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**Circular to all Chief Executives of Commercial Banks,
Credit Institutions and
Micro Finance Deposit-Taking Institutions**

Guidance Note on the Treatment of Unrealized Gains/Profits for Capital Adequacy Compliance

Background

Bank of Uganda recognizes the need for the Supervised Financial Institutions (SFI) to conform to International Financial Reporting Standards (IFRS) while preparing financial statements as per Sections 46 and 48 of the Financial Institutions Act (FIA) 2004 and the Micro Deposit Taking Institutions Act (MDI) 2003 respectively. In this regard, the Bank of Uganda in 2006 engaged commercial banks in a series of discussions to formulate a common approach of attaining possible convergence between IFRS and the Bank of Uganda Prudential Regulations. It is against this background that Bank of Uganda has decided to issue this guidance note.

(i) Unrealized gains/profits

It has been observed that supervised financial institutions are increasingly booking in their statements of comprehensive income huge amounts of unrealized gains on revaluation due to foreign exchange rate differences (**IAS 21**) and change in fair value of financial instruments measured at fair value through profit or loss (**IAS 39**) (e.g. *financial instruments classified as held for trading*). Whilst IFRS (**IAS 1**) (**revised**) permits recognition of such gains in the statement of comprehensive income, (**IAS 1**) (**revised**) it should be appreciated that some of these gains (**book gains/profits**) may not be available for immediate use. In addition, because of market fluctuations, either a gain or loss can occur and, until actual cash is received, an entity cannot predict with certainty whether it will realize a gain or loss.

(ii) Regulatory Reporting Requirement

Therefore, in line with the prudence principle and in ensuring compliance with the law and Capital Adequacy regulations, supervised financial institutions are required to ensure that:

- When compiling the Statement of Income (**BS 110**), SFIs must clearly decompose and indicate, supporting documents any income relating to **unrealized gains** on revaluation due to foreign exchange rate differences and change in fair value of

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financial instruments. Supporting documentation in this regard must be submitted to Bank of Uganda.

- In order for any SFI to comply with the Bank of Uganda Capital Adequacy regulations as well as the 1988 Basel Capital Accord (Basel I) unrealized **gains** on revaluation due to foreign exchange rate differences and change in fair value of financial instruments shall be treated as a '**deduction**' the same way as '**Goodwill**' is treated under the same Capital Accord.
- When compiling the **BS 100A**, as provided under the Financial Institutions (Capital Adequacy Requirements) Regulations 2005, such amounts shall be reflected under line **1.6 (f)**
- Unrealized **gains/profits** shall not be available for distribution as dividends. SFIs shall ensure that dividends are distributed after the unrealized **gains / profits** have been treated in accordance with this directive.

Bank of Uganda shall continue to review the regulatory requirements to take into account market developments in order to maintain safety and soundness of the financial sector.



J. Bagyenda (Mrs.)

Executive Director Supervision.

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