

iGAAP Alert.

IFRS – Potential threat to ability to pay dividends



In a nutshell

TECH 21/05 has been issued for comment by 2 September 2005 on the implications of the transition to IFRS for determining distributable profits of UK companies. Profits available for distribution are determined based on realised profits and losses. The starting point for this is the individual accounts of a company, which may now be prepared under IFRS. Even where the reported profits under IFRS are expected to be higher than under UK GAAP, the transition to IFRS may still have adverse implications on dividends. The draft guidance addresses various issues arising on the adoption of IFRS, including the impacts of IAS 10 **Events after the balance sheet date** (and UK equivalent FRS 21), IAS 27 **Consolidated and separate financial statements**, IAS 32 **Financial instruments: disclosure and presentation** (and UK equivalent FRS 25), IAS 39 **Financial instruments: recognition and measurement** (and UK equivalent FRS 26) and others. A copy of the draft guidance can be downloaded from www.icaew.co.uk.

Main implications of adoption of IFRS

Draft guidance has been developed by the joint ICAEW/ICAS Distributable Profits Working Party, whose membership includes a representative of Deloitte. This guidance describes the application of the principles of TECH 7/03 **Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 1985** to IFRS and equivalent UK standards. It proposes some amendments to TECH 7/03, particularly in connection with fair value accounting, and deals with some complex legal issues.

In view of the significant public debate in the financial press and the announcement by the European Commission of its intention to explore the IFRS threat to companies' ability to pay dividends, the guidance in TECH 21/05 is timely. The issues described below represent just a sample of those discussed in the draft guidance which runs to almost 50 pages.

- Under UK GAAP, dividends have been accounted for as an adjusting post balance sheet event, resulting in an accrual in the balance sheet for dividends proposed post year end. From 2005 onwards, IAS 10 and FRS 21 will prohibit recognising dividends declared post year end. This will have implications, particularly in the year of transition, for holding companies which rely on distributions from subsidiaries. More careful planning of dividend streams within groups is likely to be necessary.

- Under IFRS, dividends out of pre-acquisition profits reduce the cost of investment and are not treated as income as under UK GAAP. Hence on transition to IFRS, companies will have to determine to what extent dividends have been received out of pre-acquisition profits of their subsidiaries. There are no exemptions on transition and IAS 27 will have to be applied retrospectively. The position of companies may be further complicated by the effect of group reorganisations.

Example: Company A acquires company B on 1 January 200X, when company B has pre-acquisition profits of 200. During the year ended 31 December 200X, B makes further profits of 100. Under IAS 27, dividends paid by B to A in excess of 100 would result in a reduction in the cost of investment in A's accounts. When B pays a dividend of 150, the double entry in A is DR Cash 150; CR Dividend income 100; CR Investments 50.

B now has profits of 150. It makes further profits of 100 in the next period, at the end of which C is inserted as an intermediate parent (i.e. A now owns C which owns B). In respect of C, the profits of 250 in B would be considered to be pre-acquisition. So if immediately following this group reorganisation B were to pay a dividend of 50 to C, this would be treated in C's books as a distribution out of pre-acquisition profits, resulting in a credit to the cost of investment, and not dividend income. Hence the dividend paid by B to C would not be a profit in C and thus cannot be distributed up to A.

- Moving to IFRS will result in a greater use of “fair value accounting” whereas “marking-to-market” under UK GAAP is very rare. Under IFRS, many more assets and liabilities will be measured at fair value, including financial instruments, investment property, biological assets and agricultural produce. The existing guidance in TECH 7/03 is considered too narrow and requires amendment to take account of the broader use of fair values under IFRS. The main focus for determining whether fair value gains and losses are realised will be on whether they are “readily convertible to cash”. The proposed approach will result in many, but not all, fair value gains recognised on financial instruments being “readily convertible to cash” and therefore realised.
- IAS 32 and FRS 25 require non-equity shares to be presented according to their substance, rather than their legal form. For example, redeemable preference shares are required to be shown as debt, with dividends payable presented as “interest expense” in the income statement. Company law restricts distributions by a public company to the excess of its net assets over its called-up share capital and undistributable reserves. The reclassification of non-equity shares as debt reduces the net assets of companies and therefore might be expected to restrict distributions. However, the draft guidance explains that the above restriction is based on the relevant accounts and that any share capital and related share premium presented as a liability is excluded from “share capital and undistributable reserves” – therefore the change in presentation of non-equity shares does not immediately restrict the amount available for distribution for a public company.
- IAS 19 and FRS 17 both deal with defined benefit pension accounting. The impact of a pension deficit on distributable profits is addressed in TECH 13/04 **Guidance on the effect of FRS 17 'Retirement benefits' on realised profits and losses** which remains unchanged and is equally applicable to IAS 19. One significant area of difference between IFRS and UK GAAP is the treatment of multi-employer pension schemes within a group. Where there is no reasonable basis to split the pension scheme assets and liabilities between the various employers, FRS 17 permits defined contribution accounting, with additional disclosures. However, for group schemes, IAS 19 requires the sponsoring employer to recognise the full pension deficit in its balance sheet unless there is a contractual agreement or stated policy for sharing the deficit, in which case it is allocated to group companies on that basis. Hence, where the pension deficit was not recorded in the individual accounts under UK GAAP due to the multi-employer exemption, it will have to be recorded on the balance sheet of one or more group companies under IFRS, thus reducing (or potentially eliminating) the profits available for distribution.

The draft guidance also addresses complex issues around hedge accounting, “split accounting” for compound financial instruments, deferred tax and income tax, exchange differences, group reconstructions at fair value, development costs and others.

Although these problems are IFRS related, they will also arise under UK GAAP as a result of convergence over the next few years. In particular, the new UK standards FRS 20 to FRS 26 will be effective for periods beginning on or after 1 January 2005, at least for listed companies.

Comment

Some of these issues, particularly the recognition of pension scheme deficits and the treatment of dividends out of pre-acquisition profits, will cause great difficulties for some companies in terms of payment of dividends. We have already seen evidence of companies embarking on expensive capital reconstructions to deal with the problems. In a recent submission to the DTI, we have pressed for a fundamental reform of the antiquated capital maintenance regime. We advocate breaking the link between accounts prepared for financial reporting purposes and the payment of dividends. However, this will take time to achieve and the existing rules are likely to be with us for at least the next few years. TECH 21/05, once finalised, therefore will provide essential guidance under the existing law.

For further information, visit our website at www.deloitte.co.uk

In this publication references to Deloitte are references to Deloitte & Touche LLP. Deloitte & Touche LLP is a member firm of Deloitte Touche Tohmatsu.

Deloitte Touche Tohmatsu is a Swiss Verein (association), and, as such, neither Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each member firm is a separate and independent legal entity operating under the names “Deloitte”, “Deloitte Touche Tohmatsu”, or other, related names. The services described herein are provided by the member firms and not by the Deloitte Touche Tohmatsu Verein.

Deloitte & Touche LLP is authorised and regulated by the Financial Services Authority.

This publication has been written in general terms and therefore cannot be relied on to cover specific situations; application of the principles set out will depend upon the particular circumstances involved and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this publication.

Deloitte & Touche LLP would be pleased to advise readers on how to apply the principles set out in this publication to their specific circumstances. Deloitte & Touche LLP accepts no duty of care or liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

© Deloitte & Touche LLP 2005. All rights reserved.

Deloitte & Touche LLP is a limited liability partnership registered in England and Wales with registered number OC303675. A list of members' names is available for inspection at Stonecutter Court, 1 Stonecutter Street, London EC4A 4TR, United Kingdom, the firm's principal place of business and registered office.
Tel: +44 (0) 20 7936 3000. Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London.

Member of
Deloitte Touche Tohmatsu