



1 December 2009

To: **Members of the Hong Kong Institute of CPAs**
All other interested parties

**INVITATION TO COMMENT ON EXPOSURE DRAFT OF PRACTICE NOTE 610
GUIDANCE ON THE DETERMINATION OF REALISED PROFITS AND LOSSES
IN THE CONTEXT OF DISTRIBUTIONS UNDER THE HONG KONG
COMPANIES ORDINANCE**

Comments to be received by 29 January 2010

The Hong Kong Institute of Certified Public Accountants' (Institute) Financial Reporting Standards Committee (FRSC) is seeking comments on the Institute's Exposure Draft (ED) of Practice Note 610 which has been posted on the Institute's website at:
<http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/exposure-drafts/>

Limited liability companies incorporated under the Hong Kong Companies Ordinance (the Ordinance) are only permitted to make distributions out of their net accumulated realised profits. Underlying the distribution rules is the concept of "realised" profits and losses, as set out in Section 79A(3)(b) of the Ordinance. In particular, "realised profits" in relation to a company's accounts are defined as those that fall to be treated as realised 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.

At present, the Hong Kong Financial Reporting Standards (HKFRS), which have been fully converged with International Financial Reporting Standards (IFRS) since 1 January 2005, do not contain any explicit "principles generally accepted with respect to the determination for accounting purposes of realised profits" and it is implicitly clear that the HKFRS concept of income recognition in the income statement is unrelated to the concept of realisation. There has therefore been lack of guidance for determination of such "realised profit".

Accordingly, the Institute proposes to issue "Practice Note 610" for the purpose of providing guidance in respect of identifying, interpreting and applying the principles relating to the determination of realised profits and losses for the purposes of making distributions under the Companies Ordinance. With the kind permission of the Institute of Chartered Accountants in England and Wales (ICAEW) and the Institute of Chartered Accountants of Scotland (ICAS), the proposed Practice Note is closely based on Technical Release TECH 01/09 *Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Companies Act 2006* jointly published by ICAEW and ICAS, amended to tailor for the Hong Kong specific context.

The key principles for determining realised profits, as contained in the proposed Practice Note, are summarised in a separate Staff Summary which accompany the Practice Note.

In accordance with the Institute's due process, comments are invited from any interested party. The FRSC would like to hear from both those who do agree and those who do not agree with the guidance contained in the ED. Comments should be supported by specific reasoning and should be submitted in written form.



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Any comments should be submitted to the Institute on or before **29 January 2010**.

Comments may be sent by mail, fax or e-mail to:

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Comments may be made available for public review unless otherwise requested by the contributor.



HKICPA Practice Note 610 *Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Hong Kong Companies Ordinance*

HKICPA Standard Setting Department Staff Summary ([Date])

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The HKICPA Standard Setting Department welcomes your comments and feedback, which should be sent to commentletters@hkicpa.org.hk.

Introduction

The purpose of this staff summary is to provide an overview of the guidance set out in the Practice Note 610 - "Guidance on the determination of realised profits and losses in the context of distributions under the Hong Kong Companies Ordinance" issued by the Hong Kong Institute of Certified Public Accountants" (the "Practice Note"). It accompanies, but does not form part of, the Practice Note. For ease of reference, cross-references to the main text of the Practice Note are included where relevant.

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 net accumulated "realised profits". "Realised profits" are defined in 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.

Although the Ordinance refers to such profits being determined in accordance with generally accepted accounting principles, in practice it should not be assumed that simply because an amount has been recorded in the company's income statement, then it can be regarded as "realised" and hence distributable. This is because increasingly the concept of income *recognition* in the income statement under Hong Kong Financial Reporting Standards ("HKFRSs") is unrelated to the concept of *realisation* under Hong Kong law. Similarly, profits and losses recorded directly in equity are not necessarily "unrealised".

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 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 listing rules.

This Practice Note provides guidance on such issues and it is applicable on issue.

Given the common origins of the currently applicable law on distributions found in Hong Kong and the United Kingdom, the contents of this Practice Note 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” (“TECH 01/09”), reproduced by kind permission of the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland. Modifications have been made, as and where appropriate, to adapt TECH 01/09 to suit Hong Kong circumstances.

The resulting Practice Note 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. Overall, the Practice Note 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:
 - o where fair value accounting is adopted **[section 4]**;
 - o where instruments have been classified as debt for accounting purposes, but are capital under the law **[section 6]**, or
 - o 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.

MEANING OF REALISED PROFITS [SECTION 3]

Section 3 to the Practice Note provides detailed discussion of the principles underlying the determination of realised profits. This section is based on 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.

Section 3 expands this 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”;
- (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:

- (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
- (iv) a realised loss being recognised on the write-down for depreciation, amortisation, diminution in value or impairment of the related asset;
- (v) the distribution in specie of the asset to which the unrealised profit relates; or
- (vi) 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. **[para. 3.9]**

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”.

“**Qualifying consideration**” is defined in paragraph 3.11 of the Practice Note as comprising:

- (a) cash; or
- (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, unless:
 - (i) the liability arose from the purchase of an asset that does not meet the definition of qualifying consideration and has not been disposed of for qualifying consideration; and
 - (ii) the purchase and release are part of a group or series of transactions or arrangements that fall within paragraph 3.5 of the Practice Note; 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.

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 accounting purposes, as the trade debtor is a form of “qualifying consideration” under part (d) of the definition. However, profit arising for accounting purposes on the swap of two dissimilar assets, such as the swap of two dissimilar properties, would not be regarded as “realised” at the time of the swap because the property received in the swap is not a form of “qualifying consideration”.

“**Readily convertible to cash**” is discussed in paragraph 3.12 of the Practice Note. In essence, an asset, or 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
- (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.

For example, profits or losses arising on equity securities that are traded in an active market are considered to be realised, regardless of whether under HKAS 39 such changes are recorded in profit or loss or directly in equity in the fair value reserve, 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 a company holding investment properties which has adopted an accounting policy under HKAS 40 of recording valuation increases in profit or loss. 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]**

In addition to the above, the Practice Note 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]**

Sections 4 – 10 to the Practice Note further set out detailed discussions on the following specific areas by applying the broad guiding principles on realised profits as established in section 3:

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 Practice Note 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 |

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 the Practice Note.

Other Considerations When Determining Distributable Profits

Apart from the broad guiding principles on what constitutes a “realised” profit and how the concept is should be applied to specific transactions, section 2 of the Practice Note also includes discussion of other legal requirements that should be taken into consideration when determining profits available for distribution. This section 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 insurance companies carrying out long term business.

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 the Practice Note.



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. Section 2 of the Practice Note 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 the Practice Note.

December 2009
Exposure Draft

Response Due Date
29 January 2010

ED of Practice Note

Practice Note 610 Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Hong Kong Companies Ordinance

This Practice Note is based on the Technical Release (TECH 01/09) "Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006" issued by the Institute of Chartered Accountants in England and Wales (ICAEW) and the Institute of Chartered Accountants of Scotland (ICAS), adapted by the HKICPA to the Hong Kong context. The HKICPA gratefully acknowledges the permission given for the use of the material by the ICAEW and ICAS which are the copyright owners.



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ED of Practice Note 610 Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Hong Kong Companies Ordinance

This Exposure Draft may be filed in the “Exposure Drafts, Invitations to Comment” section of Volume II of the Institute’s Members’ Handbook.

The Exposure Draft can also be found on the Institute’s website at <http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/exposure-drafts/>



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Practice Note 610

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PRACTICE NOTE 610

GUIDANCE ON THE DETERMINATION OF REALISED PROFITS AND LOSSES IN THE CONTEXT OF DISTRIBUTIONS UNDER THE HONG KONG COMPANIES ORDINANCE

(Issued [] 2010)

This Practice Note provides general guidance and does not purport to deal with all possible questions and issues that may arise in any given situation. The HKICPA 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 Practice Note, whether such loss is caused by negligence or otherwise.

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APPENDIX 4 – NUMERICAL ILLUSTRATIONS FOR SECTION 8

- 1.1 This Practice Note provides guidance on the determination of distributable profits under the Hong Kong Companies Ordinance (“the Ordinance”). 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 sections 79A to 79P of the Ordinance. The most common form of a distribution is a cash dividend paid pro rata to ordinary shareholders.
- 1.2 Given the common origins of the currently applicable law on distributions found in Hong Kong and the United Kingdom, the contents of this Practice Note 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” (“TECH 01/09”), reproduced by kind permission of the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland (the “UK Institutes”).
- 1.3 TECH 01/09 contains extensive guidance, including worked examples, on the determination of realised profits and losses for UK incorporated companies that prepare their financial statements under UK GAAP or IFRS, in the context of the UK Companies Act 2006. The technical release includes overviews of the relevant legal framework and the concepts, as well as detailed discussions on how those concepts compare to accounting policies adopted for financial statement purposes, for example where fair value accounting is adopted, where instruments have been classified as debt for accounting purposes, but are capital under the law, or where non-cash intra group transactions have been recognised in the financial statements.
- 1.4 The detailed discussions in this guidance focus in particular on aspects of accounting where interpretative difficulties may arise when attempting to determine the full extent of a company’s profits available for distribution. 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. It is expected that such detailed guidance need only be referred to where the directors need to form a view on the full extent of the company’s distributable profits, for example, if they intend to utilise those profits to make a distribution.
- 1.5 In order to adapt TECH 01/09 to suit Hong Kong circumstances, the following modifications have been made in the course of preparing this Practice Note:
- where the Ordinance includes requirements similar those within the UK Companies Act, the UK source references have been replaced by references to the equivalent requirements in the Ordinance;
 - references to accounting requirements under IFRS have been replaced by references to the equivalent HKFRS requirements;
 - discussions of accounting treatments under UK generally accepted accounting principles (UK GAAP) and any requirements in the UK Companies Act that are not found in Hong Kong law have been removed; and
 - two additional examples that supplement the guidance have been added to Appendix 1.

In general, the above modifications are not specifically noted in the text of the Practice Note.

- 1.6 With the exception of this Introduction, the Practice Note follows closely the text and paragraph numbering of TECH 01/09 to the extent applicable to Hong Kong, without any further amendment. Where whole paragraphs have been deleted as a result of the above modifications (for example, where UK GAAP discussions have been deleted) the paragraph will be marked as “[HK deletion: *reason for deletion*]”. This is for the avoidance of doubt and distinguishes these modifications from the paragraphs that were annotated “[Deleted]” or “[Moved to 6.6A]” etc. in the source text of TECH 01/09. Given this preservation of the paragraph numbering, it is relatively easy to compare this Practice Note with TECH 01/09, for example if interested to find out more about the UK GAAP discussions that have been excluded from the Practice Note.

- 1.7 This Practice Note is the guidance referred to by the Hong Kong Government in their response to concerns over the lack of clarity over the meaning of “realised profits”, which were expressed by respondents to a consultation exercise carried out in June 2008 by the Hong Kong Government on the capital maintenance regime aspects of the Ordinance in the context of the programme to re-write the Ordinance.¹ While acknowledging those concerns, the Government also noted that “realised profit” is a dynamic and complex accounting concept and that the introduction of a statutory definition may result in inflexibility². Consequently, the Government supported the development of guidance by the HKICPA to address this concern.
- 1.8 This Practice Note reflects accounting standards in issue at 1 June 2009. 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.
- 1.9 The revised version of HKAS 1 issued in 2008 makes some changes of terminology, for example referring to a statement of financial position instead of a balance sheet. For simplicity and consistency with the Ordinance, the previous terminology has been retained in this guidance.
- 1.10 This Practice Note serves as guidance on the determination of realised profits and losses in the context of distributions under the Ordinance and does not aim to cover every aspect of the requirements covered by the Ordinance relating to distributions. Companies should consider taking their own legal advice, particularly in relation to any matters not covered by this guidance.

¹ Footnote 5 to paragraph 33 of the “Consultation Conclusions on the Companies Ordinance Rewrite Consultation Paper entitled “Share capital, the capital maintenance regime and statutory amalgamation procedure”” published by the Financial Services and Treasury Bureau of the Hong Kong Government in February 2009.

² Paragraph 33 of the “Consultation Conclusions on the Companies Ordinance Rewrite Consultation Paper entitled “Share capital, the capital maintenance regime and statutory amalgamation procedure”” published by the Financial Services and Treasury Bureau of the Hong Kong Government in February 2009.

The common law

- 2.1 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.
- 2.1A [HK deletion: reference to UK law with no HK equivalent]
- 2.1B 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.
- 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 Practice Note: appropriate advice will have to be taken to deal with specific circumstances.

Fiduciary duties and volatility

- 2.3 In addition, 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.
- 2.4 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.
- 2.5 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.

Definition of a distribution for Part IIA of the Ordinance

2.6 A “distribution” is defined by section 79A 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 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 sections 49 to 49S;
- (c) 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 paying off paid up share capital; and
- (d) a distribution of assets to members of the company on its winding-up.

Profits available for distribution

2.7 A company may make a distribution only out of profits available for that purpose (section 79B(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 capital) (section 79B((2)). Thus realised losses may not be offset against unrealised profits. Section 79C imposes a further restriction on listed companies (see paragraph 2.30 below).

2.8 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. Section 3 below provides guidance on the application of this requirement.

2.8A – 2.8D [HK deletion: reference to UK law with no HK equivalent]

Distributions in kind: Treatment of unrealised profits

2.9 Section 79L provides that where a company makes a distribution consisting of, or including a non-cash asset 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 specie 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.

Distributions in kind: Determination of amount

2.9A – 2.9F [HK deletion: reference to UK law with no HK equivalent]

Distributions in kind: Effect of HK(IFRIC)-Int 17

- 2.9G [HK deletion: reference to UK law with no HK equivalent]
- 2.9H [HK deletion: discussion of UK GAAP]
- 2.9I In December 2008, the HKICPA published HK(IFRIC)-Int 17 *Distributions of Non-cash Assets to Owners*. It is to be applied prospectively (i.e. no restatement of prior periods is permitted) for annual periods beginning on or after 1 July 2009. The scope of HK(IFRIC)-Int 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.
- 2.9J HK(IFRIC)-Int 17 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 may be a significant change of practice (since previously it was not uncommon to recognise such distributions at the book value of the asset transferred) and may, in certain circumstances, have an adverse impact on the ability of a listed company to make a distribution for the reasons explained below.
- 2.9K HK(IFRIC)-Int 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, 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 under HKAS 27 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, as the profit recognised on disposal of the asset (i.e. at the moment of settlement of the distribution) 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 HK(IFRIC)-Int 17 is an advance recognition of an unsettled distribution obligation and is not a realised loss. Therefore, this does not affect the ability of an unlisted company to make a distribution.
- 2.9N For a listed company, this 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 because of the net asset test in section 79C. However, it will not affect the company's ability to make the non-cash distribution in question because that distribution will have been regarded as being made as soon as it was approved (i.e. when the legal obligation was created: see 2.10 below) and is based on earlier relevant accounts.
- 2.9O The test in section 79C is a statutory one which applies to the amounts shown in the "relevant 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 79J. 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 by the members passing a written resolution under section 116B. In the case of an interim dividend authorised under common articles of association (e.g. Table A in the First Schedule to the Ordinance), normally no legally binding liability is established prior to payment being made of the dividend. In such a case, 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 9.5 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 shareholder³.

Merger relief and group reconstruction relief

- 2.11 Where the company has entered into a transaction which gives rise to merger relief or group reconstruction relief under sections 48C or 48D, it may choose under section 48E(1) to 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)⁴. 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 Ordinance 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 of accounts prepared in accordance with HKAS 28 or HKAS 31 (i.e. using equity accounting) where a company has an associate or jointly controlled entity but has no subsidiaries is considered at 10.4 below.
- 2.13 Whether or not a distribution may be made within the terms of the Ordinance 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 members⁵ or interim accounts, if the proposed distribution cannot be justified by reference to the last annual accounts.

³ Section 170(g) of the Ordinance 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 not being members of the company.

⁴ As explained at 9.44B below, a third basis of measurement may be required when applying HKAS 27 as revised in October 2008.

⁵ 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.

- 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 79F(2) as profits, losses, assets, liabilities, provisions⁶, 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 HKAS 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 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 [HK deletion: reference to UK law with no HK equivalent]
- 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 IV of the Ordinance, have been laid before the company at its annual general meeting in accordance with section 122 of the Ordinance and comply with the requirements of section 79G. The requirements of section 79G are that:
- (a) the accounts must have been properly prepared in accordance with the Ordinance, subject only to matters not material for determining the lawfulness of a distribution;
 - (b) where the shareholders of a company have agreed to apply the provisions of section 141D, the balance sheet must give a true and correct view of the state of the company's affairs; and in any other case the balance sheet must give a true and fair view of the state of the company's affairs as at the balance sheet date and the profit and loss account must give a true and fair view of the company's profit or loss for the period in respect of which the accounts were prepared;
 - (c) the accounts must be accompanied, where applicable, by the report of the auditors under section 141 or 141D as appropriate; and
 - (d) if the report of the auditors is qualified, the auditors must state in writing whether in their opinion the matter 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.

⁶ Provisions are defined for this purpose in section 79F(2) as provisions within the meaning of paragraph 30(1) of the Tenth Schedule (depreciation, renewals, diminution in value of assets, retentions to meet liabilities, etc.).

Initial and interim accounts – listed companies

- 2.20 Sections 79H and 79I respectively provide that interim and initial accounts of a listed 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 79B or 79C. A copy of the interim and initial accounts must have been delivered to the Registrar of Companies before the distribution is made (i.e. before the date of the distribution - see 2.10 above).
- 2.21 ‘Properly prepared’ means that the accounts must comply with section 123, including the true and fair requirement in relation to Companies Ordinance accounts. These requirements are to be applied with such modifications as are necessary because the accounts are prepared otherwise than in respect of a financial year. In the case of interim and initial accounts, the balance sheet must be signed in accordance with section 129B.
- 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 Ordinance, the legislation permits a listed company to omit information which is not relevant in determining whether a distribution would be lawful under the Ordinance. 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 listed 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 matter in respect of which their report is qualified is material for determining, by reference to the initial accounts, whether the distribution would contravene sections 79B or 79C. A copy of the auditors’ statement must also have been delivered to the Registrar of Companies.

Initial and interim accounts - non-listed companies

- 2.24 The requirements of sections 79H and 79I regarding the form and content of interim and initial accounts of listed companies do not apply to non-listed companies. Instead, the only requirement for non-listed companies flows from the general definition in section 79F(4) 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 satisfy this requirement. However, management accounts will often 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 Paragraph 29 of Appendix 16 to the Main Board Listing Rules and paragraph 37 of Chapter 18 to the GEM Listing Rules of the Stock Exchange of Hong Kong Limited require a listed issuer to include a statement of the reserves available for distribution to shareholders in its annual report. In the case of a Hong Kong incorporated issuer, the amount should be calculated with reference to the requirements of section 79B of the Ordinance. However, there is no other 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 [HK deletion: discussion of UK GAAP]

2.27 It may be thought helpful to users of financial statements if there is an indication of which reserves are distributable even if, as noted above, there is no legal requirement to do so. However, 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 79J(1)).

Listed companies

2.30 A further restriction is placed on distributions by listed companies (section 79C). A listed company may make a distribution only if, after giving effect to such distribution, the amount of its net assets (as defined in section 79A(1) with reference to section 157HA(15)) 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 79C(2) the following are undistributable reserves:

- (a) share premium account (see also section 48B);
- (b) capital redemption reserve (see also section 49H);
- (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 capital; and
- (d) any other reserve which the company is prohibited from distributing by any enactment, or by its memorandum or articles.

This means that, in calculating the amount available for distributions, a listed 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 the presentation of shares as liabilities in the balance sheet are addressed at 6.24 *et seq.*

Appendix I sets out two numerical illustrations of the impact of section 79C.

Provisions

The general rule and the exception

2.31A Section 79K(1) states that for the purposes of sections 79B and 79C a provision of any kind mentioned in paragraph 30(1) of the Tenth Schedule, other than:

- one in respect of a diminution in value of a fixed asset appearing on a revaluation of all the fixed assets of the company; or
- one in respect of all of its fixed assets other than goodwill

is to be treated as a realised loss.

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) is not treated as a realised loss (section 79K(1)). 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 listed company in determining the amount available for distribution as the requirements of section 79C (Restrictions on the distribution of assets) referred to at 2.30 above must be satisfied.

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. Sections 79K(4)-(6) provide 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.

Application of the exception under HKFRSs

2.34A Due to changes in accounting methods and choices as between cost and valuation, effected by the implementation of HKFRSs, the question might arise as to whether the exception provided for by section 79K(1) continues to be capable of use under HKFRSs. The following paragraphs explain the exception, the questions that might arise, and the conclusion that the exception does continue to be capable of use under HKFRSs.

2.34B Section 79K(1) excludes a provision in respect of a diminution in value of a fixed asset appearing on a revaluation of all the fixed assets of a company, or of all of its fixed assets other than goodwill from being treated as a realised loss. This preserves, for companies applying HKFRSs, an exception to the normal rule that all provisions are treated as realised losses.

2.34C For example, using section 79K, 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). Similarly where financial assets are regarded as fixed assets, such as in the case of investment companies, 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).

Definition of “fixed assets”

- 2.34D The exception in section 79K uses the term “fixed assets” which are defined in section 79(K)(7) as meaning assets of a company which are intended for use or otherwise to be held on a continuing basis in the company’s activities. This term is not used in HKFRSs. “Non-current assets” as defined in HKAS 1 will not correspond with “fixed assets” as defined in section 79K(7), for example because the former may include long term debtors.
- 2.34E For the purposes of applying section 79K, fixed assets are those assets that meet the section 79K(7) definition of “fixed assets”. As noted above, these will not necessarily correspond with those presented as non-current assets in the relevant accounts. However, there is nothing in section 79K 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 79K and HKFRSs. Under HKFRSs, only two accounting policies are available for investments in subsidiaries that are not classified as held for sale:
- (a) cost as determined under paragraph 4 of HKAS 27 (see 9.22 below); or
 - (b) in accordance with HKAS 39, which requires such investments to be maintained at fair value.

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 HKAS 39, AG 80-81). HKAS 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 likely to be unattractive to most companies. The expectation, therefore, is that most companies will hold subsidiaries at cost. The issue that arises is whether it is possible to apply the exception for revaluation provisions in section 79K in circumstances where the accounting policy is cost (either through choice or because HKAS 39 does not permit the assets to be revalued).

- 2.34G Any assessment of the value of an asset can be described, for the purpose of the exception in section 79K, 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 79K does not use the term “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 79K.
- 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 79K, 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 79K(4), “...any consideration by the directors of the value at a particular time of a fixed asset is treated as a revaluation” (subject to the requirements of sub-sections (5) to (6)). Section 79K(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 in section 79K in circumstances where the accounting policy is cost (either through choice or because HKAS 39 does not permit the assets to be revalued). Thus, for example, an impairment write down of one subsidiary recognised in the financial statements may be offset by an increase in value of another subsidiary for the purposes of determining profits available for distribution even though the accounting policy is to carry investments in subsidiaries at cost and thus the increase in value is not recognised in the balance sheet.

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 79K(2)). 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 HKAS 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 referred to in section 79K. Such a loss would become realised in the event of a subsequent scrapping, disposal or impairment of the asset.

2.37 [HK deletion: discussion of UK GAAP]

Development costs

2.38 [HK deletion: discussion of UK GAAP and reference to UK law with no HK equivalent]

Continued application of capital maintenance law under HKFRSs

2.39 Those aspects of the Ordinance that deal with matters other than those relating to the form and content of accounts continue to apply when accounts are prepared under HKFRSs. All of the rules on capital maintenance in the Ordinance therefore continue to apply. That is to say, 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 HKFRSs.

Treasury shares

2.40 – 2.42 [HK deletion: reference to UK law with no HK equivalent]

2.43 [HK deletion: see section 7]

Investment companies

2.44 – 2.47A [HK deletion: reference to UK law with no HK equivalent]

Section 79E - Long term insurance business

2.47B The normal rules of the Ordinance (i.e. the section 79B requirement for realised profits and the section 79C net asset rule) apply to insurance companies. However, for the purposes of determining whether there is a realised profit, the section 79A(3) 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.

2.48 Section 79E sets out special rules that apply to an insurance company, to which Parts III to VI of the Insurance Companies Ordinance apply, where it carries on long-term insurance business. In such cases -

- any amount properly transferred to the profit and loss account of the company from a surplus in the fund or funds maintained by it in respect of that business; and
- any deficit in that fund or those funds,

are to be treated as a realised profit and a realised loss respectively.

2.49 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 A deficit in the fund or funds maintained by the company in respect of its long-term business 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 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 For the purpose of these requirements, an actuarial investigation means an investigation to which section 18 of the Insurance Companies Ordinance applies or which is made in pursuance of a requirement imposed by section 32 of that Ordinance.

2.53 Much of the guidance in this Practice Note relates to the identification of generally accepted principles as to the determination of realised profits and losses in relation to section 79A(3). To that extent, it is inapplicable to long-term insurance business of insurance companies to which the above mentioned special rule applies instead. It should not be overlooked, however, that where such a company is a listed company, it must also have regard to the section 79C net assets test.

General

- 3.1 Section 79B(2) of the Ordinance 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, in relation to a company's accounts, are defined as '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 (section 79A(3)). It is apparent from the use of the words 'at the time when those 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 (i.e. in the Statement of Changes in Equity or Reconciliation of Movements in Components of 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" may also 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 guidance also recognises that certain amounts may, as a matter of law, be profits (see 3.8(b) below).
- 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 satisfies the definition of realised profit set out in this guidance. Thus 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. This principle is likely to be of particular relevance for intra-group transactions which are considered in section 9 of this guidance.
- 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.

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 Practice Note.

Profit

3.8 'Profit' for the purpose of section 79A(3) comprises:

- (a) 'income' as defined in the HKICPA's 'Framework' which conveys increases in ownership interest not resulting from contributions from owners; 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 48C or 48D of the Ordinance 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 profit⁷ 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
 - (iv) a realised loss being recognised on the write-down for depreciation, amortisation, diminution in value or impairment of the related asset⁸; or
 - (v) the distribution in specie of the asset to which the unrealised profit relates; or

⁷ Where the related profit has been capitalised, it will not be available for transfer from unrealised profit to realised profit.

⁸ 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.

- (vi) 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 2008⁹) in the case of dividends out of pre-acquisition profits of subsidiaries) (see 9.22 *et seq* below).

in which case the appropriate proportion¹⁰ of the related unrealised profit becomes a realised profit.

3.9A [HK deletion: reference to UK law with no HK equivalent]

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.

Qualifying consideration

3.11 Qualifying consideration comprises:

- (a) cash; or
- (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, unless:
 - (i) the liability arose from the purchase of an asset that does not meet the definition of qualifying consideration and has not been disposed of for qualifying consideration; and
 - (ii) the purchase and release are part of a group or series of transactions or arrangements that fall within paragraph 3.5 of this guidance; 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.

⁹ Amendments to HKFRS 1 First-time Adoption of HKFRSs and HKAS 27 Consolidated and Separate Financial Statements: Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate.

¹⁰ 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.

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” if:

- (a) a value can be determined at which a transaction in the asset or liability could occur, at the date of determination¹¹, 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” 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

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’) received in the form of qualifying consideration; 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 asset¹², except as noted at 2.33 and 2.36 above;

¹¹ 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 realized profits.

¹² 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.

- (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

3.17 A provision for deferred tax should generally be regarded as a realised loss. However, when assets are revalued to their fair value and the gain is 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.

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, of which 4 is cash and 6 is freehold property. If the depreciated historical cost of the asset sold is 5, the total gain is 5 but the realised profit is limited to 4.)

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 is considered in section 5 of this guidance.

Foreign exchange profits and losses

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 realised, irrespective of the maturity date of the monetary item.

3.21A This has become 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 intercompany balances within groups.

3.21B The position regarding certain exchange differences reported in a separate component of equity (i.e. not in the income statement) is considered at 5.7 below in relation to cash flow hedge accounting and at 10.59 *et seq* in relation to foreign operations and the use of a reporting currency which is different from the company's functional currency.

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.

3.23 [HK deletion: discussion of UK GAAP]

Negative goodwill in an individual company

3.24 Neither HKFRS 3 nor HKFRS 3 (Revised) uses the term “negative goodwill” but instead they describe 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 consideration.

3.26 [HK deletion: discussion of UK GAAP]

3.27 HKFRS 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.

Changes in circumstances including changes in accounting policies

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; or
- (c) some other change in circumstance (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 Ordinance defines realised profits, in relation to a company’s accounts, for determining the lawfulness of a distribution as ‘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 the accounts are prepared’ (section 79(A)(3), emphasis added).

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

3.30 The effects of the introduction of a new accounting standard 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 new accounting policies for its individual accounts in 2009 the position is as follows:
- any final dividend for 2008 will not be provided in the 2008 accounts and will first be accounted for in the 2009 accounts. Such a dividend would therefore have to have regard to the effect of adoption of the new accounting policies even though the “relevant accounts” may still be those for 2008 prepared under the previously applicable accounting policies;
 - any interim dividend paid during 2009 would have to have regard to the effect of adoption of the new accounting policies even though the “relevant accounts” may still be those for 2008 prepared under the previously applicable accounting policies; and
 - the 2009 accounts prepared under the new accounting policies would be the relevant accounts for the purposes of the final dividend approved by shareholders in 2010. The effect of a change in accounting policy known to be adopted in 2010 needs to be taken into account in determining the dividend to be approved by shareholders in 2010. The dividend will be recognised in the 2010 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).
- 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 listed company is in this position, those interim accounts are required to be delivered to the Registrar under section 79H.
- 3.35–3.37 [HK deletion: discussion of UK GAAP and application of UK law with no HK equivalent]

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 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) 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 a 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% [i.e., 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% [i.e., 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	<u>60</u>	<u>40</u>
	Available for distribution	100	40
	Distributed	<u>(70)</u>	<u>(28)</u>
YEAR 2:	Brought forward	30	12
	Profit for year	<u>170</u>	<u>-</u>
	Available for distribution	200	12
	Distributed	<u>(150)</u>	<u>(9)</u>
YEAR 3:	Brought forward	<u>50</u>	<u>3</u>

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 HKAS 8 requires all *material* errors to be corrected retrospectively through a restatement of comparatives. 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 an error on the lawfulness of a distribution raises complex legal issues that are beyond the scope of this guidance.

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 fiduciary 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 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*).

Guidance on the application of “readily convertible to cash”***Financial instruments***

- 4.2 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.
- 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” any profit on the original contract, the profit that could be “locked 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 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. 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” or the host contract and embedded derivative together meet the “readily convertible to cash” test (including by reference to close-out if appropriate).

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 (i.e. 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” 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.

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 HKAS 28. It is possible for the company to elect under HKAS 28 to account for its associates (in its separate financial statements) at fair value under HKAS 39 (e.g. as an available-for-sale asset, with fair value changes reported in equity). 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.

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. 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 HKAS 39 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" that might apply if the entire holding was disposed of at the date of determination. In the case of assets (e.g. 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 HKAS 39.
- 4.17 Holdings in financial assets traded in an active market that might be regarded as relatively small (e.g. 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 4.19 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 [HK deletion: discussion of UK GAAP]
- 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 unrealised¹³. 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. 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 HKAS 39, profits and losses on “available-for-sale” financial assets are recognised directly in equity through the statement of changes in equity or statement of recognised income and expense (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”).
- 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” 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 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 HKFRSs, there is no requirement to credit profits taken direct 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.

¹³ A similar adjustment is not required when an overall (i.e. cumulative) loss is recognised on the remeasurement of a financial instrument in accordance with HKAS 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.

Fair value option

- 4.26 HKAS 39 contains conditions regarding when it is permitted to use the fair value option to designate financial instruments “at fair value through profit or loss” on initial recognition. The conditions for using the fair value option are set out in paragraph 9 *et seq* of HKAS 39.
- 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”, “Embedded derivatives”, “Own credit” and “Block discounts” will be most relevant in interpreting the “readily convertible to 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 HKAS 39 hedge relationship, consideration of the guidance in 5.2 to 5.6 “Fair value hedge 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. 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.

Introduction

- 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 HKAS 39 is described below.

Fair value hedge accounting

- 5.2 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).
- 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. 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 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 HKAS 39, the portion of the profit or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in equity through the statement of changes in equity. Such profits and losses are unrealised and become realised only when the hedged transaction affects profit or loss (or HKAS 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 recognised directly in equity (or, later on, added to the cost of a non-financial asset) in accordance with HKAS 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. the “readily convertible to cash” test).

- 5.8 The hedging principle in 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 HKAS 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 HKAS 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 listed company to make distributions because of the application of section 79C (see 6.24 *et seq*).

Net investment hedge accounting

- 5.10 Under HKAS 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 HKAS 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 HKAS 39 is accounted for similarly to a cash flow hedge. So far as the hedge accounting is concerned, the question of whether the hedged item gives rise to realised profits is dealt with at 10.59 to 10.64 below.
- 5.11 [HK deletion: discussion of UK GAAP]

Hedge accounting for foreign equity investments

- 5.12 – 5.13 [HK deletion: discussion of UK GAAP]
- 5.14 Where hedge accounting is not available under HKAS 39, the exchange differences on the borrowings will be included in profit or loss. Unless the equity investment is held at fair value under HKAS 39, 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 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.
- 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” 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 duties, whether it would be prudent to distribute them.
- 5.17 – 5.18 [HK deletion: discussion of UK GAAP]

Introduction

- 6.1 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. 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).
- 6.2 [HK deletion: discussion of UK GAAP]
- 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 scenarios based on examples 1, 2, 4, 6 and 9 set out in the Illustrative Examples appendices to HKAS 32 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 listed companies resulting from the application of the net assets test of section 79C of the Ordinance. 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 Ordinance at the time of payment/redemption, with, where appropriate, the relevant amount being deferred until such time as the Ordinance’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 HKAS 32) or alternate settlement options (see paragraph 26 of HKAS 32). 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 79B(2) of the Ordinance 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” 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 IIA of the Ordinance. Accordingly, they are not counted as losses – and thus not as realised or unrealised losses – for the purposes of Part IIA of the Ordinance.
- 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 in respect of a preference share presented as debt is an advance recognition of a future distribution 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. 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 49P of the Ordinance).
- 6.15A [HK deletion: reference to UK law with no HK equivalent]

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 49P of the Ordinance).

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 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 (i.e. when the payments are set against the liability over time or at the end).[Principle 3]

Principles - Impact of Section 79C for listed companies

- 6.24 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**
- 6.25 Section 79C states that a listed 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 157HA(15) (via section 79A(1)) defines “net assets” for this purpose to mean the aggregate of the company’s assets less the aggregate of its liabilities. By virtue of section 79F, net assets for the purposes of section 79C are those shown in the “relevant accounts” prepared in accordance with applicable accounting standards. 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 79C. 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 79C whether there is any effect on the amount of a company’s “share capital and undistributable 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 79F, 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 79C. This is because the amount of share capital and undistributable reserves as stated in the relevant accounts excludes this amount.
- 6.28 [HK deletion: reference to UK law with no HK equivalent]
- 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 listed company under section 79C, because the issue leaves both net assets and share capital and undistributable reserves (as defined) unaffected.
- 6.30 When the section 79C 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” 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 79C(1) the net assets must be at least equal to the “share capital and undistributable reserves” both before (sub-section (1)(a)) and after (subsection (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 79C and thus restricts distributable profits for listed 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 listed companies. This is due to the advanced 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” as defined by section 79C.
- 6.33 The above contrasts with Principle 1 because in the context of section 79C, the Ordinance gives precedence to the accounting presentation and this restricts the amount of the profits available for distribution.
- 6.33A The existence of any unrealised profits does not alter this situation (e.g., 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. because the effect might be that the surplus of net assets over “share capital and undistributable 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”. This is because, accordingly, the company will meet the test in section 79C(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”, thereby meeting section 79C(1)(b). If the shares in question were originally classified as debt, then the operation of section 79C 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 listed companies under section 79C**
- 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 of cash proceeds and there is no effect on net assets. In respect of the equity component, the initial credit to equity is, at law, share capital (and share premium) and is included in “share capital and undistributable reserves” for the purposes of the section 79C 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. Thus, “share capital and undistributable 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”. 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”. Thus the issue of this instrument contributes an excess of net assets over “share capital and undistributable reserves”. This has the effect of reducing any pre-existing restriction on distributable profits under section 79C. 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 79C 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 listed companies under section 79C unless the instrument is legally a debt

6.39 Where the compound financial instrument is legally a share, the “interest 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” 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” debited to retained earnings (via the profit and loss account) due to the accretion of the liability. Hence, under the section 79C net assets test, the amount that a listed company can distribute is restricted by the accumulated amount of the “interest 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 79C 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 HKAS 32. 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 to the Practice Note 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 (i.e. a discounted amount), with a corresponding debit taken directly to equity. The accounting effect is as if the equity shares had been repurchased immediately.

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 listed company

- 6.49 For a listed 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 (i.e. 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., 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).
- 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 listed company

- 6.53 For a listed 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 6.43 *et seq* 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 listed company

- 6.56 There are no additional considerations for a listed 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 (i.e. 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 listed company

6.58 There are no additional considerations for a listed 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 6.43 *et seq* 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 listed company

6.61 There are no additional considerations for a listed 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, HKAS 32 requires that the company classifies this class of shares as a liability (i.e. debt). Under HKAS 39, 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". 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" 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”, 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 listed company

- 6.66 For a listed company, the presentation of preference shares (i.e. 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 listed company under section 79C. [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 listed company under section 79C 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” 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 HKAS 32, 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 6.43 *et seq* 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” 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”. 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 listed company

6.74 For a listed company, the effect of this HKAS 32 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 HKAS 32 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” 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” 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 HKAS 32, convertible redeemable preference shares are a compound instrument and an issuer of such instruments will use split accounting (see assumptions in 6.43 *et seq* 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 listed company

- 6.82 At the outset there is no effect on distributable profits [Principle 9]. There will be a restriction for a listed 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 HKAS 32, 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" debit in retained earnings.

- 6.86 This is achieved at conversion by crediting to retained earnings an amount equal to the accumulated "interest 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" effectively reverses the "interest 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 listed companies, the effective reversal of the "interest charge" debit at conversion removes the restriction under the section 79C net assets test.

7.1 – 7.45 [HK deletion]

Paragraphs 7.1 – 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.

The original guidance provided in the UK TECH 01/09 draws reference from UITF Abstract 38 "Accounting for ESOP trusts" under UK GAAP. Published literature suggests that a different accounting treatment may be permitted in individual accounts under IFRSs (and consequently HKFRS). The IFRIC 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). As a result, the guidance provided in TECH 01/09 would not be conclusive for a Hong Kong company.

Accordingly, these paragraphs have not been included in this Practice Note.

Expenses for share based payments required by HKFRS 2

- 7.46 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. The paragraphs which follow are concerned with equity-settled arrangements.
- 7.47 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.
- 7.48 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 (see 3.10 above). However, the overall impact of the HKFRS 2 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 HKFRS 2 cannot be a realised profit.
- 7.50 In the case of share options, the credit to equity required by HKFRS 2 will usually be a credit to reserves other than share premium account.
- 7.51 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 HKFRS 2 expense has been included in profit or loss (which would be the case except where the charge had been capitalised as part of the cost of production of an asset) the credit entry in equity in the case of options to subscribe for shares will be a realised profit. The HKFRS 2 expense in the case of options to subscribe for shares will therefore have no net effect on distributable profits.
- 7.52 The manner of settlement (e.g. subscription for new shares or purchase of shares in the market by an ESOP trust) does not affect the expense recognised under HKFRS 2 or whether this is a realised loss.

Intra-group recharges for share-based payments

- 7.53 In November 2006, the IFRIC issued IFRIC 11 “IFRS 2 - Group and Treasury Share Transactions”¹⁴. 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 IFRIC 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 and IFRIC 11 (and consequently HKFRS 2 and HK(IFRIC)-Int 11) require 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/HKFRS 2 which will no longer be available to offset the realised loss recognised as a result of the IFRS/HKFRS 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.

¹⁴ The HKICPA issued the Hong Kong equivalent of IFRIC 11, i.e. HK(IFRIC)-Interpretation 11 “HKFRS 2 – Group and Treasury Share Transactions”, in January 2007.

Introduction

8.1 [HK deletion: discussion of UK GAAP]

8.2 The guidance set out below applies both to pension schemes acquired in a business combination and those that are started by the reporting company.

Defined contribution schemes

8.3 For defined contribution retirement benefit schemes, the cost charged to the profit and loss account under HKAS 19 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 is a realised loss.

Multi-employer schemes

8.4 Under HKAS 19, some companies account for their participation in certain multiemployer defined benefit retirement benefit schemes as if they were defined contribution schemes. Where a scheme meets the criteria for this treatment in HKAS 19, the position as regards realised profits and losses will be the same as for any other defined contribution scheme.

Defined benefit schemes**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 profit and loss or in equity through other comprehensive income (i.e. 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 (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 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 [HK deletion: discussion of UK GAAP]

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 HKAS 19 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 HKAS 19 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, 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 or loss and those recognised in equity. The entries in the equity 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 equity rather than profit or loss.
- 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 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 constitutes a realised profit only to the extent that it is represented by an asset to be recovered by refunds that have been agreed 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'.
- 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 (i.e. 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 Appendix 4. As explained at 8.18 below, it will often be obvious, without any calculations, that all of the amounts included in reserves arising from pension scheme accounting are realised.

- 8.15 Companies that are able to establish the precise amount of the cumulative net credit or debit in reserves in respect of the pension scheme will treat it as realised or unrealised in accordance with 8.11 to 8.13 above.

- 8.16 It may not be practicable 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 estimated approach set out in this paragraph may be taken:
- (a) the calculation set out in 8.14 above may be performed initially using 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 prior to the date of the assessment.
- 8.17 A company adopting the estimated approach set out at 8.16 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 (i.e. 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 the acquisition of an unincorporated business, it will have been recorded initially at fair value as required by HKFRS 3. 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 HKAS 19 on reserves.
- 8.20 [HK deletion: discussion of UK GAAP]

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 HKAS 19 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.

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's¹⁵ 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, those provisions of paragraph 3.5 which relate to artificial, linked (whether legally or otherwise) or circular transactions or arrangements 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 In a group, where there is a cash pooling arrangement or a similar group treasury function, from the perspective of the company seeking to establish a realised profit an increase in debt due from, and/or a decrease in debt due to, the group finance/treasury company will constitute qualifying consideration, provided it:
- (a) is not a transaction or arrangement that falls within paragraph 3.5 of this guidance; and
 - (b) meets the criteria in paragraph 3.11 of this guidance.

An example of a cash pooling arrangement is where a group finance/treasury company effectively acts as a banker by accepting funds and settling debts on behalf of the group company seeking to establish a realised profit.

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).

¹⁵ The terms "parent" and "subsidiary" refer respectively to a "parent undertaking" and a "subsidiary undertaking" as defined in Twenty-third Schedule of the Ordinance.

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 HKAS 32).
- 9.7 A dividend payable is accrued in accordance with HK(IFRIC)-Int 17 (see 9.7A below) or HKAS 10 only when it is “appropriately authorised and no longer at the discretion of the 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. HKAS 10 refers to dividends “declared” after the balance sheet date with the implication that those “declared” before the balance sheet date would be accrued (by both the subsidiary and the parent). However, HKAS 10 refers to dividends that are declared as those that are “appropriately authorised and no longer at the discretion of the 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 In December 2008, the HKICPA published HK(IFRIC)-Int 17 *Distributions of Non-cash Assets to Owners* (see 2.9G-O above). Paragraph 10 states that the liability to pay a dividend is recognised when the dividend is appropriately authorised and no longer at the discretion of the entity. This is consistent with the previous requirement in HKAS 10 which was deleted as a consequential amendment.
- 9.7B Paragraph 10(b) of HK(IFRIC)-Int 17 states that a dividend is recognised on the date when it is declared by management or the board, if the jurisdiction does not require further approval. This might be seen as requiring a change of practice in relation to interim dividends. 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 precedence¹⁶. Also, it may be said that an 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]
- 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.

¹⁶ Paragraphs BC18-20 of HK(IFRIC)-Int 17 explain that the Interpretation does not change the principle on when to recognise a dividend payable. The principle was moved from HKAS 10 into the Interpretation and clarified but without changing the principle.

- 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 later 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.
- 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 by all the members passing a written resolution under section 116B.
- 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 (i.e., a gift); or
 - (iii) a loan which does not meet the definition of qualifying consideration; 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 Ordinance does not deal specifically with the onward distribution by a parent of dividends out of the pre-acquisition profits of its subsidiaries. The position under HKFRSs is considered at 9.22 *et seq* below.

9.21 [HK deletion: discussion of UK GAAP]

9.22 Under HKAS 27, before its amendment in October 2008¹⁷, when investments in subsidiaries are stated using the cost model, any dividends received out of their pre-acquisition profits will be credited against the cost of investment. This is explained as follows in HKAS 27:

“The cost method is a method of accounting for an investment whereby the investment is recognised at cost. The investor recognises income from the investment only to the extent that the investor receives distributions from accumulated profits of the investee arising after the date of acquisition. Distributions received in excess of such profits are regarded as a recovery of investment and are recognised as a reduction of the cost of the investment.”
[HKAS 27 paragraph 4]

9.22A In October 2008, the HKICPA issued an amendment to HKAS 27 which removes this requirement. At the same time, it also issued an amendment to HKFRS 1 which permits the use of the previous GAAP carrying amount of subsidiaries as their deemed cost on transition to HKFRSs. The guidance (9.23 to 9.27) which follows is relevant when applying the unamended HKAS 27 and HKFRS 1. When applying the amended Standards there will generally be no adjustment to the carrying amount of the investment in subsidiaries on transition to HKFRSs so there is no effect on accumulated realised profits.

9.23 On transition to HKFRSs, when applying the unamended HKAS 27, companies have to determine the extent to which any dividends have been received out of the pre-acquisition profits of their subsidiaries. This may be difficult when investments were acquired many years ago but there is no exemption from the requirement in the unamended HKAS 27 or the unamended HKFRS 1.

9.24 The position may be further complicated by the effect of group reorganisations. For example, if a new intermediate holding company is inserted between a parent company and its subsidiary, the retained profits of the subsidiary at the date of the restructuring appear to be pre-acquisition from the perspective of the intermediate holding company even though they may be post-acquisition from the perspective of the group. This is a financial reporting issue which is outside the scope of this guidance on distributable profits. The guidance in the next paragraph will be relevant when dividends received are accounted for as a reduction in the cost of investment, which may include circumstances where the investment arose on a group reconstruction. The amendment to HKAS 27 concerning the treatment of pre-acquisition dividends will eliminate this problem but consideration should be given to the implications of the separate ‘Newco’ amendment made to HKAS 27. This is described at 9.43A below.

9.25 To the extent that dividends received are accounted for as a reduction in the cost of investment, they are not treated as accounting profits at all. However, to the extent that the acquisition of the subsidiary benefited from merger relief or group reconstruction relief, the receipt of such a dividend in the form of qualifying consideration will result in the realisation of an equivalent amount of the related merger reserve (see 9.44 below).

9.26 Most companies will record investments in subsidiaries in accordance with the cost model. HKAS 27 also permits such investments to be accounted for at fair value in accordance with HKAS 39. The requirement in the unamended HKAS 27 for the treatment of dividends out of pre-acquisition profits appears in the definition of the cost method. A similar, more general, requirement appears in unamended paragraph 32 of HKAS 18. Therefore, the requirement applies even when the investments are recorded at fair value in accordance with HKAS 39, although it assumes much less importance in such a case since the company’s income (in its income statement and directly

¹⁷ Amendments to HKFRS 1 “First-time Adoption of HKFRSs” and HKAS 27 “Consolidated and Separate Financial Statements: Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate”.

in equity – e.g. on an available-for-sale classification) comprises the totality of the change in fair value of the investment. In relation to that total income, any dividend could be seen as merely a conversion of part of that income into another form of asset (e.g. cash or a receivable) with a corresponding reduction in the investment carrying value.

- 9.27 When HKAS 39 is used, profits on remeasurement will generally be treated as unrealised (see Section 4 above, dealing with unquoted equity investment carried at fair value). As explained above, when this treatment is adopted, it is still a requirement that any dividends received out of pre-acquisition profits are credited against the carrying value of the investment. To the extent that the profit arising on remeasurement of the investment has been received as a dividend in the form of qualifying consideration, the profit will be a realised profit. Therefore the overall effect is that dividends received out of pre-acquisition profits will increase accumulated realised profits when a policy of remeasuring investments in subsidiaries at fair value is adopted.

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; or
 - (ii) a capital contribution (i.e. a gift); or
 - (iii) a loan which does not meet the definition of qualifying consideration; 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 specie (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; or
 - (ii) a capital contribution (i.e., a gift); or
 - (iii) a loan which does not meet the definition of qualifying consideration; 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 specie

- 9.33 A dividend in specie 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 79L, 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.

Debits within equity arising on group reconstructions

- 9.35 Business combinations involving entities or businesses under common control are excluded from the scope of HKFRS 3, "Business 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 under common control¹⁸ 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. 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 the nominal value of the shares issued plus the value of the cash element, may exceed the book amount of the net assets acquired and this will leave a debit difference to be recognised. It is not goodwill. The debit is sometimes referred to as a "merger difference" and is recorded in equity.

¹⁸ As defined in HKFRS 3.

- 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.
- 9.40 To the extent that the assets, if they had been recognised at the higher amount, 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 79K and the principles of realisation (see section 3), to be regarded as realised.
- 9.41 [HK deletion: discussion of UK GAAP]

Additional consideration for a listed company

- 9.42 For a listed 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 79F 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 "share capital and undistributable reserves" part of the section 79C 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 48C of the Ordinance) or group reconstruction relief (section 48D of the Ordinance). In accordance with section 48E(1) of the Ordinance, 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 HKFRSs, the interaction of these reliefs with the accounting for the acquired asset is complicated.
- 9.43A The HKICPA published amendments to HKFRS 1 and HKAS 27 in October 2008¹⁹ that have implications for the treatment of merger relief and group reconstruction relief for accounting purposes. The amendments are effective for annual periods beginning on or after 1 January 2009 with earlier application permitted. The effect of these amendments is described at 9.44A to 9.44D below.

¹⁹ Amendments to HKFRS 1 "First-time Adoption of IFRSs" and HKAS 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 HKAS 27, which was published in March 2008, that has no effect on the accounting in the separate financial statements of a parent.

- 9.43B Before the amendment in October 2008, HKAS 27 was generally considered to require the acquired asset to be booked at fair value in some or all cases. Therefore, on transition to HKFRSs, it may be necessary to gross up the cost of investment to the fair value at the date of acquisition and to recognise a corresponding “merger reserve”. Although different views have been 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. Similarly, it may also occur to the extent that dividends are received from the subsidiary out of pre-acquisition profits in the form of qualifying consideration and those dividends are recognised as a reduction in the cost of investment (see 3.9(f) and 9.20 above).
- 9.44A In October 2008, the HKICPA issued an amendment to HKFRS 1 which permits the use of the previous GAAP carrying amount of subsidiaries as their deemed cost on transition to HKFRSs. If the exemption in the amended HKFRS 1 is used, there will be no adjustment to the carrying amount of the investment on transition to HKFRSs and consequently no effect on accumulated realised profits. The amendment has no effect on a company that has already adopted HKFRSs in a period before the amended standard is first applied.
- 9.44B In October 2008, the HKICPA also amended HKAS 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 met²⁰, 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”. 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 HKFRS 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 the amount that might have been recorded under section 48E(1) taking into account merger relief or group reconstruction relief (see 9.43 above).
- 9.44C The amendment requires only prospective application to reorganisations occurring in annual periods beginning on or after 1 January 2009. No restatement is required for past reorganisations although this is 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 listed 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 HKAS 27 and for other acquisitions, the guidance at 9.43B and 9.44 above continues to apply.

²⁰ 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.

HKAS 27, HKAS 28 and HKAS 31 – Separate financial statements

- 10.1 The balance of profits available for distribution is that available to the company, not to its 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 (see section 2 above).
- 10.2 HKFRSs do not use the term "individual accounts" but uses the term "separate financial statements" which are defined in HKAS 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 the consolidated financial statements are prepared and the requirements of section 123(5) are met, then the company need only present a company balance sheet, and any related notes such as are necessary in order to give a true and fair view, in order to comply with the requirements of sections 122 and 123. In practice, this company level balance sheet and the related notes are prepared following the relevant requirements set out in HKAS 27 for separate financial statements. This company level balance sheet and related notes would then be the relevant accounts under section 79F.
- 10.4 However, where a company has an associate or jointly controlled entity but has no subsidiaries, in some circumstances HKAS 28 and/or HKAS 31 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 HKAS 28(4) and HKAS 31(5)). In these circumstances, the company is not required by HKFRSs to prepare separate financial statements.
- 10.5 [HK deletion: reference to EU legal framework with no HK equivalent]
- 10.6 Even though in such circumstances the accounts including the equity accounting are the only statutory accounts for the entity, the share of results of associates/jointly-controlled-entities is not realised save 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 whether the company accounts for its investments in associates / jointly controlled entities at cost or using the equity method / proportionate consolidation as appropriate for the purposes of satisfying the requirements under the Ordinance.

[10.7 to 10.16 moved to 2.32 and amended.]

10.17 - 10.38 [HK deletion]

Paragraphs 10.17 to 10.38 are concerned with first time adoption of IFRSs in the UK. Given that HK GAAP has already converged with IFRS it is expected that the application of HKFRS 1 "First-time adoption of Hong Kong Financial Reporting Standards" by Hong Kong incorporated companies should be rare. Accordingly, these paragraphs have not been included in this Practice Note.

HKAS 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.
- 10.40 This principle is also applicable to deferred tax provisions recognised under HKAS 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 It is likely that deferred tax will often be recognised on unrealised profits under HKFRSs. 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 HKAS 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 in Appendix B to HKAS 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* 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. HKAS 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. HKAS 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 HKFRSs. This profit is likely to be unrealised because an item of property, plant and equipment is unlikely to meet the definition of “qualifying consideration” (see 3.11 above).
- 10.46 When a combination of property, plant and equipment and qualifying consideration (e.g. cash) is received, the guidance at 3.18 above on “top-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 HKAS 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. because one is larger than the other).
- 10.50 HKAS 38 provides for the same accounting treatment for swaps of intangibles as that under HKAS 16 in respect of property, plant and equipment, and therefore the foregoing analysis also applies to intangibles under HKAS 38.
- 10.51 [HK deletion: discussion of UK GAAP]

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 HKAS 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.
- 10.53 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 [HK deletion: discussion of UK GAAP]

Currency in which distributable profits are determined

- 10.57 HKAS 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, HKAS 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.
- 10.58 The "relevant accounts" for the purposes of justifying a distribution are determined in accordance with section 79F but will generally be the company's most recent statutory individual accounts. The currency in which those accounts are presented will determine the currency by which the amount of profits available for distribution is measured, but see 10.64 where the presentation currency is not the functional currency.

Exchange differences taken directly to equity

- 10.59 Under HKAS 21, certain exchange differences are reported directly in a separate component of equity (i.e. not in the income statement). This can arise when the legal entity has a foreign operation (i.e. a branch) which has a functional currency which is different from that of the legal entity. In addition, companies reporting under HKFRSs may freely adopt a presentation currency that is different from their functional currency. The exchange differences arising on translation to the presentation currency are similarly taken direct to equity. The issue that arises is whether these exchange differences that are taken direct to equity are realised or unrealised.
- 10.60 In the case of a foreign operation (branch) with a functional currency that is different from the functional currency of the legal entity, the exchange differences taken to equity should be analysed according to the nature of the assets and liabilities on which they arise. A profit that arises on retranslation of an asset which comprises qualifying consideration, or a liability, is a realised profit in accordance with 3.9(d) above. A profit arising on the retranslation of assets which do not comprise qualifying consideration (e.g. property, plant and equipment) is an unrealised profit. A loss arising on retranslation is a realised loss unless it is the reversal of an unrealised profit. The gross profits and losses on retranslation (rather than the net amount taken direct to equity) 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.
- 10.61 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 (i.e., 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 (e.g. because it was invested in assets such as property, plant and equipment which would not comprise qualifying consideration).
- 10.62 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. on an exchange of stocks for cash).
- 10.63 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. Ultimately, it would be necessary to compute and assess exchange differences continually. In conducting the analysis, reasonable approximations may be made.
- 10.64 If a company's share capital is denominated in a currency that is not its functional currency, complex issues may arise regarding the nature of exchange differences on share capital. Complex issues also arise concerning the nature of the exchange differences that arise when a legal entity uses a presentation currency that is different from its functional currency. The analysis above does not necessarily apply in these cases although the accounting treatment is similar. These issues are not addressed in this guidance.

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[HK deletion: examples of the application of certain sections under UK law]**NUMERICAL ILLUSTRATIONS OF THE IMPACT OF SECTION 79C**

As discussed in paragraphs 2.30 to 2.31 of this Practice Note, 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.

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”.

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	<u>500</u>
Total equity	<u>765</u>

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.

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)	<u>765</u>
“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)		<u>15</u>
	(B)	<u>265</u>
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.

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	<u>500</u>
Total equity	<u>700</u>

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.

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)	<u>700</u>
“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)		<u>0</u>
	(B)	<u>250</u>
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.

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 6.6A to 6.6C 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.

HKFRSs do not distinguish between profits that are realised and those that are not. 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 HKFRSs will form their relevant accounts for the purposes of section 79F of the Ordinance, 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 HKFRSs.

In the memorandum accounts, the realised profits available are shown for illustrative purposes as a separate component of equity.

In the HKFRS accounts, "Other reserves" represent amounts taken to equity for accounting purposes but which do not form part of "share capital and undistributable reserves". For listed companies in these illustrations, the expression "share capital and undistributable reserves" for the purposes of section 79C comprises "Share capital", "Share premium" and "Capital redemption 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, arising only by HKFRS 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 HKAS 32, as the company will be required to deliver cash, the forward contract meets the definition of a financial liability.

Journal entries for the HKFRS 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.

Listed company

The recognition of the liability reduces net assets and hence restricts distributable profits for listed companies as a result of the section 79C 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.

Non-listed company

Although the interest is charged to the profit and loss account, it is not a loss for the purposes of Part IIA of the Ordinance. Thus it is not a realised loss.

Listed company

However, for a listed 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 79C on the profits available for distribution of \$100 in total immediately prior to repurchase as a result of this transaction.

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 listed company this will be restricted by \$100, immediately prior to repurchase, through the operation of section 79C, which is applied to the section 79F relevant accounts (i.e. the HKFRS balance sheet below) which show that net assets are equal to share capital and undistributable reserves.

For the purposes of section 79C, in this illustration “share capital and undistributable reserves” comprise “Share capital”, “Share premium” and “Capital redemption reserve”.

HKFRS 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 HKAS 32, 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 HKFRS 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.

Listed company

The recognition of the liability reduces net assets but not share capital and undistributable reserves and hence restricts distributable profits by \$70 for listed companies as a result of the section 79C 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.

Non-listed company

Although the interest is charged to the profit and loss account, it is not a loss for the purposes of Part IIA of the Ordinance. Thus it is not a realised loss.

Listed company

However, for a listed 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 79C on profits available for distribution of the amount recognised as 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	305	0	305	(100)	205

⁺ \$105 represents the maximum profits available for distribution but for a listed company this will be restricted by \$100, immediately prior to exercise, through the operation of section 79C, which is applied to the section 79F relevant accounts (i.e. the HKFRS balance sheet below) which show that net assets only exceed share capital and undistributable reserves by \$5.

For the purposes of section 79C, in this illustration “share capital and undistributable reserves” comprise “Share capital”, “Share premium” and “Capital redemption reserve”.

HKFRS 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 the dollar.

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 HKAS 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 HKAS 32 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 HKFRS 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 listed company there is no restriction through the operation of section 79C, which is applied to the section 79F relevant accounts (i.e. the HKFRS balance sheet below) which show that net assets exceeds share capital and undistributable reserves by \$100.

For the purposes of section 79C, in this illustration “share capital and undistributable reserves” comprise “Share capital”, “Share premium” and “Capital redemption reserve”.

HKFRS 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 year's time. The functional currency of the company is the dollar. 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 HKFRS 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	305	100	405

+ \$105 represents the maximum profits available for distribution. For a listed company there will be no restriction through the operation of section 79C, which is applied to the section 79F relevant accounts (i.e. the HKFRS balance sheet below) which show that net assets exceed share capital and undistributable reserves by \$105.

For the purposes of section 79C, in this illustration “share capital and undistributable reserves” comprise “Share capital”, “Share premium” and “Capital redemption reserve”.

HKFRS 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 the dollar. There are no other features of the bond's terms and conditions that would deny equity treatment for the equity conversion option.

HKAS 32 requires, where 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 HKFRS 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 listed company there is no restriction through the operation of section 79C, which is applied to the section 79F relevant accounts (i.e. the HKFRS balance sheet below) which show that net assets exceed share capital and undistributable reserves by \$100.

For the purposes of section 79C, in this illustration "share capital and undistributable reserves" comprise "Share capital", "Share premium" and "Capital redemption reserve".

HKFRS 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 conversion	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 listed company there is no restriction through the operation of section 79C, which is applied to the section 79F relevant accounts (i.e. the HKFRS balance sheet below) which show that net assets exceed share capital and undistributable reserves by \$100.

For the purposes of section 79C, in this illustration “share capital and undistributable reserves comprise “Share capital”, “Share premium” and “Capital redemption reserve”.

HKFRS 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 HKFRS balance sheet

On day 1:

Dr	Cash	\$110
Cr	Liability	\$110

Being the recognition of the financial liability under HKAS 32.

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" 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.

Listed 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 79C 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 79C 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 HKFRS 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 Ordinance. Consequently, under section 49H of the Ordinance 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 listed company this will be restricted by \$15 through the operation of section 79C, which is applied to the section 79F relevant accounts (i.e. the HKFRS balance sheet below) which show that net assets only exceed share capital and undistributable reserves by \$160.

For the purposes of section 79C, in this illustration "share capital and undistributable reserves" comprise "Share capital", "Share premium" and "Capital redemption reserve".

HKFRS 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 HKAS 32 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 HKFRS 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.

Listed company

For the purposes of section 79C, 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 79C 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.

Non-listed 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". 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.

Listed company

However, for a listed 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 79C, 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 HKFRS 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 Ordinance. Consequently, under section 49H of the Ordinance 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 listed company this will be restricted by \$35 through the operation of section 79C, which is applied to the section 79F relevant accounts (i.e. the HKFRS balance sheet below) which show that net assets only exceed share capital and undistributable reserves by \$165.

For the purposes of section 79C, in this illustration "share capital and undistributable reserves" comprise "Share capital", "Share premium" and "Capital redemption reserve".

HKFRS 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 the dollar. There are no other features of the preference share's terms and conditions that would deny equity treatment for the equity conversion option.

Under HKAS 32 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 HKFRS 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 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.

Non-listed 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". 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.

Listed company

However, for a listed 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 79C, 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 HKFRS 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 Ordinance. Consequently, under section 49H of the Ordinance 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 listed company this will be restricted by \$40, immediately prior to conversion, through the operation of section 79C, which is applied to the section 79F relevant accounts (i.e. the HKFRS balance sheet below) which show that net assets only exceed share capital and undistributable reserves by \$110.

For the purposes of section 79C, in this illustration "share capital and undistributable reserves" comprise "Share capital", "Share premium" and "Capital redemption reserve".

HKFRS 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 reserves	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 listed company this will be restricted by \$40 through the operation of section 79C, which is applied to the section 79F relevant accounts (i.e. the HKFRS balance sheet below) which show that net assets only exceed share capital and undistributable reserves by \$110.

For the purposes of section 79C, in this illustration “share capital and undistributable reserves” comprise “Share capital”, “Share premium” and “Capital redemption reserve”.

HKFRS 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.

NOTE OF LEGAL CONSIDERATIONS REPRODUCED FROM UITF ABSTRACT 38

[HK deletion]

As mentioned in paragraph 7.1 the accounting treatments under the UK UITF Abstract are not necessarily applicable to financial statements prepared under IFRSs (and consequently HKFRSs). Accordingly, the contents of Appendix 3 have not been included in this practice note.

NUMERICAL ILLUSTRATION 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 equity.

	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 equity	4		(4)
Contributions paid	20	(20)	
Carried forward	4	(20)	16

The net effect on the balance sheet in the above example is:

Dr Pension asset	4	
Dr Reserves	16	
Cr Cash		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 as follows:

Surplus recognised in balance sheet	18
Cumulative net contributions	(4)
Surplus recognised on acquisition	(20)
Amount included in reserves (debit)	(6)

Another way of expressing the same calculation is as follows:

Cumulative net contributions		(4)
Surplus recognised in balance sheet	18	
Less: Surplus recognised on acquisition	<u>(20)</u>	
Decrease in surplus recognised		<u>(2)</u>
Amount included in reserves (debit)		<u>(6)</u>

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.