Funding the Future

The government's audit reforms will not address the iss...

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As already noted, the government has announced its proposed auditing and accounting reform process today. There is much to criticise within it because almost none of the current issues in accounting and auditing that need to be addressed are tackled by the proposals made. But there is one area where there has, at long last, been recognition that reform is required.

I mentioned in a blog post last week that the over-payment of dividends by large companies is a major issue in accounting. In the accounting year before Covid-19 research that I have participated in has shown that 37% of S&P 500 firms distributed more via dividends and share buybacks than they generated in group net income; the equivalent figures for the FTSE100 and S&P Europe 350 were 28% and 29% respectively. This is no minor issue in that case: companies are hollowing out their own capital to pay dividends in a manner that appears to be reckless. They might, in effect, be undermining their own chances of survival by pursuing their current dividend policies.

This has been noticed by the government. In the White Paper that they have issued they say:

Paying a dividend leaves a company with fewer assets with which to meets its liabilities to creditors and meet other demands for capital. For this reason, there are legal constraints on the amount a company can distribute in dividends such as a requirement that they cannot be paid out of capital, but only paid from a company's accumulated realised profits less its accumulated realised losses. The legal framework is well established, but high profile examples of companies paying out significant dividends shortly before profit warnings and, in some cases, insolvency, have raised questions about its robustness and the extent to which the dividend and capital maintenance rules are being respected and enforced. Many investors are also interested in more information from companies about their approach to allocating surplus capital between the competing demands of returns to shareholders and matters such as long-term investment, pension fund deficits and improving balance sheet resilience.

The good news is that they have noticed the issue.

The bad news is that the proposals that they are making will not address the issue. As they also note in their White Paper:

Section 830 of the Companies Act 2006 states that a distribution can only be made out of profits available for the purpose. These are broadly its accumulated, “realised profits” less its accumulated “realised losses”.

As they then note:

* There is no fixed definition of realised profits and losses;

* Although the law says that dividends can only be paid out of profits available for distribution, which are accumulated realised profits less accumulated realised losses, there is no legal requirement for companies to disclose these figures61

* The law’s focus on capital maintenance and realised profits and distributable reserves is backwards-looking when it is apparent that a forward-looking focus is required.

What they also add, almost as a footnote is:

One of the complexities is that, in law, dividends can only be paid by individual companies and not by groups. A parent company can pay a dividend to its external shareholders, but this can only be paid out of reserves built up from the business activities of the parent company itself. Profits generated by subsidiaries can be added, but only to the extent that they have been passed up to the parent company by way of a dividend.

It was this point that was the focus of my paper, and is the explanation as to why many group parent companies are able to financially engineer the payments of dividends that exceed the earnings of the groups that they control. The government does offer many reasons in the White Paper as to why parent companies might have smaller reserves than their groups. It has nothing to say on the actual risk that exists, which is that they have more reserves, which is when the risk of over-distribution arises.

Worse, the government does not suggest the obvious remedy to this problem, which is to provide that a parent company can only distribute reserves shown by the lower of its group and individual company accounts. Instead, it kicks the issue to the new regulator that it proposes be created for their attention at some time in the future, giving a nod on the way to suggest that the existing rules work quite well so that they do not expect any significant reform, by implication.

What will the result be? That is easy to predict. The outcome will be that over-distribution will c0ntinue, hollowed-out firms will still exist and that future audit failure is likely.

This problem could be tackled. *I suggest how in my paper.* *The government is providing very limited reforms that will not go to the heart of this issue and which will retain most of the opacity surrounding it.*

This is not the way to reform audit if we want to have resilient companies trading in and from the UK.