

The UK can no longer afford hollowed out firms

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The [FT noted earlier this week](#) that:

Directors must take corporate culture more seriously following recent company failures, according to the head of the UK audit regulator.

“A series of company collapses linked to unhealthy cultures — whether that be BHS, Carillion, Greensill or Patisserie Valerie — have demonstrated why cultivating a healthy culture, underpinned by the right tone from the top, is fundamental to business success,” said Sir Jon Thompson, chief executive of the Financial Reporting Council.

I think he understated the problem of what my colleagues and I call [Hollowed Out Firms](#)

I have discussed this issue on [AccountingWEB](#) this week. The article is free to access, but registration may be required.

In summary, the issue is this:

To undertake our research we examined accounting data from all 182 companies who were members of the FTSE 350 index in every year between 2009 to 2019. Those companies were ranked according to the ratio of their dividends paid plus share buyback expenditure to their declared net income after tax attributable to shareholders over that period.

Having prepared the data the companies were then grouped into quintile groups. The investment and productivity performance of those quintile groups was then analysed. Details of the companies in each group are in the report.

The results were surprising. This accounting data shows the quintile with the highest dividend and buyback distribution to net income ratio paid out on average 178% of their net earnings after tax over the decade reviewed. Admittedly losses had an impact on this quintile on occasion, but the ratios were still at levels that were much higher than we expected.

The next quintile distributed 88% of their net earnings, on average.

Significantly, these two quintiles, reflecting 40% of the companies surveyed, represented 60% of the market value of the sample of 182 companies.

In contrast, the lowest quintile ranked by their distributions ratio, or 20% of companies surveyed, distributed just 37% of their earnings, on average. They represented 7% of the sample by market value.

As we also note in the research, the financial performance of these hollowed-out firms is also worse with regard to profitability, investment, productivity, leveraged risk and balance sheet strength.

This is not just an unhealthy culture, as Jon Thompson describes it. This is systemic behaviour that suggests that the UK's largest quoted companies are being hollowed out as a result of the overpayment of dividends, supposedly out of profits, but without those dividends having actually been earned.

This is an exercise in financial engineering that transforms debt into dividends that has only one end game, which is corporate failure.

The issue needs more attention than the Financial Reporting Council is giving it, and more attention than the government is giving it. We need changes in accounting law and practice to prevent this happening.

As the article notes we have looked at these issues:

Given the significance of stock market companies for so many parts of the economy and for pension saving we suggest some serious attention needs to be given to our findings and what they might mean for the future returns of UK companies. Some of those issues are addressed in further papers that Prof Adam Leaver and I have prepared.

One looks at the need for [robust capital maintenance rules in the UK](#). Another asks how it might be that companies can generate excess [profits for distribution within their group structures](#). A third suggests how [distributable reserves can now be estimated](#) by companies that have failed to do so in the past, contrary to the requirements of UK company law, in our opinion.

For those who care about the future of the UK economy, our pensions and our stability, these issues matter. These papers are worth looking at as a result.