CHAPTER ONE: AN OVERVIEW

1.0 INTRODUCTION

The word 'profits' litters the financial pages of our newspapers, magazines and libraries of business texts, yet very few readers would feel competent to explain the precise meaning of this concept. Whatever the context, it is understandable that this is due o the subjectivity of its meaning. Elliot and Jamie (1988)

The most obvious sense in which we speak of profits relates to the 'stewardship' accounts, which convey information on how the business in question has fared during the period under review. Apart form other measures; such as balance sheet ratios or cash flow funds (all of which has distinctive usefulness), the figure of profit is the 'bottom line', in which the reader's eye readily seeks. Elliott and Jamie (1988)

Yet, if each of us were given some basic data concerning a company's transactions and the same access to any further information required, it is extremely unlikely that any two of us would prepare the same set of accounts which shows the same amount of profit. In fact, the chances of such a coincidence could almost be calculated in terms of statistical probabilities - curious that accounting is usually thought of as an exact science. Elliott and Jamie (1988)

The distribution issue is important to identify three {3} potential economic rationales for aspects of capital maintenance i.e to protect creditors, to assist managers of publicly traded firms to signal private information about their firm's future performance to investors and as a rule for a company to have a minimum share capital. John Armour (1999)

From the information gathered, the arguments put forth to counter it, was that, creditors are expected to be protected against ordinary business risks as these are taken care of by the financial markets in other ways, e.g through rates of interest charged and insurance against bad debts. However, they are entitled to depend on the non-erosion of the permanent capital by shareholders paying themselves out of capital. Such protection is provided by the U.K, Companies Act 1985, to a certain extent. John Armour (1999)

Under the U.K Companies Act 1985, due to the limited liability of shareholders, the legislature provided creditors with some protection by requiring some minimum capital and introducing rules governing capital reduction and use of share premium and capital redemption reserves. In the case of public companies, the minimum share capital is 50,000 pounds, which cannot be reduced. However this is far too low a figure to provide any reasonable level of protection for creditors. U.K (Technical Release) 5/2000

Furthermore, in the case of distributions of profits, the U.K Companies Act, 1985, lays down rules for determining the amount that can be distributed as dividend without reducing the permanent capital. The rules are more stringent for public companies than for private, but despite the improved situation, its rules may still lead to a reduction in permanent capital and still involve recognition and measurement problems in calculating distributable profits. U.K (Technical Release) 5/2000

As far as the Malaysian Companies Act 1965 {Section 365}, is concerned, the Act only stipulates that "no dividend shall be payable to the shareholders of any company except out of profits or pursuant to section 60". It appears that there is no clear guideline on distributable profits i.e realised and unrealised profits, qualifying considerations of profits, intra-group transactions and the legal framework of it.

The study is undertaken to explore the current practices in distribution of dividends among Malaysian companies to find out if they comply with the generally accepted practices world-wide since the Malaysian Companies Act is silent on the actual meaning of profits. The details obtained could be used to evaluate the current scenario of company's distribution of dividends from negative earnings and recommend the necessary changes to the standard setters.

The underlying idea of the maintenance of capital principle is that only profits maybe distributed by a company to its shareholders whilst it is a going concern. This will "maintain" the capital in the sense that where a company's net assets are less than or equal to the amount of its capital amounts, a distribution to shareholders would deplete the assets which represent the value of the capital. Hence, distributions may not be made in these circumstances. The maintenance of capital is implemented by restrictions on distributions to shareholders and restrictions on reductions of the share capital figures in the accounts.

Without proper rules, guidelines and procedures on the distribution of profits, the directors and shareholders of the company, would be able to devise and manipulate profits at their own discretion. {Case law - Royal Mail Steam Packet Co.Ltd - Rex v. Kylsant and Morland} Elliot and Jamie (1988)

2.0 INTERNATIONAL DEVELOPMENTS

A summary of the rules, regulations and policies on the dividends internationally had been abstracted for comparison purposes. The development has been categorised as follows: developments in Europe that includes U.K and U.S, New Zealand/Australia, Middle East and Asia. The purpose of this comparison is to gather established rules on dividend distribution of other countries and use them as a guide to establish rules on dividend distribution in the Malaysian context.

2.1 A review of developments in Europe

United Kingdom - Prior to 1980

Before the U.K Companies Act 1980, now part of the 1985 Act – the position of distributable profits rested largely on case law from the early 1900s. The judgements in those cases were sometimes contradictory and confusing, and often did not coincide with an accountant's view of what constitutes distributable profits. This was due to the fact that until 1980 statutes stated only that dividends must not be paid out of capital.

<u>Views taken by the courts.</u>

Capital profits {case Dimbula Valley(Ceylon) Tea Co.Ltd v. Laurie(1961).

It was held that an unrealised revaluation surplus could, with certain safeguards (such as a professional revaluation of all assets), be used to pay a cash dividend on the 'grounds' that if any reserve arising from a revaluation could not distributed, only that which could be distributed in dividends can be capitalized.

Movement in Reserves {Royal Mail Steam Packet Co.Ltd 1931}

The accounts of the company over a number of years showed large profits available for dividends despite the fact that it was at the same time making substantial trading losses.

Past losses & Current Profits {Ammonia Soda Co.Ltd v Chamberlain}

In which a dividend out of current profits was permitted despite the fact that the balance on profit and loss account brought forward showed a debit balance. It was pointed out on the judgement, however, that the decision was based on the particular circumstances prevailing and that it should not be regarded as a precedent in cases where normal considerations of financial prudence suggested otherwise.

Writing of Goodwill {Stapley v.Read Bros Ltd}

The company wrote off a substantial goodwill account out of reserves built up from profits. Subsequent substantial losses resulted on an overall debit on profit and loss account, and the preference dividend fell into arrears. The directors that proceeded to write back to goodwill most of the value already written off, the effect of which was not only to wipe out the deficit on the profit and loss account, but also to enable the arrears of preference dividend to be settled.

Property Company profits {Chancery Lane Safe Deposit and Offices Co.Ltd}

It was held that if interest paid in financing a fixed asset development project is capitalized, and then it is not allowable as a deduction in computing assessable profits for tax purposes. As a result property companies have, ever since, in order to obtain tax relief for interest paid on development finance, been obliged to charge it in full and then 'create' revaluation surpluses out of which to pay dividends that the write-off of interest charges would otherwise have precluded.

Subsequent to 1980's

The issue on distributable profits was subsequently clarified by the U.K Companies Act 1980. The definition of distributable profits under the U.K Companies Act 1985 is: Accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less is accumulated, realised loses, as far as not previously written off in a reduction or reorganisation of capital.

According to the U.K Companies Act, the undistributable reserves of a public company are its share capital, share premium, capital redemption reserve and also 'the excess of accumulated unrealised profits over accumulated unrealised losses at the time of the intended distribution and ...any reserves not allowed to be distributed under the Act.

Current development in the Companies Act 1985 (U.K)

Technical release {U.K} – Tech6/99

The Technical Committee of the London Society of Chartered Accountants {LSCA} has considered the draft guidance on the determination of realised and distributable profits under the Companies Act 1985. In summary it was stated that more guidance is required on the analysis of reserves and that additional thought on the true substance of a series of transactions should be reinforced by reference to FRS 5.

Technical release {U.K} – Tech25/00

Statement of guidance issued in 2000 by the Company Law Committee of the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland. The statement replaces previous guidance on the determination of realised profits and distributable profits issued in September 1982 as Technical Releases 481 and 482. This Act provides further clarification on realised and unrealised profits, legal implications, principle of realisation, qualifying considerations and intra-group transactions.

Developments in United States

Accounting for stock distributions comes under the jurisdiction of corporate law in the state, territory or other U.S. governmental unit in which the firm is incorporated. There is no standardisation of these provisions, but they are often patterned after those used by larger states. In addition, the American Bar Association has developed a series of Model Business Corporations Acts that are often used when revising state legal requirements. The resulting corporate statutes concerning stock distributions are loosely grouped into two categories - those states that base their restrictions on the concept of legal capital and those that do not. (Kummert 1994)

Statutory systems that are not based on legal capital generally follow the form of the California Corporations Code or the 1984 Amended Business Corporations

Act. Since distributions are defined as "...transfers of cash or property by a corporation to its shareholders. Kummert (1984, pp, 226-227), stock distributions are not considered to be distributions. Accounting for stock dividends and stock splits are left to accounting rules. Ben-Dror, Yoav (1983), " An empirical study of distribution rules Under California Corporations Code: Are creditors protected?", University of California Davis Law Review 375-418

Current GAAP for stock distributions is stated in Chapter 7B of ARB 43 (AICPA 1953). Stock dividends are differentiated from stock splits on the basis of the time of issuance. In Accounting Series Release 124(1972), the Securities and Exchange Commission (SEC) reaffirmed the accounting treatment specified in ARB 43.

In ARB 43, the Committee on Accounting Procedure (CAP) indicates that the distinction between stock splits and stock dividends occurs at approximately 20 percent to 25 percent. "If the transaction more closely resembles a stock split,"...there is no need to capitalise earned surplus, other than to the extent occasioned by legal requirements"(AICPA 1953)

Developments in Netherlands (Civil Code)

Companies are controlled by the Netherlands Civil Code as supplemented by the Act on Annual Accounts of Enterprises 1970, and the Act of Private limited liability Companies 1971 together with the Adaptation Act on the Private Companies 1971

Reserves must distinguish non-distributable from distributable reserves and the former category must show separately revaluation, legally required reserves and those required by the company's own statutes. The distributable reserves include retained profits. Legally-required reserves must be created for capitalized share issue expenses, capitalized research and development costs, undistributed profits arising from the equity method of valuing investments in associated companies, negative goodwill and upward valuations of assets. Statutory reserves are those required by the company's own statutes. (K.Michael Oldham – Accounting Systems and Practice in Europe)

Developments in Portugal (Commercial Code)

In general, business units are governed by the Commercial Code as extended from time to time by decrees and, particularly, by fiscal policies. A legal reserve must be maintained by annual appropriations of 5 percent of net profits after tax until the reserve has reached 20 percent of the subscribed capital. The reserve is not available for distribution to shareholders and, if used to set off losses, must be built up out of successive profits to a minimum level of 20 percent of the capital once more. Companies may also create statutory reserves in accordance with their own statutes. Although provisions must be made in the accounts for all anticipated losses, contingency reserves are seldom created. Law expressly forbids secret reserves. (Oldham,K.Michael, Accounting Systems and Practices in Europe)

Development in the Swedish Companies Act of 1975

Pursuant to Section 12 of the Swedish Companies Act of 1975, companies must comply with certain substantive and procedural provisions when distributing dividends. Distributions that violate these requirements may be recovered from the recipients, or in some cases, the directors, the managing directors and possibly others. The Swedish courts have stretched the contours of this statute to reach transitions not normally thought of as dividends and to cover persons not generally subject to laws regulating dividends. The Supreme Court has broadly construed the provisions thereby providing creditors (in practice, trustees in bankruptcy) with powerful tools to recover company asset. Directors, management and others must therefore review all transfers that are not supported by fair consideration - including loans to affiliated companies or guarantees on their behalf or decisions to refrain from commencing litigation or to settle litigation. (Fyman and Barney,1996)

Development in the French Company Law

The company is subject to the French Law. The provisions of the article of the Code of Commerce and Decree 67-236, concerning commercial companies, govern corporations. The net profit for the financial year, reduced by prior losses if any, one makes a mandatory deduction of five percent assigned to formation of a legal reserve fund known as the "Legal reserve". The said deduction ceases to be mandatory when the reserve reaches a level of one-tenth of the share capital.

The balance of the financial year profit, after the deduction, constitutes the distributable profit that is freely available to an ordinary shareholders' meeting, which it may either carry forward or enter in the reserves, or distribute in totality or in part to the shareholders and to the owners of investment certificates. The shareholders' meeting may grant an option to each shareholder, with respect to all or part of the dividend or of the interim dividends paid, between payment of the dividend or of the interim dividends in cash or in company shares, under the legislative and regulatory conditions in force.

2.2 A review of developments in Australia and New Zealand

Developments in the Corporation Law {Australia} – Section 263(3)

Under the distribution rules, the main substantive provision in the Act concerning realised profits and losses is:"...a company's profits available for distribution are its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made"

Furthermore Section 264 imposes an additional constraint on distributions by public companies, restricting them to the excess of net assets over called-up share capital and undistributable reserves. Undistributable reserves include share premium, capital redemption reserve and "the amount by which the company's accumulated unrealised profits...exceed its accumulated unrealised losses".

Developments in the New Zealand Companies Act {section 53}.

Under the New Zealand Act, there are three main criteria's to be met i.e firstly the board of a company that is satisfied on reasonable grounds that the Company will, immediately after the distribution, satisfy the solvency test, may authorise a distribution by the company at a time, and of an amount, and to any shareholders it thinks fit. Secondly, the directors who vote in favour of a distribution must sign a certificate stating that, in their opinion, the company will, immediately after distribution, satisfy the solvency test and the grounds for the opinion. Thirdly if after the distribution has been made the company does not satisfy the solvency test, then any distribution made by the company are deemed not to have been authorised.

Accounting Rules

The main substantive provision in the accounting rules is Schedule 4, paragraph 12(a), which provides, amongst the "accounting principles" that "only profits realised at the balance sheet date shall be included in the profit and loss account".

However, paragraph 15 enables directors to depart from this rule where there are special reasons to do so, so long as particulars, reasons and the effect are shown in the notes. The annual accounts must still, of course, give a true and fair view in accordance with section 226. Section 262(3) provides that generally references, which include the accounting schedules, to "realised profits" and "realised losses", are to such profits and losses as fail to be treated in accordance with principles generally accepted...with respect to the determination for accounting purposes of realised profits or losses.

2.3 A review of developments in Asia

Developments in the Commercial Code Law {Japan}

The Commercial Code of Japan provides that a company may not make any distributions of profits by way of dividends or interim dividends for any fiscal period unless it has set aside in its legal reserve an amount equal to at least one-tenth of the amount paid by way of appropriation of retained earnings for such fiscal period until the legal reserve is one-quarter of its stated capital.

The code currently does not provide for "stock dividends'. However, under the Code, the shareholders may by resolution transfer any amount which is distributable as dividends to stated capital and the Board of Directors may by resolution issue additional shares by way of a stock split up to the aggregate par value equal to the amount so transferred; thus, the same effect as a stock dividend can be achieved.

Developments in the Thai Accounting Standard

ICAAT has issued an updated Framework for the preparation and presentation on financial statements dated 25th February 1999. This framework is not an Accounting Standard and hence does not define standards for any particular disclosure. Nothing in this framework overrides any specific Thai Accounting Standard. In case where there is conflict between the framework and a Thai Accounting Standard, the requirement Accounting Standard prevails over those of the framework.

On line with the Thai capital maintenance concept, a profit is earned only if the financial amount of the next year-end of the period exceeds the financial amount of the net assets at the beginning of the period, after excluding distributions to and contributions from, owners during the period. Financial capital maintenance can be nominal monetary units of constant purchasing power.

Developments in the China Accounting System

Prior to 1992, there were great differences in the financial statements among different companies. In 1992, the Ministry of Finance, in conjunction with the Structural Reform Office of the State Council, promulgated the "Accounting System for the Enterprises with Shareholding System" helped reduce those differences. In 1998, the Ministry of Finance promulgated the "Accounting System for Shareholding Companies – Accounting Items and Accounting Statements". Since then, the financial statements of listed companies have been standardised. In line with Industry classifications as decided by the Shanghai and Shenzhen stock exchanges, and the differences exhibited in the financial statements of listed companies, it has been grouped into two i.e general industry and financial industry.

Developments in the Hong Kong regulatory system

Under the articles of Association of Companies, it has been provided that distributable earnings shall equal the after -tax income of the company as determined by (a) international accounting standards or (b) accounting rules and standards set by the Hong Kong Accounting body, whichever yields a lower amount.

2.4 A review of development in the Middle East.

Bahrain Commercial Companies Law 1975 (as amended)

The accounting policies of the companies are prepared in accordance with the accounting standards issued by the International Accounting Standards Committee {IASC}, interpretations issued by the Standard Interpretations Committee of the IASC and the requirements of the Bahrain Commercial Companies Law 1975 {as amended}.

The Bahrain Commercial Companies Law 1995 {as amended} requires all Companies incorporated in Bahrain to transfer 10% of the profit for the year to a statutory reserve, until such reserve totals a minimum of 25% of the issued share capital. The reserve is not available for distribution, except in the circumstances stipulated in the Bahrain Commercial Companies Law.

Transfers to statutory reserve effected by subsidiaries in accordance with the applicable laws of their countries of incorporation are retained in the subsidiaries concerned, and are not available for distribution except in circumstances stipulated by the laws in their countries of incorporation. The general reserve is only distributable following a resolution of the shareholders at the Annual General Meeting. (Figure 1 below, depicts the summary of the distribution practices observed by countries internationally)

Figure 1 Summary of International Developments on Distribution of Dividends

COUNTRIES	PRACTICES ON DIVIDEND DISTRIBUTION
United Kingdom	-Prior to 1980, based on Case Laws -Subsequent to 1980, Companies Act 1985 Clearly defined distributions of dividends -Current developments TR 6/99& 25/00
United States	-California Corporation Code (1984) -GAAP (ARB 43), Creditors Protection
Australia	-Australia Companies Act -Profits available for distribution, should be realised. -Additional restrictions on Public Limited Co's -Distinguish between undistributable and distributable profits
New Zealand	-Need to satisfy solvency test -Directors must sign certificate on solvency test -If conditions not satisfied anytime in the future, the certificate signed is considered not approved

Figure 1 **Summary of International Developments on Distribution of Dividends (Continuation)**

COUNTRIES	PRACTICES ON DIVIDEND DISTRIBUTION
Netherlands	-Civil Code Distinguish between distributable & undistributable reserves.
Portugal	-Commercial Code -Reserves must reach 20% of subscribed capital -Forbids secret reserves
Swedish	-Swedish Companies Act 1975 -Substantive & procedural provisions to distribute dividends -Severe penalties for non-compliance.
French	-Code of Commerce and Decree -Requirement for minimum reserve I/10 of Share Capital
Japan	-Commercial Code -Legal reserve 1/10th of appropriated profit
Thailand	-No specific regulation
China	-No specific regulation
Hong Kong	-Commercial Code -Stated distributed earnings shall equal tax earnings
Middle East	-Commercial Company Law -Transfer 10% of the profit for the year to statutory Reserve, until such reserves total 25% of issued share capital

3.0 PROBLEM STATEMENT

The comparative analysis gathered on the issue of distributable dividends internationally has brought about uncertainty on the way dividends are distributed from profits in Malaysia. Malaysia has no specific rules and regulations on the distributions of profits. The term is rather vague and section 365 of the Malaysian Companies Act 1965 merely states that no dividend shall be payable except from profits.

Therefore this study seeks to obtain evidence on the distribution of dividends from negative earnings by Public Limited Companies and others.

4.0 OBJECTIVES OF THE STUDY.

To explore the current practices in the distribution of dividends among Malaysian Companies in comparison to established rules of other countries internationally.

5.0 METHODOLOGY / DATA COLLECTION

An exploratory nature of study has been selected due to the availability of data that are ready for use at the Kuala Lumpur Stock Exchange (KLSE) and the Registrar of Companies (ROC). The financial data's obtained could be used to investigate the current scenario on the distribution of dividends of the selected companies concerned.

Sample Selection

An estimated eight hundred {800} Malaysian listed Companies, fifty {50} large private limited companies and companies which fall into section 176 of the Malaysian Companies Act were sampled, analysed and evaluated for this research purpose.

The listed companies consist of all the listed companies listed at the KLSE board as at 15th March 2002. They were made up of first board and second board companies whereas a computer program downloaded at the Registrar of

Companies (ROC) selected the fifty largest private limited companies. In addition, companies which were under s176 (10) i.e. those companies, which was given an extension to their restraining order not to prosecute them for the long outstanding unpaid loans.

6.0 LIMITATION OF THE STUDY

The main limitation of the study was the time duration itself, as there is a necessity to strike a balance between work and studies. Another issue was on the availability of data's for the period 1991 to 2001. The KLSE library and the resource data's can be assessed for the current years only and for the later part of the years, it could only be assessed manually. However, there was still a handful of annual reports that could not be sighted.

7.0 CONCLUSION

The overview of the subject would be able to guide the researcher to obtain relevant literature reviews to back up the empirical evidence on the proposed selection of companies.