Investors and the public need to know whether profits and capital are real[1]

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Summary

Investors need to know what portion of a company's profit has been realised in cash or near cash, and what portion has not. They also need to know what losses/liabilities are likely, even where they are hard to measure or uncertain in timing. Not only is this important to judging the reliability and quality of a business's income stream, it is also key to determining a company's true capital strength and ability to pay dividends: in the UK only accumulated realised profits – after accounting for foreseeable losses and liabilities – can legally be distributed to shareholders in the form of dividends or share buybacks.

UK law reflects the economic reality that if a 'profit' is not realised as cash or near cash, then any distribution based on such profits will have to come from other sources, and this creates a drain on capital and could risk solvency. Long-term investors want their companies to stick to a simple rule: cash must come in and not be required to cover foreseeable liabilities/losses, before cash is paid out as dividends.

The legal rules – known as the capital maintenance regime – do not just protect investors, but are also critical to the public interest. Healthy and well-capitalised companies that prudently prepare for foreseeable losses and liabilities will be more sustainable. This matters to staff, customers, suppliers, and – for larger more systemically important companies – to all taxpayers. If the failure of the construction and outsourcing company Carillion in 2018 has taught us anything, it is that having robust rules to prevent unnecessary insolvencies matters to us all.

The problem is that current accounting rules – International Financial Reporting Standards (IFRS) – are not designed to meet capital maintenance rules. Consequently, they do not distinguish between the realised and unrealised element of profits or capital, nor do they require all foreseeable losses/liabilities to be accounted for, leaving out those that are harder to measure or uncertain in timing.

Auditors and the standard setters have stressed that IFRS cannot provide a basis for enforcing the UK's capital maintenance regime, and directors must calculate what is distributable separately. But there is currently no routine disclosure of companies' realised and unrealised profits or capital, nor what foreseeable losses/liabilities have been taken into account beyond those required by IFRS.

To make matters worse, the guidance for calculating what is distributable appears to be flawed. This guidance – drawn up by the audit profession – permits expected profits to be treated as realised. It also appears to leave out material and probable losses/liabilities that are harder to measure. In essence, it appears to treat IFRS numbers as providing a basis for assessing dividend paying capacity.

The problems identified in this paper need to be tackled urgently. The Government should review the guidance directors and auditors are using to calculate companies' dividend paying capacity; it should ensure that this guidance is being properly implemented; and it should require that shareholders and the public can see how distristributable profits and reserves are being calculated

[1] This paper updates an earlier paper "Investors need to know whether profits and capital are real", published in May 2017. Investors have been raising concerns about weaknesses with the UK's capital maintenance regime for some time, and these concerns have been heightened by the recent string of corporate failures. This paper builds on the earlier work to reflect these events, insights provided by government consultations into audit, and the BEIS Select Committee inquiry into the Future of Audit (April 2019).

In the end, the signatories to this paper believe that investors and the public require more visibility: long-term stewardship and the smooth functioning of our financial markets depend on clarity over whether profits and capital are real.

Why investors need to know whether profits have been realised

There are at least four reasons why investors require clarity over whether profit has been realised:

- *To understand how companies are generating value, and the quality of these earnings:* Realised profits are profits that have been received in cash or near cash, after accounting for all expected losses (see below). Unrealised profits, in contrast, have an element of uncertainty about them because they are generally "accrued" profits that management believes the company has "earned" in an economic sense, but has not yet been paid for. Profits from long-term contracts, for instance, that are recognised under the percentage of completion method, essentially anticipate that these profits will come through, even though they are not certain until satisfactory contractual completion[2]. Mark-to-market gains on assets held in a company's trading book is another example of unrealised profits[3&4]. Realised profits are thus higher quality, and investors benefit from knowing what proportion of reported profits are realised and unrealised[5].
- *To provide transparency around capital strength*: Accumulated realised profits offer true loss absorbing capital that strengthens a company's capital base, providing a buffer for shareholders (and creditors) against insolvency. Unrealised profits cannot be relied upon to provide this buffer.
- *To provide visibility of dividend-paying capacity*: Under Part 23 and Part 16 of the UK Companies Act 2006, realised profits can be classified as distributable after allowing for foreseeable losses and liabilities, so can legally be used to pay dividends. These rules form the backbone of the UK's capital maintenance regime. The law reflects the economic reality that if a 'profit' is not realised as cash or near cash, then any distribution based on such profits will have to come from other sources, and this creates a drain on capital and could risk solvency. Long-term investors want their companies to stick to a simple rule: cash must come in and not be required to cover foreseeable liabilities/losses, before cash is paid out as dividends.
- *To align executives with the delivery of sustained value*: Executives' performance-related pay is generally linked to numbers reported in their accounts[6]. Having visibility around what part of profits has been realised as opposed to anticipated, or the result of short-term market momentum, would help to ensure better alignment between executives and long-term shareholders.

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[2] Even where cash instalments are received, the final matching expense to generate this may not be clear, e.g. due to cost over-runs or penalties etc that could result in overstatement.

[3] In the case of very deep and liquid assets like gilts, mark-to-market gains are more legitimately treated as 'near realisable', and thus may be classified as distributable.

[4] It is worth noting that whilst mark-to-market gains on Available for Sale assets are not reported as 'profit', they do directly boost capital. Investors would also benefit from transparency around these unrealised – and normally non-distributable – gains in capital.

[5] It is worth stressing that the signatories to this paper do not object to accrual accounting. As long as it is properly policed, accrued profits are seeking to ensure the reported profit reflects more closely the economics of the underlying activity. Likewise, this paper is not calling for a return to cash accounting. Rather, the signatories wish to have supplementary disclosure to IFRS to provide greater visibility of the split in reported profit between that received in cash and that which is anticipated. Moreover, we believe capital preservation demands that expected but unrealised (so non-cash) costs are accounted for.

[6] Even where adjusted numbers are used the starting point is often the reported IFRS number, whether it is net income, earnings before interest and tax (EBIT), a return based number, etc.

Why investors need to have a prudent view of foreseeable losses and liabilities

Alongside having clarity on realised profits, investors need to have visibility of losses/liabilities that are probable, even if they are hard to measure or uncertain in timing. Otherwise, there is a risk that investors will overestimate the capital strength of the business and its dividend paying capacity, and ultimately misjudge solvency risk[7&8]. Examples of foreseeable losses and liabilities include impairments of physical assets or goodwill linked to assets whose expected cash generation potential has weakened; or expected litigation costs[9].

In terms of executive remuneration, to ignore known and probable losses and liabilities in determining pay, could result in bonuses being paid inappropriately and drive the wrong behaviours amongst executives[10].

Disclosure of realised profits and foreseeable liabilities matters to the public interest

In the end, transparent and reliable accounting for realised profits, capital and foreseeable losses/liabilities are not just an investor and creditor concern, but are of deep interest to the public. Staff, suppliers, customers and local communities all have an interest in the capital strength of businesses they have relationships with. This has been made clear by a string of corporate failures in the past year, such as BHS, Carillion, Interserve, and London Capital & Finance. In the case of large and systemically important companies that may end up receiving public funds in the event of insolvency, such as UK banks, capital strength matters to all tax payers[11].

The problem: investors have no visibility of realised profits or all foreseeable losses/ liabilities (and it is not clear whether directors have visibility either)

Existing accounting rules – International Financial Reporting Standards (IFRS) – do not meet investor (or public) requirements relating to ensuring visibility of capital strength and dividend-paying capacity set out above. This is because IFRS are not intended to protect capital[12]. Consequently:

- IFRS mixes together realised and unrealised profits[13].
- IFRS only includes losses/liabilities that are both probable and measureable. Foreseeable penalties or legal liabilities that management deem hard to measure are left out.

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[7] CA06, Part 23, s839 requires that expected losses/liabilities are treated as "realised losses" for the purposes of calculating distributable reserves. In this way, the rules protect shareholders from over-distribution, leaving a company vulnerable to an expected liability. This intentionally contrasts with the requirement for realised income. Taken together (a requirement for realised income, and provisions for unrealised losses) the law embeds a prudent approach.

[8] CA06, Part 23, s840 further makes clear the importance of provisioning for probable liabilities that are hard to measure [emphasis added]: "(5) For this purpose a company's liabilities include any amount retained as reasonably necessary for the purposes of providing for any liability— (a) the nature of which is clearly defined, and (b) which is either likely to be incurred or certain to be incurred *but uncertain as to amount or as to the date on which it will arise."*

[9] Recent corporate failures, such as Carillion and Interserve, involved companies that continued to pay dividends despite indications that goodwill may have been meaningfully overstated.

[10] Some early case law in this area, which led to statutory requirements, related to management overstating numbers to enhance management bonuses, see for instance Leeds Estate Building and Investment Co 1880.

[11] The Financial Times' Jonathan Ford has provided excellent analysis of the role inadequate accounts and audits have played in several recent corporate failures. See https://www.ft.com/content/bdaf51da-9ae6-11e8-ab77-f854c65a4465

[12] Capital maintenance is not identified as a goal for accounts under the IFRS Conceptual Framework, nor is it mentioned within individual standards.

[13] Unfortunately, the lack of disclosure of realised and unrealised profits is not dealt with in cash flow disclosures. This is an argument for that accounting standard to be reviewed.

Taken together, IFRS accounts cannot provide a reliable basis for investors and others to assess companies' capital strength or dividend paying capacity in accordance with UK Company Law.

The current 'work-around' is flawed

The disconnect between IFRS accounts and the UK's rules for dividends and capital protection is widely known. Most recently, in February 2019, the International Accounting Standards Board published an article emphasising the fact that IFRS accounts are not intended to provide a basis for determining dividend paying capacity, or meeting local capital maintenance regimes[14]. Given the goal of IFRS to provide a global set of accounting standards, it would be extremely difficult if not impossible for them to meet legal rules in every jurisdiction[15].

To bridge the gap between IFRS and the law, the Institute of Chartered Accountants for England and Wales (ICAEW) and the Institute of Chartered Accountants for Scotland (ICAS) have developed "Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Companies Act 2006". This was most recently updated in 2017.

There are at least three important problems with this Guidance, however:

1) It claims that there is no requirement for companies to disclose what their realised or unrealised profits are, leaving investors and the outside world in the dark on these vital company health indicators[16].
2) It has defined 'realised profits' to include accrued profits, permitting companies to mix together those profits that have been realised in cash and near cash, with those that have not[17]. Not only does this appear to run contrary to the intent of the Companies Act, but it leaves investors (and the public) vulnerable by paving the way for unrealised profits to be paid as dividends.
3) It appears to rely on IFRS-style definitions for what losses and liabilities need to be provisioned for, even though the Companies Act requires a more prudent approach[18]. Again, this leaves investors and other stakeholders vulnerable by allowing companies to ignore potentially important and foreseeable, but hard to measure, liabilities, e.g. legal liabilities/fines or even pension benefits[19], when they are determining what they can distribute as dividends[20].

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[14] https://www.ifrs.org/news-and-events/2019/02/returns-reinvestment-opportunities-and-dividend-distribution/

[15] It is worth noting, however, that the UK's capital maintenance rules are echoed in much of the Commonwealth as well as the EU, so these issues are unlikely to be unique to the UK.

[16] See ICAEW and ICAS Guidance, para 2.25: "There is no requirement under law or accounting standards for financial statements to distinguish between realised profits and unrealised profits or between distributable profits and non-distributable profits." However, s836 of the CA06 suggests that it should be disclosed in annual accounts [italics added]: (1) "Whether a distribution may be made by a company without contravening this Part *is determined by reference to the following items as stated in the relevant accounts*—(a) profits, losses, assets and liabilities; (b) provisions of the following kinds—(i) where the relevant accounts are Companies Act accounts, provisions of a kind specified for the purposes of this subsection by regulations under section 396; (ii) where the relevant accounts are IAS accounts, provisions of any kind; (c) share capital and reserves (*including undistributable reserves)*. (2) The *relevant accounts are the company's last annual accounts*,….."

[17] See ICAEW and ICAS Guidance, para 3.9, which defines a realised profit as arising from a "qualifying consideration", which is defined in para 3.11 as comprising: (a) cash; or (b) an asset that is readily convertible to cash; or (c) the release, or the settlement or assumption by another party, of all or part of a liability of the company; or (d) an *amount receivable in any of the above forms* of consideration where: (i) the debtor is capable of settling the receivable within a reasonable period of time; and (ii) there is a reasonable certainty that the debtor will be capable of settling when called upon to do so; and (iii) there is an expectation that the receivable will be settled…"

[18] See ICAEW and ICAS Guidance, para 3.15 – no mention is made of included likely/probable losses that may be uncertain in timing or amount – see CA06, s840 (footnote 8 above)

[19] Pension liabilities are only included according to IFRS measurement rules, so where the legal pension liability is higher, this is likely to be ignored.

The Audit Institutes' Guidance has never been formally approved by the Government, but is widely used by directors and auditors in fulfilling requirements for the capital maintenance regime. It is time this was reviewed.

Company versus Group accounts[21]

While dividends are legally paid from the distributable reserves in the holding (or parent) company, the broader group picture has a vital bearing on the ability of the parent to pay these dividends. Where there are problems brewing within a subsidiary, this could materially affect the parent's ability to make dividend payments in the future. Shareholders should, therefore, have visibility of group-wide distributable reserves to give clarity over dividend paying capacity and capital strength. Any practical or policy restrictions on what could be legally distributed by individual subsidiaries up to the parent should be made clear.

In the case of UK-only businesses, because all UK subsidiaries must calculate their non-distributable reserves and profits, it should be straightforward to consolidate this information. In the case of multinationals, where the subsidiaries are incorporated outside the UK, even if local laws do not mandate that companies track distributable reserves, this does not mean the calculation is not important. Shareholders ultimately have an economic stake in the group (and their capital has been distributed through the group), and thus they also have an interest in capital protection rules being applied throughout the business, whatever the legal status of individual subsidiaries. Indeed, the capital position of subsidiaries needs to be considered in assessing the going concern status of the parent.

Take the case of a UK business with a subsidiary in the US, where local laws do not normally restrict distributions out of capital[22]. If distributions are made out of capital that weakens the capital strength of that subsidiary and ultimately raises the risks to the business. At the very least, this reduction in dividend paying capacity of the group should be made clear. Ideally, the company's management would avoid making such distributions out of capital from foreign subsidiaries[23].

What needs to happen

The situation today is concerning. Weaknesses with enforcement of the UK's capital maintenance regime were exposed in the financial crisis, but do not appear to have been tackled. The fact that management teams at BHS, Carillion, Interserve and London Capital & Finance were making dividend distributions prior to going bankrupt raises questions over whether they were properly differentiating between realised and unrealised profits and making prudent provisions for foreseeable losses/liabilities. At the same time, we continue to see stock exchange-listed companies

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[20] Another example of something IFRS ignores, but is required under the Companies Act, is capitalised development costs. Section 844 Companies Act 2006 requires development costs carried as assets to be treated as realised losses for distribution purposes, unless the reason why this should not be the case is explicitly stated. This creates a statutory adjustment to distributable reserves, determined by items as stated in the accounts. The ICAEW Guidance para 2.38 refers to this requirement, but then indicates that as long as costs are capitalised in accordance with IFRS an exception can be made. We have not been able to identify a clear analysis of why the exception to the law can be presumed. Also, we have not identified examples of this rule's implementation, either in terms of disclosure of the adjustment to distributable reserves, or a note to explain why the adjustment was not made.

[21] See "Supplementary written evidence submitted by PIRC (FA00032)" to the BEIS Select Committee hearings into the "Future of Audit", Feb 2019.

[22] Solvency rules are common, however, which prohibit companies from allowing their net assets to fall below zero. Capital maintenance rules apply a higher threshold, by protecting the paid in capital in the business.

[23] In principle, where dividends are paid out of capital in a subsidiary, we should see directors of the holding company writing down the value of the investment in this subsidiary on their balance sheet, thereby reducing distributable reserves in the holding company. In practice, it is not clear this is always happening.

self-reporting that they have paid illegal dividends[24]. In no case were these problems identified by auditors, who have a responsibility to ensure compliance with dividend rules and alert shareholders where dividends are inappropriately made[25].

The signatories to this paper call on the Government to tackle any weaknesses in the enforcement of the UK's capital maintenance regime. Specifically, the Government needs to:

- Produce its own independently verified guidance for adjusting IFRS accounts to calculate realised profits and distributable reserves.
- Ensure that directors are keeping records of their realised and unrealised profits and distributable and undistributable capital.
- Require companies to publish their realised and unrealised profits and capital in their annual audited accounts to shareholders, and how these have been calculated[26].
- Ensure auditors are checking that these numbers are reliable, and require that they provide an explicit opinion on their findings, with any relevant commentary, e.g. on key judgements made, in the published annual financial statements.
- Ensure that these disclosures are made for the parent, subsidiary and group accounts, to give shareholders sufficient comfort around the entity's dividend paying capacity and capital strength.

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[24] It appears that most illegal dividends resulted from a failure to file accounts that demonstrated the companies had sufficient distributable reserves prior to paying the dividend. Examples include Next, Wm Morrison, Ladbrokes and Foxtons. In the cases of Betfair, Domino's Pizza, and most recently Keyword Studios, however, there were insufficient distributable reserves.

[25] CA06 Part 23 already sets out requirements that auditors alert shareholders in the event that there could be problems with distributions when they qualify their opinion on the annual accounts. C837 [emphasis added]:
"Requirements applicable in relation to relevant accounts
Requirements where last annual accounts used
(1) The company's last annual accounts means the company's individual accounts—…
(2) The accounts must have been properly prepared in accordance with this Act, or have been so prepared subject only to matters that are not material for determining (by reference to the items mentioned in section 836(1)) whether the distribution would contravene this Part.
(3) Unless the company is exempt from audit and the directors take advantage of that exemption, *the auditor must have made his report on the accounts.*
(4) If that report was qualified— (a) the auditor must have stated in writing (either at the time of his report or subsequently) whether in his opinion the matters in respect of which his report is qualified *are material for determining whether a distribution would contravene this Part*, and (b) a copy of that statement must—
(i) in the case of a private company, have been circulated to members in accordance with section 423, or
(ii) in the case of a public company, have been laid before the company in general meeting.
(5) An auditor's statement is sufficient for the purposes of a distribution if it relates to distributions of a description that includes the distribution in question, even if at the time of the statement it had not been proposed."

[26] An argument against requiring companies to provide a breakdown between realised and unrealised profit is that it will incentivise management manipulation: executives will be encouraged to engage in end of reporting period sales to boost the reported realised profit number. Once booked, the management then repurchases the same assets, leaving shareholders worse off (post transaction costs etc) versus the situation where such sales did not take place. However, this behaviour is a good example of "window dressing", which would be prohibited under rules that require accounts to reflect the underlying and ongoing health of the business. Such accounting misconduct should be dealt with through a robust and independent audit, not by reducing transparency to shareholders.

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