Deloitte.

A Closer Look

Capital maintenance and distributions under the spotlight

Contents

The headlines

- Companies' capital allocation and dividend policies are a specific area of investor focus and high up on the political agenda. Investors expect transparency around dividend policy and capital allocation. Some are calling for an audited figure for distributable reserves within the annual report and accounts. Recently, the Investment Association has called on all listed companies to improve their approach to paying dividends, recommending that they include their distribution policy within their annual report.

- New strategic report requirements reinforce the focus in this area. For accounting periods beginning on or after 1 January 2019, all large companies will need to include a section 172(1) statement in their strategic report describing how the directors have discharged their duty under section 172 to promote the success of the company having regard to a number of factors including stakeholder interests and the likely consequences of any decision in the long term. The FRC's updated Guidance on the Strategic Report makes it clear that discussion of the basis for capital allocation and dividend policy decisions should be part of the section 172(1) statement. FRC expectations and investor pressure, therefore, make it increasingly difficult for companies to avoid making such disclosure.

- The UK Government is yet to legislate to mandate any specific capital allocation or dividend disclosures. However, it has stated that if sufficient progress is not made it will legislate to require companies to disclose and explain their capital allocation decisions in their annual report and accounts and will also consider whether to mandate the disclosure of an audited distributable reserves figure.

- The rules on capital maintenance, which aim to protect the interests of creditors, can be complex, especially those in relation to distributable profits. Incorrect application may lead to unlawful dividends and potentially serious repercussions for companies and their directors.

For more information please see the following websites:
www.ukaccountingplus.co.uk
www.deloitte.com

What is capital maintenance?

Put simply, the rules on capital maintenance exist in order to protect the interests of creditors. A key principle underlying the rules is that the capital base of a company (in the majority of cases share capital and share premium) must be maintained. This is often referred to as the "creditors' buffer".

The shareholders of a limited company have no liability for the losses of the company in which they have invested beyond the amount of capital they have invested or agreed to invest. The price paid for limited liability is that shareholders cannot simply withdraw the capital from the company at will.

The capital maintenance rules aim to protect creditors and other company stakeholders by preventing directors from paying dividends or returning capital to members other than in limited circumstances. As a company is, in law, a separate legal person from its owners, the owners cannot simply help themselves to the company's property and assets. The rules are tougher on public companies, which are subject to tighter restrictions than private companies in return for the ability to offer their shares publicly.

This guide is written primarily for directors of large companies who are required to make a section 172(1) statement. However, many of the principles will be equally relevant for small and medium-sized companies wishing to make dividend disclosures in line with better practice. The law on distributable profits is relevant to limited companies of all sizes.

Why is capital maintenance so topical now?

The way companies allocate capital and determine and communicate their dividend policy and practice are a specific area of focus for investors and are high on the political agenda. Investors are challenging companies on the issue as they perceive a lack of transparency about how companies allocate surplus capital between dividends, investment (e.g. R&D), and other significant areas such as pension contributions or deficit reduction. Many institutional investors regard capital allocation decisions as being amongst the most important responsibilities of company management and a key area for shareholder engagement with boards because they are seen as playing a vital role in determining a company's ability to be successful in the long-term.

The UK's capital maintenance regime is also under the spotlight as a result of high-profile corporate collapses, particularly where there is a perception that directors have prioritised paying dividends or buying back shares over other potential uses of capital, such as reinvesting in the business or funding pension deficits. The BEIS Select Committee in its March 2019 report[1], 'The Future of Audit', commented that there was "…little compliance with and enforcement of the capital maintenance regime" and highlighted a number of instances of companies paying unlawful dividends.

Investors and other stakeholders are now calling for change. In March 2018[2], the UK Government, as part of a wider consultation on insolvency and corporate governance, sought views on, amongst other things, whether there was sufficient transparency and accountability to shareholders for dividend decisions and broader choices about how any surplus profits generated by a company should be allocated between investment in the company, payment of dividends, payments to reduce pension fund deficits and other demands.

The Government's response to the consultation in August 2018[3] highlighted investor sentiment that that there is a lack of transparency around dividend policy and practice including the links between the principal risks of the company and its future viability and a company's ability to pay dividends now and in the future. Several respondents indicated that there has not been the desired uptake of the better practice on disclosure included within the November 2015[4] and October 2017[5] research reports of the Financial Reporting Lab (the Lab). These reports support the messages from investors coming out of the Government-backed reports and provide better practice examples of disclosure.

Investors have also indicated that they would like to see disclosure of an audited figure for available reserves and distributable profits within the financial statements, including greater clarity over the split between unrealised and realised profits included within those reserves. The Government found that "a significant number of respondents" regarded this as an important transparency measure for shareholders giving them more confidence about the underlying basis for decisions on dividends and helping to clarify the dividend resources available within the group.

1. https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/1718.pdf
2. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/691857/Condoc_-_Insolvency_and_Corporate_Governance_FINAL_.pdf
3. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/736163/ICG_-_Government_response_doc_-_24_Aug_clean_version__with_Minister_s_photo_and_signature__AC.pdf
4. https://www.frc.org.uk/getattachment/96ac6006-7a5a-4c69-8c30-010191139ec4/Lab-Project-Report-Disclosure-of-dividends-policy-and-practice.pdfw
5. https://www.frc.org.uk/getattachment/3a7972af-35ae-4354-8136-0b395f5bbbba/Dividends-implementation-study-Lab.pdf

Some investors believe disclosure of distributable reserves is a legal requirement of the Companies Act 2006 (the Act) and that without it the accounts do not provide a true and fair view. The Financial Reporting Council (FRC) understands that under the Act there is no requirement for companies to separately identify distributable profits in the accounts, although it does recognise that such disclosure may be useful in particular circumstances.

The Government has indicated that it will consider options to strengthen the UK's capital maintenance framework. Some respondents to the March 2018 consultation suggested more radical changes beyond increased disclosure such as a move to a solvency-based framework or a complete overhaul of the UK's capital maintenance regime, currently comprising the Act and common law, underpinned by the joint ICAEW/ICAS TECH 02/17 *Guidance on realised and distributable profits under the Companies Act 2006*[6]. Whilst those more fundamental changes will require further consideration, investors are demanding immediate changes, beginning with disclosure.

Recent developments

For periods beginning on or after 1 January 2019, all large companies[7] (private as well as public) are required to include a section 172(1) statement in their strategic report describing how directors have discharged their duty under CA 2006, section 172 to promote the success of the company for the benefit of its members whilst having regard to matters set out in section 172(1) (a)-(f):

a. *the likely consequences of any decision in the long term;*

b. *the interests of the company's employees;*

c. *the need to foster the company's business relationships with suppliers, customers and others;*

d. *the impact of the company's operations on the community and the enviroment;*

e. *the desirability of the company maintaining a reputation for high standards of business conduct; and*

f. *the need to act fairly between members of the company.*

The FRC's revised Guidance on the Strategic Report, published in July 2018[8], sets out the FRC's expectations for the new statement and provides guidance to directors on how they can meet this new legal requirement. It is non-mandatory guidance but indicative of best practice.

It is hoped that compliance with this legal requirement will drive company reporting around capital allocation decisions and will go some way to addressing investor and other stakeholder expectations.

Further pressure on companies to make fuller disclosure has come recently from the Investment Association which, in May 2019[9], issued a statement calling on companies to improve significantly the transparency of their approach to paying dividends, recommending that "all listed companies… as a minimum, articulate a 'distribution policy'. This policy would include a company's long-term approach to making decisions on the amount and timing of returns to shareholders, including dividends, share buy-backs and other capital distributions within the context of any relevant legal or financial constraints". To support companies in applying its recommendations, the Investment Association plans to issue best practice guidance in the autumn of 2019. The Government is yet to legislate or mandate any form of dividend disclosure. It has stated that it will assess the effect that pressure from institutional investors, the forthcoming Investment Association guidance and the new section 172(1) reporting requirement has on company behaviour before making a decision. It has expressed the preliminary view that it expects reporting to improve, especially with the FRC guidance providing insights into reporting expectations in this area.

Nevertheless, if sufficient progress is not made, the Government has indicated that it will legislate to require companies to disclose and explain their capital allocation decisions in their annual report and accounts. It will also consider whether to mandate the disclosure of an audited distributable reserves figure.

6. https://www.icaew.com/-/media/corporate/files/technical/technical-releases/legal-and-regulatory/tech-02-17-bl-guidance-on-realised-and-distributable-profits-under-the-companies-act-2006.ashx

7. The definition of 'large' is set out in the Companies Act. A company is large if it meets two out of three of the following:
   - Turnover of more than £36m
   - Balance sheet total of more than £18m
   - More than 250 employees

   A company may also be treated as large below these size limits if it is an ineligible company (e.g. a PLC whether listed or not or a company with permission to perform certain financial services).

8. https://www.frc.org.uk/getattachment/fb05dd7b-c76c-424e-9daf-4293c9fa2d6a/Guidance-on-the-Strategic-Report-31-7-18.pdf

9. http://cdn.roxhillmedia.com/production/email/attachment/740001_750000/Shareholder%20votes%20on%20dividend%20distributions%20in%20UK%20listed%20companies.pdf (page 5)

What should company directors be doing?

Legally, companies are required to make a section 172(1) statement within their strategic report indicating how they have complied with their duty to have regard to matters set out in section 172(1) (a)-(f).

The revised FRC Guidance on the Strategic Report indicates that the new statement could identify the "principal decisions taken by the board during the year, how regard was had to the matters set out in section 172(1) when making decisions and the effect of that regard". It then goes on to indicate that capital allocation, being a principal decision for most companies, is an area that most companies will need to consider in their section 172(1) statement. Many institutional investors regard capital allocation decisions as being amongst the most important responsibilities of company management and a key area for shareholder engagement with boards because they are seen as playing a vital role in determining a company's ability to be successful in the long-term.

The FRC guidance states that:

Capital allocation and dividend policy

8.26 For many companies, determining how a company allocates capital may be a principal decision. These capital allocation decisions could include considering working capital requirements, investment, capital expenditure, research and development, capital distribution, and investment in skills and training.

8.27 Part of that capital allocation decision may be the determination of whether to pay a dividend, and, if so, how much to pay.

8.28 On a year-to-year basis, directors will decide how to apply the company's capital allocation and dividend policies given events and circumstances that have arisen during the period. In both the setting of the policy and the application of that policy in any given period, directors are encouraged to consider the interests of the company's shareholders as a whole, while having regard to, for example, the long-term viability of the company, the need for research and development or capital investment and the interests of other stakeholders, such as the pension fund or current employees.

8.29 If the setting and application of the capital allocation and dividend policies are principal decisions, the section 172(1) statement could explain how directors have had regard to the long term and the interests of stakeholders, both in the setting of the capital allocation and dividend policies and then in the application of those policies each year.

The guidance then provides an example as to what a company's section 172(1) statement might include:

Example

The company could explain how its capital allocation and dividend policies have had regard to the matters set out in section 172(1). In particular, the statement could include how directors have had regard to the long-term success of the company and the interests of other stakeholders in determining the dividend level. The company could include a quantified analysis of allocations of free cash flow, to enable users of the accounts to understand how discretionary resources have been allocated between shareholders, other stakeholders and retained in the company.

The section 172(1) statement needs to be meaningful and informative for shareholders. The disclosures should therefore be tailored to the individual circumstances of the company, focusing on matters of strategic importance to the company which are consistent with the size and complexity of the business. In line with the FRC's revised Guidance on the Strategic Report, directors should "consider the significance of the matter relative to the entity's business model and strategy" when determining whether a matter is material for the strategic report. Some companies may therefore consider that setting and application of the capital allocation and dividend policies are not principal decisions and may make no disclosure to that effect in their section 172(1) statement. Against the backdrop of investor pressure, calls from the Investment Association, the new section 172(1) reporting requirement and the expectations of the FRC this, however, will be increasingly difficult for them to justify.

The contents of the section 172(1) statement will depend upon the individual circumstances of the company. References to capital allocation and dividend policy could include the following content elements:

- The policy on payment of dividends and share buy-backs in the context of wider capital allocation decisions in line with the revised FRC Guidance on the Strategic Report.
- Any judgements, risks and constraints associated with the policy.
- How directors have had regard to the long-term success of the company and the interests of other stakeholders in determining the policy including the governance process in determining the policy.
- Actual practice including allocation decisions made.

Observation

Although non-mandatory, we strongly encourage all directors to follow the revised FRC Guidance on the Strategic Report to assist them in discharging this responsibility.

There are diverse views as to the nature and necessary detail that such disclosures should contain. Whilst legally companies are required to include the section 172(1) statement within their strategic report, there is nothing to prevent disclosure elsewhere in the annual report (e.g. providing a figure for distributable profits in the audited financial statements) with a cross reference to/from the section 172(1) statement in the strategic report to avoid duplication.

The research reports issued by the Lab provide further practical guidance to assist companies and will be useful when deciding what to include within the suggested elements above. The Lab reports also provide a number of examples of better practice disclosure. Being drawn from the input of investors, the examples seek to illustrate the characteristics of what good looks like through an investor lens. Below we highlight some of the findings from the reports which companies might find useful:

Area	Suggested disclosure elements
Dividend policy disclosure	• Why a particular policy has been selected, what it will mean in practice and how it ties into the company's overall business model, strategy and capital management process. • Risks and constraints that the board considered in setting the policy. For example distributable profits, debt covenants or regulatory capital. • Changes made to and departure from the policy. • The board's consideration in setting the policy. • The timeframe over which the policy is likely to apply with linkage to the timeframe expressed in the viability statement. • The circumstances in which special dividends will be paid out particularly where they are being paid out regularly. • Detail on considerations made to conduct a share buy-back and the impact of the buy-back on the company's use of cash.

Area	Suggested disclosure elements
Dividend practice/ application disclosure	• How the policy has been implemented in practice including significant judgements and assessments made as part of its implementation. • Key judgements and constraints considered by the board in applying the dividend policy. • Enhanced disclosure on declaration of dividends, including: – The period to which the dividend relates. – Amount per share and aggregate amount. – Date of payment. – Remaining steps necessary to approve the dividend. – Link between the dividend declared and the dividend policy explaining any departures made from the policy. – Level of resources available to the parent including details of how the dividend will be funded. – Resulting dividend cover. • Dividend resources (cash and distributable profits). Disclose in line with particular circumstances. Consider disclosing the distributable profits figure of the parent company or confirm the sufficiency of distributable profits for dividends. Expect level of disclosures to increase as company dividend resources become more limited: – **Abundance of resources v proposed dividend** – minimal disclosure such as a statement indicating an abundance of resources or the year-end balance of dividend resources. – **Sufficient resources v proposed dividend** – enhanced disclosures providing context to source and quality of distributable profits and the year-end balance of dividend resources. – **Insufficient resources to deliver the dividend in accordance with the policy** – further disclosure on action being undertaken by the company to address the issue and the year-end balance of dividend resources. • Consider disclosure of dividend resources that exist in entities below the parent including what resources are available, where they are available and how they may be passed to the parent entity.

Observation

We strongly encourage companies to follow the practical guidance issued by the Lab – a view shared by the Government in its response to the consultation on Insolvency and Corporate Governance. Although inclusion of some of these elements will extend into better practice disclosure, emerging practices of company disclosure (see below) suggest that many of them may become the 'norm' and may be seen as 'expected disclosure' by investors and stakeholders in the near future.

Once published, we would also expect companies to follow the better practice guidance from the Investment Association on what to include within and how best to articulate their distribution policy in their annual report and accounts.

Emerging better practice examples

Some companies have taken the lead by providing some form of dividend disclosure.

Deloitte's forthcoming annual reporting survey, *Annual report insights 2019*, which surveyed 100 listed company annual reports, found that 70 companies were disclosing their dividend policy, with 48 of those companies making clear what it meant in practice. 18 companies disclosed potential restrictions that could prevent them from paying dividends but only nine companies linked their discussion of dividend policy to their discussion of principal risks and uncertainties. Similarly, only 13 companies linked dividend policy disclosures and their viability statements, although 28 companies linked dividend policy to their strategy or business model. 26 companies explicitly disclosed a 'single figure' for their level of distributable profits, with a further 14 instead describing which of their equity reserves were distributable.

These figures are encouraging and, as better practice emerges, we expect that most companies will improve the quality and level of disclosures made. Whilst the disclosures may not yet be at the level that investors and stakeholders expect, they do indicate an emerging trend of companies making these disclosures voluntarily, driven by the desire to demonstrate better practice and satisfy the demands of investors.

Appendix 2 provides practical examples of disclosures that some companies have made.

The role of auditors

Although there is no legal requirement for a company to disclose a figure for distributable reserves, those investors who believe one is required often argue that the figure must be audited even when it is disclosed only in the other information in the front end of the annual report rather than the audited financial statements. Companies may find that quantifying the level of distributable reserves, such that it may be audited, is no easy task due to the extensive guidance on realised profits in TECH 02/17 (see below) and the need to go back a number of years.

When a company makes disclosures of its capital allocation and dividend policy within its section 172(1) statement in the strategic report, the auditor will need to assess whether this disclosure is consistent with the audited financial statements and the auditor's knowledge obtained in the audit. In the light of the expectations published by the FRC in its thematic review on other information[10], the auditor may choose to go beyond those requirements and perform further specific work in this area, such as review of board minutes and agreeing disclosures to the actual policy.

In addition, the auditor will have responsibilities in applying International Standard on Auditing (UK) 250[11] Section A *Consideration of laws and regulations in an audit of financial statements*. This requires auditors to "obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements". The guidance makes it clear that in considering such laws and regulations, the auditor will need to determine whether any distributions have been made lawfully; a view supported by recent case law.

10. https://www.frc.org.uk/getattachment/7afae1fe-75c8-43fc-9f60-3f2a78b438a9/AQR-Thematic-Review-Other-Information-in-the-Annual-Report-Dec-2018.pdf

11. https://www.frc.org.uk/getattachment/e6edadd0-83dc-4532-b731-9e4f77c90e83/ISA-(UK)-250A-Revised-June-2016_final.pdf

Key legal points on capital maintenance and common pitfalls

There are many areas that the rules on capital maintenance underpin. The law is focused on creditor protection. Understanding and correctly applying these rules will be important to directors not only in assisting them to discharge their section 172 responsibilities but also their fiduciary and other duties including to safeguard the company's assets and to take reasonable steps to ensure that the company is in a position to settle its debts as they fall due.

Distributions

One key area that is restricted by the law on capital maintenance is the payment of dividends to shareholders. TECH 02/17 published by the ICAEW and ICAS provides guidance on how to determine realised profits in the context of IFRS Standards and UK GAAP.

The question of determining whether profits are available for distribution, and the procedures to be followed when paying dividends, can be quite tricky and there have been many instances of companies making unlawful distributions.

In fully understanding the law on distributions, there are a number of key concepts that directors will need to be familiar with. These are summarised below along with common pitfalls for directors to avoid in this often complex area.

Key concepts of the law on distributions

1. Dividends can only be paid out of profits available for distribution regardless of the cash resources that a company has.
2. Only realised profits may be distributed – in outline, these are a company's accumulated realised profits less its accumulated realised losses.
3. A profit is regarded as realised if it arises from a transaction where the consideration received by the company is 'qualifying consideration' – broadly cash or something close to cash or readily convertible to cash, such as quoted investments traded on an active market. A capital contribution received in the form of qualifying consideration and the release from a liability are also instances of realised profits.
4. A distribution is made when it becomes a legally binding liability of the company regardless of the date on which it is to be settled. For a final dividend, this will be when it is declared by the company in general meeting or, for private companies, by the members passing a written resolution. For an interim dividend, this is usually when the dividend is paid although steps may be taken to establish a legally binding obligation at an earlier date. The consequence of this is that no dividends should be accrued in the absence of a legally binding obligation at the balance sheet date.
5. Public companies are subject to an additional 'net assets' test, discussed below, which may further limit the amount available for distribution.
6. Under common law, a company cannot make a distribution out of capital – the directors must consider both at the time of proposing the distribution and the time that it is made whether the company, subsequent to the date to which the 'relevant accounts' were prepared, has incurred losses that have eroded its profits available for distribution (the 'capital maintenance rule'). Directors should also consider losses expected to be incurred subsequent to the distribution in exercising their fiduciary duties.
7. Distributions are defined widely and include dividends and other ways in which a company's assets are transferred to members for no, or insufficient, consideration. Intragroup loans on off-market terms, transfers of assets within a group at undervalue and charitable donations made by a subsidiary to its parent charity are examples of situations that involve or may involve a distribution.
8. Distributions are made by individual companies and not by groups; group accounts are not relevant. They are also based upon relevant accounts. These are a company's last annual financial statements or more recent interim accounts if a distribution cannot be justified by reference to the latest annual accounts. For private companies, reliable management accounts are often sufficient to constitute the interim accounts whereas for a public company the rules are stricter. Where a public company is newly incorporated and therefore has no last annual accounts, if it wishes to pay a dividend, it must prepare a set of initial accounts that must be audited.
9. In general, losses should be regarded as realised. Examples are provisions (e.g. for liabilities or to write-down assets) and pension deficits. There are very few instances of unrealised losses.

Common pitfalls for directors to avoid

1. Intragroup transfers of assets at book value

Making an unlawful distribution through incorrect application of s845 CA 2006

Section 845 is concerned with distributions of non-cash assets. Where one group company wishes to transfer an asset to its parent, shareholder, a fellow subsidiary or a company under common control for consideration less than fair value, e.g. at a book value that is lower than fair value, this is only possible where the company has positive distributable reserves at the time of the transfer.

If this condition is met and the asset is transferred for consideration at least equal to book value, the amount of the distribution is zero and the transfer may lawfully be made. Any shortfall of consideration below book value must be covered by distributable profits. Where there is a negative balance on distributable reserves, any profit made on the transfer by selling for an amount between book and fair value can also be taken into account in meeting this requirement.

Where this condition is not met, any transfer below fair value may amount to a distribution and be unlawful.

2. Interim accounts for public companies

Not filing interim accounts prior to making a distribution or share buy-back

For a public company, when the last annual accounts do not show sufficient profits, more recent interim accounts for the company individually must be prepared and filed at Companies House before a distribution or share buy-back is made. Such accounts will usually consist of a balance sheet and profit and loss account with notes restricted to only those matters required to support the distribution. Such accounts do not have to be audited. Failing to follow these procedures will render the dividend or share buy-back unlawful.

Private companies do not need to file any form of interim accounts to support a proposed distribution. However, when the most recent annual accounts do not show sufficient profits to support a planned distribution, the directors must base their dividend decisions on more recent interim accounts that are sufficient for them to make a reasonable judgement as to profits, losses, assets and liabilities, provisions, and share capital and reserves.

3. Successive distributions

Failing to consider previous distributions made

One or more distributions or share buy-backs may already have been made by reference to a particular set of accounts. In determining the lawfulness of any proposed further distribution by reference to the same accounts, directors must take into account any such distributions already made. Any profits made since the date of the most recent relevant accounts cannot be taken into account.

4. Net assets test for public companies

Incorrect application of the further restriction placed on public companies

Distributions by public companies are subject to a net assets test in s831 of the Act. A public company may only make a distribution if, after making that distribution, its net assets are not less than the aggregate of its called up share capital and undistributable reserves shown in its relevant accounts. Undistributable reserves include the share premium account, capital redemption reserve, any reserve designated by its Articles and any excesses of unrealised profits (e.g. revaluation reserves and some hedge accounting gains) over unrealised losses (net unrealised losses are treated as nil). A debit in reserves relating to shares held in an employee benefit trust (EBT) is not in law a loss and does not affect called-up share capital and undistributable reserves. However, a purchase of own shares by an EBT does reduce net assets and thus immediately reduces the headroom in this test. The net assets test should be considered both at the time the distribution is proposed and when it is made.

By way of example, consider the following balance sheet extract for a public company:

	£000
Share capital	10,000
Share premium account	20,000
Shares in Employee Benefit Trust	(2,000)
Retained profits	5,000
	33,000

In this example, although retained profits are £5 million, the excess of net assets (£33 million) over the aggregate of called-up share capital and undistributable reserves of £30 million (comprising £10 million share capital plus £20 million share premium) is only £3 million, which means that the net assets test restricts the amount available for distribution to this lower figure.

5. Fair value accounting and realised profits

Assuming that fair value profits recognised in the profit and loss account are always realised

Fair value movements are often included in the profit and loss account. Whilst fair value losses are generally realised, not all fair value gains are realised.

Fair value gains will meet the definition of a realised profit only where the change in fair value is readily convertible to cash. This essentially means that the entity, in its current circumstances, must be in a position, without negotiation or marketing, to convert immediately the asset or change in fair value into cash at a price that is observable in the market. This rules out fair value changes in unquoted investments and investment properties but fair value movements on financial instruments traded in an active market whose valuations are based on observable market inputs are likely to be realised and available for distribution.

A gain on a financial instrument may also be capable of being readily converted to cash if it can be immediately closed out meaning the relevant contract or underlying market risk position is capable of being immediately offset in the market and the normal market practice would be to close out the position in this way. For example, risks inherent in a derivative may be eliminated by taking out another derivative contract with an offsetting risk profile.

The rules on fair value accounting are complex and directors need to exercise judgement to determine whether such profits are realised and available for distribution.

6. Linked transactions

Looking at each step in a series of transactions in isolation

In assessing whether a company has a realised profit, transactions and arrangements should not be looked at in isolation. A group or series of transactions or arrangements should be viewed as a whole, particularly if they are artificial, linked (whether legally or otherwise) or circular or any combination of these. Thus, a realised profit will arise only where the overall commercial effect on the company is such that the definition of realised profit is met. Directors should particularly consider this 'linkage' principle for intragroup transactions which may involve a series of interconnected steps which would not usually be undertaken in isolation. A profit may arise on step 1 of a series of transactions which is represented by cash and, therefore, in isolation, appears to be a realised profit. But, if step 2 involves that cash being paid out again, it is necessary to look at the combined effect of these from the company's perspective, because the overall effect may be that there has been no increase in qualifying consideration and thus no realised profit.

For example, if a parent provides funds to a subsidiary by subscribing for additional shares so that the subsidiary can pay a dividend to the parent, the dividend will not be a realised profit in the parent's hands if this falls foul of the linkage principle, as the overall effect is that the parent has the same cash at the end of the series as at the beginning and the subsidiary has, in effect, capitalised retained profits by issuing new shares to its parent. These shares will not usually be qualifying consideration for the parent. This may not be obvious from looking at each of the parent's transactions in isolation.

7. Intercompany receivables and qualifying consideration

Always treating intercompany receivables as qualifying consideration

Receivables will usually meet the definition of qualifying consideration if certain conditions are met, namely that the counterparty is capable of settling within a reasonable period of time, there is reasonable certainty that the debtor can settle when called upon and that there is an expectation that the receivable will be settled. Whilst for many third party receivables these conditions will not present an issue, when applied to intercompany receivables, directors will need to exercise judgement especially when evaluating what is a 'reasonable' period of time for settlement. The guidance in TECH 02/17 was written primarily to deal with intragroup balances where there is no expectation that they will be settled with the implication being that not all intercompany receivables will meet the definition of qualifying consideration and therefore any related profits may not be realised.

8. Unrealised profits

Treating unrealised profits as realised and available for distribution

Certain profits such as amounts taken to a revaluation reserve, merger reserve or other similar reserves are regarded as unrealised and are not available for distribution. That does not mean that they cannot become realised in the future. A profit previously regarded as unrealised may become realised in a number of scenarios, the most common of which are:

- Consideration previously received by the company becoming qualifying consideration.
- The related asset (to which the unrealised profit relates) being disposed of in a transaction where the consideration received by the company is qualifying consideration.
- A related portion of the unrealised profit becoming realised as the related asset is amortised or written down for impairment.

It is best that such unrealised reserves are maintained in a separate component of equity to reduce the risk that they are mistaken for realised profits and distributed in error before they have become realised. It is also advisable to track the related assets so that instances when the reserves become realised can be identified.

9. Share-based payments

Treating the credit in equity in the parent's separate financial statements as realised
When a parent grants rights to its equity instruments to the employees of its subsidiary, the parent has an obligation to settle the transaction with the subsidiary's employees by providing the parent's own equity instruments. In such equity-settled share-based payment arrangements, the parent will usually debit the cost of investment in its subsidiary and recognise a corresponding credit to reserves (where there is no reimbursement in place). In such situations, the credit in the parent's reserves is an unrealised profit and is not distributable, so should not be added to the parent's profit and loss reserves when determining profits available for distribution.

Directors can be held personally liable to repay a distribution if, at the time of the distribution, they knew or had reasonable grounds for believing that the distribution was unlawful and not in accordance with the Companies Act. In such instances Directors are recommended to seek legal advice.

Other areas
There are many other areas that the capital maintenance principle underpins such as:

- Reduction of a company's share capital and/or reserves.
- A company's redemption or purchase of its own shares.
- Prohibition on the provision by a company of financial assistance for the purchase of its own shares.

These areas are considered briefly in Appendix 1 to this publication.

Appendix 1 – further capital maintenance issues

Share capital and share premium

Share capital must not be issued at a discount, i.e. for consideration less than its par or nominal value. The consideration equal to par value is placed in share capital. When shares are issued for consideration (whether cash or otherwise) in excess of their par value, the excess must be placed in a share premium account, other than in limited cases where group reconstruction relief or merger relief apply.

Once created, the ways in which share premium may be used are very limited and include, for example, using the account to:

- Write off the expenses of the issue of the shares giving rise to the premium.
- Write off any commission paid on the issue of those shares.
- Issue fully paid bonus shares.

Reduction of capital

The Act is founded on the capital maintenance principle that once a limited company issues shares, the capital base is increased permanently. This principle was established originally in common law. Where part of this capital base is repaid, it must be replaced at that time from new capital or from distributable profits. By comparison, unlimited companies may freely distribute capital to members. There are two exceptions for limited companies: a capital reduction, which is available for both public and private companies, and a procedure for private companies to redeem or purchase their own shares out of capital subject to certain safeguards.

A capital reduction allows a limited company to reduce the capital base of the company, create distributable reserves and return capital to members whilst also meeting the general requirement to protect the interests of the company's creditors.

A capital reduction can be applied to share capital, share premium account, capital redemption reserve and any redenomination reserve, which arises in limited cases where shares are converted from one currency to another.

Public companies need court approval for a capital reduction. A private company may make a capital reduction by special resolution of shareholders (75% majority of those voting) and a solvency statement signed by all directors. This is a cheaper and quicker alternative to a court approved capital reduction, which is still an option but is rare in practice for private companies. The solvency statement made by each director confirms that, in essence, the company after reducing its capital can pay its debts as they fall due for at least twelve months. It is an offence for a director to make a solvency statement without having reasonable grounds for the opinions expressed in it.

Purchase or redemption of own shares

The Act permits limited companies to redeem or purchase their own shares in strictly limited circumstances. Shares redeemed or purchased must usually be cancelled. This is subject to an exception in the case of 'treasury shares' which, subject to some restrictions, may be held by a company without being cancelled (i.e. so that they can be sold or used for an employee share scheme at a later date).

Except in the case of private companies, shares may only be redeemed or purchased out of distributable profits or out of the proceeds of a fresh issue of shares made for the purpose of financing the redemption or purchase. Treasury shares may be purchased only out of distributable profits. Private companies are also able to buy back their own shares, without having to use distributable reserves, up to a value of the lower of £15,000 and five per cent of the share capital of the company in each financial year.

When the shares redeemed or purchased are cancelled, the amount by which the nominal value of shares cancelled exceeds any fresh issue proceeds is transferred to the capital redemption reserve, which is non-distributable and similar to share capital.

In general, any premiums paid on redemption of purchase or shares, i.e. where the amount paid exceeds the nominal value of the shares, must come from distributable profits, subject to limited exceptions.

Financial assistance for the acquisition of own shares

The principles of capital maintenance underpin the rules around financial assistance for the acquisition by a company of its own shares. The basic rule, subject to certain exemptions, is that it is unlawful for a public company to give financial assistance directly or indirectly, for the purpose of the acquisition of its shares or those of its holding company. An exception to this is in relation to employee share schemes, subject to meeting specific requirements in the Act.

For private companies, the rules are less strict and such a company may give financial assistance for the purchase of its own shares provided that this does not result in an unlawful return of capital.

For more information on these and other capital maintenance issues, see chapter A5 of GAAP in the UK, available on the Deloitte Accounting Research Tool at https://dart.deloitte.com/UKGAAP.

Appendix 2 – Recent examples of better practice disclosure

Company	Commentary
BAE Systems Annual Report 2018 – strategic report extracts **Balance sheet and capital allocation** The Group's balance sheet is managed conservatively, in line with its policy, to retain its investment grade credit rating and to ensure operating flexibility. Consistent with this approach, the Group expects to continue to meet its pension obligations, invest in research and technology and other organic investment opportunities, and plans to pay dividends in line with its policy of long-term sustainable cover of around two times underlying earnings and to make accelerated returns of capital to shareholders when the balance sheet allows. Investment in value-enhancing acquisitions will be considered where market conditions are right and where they would deliver on the Group's strategy. **Dividends** As part of the Group's capital allocation policy, the Group plans to pay dividends in line with its policy of long-term sustainable cover of around two times underlying earnings. The Board has recommended a final dividend of 13.2p per share making a total of 22.2p per share for the year, an increase of 2% over 2017. At this level, the annual dividend is covered 1.9 times. Subject to shareholder approval at the 2019 Annual General Meeting, the dividend will be paid on 3 June 2019 to holders of ordinary shares registered on 23 April 2019. The ex-dividend date is 18 April 2019. At 31 December 2018, the Company had retained earnings of £2.8bn (2017 £2.6bn), the non-distributable portion of which is £701m (2017 £649m) (see page 212). Total external dividends relating to 2018 are £710m (2017 £695m), including the interim dividend paid during the year of £288m (2017 £280m) and the final dividend proposed of approximately £422m (2017 £415m). On an annual basis, the Company receives dividends from its subsidiaries to increase further its distributable reserves and, accordingly, the Company expects to have sufficient distributable reserves to support its dividend policy. The Group's dividend policy is underpinned by its viability and going concern statements (see pages 81 and 82).	• Includes a clear statement of the capital allocation and dividend policy. • Provides the level of non-distributable reserves for the parent entity. • Clearly indicates that dividend resources exist in other group companies that are passed up annually to the parent with a clear statement that the company expects to have sufficient resources to support its dividend policy. • Linkage to viability and going concern statements.

Company	Commentary

Company

BHP Annual Report 2018 – annual report extracts

Shareholder information section (extract)

7.7 Dividends

Policy

The Group adopted a dividend policy in February 2016 that provides for a minimum 50 per cent payout of Underlying attributable profit at every reporting period. For information on Underlying attributable profit for FY2018, refer to section 1.11.1.

The Board will assess, at every reporting period, the ability to pay amounts additional to the minimum payment, in accordance with the Capital Allocation Framework, as described in section 1.4.3.

Strategic report (extracts)

Capital discipline

Our Capital Allocation Framework is the framework by which we assess decisions relating to the most efficient deployment of capital.

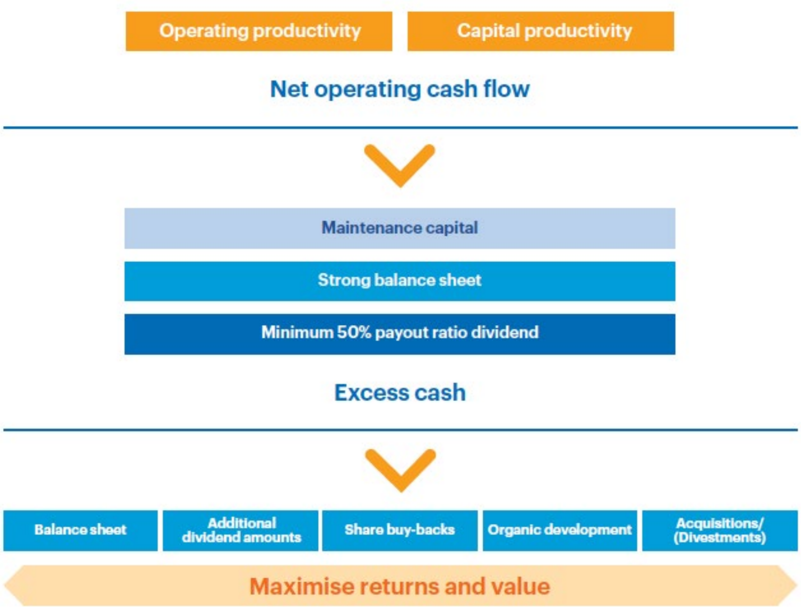
We put capital to work to:

- maintain our plant and equipment to support safe and efficient operations over the long term;
- keep our balance sheet strong, to give us stability and flexibility through the cycle;
- reward our shareholders by paying out at least 50 per cent of our Underlying attributable profit in dividends.

We then look at what would be the most valuable risk-adjusted use for any excess capital that remains after these three priorities are met, and decide whether to:

- further reduce our debt;
- return more cash to shareholders through additional dividends or share buy-backs;
- invest in growth, either through projects within our asset portfolio or through exploration or acquisitions, provided the investment will create more value on a risk-adjusted reward basis than a share buy-back.

Our Capital Allocation Framework



Commentary

- Extensive disclosure of capital allocation and dividend policy.
- Addresses wider capital allocation issues and priorities for excess capital.
- Visual representation of capital allocation framework.

Company	Commentary
DS Smith plc 2019 – annual report and accounts extracts ***Strategic report (extract)*** The Board considers the dividend to be an important component of shareholder returns and, as such, has a policy to deliver a progressive dividend, where dividend cover is between 2.0 and 2.5 times, through the cycle and having taken into account the future financing requirements of the Group. For the year 2018/19, in accordance with our dividend policy, the Board recommends a final dividend of 11.0 pence per share, which will be paid to all shares on the record date. This, combined with the 2018/19 interim dividend of 5.2 pence, makes a total dividend for the year of 16.2 pence (2017/18: 14.4 pence). **Dividend** The proposed final dividend is 11.0 pence (2017/18: 9.8 pence), which will be paid on 1 November 2019 to ordinary shareholders on the register at close of business on 4 October 2019. As at 30 April 2019, the Company had distributable reserves of £1,459 million (30 April 2018: £1,651 million). ***Extract from note 11 to the company financial statements*** As at 30 April 2019, the Company had distributable reserves of £1,459m (30 April 2018: £1,651m).	• Includes a clear capital allocation and dividend policy. • Provides the level of distributable reserves for the parent entity in the audited financial statements.
ITV plc Annual Report and Accounts 2018 – notes to the company financial statements (extract from note viii 'Equity and dividends') **Keeping it simple** ITV plc is a non-trading investment holding company and derives its profits from dividends paid by subsidiary companies. The Directors consider the Company's capital structure and dividend policy at least twice a year ahead of announcing results and do so in the context of its ability to continue as a going concern, to execute the strategy and to invest in opportunities to grow the business and enhance shareholder value. The dividend policy is influenced by a number of the principal risks as identified on pages 56 to 61 that could have a negative impact on the performance of the Company. In determining the level of dividend in any year, the Directors follow the dividend policy and also consider a number of other factors that influence the proposed dividend, including: • The level of retained distributable reserves in ITV plc the Company • Availability of cash resources (as disclosed in note 4.1 to the consolidated financial statements) and • Future cash commitments and investment plans, in line with Company's strategic plan **Equity** The retained earnings reserve includes profit after tax for the year of £344 million (2017: £351 million), which includes dividends of £400 million from subsidiaries in 2018 (2017: £426 million). Other reserves of £37 million (2017: £26 million) relate to share buybacks in prior periods and foreign currency translation net of cash flow hedging. **Dividends** The Directors of the Company propose a final dividend of 5.4 pence per share, which equates to a full year dividend of 8 pence per share. **Distributable reserves** The distributable reserves of ITV plc approximate to the balance of the retained earnings reserve of £1,612 million (2017: £1,571 million) as at 31 December 2018.	• Discloses the dividend resources that exist in other group companies and the nature of the entity. • Indicates how frequently the policy is considered and highlights a link to risks that influence the policy. • Identifies a number of other factors that affect the proposed dividends. • Confirms the approximate level of distributable reserves and source of retained earnings.

Company	Commentary
Next plc 2019 – financial statement notes of the parent entity (extract) **C7. Profit and Loss Account and Distributable Reserves** The Profit and Loss account of the Parent Company does not include any unrealised profits, however the amount available for distribution under the Companies Act 2006 by reference to these accounts is effectively reduced by the ESOT reserve of £271.6m (2018: £231.6m). At January 2019, therefore, the amount available for distribution by reference to these accounts is £505.0m (2018: £516.7m). The Group also has substantial retained profits in its subsidiary companies which are expected to flow up to the Parent Company in due course, such that surplus cash generated can continue to be returned to our external shareholders.	• Discloses the level of reserves available for distribution. • Identifies the limit imposed by the application of the 'net assets' test. • Indicates that there are substantial resources in subsidiary companies which can be passed up to return value to shareholders.

Deloitte.

Designed by CoRe Creative Services. RITM0314494