



HKICPA Accounting Bulletin 4 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 (April 2010)

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Contents

	Page
Introduction	2
Development of the Bulletin and Overview of its Contents	3
Section 3 of the Bulletin: Guiding Principles for the Determination of Realised Profits and Losses	4-6
Sections 4-10 of the Bulletin: Further Guidance on Applying the Guiding Principles to Specific Transactions	7-8
Applying the Guidance in this Bulletin to Estimate Net Realisable Profits available for Distribution	8
Other Considerations When Determining Distributable Profits	9-10
Appendix: Adjusting Retained Earnings under HKFRS to Estimate Net Realisable Profits Available for Distribution	11-12



Introduction

The purpose of this staff summary is to provide an overview of the guidance set out in Accounting Bulletin 4 - "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 Bulletin") and to assist in its application. It accompanies, but does not form part of, the Bulletin. For ease of reference, cross-references to the main text of the Bulletin 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 accumulated "realised profits" (so far as not previously utilised or capitalised) less its accumulated, realised losses (so far as not previously written off in a reduction or reorganisation of capital).

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

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

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

Accounting Bulletin 4 provides guidance on the principles to be applied in analysing any given transaction to determine whether it has given rise to a realised profit or loss, as well as commentating on specific areas of complexity that may arise in this regard when a company prepares its financial statements in accordance with HKFRS. In addition, the appendix to this Staff Summary assists with applying this guidance, by identifying common adjustments to retained earnings under HKFRS to arrive at an estimate of net realisable profits available for distribution.

Consistent with the Preface to Hong Kong Financial Reporting Standards, this Bulletin and the accompanying Staff Summary are issued for general guidance only and do not introduce additional accounting, disclosure or legal requirements. They are therefore available as a source of guidance immediately on issue.



Development of the Bulletin and Overview of its Contents

Given the common origins of the currently applicable law on distributions found in Hong Kong and the United Kingdom, the contents of the Bulletin 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”). Limited modifications have been made, as and where appropriate, to correlate the guidance in TECH 01/09 to the corresponding legal and financial reporting requirements applicable in Hong Kong.

The resulting Bulletin 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. Specifically, the Bulletin 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.

In order to discuss the issues surrounding the identification of realised profits and losses by entities which prepare their financial statements in accordance with HKFRS, the Bulletin includes background information on the relevant financial reporting requirements. Whilst care has been taken to ensure that this information is consistent with HKFRSs in effect as of the time of writing, the Bulletin should not be relied upon as a source of guidance on how to account for any given transaction in accordance with HKFRS. Instead, the original text of the HKFRS Standards and Interpretations, as set out in Volume II of the HKICPA Members’ Handbook, should be referred to if in doubt.

The Bulletin is based on HKFRSs in effect at the time of writing and discusses issues arising from the interaction of those Standards and Interpretations with the currently applicable Companies Ordinance to the extent that equivalent issues have been discussed in TECH 01/09. The Bulletin will be revised periodically as HKFRSs are amended, to maintain consistency with any updated guidance issued by the UK Institutes and/or to reflect changes in local requirements.



Section 3 of the Bulletin: Guiding Principles for the Determination of Realised Profits and Losses

Section 3 of the Bulletin provides a detailed discussion of the principles underlying the determination of realised profits and losses as follows:

Realised profits

The discussion in section 3 begins with 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, for example, the related asset being disposed of in a transaction where the consideration received by the company is “qualifying consideration” or the distribution in specie of the asset to which the unrealised profit relates.

[para. 3.9]

The above list of circumstances includes the following two concepts which are key to determining whether a profit is realised:

- “qualifying consideration”; and
- “readily convertible to cash”.

The most common form of “**qualifying consideration**” is cash i.e. put simply, a profit made on a cash sale is a realised profit. However, other forms of consideration may also be sufficiently near cash in order to be regarded as “qualifying”. These other forms of near cash consideration are listed in paragraph 3.11 of the Bulletin as follows:

- (a) an asset that is “readily convertible to cash”; or
- (b) the release, or the settlement or assumption by another party, of all or part of a liability of the company ¹; or
- (c) an amount receivable in any of the above forms of consideration where:
 - (i) the debtor is capable of settling the receivable within a reasonable period of time; and
 - (ii) there is a reasonable certainty that the debtor will be capable of settling when called upon to do so; and
 - (iii) there is an expectation that the receivable will be settled.

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

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

- (a) a value can be determined at which a transaction in the asset or liability could occur, at the date of determination, without negotiation and/or marketing, to convert the asset, liability or change in fair value into cash or to close it out; and
- (b) the input for price determination is observable by market participants; and
- (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, revaluation gains arising on equity securities that are traded in an active market are usually considered to be realised, regardless of whether under HKAS 39 such changes are recorded in profit or loss or in other comprehensive income, because it will generally be possible to enter into a transaction to convert the change in value to cash at short notice without any period of marketing and/or negotiation. **[para. 4.2 – 4.4, 4.23 – 4.25]**

¹ An exception would be where 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 the purchase and release are part of a group or series of transactions or arrangements that fall within paragraph 3.5 of the Bulletin.



This contrasts with revaluation gains arising on investment properties carried at fair value under HKAS 40. Even though the valuation increases are recognised in profit or loss in the financial statements, these gains are not “realised” because the company would need to go through the process of negotiation and/or marketing of the property in order for the recognised gain to be converted into cash. Accordingly, such gains cannot be regarded as “realised” (and hence distributable) until the property is disposed of for qualifying consideration. **[para. 4.13]**

Linked transactions

In addition to the above, the Bulletin 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]**

Realised losses

Consistent with the broad definition of realised losses in section 79K(1) of the Ordinance, the Bulletin states that any provision, including one for depreciation or diminution in value, as well as provisions for liabilities, charges or losses should be treated as a realised loss. In general therefore, where amounts are charged against profit or loss (and hence recorded in retained earnings), the charge should be regarded as being “realised” irrespective of whether it arose on re-measurement of the carrying value of an asset or liability, or the charge has crystallised, for example on settlement of a law suit.² **[para. 2.31 - 2.37, 3.10, 3.17]**

² It should, however, be noted that by law, certain amounts recognised as expenses for financial reporting purposes are not losses at all (i.e. they are neither realised nor unrealised losses). These include, for example, dividends on preference shares which for financial reporting purposes may be reported as interest expense under HKAS 32 but under the law are still regarded as dividends to be paid out of distributable profits, rather than being a loss. This issue is discussed further in section 6 of the Bulletin.



Sections 4-10 of the Bulletin: Further Guidance on Applying the Guiding Principles to Specific Transactions

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

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

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 Bulletin.



Applying the Guidance in the Bulletin to Estimate Net Realised Profits Available for Distribution

The Bulletin focuses its guidance on determining whether particular transactions may be regarded as giving rise to realised profits or losses. This guidance can be used to determine which adjustments should be made to retained profits as reported under HKFRS in the company's stand-alone financial statements in order to arrive at net realisable profits. These adjustments will generally fall into one of the following four categories:

- excluding unrealised profits recognised in profit or loss;
- including realised profits recognised outside of profit or loss;
- deducting realised losses recognised outside of profit or loss; and
- other permissible or required statutory adjustments,

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

In order to assist companies in estimating their net distributable profits, the appendix to this Staff Summary identifies common adjustments in each of these categories, together with references to where the treatment of these transactions is discussed further in the Bulletin.

The examples listed in the appendix include those that we consider are likely to be the most commonly encountered. However, the list is not exhaustive, and it is important that directors consider whether further adjustments to retained earnings are required in order to estimate the net amount of realised profits available for distribution.

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



Other Considerations When Determining Distributable Profits

Apart from the broad guiding principles on what constitutes a “realised” profit or loss and how the concept should be applied to specific transactions, section 2 of the Bulletin 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 authorised institutions and 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 Bulletin.

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 Bulletin 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 Bulletin.

DIRECTORS’ FIDUCIARY DUTIES
[para. 2.1 – 2.5]

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

Therefore, in determining the amount of dividends to be proposed directors should consider whether it is prudent to distribute profits even though they may otherwise be realised profits in accordance with this guidance, with due regard for the future cash needs of the company. Likewise, where there is uncertainty as to whether a profit ought properly to be regarded as realised or unrealised, it may be prudent for directors to assume the profit is unrealised and therefore not regard the amount as being available for distribution.



Appendix

Adjusting Retained Earnings under HKFRS to Estimate Net Realisable Profits Available for Distribution

As discussed in the main body of this Staff Summary, the guidance in the Bulletin on determining whether a profit or loss is realised can be used to determine which adjustments need to be made to accumulated retained profits as reported under HKFRS in the company's statement of financial position (commonly referred to as the balance sheet) in order to arrive at net realisable profits available for distribution. These adjustments will generally fall into one of the following four categories:

- A. excluding unrealised profits recognised in profit or loss;
- B. including realised profits recognised outside of profit or loss
- C. deducting realised losses recognised outside of profit or loss
- D. other required or permissible statutory adjustments

Set out below are examples of such adjustments, together with references to the paragraphs in the Bulletin where the adjustment is explained. These examples include references to the key concepts of "qualifying consideration" and "readily convertible to cash", which are discussed further in the main body of this staff summary with reference and paragraphs 3.11-3.13 of the Bulletin.

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

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

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



Examples of adjustments that may need to be made to company level retained profits as reported under HKFRS in order to arrive at net realisable profits available for distribution:	AB4 Paragraph Reference
A Exclude profits which have been recognised in profit or loss but which are not yet realised	
Valuation gains from investment properties, less related deferred tax, to the extent that the properties are carried at the balance sheet date at more than cost	4.13 / 10.41
Valuation gains from fair value re-measurement of financial instruments (including embedded derivatives and financial liabilities), less any related deferred tax, that have been classified as at fair value through profit or loss under HKAS 39 but do not meet the “readily convertible to cash” criteria, to the extent that the assets are carried at the balance sheet date at more than cost (or, in the case of liabilities, are carried at less than cost)	4.2 – 4.11, 4.26 – 4.28, 10.40
Profits that arose from the swap of dissimilar assets or barter transactions, where the asset received did not meet the definition of “qualifying consideration” (e.g. profits arising on a swap of dissimilar properties) and is still held at the balance sheet date ³	10.44 - 10.55
Negative goodwill (e.g. on the acquisition of an unincorporated business), to the extent not yet realised in accordance with the guidance in paragraph 3.25	3.24 – 3.27
Accumulated share of profits of associates or joint ventures recognised in the company’s financial statements under the equity or proportional consolidation method, adjusted for any dividends received or receivable in the form of “qualifying consideration”	10.1 - 10.6
Exchange gains on retranslation of long-term inter-company balances denominated in foreign currencies, when the underlying balance does not meet the definition of “qualifying consideration”	3.21A
Dividends from subsidiaries and profits arising on other inter-company transactions which were not in the form of “qualifying consideration” when considered in isolation or together with other linked transaction(s). For example: <ul style="list-style-type: none"> - dividends from a subsidiary, or profits from sales of assets from the parent to a subsidiary, funded directly or indirectly by funds from the parent - sale of an asset by a subsidiary to the parent followed by a dividend out of the resulting profit, where the transactions and arrangements from the parent’s perspective are in substance the receipt of a dividend in specie 	9.5-9.34

³ The amount that should be treated as unrealised is reduced as and when the acquired asset is depreciated, or written down for impairment [para.10.47]

B	<i>Include realised profits that were not recognised in profit or loss</i>	
	Valuation gains from available-for-sale financial instruments recognised in the fair value reserve, less any related deferred tax, except when they are not “readily convertible to cash” (for example, when there is no ready market for the instruments and/or they are being held for strategic purposes)	4.2 – 4.12, 4.25, 10.40
	Capital contributions from shareholders recognised directly in equity, which were received in cash or another form of qualifying consideration or converted into such since receipt	3.14(c)
	Option premiums received in the form of “qualifying consideration” recognised directly in equity (this does not include the amount credited to equity as the equity component of a convertible instrument), unless the amount has been credited by the company to a non-distributable reserve	6.16 – 6.20
	The credit entry recognised directly in equity for the fair value of options granted under a share-based payment arrangement ⁴ , unless the amount has been credited by the company to a non-distributable reserve	7.46 – 7.56
	Amounts credited directly to a merger reserve within equity, to the extent that they have been realised in accordance with the guidance in paragraph 9.44 e.g. when dividends have been received from the relevant subsidiaries out of pre-acquisition profits	9.44
C	<i>Deduct realised losses that were not recognised in profit or loss</i>	
	Amounts debited directly to a merger reserve within equity which have become realised losses as a result of the corresponding assets being depreciated / impaired	9.35 – 9.40
D	<i>Consider other required or permissible statutory adjustments</i>	
	Under section 79C of the Ordinance, listed companies are subject to an additional “net assets” test, which restricts the profit available for distribution when the listed company has net unrealised losses	2.30 – 2.31, Appendix I
	Under section 79K of the Ordinance, certain losses may be regarded as unrealised if they arise on the revaluation of all of a company’s fixed assets. For example, an impairment loss recognised in respect of an investment in a subsidiary carried at cost, which would otherwise be considered a realised loss, may be offset by an increase in value of another subsidiary even though that gain is not recorded in the financial statements. Certain conditions need to be met if a company intends to take advantage of this section: further details are set out in the Bulletin.	2.31A-2.31I

⁴ This should be reduced by any amounts recognised directly in equity in respect of reimbursement to parent of a group share-based scheme accounted for as equity-settled in accordance with HK(IFRIC)-Int 11