pension surplus or deficit**

It is the cumulative gain or loss credited or debited to reserves in respect of a pension scheme, rather than the existence of a surplus or deficit, that affects the realised profits and losses of a company. Consider the example below of a scheme set up at the start of the year. For simplicity, current and deferred tax is ignored. The scheme has a surplus of 4 at the end of the year that would be reported on the company's balance sheet as an asset. Contributions have been paid which are equal to the expense recognised in the profit and loss account of 20. An actuarial gain of 4 has also been recognised in the STRGL.

***Originated scheme in deficit***

A cumulative charge will have been recognised equal to the net contributions paid since the inception of the scheme plus the amount of the deficit at the balance sheet date. This cumulative charge is a realised loss. No adjustment is therefore required in determining distributable reserves.

***Originated scheme in surplus***

A surplus on the balance sheet will usually represent a reduction in a cumulative charge. No adjustment is required in this case. This is illustrated in the following example.

| | Increase/ (decrease) in pension asset | (Reduction) in cash balance | Amount debited/ (credited) in reserves |
|---|---|---|---|
| Brought forward | 0 | | |
| Debited to profit and loss | (20) | | 20 |
| Credited in STRGL | 4 | | (4) |
| Contributions paid since the inception of the scheme | 201,000 | (20) | |
| Carried forwardLess: Surplus recognised on balance sheet | 4(750,000) | (20) | 16 |
| Cumulative charge within reserves | | | £250,000 |

The net effect oncumulative charge within reserves is a realised loss and no adjustment is required.

However, if there has been a cumulative amount credited to reserves, an adjustment will be required to arrive at distributable profit, unless the balance sheetcumulative credit meets the test in the aboveparagraph 8.5. This is illustrated in the following example is:.

| | | |
|---|---|---|
| Dr Pension assetContributions paid since the inception of the scheme | 4500,000 | |
| Dr ReservesLess: Surplus recognised on balance sheet | 16(750,000) | |
| Cr CashCumulative credit within reserves | £(250,000) | 20 |

It is the cumulative loss of 16 in the above example that has been debited to reserves in respect of the pension scheme that falls to be treated as realised, rather than any notional "credit" relating to the asset of 4.

**Establishing the effect on realised profits at a particular date**

~~This example illustrates the application of paragraph 8.14 of the guidance in the case where the company has recognised a pension asset on acquisition of an unincorporated business.~~

~~In 2005, a company acquired an unincorporated business and the fair values of the net assets recognised included a pension asset of 20. At 31 December 2007, cumulative post-acquisition contributions of 4 have been made and the asset has reduced to 18. The cumulative amount included in reserves is calculated~~The cumulative net credit is a realised profit only to the extent that it is represented by an asset that is to be recovered by refunds that have been agreed for a specific amount by the pension scheme trustees at the balance sheet date of the relevant accounts and the refunds will take the form of cash or other qualifying consideration. Being eligible for a refund when the scheme is wound up would not be sufficient. In any other case, when this test is not met, the cumulative credit of £250,000 is an unrealised profit and therefore not available for distribution.

***Practical application of originated scheme cumulative charge / credit***

It may not be practical for companies with long-established schemes to ascertain the net contributions less refunds to perform the calculation described above to calculate the cumulative charge or credit within reserves. However, taking the above example, it can be seen that it is only necessary to determine that the net contributions paid since the inception of the scheme exceed £750,000 to be sure that there is no unrealised profit.

***Scheme acquired in a past business combination with a surplus***

The need for adjustment is more difficult to identify when the pension scheme has been acquired as part of a business combination (see paragraph 8.13). In this case, it is necessary to identify whether there has been a post-acquisition cumulative charge or credit. This is illustrated in the following examples.

~~as follows:~~

| | | |
|---|---|---|
| ~~Surplus recognised in balance sheet~~Contributions paid post-acquisition | 500,000 | ~~18~~ |
| ~~Cumulative net contributions~~Less: Surplus recognised on balance sheet | (750,000) | ~~(4)~~ |
| Add: Surplus recognised on acquisition | 400,000 | ~~(20)~~ |
| ~~Amount included in~~Cumulative charge within reserves ~~(debit)~~ | £150,000 | ~~(6)~~ |

~~Another way of expressing the same calculation is as follows:~~

Although there is an asset representing the surplus on the balance sheet, there is a cumulative post-acquisition charge. No adjustment is therefore required in determining distributable reserves.

***Scheme acquired in a past business combination with a deficit***

It is possible for an unrealised profit to arise when there is no surplus in the balance sheet if there is a reduction in a deficit which exceeds the contributions paid. This is illustrated in the following example.

| | | |
|---|---|---|
| ~~Cumulative net contributions~~Contributions paid post-acquisition | 100,000 | ~~(4)~~ |
| ~~Surplus~~Add: Deficit recognised ~~in~~on balance sheet | ~~18~~250,000 | |
| Less: ~~Surplus~~Deficit recognised on acquisition | (~~20~~500,000) | |
| ~~Decrease in surplus recognised~~ | | ~~(2)~~ |
| ~~Amount included in~~Cumulative credit within reserves ~~(debit)~~ | £(150,000) | ~~(6)~~ |

~~It can be seen from this example that there must be a cumulative debit in reserves if the asset recognised in the balance sheet is less than the amount recognised on acquisition provided that the cumulative net post-acquisition contributions are not negative and the scheme has not been combined with any other scheme.~~

The cumulative credit within reserves is an unrealised profit. This is because the reduction in the pension liability from £500,000 to £250,000 is not readily convertible to cash (see paragraphs 3.9(g) and 3.9B). In this example, it reverses a previous charge of £100,000 but the balance of £150,000 is an unrealised profit.

# APPENDIX 5

## ILLUSTRATIVE EXAMPLES OF THE EFFECT OF THE PRINCIPLES RELATING TO FOREIGN CURRENCY SET OUT IN SECTION 11

### Example 1 – illustration of principles 1 and 2 (functional currency strengthens)

Principle 1: Realised profits and losses are measured by reference to the functional currency of the company.

Principle 2: An 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 a loss as a matter of law. Such an amount therefore cannot be a realised profit or loss.

Facts:

| | |
|---|---|
| Type of company | Private |
| Functional currency | Sterling |
| Share capital currency | Sterling |
| Presentation currency | Dollars |
| Opening exchange rate | £1 = $1.6 |
| Average exchange rate | £1 = $1.7 |
| Closing exchange rate (sterling has strengthened against the dollar) | £1 = $1.8 |

The company began the year with no cumulative translation difference (eg, there has been no exchange rate variation to date).

The company's assets and profits are as shown in the table below.

The company's functional and presentation balance sheets and income statements are as follows:

| | Opening balance sheet | Profit | Retranslation difference | Closing balance sheet |
|---|---|---|---|---|
| In functional currency | £ | £ | | £ |
| Share capital | 100 | | | 100 |
| Profit and loss account reserve (all realised) | 20 | 30 | | 50 |
| Net assets | 120 | 30 | | 150 |

| In presentation currency | $ | $ | $ | $ |
|---|---|---|---|---|
| | (at $1.6) | (at $1.7) | | |
| Share capital | 160 | | | 160 |
| Profit and loss account reserve | 32 | 51 | | 83 |
| Cumulative translation difference | - | | 27 | 27 |
| Net assets | 192 | 51 | 27 | 270* |

* Net assets of £150 translated at £1 = $1.8.

What are this company's realised profits for the purposes of Part 23?

In accordance with principle 1, the realised profits are measured in the functional currency. In accordance with principle 2, the cumulative translation difference of $27 is not a realised profit. The realised profits are therefore £50. The company could, therefore, so far as the Act is concerned, distribute £50, being $90 in presentation terms (£50 at $1.8) (note that the $83 shown in the profit and loss account reserve is the accumulation of functional currency profits translated at historical presentation rates). The retranslation process has no effect on the determination of realised profits, which occurs at the level of the underlying functional numbers.

Public companies should give consideration to principle 7 when applying the s831 net assets test, as the test operates by reference to the amounts shown in presentation currency, in contrast with the fact that realised profits are measured in the functional currency. In this example there is no restricting effect as the difference between the net assets of $270 and share capital of $160 is $110, which equates to £61 when translated at the closing rate, which is greater than the realised profits in functional currency terms.

**Example 2 – illustration of principles 1 and 2 (functional currency weakens)**

Principle 1: Realised profits and losses are measured by reference to the functional currency of the company.

Principle 2: An 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 a loss as a matter of law. Such an amount therefore cannot be a realised profit or loss.

Facts:

| | |
|---|---|
| Type of company | Private |
| Functional currency | Sterling |
| Share capital currency | Sterling |
| Presentation currency | Dollars |
| Opening exchange rate | £1 = $1.6 |
| Average exchange rate | £1 = $1.5 |
| Closing exchange rate (sterling has weakened against the dollar) | £1 = $1.3 |

The company began the year with no cumulative translation difference (eg, there has been no exchange rate variation to date).

The company's assets and profits are as shown in the table below.

The company's functional and presentation balance sheets and income statements are as follows:

| | Opening balance sheet | Profit | Retranslation difference | Closing balance sheet |
|---|---|---|---|---|
| In functional currency | £ | £ | | £ |
| Share capital | 100 | | | 100 |
| Profit and loss account reserve (all realised) | 20 | 30 | | 50 |
| Net assets | 120 | 30 | | 150 |
| In presentation currency | $ | $ | $ | $ |
| | (at $1.6) | (at $1.5) | | |
| Share capital | 160 | | | 160 |

| | | | | |
|---|---|---|---|---|
| Profit and loss account reserve | 32 | 45 | | 77 |
| Cumulative translation difference | - | | (42) | (42) |
| Net assets | 192 | 45 | (42) | 195* |

* Net assets of £150 translated at £1 = $1.3.

What are this company's realised profits for the purposes of Part 23?

In accordance with principle 1, the realised profits are measured in the functional currency. In accordance with principle 2, the cumulative translation difference of $(42) not a realised loss. The realised profits are therefore £50. The company could, therefore, so far as the Act is concerned, distribute £50, being $65 in presentation terms (£50 at $1.3) (note that the $77 shown in the profit and loss account reserve is the accumulation of functional currency profits translated at historical presentation rates). The retranslation process has no effect on the determination of realised profits, which occurs at the level of the underlying functional numbers.

Public companies should give consideration to principle 7 when applying the s831 net assets test, as the test operates by reference to the amounts shown in presentation currency, in contrast with the fact that realised profits are measured in the functional currency. Example 7 follows the same fact pattern as above but is for a public company and illustrates the resulting restriction.

**Example 3 – illustration of principle 3**

Principle 3: The profit or loss arising upon the necessary retranslation of an autonomous branch, from its functional currency into the functional currency of the company, is a realised profit or a loss to the extent that the branch net assets during the period, in relation to which the components of that profit or loss arise, were qualifying consideration.

Facts:

| | |
|---|---|
| Functional currency of company | Sterling |
| Functional currency of branch | Dollars |
| Presentation currency of company[53] | Sterling |
| Opening exchange rate | £1 = $2.0 |
| Closing exchange rate | £1 = $1.5 |

The company began the year with no cumulative translation difference (ie, there has been no exchange rate variation to date).

For simplicity and illustrative purposes it has been assumed that there has been no trading during the period, no interest has accrued on the loan and there are no intercompany balances.

The branch's functional currency balance sheets are as follows:

| | Opening balance sheet | Closing balance sheet |
|---|---|---|
| | $ | $ |
| Property, plant and equipment (land) | 30 | 30 |
| Cash | 30 | 30 |
| Loans | (6) | (6) |
| Net assets | 54 | 54 |
| Represented by: | | |
| Retained profits (all realised) | 54 | 54 |

When included in the functional currency balance sheet of the company (which currency is also its

[53] This example is not concerned with presentation currency issues. A presentation currency is included as a simplifying assumption.

presentation currency), the assets and liabilities of the branch will be stated as follows:

| | £ (at $2.0) | £ (at $1.5) |
|---|---|---|
| Property, plant and equipment (land) | 15 | 20 |
| Cash | 15 | 20 |
| Loans | (3) | (4) |
| Net assets | 27 | 36 |
| Represented by: | | |
| Cumulative translation difference | | 9 |
| Profit and loss account reserve | 27 | 27 |
| Total | 27 | 36 |

What are this company's realised profits, in relation to its branch, for the purposes of Part 23?

In accordance with principle 3, the cumulative translation difference needs to be analysed with reference to the assets and liabilities that give rise to the difference. In the example above, there is a net profit of 9 which comprises:

| | |
|---|---|
| Retranslation gain on property, plant and equipment | 5 |
| Retranslation gain on cash | 5 |
| Retranslation loss on loans | (1) |
| Total | 9 |

The gain on the property, plant and equipment is not a realised gain, as these assets do not constitute qualifying consideration. The gain on the cash balance held will be a realised gain as cash is qualifying consideration. The loss on the translation of the loan is a realised loss. Therefore, despite a net gain recorded in equity of 9, only 4 of this constitutes realised profit. In total the company's realised profits in relation to its branch are £31. Note that this amount is the realised profits of the branch measured in the company's functional currency in accordance with Principle 1; although the branch has profits of $54 in its branch functional currency of dollars, there is no concept of realised profits at branch level but only at company level where the functional currency is sterling and thus the $54 figure is of itself of no relevance.

If in the example above the company did not have any assets that comprise qualifying consideration, for example, if the cash was instead say an investment property then despite there being a net gain of 9 recognised in equity, the impact on distributable profits would be a reduction of 1, as the loss of the loan would be realised but the gains unrealised.

**Example 4 – illustration of principle 4**

Principle 4: Where a company's shares, whether those shares are classified as equity or debt for accounting purposes, are denominated in a currency other than the company's functional currency, the adjustment arising upon any translation for accounting purposes of the share capital is not a profit or loss at law. Such an amount therefore cannot be a realised profit or loss.

Facts:

| | |
|---|---|
| Functional currency | Sterling |
| Presentation currency | Sterling |
| Share capital currency | Euro |
| Nominal value of shares | €90 |
| Opening exchange rate | £1 = €1.8 |
| Closing exchange rate | £1 = €2.0 |
| Share classified as | Accounting equity |
| Share capital retranslated at balance sheet date | Yes |

There have been no translation differences on the share capital prior to the opening balance sheet.

The company has no other foreign (ie, non-sterling) assets or liabilities.

The company's functional and presentation currency balance sheets and income statements are as follows:

| | Opening balance sheet | Profit | Retranslation difference | Closing balance sheet |
|---|---|---|---|---|
| | £ | £ | £ | £ |
| | (at €1.8) | | | (at €2.0) |
| Share capital | 50 | | | 45 |
| Reserve for translation difference on share capital | | | 5 | 5 |
| Profit and loss account reserve (all realised) | 490 | 270 | | 760 |
| Net assets | 540 | 270 | 540 | 810 |

What are this company's realised profits for the purposes of Part 23?

It is only the profits represented in the retained profit account that are realised (£760). The translation difference of £5 that arises in the above scenario is not a profit at law, and as such the amount cannot be a realised profit. The same would apply if the closing balance sheet exchange rate was £1 = €1.5 meaning that the share capital was stated at £60, the resulting debit balance of £10 would not be a realised loss.

Public companies should give consideration to principle 7 when applying the s831 net assets test, as the test operates by reference to the amounts shown in the accounts. Therefore, the s831 test is applied by reference to share capital recorded at £45, even though the difference of £5 shown above for the retranslation of share capital is not realised (in this particular case there is no restricting effect, since £810 of net assets less £45 of share capital exceeds the realised profits of £760). The s831 test only determines the maximum amount of realised profits that are distributable; it does not have an impact on the calculation of realised profits for the purposes of Part 23.

If the shares were measured at their historical amount (ie, not retranslated) there would be no foreign currency movement in respect of the share capital as they remain at their historical amounts (although please see example principle 5 as the current currency worth of the shares would need to be considered).

### Shares classified as an accounting liability

Suppose that the facts are the same as before but instead the shares are classified as an accounting liability. In this scenario IAS 21 requires the liability to be retranslated at each balance sheet date, and the foreign exchange difference that arises will be recognised in the income statement. Even though the shares are presented as an accounting liability, they remain share capital as a matter of law; any exchange difference arising on the retranslation is the result of an accounting exercise rather than a profit or loss in law; and the company's realised profits would be as above. However, consideration will need to be given to the other principles (such as the current currency worth of share capital) to determine whether there is any restriction as to the amounts that can be distributed.

**Example 5 – illustration of principle 5**

Principle 5: Where a company's shares, whether those shares are classified as equity or debt for accounting purposes, are denominated in a currency other than the company's functional currency, 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.

Facts:

| | |
|---|---|
| Functional currency | Sterling |
| Presentation currency | Sterling |
| Share capital currency | Euro |
| Nominal value of shares | €90 |
| Opening exchange rate | £1 = €2.0 |
| Closing exchange rate | £1 = €1.8 |
| Share classified as | Accounting equity |
| Share capital retranslated at balance sheet date | No |

Assume shares were issued when the exchange rate was £1 = €2.0.

The company has no other foreign (ie, non-sterling) assets or liabilities.

The company's functional and presentation balance sheets and income statements are as follows:

| | Opening balance sheet | Profit | Closing balance sheet |
|---|---|---|---|
| | £ | £ | £ |
| Share capital | 45 | | 45 |
| Profit and loss account reserve (all realised) | 495 | 270 | 765 |
| Net assets | 540 | 270 | 810 |

What are this company's realised profits for the purposes of Part 23, and what is the maximum amount that the company could distribute?

For the purposes of Part 23, the company's realised profits are £765.

Even though the company has not translated its share capital it still needs to take account of what is the current currency worth of its shares. At the balance sheet date, the €90 of share capital would be worth £50. Therefore when comparing the current worth of the share capital and the net assets in functional currency terms, any distribution would be limited to £760 (£810 - £50).

**Example 6 – illustration of principle 6**

Principle 6: Share premium account, and similar capital accounts, do not have a currency of denomination but are amounts of record in the books of account in functional currency.

Facts:

| | |
|---|---|
| Functional currency | Sterling |
| Presentation currency | Sterling |
| Currency shares denominated in | Euro |
| Nominal value of shares (in denomination currency) | €90 |
| Consideration originally received for share issue | €100 |
| Opening exchange rate | £1 = €2.0 |
| Closing exchange rate | £1 = €1.8 |
| Share classified as | Accounting equity |
| Share capital retranslated at balance sheet date | No |

Assume shares were issued when the exchange rate was £1 = €2.0.

Share premium fixed in sterling at historical rate (€100-€90, at £1 = €2.0) £5

The company has no other foreign (ie, non-sterling) assets or liabilities.

The company's balance sheets and income statements are as follows:

| | Opening balance sheet | Profit | Closing balance sheet |
|---|---|---|---|
| | £ | £ | £ |
| Share capital | 45 | | 45 |
| Share premium | 5 | | 5 |
| Profit and loss account reserve (all realised) | 490 | 270 | 760 |
| Net assets | 540 | 270 | 810 |

What are this company's realised profits for the purposes of Part 23, and what is the maximum amount that the company could distribute?

For the purposes of Part 23, the company's realised profits are £760.

As illustrated in example 5, the company needs to take account of what the current currency worth of the share capital is. As before at the balance sheet date the €90 of share capital (the amount initially issued) would be worth £50. Therefore, there may be a restricting effect due to the increase in the currency worth of the shares as a result of the exchange rate movement. There is, however, no equivalent variation in worth in relation to the share premium; but the share premium account is capital that may not be distributed. Thus under Principle 5 this company compares its net assets of £810 with the aggregate of the current functional currency worth of its share capital (£50) and the functional currency amount of record of its share premium (£5), amounting to £55, and finds that the result does have a restricting effect: ie, £755 is less than the realised profits of £760.

Thus only £755 of the realised profits would be distributable.

It should be noted that in this computation the existence of a share premium account has not, however, increased the restriction. (Eg, if the company had not issued the shares at a premium and had correspondingly lower net assets, then Principle 5 would still yield a £5 restriction: £805 – 50 = £755 vs £760 realised.)  What should be appreciated is that had the share premium account in this Example 6 been omitted from the capital side of the Principle 5 calculation, then the company would incorrectly have concluded that there was no restriction (£810 net assets less £50 share capital = £760 vs £760 realised, ie, no apparent restriction) and could have inadvertently distributed part of its capital.

**Example 7 – illustration of principle 7**

Principle 7: The application of the s831 statutory net assets test operates by reference to amounts as shown upon the face of the accounts in presentation currency.

Facts:

| | |
|---|---|
| Type of company | Public |
| Functional currency | Sterling |
| Share capital currency | Sterling |
| Presentation currency | Dollars |
| Opening exchange rate | £1 = $1.6 |
| Average exchange rate | £1 = $1.5 |
| Closing exchange rate | £1 = $1.3 |

The facts are the same as Example 2 except the company is a public company.

The company began the year with no cumulative translation difference (eg, there has been no exchange rate variation to date).

Its assets and profits are as shown in the table below.

The company's functional and presentation balance sheets and income statements are as follows:

| | Opening balance sheet | Profit | Retranslation difference | Closing balance sheet |
|---|---|---|---|---|
| In functional currency | £ | £ | | £ |
| Share capital | 100 | | | 100 |
| Profit and loss account reserve (all realised) | 20 | 30 | | 50 |
| Net assets | 120 | 30 | | 150 |
| | | | | |
| In presentation currency | $ | $ | $ | $ |
| | (at $1.6) | (at $1.5) | | |
| Share capital | 160 | | | 160 |
| Profit and loss account reserve | 32 | 45 | | 77 |
| Cumulative translation difference | - | | (42) | (42) |
| Net assets | 192 | 45 | (42) | 195* |

Net assets of £150 translated at £1 = $1.3.

What are this company's realised profits for the purposes of Part 23, and how much can be distributed under Part 23?

In accordance with principle 1, the realised profits are measured in the functional currency. The realised profits are therefore £50 (see example 2). In accordance with principle 2, the cumulative translation difference of $(42) is not a realised loss. If it were a private company, the company could, therefore, so far as the Act is concerned, distribute £50, being $65 in presentation terms (£50 at $1.3).

However, a public company is subject to s831 (see 2.30 – 2.31 above). In summary, a public company may make a distribution only if, after giving effect to such distribution, the amount of its net assets (as defined in s831(2)) is not less than the aggregate of its called-up share capital and undistributable reserves (as defined in s831(4)) as shown in the relevant accounts. This calculation is performed using figures taken directly from the presentational currency accounts.

The cumulative translation reserve does not meet the s831(4) definition of an undistributable reserve (nor is it share capital), therefore the purposes of s831 the amount that could be distributed is calculated below:

| | $ |
|---|---|
| Net assets | 195 |
| Share capital | (160) |
| Undistributable reserves | - |
| Amount that can be distributed under s831 | 35 |

The company could under Part 23 distribute only $35, rather than the full £50 ($65) of realised profits (see above).

Note that this restriction is correctly expressed in dollars since it is derived according to the statutory formula from amounts expressed on the face of the accounts in presentation dollars. This is so even though the realised profits, the distribution of which it restricts, are themselves in sterling (in accordance with Principle 1). In order to ascertain the effect of this restriction on any particular distribution, it is necessary to compare the dollar worth of that distribution with this $35 figure. The dollar worth of the distribution would be computed at the exchange rate applying at the date of making the distribution (see ~~[TECH 01/09]~~ paragraph 2.10 above as to this date).

# APPENDIX 6

## FOREIGN CURRENCY BRANCH EXAMPLES

### Example 1 – Illustration of a non-trading branch that purchases and holds PPE

***Principle 3: The profit or loss arising upon the necessary retranslation of an autonomous branch, from its functional currency into the functional currency of the company, is a realised profit or a loss to the extent that the branch net assets were qualifying consideration when the profit or loss arose.***

The simplified illustration below demonstrates the effect on realised profits from changes in the composition of a branch's net assets (in this case purchasing and holding PPE). In analysing a net retranslation gain or loss, regard must be had to the nature of the changing asset base on which they arise. In practice, when conducting the analysis, reasonable approximations may be made.

See illustration on next page.

*Assumptions*

Company with a sterling functional currency establishes a branch which has a dollar functional currency

All cash flows happen at the end of the month

All of the branch's transactions are transacted in Dollars

*Background*

The branch starts the period with cash, which it uses to purchase land. No further transactions are undertaken

| Actions | Start of period | | Day 1<br>Buys land for $300 | | Day 365 | | |
|---|---|---|---|---|---|---|---|
| Exchange rate - £1 = | | **2** | | **2** | | **1.8** | |
| | $ | £ | $ | £ | $ | £ | |
| PPE | | | | | | | |
| (land) | 0 | 0 | 300 | 150 | 300 | 167 | |
| Cash | 300 | 150 | 0 | 0 | 0 | 0 | |
| | 300 | 150 | 300 | 150 | 300 | 167 | |
| Foreign exchange | | | | 0 | | 17 | |
| | 0 | 0 | 0 | 0 | 0 | 0 | |
| | | | £ | £ | £ | £ | |
| FX differences | | | Period | Cumulative | Period | Cumulative | |
| PPE | | | | | | | |
| (land) | | | 0 | 0 | 17 | 17 | Unrealised gain |
| Cash | | | 0 | 0 | 0 | 0 | |
| | | | 0 | 0 | 17 | 17 | |

Even though the branch has been dormant since it purchased the land, we can not assume that the foreign exchange difference of 17 arising in the year on the opening balance sheet is realised just because the balance sheet was represented by cash on day 1.

**Example 2 - Illustration of a trading branch and the importance of the composition of foreign exchange movements**

***Principle 3: The profit or loss arising upon the necessary retranslation of an autonomous branch, from its functional currency into the functional currency of the company, is a realised profit or a loss to the extent that the branch net assets were qualifying consideration when the profit or loss arose.***

The simplified illustration below demonstrates the effect on realised profits from changes in the composition of a branch's net assets (in this case building up inventory to a peak and then running it down again). In analysing a net retranslation gain or loss, regard must be had to the nature of the changing asset base on which they arise. In practice, when conducting the analysis, reasonable approximations may be made.

See illustration on next page.

*Assumptions*

Company with a sterling functional currency establishes a branch which has a dollar functional currency.
All cash flows happen at the end of the month.
The loan that the branch has taken out is non-interest bearing
All of the branch's transactions are transacted in Dollars

*Background*

The branch obtains a loan at the start of the period, which it uses to purchase inventory in the first half. It then starts to run down the inventory.

| | Start of period | | Month 1 | | Month 2 | | |
|---|---|---|---|---|---|---|---|
| Actions | Obtain loan of $300<br>Purchase inventory for $100 | | Buys inventory for $100 | | Sells $50 of inventory for $100 | | |
| Exchange rate - £1 = | | **2** | | **2.2** | | **1.9** | |
| | $ | £ | $ | £ | $ | £ | |
| Inventory | 100 | 50 | 200 | 91 | 150 | 79 | |
| Cash | 200 | 100 | 100 | 45 | 200 | 105 | |
| Loan | (300) | (150) | (300) | (136) | (300) | (158) | |
| | 0 | 0 | 0 | 0 | 50 | 26 | |
| Trading profit (realised) | | | 0 | 0 | 50 | 26 | |
| Foreign exchange | | | | 0 | | 0 | |
| | 0 | 0 | 0 | 0 | 50 | 26 | |
| | | | £ | £ | £ | £ | |
| FX differences | | | Period | Cumulative | Period | Cumulative | |
| Inventory | | | (4.5) | (4.5) | 13.0 | 8.5 | Unrealised gain |
| Realisation of inventory FX (*1) | | | | | 1.3 | 1.3 | Realised gain *1 |
| Cash | | | (9.1) | (9.1) | 7.2 | (1.9) | Realised loss |
| Loan | | | 13.6 | 13.6 | (21.5) | (7.9) | Realised loss |
| | | | 0.0 | 0.0 | 0.0 | 0.0 | |

*1 - See separate sheet on pages 160-161

If the opening and closing cash balance is looked at in isolation, one might assume that when calculating the realised profits of the branch, foreign currency movements on the cash balance would not have an adverse effect on the amounts that can be distributed - the balance at the start and end of the period is the same and there has been a favourable change in the exchange rate - the $200 that at the start of period was worth £100 is now worth £105.

On that assumption, one might conclude that all that needs to be considered is the foreign exchange movements on the loan balance, as the foreign exchange movements on the inventory will be unrealised gains.

However as can be seen from the foreign exchange movements that arise in the period, there is actually a cumulative foreign exchange loss on cash balance during the period. This will be a realised loss. The realised profits at the end of the period are £17 (£26 trading profit less £10 realised foreign exchange loss (on the cash and the loan) and a £1 realised gain in relation to foreign exchange movements that have arisen on the sale of inventory (see separate sheet).

The example above is a simplified example which demonstrates that when analysing a net retranslation gain or loss, regard must be had to the nature of the changing asset base on which they arise. When conducting the analysis in a more complicated scenario reasonable approximations may be made.

## Analysis of movements from the company's perspective of changes in the composition of the branch's net assets

| | Inventory | | | Cash | | | Loan | | |
|---|---|---|---|---|---|---|---|---|---|
| | **$** | **£** | | **$** | **£** | | **$** | **£** | |
| **Balance at start of period (£1:$2)** | 100 | **50.0** | | 200.0 | **100.0** | | (300.0) | **(150.0)** | |
| *FX during period* | | | | | | | | | |
| *$100 @ £1:$2.2 - $100 @ £1:$2* | | *(4.5)* | | | | | | | |
| *$200 @ £1:$2.2 - $200 @ £1:$2* | | | | | *(9.1)* | | | | |
| *$300 @ £1:$2.2 - $300 @ £1:$2* | | | | | | | | *13.6* | |
| Cashflow movements | | | | | | | | | |
| $100 @ £1=$2.2 | | | | (100.0) | (45.5) | | | | |
| Inventory movements | | | | | | | | | |
| $100 @ £1=$2.2 | 100.0 | 45.5 | | | | | | | |
| **End of month 1 (£1:$2.2)** | 200.0 | **90.9** | | 100.0 | **45.5** | | (300.0) | **(136.4)** | |
| FX during period | | | | | | | | | |
| $200 @ £1:$2 - $100 @ £1:$1.9 | | 14.4 | | | | | | | |
| $100 @ £1:$2 - $200 @ £1:$1.9 | | | | | 7.2 | | | | |
| $300 @ £1:$2 - $300 @ £1:$1.9 | | | | | | | | (21.5) | |
| Sub-total before trading profits | | 105.3 | | | 52.6 | | | (157.9) | |
| Cumulative FX | | 9.8 | | | (1.9) | | | (7.9) | |
| *Inventory movements* | | | | | | | | | |
| *Sale of $50* | *(50.0)* | *(25.0)* | **1* | | | | | | |
| *Realisation of inventory FX movement* | | *(1.3)* | **2* | | | | | | |
| | | *(26.3)* | **3* | | | | | | |
| *Cashflow movements* | | | | | | | | | |
| *Realisation of historic cost of inventory* | | | | *100.0* | *25.0* | **1* | | | |
| *Realisation of inventory FX* | | | | | *1.3* | **2* | | | |
| *Trading profit* | | | | | *26.3* | **4* | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | *52.6* | **5* | | |
| **End of month 2 (£1:$1.9)** | 150.0 | **78.9** | | 200.0 | **105.3** | | (300.0) | **(157.9)** |
| **Cumulative FX at end of month 2** | | **8.5** | | | **(1.9)** | | | **(7.9)** |

*1 On a FIFO basis $50 of inventory sold was originally £25 (at £1:$2).
Whilst this example assumes a FIFO approach, other methods may be adopted according to normal considerations.

*2 This difference, between (*1) and (*2) is the FX gain in inventory realised as a result of its sale for cash.

*3 Inventory of $50 removed from the inventory balance when the rate is £1:$1.9.

*4 Calculated as the difference between the proceeds received ($100 @ £1:$1.9) and the carrying amount of inventory sold ($50 @ £1:$1.9)

*5 This equals $100 at £1:$1.9 (the exchange rate on the date of the transaction) and is comprised of the 3 components above

# APPENDIX 7

**ILLUSTRATIVE EXAMPLES OF A COMPANY'S POSITION IN SEVERAL SCENARIOS FOR CAPITAL REDUCTIONS WHERE THERE HAVE BEEN MOVEMENTS IN THE EXCHANGE RATE BETWEEN THE FUNCTIONAL CURRENCY AND FOREIGN SHARE CAPITAL CURRENCY.**

**Facts:**

| | |
|---|---|
| Functional currency | Sterling |
| Presentation currency | Sterling |
| Share capital currency | Dollars |
| Nominal value of shares | $200 |
| Opening exchange rate | £1 = $2.0 |
| Closing exchange rate | See the illustrations below for alternates |
| Share classified as | Accounting equity |
| Share capital retranslated at balance sheet date | See the illustrations below for alternates |

Assume that the shares were issued when the exchange rate was £1 = $2.0, and the proceeds received on issue were converted into sterling.

Assume that the company has no other foreign (ie, non-sterling) assets or liabilities.

Please see the illustrations below for a company's position in several scenarios.

| | Reduction of currency shares capital £1 = $x 1.00 | | | | Exclusive of repayment £1 = $x 4.00 | | | |
|---|---|---|---|---|---|---|---|---|
| | Share capital £ | Retrans entry £ | Redux reserve £ | Total £ | Share capital £ | Retrans entry £ | Redux reserve £ | Total £ |
| Without retranslation | | | | | | | | |
| b/f | 100 | | | 100 | 100 | | | 100 |
| Reduction | (200) | | 200 | 0 | (50) | | 50 | 0 |
| Un(over)eliminated | 100 | | (100) | 0 | (50) | | 50 | 0 |
| c/f | 0 | 0 | 100 | 100 | 0 | 0 | 100 | 100 |
| With retranslation | | | | | | | | |
| b/f | 200 | (100) | | 100 | 50 | 50 | | 100 |
| Reduction | (200) | | 200 | 0 | (50) | | 50 | 0 |
| Un(over)eliminated | 0 | ~~0~~100 | (100) | 0 | 0 | (50) | 50 | 0 |
| | 0 | 0 | 100 | 100 | 0 | 0 | 100 | 100 |

| | Reduction of currency shares capital £1 = $x 1.00 | | | | With repayment £1 = $x 4.00 | | | |
|---|---|---|---|---|---|---|---|---|
| | Share capital £ | Retrans entry £ | Redux reserve/ (distr'n) £ | Total £ | Share capital £ | Retrans entry £ | Redux reserve/ (distr'n) £ | Total £ |
| Without retranslation b/f | 100 | | | 100 | 100 | | | 100 |
| Repayment | (200) | | | (200) | (50) | | | (50) |
| Un(over)eliminated | 100 | | (100) | 0 | (50) | | 50 | 0 |
| | 0 | 0 | (100) | (100) | 0 | 0 | 50 | 50 |
| With retranslation b/f | 200 | (100) | | 100 | 50 | 50 | | 100 |
| Repayment | (200) | | | (200) | (50) | | | (50) |
| Un(over)eliminated | 0 | 100 | (100) | 0 | 0 | (50) | 50 | 0 |
| | 0 | 0 | (100) | (100) | 0 | 0 | 50 | 50 |

Where an overall debit is left behind as a consumption of amounts available for distribution it is assumed that either the company had such amounts available prior to the reduction or that, if such a reduction may be validly effected, the consequence is that the company has a deficit (an excess utilisation of realised profits) which must be made good before any further distribution can be made.

# APPENDIX 8

## EXAMPLE OF APPLICATION OF SECTION 846 TO FUNGIBLE ASSETS

Company A has a freehold property with a book value of £100 and a fair value of £1,000. The company would be unable to distribute the property as a distribution in kind because it does not have sufficient distributable reserves.

| | |
|---|---|
| **Freehold property** | **100** |
| | **100** |
| **Share capital** | **50** |
| **Realised profits** | **50** |
| | **100** |

If Company A sells the freehold property in exchange for 1,000 £1 loan notes which represents qualifying consideration, the position is as follows:

| | |
|---|---|
| **Loan notes receivable** | **1,000** |
| | **1,000** |
| **Share capital** | **50** |
| **Realised profits** | **950** |
| | **1,000** |

As the loan notes represent qualifying consideration, the profit of £900 is a realised profit and Company A can make a distribution equal to its accumulated realised profits of £950.

Alternatively, if Company A sells the freehold property in exchange for £1,000 of loan notes which do not represent qualifying consideration, the position is as follows:

| | |
|---|---|
| **Loan notes receivable** | **1,000** |
| | **1,000** |
| **Share capital** | **50** |
| **Realised profits** | **50** |
| **Unrealised profits** | **900** |
| | **1,000** |

As the loan notes are fungible assets, the distribution of a proportion of the loan notes results in the realisation of the same proportion of the unrealised reserve. Every £1 loan note represents 90p of unrealised profit. Therefore, the element of each loan note which is not a profit is 10p. As realised profits are £50, only 500 loan notes may be distributed (because distribution of each £1 loan note

will consume 10p of realised profits) The balance sheet after such a distribution would be as follows:

| | |
|---|---|
| **Loan notes receivable** | **500** |
| | **500** |
| **Share capital** | **50** |
| **Realised profits** | **-** |
| **Unrealised profits** | **450** |
| | **500** |

No further distribution of the remaining loan notes is possible because the distribution of £1 of loan notes would cause only 90p of unrealised profit to become realised and there are no other realised profits available. The maximum distribution possible as a distribution in kind is therefore less than would be the case if all of the loan notes were redeemed or sold for qualifying consideration.

# APPENDIX 9

## ~~EXAMPLE OF APPLICATION OF 3.11(e) FOR DISTRIBUTION BY SET OFF~~

~~This example is concerned with the scenario where a subsidiary wishes to make a distribution to its parent of an unrealised profit and the distribution would result in the elimination, or reduction, of the asset which represents the unrealised profit.~~

~~The subsidiary has an unrealised profit which is represented by a balance due from its parent company. Without considering paragraph 3.11(e), the balance would not meet the definition of qualifying consideration because it would fail to meet one or more of the three criteria specified in paragraph 3.11(d).~~

~~The subsidiary's balance sheet is as follows.~~

**[Deleted]**

| | | |
|---|---|---|
| ~~Amount receivable from parent~~ | | ~~130~~ |
| ~~Other~~ | ~~20~~ | |
| | ~~150~~ | |
| ~~Share capital~~ | ~~10~~ | |
| ~~Unrealised profit related to amount receivable from parent~~ | | ~~130~~ |
| ~~Realised profit~~ | | ~~10~~ |
| | | ~~150~~ |

~~The company could lawfully make a distribution in kind of the £130 receivable by applying section 846 of the 2006 Act and treating the unrealised profit as realised for the purposes of the distribution (see paragraph 2.9). Following the distribution, its balance sheet would be as follows.~~

| | |
|---|---|
| ~~Amount receivable from parent~~ | ~~-~~ |
| ~~Other assets~~ | ~~20~~ |
| | ~~20~~ |
| ~~Share capital~~ | ~~10~~ |
| ~~Unrealised profit related to amount receivable from parent~~ | ~~-~~ |
| ~~Realised profit~~ | ~~10~~ |
| | ~~20~~ |

~~The same effect is achieved through a waiver of the balance. A waiver by a subsidiary of a balance due to it by its parent would be classified legally as a distribution in kind (see paragraph 2.8E).~~

~~However, the legal position is different if the company instead declares a dividend of £130 with the intention of settling it through inter-company account. Section 846 is not applicable because there is no transfer of a non-cash asset. To declare the dividend, the company needs to have realised profits of £130 or more.~~

~~The definition of qualifying consideration in paragraph 3.11 addresses these circumstances, specifically at 3.11(e). It confirms that for the purposes of assessing the lawfulness of such a proposed distribution, the amount receivable from the shareholder is qualifying consideration where and to the extent that:~~

~~(i) the company intends to make a distribution to the shareholder of an amount equal to or less than its receivable from that shareholder; and~~

(ii) the company intends to settle such distribution by off-setting against the amount receivable (in whole or in part); and

(iii) within the meaning of paragraph 3.5 of this guidance, (i) and (ii) are linked.

These conditions are met in the circumstances described above and therefore it is lawful for the subsidiary to make a distribution of £130 by set off.

The above example is concerned only with whether the distribution may lawfully be made by the subsidiary. It does not address whether the receipt of the distribution by the parent is a realised profit. For example, where the profit in the subsidiary arises from a hive up of assets, the guidance at 3.5 concerning arrangements that are artificial, linked or circular is relevant.

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