# Distributable profits – questions not answers

Max Ziff of Warburg Dillon Read looks at TECH 6/99, a far-reaching paper on distributable reserves, and discovers that it has more questions than answers.

Treasurers have long used the ability to distribute profits as a means of managing the balance sheet, particularly to achieve a higher gearing in an effort to lower the cost of capital. But the freedom to do this may be about to change.

The ICAEW has produced TECH 6/99, a far-reaching paper on distributable reserves which, if implemented, will have radical implications for many corporates. What is alarming is that while this discussion paper has not been widely disseminated, it is already regarded by many of the big accounting firms as best practice, despite the opposition of a number of leading lawyers and market practitioners. Whereas it is right that the important issues relating to this subject are debated in full and a general consensus arrived at, it is critical that the existing status quo is maintained while the debate takes place.

The most significant shortcoming of the paper is that it seems to have lost touch with the main principle underlying the concept of distributable reserves: creditor protection. From a credit perspective shareholders rank behind trade and other creditors and should, in normal circumstances, only receive distributions from the company to the extent that the company has earned profits. Therefore the payment of such distributions would not unfairly prejudice the position of the creditors. The two common exceptions to this rule of making payments to shareholders only from distributable reserves are for unlimited companies and where the company in question has been to court to effect a reduction of capital.

In the case of unlimited companies the share premium account can be distributed to shareholders without creditor consent because any deficiency in the company has to be compensated for by the company's shareholders. In the case of a court-approved capital reduction scheme, the court reviews the position of creditors and only allows the capital to be reduced once creditors have been protected and had the opportunity to object.

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In arriving at any new accounting rules for the creation of distributable reserves it is critical therefore to remember why the exercise is being undertaken and the parties which are intended to be protected. The rules we employ are of real importance to companies not merely because of the aesthetics of the balance sheet, but because of the fundamental implications for how our companies are managed and the creation of shareholder value.

Max Ziff

***Shortcomings of the proposals***

TECH 6/99 points out that it is not intended that adoption of the proposals will serve to reclassify as illegal distributions which have already been made. However, some parts of the proposals are effectively retrospective. Take the example of a company that has been to court to seek an order to make its share premium account distributable. The company may have met the conditions laid down by the court and received approval for the account to be made distributable and, to the extent that a company had made such a distribution out of such a reserve, that is acceptable. However, to the extent that a distribution has not been made at the time the proposals come into effect, any remaining balance on the reserve may no longer be distributable.

For example, where a company has an outstanding redeemable preference share and has prudently taken steps via the courts to put itself in a position to effect redemption, adoption of these proposals may now make such a redemption in accordance with its terms an illegal act. Indeed, the provisions may result in what the company thought was a positive balance on distributable reserves now being reclassified as a deficit so that no distributions (including regular dividends) can be made until the deficit is made up through future realised profits.

In other words, where a company has been to court, and has complied with all the conditions for creditor protection that are set down by the court, this may simply have the effect of transferring

one non-distributable reserve to another!

Part of the problem relating to the proposals is a fundamental flaw in logic with respect to capital reductions. Essentially the accountants accept that the case of Quayle versus Munro provides legal precedent that the capital reduction of the share premium account gives rise to a profit. They accept this because the law tells them so, not because in accounting terms they are convinced a profit has in fact arisen. However, a profit is not distributable unless it has been realised, and the question of realisation is determined by generally accepted accounting practice at the time. It defies logic to argue that what would otherwise not be a profit in accounting terms, is indeed a profit because the law so advises, if you then have to turn back to the accountants and ask them to opine whether or not that 'legal' profit has in fact been realised for accounting purposes. The accountant is not equipped to make such a judgement and as a result TECH 6/99 comes up with a nonsensical series of arbitrary tests that have little to do with the original rationale for the concept of distributable reserves.

In setting the test as to whether a legal profit has been realised, TECH 6/99 then goes on to draw a distinction between a share premium created on the issue of shares for cash and those created on the issue of shares to acquire assets. To focus on the asset side of the balance sheet in this context is somewhat puzzling. Accountants seem to preach the doctrine of substance over form as being the basis for good common sense accounting, however, this doctrine is not consistent with such an arbitrary distinction between the issue of shares for assets and the issue of shares for cash where that cash is immediately used to purchase assets.

However, if it all seems too complex, then TECH 6/99 provides a helpful escape valve in that, if a company is unable to identify whether it has met the conditions to permit a particular reserve to be distributable, it is simply assumed that the conditions have been met and the reserve will be duly treated as being distributable!

In Appendix A, TECH 6/99 turns to the application of the general principles and looks at goodwill. In so doing it makes no distinction between writing off goodwill in the consolidated accounts as against the parent company's accounts. The former is, of course, irrelevant for the purposes of determining distributable reserves.

The proposals set out in Appendix A are in effect retrospective changes that could potentially be catastrophic for many companies which have restructured themselves, particularly those utilising S425 schemes of arrangement to put new holding companies on top of their existing groups. A specific review of the position of such companies needs urgent consideration before proposals of the type mooted are universally and heavy-handedly applied.

Inter-company transfers are also addressed in TECH 6/99. This is a contentious area and is commonly subject to debate when it comes to determining the creation of distributable reserves. Often, auditors have taken the view that distributable reserves can be validly created within a parent if its subsidiary borrows externally without parental support to effect a dividend payment. However, the proposals would not allow the creation of distributable reserves in the parent if it subsequently reinvested a dividend received from a subsidiary in that subsidiary's equity as part of a series of related transactions. As currently worded the paper certainly talks about those situations that do not create distributable reserves, but it is not clear exactly what would be permitted. Clearly it is difficult to include specific examples of what is satisfactory, but as currently drafted it leaves the reader with more questions than answers: what is needed is certainty and clarity.

### *How to go forward*

This article has focused on a few fairly narrow aspects of this far-reaching technical release. Members of the Association are encouraged to obtain a copy of the document and digest its implications. If the proposals are adopted, the implications for a considerable number of companies will be significant and potentially catastrophic. Although the deadline for formal representations has passed, members may feel it is appropriate to make their views known and encourage the ICAEW to shelve TECH 6/99 pending the setting up of a more broadly based working party to consider how best to take the proposals forward. ■

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