The convergence of the domestic accounting standards with the International Financial Reporting Standards (IFRS), without amending the local statutory provisions, may result in unintended consequences. The IFRS emphasis on fair value accounting may have an impact on the size of the funds distributable to shareholders. This article examines the position in the United Kingdom and Malaysia.

Introduction

The International Accounting Standards Board (IASB) is an independent board, established with the aim of developing high quality, global accounting standards which are generally known as International Financial Reporting Standards (IFRS). Towards this end, the IASB co-operates with national accounting standard-setters and as at March 24, 2009, 117 jurisdictions have either required or permitted their domestic listed companies to use the IFRS as the primary generally accepted accounting practices. Twelve other jurisdictions which do not have a stock exchange have also adopted the IFRS for their domestic companies.¹

However, as the IFRS are intended for global application regardless of local legislative and regulatory environment,² a review of the local statutory provisions pertaining to company accounting is pertinent. The implementation of the IFRS without revising the relevant laws accordingly, may result in unintended consequences. One area which needs urgent attention is divisible profits, i.e. the profits that are available for distribution to shareholders as cash dividend. The IFRS emphasis on fair value accounting, which may differ from the national accounting standard, may have an impact on the size of funds available for distribution.

The case of Malaysia is taken as a point of reference, but similar issues may also arise in other Commonwealth countries which have comparable company law framework. The company law frameworks of these former British colonies were initially based on the English framework and the latter has since undergone major reformation. Thus lessons may be drawn from the UK experience.

Dividend rule

Section 365(1) of the Malaysian Companies Act 1965 provides, inter alia, that no dividend shall be payable to the shareholders of any company except out of profit. Given that the term "profit" is the key to the legality of a distribution to shareholders, it is unfortunate that the Act did not define this word. There is also no court decision in Malaysia defining the said word for this purpose. Thus, the guidelines propounded by the English courts may be referred to as they are of persuasive authorities in Malaysia.

In Spanish Prospecting Co Ltd, Re,³ Fletcher Moulton L.J. said that:

"...Profits' implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates. For practical purposes these assets in calculating profits must be valued and not merely enumerated."

In the early 20th century, there were no settled principles on the valuation of assets and liabilities for the purpose of drawing up a company's financial statements. Immaterial of what rule applies, the method of valuation of the company's assets and liabilities was, and still is, important. As there were variances in the practice then, disputes on the legality of paid dividends arose. One issue raised was whether a company could distribute cash dividend from unrealised profit on a revaluation of asset. There were conflicting decisions. The court in Westburn Sugar Refineries v IRC⁴ held that this practice was prohibited but in Dimbula Valley (Ceylon) Tea Co v Laurie,⁵ the court condoned the practice even though it was detrimental to the company's creditors.

In the United Kingdom, the Committee on Company Law was formed in 1963 to review the Companies Act 1948. The committee which was chaired by Lord Jenkins, proposed to abrogate the Dimbula Valley rule, and that the capital surplus arising from the revaluation of unrealised fixed assets should not be available for distribution in cash dividend. According to the Jenkins Report⁶:

"It is a fundamental principle or convention of accounting practice that profit is normally established at the point of time when it is realised by transfer of ownership or completion of services rendered." However, it took the UK legislature more than 15 years before giving effect to the Jenkins Committee's proposal, and even then it was done to ensure compliance with the EC's Second Directive.⁷ In 1980, when the Companies Act 1980 was enacted, s.39 provided that a company could pay dividend out of the company's profit which was defined as the company's:

"... accumulated realised profit, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, as far as not previously written off in a reduction or reorganisation of capital duly made". This definition was retained in the subsequent revisions of the Companies Act in the United Kingdom. However, this basic dividend rule was subject to much debate.⁸ The phrase "realised profit" was not defined in the Act. The intention was to leave its application "to directors in the light of accounting practice, and ultimately to the courts".⁹ Possibly, the legislature had intended the concept as approved by the Jenkins Committee to apply. Further, para.14 of the Statements of Standard Accounting Practice (SSAP) 2 which was then applicable prescribed that:

"... [R]evenue and profits are not anticipated, but are recognised by inclusion in the profit and loss account only when realised in the form either of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty." If there was no actual realisation of the gains in the form of cash, then such gains should unlikely be reversed.¹⁰ Similarly, SSAP 6 prohibited unrealised gains, i.e. gains on revaluation, to be credited to profit.¹¹ The concept of
realisation as envisaged in SSAP 2 was also in tandem with the judicial attitude. In Willingale v International Commercial Bank, the court held that profit becomes realised when it has been earned, and not merely anticipated.

For better or worse, the link of the concept of realisation of profit for the purpose of divisible profit to accounting standards was expressed in the Companies Act 1981. This Act was enacted to implement the EC Fourth Directive on company accounts. According to art.31(c)(aa) of the Directive, "only profits made at the balance sheet date may be included" in a company's accounts. The UK Department of Trade interpreted "profits made" to mean "that the profits should not be anticipated but... earned and ascertained". In Parliament, the phrase "profits earned and ascertained" was changed to "realised profits". Paragraph 90 of the Eighth Schedule defined realised profits to mean profits treated in accordance with principles generally accepted with respect to the determination for accounting purposes of realised profits. The intention was to clarify that realised profits should be defined in the accounting context, and not in the taxation context. As the Government wanted to link accounting profits and realised profits in the dividend rule, s.21(1) of the Companies Act 1981 extended the definition of "realised profits" to the Companies Act 1980. Thus this definition was applied too to the dividend rule and as a result, there was convergence of the divisible profit rule with the accounting profit in the United Kingdom.

Subsequently, the concept of "realisation" became more obscure. In December 2000, the UK Accounting Standards Board (ASB) issued FRS 18, to supersede SSAP 2. The ASB recognised the significance of the concept of realised profits and Appendix IV (The Development of the FRS) to the FRS traced the development of the concept of realisation. As the concept propounded in SSAP 2 had by then become out dated and no longer accommodate new instruments, it was rephrased. A gain should also be recognised if there is reasonable certainty that it exists and if it can be measured reliably. Accordingly, para.28 of FRS 18 reads:

"... [C]ompanies legislation requires realised profits to be determined in accordance with principles generally accepted at the time that financial statements are prepared. It is generally accepted that profits shall be treated as realised, for these purposes, only when realised (in this context, 'realised' may also encompass profits relating to assets that are readily realisable) in the form either of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty." As the concept of realisation in accounting profit is used too to determine the size of fund available to be distributed to shareholders, the issue of what can lawfully be included into the fund becomes more complicated, particularly with the changes made to the accounting standards. To assist members to deal with this complicated issue, the Institute of Chartered Accountants in England and Wales (ICAEW) issued various Technical Releases (TR). In the year 2008 itself, the ICAEW issued three Technical Releases in response to the enactment of the Companies Act 2006 and the changes to the nation's accounting standards. They are TR 01/08 (Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under Companies Act 1985); TR 07/08 (Draft Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under Companies Act 2006), which is an exposure draft to update TR 01/08; and TR 08/08 (A Comparison Illustrating the Changes Made in Tech 07/08 "Draft Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under Companies Act 2006" to Tech 01/08 "Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under Companies Act 1985").

The ICAEW recognised that:

"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 principles of realisation set out in this guidance are consistent with the notion of realisation as expressed in FRS 18. They are, however, relevant irrespective of whether the relevant accounts are prepared under the UK GAAP or under IFRS."

What is readily convertible to cash is defined in para.3.12 of the TR08/08. It must fulfil three criteria, namely:

1. a value can be determined at which a transaction in the asset or liability could occur, at the date of determination, 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
2. in determining the value, information such as prices, rates or other factors that market participants would consider in setting a price is observable; and
3. 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 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.

According to TR08/08, para.4.10 states that the increase in the fair value of unquoted equity investments may not fulfil the test of being readily convertible to cash. Similarly, the increase in the fair value of investment property for they require a period of marketing or negotiation or both. Thus, even though the increase are recognised as profit in the balance sheet account, they should not be considered as realised for the purpose of distribution to shareholders.

However, it must be stressed the TRs issued by the ICAEW are merely guidelines and are not approved accounting standards. The approved accounting standards in the United Kingdom are the FRS issued by the ASB, and the IFRS issued by the IASB. The FRS applies only to non-listed entities, whereas the IFRS applies to the listed entities since 2005. Thus, although para.3.4 of TR 08/08 states that the Guidelines are "relevant irrespective of whether the relevant accounts are prepared under UK GAAP or under IFRS", the writers beg to differ.

Compared with the FRS, the concept of realisation in the IFRS is different. Some of the IFRS, for example IAS 40, which pertains to the accounting standards for investment property, does recognise appreciation in the fair value
of a company's assets as "realised profits". IAS 40.35 expressly provides that "a gain or loss arising from a change in the fair value of investment property shall be recognised in profit or loss for the period in which it arises". Thus, technically, these gains are distributable to the shareholders. It is immaterial that the accounting profit is not readily convertible to cash. It is irrelevant that the conversion from asset to cash transaction still has to go through the process of marketing and negotiation before it may be finalised.23

Another example is IAS 39 (Financial Instruments: Recognition and Measurement), which is the subject of intense debate.24 According to this IAS, a company's financial assets and liabilities will be initially measured at their fair value. Financial assets categorised as held for trading are measured at fair value and the resulting surplus (or deficit) is taken to profit and loss in the income statement. It must be stressed that this surplus is unrealised income. It is immaterial that the assets have not been disposed, to give an actual profit to the company. However, despite that, they are realised profit and included in the fund available for distribution to shareholders.

Following s.853(4) of the Companies Act 2006, which links the concept of realised profit for the purpose of distribution to the concept of realisation in accordance with the approved accounting standards, the writers submit that a public listed company in the United Kingdom may distribute the increases which are recognised by the IFRS as realised profit. The guidelines issued by ICAEW are not legally enforceable and are not binding.

Fortunately for the creditors in the United Kingdom, the directors are subject to fiduciary duties which include the obligation to ensure that the company is in the position to pay its debts as they fall due. Thus the directors must consider the financial position of the company before proposing the dividend. If such distribution will cause the company to become insolvent, the directors cannot pay out the dividend. Further, the directors also should consider whether it is prudent to distribute profits arising from changes in the fair value of the assets which are volatile.25

An issue to consider is whether the adoption of the IFRS as the approved accounting standards has any implication on the divisible profit rule in Malaysia. The dividend rule in Malaysia has remained unchanged since the enactment of the Companies Act in 1965.26 According to this rule, no cash dividend may be payable except out of profit. What tantamount to "profit" is not defined in the Act and thus, following the principle in Dimbula Valley,27 a company may pay cash dividend out of unrealised profit.

Although the accounting standards in Malaysia have yet to fully converge with the IFRS,28 Malaysia has adopted some of the IFRS. IAS 40 has been adopted in Malaysia since January 1, 2006 and is known as FRS 140. And as highlighted above, this standard recognises appreciation in the fair value of a company's assets as realised profits. Another IFRS which has an impact on divisible profit is IAS 39. In Malaysia, IAS 39 is known as FRS 139, and its application has been deferred to January 1, 2010. However, the Central Bank of Malaysia has required all financial institutions to comply with some of the prescribed provisions in FRS 139 since 2005. And on April 1, 2008, the Ministry of Finance issued the Guidelines on the Income Tax Treatment from Adopting FRS 139 (FRS 139 Tax Treatment). The guidelines, which are applicable only to financial institutions regulated by the Central Bank, were issued:

"... to explain the changes and the resulting income tax treatment in determining the timing of income and deduction for tax purposes ... The income tax treatment will be aligned with the accounting treatment to the extent that the accounting treatment represents a difference in the timing of taxation or deduction only".

Thus, for example, for financial assets which are held for trading, any gains arising from the appreciation in their fair value are recognised in the income statement, and thus will be taxed. Likewise, any loss will be allowed a deduction. It is immaterial that the gains or losses are unrealised. This is an exception to the general principle under the Income Tax Act 1967 that only realised gains and losses from the disposal of assets are taxable and deductible respectively.

A financial institution is given the option whether to elect the FRS 139 Tax Treatment or to maintain its existing tax treatment of unrealised profits. There are unintended consequences of having to pay tax on unrealised profits, and these were examined by Kasipillai and Selvarajah in their recent article "Tax Guidelines for Financial Institutions Adopting FRS 139 and Its Impact on Commercial Activity".29

It is submitted that the FRS 139 Tax Treatment gives credence to the view that there now appears to be a movement in Malaysia to converge taxable profits with accounting profits prescribed in the approved accounting standards. Upon convergence, what is recognised as profit in the income statement will be taxable. It may be further argued that since the company is required to pay taxes on the "unrealised" accounting profit, the company should be permitted to distribute the balance of such profit to its shareholders in the form of cash dividend. The distribution of unrealised profit is not prohibited by the Companies Act 1965, and it is permitted following the principle in Dimbula Valley.30

The creditor's protection is at stake. As the market value of the asset fluctuates, such gains may be "temporary" and may be reversed in the following financial year owing to a change in the business environment. Further, since the company may borrow to pay the dividend,31 it is immaterial that the company does not have ready cash to do so. Thus its shareholders are enriched at the expense of its creditors.

To further compound the problem, s.365(1) of the Companies Act 1965 provides that no dividend shall be payable except out of profit. The wording has its genesis in the Companies Act 1961 of Victoria, Australia. In 1977, the Australian court in Marra Development Ltd v BW Rofe Ltd32 interpreted the phrase "payable out of profit" to mean that there should be profit at the time of declaration, and not necessary at the time of payment.

It is trite that once the company declares the dividend, it becomes a debt in favour of the shareholders.33 It thus becomes an enforceable obligation and cannot be cancelled or revoked even though there is a change in circumstances. Therefore the directors need to ensure that the company has profit at the time of declaration. If the business environment changes to the detriment of the company and wipes out its profit, the company still has to pay the dividend which was declared earlier for it is a debt due to the shareholders. The Australian legislature has since amended its dividend rule to the effect that dividend may only be paid out of profit, i.e. that there must be profit at the time of its payment.
International

It is unfortunate that no steps were taken by the Malaysian legislature to amend the wording of §3.65(1) to clarify the intention that dividend is to be paid only if there is profit. In this connection, it is observed that since 1977, there have been 16 Companies (Amendment) Acts, but none corrected the wording of §3.65(1) to reflect its true intention. The likelihood of §3.65(1) being amended in the near future is also slim. The Companies Law Reform Committee (CLRC), which was established by the Companies Commission of Malaysia on December 17, 2003 to review the Companies Act 1965 to reflect the current and future needs of the business environment, did not propose any revision to the dividend rule, even though it has proposed a solvency test for reduction of capital and share buyback. It is submitted that since payment of dividend not out of profit is also tantamount to a reduction in the company’s capital, a similar solvency test should be made applicable to the payment of dividend. The company should remain solvent after the distribution. Such a solvency requirement is found in the Australian and New Zealand legal framework for dividends.

Pending the amendment to include the safeguards as mentioned above into the dividend rule in Malaysia, the position of the creditor may be salvaged by the provisions found in ss.303(3) and 304(2) of the Companies Act 1965. According to these provisions, a director who was knowingly a party to the contracting of a debt had, at the time the debt was contracted, no reasonable or probable ground of expectation that the company would be able to pay the debt when due, is personally liable for the payment of the debt. These provisions apply, too, to dividend, for once it is declared, it becomes a debt due from the company to the entitled shareholders.

Conclusion

It is submitted that it is important that the interests of creditors are adequately protected. La Porta et al. in their article “Legal Determinants of External Finance” showed that legal protection of creditors does have a significant impact on the development of capital market. Thus it does not benefit the country’s capital market that there is no expressed prohibition against a company paying dividend there is no profit at the time of payment. The legislature should take steps to redefine the rule on the payment of cash dividend. A company should be permitted to pay dividend only out of profit and only if the company remains solvent after such distribution.

Wai-Meng Chan Senior Lecturer, Faculty of Business and Accountancy, University of Malaya, Kuala Lumpur, Malaysia. Email: chanwum@um.edu.my.

Devi S. Susela Associate Professor, Faculty of Business and Accountancy, University of Malaya, Kuala Lumpur, Malaysia. Email: susela@um.edu.my.

3 Spanish Prospecting Co. Ltd, Re [1911] 1 Ch. 92 CA.
4 Westhun Sugar Refineries v IRC (1960) 39 T.C. 45 C5 (B).
5 Dimbula Valley (Ceylon) Tea Co v Laurie [1961] Ch. 353 Ch D.
9 Department of Trade, “Company Accounting and Disclosure—A Consultative Document” (1979), Cmd 7654, p.35.
10 RFS 18, Appendix IV, para.16.
11 Bruce Wood, Auditing Today [1979], p.420.
12 Wittingale v International Commercial Bank [1977] Ch. 78 CA (Civ Div) at 88. Wittingale is a case of taxable profits.
13 Department of Trade, “Company Accounting and Disclosure” (1979), Cmd 7654, p.35.
16 The ASB also recognises that the concept of realised profit as it is linked to the size of the funds available for distribution to shareholders. See RFS 18, Appendix II (Note on Legal Requirements), para.13.
17 The foreword of the RFS 18 states that Appendix IV reviews consideration and arguments that were thought significant by the members of the Board in reaching the conclusion on the RFS. In paras 15 to 17 of Appendix IV (The Development of the RFS) to the RFS 18, the notion of realisation was traced. It “was originally concerned with the conversion of cash of non-cash resources and rights, and was intended to ensure that sufficient cash was available to distribute profits without (the company) becoming insolvent”. In 1971, SSAP 2 was issued and the notion had “evolved so that it was also concerned with claims to cash, and was used to ensure that only gains that were reasonably certain, and unlikely to reverse, were included in the profit and loss account”. However, this concept has since become outdated. “Markets have developed so that it is often possible to be reasonably certain that a gain exists, and to measure it with sufficient reliability, even if no disposal has occurred.”
19 Under the Companies Act 2006, the dividend rule is found in ss.830 and 831. A company in the United Kingdom is still prohibited from paying dividend out of unrealised profit. What is realised profit is still linked to the concept of realisation in accordance with the approved accounting standards—s.835(4).
20 TR 08/08, paras 3.3 and 3.4.
21 ICAEW TR 08/08, para.4.13.
22 ICAEW TR 08/08.
24 ICAEW TR 08/08, para.2.3.
25 The legislature did amend s.365 of the Companies Act 1965 in 1998 but reverted to the original position less than one year later. In 1998, the section was amended by inserting subss.(1A), (1B), (1C) and (1D).
Subsections (1A) and (1B) pertained to the maximum amount of dividend which could be paid by a company. They read as follows:

"(1A) A company is allowed to declare dividends (after making deductions for income tax, if any) for a financial year only up to an amount—
(a) not exceeding the after-tax profit of that financial year; or
(b) not exceeding the average dividends declared in respect of the two financial years immediately preceding that financial year, whichever is the greater.

(1B) Any after-tax profit not declared as dividends for any financial year commencing on or after 1 July 1997 may be accumulated and paid out as dividends in any financial year subsequent to that financial year."

The effect of subs.(1A) was to limit the amount of dividend to the higher of the after-tax profit of that particular financial year and the average dividends declared in respect of the previous two financial years. Unfortunately, these new provisions, which came into effect on November 1, 1998, had short lives. They were deleted with retrospective effect from October 29, 1999 according to the Companies (Amendment) Act 2000 because they were contrary to the Malaysian Government’s decision to relax capital controls (DR 25.04.00, p.95).

27 Dimbula Valley [1961] Ch. 353.

28 According to the Malaysian Accounting Standards Board’s website, http://www.mash.org.my [Accessed on December 16, 2009], the Malaysian accounting standards have not fully converged with the IFRS, but are planned to do so by January 1, 2012.


30 Dimbula Valley [1961] Ch. 353.

31 Mercantile Trading Co, Re (Stringer’s Case) (1868-69) L.R. 4 Ch. App. 475 CA.

32 Marra Development Ltd v BW Rode Ltd [1977] 2 N.S.W.L.R. 616.

33 Severn and Wye, Re [1896] 1 Ch. 559 Ch D.
