IMPLICATIONS OF IFRS FOR DISTRIBUTABLE PROFITS ICAEW BRIEFING PAPER

Further information is available from Liz Cole at the Institute (liz.cole@icaew.co.uk).

INTRODUCTION

The transition to IFRS is leading to serious concerns about the payment of dividends for some companies. It is not right that companies should be prevented from paying dividends to their shareholders as a consequence of the changes in financial reporting requirements, but no changes in cash flows, when they are solvent and easily able to pay their debts as they fall due. It is necessary to break this traditional link between accounting profit and dividends.

The Institute of Chartered Accountants in England and Wales has identified many issues that companies within the capital maintenance regime will encounter in determining their profits available for distribution using accounts prepared under IFRS. This paper sets out the Institute's views, provides an overview of some of the issues and explains how the difficulties caused by the existing legal capital maintenance requirements might be addressed by the European Commission.

THE ISSUE: DETERMINATION OF DISTRIBUTABLE PROFITS USING IFRS ACCOUNTS

The capital maintenance regime in the EU Second Company Law Directive imposes limits on public company distributions by reference to the historical amounts contributed by investors. This regime is based on factors such as subscribed capital and accounting profits, rather than present and future cash flows. It is very complex, can fail to achieve the objective of protecting creditors, imposes unwarranted burdens on business and impedes the development of financial reporting.

The regime imposes a rigid link between company balance sheets and the amount of company distributions and, especially with the introduction of IFRS, is becoming increasingly flawed. This is because it is based on a supposition that realisation is a key driver of accounting profit recognition, and thus it bases distributions on realised profits as shown in the accounts; whereas accounts, especially under IFRS, are becoming less and less driven by realisation. The regime also restricts a public company from making a distribution where its net assets would fall below the sum of its share capital and undistributable reserves. IFRS has created conflicts with this rule, particularly as regards cash flow hedge accounting (IAS 39) and split accounting (IAS 32). So the founding idea of the current regime's accounts-basis is outdated, and

the consequence is uncertainty, resulting in a time-consuming exercise for all concerned.

It is already clear that the adoption of IFRS exacerbates these problems by increasing the complexity of determining which accounting profits are distributable (for companies using IFRS in their individual accounts). This is illustrated by the length and complexity of the guidance on the implications of IFRS for distributable profits recently issued for consultation by a joint working party of experts from our Institute and the Institute of Chartered Accountants of Scotland (TECH 21/05). Whilst such guidance assists companies dealing with the current complex regime, it is no substitute for fundamental reform. Until the regime is changed, companies will still be required to carry out complex profit and loss adjustments in order to determine distributable profits, for example, in order to strip out fair value gains that are not distributable.

WHY IFRS IS RELEVANT FOR THE INDIVIDUAL ACCOUNTS OF UK COMPANIES

A UK company may prepare its individual accounts (i.e., those used to determine distributions) either using IFRS directly or UK GAAP, which is in the process of converging with IFRS. We believe that there should not be any barriers, such as those concerning distributions, to a move to the same accounting platform in both individual and group accounts, which we regard as desirable in the interests of both cost and clarity in financial reporting.

OVERVIEW OF ISSUES

In developing the Draft Guidance, we identified many issues requiring consideration, including legal issues arising due to the capital maintenance regime not having been written with IFRS in mind, and the development of what is generally accepted practice for determining realised profits where IFRS introduces new accounting practices.

We set out below an overview of three of the issues that may arise on the adoption of IFRS in individual accounts.

Split accounting (IAS 32)

IAS 32 raises several complex legal issues in determining realised profits, for example, in relation to ‘split accounting’ for convertible preference shares. IAS 32 requires that these are split into liability and equity components, which gives rise to an additional interest expense over and above the actual interest payable, recognised through profit and loss. This additional interest expense (equivalent to the amount of the equity component) is not a loss as a matter of law but reduces net assets and thus may restrict the ability of a public company to make a distribution.

Cash flow hedge accounting (IAS 39)

The effects of a cash flow hedge are recognised in shareholders’ equity until the effect of the hedged item is recognised in the accounts. So, for example, a loss arising on a derivative which is a cash flow hedge will be recognised in shareholders’ equity and, in our view, be treated as an unrealised loss for distribution purposes, as there will be

a corresponding unrecognised gain in the hedged item. However, under the capital maintenance regime, a public company would be restricted from making a distribution where net losses from cash flow hedges reduce net assets below the sum of its share capital and undistributable reserves.

Fair value accounting

Fair value accounting will be much more common under IFRS. Many more assets and liabilities will be measured at fair value with gains and losses recognised in profit and loss, including financial instruments, investment property, biological assets and agricultural produce. However, under existing accounting principles in Member States including the UK, such accounting profits would not be considered to be distributable.

In order to mitigate the mismatch between accounting and distributable profits, Member States will need to reconsider the circumstances in which gains and losses arising from remeasurement at fair value through profit and loss should be regarded as realised. In our draft Guidance in TECH 21/05, we propose that the generally accepted definition of realised profits in the UK is revised to include gains and losses arising from fair value accounting, in accordance with the applicable accounting standards, would be regarded as realised provided that they were *'readily convertible into cash'*.

However, this process of determining whether the gains and losses arising from fair value accounting are readily convertible into cash may be time-consuming and costly.

RECOMMENDATION

The Institute of Chartered Accountants in England and Wales believes a solvency-based regime, under which distributions would be determined by reference to the effect on company solvency and the need to preserve the company as a going concern, would be simpler and more cost effective, whilst also protecting creditors and allowing investors appropriate returns.

The European Commission has announced a study that may lead to the replacement of the Second Company Law Directive. We believe the Commission should act quickly and take a radical approach. Payment of dividends based on a solvency declaration by the directors is likely to be the way forward for public companies. This has been done elsewhere, for example in New Zealand.

We therefore strongly urge the Commission to further accelerate its timetable for a review of the feasibility of an optional alternative regime based on solvency requirements with a view to amending the EU Second Company Law Directive.

LC/ 20.07.05