KPMG

Capital maintenance

Let's tackle the difficult questions

December 2019

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Aims of this paper

Company distributions have become a controversial subject. The reviews by the BEIS Select Committee, Sir John Kingman and Sir Donald Brydon have all referred to this.

A number of questions have been raised:

- Are accounting standards and the current ICAEW guidance alone satisfactory for regulatory distributable reserves?
- Does the realisation regime need to change to meet creditors' and shareholders' needs?
- Should distributable reserves be calculated at a group level?
- Should ARGA take responsibility for oversight of distributable reserves?
- Should further disclosures be made on distributable reserves?

We believe that all those concerns can be addressed. The question is how to do so.

The aims of this paper are to examine the issues and sketch out, for debate, possible ways forward. Resolution of these key issues is a core element of the programme of work required to restore trust in the profession.

We trust that this initiative will assist in progressing resolution of these important matters.

Michelle Hinchliffe
UK Chair of Audit

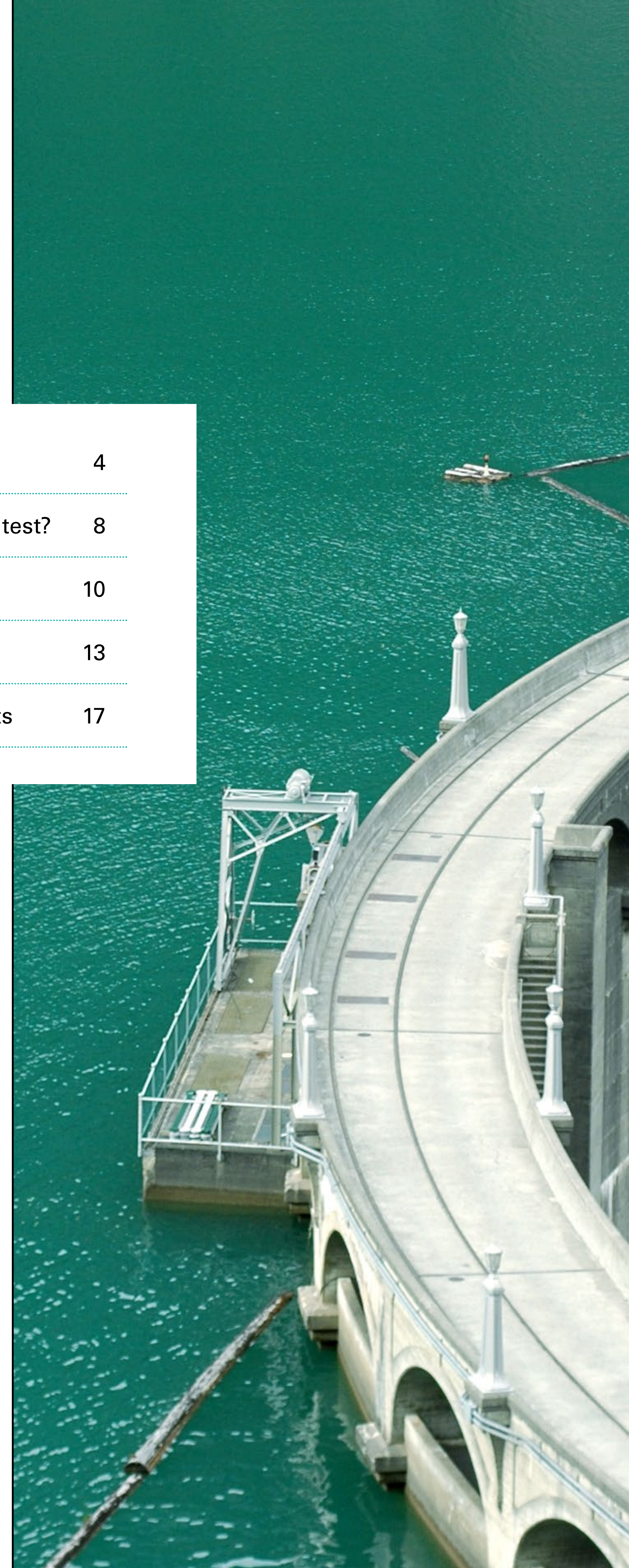
In summary

- We can move beyond the controversy over whether accounting standards and ICAEW's realisation test are contrary to law.
- The realisation test should be owned by ARGA not ICAEW.
- It should be consulted upon in order, if felt appropriate, to change the realisation test.
- We believe, however, that there is a strong argument to change the whole distributions regime, say to a prudential or a solvency test.
- If, after consultation, shareholders want disclosure of distributable profits, then it should be required.
- If disclosure is wanted, the consultation is an opportunity to resolve how the group position is to be addressed.

Next steps

- In the face of such questions and criticism, the need for consultation and debate is clear. The views of affected parties – investors, creditors, companies – are key to inform any changes to be introduced by government or regulators.

Contents



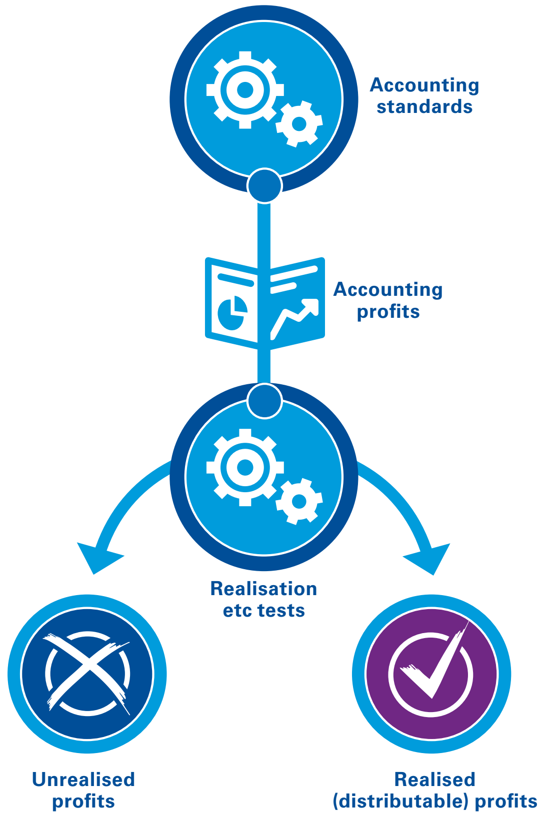
01.

The controversy

The current regime

Accounting standards vs legal tests

Accounting standards do not determine distributable profits but only, as stage one, their starting point. They determine the profits and losses in the accounts. The realisation and other legal tests are a second stage that then separate them out into what are and are not distributable profits.



The main statutory test is the realisation test, but others are:

- net assets test (PLCs only – required to deduct net unrealised losses); and
- alternative surplus assets test (investment companies only).

There are also tests in the common law: first on capital maintenance (e.g. post-balance sheet erosion of realised profits must be taken into account); and also on fiduciary duties (e.g. effect on the company of making the distribution) – and it may be that, all other considerations aside, directors also need to give more attention to this duty.

Criticisms

Some say that accounting standards are legally flawed by permitting distribution of profits that prudently ought not to be distributed. This is based on the contention that the defining purpose of accounts is to further a capital maintenance objective of preventing such distributions and that this is what the true-and-fair standard is all about.

Moving forward

However, there is an opportunity to move beyond this controversy. What is distributable is, under the two-step process, restricted by the realisation and other legal tests.

So do we have the right tests?

ICAEW’s realisation test

Why is it set by ICAEW?

By law, the test is whatever is generally accepted accounting practice for determining realised profits (s853 Companies Act 2006). Accordingly, what is realised is in fact a matter of accounting practice.

The Institute of Chartered Accountants in England and Wales (ICAEW) and the Institute of Chartered Accountants of Scotland (ICAS) have codified practice since 1980, most recently in 2017 in their TECH 02/17BL ‘Guidance on realised and distributable profits under the Companies Act 2006’, through open consultations.

It was not unusual for a professional accountancy body to seek to do this, particularly in years gone by when self-regulation was normal; and so far as we are aware, the Financial Reporting Council (FRC) has never sought to take over the codification of accounting practice in this area. Furthermore, if ICAEW had not sought to codify and thereby regularise practice the result would have been diversity, with one end of the spectrum perhaps being very loose.

So, although it is not the case, one criticism that is made is that a professional body is interpreting or even making the law.

Is the ICAEW’s test too generous?

Reducing it to its simplest, the ICAEW test is an accruals basis (allocation of income and expense to the period even if cash has not yet flowed) with some fair value (FV) gains allowed and almost all losses being realised (some FV losses are unrealised).

In particular accrued income is realised, e.g. on long-term contracts.

Financial instrument FV gains can be realised. This too has attracted some disquiet as they may not be readily convertible to cash. This is notwithstanding that ICAEW provides that they are realised only if readily convertible to cash, which ICAEW defines as being traded in an active market or valued with all of the valuation inputs being observable and the company’s circumstances not preventing its being converted to cash.

Is ICAEW's test too complex?

It weighs in at just over 170 pages. The criticism is that it is too complex.

The criticism might, however, be better stated as its being unwieldly rather than inherently complex. Length and complexity are not necessarily the same things.

A thumbnail sketch of the coverage of the ICAEW TECH is shown below. The core principles are fairly short. The length comes principally from three factors:

- comprehensive examples;
- some specific issues. One arises from an accounting treatment, i.e. of the boundary between accounting equity and liabilities not being the legal boundary between shares and debt. The other arises from what is possible in law, i.e. foreign currency share capital; and
- anti-avoidance. In particular it aims to be robust in dealing with intra-group linked transactions that might otherwise create realised profits; and with the so-called cash-box scheme that might otherwise create realised profits by legal structuring of an issue of share capital.

What those 170+ ICAEW pages contain

- Explanation of the legal framework (15 pages)
- Core provisions/ principles (4 pages)
- Application of principles to:
  - fair value accounting (6 pages)
  - hedge accounting (4 pages)
  - employee share schemes (9 pages)
  - pension expenses (2 pages)
  - miscellaneous issues (18 pages) (39 pages total)
- How to handle, for distributions, the effect of treating some shares as debt, and similar issues (12 pages)
- Foreign currency share capital (6 pages)
- Anti-avoidance (intra-group transactions, cash-box structures etc) (22 pages)
- Numerical examples, mostly shares/ debt issues and foreign currency shares (63 pages)

02.

Who should own the realisation test?

Who should own the realisation test?

We believe that it should move to ARGA

- ICAEW's ownership is a product of history. The creation of the Audit, Reporting and Governance Authority (ARGA) is the ideal time to revisit that.
- Despite open, public consultation on the development of its realisation test, potentially it can be seen as self-regulation.
- Logically this belongs to an independent regulator to decide if it wants to set the test itself directly or indirectly by involving ICAEW's expertise under its authority and control.

How to move it?

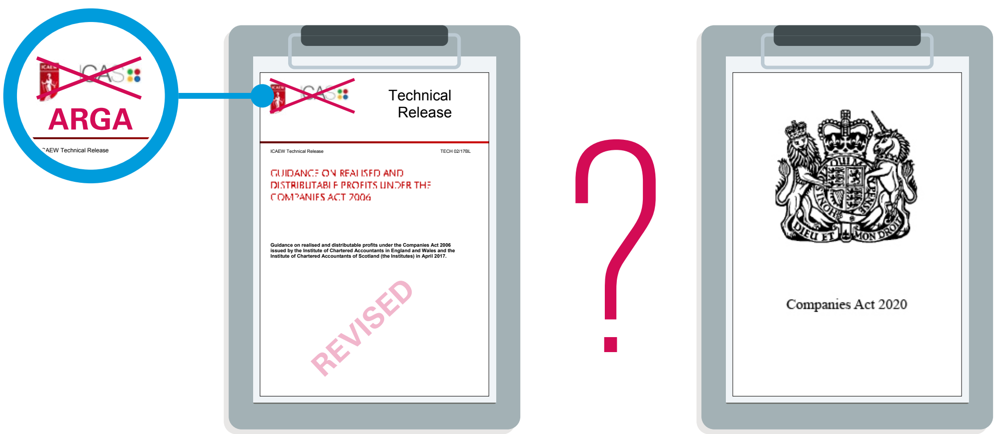
It could be done by in effect re-branding:

- ARGA would issue replacement guidance, and ICAEW would withdraw its guidance.
- The ARGA guidance would be covered by the existing s853 generally-accepted-practice formula.
- This would be simple to accomplish.

Or Parliament could legislate to give ARGA power to make a realisation rule with which companies must comply:

- This would provide the certainty of "must comply", although the existing guidance is treated as if it were a rule anyway.
- Legislation would be time consuming, but arguably not incremental given the need for legislation to create ARGA in the first place.

Either would be workable, but the latter would be more consistent with ARGA's role as a directly empowered rule-making regulator.



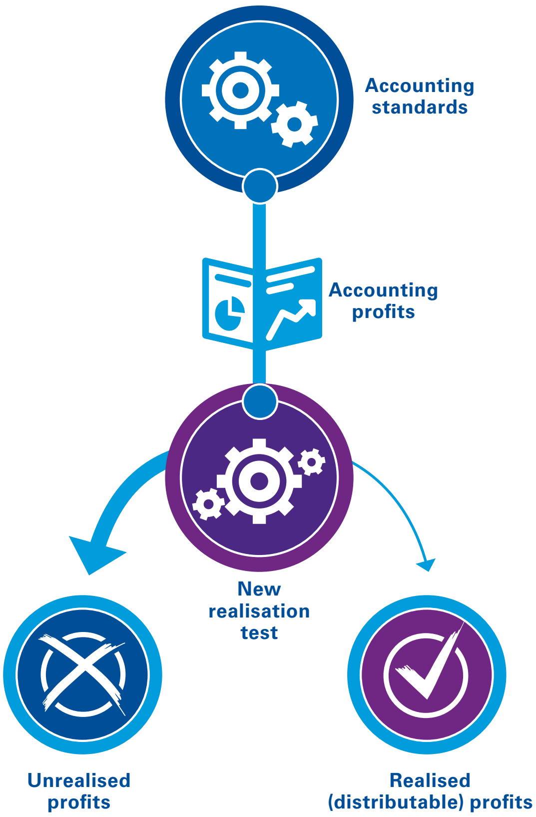
03.

Alternative realisation tests

A new realisation test?

Should the realisation test be re-opened?

Yes. The codification of "realised" was settled through public consultations most recently 10+ years ago. Nevertheless, the current interest in the test, and questions being asked, means that it is reasonable to re-open the guidance on the occasion of its transfer to ARGA.



Moreover, it would be inappropriate for ARGA to take over guidance without going through its own due process to ensure that ARGA is satisfied with it.

It would also be consistent with Government's August 2018 commitment to look into strengthening the framework.

What would the definition become?

It would be for ARGA to decide whether to make changes and what change to make, taking into account the views of affected parties through consultation: investors, creditors and companies.

Some potential alternatives to the current test are set out overleaf.

Note that a new realisation test would not necessarily obviate the need for all of the existing guidance – a large part of which is not about the realisation test itself, or is about anti-avoidance that would presumably remain an issue.

Unless…

The alternative to a revised realisation test is a completely different regime for control of distributions. As modern business involves more intangibles on the balance sheet and contracts that last many years, our initial thinking is that, rather than seek to improve the realisation test, there is more merit in exploring alternatives. That is addressed in the next section.

For example

One or a combination of these three more restrictive suggestions could be adopted.

1

Test

Accruals
FV losses but not gains

Example effect
Financial instrument active market gains are unrealised.

All financial instrument losses remain realised.

E.g:
Mark-to-market gains of 100 and mark-to-model losses of 100 become: 100 realised losses and 100 unrealised gains.

2

Test

Restricted accruals: all payables/ expenses but only defined short-term receivables
FV losses but not gains

Example effect
Many long-term contract assets are unrealised.

The same applies to, e.g. much financial services trail commission.

Some accrued interest income, e.g. yield to maturity as well as some credit card effective interest rates, are unrealised.

Equivalent expenses remain realised.

E.g:
Total long-term contract price 100; 60% delivered, at cost of 54, but 40% billed. Profit is 60% x 100 – 54 = 6, made up of: unrealised accrued income 20 (unbilled 20% x 100), realised loss 14 (billed 40% x 100 – costs 54).

For example, insurance broker has 30 accrued income for expected but highly probable renewal commissions over the next three years – all unrealised.

3

Test

Cash income only
Accrued expenses
FV losses but not gains

Example effect
Asymmetric bases for revenue and cost of sales requires companies to hold a permanent retained profits balance to cover trade etc debts.

All financial instrument losses remain realised.

E.g:
Annual sales 120, of which 30 is in trade receivables (unpaid sales invoices on 90 days terms). Cost of sales 100, of which 25 is in trade payables (unpaid suppliers, similar terms). Profit of 20 is made up of unrealised profit 30 (unpaid sales invoices) less realised loss 10 (90 sales collected in cash – cost of sales 100).

04.

A different regime?

Why consider this?

What is the purpose of controlling distributions?

It is necessary to regulate the ability of a limited liability company to pay out money or assets to shareholders if this could put at unreasonable risk the ability of the company to pay its creditors.

Why is any realisation test not necessarily perfect?

A realisation test does not directly address the ability to pay debts post-distribution. It is indirect and approximate, perhaps occasionally almost irrelevant. See the examples.

The issue is that its basis is historical book equity: i.e. past capital subscriptions vs past unrealised vs realised profits. It does not consider the assets and liabilities currently on the balance sheet. The liabilities are the creditors' claims on the company. The assets are what is available to meet them. They may be liquid or illiquid, their values may be firm/ objective or soft/ subjective, and they may be steady or volatile.

Should alternatives be considered?

Yes. The existing system has largely served well (for over a century), and it has had some very strong supporters (some investors). Yet if fundamental questions are being asked, there is no good reason to confine questioning to adjustments within the current system. Whether an alternative is better should be a question on the table for debate.

So, we believe that alternatives should be debated (two options are sketched on the following pages), and we note that the Government's August 2018 commitment included consideration of alternatives. Any change would require primary legislation. This would be time-consuming but could be included within the legislation already necessary to create ARGA.

Whilst our initial thinking favours a switch away from a realisation test, whether to change, and if so to what, would be for Government, taking into account the views of investors, creditors and companies.

Example

Turnover of balance sheet

In 2014, a property company sells a property for cash to an unrelated party – just part of the normal turnover of the property portfolio. On any realisation test, that is a realised and hence distributable profit.

In 2017, the company spends the cash to add a new property to its portfolio. Its balance sheet now consists entirely of properties.

In 2019, it wishes to pay a dividend. It has the distributable profits, brought forward from 2014, and so is permitted to do so. However, it has no cash – no solvency. It might be able to borrow against the property to fund the dividend, but that changes its future solvency prospects including as the value of the property changes over time.

Example

Inherently soft balance sheet measures

A bank provides 100 for impairment in its loan book – a realised loss on any basis. Yet there is no objectively right impairment number. It is judgemental, especially under the highly subjective expected-credit-loss basis. It could have been, say, 50 to 150.

With a 100 realised loss, in effect the bank keeps back 100 of assets to cover its creditors. However, that 100 balance sheet figure does not capture the risk that, as a soft estimate, the eventual out-turn might be less.

In practice, company law is rarely the key factor for control of bank dividends, which is instead prudential regulation to ensure that enough of the right assets are maintained in relation to the liabilities.

Prudential basis

How might this option work

This would be based on the book values of assets and liabilities.

A distribution would be permitted to the extent that risk-weighted assets exceed liabilities, either absolutely or by some prescribed margin.

For example, goodwill or some or all other intangibles could be weighted by a factor of zero (similar to prudential regulation of banks).

Receivables and other accrued income could be weighted differently according the degree of subjectivity, volatility or liquidity.

A variation on this system might be to compare assets and liabilities across maturity categories, e.g. so that a long-term receivable is not used to cover a short-term payable.

Commentary

This would directly address the question of the quality of the assets available to meet creditors' claims.

The challenges in this system would include:

- the need for ARGA to determine a "rate card" of subjective weightings to be applied;
- the need to allocate receivables and accrued income into categories of subjectivity;
- how to apply this to holding companies. In particular, how should intra-group receivables be weighted, and how should investments in subsidiaries be handled? Should investments be:
    - treated as financial investments with some simple, fixed weighting to reflect illiquidity and lack of intention to sell; or
    - assessed using a weighting based on some kind of look-though to the quality of the subsidiary's assets in excess of its liabilities?
- It would be a version of the system already applying to banks and insurers. In fact, for most life insurers realised profits are already defined by the Companies Act by reference to the Solvency II regulatory balance sheet.
- There would be little point in two prudential systems applying to banks and insurers. So for them the company law system would be superseded by their own, bespoke existing system.

Solvency basis

How might this option work

A distribution would be permitted if, assuming that the distribution were made, the company would, on a cash flow test, be able to pay its debts due over a specified period.

To that might be added a requirement that it would not be found under the Insolvency Act 1986 tests as unable to pay its debts.

Directors would be required to make a formal, documented conclusion and rationale, having undertaken due consideration.

Commentary

This would directly address the question of ability to pay in cash.

It is not new: company law already uses this for private companies' share buy-backs out of capital or other capital reductions, and it was used for many years for private companies' financial assistance "white wash". It is used in other jurisdictions (e.g. the US and Australia).

The challenges in this system would include:

- Some defined period would need to be set for the cash flow test, as long-term cash flow forecasts are inherently unreliable. Wherever it is set, the longer term still needs to be addressed, and judgements about the future would need to be made.
- Existing law uses a one-year test. Even so, there is still a reasonable degree of subjectivity in such forecasting.
- As far as companies are concerned, it could be quite an exercise to do twice a year or more to pay dividends.
- Given the problem of long-term forecasts, how can long-term liabilities, such as defined-benefit pension obligations, be addressed? The Insolvency Act test is the usual answer to that, because it includes a test that the value of the assets exceeds the amount of the liabilities. That is a proxy for a long term cash flow test, and as a net assets test perhaps it might need to be done on a prudential basis – so does that argue for the prudential basis in the first place?
- It might be argued that directors' fiduciary duties already require them to be satisfied that a distribution will not make the company insolvent. Thus all that this alternative might be said to add is formality and documentation (whilst taking away other tests).

05.

Disclosure of distributable profits

Disclosure of distributable profits

Another controversy

Some have said that the Companies Act requires disclosure of the balance of distributable profits. The FRC disagrees but encourages disclosure.

In June 2019, the Government renewed its commitment to look into such disclosure, saying it had asked for technical advice and options from ICAEW. More recently Sir Donald Brydon has made recommendations, were there to be no disclosure obligation.

If shareholders want it disclosed, it should be required

So the important point is that a consultation should be undertaken and if shareholders want this, then it should be a required disclosure. Encouragement from the FRC is not enough. What would be needed is a requirement that puts the matter beyond argument.

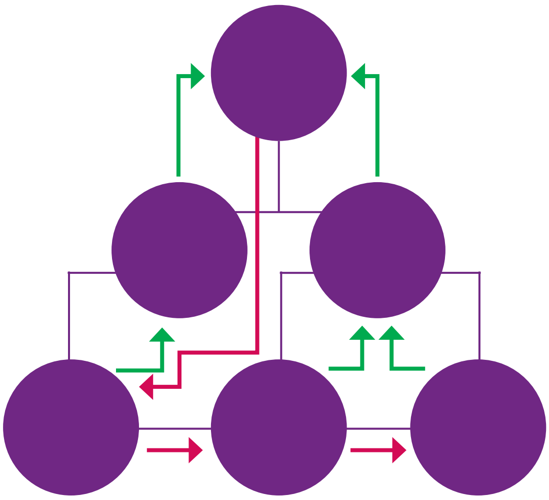
So either the Act would be amended to do so or ARGA would make a disclosure rule to that effect. Note that the latter would require ARGA to have power to add disclosures to a set of accounts prepared using IFRS.

Company or "pro forma" group figure?

Those calling for disclosure would like it on a group basis. This is a sensible request. Yet in law distributable profits are a company-only measure. Subsidiaries affect a parent only to the extent that they have paid up dividends or need to be impaired.

Sir Donald Brydon has suggested a disclosure of obstacles to drawing up reserves from subsidiaries.

Another option would be a figure for the maximum that could be drawn up from subsidiaries and be distributable in the hands of the parent – call it a pro forma figure.



That is not necessarily straightforward. There would be a number of issues to solve to do it (see next page). They make the pro forma figure more complex to derive as the group becomes larger and more complex.

In our view the consultation should take place soon – in advance of any wider changes – on both options and the implementation challenges to be overcome, including that the pro forma approach would require a practical, standardised solution to all of its issues.

The above applies on whatever is the realisation test. However, if the regime were subsequently changed to an alternative, then it may be that some of the issues are of a different complexion and perhaps easier to solve. For example, if a prudential basis, it may be necessary to solve the subsidiary issue in the basic test in the first place.

The group obstacles to clear

Impairment of investment in subsidiary

If a subsidiary pays up all its available distributable profits then it may no longer be worth its carrying value in its holding company. This may result in the holding company booking an impairment, at least partly offsetting the dividend income. As that net income is passed up the chain of holding companies there may be further impairments in intermediate companies and the ultimate parent, although this may depend on the precise group structure.

Impairment of debt receivable from subsidiaries

Furthermore, such impairments are not just directly between parent and subsidiary. A dividend paying subsidiary may owe debts to fellow subsidiaries, who, through a long chain of debts, owe money to the ultimate parent. These debts too might be impaired when assets are distributed out of the subsidiary.

Profits but no cash in the subsidiary

A subsidiary may have 100 of profits legally distributable, but have only 20 of cash. In order to pay up the full 100 it would need to borrow 80. If that loan is from/ guaranteed by the parent, then the funding/ guarantee is a linked transaction with the dividend. The parent needs to assess the two against the realisation test on a combined basis (ICAEW's anti-avoidance approach) – and is probably not realised. The assessment is more complex when long chains of intra-group funding arise.

Commercial factors

Though legally funds may be available for distribution by a subsidiary, they may need to be retained in the subsidiary in order to fund, say, expansion plans. Should that be factored in? At ultimate parent level there may also be commercial factors, e.g. debt covenants or banking regulation, that would limit the extent to which the pro forma group distributable profits could actually be paid out. Should these be factored in?

Foreign subsidiaries

These may not be subject to any kind of realisation test. For example, a solvency test applies in some jurisdictions. How are they to be factored in?

Planning opportunities

There are a number of restructuring and other legal steps that groups might take to create distributable profits. For example, an intra-group issue of shares by a subsidiary followed by a reduction of that new capital into distributable reserves. Are such opportunities to be taken into account or disregarded?

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