Why the principle of capital maintenance and the definition of distributable profits matter

A Briefing Note From The Audit Reform Lab

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Summary

- This note has been developed in preparation for the Audit and Corporate Governance Reform Bill proposed by the new Labour administration in the 2024 King's Speech.

- It focuses specifically on the matter of capital maintenance and the definition of distributable reserves, initially discussed in the BEIS Select Committee '*Future of Audit*' report in 2019, and then in watered down form in the government's March 2021 White Paper, *'Restoring trust in audit and corporate governance'*.

- In this note we explain the significance of the capital maintenance regime, not only to the crisis in audit and accountability, but also the wider growth agenda, the ongoing challenge of State bailouts in socially necessary infrastructures and activities, and the climate crisis.

- We believe that the dilution of this regime has produced an overly short-termist corporate mindset which threatens to deter necessary long-term investments.

- We therefore view the problems of weak investment, weak growth, the slow pace of green transitioning and corporate fragility as interlinked: the product of a short-termism that reflects the overly permissive guidance on distributable reserves and the creative accounting it incentivises

- Our argument is that companies too often use creative accounting and legal work to make cash distributions from non-cash (anticipated) revenues or by reporting speculative profits by ignoring/postponing important costs.

- The incentive to do so lies in the lax enforcement of the 2006 Companies Act capital maintenance requirements that only 'realised' profits can be paid out legally.

- This weakening of the capital maintenance regime creates an inter-temporal risk: if dividends are paid out today from profits linked to, for example, asset revaluations based on future expectations, then firms may not have the balance sheet buffers to absorb future shocks if those expectations turn out to be misplaced.

- Economies are by their nature cyclical, and it is imprudent to allow firms to pay out today from speculative/unrealised income streams expected to accrue from future events that are always uncertain. The purpose of the Companies Act 2006 capital maintenance regime was to prevent this from happening.

- The incentives to distribute today also disincentivises the recognition of likely future liabilities, such as asset retirement obligations for energy companies or water company liabilities, meaning necessary economic, social and environmental expenditures are not being made or provisioned for, storing up all kinds of contingent costs which will likely

be borne by the State in the future.

- We present evidence which shows the poor growth, investment and productivity performance of UK companies that over-distribute, who are, in many cases, paying out more in dividends than they generate in group net income for prolonged periods.

- Tightening the enforcement of the capital maintenance rules of the 2006 Companies Act is therefore central to solving a number of inter-linked social, economic and environmental challenges in the UK

- In our view, the 2019 BEIS report 'The Future of Audit' provides the best start point for the policy discussion about capital maintenance and the reform of audit and corporate governance.

- We conclude with reform recommendations from that report.

1. **Why we think the principle of capital maintenance and the definition of distributable profits matter.**

- Recent corporate collapses show that when strategically important companies fail, they impose a social cost which may demand government support.

- We saw this in the banking sector during the Great Financial Crisis, at Carillion, Thomas Cook, the energy retail companies, and potentially now with water companies like Thames Water too.

- All stakeholders, including shareholders, creditors, the workforce, tax authorities, regulators and government, therefore have an interest in ensuring that companies are resilient and can stand on their own two feet under adverse conditions.

- This idea is enshrined in the capital maintenance regime. This is set out in the 2006 Companies Act which requires that the protection of capital should be the superordinate legal duty of directors.

- Our view is that the capital maintenance requirements have been eroded by permissive accounting rules, the growth of internal and external creative accounting expertise in corporations and unnecessarily complex and loophole-laden guidance on distributable profits, notably the ICAEW's 2017 'Guidance on realised and distributable profits under the Companies Act 2006' TECH02/17BL.

- Directors have consequently pursued a more aggressive approach to profit realisation and shareholder distributions which relies on unrealistic future projections and asset revaluations. In certain cases, these are borrowed against and distributed. This has hollowed out firm equity buffers – the shock absorbers for unexpected future events.

- Auditors have failed to exercise sufficient challenge to these practices, largely because they are done within the current accounting guidance on distributions; and auditors tend to view their role as verifying directors' 'compliance' with that guidance. There is little evidence that additional checks are made on capital maintenance adherence – a *legal* responsibility - despite this being a core auditor function.

- In some cases large audit firms and their industry representative have even lobbied to weaken those rules.

- In our view, the dilution of this regime has produced a set of corporate pathologies that threaten to undermine the UK's future prosperity - they encourage risky short-termism and discourage prudence, planning and investment, from which real productivity gains and economic resilience emerge.

- *On growth specifically:*

    - We believe those lax distribution rules lead to a *misallocation of investment and innovative capacity* in the UK: innovation is concentrated in the legal and accounting work that goes into the presentational aspects of financial reporting to increase distributable profits, rather than the new products, processes and operational efficiencies that are the source of long-term economic growth.

    - If distributable reserves can be recognised sooner and more reliably by buying in law and accounting expertise than by doing the 'difficult stuff' of management (project selection, product/process innovation) where returns take longer to materialise, then creative accounting strategies will 'crowd-out' investment-led strategies.

    - If accounting rules are lax, creative accounting expertise is rich, and auditors simply verify compliance with those lax rules, then financial window-dressing may provide equivalent returns for less effort and risk than investment-led growth in the short term.

    - This problem then becomes self-reinforcing if senior managers with financial engineering behaviours displace those with operational expertise; exacerbated by the expectations of short-term investors.

- Tightening the enforcement of rules on distributions to align better with the 2006 Companies Act would have its own positive market-sorting effects:

    - If non-cash revaluations and other aspirational profits were undistributable, managers would have to create shareholder value through other means – namely investment-led growth and better operational management.

    - It is likely this would produce organisations with lower leverage levels, because there would be no need to borrow against asset revaluations to pay dividends, so they would be more secure.

    - Those developments would have the additional benefit of skills-sorting in UK boardrooms, challenging those who rely on bought-in accounting and law expertise to develop new skills or risk replacement.

    - The capital maintenance commitment would also provide the solvency assurances that encourage long term, patient capital and disincentivise debt-loading and financial engineering of the kind recently seen at companies like Thames Water.

    - It would also support a pivot away from uneconomic and damaging carbon-

intensive (or other environmentally or socially harmful) investments by ensuring a focus on distribution capacity, taking expected carbon costs/clean-up liabilities into account. There is a need to build resilience today - the transition will upend certain industries, and create losses and liabilities. If these are hidden from view due to a failure to enforce the capital maintenance regime properly, this will lead to a build-up of systemic risk.

- A number of influential studies provide support for these arguments:
  - The consulting firm McKinsey (p.89) find that returns from asset revaluations have been roughly the same as returns from operations in the post-crisis period. This is a staggering finding.
  - Andy Haldane's recent opinion piece in the Financial Times, which accompanies his co-authored academic paper finds that since 2005, these revaluations have been a source of shareholder distributions, which have doubled as a ratio of sales among listed EU companies, whilst business investment has fallen by between a third and a quarter. They attribute this outcome to the propensity for firms to revalue their assets for short-term profit under the fair value accounting regime.

- These findings suggest that many distributions are now coming out of profits from fair value revaluations which are not backed by cash.

- Haldane's critics argue that marking assets to market provide investors with a more accurate view of firm economics.

- We believe this conflates two things: the capital maintenance and accounting rules are separate. The key point is not whether assets should be marked to market; but whether those re-markings should be distributable. The former pertains to matters of user information, the latter to capital maintenance.

- Our research shows that firms regularly distribute more than their group net operating profits, and that the highest distributers tend to be the worst performers in terms of investment and efficiency. These are distributional/capital maintenance issues, not informational problems. We summarise our findings below.

2. The evidence

- Our paper on Hollow Firms, and more recent work on UK productivity discuss the outcomes of overly lax rules on distributable profits.

- The salient findings are that in the FTSE350 over the period 2009 - 2019:

- the top 20% of highest distributing firms paid out, on average, **178 percent of their net income** attributable to shareholders over the entire period. The next quintile distributed 88 per cent of their earnings, on average over the period in question.
- these two quintiles represented between them **60 percent of the market value** of the sample 182 companies in the FTSE350 for whom we had results in every year for this period.
- the top 20% of highest distributing firms registered the **lowest productivity increases,** measured by sales growth per employee and value added growth per employee.
- **The top 20% of highest distributing firms also had the** lowest growth in capex per employee
- **The top 20% of highest distributing firms had the** lowest net income margin **and** net income ROCE performance, **the** highest gearing ratio **and the** highest goodwill to shareholder equity ratio,

- There are, therefore, a sizeable minority of firms who distribute in excess of their net income, are highly acquisitive and highly geared and who buy up swathes of the UK corporate economy despite weak investment, productivity and margin growth.

- We do not think this pattern of corporate behaviour is sustainable. Nor do we think that it benefits the long-term strength of the UK economy, even though a powerful constituency may support such practices (directors, Big 4 consultants, some short-term shareholders, more extreme free market academics).

- We do not think this pattern of corporate behaviour attracts patient capital where longer-term performance and solvency issues are more salient

- We also believe that many of these companies are not recognising the true costs of climate change (future carbon taxes/liabilities, investments needed to transition the business model, removing carbon from supply chains etc). By not recognizing/provisioning for these costs, or making these investments to meet net zero 2050 requirements, companies may – inadvertently – be paying illegal dividends.

- We anticipate that this will ultimately mean the state picks up the tab for climate change: if income is consistently paid out and costs are not recognised, then these companies will eventually become 'carbon insolvent' – unable to finance the costs of the climate-associated liabilities, passing on that responsibility to the state and taxpayer. In our view this poses a systemic risk.

3. The accounting practices

- Companies are able to pay more out in dividends than they generate in profit because, whilst net profit is generally reported at a consolidated group level, distributable

reserves are calculated at the level of the corporate parent company only. This may be current practice, but runs contrary to the spirit, if not the letter, of the Companies Act 2006.

- Whilst loss-making subsidiaries are netted against the profit-making ones in a consolidated set of accounts, distributable reserves depend on the fees, dividends, interest, rents etc paid by the subsidiary network to the parent of the group; where loss-making subsidiaries cannot - by definition - pay up negative dividends.

- Parents currently take the upside of subsidiary profits paid to them without necessarily balancing these profits against the losses realised elsewhere in the subsidiary network.

- It is for this reason that many of the recent corporate failures are characterised by a parent company reporting higher net assets and retained earnings than the consolidated group.

- It is also for this reason that some companies have paid out more in dividends from the parent company than they realise in consolidated group profit, or in group net assets.

- This financial strategy of 'packing the parent' with dividends, fees etc, sets in train an incentive to engage what, in a different time and context, was viewed critically as 'tunneling' – levering the subsidiary network to pay up excessive returns to the parent, who then transfers those profits and/or assets to (controlling) shareholders, at the expense of others. In essential services like water, energy, banking etc, those stakeholders include the UK State who effectively assume responsibility when those companies fail.

- We have identified a series of accounting practices which allow these firms to make distributions in excess of their group net income. These include:
    - Booking fair value asset revaluations as distributable profits when rules are interpreted generously,
    - Selling revalued items within the subsidiary network so that a fair value gain can be moved from the non-distributable 'Revaluation Reserve' to distributable earnings,
    - Using inter-group transactions to create profit overloads in individual subsidiaries (leaving others in negative net asset positions). This allows those subsidiaries to distribute the accumulated profits to the parent, who then pays out those profits, even though they exceed the retained earnings of the group,
    - Cancelling items reported as non-distributable reserves to release profits into distributable 'retained earnings'
    - Avoiding impairments to boost reported profits through various forms of shielding (e.g. using and abusing 'cash generating unit' impairment assessments of goodwill),

- Aggressive revenue recognition practices
- Aggressive receivables/payables accounting, including the use of supply chain financing.

4. The risks

- This research shows patterns of aggressive revenue recognition, asset revaluations, profit realisation and shareholder distribution in the non-financial sector reminiscent of pre-2008 excesses in the banking sector.

- Our argument is that a series of negative outcomes are likely if distributions are made through aggressive accounting:

  - If assets are revalued upwards aggressively and firms then borrow against that uplift and distribute the gains, this can expose firms to pro-cyclical risks - i.e. that a downturn not only depresses operating profits, but also downgrades expectations of future cashflows, triggering impairment assessments of previously revalued assets, so that losses compound through both operating losses and accounting impairment channels simultaneously,
  - Relatedly, borrowing against paper profits or aspirational cashflows to pay out to shareholders, can create liquidity risks when borrowing conditions change and creditors are reluctant to roll over debt; or charge higher interest rates which can't be accommodated by future cashflows.
  - Alternatively, something as simple as a rise in interest rates will (or at least should) increase the discount rate, reducing the net present value of assets valued on a DCF-basis. This may trigger the kind of downward spirals outlined above (ie that asset impairments trip covenants, producing liquidity risks which lower credit ratings and/or raise borrowing rates which trip covenants etc).
  - Whilst consolidated group accounts net the asset position of group subsidiaries, parent company disclosures are often much more opaque. This creates transparency risks - it becomes difficult for investors and other users of accounts to see where distributable profits are made,
  - Finally, if management can generate distributable profits through the accounting channel rather than through the nuts and bolts of running a company efficiently, this can have longer term problems for national competitiveness - it sedates entrepreneurialism and makes it difficult to sort good management from bad. Lax capital maintenance rules may divert corporate efforts towards representational rather than operational concerns, crowding out investment-led productivity-enhancing strategies.

- Ultimately, we believe that there are too many thinly capitalised, over-levered companies who have hollowed out their redundancies to pay out to shareholders.

They are now holding bundles of assets whose values are speculative and they will confront liquidity issues very quickly if banks begin to doubt their asset valuations and the cashflows expected to flow from them; or if they are required to make meaningful investments in the green transition or other sectorally-specific costs, such as the post-Grenfell remediations needed in the real estate development sector.

- This stems partly but no less directly from the abuse of lax distributable profit rules and guidance. If the threshold of realisation were higher, then there would be fewer incentives to lever up and more retained cash/larger equity buffers.
- The ultimate risk is a 'perfect storm' of declining profits, rising interest payments, & asset impairments leading to covenant breaches & insolvency because capital maintenance has been neglected.

5. Conclusion: Recommendations for the future audit & governance reform agenda

- The 2021 White Paper took important steps towards mitigating the problems detailed above. And the Audit Reform Lab supports:
    - Assigning responsibility for the definition of realised profits and losses to ARGA either through guidance or binding rules (paras 2.2.8 and 2.2.9). ***This should be supported by an independent legal opinion.***
    - The disclosure of a parent company's distributable reserves, whether known or estimated (para 2.2.14 and 2.2.15). We believe this is also necessary for all subsidiaries too.
    - The disclosure of the ***consolidated group's*** distributable reserves, which is vital to understand their 'dividend paying capacity' (para 2.2.17).
    - Greater accountability by mandating that directors produce a statement that dividends are compliant with capital maintenance rules and will not threaten the solvency of the firm over the next two years (para 2.2.21).
    - Fuller narrative disclosures about dividend policies and capital allocation strategies (para 2.2.28)
    - Other disclosure requirements - a proposed Resilience Statement and Audit and Assurance Policy - designed to make directors' resilience planning more transparent to all stakeholders and to incentivise strategic action in the wider public interest (Chapter 3 *passim*).

- However, there were also many tensions within the 2021 White Paper recommendations on capital maintenance, and a clear dilution of the BEIS Select Committee's original recommendations presented in the 2019 Future of Audit report, which may be the outcome of industry lobbying, and which threatened to undermine many of the positive recommendations.

- There was, for example, nothing in the 2021 White Paper about preventing the payment of dividends from revaluations and other accounting interventions, which create the pathologies and risks identified in the preceding sections.

- Paragraphs 2.2.16 to 2.2.19 in the 2021 White Paper also critically undermine many of the good recommendations outlined above. They recommend that management should be able to define 'potential' distributable profits stuck in the subsidiary network that could 'in principle' be passed to the parent, where management would have discretion about '*how to present these estimates and to allow parent companies to select…which group companies to include in the assessment*'.

- Speculative, discretionary and optimistic decisions about distributions are the core capital maintenance problem, so it is perplexing that this caveat was inserted when it would only seem to benefit accounting firms who want to sell consultancy products and executives who want to maintain their short-termist strategies.

- We believe that a return to the 2019 Future of Audit report should be the first point of reference for the capital maintenance rules in any forthcoming audit and corporate governance legislation.

- The BEIS Select Committee report, chaired by Rt Hon Rachel Reeves, now Chancellor, made the following observations and recommendations:

Capital maintenance

1. Compliance with the capital maintenance regime is patchy at best and it is not adequately audited. *We recommend that the FRC urgently reminds directors and auditors of their duties relating to the accounts and impose severe sanctions for breaches. Most importantly, auditors must be prepared to challenge management on their accounting of realised profits and distributable reserves.* (Paragraph 61)
2. We are alarmed and disappointed that the FRC has not provided clarity on these fundamental issues, given the potential and actual problems that have arisen. *The Government and the FRC should work together to resolve these issues as soon as possible, and produce simple and prudent guidance for companies and auditors to follow.* (Paragraph 78)
3. *We recommend that the Government and the FRC urgently produce a clear, simple and prudent definition of what counts as realised profits for the purpose of distributions. We support defining realised profits as realised in cash or near cash.* (Paragraph 79)
4. *We reject any legislative change the aim of which is to adapt the law to the accounting standards. Instead, auditors and directors need to be reminded that compliance with the accounting standards does not fulfil all legal obligations, and that the law comes first. We regret that the FRC has failed to clarify this basic point with those it regulates. We recommend that the FRC and its successor vigorously enforce the revised capital maintenance regime.* (Paragraph 80)
5. We strongly support the Government's proposal to require companies and auditors to take a more critical look at the valuation of goodwill for the purpose of distributions. *We recommend that the Government urgently take steps to tighten the net assets test.* (Paragraph 86)
6. The Government cannot unilaterally change the international accounting standards, but it can seek to tighten the law. Stopping imprudent distributions makes companies more resilient and encourages management to think longer term and tackle problems earlier.

The principle of prudence should be made explicit in the law and its interpretation. (Paragraph 90)

7. *The Government and the FRC should lead international efforts to improve accounting standards. If the Government wants to achieve its ambitions of a Global Britain advancing UK influence and interests, then it should be prepared to spell out how it wants to lead international standards on key sectors such as accounting and audit.* (Paragraph 91)
8. *We recommend that companies be required to disclose the balance of distributable reserves in the annual accounts and break down profits between realised and unrealised.* (Paragraph 93)
9. A solvency system should complement the revised capital maintenance regime that we recommend, not replace it. *We recommend that the Government adopts a complementary solvency-based system in which directors must state that dividend payments will not make the company insolvent or create cashflow problems.* (Paragraph 96)

- **We believe that these recommendations should form the principal basis for the capital maintenance provisions in the Audit and Corporate Governance Reform Bill, announced in the 2024 King's Speech.**