DIXON WILSON
CHARTERED ACCOUNTANTS

Dividends and Distribuatable Profits Under FRS 102

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DISTRIBUTABLE PROFITS - A REMINDER

Under company law, a company may only pay a dividend out of distributable profits. The distributable profits of a company, being the accumulated realised profits less accumulated realised losses, are determined by reference to 'relevant accounts'. These are usually the company's last individual annual accounts (rather than group accounts) or, where there are insufficient distributable reserves in the last annual accounts, an interim set of accounts.

The consequences of making an unlawful distribution will depend on the circumstances, but could result in a shareholder or director being liable to repay the illegal portion. Directors should consider seeking legal advice where an unlawful distribution has been made.

REALISED AND UNREALISED PROFITS AND LOSSES

A profit or loss is treated as realised in accordance with generally accepted accounting practice. For most transactions this will be obvious, following the underlying principle that profits are treated as realised only when realised in the form of cash or other assets, the ultimate realisation of which can be assessed with reasonable certainty (eg a trade debtor). This will include profits and losses arising on fair value adjustments where the asset or liability being re-valued is readily convertible into cash (eg a listed investment).

For other transactions, the treatment will be less obvious. Transactions that require particular attention include changes in the fair value of financial instruments, especially those with embedded derivatives, certain intra-group transactions and some movements on defined benefit pension scheme assets.

One should also bear in mind that under FRS 102 any movements arising from the revaluation of investment property will go through the profit and loss account, and accumulated profits and losses on these movements will be included in the profit and loss reserve. These movements are unrealised until the investment property is sold and will not form part of distributable reserves. Under old UK GAAP these movements had to be included in a separate revaluation reserve and were therefore easy to identify as being non-distributable. An entity may now therefore wish to maintain a separate reserve to highlight these unrealised amounts.

TRANSITIONAL ADJUSTMENTS

The move from old UK GAAP to FRS102 may result in changes to accounting policies which could give rise to opening reserve adjustments. Where these changes result in a deficit in distributable reserves it will not usually mean that past distributions were unlawful.

The Companies Act is clear in that it is the realised profits and losses calculated in accordance with generally accepted principles in force at the time when the accounts were prepared that should be considered in determining whether a distribution is lawful.

ACCOUNTING ERRORS

The lawfulness of a distribution may be questionable if the accounts on which a distribution was based contained an error whose correction results (or would have resulted if corrected) in a deficit in distributable reserves. Whether or not an error is corrected in the accounts does not have a bearing on the unlawfulness of a distribution. It is the error, rather than its correction, that may make a distribution unlawful. Under FRS 102, the correction of errors by restatement of comparatives is likely to be more common. This is because FRS 102 requires the correction of all material errors. Old UK GAAP only required the correction of fundamental errors. Errors are therefore likely to be more visible.

IMPACT ON APPLYING FRS 102

There are a number of areas where adopting FRS 102 may have an impact on distributable reserves. These are some of the more common issues:

FINANCIAL INSTRUMENTS – FAIR VALUE ACCOUNTING

Fair value accounting will result in the realisation of profits and losses in respect of the change in fair value of some financial instruments. This could have a positive or negative impact on distributable reserves and in some cases the impact could be very significant.

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GOODWILL AND INTANGIBLES AMORTISATION PERIOD

Unlike old UK GAAP, FRS 102 does not permit an intangible asset to have an indefinite useful life. It also sets a limit of 5 years (10 years from 1 January 2016) where a reliable estimate of the useful life cannot be made. Where the useful life of an asset is adjusted downwards, this will accelerate the amount of amortisation charged to profit and loss with a consequential impact on distributable reserves.

LEASE INCENTIVE SPREADING

FRS 102 requires an operating lease incentive to be spread over the term of the lease whereas under old UK GAAP, an incentive was generally spread over the period ending on the first rent review date. This change would spread the incentive over a longer period thus accelerating the overall rent charge to profit and loss. For leases that commenced before the date of transition to FRS 102, there is a transitional exemption allowing the entity not to restate the treatment of the lease incentive.

CONCLUSION

In conclusion, the consequences of making an unlawful distribution can be severe and therefore directors must be increasingly aware of the accounting entries that can impact on distributable reserves.

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