

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

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## 1. Summary

This note, and that associated with it<sup>4</sup>, has been prepared in response to the notion that the recommendations on the group disclosure of distributable reserves in the government White Paper, *'Restoring trust in audit and corporate governance'*, are too complicated for large UK based public interest entities to implement.

We explain in this note the significance of addressing this issue and in our associated note why it is not legally sustainable to continue to use the existing preferred arrangement for estimating these reserves and how a better methodology is available.

## 2. Why we think the principle of capital maintenance and the definition of distributable profits matter.

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

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<sup>4</sup> 'How to estimate distributable reserves', Adam Leaver and Richard Murphy, November 2021, published simultaneously with this one.

- b. 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.
- c. This idea is enshrined in the principle of capital maintenance. This is set out in the 2006 Companies Act which requires that the protection of capital should be the superordinate legal duty of directors.
- d. *Our view is that this principle has been eroded as directors have pursued a more aggressive approach to profit realisation and shareholder distributions which has hollowed out firm redundancies. We also believe that auditors and regulators have failed to act with sufficient robustness on this issue.*
- e. Our view is that this practice is becoming systemic because it is rooted in the overly-permissive guidance provided by professional accounting institutes on distributable profits (i.e. ICAEW 2017).

### 3. The evidence

- a. Our paper on [Hollow Firms](#), and more recent work on [UK productivity](#) discuss the outcomes of overly lax rules on distributable profits.
- b. The salient findings are that in the FTSE350 over the period 2009 - 2019:
  - o the top 20% of highest distributing firms paid out, on average, **178 per cent of their net income** attributable to shareholders. The next quintile distributed 88 per cent of their earnings, on average.
  - o these two quintiles represented between them **60 percent of the market value** of the sample of 182 companies.
  - o the top 20% of highest distributing firms registered the **lowest productivity increases**, measured by sales growth per employee and value added growth per employee.
  - o The top 20% of highest distributing firms also had the **lowest growth in capex per employee**.
  - o 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**,
- c. 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.
- d. 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 in the short run (directors, Big 4 consultants, some shareholders).

#### 4. The accounting practices

- a. From case study work, we have identified a series of accounting practices which allow these firms to make distributions in excess of their 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 various creative accounting techniques 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 'merger 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.

#### 5. The risks

- a. This research shows patterns of aggressive profit realisation and shareholder distribution in the non-financial sector reminiscent of pre-2008 excesses in the banking sector
- b. 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 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 companies operate as a vessel into which subsidiaries pay dividends. It is possible, through transfer pricing and other forms of creative reporting to generate [profit overloads in individual subsidiaries](#) (leaving others in negative equity positions) which allow the profitable subsidiary to pay up disproportionate profits to the parent. This means parent companies can have significantly higher net assets and retained earnings than the consolidated group, and allow parents to distribute in excess of group retained earnings. This hollows out firm redundancies, but also 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. Loose profit recognition rules may divert corporate efforts towards representational rather than operational concerns, crowding out investment-led productivity-enhancing strategies.
- c. 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.
- d. 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 or equity.
- e. The present risk is a 'perfect storm' of declining profits, rising interest payments, & asset impairments leading to covenant breaches & insolvency because capital maintenance has been neglected.

## 6. Implications for the White Paper

a. Much that is recommended with regard to capital maintenance in the White Paper takes an important step towards mitigating the problems detailed above. We would support:

- Assigning responsibility for the definition of realised profits and losses to ARGAs either through guidance or binding rules (paras 2.2.8 and 2.2.9).
- The disclosure of a parent company's distributable reserves, whether known or estimated (para 2.2.14 and 2.2.15). We refer to our suggested methodologies for achieving this goal and reasons for doing so in the attached note.
- The disclosure of the *consolidated group's* estimated distributable reserves, or at least their 'dividend paying capacity' (para 2.2.17). This would be supported by organograms of group structure which shows where those potential distributable reserves lie within the subsidiary network (para 2.2.18). Again, we suggest methodologies for achieving this goal in the attached note.
- 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*).

b. However, we believe that paragraphs 2.2.16 to 2.2.19 create ambiguities that should be avoided. Paragraph 2.2.16 states,

*'In some group situations, the disclosure of the parent company's own distributable profits (as proposed above) would understate the potential overall capacity to pay future dividends'.*

This can happen, it is argued, when subsidiaries do not fully pay up all potential dividends to the parent company. **Our work suggest the problem is the obverse: that parent company reserves are often much higher than consolidated group reserves, and it is this that undermines capital maintenance because parent companies may distribute more in dividends than the consolidated group has reserves.** This was a key feature of many recent corporate collapses (Interserve, Carillion, Thomas Cook).

Furthermore, the White Paper argues that:

*'The Government's second proposal would address this weakness by, in addition, requiring a parent company to estimate and **disclose the amount of potential distributable profits across the group** that could, in principle, be passed to the parent company for the purpose of paying future dividends to shareholders'. Para 2.2.17 (our emphasis)*

And that,

*'The Government envisages the reporting requirement giving companies **a degree of discretion about how to present these estimates** and to allow parent companies to select, on a reasonable basis, **which group companies to include in the assessment.**' Para 2.2.18 (our emphasis)*

It concludes:

*'The new proposed disclosure requirements will be of value primarily to external investors who will, as a result, have more information about the **legality** and potential future sustainability of dividends'. Para 2.2.19 (our emphasis)*

- c. Three risks emerge as a consequence:
- i. That there is a slippage from the identification of potential distributable profits to the payment of dividends or other forms of distribution to shareholders from those 'potential' profits. Paras 2.2.16 to 2.2.19 may allow directors to extend the distributable capacity of the firm on a discretionary basis which would work to the detriment of capital maintenance.
  - ii. Directors would also be handed discretion as to which group entities to include in this calculation. This may further encourage corporations to create profit overloads in individual subsidiaries through transfer pricing and other creative accounting techniques, leaving swathes of the subsidiary network with negative net asset balances. If the profit-overloaded companies are included in the analysis of latent distributable reserves and the loss-making subsidiaries are not, then this would present a very skewed picture of the distributable potential of the parent, to the detriment of capital maintenance and reducing transparency for investors and other stakeholders.
  - iii. The wording of para 2.2.19 is also worrying because it implies that it is the responsibility of investors to adjudge the putative legality of dividends. In a

context of only partial transparency where directors are given discretion as to which group entities to include in their summary of the latent distributable capacity of the parent, it would be very difficult to form this kind of view if only the upside of the corporate network were being disclosed.

As a result we do not think the recommendations in paragraphs 2.2.16 to 2.2.19 should be adopted.

## **7. Basis for progress**

We are aware that existing guidance on what might constitute distributable reserves may be retained for use in a new audit environment because of the difficulty in estimating distributable reserves. We have spent some time considering this issue and attach a note suggesting why, for good legal reasons, we think that there does need to be change. We propose alternative methodologies to estimate realised reserves.