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Accounting Bulletin 4 "Guidance on the Determination of Realised Profits and Losses in the Context of Distributions Under the Hong Kong Companies Ordinance

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Section A
Key Features of AB4

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Part 1 - Introduction

- Under sections 79A to 79P of the Hong Kong Companies Ordinance (the "Ordinance"), a company can only make a distribution, such as a dividend, out of its accumulated "realised profits" (so far as not previously utilised or capitalised) less its accumulated, realised losses (so far as not previously written off in a reduction or reorganisation of capital)

- "Realised profits" are defined in section 79A(3) of the Ordinance as those profits that fall to be treated as realised in the company's accounts in accordance with principles generally accepted with respect to the determination for accounting purposes of realised profits at the time those accounts were prepared

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- Although the Ordinance refers to such profits being determined in accordance with generally accepted *accounting* principles, in practice it should not be assumed that all amounts which have been recorded in the company's income statement prepared in accordance with Hong Kong Financial Reporting Standards (HKFRSs) can be regarded as "realised" and hence distributable.
  - This is because increasingly the concept of income *recognition* in the income statement under HKFRSs is unrelated to the concept of *realisation* under Hong Kong law.
  - Similarly, profits and losses or other changes in net assets recorded outside of the income statement under HKFRSs are not necessarily "unrealised"

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- As a result, interpretive difficulties may arise when the directors need to determine the full extent of a company's distributable profits, for example, if they intend to utilise all of those profits to make a distribution, or, in the case of a company listed on the Hong Kong Stock Exchange, they need to satisfy the disclosure requirements under the Exchange's Listing Rules

- Accounting Bulletin 4 (AB4) provides guidance on the principles to be applied in analysing any given transaction to determine whether it has given rise to a realised profit or loss, as well as commentating on specific areas of complexity that may arise in this regard when a company prepares its financial statements in accordance with HKFRS

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- AB4 and the relevant staff summary are issued for general guidance only and do not introduce additional accounting, disclosure or legal requirements. They are therefore available as a source of guidance immediately on issue

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Part 2 - Development of AB4 and Overview of its Contents

- Given the common origins of the currently applicable law on distributions found in Hong Kong and the United Kingdom, the contents of AB4 are closely based on TECH 01/09 “Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006”, reproduced by permission of the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland (the “UK Institutes”)

- Limited modifications have been made, as and where appropriate, to correlate the guidance in TECH 01/09 to the corresponding legal and financial reporting requirements applicable in Hong Kong

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- The resulting AB4 contains extensive guidance, including worked examples, on the determination of realised profits and losses for HK incorporated companies that prepare their financial statements under HKFRSs, in the context of the Ordinance

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- Specifically, AB4 includes:
  - overviews of the relevant legal framework **[section 2]** and the concepts **[section 3]**;
  - detailed discussions on how those concepts compare to accounting policies adopted for financial statement purposes **[sections 4 – 10]**, for example:
    - where fair value accounting is adopted **[section 4]**;
    - where instruments have been classified as debt for accounting purposes, but are capital under the law **[section 6]**, or
    - where non-cash intra group transactions have been recognised in the financial statements **[section 9]**; and
  - illustrative numerical examples in the Appendices to supplement the guidance

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- In order to discuss the issues surrounding the identification of realised profits and losses by entities which prepare their financial statements in accordance with HKFRS, AB4 includes background information on the relevant financial reporting requirements
- AB4 is based on HKFRSs in effect at the time of writing and discusses issues arising from the interaction of those Standards and Interpretations with the currently applicable Companies Ordinance to the extent that equivalent issues have been discussed in TECH 01/09
  - AB4 will be revised periodically as HKFRSs are amended, to maintain consistency with any updated guidance issued by the UK Institutes and/or to reflect changes in local requirements

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Part 3 - Section 3 of AB4 Guiding Principles for the Determination of Realised Profits and Losses

- Section 3 of AB4 provides a detailed discussion of the principles underlying the determination of realised profits and losses

Realised profits

- The principle that a profit shall be treated as realised only when realised in the form of:
  - cash; or
  - other assets, the ultimate cash realisation of which can be assessed with reasonable certainty

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- Section 3 expands the principle to set out 6 categories of circumstances under which an increase in net assets may be regarded as a "realised profit". These are as follows:
  - (a) a transaction where the consideration received by the company is "qualifying consideration";
  - (b) an event which results in "qualifying consideration" being received by the company in circumstances where no consideration is given by the company;
  - (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";

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(d) the translation of:

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

(ii) a liability,

denominated in a foreign currency;

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

(f) a profit previously regarded as unrealised (such as amounts taken to a revaluation reserve, merger reserve or other similar reserve) becoming realised as a result of, for example, the related asset being disposed of in a transaction where the consideration received by the company is "qualifying consideration" or the distribution in specie of the asset to which the unrealised profit relates.

[para. 3.9]

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- The above list of circumstances includes the following two concepts which are key to determining whether a profit is realised:
  - "qualifying consideration"; and
  - "readily convertible to cash"
- The most common form of "**qualifying consideration**" is cash i.e. put simply, a profit made on a cash sale is a realised profit. However, other forms of consideration may also be sufficiently near cash in order to be regarded as "qualifying"
- These other forms of near cash consideration are listed in paragraph 3.11 of AB4 as follows:

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

  (b) the release, or the settlement or assumption by another party, of all or part of a liability of the company[1] ; or

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(c) 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.

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- For example, in addition to profits on cash sales, profits that arise from sales on normal credit terms can be regarded as "realised" at the time that the sale is recognised for financial reporting purposes, as the trade debtor is a form of "qualifying consideration" as per (c) above
  - However, profit arising for financial reporting purposes on the swap of two dissimilar illiquid assets, such as the swap of two dissimilar properties, would not be regarded as "realised" at the time of the swap because the illiquid asset (i.e. the property) received in the swap is not a form of "qualifying consideration"

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- "**Readily convertible to cash**" is discussed in paragraph 3.12 of AB4. In essence, an asset, or a change in the fair value of an asset or liability, is considered to be "readily convertible to cash" if:

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

  (b) the input for price determination is observable by market participants; and

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  (c) the company's circumstances must not prevent immediate realisation of the item concerned; for example, in disposing of the item there would not be any intention or need to liquidate or curtail materially the scale of the company's operations, or to undertake a transaction on adverse terms

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- For example, revaluation gains arising on equity securities that are traded in an active market are usually considered to be realised, regardless of whether under HKAS 39 such changes are recorded in profit or loss or in other comprehensive income, because 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. **[para. 4.2 – 4.4, 4.23 – 4.25]**
  - This contrasts with revaluation gains arising on investment properties carried at fair value under HKAS 40. Even though the valuation increases are recognised in profit or loss in the financial statements, these gains are not "realised" because the company would need to go through the process of negotiation and/or marketing of the property in order for the recognised gain to be converted into cash. Accordingly, such gains cannot be regarded as "realised" (and hence distributable) until the property is disposed of for qualifying consideration. **[para. 4.13]**

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Linked transactions

- In addition to the above, AB4 specifies that in assessing whether a company has a realised profit, a series of transactions should be viewed as a whole rather than in isolation, particularly when they are artificial, linked or circular. A realised profit will arise only where the overall commercial effect on the company satisfies the definition of realised profits. **[para. 3.5]**

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Realised losses

- Consistent with the broad definition of realised losses in section 79K(1) of the Ordinance, AB4 states that any provision, including one for depreciation or diminution in value, as well as provisions for liabilities, charges or losses should be treated as a realised loss. In general therefore, where amounts are charged against profit or loss (and hence recorded in retained earnings), the charge should be regarded as being "realised" irrespective of whether it arose on re-measurement of the carrying value of an asset or liability, or the charge has crystallised, for example on settlement of a law suit. **[Para. 2.31 - 2.37, 3.10, 3.17]**

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Part 4 - Sections 4-10 of AB4 Further Guidance on Applying the Guiding Principles to Specific Transactions

- Sections 4 – 10 of AB4 set out detailed discussions on the following specific areas by applying the broad guiding principles on realised profits and losses as established in section 3:

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Section		Topics discussed
(4)	Fair value accounting	Financial instruments, investment properties
(5)	Hedge accounting	Fair value, cash flow and net investment forms of hedge accounting permitted under HKAS 39
(6)	Issues arising from HKAS 32	Financial instruments presented according to their substance rather than their legal form. NB Appendix 2 to the Bulletin contains extensive numerical illustrations of the principles discussed in section 6.
(7)	Employee share schemes	Share based payment expenses recognised under HKFRS 2 and any intra group recharges for share-based payments
(8)	Retirement benefit schemes	Defined contribution, multi-employer and defined benefit retirement plans recognised in accordance with HKAS 19, with particular focus on defined benefit plans
(9)	Intra-group transactions	Intra-group dividends, group treasury functions, intra-group sales and purchases, merger relief etc..
(10)	Other issues	Preparation of company level financial statements which include equity method investees, deferred tax, swaps of property, plant and equipment, barter transactions, foreign currency translation differences

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- The discussions address the principles concerned in analysing any given transaction, rather than focusing on whether the effect is likely to be material. For example, in section 6, the guidance discusses the extent to which interest expensed on the liability component of a convertible bond need not be regarded as a realised loss for the purposes of the Ordinance.

- Despite the extensiveness of the guidance, companies should consider taking their own legal advice, particularly in relation to any matters not covered by AB4.

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Part 5 - Applying the Guidance in AB4 to Estimate Net Realised Profits Available for Distribution

- AB4 focuses its guidance on determining whether particular transactions may be regarded as giving rise to realised profits or losses
- AB4 can be used to determine which adjustments should be made to retained profits as reported under HKFRS in the company's stand-alone financial statements in order to arrive at net realisable profits

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- The adjustments should be made to retained profits as reported under HKFRS in the company's stand-alone financial statements in order to arrive at net realisable profits will generally fall into one of the following four categories:
  - excluding unrealised profits recognised in profit or loss;
  - including realised profits recognised outside of profit or loss;
  - deducting realised losses recognised outside of profit or loss; and
  - other permissible or required statutory adjustments,

with the most common adjustments appearing in the first category, such as excluding investment property revaluation gains (less deferred tax) when the investment property is carried at more than its cost.

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- It is important that directors consider whether further adjustments to retained earnings are required in order to estimate the net amount of realised profits available for distribution
  - Specifically, the directors need to consider whether, at the relevant date for determining net realised profits available for distribution, the company's balance sheet contained other assets or liabilities, the acquisition or re-measurement of which may have given rise to amounts being reported in profit or loss which did not represent realised profits or losses
  - Likewise, directors should consider whether there are other amounts that have been recognised in equity other than through profit or loss which may represent realised profits or losses

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Part 6 - Other Considerations When Determining Distributable Profits

- Section 2 of AB4 also includes discussion of other legal requirements that should be taken into consideration when determining profits available for distribution
- Section 2 covers the following key matters, as well as discussion of the other aspects of the legal framework for distributions, such as the date of the distribution, the references in the Ordinance concerning distributions in kind and the specific rules relating to authorised institutions and insurance companies carrying out long term business
  - Listed companies – Additional requirements
  - Accounts supporting a distribution – Relevant accounts
  - Directors' fiduciary duties

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LISTED COMPANIES – ADDITIONAL REQUIREMENTS

[para. 2.30 – 2.31, Appendix 1]

- Listed companies are required to comply with additional statutory restrictions on the amount of profits available for distribution
  - Under section 79C of the Ordinance, a listed company may make a distribution only if, after giving effect to such distribution, the amount of its net assets is not less than the aggregate of its called up share capital and undistributable reserves as shown in the relevant accounts
  - The consequence of such restriction is that the realised profits of a listed company would have to be reduced by its net unrealised losses in order to arrive at the amount of profit available for distribution. This is illustrated in appendix 1 to AB4

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ACCOUNTS SUPPORTING A DISTRIBUTION – RELEVANT ACCOUNTS

[para. 2.2, 2.12 – 2.24, 2.28 – 2.29]

•Whether or not a distribution may be made is determined by reference to the information set out in the “relevant accounts”

•The “relevant accounts” are normally the audited financial statements of the company in respect of the last preceding financial year

- However, where a distribution would be found to contravene the distribution rules if the directors only make reference to the company’s last annual financial statements, the company must prepare “interim accounts” so as to enable a reasonable judgement to be made

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- Section 2 of AB4 contains further details of the requirements relating to the preparation of these accounts and the extent to which they need to be audited

- Notwithstanding the above, if the last annual accounts show sufficient accumulated distributable profits to support a proposed distribution but the directors are aware that this position has been eroded by subsequent losses, it would be imprudent for the directors to declare a dividend in excess of the estimated distributable profits at the time of the declaration: it may also be regarded as an unlawful payment out of capital

- These common law principles and the directors' fiduciary duties in respect of the prudence of making a distribution are discussed further in paragraphs 2.1 to 2.5 of AB4

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DIRECTORS' FIDUCIARY DUTIES

[para. 2.1 – 2.5]

- Directors are subject to fiduciary duties in the exercise of the powers conferred on them
  - Examples of fiduciary duties include the obligation on directors to safeguard the company's assets and to ensure that the company is in a position to settle its debts as they fall due

- Therefore, in determining the amount of dividends to be proposed directors should consider whether it is prudent to distribute profits even though they may otherwise be realised profits in accordance with this guidance, with due regard for the future cash needs of the company.

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- Likewise, where there is uncertainty as to whether a profit ought properly to be regarded as realised or unrealised, it may be prudent for directors to assume the profit is unrealised and therefore not regard the amount as being available for distribution

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Part 7 - Examples on Adjusting Retained Earnings under HKFRS to Estimate Net Realisable Profits Available for Distribution

- As discussed in the forepart of this presentation, the guidance in AB4 on determining whether a profit or loss is realised can be used to determine which adjustments need to be made to accumulated retained profits as reported under HKFRS in the company's statement of financial position (commonly referred to as the balance sheet) in order to arrive at net realisable profits available for distribution

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- The adjustments will generally fall into one of the following four categories:
    - excluding unrealised profits recognised in profit or loss;
    - including realised profits recognised outside of profit or loss
    - deducting realised losses recognised outside of profit or loss
    - other required or permissible statutory adjustments

- As mentioned in the main body of the Staff Summary, the examples listed below include those that we consider are likely to be the most commonly encountered
    - However, the list is not exhaustive, and it is important that directors consider whether further adjustments to retained earnings are required in order to estimate the net amount of realised profits available for distribution

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- Specifically, the directors need to consider whether, at the relevant date for determining net realised profits available for distribution, the company's balance sheet contained other assets or liabilities, the acquisition or re-measurement of which may have given rise to amounts being reported in profit or loss which did not represent realised profits or losses
    - Likewise, directors should consider whether there are other amounts that have been recognised in equity other than through profit or loss which may represent realised profits or losses

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- For example, if a company early adopts HKFRS 9 and no longer transfers losses on impaired financial assets carried at fair value through other comprehensive income to profit or loss, then such a company would need to consider whether any of the losses in value below cost recorded in the fair value reserve in equity should be regarded as "realised losses" in accordance with the principle set out in paragraph 3.10 and the additional guidance set out in section 4 of AB4 (specifically paragraphs 4.29 to 4.32)

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Examples of adjustments that may need to be made to company level retained profits as reported under HKFRS in order to arrive at net realisable profits available for distribution (Annex I)

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(A) Exclude profits which have been recognised in profit or loss but which are not yet realised

- Valuation gains from investment properties, less related deferred tax, to the extent that the properties are carried at the balance sheet date at more than cost *[Para. 4.13 / 10.41]*
- Valuation gains from fair value re-measurement of financial instruments (including embedded derivatives and financial liabilities), less any related deferred tax, that have been classified as at fair value through profit or loss under HKAS 39 but do not meet the "readily convertible to cash" criteria, to the extent that the assets are carried at the balance sheet date at more than cost (or, in the case of liabilities, are carried at less than cost) *[Para. 4.2 – 4.11, 4.26 – 4.28, 10.40]*

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- Profits that arose from the swap of dissimilar assets or barter transactions, where the asset received did not meet the definition of "qualifying consideration" (e.g. profits arising on a swap of dissimilar properties) and is still held at the balance sheet date *[Para.10.44 - 10.55]*
- Negative goodwill (e.g. on the acquisition of an unincorporated business), to the extent not yet realised in accordance with the guidance in paragraph 3.25 *[Para.3.24 – 3.27]*
- Accumulated share of profits of associates or joint ventures recognised in the company's financial statements under the equity or proportional consolidation method, adjusted for any dividends received or receivable in the form of "qualifying consideration" *[Para.10.1 - 10.6]*

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- Exchange gains on retranslation of long-term inter-company balances denominated in foreign currencies, when the underlying balance does not meet the definition of "qualifying consideration" *[Para. 3.21A]*

- Dividends from subsidiaries and profits arising on other inter-company transactions which were not in the form of "qualifying consideration" when considered in isolation or together with other linked transaction(s). For example:
  - dividends from a subsidiary, or profits from sales of assets from the parent to a subsidiary, funded directly or indirectly by funds from the parent
  - sale of an asset by a subsidiary to the parent followed by a dividend out of the resulting profit, where the transactions and arrangements from the parent's perspective are in substance the receipt of a dividend in specie

  [Para. 9.5-9.34]

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B Include realised profits that were not recognised in profit or loss

- Valuation gains from available-for-sale financial instruments recognised in the fair value reserve, less any related deferred tax, except when they are not "readily convertible to cash" (for example, when there is no ready market for the instruments and/or they are being held for strategic purposes) *[Para. 4.2 – 4.12, 4.25, 10.40]*

- Capital contributions from shareholders recognised directly in equity, which were received in cash or another form of qualifying consideration or converted into such since receipt *[Para. 3.14(c)]*

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- Option premiums received in the form of "qualifying consideration" recognised directly in equity (this does not include the amount credited to equity as the equity component of a convertible instrument), unless the amount has been credited by the company to a non-distributable reserve *[Para. 6.16 – 6.20]*

- The credit entry recognised directly in equity for the fair value of options granted under a share-based payment arrangement, unless the amount has been credited by the company to a non-distributable reserve *[Para. 7.46 – 7.56]*

- Amounts credited directly to a merger reserve within equity, to the extent that they have been realised in accordance with the guidance in paragraph 9.4 e.g. when dividends have been received from the relevant subsidiaries out of pre-acquisition profits *[Para. 9.44]*

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C Deduct realised losses that were not recognised in profit or loss

- Amounts debited directly to a merger reserve within equity which have become realised losses as a result of the corresponding assets being depreciated / impaired *[Para. 9.35 – 9.40]*

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D Consider other required or permissible statutory adjustments

- Under section 79C of the Ordinance, listed companies are subject to an additional “net assets” test, which restricts the profit available for distribution when the listed company has net unrealised losses *[Para. 2.30 – 2.31, Appendix I]*
- Under section 79K of the Ordinance, certain losses may be regarded as unrealised if they arise on the revaluation of all of a company’s fixed assets
  - For example, an impairment loss recognised in respect of an investment in a subsidiary carried at cost, which would otherwise be considered a realised loss, may be offset by an increase in value of another subsidiary even though that gain is not recorded in the financial statements
  - Certain conditions need to be met if a company intends to take advantage of this section: further details are set out in AB4. *[Para. 2.31A-2.31I]*

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•Part 2 – Fair Value Accounting (Section 4 of AB4)
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•Part 4 – Highlights of Complex Sections
To get a flavor!

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Part 1 – The Legal Framework

- **The Common Law**
  - The legal framework relating to the determination of realised profits and losses and of profits available for distribution consists of two elements: common law and statutory provisions
  - Under section 79P, 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

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- 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, 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 of AB4
  - It is not practicable to give further guidance on the application of the capital maintenance rule in AB4: appropriate advice will have to be taken to deal with specific circumstances

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- **Fiduciary duties and volatility**
  - Directors are subject to fiduciary duties in the exercise of the powers conferred on them
    - Examples of fiduciary duties include the obligation on directors to safeguard the company's assets and 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

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- In the context of fair value accounting, volatility is an aspect where directors will need to consider their fiduciary duties
  - The fair value of financial instruments may be volatile even though such fair value is properly determined in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement* (subsequently referred to as HKAS 39 for brevity)
  - Directors should consider, as a result of their fiduciary 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

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- Similarly, HKAS 39 is based on a “mixed measurement 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 fiduciary duties, whether it would be prudent to distribute them

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- **Profit available for distribution**

- A company may make a distribution only out of profits available for that purpose (section 79B(1))
- 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 capital) (section 79B((2))
- Thus realised losses may not be offset against unrealised profits. Section 79C imposes a further restriction on listed companies

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- Section 79A(3) of the Ordinance provides that references to realised profits, in relation to a company's accounts, are to such profits of the company as fall to be treated as realised profits for the purposes of those accounts in accordance with principles generally accepted with respect to the determination for accounting purposes of realised profits at the time when those accounts are prepared.

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- **Locally incorporated authorised institutions**

  - Under the guidance issued by the Hong Kong Monetary Authority (HKMA) on 12 April 2005 following the implementation of HKAS 39 in Hong Kong, locally incorporated authorised institutions (AIs) are generally required to hold a regulatory reserve in excess of the individual and collective impairment allowance determined under HKAS 39

  - The regulatory reserve is defined under Section 2 of the Banking (Capital) Rules as that portion of an AI's retained earnings which, for the purpose of Paragraph 9 of the Seventh Schedule to the Banking Ordinance, is earmarked or appropriated to maintain adequate provision for losses which the institution will or may occur

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- Given that the regulatory reserve is intended to cover losses which may occur at some point in the future, it is not distributable
- Movements in the reserve are subject to the consultation with the HKMA. Appropriate disclosure in respect of the regulatory reserve is also required. Other than the regulatory reserve requirement, AIs are obliged to observe minimum capital adequacy and liquidity ratios on an ongoing basis under the Banking Ordinance, on which the distribution of profits will have a bearing
- Therefore AIs should ensure that they have taken into account these supervisory requirements in determining their profits distribution and the related disclosures

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- **Subsequent Events**
  - 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
  - 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 79J(1))

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Part 2 - Fair Value Accounting (Section 4 of AB4)

- **Financial instruments**
  - The definition of "readily convertible to cash" in paragraph 3.12 is closely but not completely aligned with the measurement guidance in HKAS 39. Necessary differences remain
  - 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,

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- ➢ 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

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- 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.

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- **Unquoted equity investments**
  - Although increases in the fair value of many financial assets will meet the test of being “readily convertible to cash” at 3.12 above, this will not generally be true of unquoted equity investments
  - 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 HKAS 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

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- **Investment properties**

   - 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

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

   - Under HKAS 39, profits and losses on “available-for-sale” financial assets are recognised in equity through 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. sold) at which time the cumulative profit or loss previously recognised in equity is recognised in profit or loss (i.e. “recycled”)

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- 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
  - 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” on initial recognition, when using the fair value option in the circumstances permitted by the relevant accounting standards
  - However, profits on remeasurement of available-for-sale financial assets will be realised or unrealised in accordance with the principles described above, irrespective of whether they meet the requirements to be accounted for at fair value through profit or loss

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- For companies reporting under HKFRSs, there is no requirement to credit profits taken to equity on available-for-sale investments to any particular reserve
  - 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.

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- **Losses**

  - 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 AB4

  - 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 Para. 3.9(f)

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- Para. 3.9(f) of AB4 states that a profit previously regarded as unrealised (such as amount taken to a revaluation reserve, merger reserve or other similar reserve) becoming realised as a result of:

  - consideration previously received by the company becoming "qualifying consideration"; or

  - the related asset being disposed of in a transaction where the consideration received by the company is "qualifying consideration"; or

  - A realised loss being recognised on the scrapping or disposal of the related asset; or

  - A realised loss being recognised on the write-down for depreciation, amortisation, diminution in value or impairment of the related asset; or

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- The distribution in specie of the asset to which the unrealised profit relates; or
- The receipt of a dividend in the form of qualifying consideration when no profit is recognised because the dividend is deducted from the book value of the investment to which the unrealised profit relates (e.g. as required by HKAS 27 (before its amendment in October 2008) in the case of dividends out of pre-acquisition profits of subsidiaries)

in which case the appropriate proportion of the related unrealised profit becomes a realised profit.

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- Cumulative net losses arising on fair value accounting will be unrealised only if both:
  - profits on remeasurement of the same asset or liability would be unrealised; and
  - the losses would not have been recorded otherwise than pursuant to fair value accounting
    - 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

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- It is well established that the recoverable amount of tangible fixed assets (e.g. properties used in a business) may exceed their fair value
  - 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

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Part 3 – Numerical Illustrations of the Impact of Section 79C (Annex II)

- As discussed in paragraphs 2.30 to 2.31 of AB4, Section 79C places a further restriction on the amount of profits that a listed company may regard as distributable
- Under section 79C, a listed company may make a distribution only if, after giving effect to such distribution, the amount of its net assets is not less than the aggregate of its called up share capital and undistributable reserves as shown in the relevant accounts. The following examples illustrate how this test works to restrict the amount of profits that a listed company may distribute in certain circumstances

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- For ease of illustrating the impact of section 79C, it is assumed in the following examples that all profits and losses recognised through the income statement (and therefore the balance of "retained earnings") are "realised" within the meaning of section 79B and that all profits or losses recognised directly in equity are "unrealised"

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Example 1: "unrealised profits" exceed "unrealised losses"

Company A has the following equity:

Share capital	100
Share premium	80
Capital redemption reserve	70
Unrealised profits	140
Unrealised losses	(125)
Retained earnings	500
Total equity	765

Determination of profits available for distribution:

- If Company A is unlisted then only section 79B would apply. On this basis, the company's distributable profits are simply the net amount of realised profits not previously distributed or capitalised i.e. here it would be the balance of retained earnings of 500.

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However, if Company A is a listed company then section 79C also applies (in addition to section 79B) to restrict the amount of a distribution and the amount that may be distributed is calculated as follows:

"Net assets" (i.e. total equity)	(A)	765
"Aggregate of called up capital and undistributable reserves":		
Share capital		100
Share premium		80
Capital redemption reserve		70
Amount by which unrealised profits (140) exceeds unrealised losses (125)		15
	(B)	265
Profits available for distribution under section 79C: excess of (A) over (B)		500

Conclusion: if a listed company's unrealised profits are more than its unrealised losses then there is no practical impact of section 79C i.e. the distributable profits computed under section 79C for a listed company would be the same as those computed under section 79B for an unlisted company.

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Example 2: "unrealised profits" are less than "unrealised losses"

The facts are the same as in example 1, except that Company A's unrealised profits are 75, not 140 i.e. Company A has the following equity:

Share capital	100
Share premium	80
Capital redemption reserve	70
Unrealised profits	75
Unrealised losses	(125)
Retained earnings	500
Total equity	700

Profits available for distribution:

- If Company A is unlisted then only section 79B would apply. On this basis, as with example 1, the company's distributable profits are simply the net amount of realised profits not previously distributed or capitalised i.e. here it would be the balance of retained earnings of 500.

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However, if Company A is a listed company then section 79C also applies and the amount that may be distributed is calculated as follows:

"Net assets" (i.e. total equity)	(A)	700
"Aggregate of called up capital and undistributable reserves":		
Share capital		100
Share premium		80
Capital redemption reserve		70
Amount by which unrealised profits (75) exceeds unrealised losses (125)		0
	(B)	250
Profits available for distribution under section 79C: excess of (A) over (B)		450

- Conclusion: Example 2 demonstrates that section 79C reduces the amount that a listed company may distribute when the listed company's unrealised losses exceed its unrealised profits. That is, here Company A's unrealised losses were 125, while its unrealised profits were only 75 (i.e. a shortfall of 50). As a result, if Company A is listed then the maximum that it may distribute is 450, compared to 500 if it were unlisted.

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Part 4 – Highlights of Complex Sections - To get a flavor!

- **Section 5 – Hedge Accounting**

- In the case of fair value hedges under HKAS 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)
  - 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. if a fair value movement is not readily convertible to cash)

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- **Section 6 – Issues Arising from HKAS 32 "Financial Instruments: Presentation"**

  - Under HKFRSs, financial instruments are presented according to the substance of the contractual arrangement, determined by the rules in HKAS 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

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- Also, compound financial instruments are accounted for under the relevant standards using "split 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 HKAS 32)

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- There are ten principles underpinning the guidance. The principles are those underlying statute and common law in respect of distributions and capital maintenance
- ***Principles - General***
  - 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
  - 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

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

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- 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

- ***Principles - Impact of Section 79C for listed companies***
  - Principle 7 - The treatment of certain shares wholly as liabilities under HKFRSs does not in itself affect the application of the section 79C net assets test for listed companies and thus does not restrict distributable profits

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- 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 79C and thus restricts distributable profits for listed companies under that section

- Principle 9 - On initial recognition, split accounting for compound financial instruments does not restrict distributable profits for listed companies under section 79C

- Principle 10 - The accretion of the liability component of compound financial instruments reduces distributable profits for listed companies under section 79C unless the instrument is legally a debt

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- **Section 7 – Employee Share Scheme**

  - HKFRS 2 requires 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

  - HKFRS 2 requires 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

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- Any expense recognised in accordance with HKFRS 2 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. However, the overall impact of the HKFRS 2 expense on distributable profits will depend on the status of the credit entry in equity.

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- **Section 8 – Retirement Benefit Schemes**

  - 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 profit and loss or in equity through other comprehensive income (i.e. the total amounts taken to reserves).

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- Paragraphs 8.11 to 8.13 of AB4 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 of AB4 provide that it is determined from the movement in the pension scheme asset or liability on the balance sheet since inception of the scheme (i.e. 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 of AB4 provide a method of estimating the amounts

- Paragraph 8.18 of AB4 then describes some circumstances when it is possible to deduce easily, without working through these procedures, that all amounts accumulated in reserves are realised

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- **Section 9 – Intra-group Transactions**

  - Dividend received or receivable on an investment in a subsidiary

    - 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 Paragraph 9.6 of AB4 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)

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- **Section 10 – Other Issues**

  - HKAS 27, HKAS 28 and HKAS 31 – Separate financial statements
  - HKAS 12 – Income taxes – Deferred tax
  - HKAS 16 – Property, plant and equipment – asset swaps
  - HKAS 18 – Revenue – Barter transactions
  - Currency in which distributable profits are determined
  - Exchange differences taken to equity other than through profit or loss

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The Upcoming Technical Programmes for 2010

- Financial Reporting Forum – Developments in proposed IFRS on Revenue Recognition and Leases
  Meeting with IASB Member, Tatsumi Yamada **(2 September 2010)** NEW *Book now*
- TUE 122 - HKAS 36 *Impairment of Assets* and new developments (21 September 2010)) **– FULL**
- TUE 123 - Practice Note 740 *Auditor's letter on Continuing Connected Transactions* (28 September 2010) **– FULL**
- Seminar on the revised Code of Ethics for Professional Accountants to discuss key changes in the Institute's revised Code of Ethics 27 July, 7 September, 5 October and 2 November 2010) **– FULL**
- Re-run workshop on HKFRS for Private Entities (September **– FULL** and October) NEW

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Other Ongoing Technical Services provided

(1) TechWatch

- A monthly publication with the objective of updating members on the latest technical developments in auditing, code of ethics, financial reporting and business

http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/techwatch

(2) Small and Medium-sized Practitioners and Small and Medium-sized Enterprise Resource Centre

- Specifically created to assist the SMP and SME sectors to access technical publications and knowledge on an effective basis

http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/smp-and-sme-resource-centre

(3) Financial reporting and auditing alerts

- Alert to draw members' attention to topical financial reporting and auditing issues that should be given particular attention

http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/financial-and-auditing-alert

(4) Staff summary of newly issued financial reporting standards

- Provide members with an overview of requirements in relation to new Hong Kong Financial Reporting Standards issued by the Institute

http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/staff-summary

(5) Technical enquiry system

- Members can submit technical queries by email on standards issued by the Institute and where appropriate, examples will also be provided to assist members' understanding on issues related to auditing, code of ethics or financial reporting

https://app1.hkicpa.org.hk/professionaltechnical/policy/content.php

(6) HKFRS for Private Entities Information Centre

- Specially created to assist members and other stakeholders to have an easy access to information in relation to the HKFRS for Private Entities

http://www.hkicpa.org.hk/en/standards-and-regulations/standards/hkfrs-pe-info-centre

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