Australian Government

Australian Accounting Standards Board

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The Hon. Chris Pearce MP
Parliamentary Secretary to the Treasurer
Parliament House
CANBERRA ACT 2600

Dear Mr Pearce

IFRS and Distributable Dividends

Very recently the Institutes of Chartered Accountants in England and Wales and of Scotland have considered it necessary to issue a 50 page technical release (Tech. 21-05) on the Implications of IFRS upon Distributable Profits.

Also very recently ASIC issued a brief Information Release (IR-05-57) clarifying that retained profits available for distribution as dividends ought be the restated amount after the initial application of IFRS.

The *Corporations Act 2001*, at Section 254T, specifies very briefly that "A dividend may only be paid out of profits". Section 588G of the Corporations Act further clarifies this requirement by providing that it is an offence for a director to incur a debt by the paying or declaring a dividend if the company is insolvent at the time or becomes insolvent by incurring that debt. The Section 254T requirement or very similar wording has remained in our Company Law for a very long time and has been subject to a number of legal precedents many of which are now very dated.

On the other hand, the United Kingdom legislation on distributable profits was extensively revised in 1985 to give clarity to the requirement in the light of the evolution of accounting practice and to render obsolete much of the old legal precedent. In the UK however, the broad "distributable only out of profits" principle was retained. In New Zealand, the dividend distribution rules were changed in the *Financial Reporting Act 1993* such that dividends can be paid subject only to a solvency test.

By combining the various Australian legal precedents, the following Australian general distribution rules can be summarised as follows:

- Dividends may not be declared if this would result in the company being unable to pay its debts as and when they fall due [Peter Buchanan Ltd v McVey 1955].

- A company has no obligation to make up prior period trading losses or to cancel those losses by reducing share capital before it can distribute trading profits of later years [Marra Developments Ltd v B W Rofe Pty Ltd 1977].

- Undistributed profits of past years can be used for dividends to the extent that they have not been lost through past or current losses [Marra Developments].

- A dividend may be paid out of capital profits only after past capital losses have been recouped [Australasian Oil Exploration Ltd v Lachberg & Others 1958].

- An unrealised capital profit arising from an upwards revaluation of assets can be distributed, subject to:

  - the revaluation being made in good faith and by a competent valuer;

  - no doubt exists as to the permanent character of the accretion;

  - the revaluation cannot be selective or incomplete;

  - the surplus arising from the revaluation needs to be transferred to the profit and loss account

  [Industrial Equity Ltd v Blackburn 1977]

It can be seen from the above summary that many of the concepts spelled out in the precedents are no long readily ascertainable from today's accounting reports and therefore directors cannot readily determine the legal limits of dividend distributions. The distinction between capital profits and trading profits is no longer made for accounting purposes (although it still exists in taxation law) and modern accounting practice does not necessarily distinguish between realised profits and unrealised profits. The introduction of IFRS moves current accounting practice even further from these legal principles with fair value measurement (involving unrealised gains and losses taken to profits) being further introduced into financial instruments accounting, hedging transactions; investment properties and agricultural pursuits.

Furthermore, the legal precedents and indeed also the legislation itself, are based upon an outdated fundamental principle of capital maintenance which is no longer dominant in accounting thinking and is no longer supported by other sections of the same legislation, such as capital reconstructions and share buy-backs.

I also understand that the "dividends out of profits" rule is now being circumvented by corporate structures. Twenty eight out of the largest of Australian listed entities now involve the stapling of the securities of companies and trusts. These structures enable dividends to be paid to share/unit holders notwithstanding that the structure has made losses.

In my opinion the time has arrived when the rules on dividend distribution need to be brought up to date in Australia, either in the UK manner by rendering obsolete the old precedents and restating the capital maintenance principle in modern terms, or in the New Zealand manner by having only a solvency test. In the light of the UK approach still needing a 50 page technical document to explain the effects of IFRS my recommendation would be for Australia to adopt the New Zealand approach of a solvency test only containing adequate safeguards for the protection of creditors. This approach would also be consistent with the existing Australian solvency rules for share buy-backs.

I am aware that from time to time other organisations have also made representations for a change of this nature, but these suggestions have not been taken up. However, I believe that with the introduction of IFRS, it is now an appropriate time for change, as the old requirements can no longer be readily measured in practical terms.

At a forthcoming meeting that I will be having with the ASIC Chief Accountant, I will also be canvassing the ASIC views.

I would be pleased to meet with you to discuss this issue, or elaborate on the arguments if necessary.

Yours sincerely

David Boymal
Chairman

cc: Mr Charles Macek
Chairman, FRC

Ms Kerstin Wijeyewardene
Treasury