International Journal of Management and Business Studies ISSN 2167-0439 Vol. 7 (4), pp. 001-006, April, 2017. Available online at www.internationalscholarsjournals.org © International Scholars Journals



*Review*

# Convergence to international financial reporting standards (IFRS): The need to tighten the rule on divisible profit

**Wai-Meng Chan*, S. Susela Devi, Sai-Leong Lee and Kok-Thye Ng**

University of Malaya, 50603 Kuala Lumpur, Malaysia.

Accepted 13 January, 2017

**The issue of convergence with the International Financial Reporting Standards (IFRS) has been a subject of increasing academic debate. One of the issues raised is that the IFRS are fair value based, and in some instances, recognizes unrealized gains and thus, include them in the income statement. Despite resistance, it is a foregone conclusion that the IFRS convergence exercise will continue to gain momentum. This article focuses on the importance of examining the existing legislative requirements that form part of the national specificities. As an illustration, this article highlights the importance to resolve the issue on the size of profit which may be legally distributed to shareholders as dividend. An examination on the legal approaches to the payment of dividends in the United Kingdom, Australia, New Zealand, India, Malaysia and Singapore found most of them to be lacking.**

**Key words:** Convergence, international financial reporting standards (IFRS), divisible profits, unrealized gain.

## INTRODUCTION

The issue of convergence with the International Financial Reporting Standards (IFRS) has been a subject of increasing academic debate (Chua and Taylor, 2008; Irvine, 2008; Rodrigues and Craig, 2007; Perera and Baydoun, 2007; Chand and White, 2007; Hernandez et al., 2007; Weetman, 2006; Harverty, 2006; Lewis and Salter, 2006; Jemakowicz and Tomaszewski, 2006; Fontes et al., 2005; IFAC, 2004; Larson and Street, 2004; Street and Larson, 2004; Stolowy et al., 2001; Cairns and Nobes, 2000). The question of whether all countries should adopt a single global accounting standard seems to be a foregone conclusion. However, the issue that is increasingly debated is the process of convergence. IFAC (2004) explored the challenges and successes in implementing IFRS and observed that achieving international convergence, however, requires more than theoretical support.

It requires reaching consensus as to the international standards that will serve as the foundation for financial reporting and auditing globally, determining how to facilitate the adoption of those standards and ultimately, taking the actions necessary to encourage implementation.

The impediments to convergence identified by the comprehensive IFAC (2004) study include the following: The adoption and implementation of the international standards in a country takes place in an environment that is affected by factors unique to that country, for example, the economy, politics, laws and regulations, and culture. A reason cited in IFAC (2004) by countries for not fully converging to IFRS is that countries find it necessary to amend the international standards to provide for national specificities (IFAC, 2004).

However, in moving towards convergence, debates arise regarding the need to examine existing legislative requirements that form part of the national specificities (Freedman, 2004) . Concerns about defining taxable profits (Freedman, 2004) and divisible profits have been raised (Woolf, 1979) as the accounting profits depart significantly from taxable profits (Freedman, 2004) and divisible profits (Woolf, 1979). Divisible profit here refers to profit that is available for distribution as dividends. This paper focuses on the divisible profits aspect, specifically,

*Corresponding author. E-mail: chanwm@um.edu.my. Tel: 603-7967 3890. Fax: 603-7967 3980.

**Abbreviations: IFRS,** International Financial Reporting Standards; **EEC,** European Economic Community; **IASB,** International Accounting Standards Board; **IASC,** International Accounting Standards Committee.

"what can be distributed as dividends?"

The payment of dividend is clearly one of the most important unsolved problems in finance (Bhattacharya et al., 2008) and it is also the most controversial subject in finance. Finance scholars have engaged in extensive theorising to explain why companies should pay or not pay dividends. Other researchers have developed and empirically tested various models to explain dividend payments. Some researchers have surveyed corporate managers, fund managers and institutional investors to determine their views and perceptions about dividends (Chiang et al., 2006). Despite extensive debate and research, the actual motivation for paying dividends remains a puzzle (Baker and Powell, 1999). This paper adds another dimension to the already intriguing dividends issue. It concerns what can be paid out as dividends.

In this paper, we examine the company legislation relating to divisible profits or what can be legally distributed as cash dividends. This issue is pertinent in view of the convergence of national accounting standards to the IFRS which is fair-value-based and thus, may differ from the national accounting standards. Fair-value profits comprises mainly of primarily realised profits and unrealised changes in values of assets and liabilities (Laswad and Baskerville, 2007). The convergence to IFRS by countries may have an impact on the payment of dividend and thus, it may be necessary for the countries that have converged or planned to converge to the IFRS to revise their respective dividend rule.

## DIVIDEND RULE

A person may invest in a company by subscribing in its shares. As a company has a legal entity separate from its shareholders, his liability is limited only to the amount he has agreed to subscribe. In this event, the company is wound-up and the shareholder is liable to contribute to the assets of the company a sum which is sufficient to repay the company's creditors or the sum unpaid on his shares, whichever is lower. In return for this undertaking and investment, the shareholder expects to be rewarded, particularly when the company had made some profits from its trade or business. Apart from capital gains from the revaluation of his shareholding, the shareholder expects returns in the form of dividends.

However, a company when carrying on its trade, will incur liabilities to its suppliers who supply goods on credit. It may also borrow money from banks to carry on its business. As the company has a separate legal entity from its shareholders, its creditors cannot take action against the shareholders to recover the debts. The creditors have to rely on the company's financial means to be paid. Thus, to safeguard the position of the creditors, the company's capital should be maintained. As Jessel MR in Re Exchange Banking Corporation (1882) said:

"A limited company by its memorandum of association declares that its capital is to be applied for the purposes of the business …, and on the faith of the statement (in the memorandum) which is said to be an implied contract with creditors, people dealing with the company give it credit. The creditor has no debtor, but with that impalpable thing, the corporation has no property except the assets of the business. The creditor, therefore .. gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business, and he has therefore a right to say that the corporation shall keep its capital and not return it to the shareholders''.

The concept of capital maintenance is enshrined in companies' legislations throughout the common law countries. The conflicting demands between the shareholder and the creditor were recognised by the English legislature when enacting the English Companies Clauses Consolidation Act 1845. Section 121 provided that "a company shall not make any dividend whereby the capital stock will be in any way reduced". In other words, the dividend should not be paid out of the company's capital, but only out of the company's profit. In 1856, when the English legislature enacted the Joint Stock Companies Act 1856, it introduced a further rule, that is, the payment of dividend was subject to the solvency of the company. Section 14 provided that if the directors of a company declared and paid dividend when they knew the company was insolvent or the payment of the dividend would cause the company to be insolvent, they would be subject to a civil liability. The requirement that the dividend was payable out of profit arising from the company's business was retained in Article 64 of Table B, which pertained to the regulations for the management of a company. Unfortunately, in 1862, when the Companies Act was enacted to repeal the Companies Clause Consolidation Act 1845 and the Joint Stock Companies Act 1856, the 1862 Act did not include any rule on dividend. However, this was mitigated by two factors. First, Article 73 of the Table A pertaining to the regulation for management of a company limited by shares, retained the rule prescribed in its predecessor, Article 64 of Table B to the 1856 Act. But, it must be noted that Article 73 did not apply to all companies. A company could opt not to adopt Table A to the Companies Act 1862 or modify it (section 15). Secondly, it was said that even though the Act did not expressly prescribe so, the dividend had to be paid out of profit (Lubbock v British Bank of South America, 1892; Foster v New Trinidad Lake Asphalte Co, 1901). Otherwise, it would result in the reduction of the company's capital which would conflict with the capital maintenance provisions found in the company legislations (Woolf, 1979). The subsequent revisions of the Act did not alter this position in the United Kingdom until the 1980, when the Companies Act 1980 was enacted.

In summary, it is observed that the legislated dividend rule applicable to a company in the United Kingdom prior to 1862 was based on the solvency of the company. Subsequently, until 1980, the English company legislations did not prescribe any mandatory rule on dividend. Despite that, it was generally held that any dividend paid should be derived from the company's profit. This gave rise to the issue of what is tantamount to profits. The term "profit" conjures different meanings to different persons. It is subjective, depending on the party that interprets it (Woolf, 1979). For example, the Inland Revenue had its own rules and principles on profit for the purpose of tax. But for the purpose of dividend, the legislature's stand was deafeningly silent. The matter was left to the courts.

The arrangement of this paper is as follows. The court interpretation of the dividend rule will be discussed next. This will be followed by an examination of the development of the dividend rule in the United Kingdom and some of the commonwealth countries in the Asia Pacific region which adopted the common law system practised in England, namely Australia, New Zealand, India, Singapore and Malaysia. The company law frameworks of these former British colonies were initially based on the English framework and thus, their dividend rule was essentially profit based. Some have since revised and modified their dividend rule. Only Malaysia and Singapore have not amended their dividend rule and as can be seen from the following discussion, such state cannot be allowed to continue as it may be detrimental to creditors.

**Court interpretation**

As observed earlier, the dividend rule in the United Kingdom prior to the Companies Act 1980 was essentially profit based. Unfortunately, the meaning of the crucial term "profit" for this purpose was not defined in the statute, but left to the courts. In Re Spanish Prospecting Co Ltd (1911), Fletcher Moulton LJ 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. An enumeration might be of little value. Even if the assets were identical at the two periods, it would by no means follow that there had been neither gain nor loss, because the market value – the value in exchange of these assets might have altered greatly in the meanwhile. A stock of fashionable goods is worth much more than the same stock when the fashion has changed. And to a less degree but no less certainty the same considerations must apply to buildings, plant and other fixed assets used in the business. If the total assets of the business at the two dates are compared, the increase which they show at a later date as compared with the earlier date (due allowance of course being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in "question".

Then, there were no settled principles on the revaluation of assets for the purpose of drawing up the balance sheet and profit and loss accounts. The practices varied and there were disputes on the legality of paid dividends. As the court was called to arbitrate the issue, it could not escape from the task of interpreting the definition for the all crucial term "profit". Reluctantly, the court provided a few guidelines (Lord Macnaghten in Dovey v Cory, 1901), some of which "baffled lawyers, accountants and businessmen alike" (Davies, 2003).

1. A company could distribute its trading profit for a financial year without any regard to the losses incurred in previous financial years (Re National Bank of Wales, 1899; Ammonia Soda Co v Chamberlain, 1918).
2. A company could distribute its revenue profit without any regard to its losses in its fixed assets (Lee v Neuchatel Asphalte Co, 1889) nor make any provision for depreciation of its fixed assets (Ammonia Soda Co v Chamberlain, 1918).
3. A company could distribute its realised profit made on the sale of a fixed assets if there was an overall surplus of fixed and current assets over liabilities (Lubbock v British Bank of South America, 1892). However, there were conflicting views whether a company could distribute cash dividend from unrealised profit on a revaluation of assets (Westburn Sugar Refineries v IRC, 1960; Dimbula Valley (Ceylon) Tea Co v Laurie, 1961).
4. A company could distribute its trading profit even if there was loss in its current assets other than its stock-in-trade (Ammonia Soda Co v Chamberlain, 1918).

Even though by implication, dividend was not to be paid out of capital; an item which should remain intact for the purpose of creditors' protection, it was obvious that some of the general principles above could act contrary to this concept. Indeed, though it was held that the paid-up capital of a company cannot be lawfully returned to the shareholders under the guise of dividends, yet the law then did not expressly prohibit the company from paying dividends unless its paid-up capital was intact (Re National Bank of Wales, 1899).

**DEVELOPMENT OF THE DIVIDEND RULE IN SELECTED COMMONWEALTH COUNTRIES**

This part examines the development of the dividend rule in the United Kingdom and some selected commonwealth countries, namely Australia, New Zealand, India, Malaysia and Singapore. United Kingdom is chosen because it is the seat of the issuer of the IFRS, namely the International Accounting Standards Board (IASB). Australia and New Zealand are chosen for their progressive reformation to their company legislations; India for her status as the new economy giant; Singapore for her status as an established international financial hub; and lastly, Malaysia, for her on-going agenda to reform her company legislation and its announcement of its road map to convergence by 2012.

**United Kingdom**

Prior to the Companies Act 1980, the dividend rule was generally held to be profit based, that is, a company could pay dividend only out of its profit. What amounted to “profit” was not legislatively defined, but left to the courts. As mentioned above, some of the prescribed guidelines did not make any commercial sense. In 1980, the legislature in the United Kingdom saw the need to review the position and to define the term “profit” for the purpose of dividend payment. It was defined in section 39 of the Companies Act 1980 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”. Furthermore, section 40 imposed an additional condition on a public company. A public company was restricted from paying dividend if the amount of its net assets (that is, aggregate assets less aggregate liabilities) after the distribution fell below the value of its share capital and undistributable reserves. This solvency condition was imposed as a result of the European Economic community (EEC) Second Directive (Gower, 1979) . To further enhance creditor’s protection, section 40(5) provided that the public company must not include its uncalled share capital as an asset for the purpose of calculating its net assets.

The definition of “profit” and the additional conditions imposed on a public company were retained in the subsequent revisions of the Companies Act in the United Kingdom. Currently, they are found in sections 830 and 831 of the Companies Act 2006. Thus, in the United Kingdom, a company may no longer pay ‘nimble dividends’, that is, distribute its trading profit for a financial year without any regard to the losses incurred in previous financial years. However, in 1981, when Parliament enacted the Companies Act 1981 to implement the EC Fourth Directive on company accounts, the concept of realisation of profit for the purpose of divisible profit was linked to the accounting standards. 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 approved standards then did not recognise gains on revaluation as profits. The standards have since changed and for listed companies in the United Kingdom, the approved accounting standards are the IFRS issued by IASB. Some of the IFRS recognises the appreciation in the fair value of a company’s assets as “realised profits” and thus, technically these gains may be distributable to the shareholders. The evolution of the divisible profit rule in the United Kingdom was discussed in Chan and Devi (2010).

**Australia**

The former British colonies in Australia modelled their respective company legislations after the English Companies Act 1862. In the twentieth century, the state of Victoria took the initiative to reform her company legislation. The Victorian Companies Act 1938 was an improvement of the English Act. In 1958, the state adopted the improvement made to the English Act in 1947.

As there was no uniformity of the company legislations of the various states in Australia, a Uniform Companies Bill was drafted based largely on the Victorian Companies Act 1958. Each of the state in Australia then passed a Companies Act which was modelled after the Uniform Bill (Ford, 1978). The rule on dividend was found in section 376 of the Uniform Companies Act. It provided that dividend shall be payable only out of profit. The New South Wales Court of Appeal in Marra Development Ltd v BW Rofe Ltd (1977) interpreted this to mean that there should be profit at the time of declaration, and not necessary at the time of payment. In view thereof, amendments were made in 1998 to require that the dividend may only be paid out of profit, that is, that there must be profit at the time of its payment (Ford, 2001). This position was retained in section 254T of the Australian Corporations Act 2001.

In June 2010, the dividend rule was revised from profit based to solvency based. Section 254T now provides that a company may pay dividend only if the company is solvent and remains solvent after the distribution. The following reasons were given to omit the profit based rule:

(a) The term “profit” was not defined and the guidance from court decisions were outdated, complex and not in line with current accounting standards;
(b) The changes to the accounting standards with the adoption of the IFRS, thus impacting the profitability of a company; and
(c) The current trend is to lessen the capital maintenance doctrine.

**New Zealand**

Currently, the company legal framework is found in the

Companies Act 1993. Its predecessor, the Companies Act 1955 did not prescribe any rule pertaining to the payment of dividend. However, for companies limited by shares which adopted Table A to the Act, Article 116 provided that "no dividend shall be paid otherwise than out of profit".

Under the prevailing Companies Act 1993, section 52 prescribes the dividend rule. It is not based on the company's profit. Rather, it is based on the state of the company's solvency. Section 52 provides that the board of directors may authorise the payment of dividend if and only if the company remains solvent after the distribution. The directors who vote for the authorisation are required to sign a certificate of solvency. According to section 4, a company satisfies the solvency test if the company is able to pay its debts as they become due in the normal course of business and the value of the company's assets is greater than the value of its liabilities (including its contingent liabilities) after the distribution of the dividends to its shareholders. Reference should be made to the company's most recent financial statements which have been prepared in accordance with generally accepted accounting practice (sections 4, 10 and 11 of the Financial Reporting Act 1993) and consideration should also be given to all circumstances which may affect the value of the company's assets and liabilities. In this connection, the directors may rely on valuation of assets or estimates of liabilities that are reasonable in the circumstances.

**India**

Section 205 of the Indian Companies Act 1956 provides that a company may declare dividend out of profit for that financial year after providing for the depreciation of its assets in accordance with the rules laid down in sub-section (2). The company may also pay dividend out of its profits for any previous financial years which have yet to be distributed to its members provided its assets have been depreciated accordingly. To further safeguard creditors, the Indian Act also provides that if the company has suffered any loss in any previous year, the lower amount of the loss or the amount which is equal to the amount provided for that year shall be set off against the company's profits before the dividend may be declared. A company in India has to make good its accumulated losses or the depreciation of the previous years before declaring dividend. The Indian legislation abrogated the principles laid down in Re National Bank of Wales (1899), Ammonia Soda (1918) and Lee v Neuchatel (1889). In 1974, section 205 of the Companies Act 1956 (India) was amended to include a further condition. New sub-section (2A) requires the company to transfer a specified percentage of its profits to its reserves before declaring dividend.

In 2004, the Indian Ministry of Corporate Affairs carried out a comprehensive review of the Companies Act 1956. As a result, the new Companies Bill 2009, to consolidate and amend the company legislation, was introduced in the Indian Parliament on 3 August, 2009. The framework governing the payment of dividend was slightly modified. Apart from the proposal to retain the provision that a company may declare dividend out of profit for that financial year after providing for the depreciation of its assets in accordance with specific rules, the Bill introduces another condition for the payment of dividend out of the company's previous years' profits which is yet to be distributed to its members. The new framework also requires approval from the following persons. First, all the directors at a board meeting; secondly, the shareholders by passing a special resolution at the company's annual general meeting; and thirdly, the company's bankers whose term loans are still subsisting.

Though it is heartening to note that the proposed rule pertaining to the payment of dividend out of previous year's profits is more stringent, much could still be done to improve it to enhance creditors' protection. For example, the company may have obtained financing from sources other than banks. Also, borrowings from banks are not limited to term loans. They include revolving credit lines in the form of overdraft and trade financing facilities. The company should also be required to obtain approval for the payment of dividend out of previous years' profits from its non banker financiers, and also its bankers who have granted other forms of financing.

In addition, the dividend rule proposed by the Indian Companies Bill 2009 which is profit based, are lacking in the following aspects. It does not require the company to make good the accumulated losses or unabsorbed depreciation of the previous years before declaring dividend from the current year's profits. It reversed the abrogation of the principles in Re National Bank of Wales (1899) and Ammonia Soda (1918) . Further, the proposed dividend rule does not require the company to transfer a specified percentage of its profits to its reserves before declaring dividend.

**Malaysia**

The Malaysian Companies Act 1965 was adopted from the Companies Act 1961 of Victoria, Australia (Ford, 1978). However, unlike Australia which has since revised and enacted a new Corporations Act 2001, Malaysia is still lagging behind. Piecemeal amendments were made to the Companies Act 1965 from time to time to meet the changing needs of the business environment, but the dividend rule is still based on profit. The dividend rule is found in section 365(1) read together with section 60 of the Malaysian Companies Act 1965. It states that no cash dividend shall be payable to the shareholders of any company except out of profits. As was the position in Australia, the key word "profit" is not defined in the Malaysia Malaysia Companies Act 1965. Further, there is no Malaysian case law on the definition of the said word.

Thus, the guidelines propounded by the English courts on the profit based dividend rule prior to the Companies Act 1980 (United Kingdom) are of persuasive authorities in Malaysia.

Moreover, the wording of section 365 provides that the company may pay dividend if there is profit at the time of declaration. It is immaterial that there is no profit at the time of payment. The principle in the Australian case of Marra Development Ltd v BW Rofe Ltd (1977) still applies in Malaysia.

It is also noted with dismay that though the Companies Law Reform Committee (CLRC) was established on 17 December 2003 to review the Companies Act 1965 to reflect the current and future needs of the business environment, it did not propose revision to the dividend rule. However, in early 2010, the Companies Commission of Malaysia established the Accounting Issues Consultative Committee, and one of the areas which were reviewed by the Committee was related to dividend payment.

### Singapore

The genesis of Singapore's Companies Act (Cap 50 of the 1994) was the Companies Act 1961 of Victoria, Australia (Ford, 1978) . It has undergone many amendments, the latest was in 2005. Section 403 which is on the payment of dividend, was amended twice in 1984 and 2005, respectively. However, the basis of the rule which is on the company's profit remains unchanged. There is no attempt either to define the term "profit" or to abrogate any of the judge made dividend payment rules which are not commercially prudent. Thus, the above discussion on the current position in Malaysia applies, too, to Singapore.

## INTERNATIONAL FINANCIAL REPORTING STANDARDS

Our examination of the dividend rules which are currently applicable in the United Kingdom, Australia, New Zealand, India, Malaysia and Singapore reveals that though the dividend rule adopted by them (except for Australia and New Zealand) is based solely on profit, the legislatures in the aforementioned countries, other than the United Kingdom and India, have not taken any step to abrogate any of the judge- made guidelines on "profit" for the purpose of dividend payment. Thus, unless the company in Malaysia or Singapore exercises self restrain, it is legalised to pay nimble dividend.

Similarly, a company in Malaysia and Singapore may distribute its unrealised profits to its shareholders. This is also the position in the United Kingdom as its legislature has linked the concept of realised profit to the approved accounting standards. As will be discussed subsequently, as countries converged their national standards to the IFRS which are shifting to a fair value based regime, not amending the dividend rule will encourage distribution of unrealised profits which is detrimental to the company's creditors.

In this regard, the principles of fair value accounting and some of the IFRSs which have an impact on the divisible profits (that is, the profit available for the payment of dividend) will be discussed.

## FAIR VALUE ACCOUNTING

The financial position of a company is disclosed in the company's balance sheet, and profit and loss account. To ensure uniformity and consistency, the company legislations require the financial statements of a company to be prepared in accordance with accounting standards approved by the relevant authorities. As different jurisdictions may impose different accounting standards, there may arise situations where a multinational company which is required to prepare its accounts under two jurisdictions, will end up reporting profit in one jurisdiction and loss in another jurisdiction. Different standards may treat an item differently. Thus, the call and move to establish a single set of financial reporting standards which apply in all jurisdictions (Chand and White, 2007).

In 2001, IASB was reconstituted from its predecessor, the International Accounting Standards Committee (IASC) "to develop, in the public interest, a single set of high quality, understandable and international financial reporting standards for general purpose financial statements". It adopted the International Accounting Standards (IAS) issued by IASC and where necessary, issue new standards and interpretations. Thus, the phrase "International Financial Reporting Standards" covers not only the standards and interpretations issued by IASB, but also those issued by IASC and adopted by IASB.

The IFRS emphasises fair value accounting, which according to Cairns (2006) "mirrors longstanding requirement of UK GAAP (Generally Accepted Accounting Principles)". The term "fair value" is generically defined in Appendix A to IFRS 1 as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable and willing parties in an arm's length transaction". Fair value is used not only to measure the initial costs of the asset and liabilities, but also in their subsequent measurements. According to Cairns (2006), the IASC first introduced this approach in IAS 39 (Financial Instruments: Recognition and Measurement) in 1992, and subsequently extended it to the measurement of certain non-financial assets, namely IAS 41 (Agriculture). The application of fair value in subsequent measurement is currently found in IAS 16 (Property, Plant and Equipment), IAS 19 (Employee Benefits), IAS 26 (Accounting and Reporting by Retirement Benefit Plans), IAS 27 (Consolidated and Separate Financial

Statements), IAS 28 (Investments in Associates), IAS 31 (Interests in Joint Ventures), IAS 38 (Intangible Assets), IAS 39 (Financial Instruments: Recognition and Measurement), IAS 40 (Investment Property) and IAS 41 (Agriculture).

For subsequent measurement, the IASB's approach to fair value is as follows. If the asset or liability is traded in an active market, then the quoted price is used as the fair value of the said asset or liability. If the asset is not quoted in an active market, then the fair value is estimated using market information. However, if there is neither active market nor reliable market information, fair value accounting should not be used for the subsequent measurement of the asset or liability. Instead, other techniques are applied. AG78 and BC 104 of IAS 39 (Financial Instruments: Recognition and Measurement) illustrate the application of historical cost accounting, whereas IAS 16.33 (Property, Plant and Equipment) prescribes the revaluation technique for the property, plant or equipment which is specialised in nature, with no market-based evidence of fair value. The revaluation may be estimated using an income or a depreciated replacement cost approach.

## SOME IFRSS WHICH MAY HAVE AN IMPACT ON DIVISIBLE PROFITS

In this section, we will discuss some of the IFRSs which may have an impact on the size of the fund available for the payment of dividend. They are IAS 16 (Property, Plant and Equipment), IAS 39 (Financial Instruments: Recognition and Measurement), IAS 40 (Investment Property) and IAS 41 (Agriculture).

IAS 16 pertains to the accounting standards applicable for property, plant and equipment, which are identified as "tangible items that are held for use in the production or supply of goods or services, for rental to others, or for administrative purpose; and are expected to be used during more than one period" (IAS 16.6). It includes owner-occupied property. IAS 16.29 gives an option to the company to choose either the cost model or the revaluation model as its accounting policy for these items. If it decides to opt for the fair value model, IAS 16.32 provides that the value of the items will be determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers. If the item is specialised in nature, with no market-based evidence of its fair value, it may then be estimated by using an income or a depreciated replace-ment cost approach (IAS 16.33). IAS 16.34 and 36 do not require the items to be revalued every financial year. But if an item is revalued, the entire class of property, plant and equipment to which that class belongs shall be revalued. If the difference in value from the revaluation exercise is a surplus, it is credited to a reserve account.
The revaluation in this case does not impact divisible profits.
However, if there is a deficit arising from the revaluation, this loss is recognized in the profit or loss. Subsequent revaluation surplus relating to the same asset for which a deficit was recognised earlier, is credited to the profit and loss, thus impacting the divisible profits for the year (IAS 16.39 and 40).

IAS 39 laid down the accounting standards pertaining to the recognition and measurement of financial instruments. IAS 39.43 provides that a company's financial assets and liabilities will be initially measured at their fair value. Its financial assets will continue to be measured at their fair value (IAS 39.45). However, IAS 39.47 states that other than a few exceptions, the company's financial liabilities will be measured at amortised costs using effective interest method. Financial assets categorised as held for trading are measured at fair value and the resulting surplus (or deficit) is taken to profit and loss thus impacting the divisible profits. However, it is to be noted that this surplus is unrealised income.

IAS 40 pertains to the accounting standards for investment property. According to IAS 40.7, an investment property is property held to earn rentals or for capital appreciation or both. It generates cash flow largely independent of the company's other assets. Owner occupied property is excluded. A company may choose either the fair value model or the cost model for all its investment property backing liabilities that pay a return linked directly to the fair value of, or return from, specified assets including that investment property. It may also choose either one of the two models for its other investment properties, regardless of the choice made for the investment property backing liabilities. The company is not allowed to change the valuation model once selected. One exception is where the company has chosen the fair value model for its investment properties but the fair value of one of the said assets cannot be reliably determined. The company shall then apply the cost model to that particular asset. However, it should continue to measure its other investment properties at fair value (IAS 40.53 and 54) . It must be highlighted that 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".

IAS 41 (Agriculture) applies to accounts for living plants and animals (biological assets), harvested product of the plant or animal and specified government grants which are related to agriculture activity. It requires the agriculture based company to use fair value approach in measuring its biological assets unless the fair value cannot be measured reliably.

What then are the implications of these IFRSs on the divisible profits? This will be discussed in the next section.

## IMPLICATION

As discussed earlier, the company legislations in the

**Table 1.** Status of convergence to IFRS.

| Country | Legislations on application of accounting standards | National Accounting Standard Setter | Status of convergence to IFRS |
|---|---|---|---|
| United Kingdom | Sections 395 and 396 of the Companies Act 2006 | Accounting Standards Board | Converged in 2005 |
| Australia | Sections 296 and 334 of the Corporations Act 2001 | Australian Accounting Standards Board | Converged in 2005 |
| New Zealand | Sections 4,10 and 11 of the Financial Reporting Act 1993 | Accounting Standards Review Board | Converged in 2007 |
| India | Section 211 of the Companies Act 1956 | National Advisory Committee on Accounting Standards | Proposal to converge by 2011 |
| Malaysia | Section 166A of the Companies Act 1965 Section 26D of the Financial Reporting Act 1997 | Malaysian Accounting Standards Board | Proposal to converge by 2012. |
| Singapore | Sections 200A and 201(1A) of the Companies Act (Cap 50) Section 8 of the Accounting Standards Act (Cap 2B) | Singapore Accounting Standards Council | Converged in 2005 |

Source: www.iasplus.com/country.

United Kingdom, India, Malaysia and Singapore prescribe that a company may pay dividend out of its profit. If the term "profit" for the purpose of dividend is not defined in the statutes, reference may be made to the applicable accounting standards as the standards dictate what goes into the income statement and what can be recorded as the company's profit or loss. The accounting standards hence impact the divisible profits.

In this connection, it is observed that the legislations of the countries mentioned earlier, have expressly stipulated that the accounts of the companies shall be made out in accordance with the approved accounting principles. Many of them have converged to the fair value IFRSs and the rest have announced their plan to converge to the internationally accepted standards. Table 1 summarizes their positions.

We shall use IAS 40 to illustrate the implication of the IFRSs on divisible profit. As discussed above, where a company chooses the fair value model for its investment property, IAS 40 expressly provides that a gain from the increase in their fair value shall be recognised as profit. It is immaterial that the property has not been disposed, to give an actual profit to the company. It is admitted that even though in Australia and New Zealand, a company may pay dividend from its unrealised gains, their respective statutes require the company to fulfill the solvency tests. It is prohibited from distributing the unrealised gains if the distribution will cause the company to suffer cash flow problems. To recap, the Australian and New Zealand dividend rules as prescribed in Section 254T of the Australian Corporations Act 2001 and Section 52 of the New Zealand Companies Act 1993 respectively are not linked to the company's profit, but to its solvency.

What then are the current positions in the United Kingdom and Singapore which have converged to the IFRS, and the positions in India and Malaysia when they fully converged to the IFRS in 2011 and 2012, respectively? As discussed earlier on, it is unfortunate that though the United Kingdom legislature has capped the divisible profit to realised profit, the concept of the latter has been linked to the accounting standards. Thus, in the United Kingdom, arguably, the companies are not prohibited from paying dividend from its unrealised gains. The position in Singapore, India and Malaysia are similar, for their legislations currently provide that a company may pay dividend out of its profit. There is also no prohibition against the payment of dividend from the company's unrealised gains. Thus, following the principle in Dimbula Valley (Ceylon) Tea Co v Laurie (1961), companies in these jurisdictions may do so even though such practice is commercially unwise. The implementation of IAS 40 will lend support to the argument that unrealised profit may be distributed to the shareholders in the form of cash dividend, for unrealised profit is recognised as profit by the approved accounting standards. It appears to be immaterial that the market value of the asset fluctuates, which may result in the unrealised profit being wiped out in the following financial year. To further compound the problem, a company which does not have the cash, may borrow to pay dividend to its shareholders (Stringer's Case, 1869).

## CONCLUSION

The implementation to IFRS is a foregone conclusion. Four of the six nations discussed in this paper have already converged. The effects of the fair value standards and the recognition of unrealised profit which are championed in the IFRS, on profits that are distributable as dividends have been discussed earlier. As the IFRS treats the unrealised gains as income, a company may declare and pay cash dividend from the gains. It is immaterial that such gains may be "temporary" and may be reversed in the following financial year due to a change in the business environment. It is also immaterial that the company does not have ready cash to pay, for it can obtain cash through debt for the purpose of enriching its shareholders at the expense of its creditors.

Possibly, the recent global financial crisis after the buoyant economy of the past decade will jolt the legislatures to tighten the dividend rule and cap what is available for the distribution to shareholders. The experience of some jurisdictions in defining the dividend rule is useful for other jurisdictions to reflect upon, to craft their legislations and to address any unintended consequences of the convergence exercise. It is suggested that there is opportunity for research in examining the extent of the practice of dividend payment from unrealised profits where the legislation permits and investigate the consequences of such practices. In this context, the importance of examining necessity of cash flow information for entities such as pension plans that operate as trust, where the income statements incorporate changes in fair values of assets, both realised and unrealised, merits consideration (Laswad and Baskerville, 2007).

### REFERENCES


Baker HK, Powell GE (1999). How corporate managers view dividend policy. Q. J. Bus. Econ. 38(2): 17-35.

Ball R (2006). IFRS: Pros and cons for investors. Account. Bus. Res. 36: 5-27.

Bhattacharyya N, Mawani A, Morrill C (2008). Dividend payout and executive compensation: Theory and evidence. Account. Financ. 48(4): 521-541.

Cairns D (2006). The Use of fair Value in IFRS. Eur. Account. Rev., 3:5-22

Cairns D, Nobes C (2000). The convergence handbook: a comparison between international accounting standards and UK financial reporting requirements, The Institute of Chartered Accountants of England and Wales. London. December: 108.

Chan WM, Devi SS (2010). Convergence to International Financial Reporting Standards: Some implications on the company legislation in Malaysia. Com. Law. 31(3) (forthcoming)

Chand P, White M (2007). A critique of the influence of globalisation and convergence of accounting standards in Fiji. Critic. Pers. Account., 18: 605-622.

Chiang K, Frankfurter GM, Kosedag A, Wood BG Jr (2006). The perception of dividends by professional investors. J. Manage. Financ., 32(1); 60-81.

Chua WF, Taylor SL (2008). The rise and rise of IFRS: An examination of IFRS diffusion. J. Account. Pub. Pol. 27: 462-473.

Davies P (2003). Gower and Davies' Principles of Modern Company Law. London: Sweet and Maxwell.

Freedman J (2004). Aligning taxable profits and accounting profits: Accounting standards, legislators and judges".J. Tax Res., 2(1): 71-99.

Fontes A, Rodrigues LL, and Craig R (2005). Measuring convergence of national accounting standards with International Financial Reporting Standards", Account. For. 29: 415-436.

Ford, HAJ (1978). Principles of Company Law. Australia: Butterworths.

Ford, HAJ, Austin RP, Ramsay IM (2001). Ford's Principles of Corporations Law. Australia: Butterworths.

Gower, LCB (1979). Gower's Principles of Modern Company Law. London: Stevens and Sons.

Harverty JL (2006). Are IFRS and US GAAP converging? Some evidence from People's Republic of China companies listed on the New York Stock Exchange. J. Int. Account., Audit. Tax., 15: 48-71.

Hernandez SM, Manzano MP, Hazera A, and Quirvan C (2007). Latin American banking institutions trading on the New York Stock Exchange- convergence-divergence of Latin American accounting standards and US GAAP. Adv. Int. Account., 20: 225-251.

IFAC (2004). Challenges and Successes in Implementing International Standards: Achieving Convergence to IFRSs and ISAs. International Federation of Accountants, September.

Irvine H (2008). The global instituitionalisation of financial reporting: the case of the United Arab Emirates. Account. For. 32: 125-142.

Jemakowicz EK, Tomaszewski SG (2006). Implementing IFRS from the perspectives of EU publicly traded companies. J. Int. Account. Audit. Tax. 15:170-196.

Larson RK, Street DL (2004). Convergence with IFRS in an expanding Europe: progress and obstacles identified by large accounting firms' survey. J. Int. Account., Audit. Tax., 13: 89-119.

Laswad F, Baskerville RF (2007). An analysis of the value of cash flow statements of New Zealand pension schemes. Bri. Account. Rev., 39: 347-355

Lewis PA, Salter SB (2006). Europe and America. Together or apart. An empirical test of differences in actual reported results. Adv. Int. Account., 19: 221-242.

Perera H, Baydoun N (2007). Convergence with International Financial Reporting Standards: The case of Indonesia. Adv. Int. Account., 20: 201-224.

Rodrigues LL, Craig R (2007). Assessing international accounting harmonisation using Hegelian dialetic, isomorphism and Foucault. Critic. Pers. Account., 18: 739-757.

Stolowy H, Haller A, Klockhaus V (2006). Accounting for brands in France and Germany compared with IAS 38 (Intangible Assets). An illustration of the difficulty of international harmonization. Int. J. Account., 36: 147-167.

Street DL, Larson RK (2004). Large accounting firm's survey shows emergence of two standard systems in the European Union. Adv. Int. Account. 17: 1-29.

Weetman P (2006). Discovering the "international" in accounting and finance. Brit. Account. Rev., 38: 351-370.

Woolf, Emile. (1979). Auditing Today. London: Prentice Hall International.

Ammonia Soda Co v Chamberlain [1918] 1 Chancery Div. Rep., p.266

Dimbula Valley (Ceylon) Tea Co v Laurie [1961] Chancery Div. Rep., p.353.

Dover v Cory [1901] App. Cas., p. 477

Foster v New Trinidad Lake Asphalte Co [1901] 1 Chancery Div. Rep., p. 208.

Lee v Neuchatel Asphalte Co (1889) 41 Chancery Div. Rep., p.1

Lubbock v British Bank of South America (1892) 2 Chancery Div. Rep., p. 198.

Marra Developments Ltd v BW Rafe Ltd [1977] 2 New South Wales Law Report 616.

Re Exchange Banking Corporation (1882) 21 Chancery Div. Rep., p. 519.

Re National Bank of Wales [1899] 2 Chancery Div. Rep., p. 629.

Re Spanish Prospecting Co Ltd [1911] 1 Chancery Div. Rep., p92.

Stringer's Case (1869) 4 Chancery App., p. 475.

Westburn Sugar Refineries v IRC (1960) 39 Tax Cas., p. 45.