Accounting for dividends

Directives, disclosures and durability of distributable reserves

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- The rules for distributions are not as simple as one might think, sitting (uncomfortably) between law and accounting
- Increased regulator focus may cause companies to re-examine and disclose their distributable reserve position
- We consider how to identify potential risks to distributions based on the often limited information available

Dylan Whitfield, FCA
Head of Forensic Accounting
HSBC Bank plc

How sustainable are distributions?
As cuts made to dividends in 2020 begin to be restored, we look at whether one can identify potential risks to future dividends (from an accounting perspective) given the limited information available.

The rules are commonly misunderstood
No specific accounting standard exists on distributable reserves, and surprisingly disclosure is not mandated by IFRS. It is left to legislators to decide. Unfortunately, this means that distribution rules sit (sometimes awkwardly) between accounting and law which can cause some misconceptions, that we seek to address. For example:

- There must be **both** sufficient legal **distributable profit** reserves and **cash**;
- Group Retained earnings **do not necessarily equate** to distributable reserves;
- Adjustments by management to arrive at alternative performance measures don't count;
- Distributions are made by individual companies, any profits down the group structure have to be themselves legally transferred up the group to get paid out.

More disclosure may cause issues to be highlighted
There are moves to increase disclosure in this area which may make companies more open to challenge about interpretation of the complex rules.

Analysis of the FTSE 350
We have compared the distributions of the companies in the FTSE 350 to net profits over 10 years. 66 companies paid aggregated dividends of more than 80% of their 10-year aggregated net profit, whilst 70 companies have distributed less than 20%.

Our forensic approach to identifying risks
Before making conclusions on those stark numbers, we think that granular analysis is required, however, prioritisation is critical to make that manageable. We have set out a method for doing so, along with questions our forensic accountant applies in this area.

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Sustainable distributions?

- The accounting and legal rules on distributable reserves are often ignored by investors when considering the sustainability of dividends or buybacks
- Regulators appear to be increasing their focus on distributions and there are moves to make greater disclosure mandatory in this area
- We set out an approach to identify whether there is an elevated risk that distributable reserves may be being consumed

Dividends restored?

Sustainability of distributions – indicators of risk

The ability to make distributions has many moving parts, some of which are ignored

As our equity strategists discussed in September, we expected that the cuts made to dividends in 2020 may have either been restored or will be restored during 2022. In addition, we noted that "…[companies] *cutting dividends in 2020 may have taken the opportunity to resume dividend payments with a more sustainable pay-out policy*".

Sustainability of distributions is a complex subject with many moving parts. However, we think a number of those parts are often overlooked as they are often challenging to discern from the information provided in annual reports and on data aggregators. In particular, one cannot always see what reserves (or profits) are available to distribute.

Incorrect assumptions are sometimes made

As we will explore below:

- having sufficient cash is not necessarily enough to make a distribution permissible;
- consolidated retained earnings have to be able to be passed through subsidiaries to the individual company-only reserves to be distributable to the ultimate shareholders;
- consolidated (and company-only) retained earnings do not necessarily equate to distributable profits; and
- arbitrary "adjustments" to earnings made by management are likely to b be added back (i.e. subtracted) when a company is deriving distributable profit.

Lack of consistent distributable reserves disclosure means we have to use a proxy

We have, therefore, taken a closer look at whether there may be indicators of potential risks to distributions. We have also set out:

- an approach using a proxy for distributable reserves by analysing the net profits after tax versus distributions made over the past 10 years.
- 10 questions that we use when considering sustainability of distributions.

Increased focus may lead to some mishaps

Regulators are focusing on this area more and that may lead to companies having to disclose the actual legal position

Regulator focus on distributable reserves is increasing

Following a number of accounting and corporate governance scandals, there appears to be a renewed focus from regulators around the world on sustainability of dividends and distributable reserves. In particular, the divergence of actual profits to amounts distributed[1] has given regulators pause to comment. In the UK, for example, the government has gone a step further and is proposing to bring forward legislation that will make disclosure of distributable reserves mandatory.

Could companies have to rethink their distributions?

In theory, the additional focus, disclosure and regulatory scrutiny should have limited impact upon companies that have been adequately managing and tracking their distributable reserves.

However, we think that, as this is such a complex area, which often lacks clear and consistent rules, there is the possibility that companies may have previously interpreted the rules inconsistently. The increased clarity from governments and regulators (particularly in the UK) may, therefore, lead some companies to be more open to challenge over whether their distributions meet the rules.

Are distributions sustainable?

It is often difficult (if impossible) for an investor to derive the actual position of distributable reserves

How much of recent profit has been distributed?

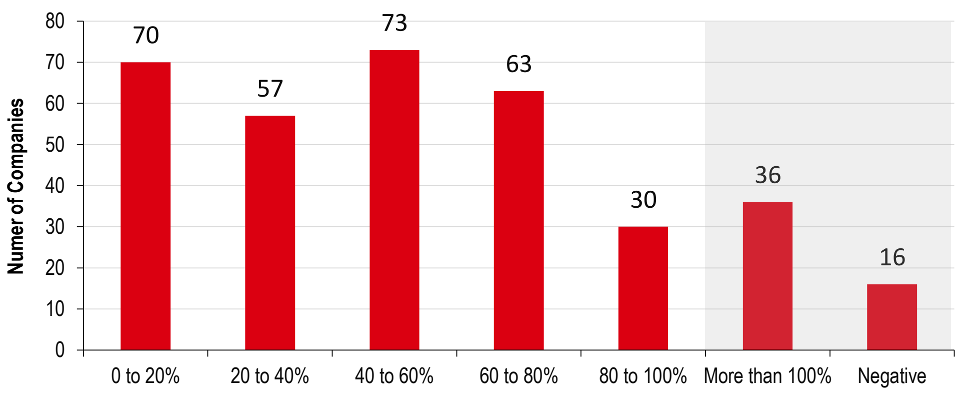
In the absence of specific disclosure from companies, it is almost impossible for anyone outside of the company to determine what judgements a company may have made in relation to deciding what earned profits meet the criteria to be distributable. We suggest using profits after tax, less any distributions for a given period, is sufficient for prioritising further, more granular, analysis.

Analysis of the FTSE 350

We have analysed profits and dividends and distributions for a period of 10 years for the FTSE 350 as set out in the charts below. Note: where a company has aggregated profits that are negative we have categorised those separately.

Distributions from dividends only

10-year aggregated dividends paid as a percentage of profit after tax



Source: Factset and HSBC analysis

1 For example, see https://www.pwc.com.au/assurance/ifrs/assets/spotlight-capital-and-dividends-achieving-a-sustainable-and-efficient-model.pdf

Most, but not all, companies distribute below 80%

As the chart above shows, most companies appear to be paying dividends within the range of 20-80% of earnings. What may stand out at first glance however, are the 66 companies that have paid dividends in the last 10 years which are over 80% of their profit after tax.

However, of those 66 companies:

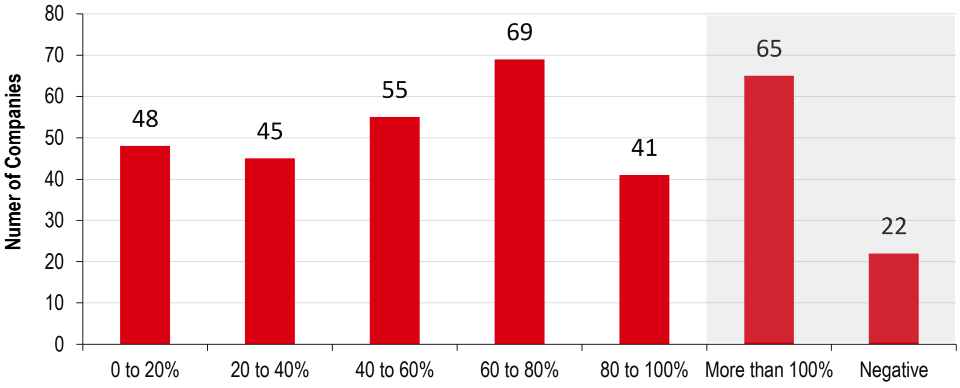
- 21 of those made a net loss after tax in the most recent financial year;
- Seven made losses after tax in both of the last two years.

Whilst it is tempting to attribute that to the disruption caused by the COVID-19 pandemic, the range of industries and the inconsistencies for peers within industries suggest to us that there are likely to be more subtle reasons for our observations.

We also note that we observed 14 companies which had negative aggregate 10-year profits, all 14 of these companies had also paid dividends within the 10-year period.

Distributions including share buybacks

10-year aggregated distributions made as a percentage of profit after tax



Source: Factset and HSBC analysis

Whilst buyback data may have introduced some inconsistencies, the broad trend is similar to dividends (above)

As we set out above, although including buyback data in our screening analysis may have introduced inconsistencies, one can make broader comparisons of dividends versus total distributions.

Whilst we expected there to be an increase in the number of companies that had distributed over 80% of their profits we did not expect that number to be almost a third of the FTSE 350 (at 166).

However, we think that drawing conclusions about individual companies from this analysis would likely raise too many “false positives” to make it an effective means of prioritisation.

That being said, we think that where companies have made significant buybacks we think that investors should carefully consider the rationale for the buybacks, the source of the distributable reserves (or capital reorganisations within the equity section of the company’s balance sheet) along with the potential impact on future distributions (whether in shares or by dividends).

Fundamental analysis remains key

We think fundamental analysis is key

Our approach is designed **to prioritise not replace** fundamental analysis. Understanding this area requires granular work, and one cannot distil this down to a simple ratio.

Our forensic approach to analysis of distributions

10 questions to start

Questions to ask

There is no one size fits all approach for accounting analysis; but, with the added complication of legal and regulatory variations, this sentiment is even more pertinent.

However, considering some straightforward questions (or posing them to the company) should allow one to identify whether there are indications that sustainability of distributions may be at increased risk.

We set out below the questions we use having prioritised via historical profits and distributions (as above). These questions are not intended to be exhaustive, nor are they specific to a particular company. Rather, we suggest these act as a starting point that can be used in conjunction with a healthy level of scepticism

1. **Does the company disclose and adequately explain its dividend/distributions policy?**
2. **Does the company disclose its distributable reserves?**
3. **Are there any recent events (not limited to COVID-19) that may have impacted distributable reserves, particularly if one off?**
4. **Are there any other accounting indications of risk to distributions?**
5. **Is the company subject to particular restrictions on distributions?**
6. **Is the group structure complex?**
7. **Have there been any reserve transfers that move non-distributable reserves into distributable?**
8. **Has the audit committee considered distributable reserves?**

   Is there a possibility that directors' remuneration and incentives are driving distribution decisions?
9. **Governance considerations – is the company taking a long-term or short-term view?**
10. **Are there any other indications that distribution decisions are being taken with a short-term view (e.g. making distributions to satisfy a particular shareholder, or taking operational decisions in order to pay a dividend)?**

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Distribution rules

- The rules sit between accounting and law; the rules are not straightforward and vary by jurisdiction
- Modern accounting standards add further complications as accounting requirements move further away from a cash basis
- Understanding enough of the rules ensures that incorrect assumptions are not made

Earnings might be "adjusted", but distributions come from unadjusted reserves

By any measure, distributable reserves do not equal "adjusted" EBITDA

Mind the non-GAAP: assuming that adjusted earnings drop through to distributions may be a risky assumption
Although it is seemingly simple that any distributions a company makes, via dividend or through a return of capital have to be made from its profits up to that date; how "profits" are defined in this context, is not straightforward.

Unfortunately, profits available to distribute are not necessarily directly equal to disclosed group retained earnings as the retained earnings numbers are derived from following accounting rules. Accounting rules, unfortunately, do not necessarily agree to the legal form of distributable profits.

However, we think that it is fair to say that in most (although not all) scenarios profits recognised each year into retained earnings are likely to be closer to what is distributable than any non-GAAP measures (also known as alternative performance measures") such as "adjusted" EBITDA, and adjusted EPS although, again it is not that simple and there can be significant divergences.

We see the potential over use and over reliance on adjusted non-GAAP metrics as a risk. One of the key reasons we advise caution when considering adjusted metrics, for all the rationale provided by company management, is that distributions ultimately come out of (some form of) profits after all expenses. Consequently, we think that non-GAAP measures, although helpful, should be treated with care and scepticism, and the **unadjusted** earnings should, in most cases, be given at least equal weight when considering the financial performance of a company.

Availability of cash and cash generation is not the only hurdle before distributing

Whether distributions are permitted is not just about availability of cash
We have also come across a common misconception that, as long as a company is

- generating cash
- able to pay its creditors, and remain solvent,
- distributions can be from the residual cash.

Again it is not that straightforward, and will depend upon the governing rules in each jurisdiction. However, even if that was the case, making distributions before profits have been earned is potentially just storing up problems for later down the road.

Finally, from an accounting perspective it is perfectly possible for a company to be in a net cash position and not have distributable reserves available to permit a dividend.

Put simply, cash generation or availability is not the prime consideration but taken in concert with the legally defined distributable reserves.

Turn a profit then pay a dividend from it; simple enough?

It's not just simple accounting rules that apply

Sitting between law and accounting, not the most comfortable seat…
Identifying how much a company can distribute can be challenging. The rules straddle technical areas of both accounting and law which, one could argue, is a difficult and awkward position in which to perch. Also, the legal and accounting rules do not operate independently of one another and therefore unpicking the true position can be near impossible for an investor unless a company provides specific disclosure.

Definitions and disclosure requirements

Unlikely as it sounds, IFRS does not mandate disclosure of distributable reserves

There is no accounting standard that defines profits available for distribution
As unlikely as it might seem for such a fundamental principle and area of financial reporting, there is no accounting standard that explicitly defines what profits are available for a company to distribute to shareholders.

We think that there ought to be.

The impact of modern accounting standards

IFRS deviates far more from a cash basis than older accounting standards

Accounting standards and how accountants apply the law
As investors are well aware, accounting standards have continued to develop in complexity and the adoption of IFRS has increased the level of subjectivity and accounting estimation required when producing financial statements.

This has, in turn, increased the divergence of financial statements from a straightforward 'prudent' and historical cost basis (that more closely follows the cash basis of transactions) to a more technical form of accounting which, introduces more fair value and/or technical based recognition within financial statements.

In other words, being crystalized as cash (or convertible to cash) is not used by accounting standards as a measure of whether an income has happened or and expense has been incurred.

173 pages of technical guidance are used to change IFRS into legally realised

Bridging the "GAAP"
This has led to the practice in the UK of relying upon a lengthy technical guidance paper (issued by the UK accounting professional bodies) to determine which profits count as realised. Although this paper has no formal legal standing, to date has been regarded as an acceptable and the means to determine what is considered distributable.

As we discussed in a previous note, the UK government is considering transferring the responsibility for the rules on what constitutes realised profit and distribution, to the new financial reporting regulator, ARGA. An idea which, incidentally, we support.

The assumption that retained earnings = distributable reserves is often incorrect

Put simply, the established wisdom that accounting retained earnings equals distributable reserves is perhaps not as firm as it might have been before the adoption of more complicated accounting standards.

For the avoidance of doubt, that's not to say accounting standards are not trying to better reflect the financial transactions by adding complexity; merely that the basis of the law and accounting as not as close as they perhaps once were, evidenced by the need for a 173-page technical paper (as referred to above) to bridge the gap (no pun intended).

Which accounts, and which reserves?

Consolidation vs company-only accounts

Dividends come from the top-co, most analysis is undertaken on the consolidated numbers. These can be vastly different

As investors are aware, dividends are made from the individual company-only accounts of the listed entity. In most cases (but not all) this company sits at the top of a group. However, there is a tendency to ignore the company-only accounts which often languish at the back of annual reports and are rarely given commentary in company presentations. This is understandable when one is considering the results of company as one is more likely to be interested in the performance of the operations of group as a whole rather than that of the top-co which often just holds investments in subsidiaries and have no operations themselves.

However, this ignores that:

- a consolidated set of accounts is an accounting exercise and there is no legal entity represented by the consolidated accounts;
- consolidated accounts are prepared using a different basis (usually using the acquisition method of accounting) for the company-only accounts;
- different legal rules for distributions may exist across the group (particularly if there are different laws and regulations governing subsidiaries in different jurisdictions; and
- one often observes significant divergence between the consolidated retained earnings of a group and that of the top-co.

It is also possible that earnings in subsidiaries may not always be readily transferred up the group to the top-co. This can be the result of the group structure, accounting in individual subsidiaries (for example, where profits/losses can be consolidated but are restricted from being passed up to the top-co if there is a loss making intermediate subsidiary).

Therefore, whilst it is often helpful to consider the difference between the group retained earnings and the company-only position, a divergence, of itself, does not mean there is an issue. Where there is a significant difference we do, however, advocate understanding why.

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