



Distributable reserves

Determining realised profits for paying dividends

What's the issue?

Proposals for change

As a result of recent high-profile corporate failures, the government's Department of Business, Energy and Industrial Strategy (BEIS) has published its long-awaited consultation: **Restoring Trust in audit and corporate governance**, which sets out an array of proposals to reform different aspects of the corporate governance and the audit regime.

Within the proposals are specific changes concerning compliance by companies with the distributable reserves and capital maintenance regime – requirements set out in the Companies Act 2006 (Companies Act) regarding the lawful payment of dividends and the protection of a company's capital form.

The proposals consider how the existing requirements for distributable reserves and capital maintenance can, and should be, improved in order to support the prevention of future corporate failures, provide greater transparency and boost confidence for investors, creditors and other stakeholders.

At this stage, the proposals aim to keep the current legislation and technical guidance¹ in place surrounding how to determine distributable reserves and what should be treated as realised profits and losses, but instead give responsibility to the new regulator, the Audit, Reporting and Governance Authority (ARGA), over maintaining and governing its legal status.

There are four key areas that directly impact businesses in relation to increasing directors' accountability over dividends, distributable reserves and capital maintenance, with the overarching aim of aiding transparency over directors' dividend decision-making processes:

1. Disclosure of distributable reserves in the financial statements.
2. Disclosure of group estimated dividend-paying capacity in the financial statements.
3. Provide a directors' compliance and solvency confirmation statement.
4. Disclosure of dividend decisions and capital allocation policies and practices.

¹ICAEW/ICAS TECH 02/07BL Technical release: Guidance on realised and distributable profits under the Companies Act 2006

Why is this important?

Unlawful dividends

Companies may only declare a distribution (or more commonly referred to as a dividend) out of reserves that are distributable. Accumulated accounting profits that are made by a company and held within reserves are not necessarily able to be distributed unless they are 'realised' for legal purposes under Part 23 of the Companies Act.

It is therefore important for directors to ensure that the reserves used to declare a dividend are distributable, otherwise such a dividend will be unlawful.

Implications for shareholders, directors and the company

Where an unlawful dividend is declared, the Companies Act sets out the implications being that the recipients (i.e. shareholders) of the dividend are liable to repay the dividend in cash (or a sum equivalent to the value of any non-cash distribution) if, at the time of the distribution, the recipients knew, or had reasonable grounds for believing, that the distribution was in contravention of the law.

Whether or not the shareholders will be required to repay the dividend will depend on various facts and circumstances, including whether the shareholder is a private individual or a company.

Additionally, aside from the potential reputational damage for the company, the directors may also be held liable to repay the dividend if the dividend was paid in breach of their fiduciary duties to the company.

Once more this will depend upon various facts and circumstances, including agreement from the shareholders not to pursue the directors personally and the solvency position of the company.

What are the current requirements for companies?

Determining profits available for distribution

The requirements surrounding what constitutes lawful profits available for distribution are set out in Part 23 of the Companies Act, with additional guidance set out in the Technical Release: Guidance on realised and distributable profits under the Companies Act 2006 (TECH 02/17BL). Many factors, however, need to be considered before declaring a distribution, including:



Disclosure

There are currently no specific requirements under company law or accounting standards for financial statements to disclose the amount of profits available for distribution and distinguish between those realised and unrealised. Nevertheless, the issue of disclosures surrounding dividends and distributable profits has, in recent years, become more topical and prevalent.

The Financial Reporting Lab published a report: **Disclosure of dividends – policy and practice in 2015**, with follow-up reports in 2016 and 2017, which set out best practice guidance for companies to consider when preparing their annual reports in order to enhance dividend disclosures. Additionally,

in July 2018, the Financial Reporting Council (FRC) published guidance: **Guidance on the Strategic Report**, stating that if the setting and application of the capital allocation and dividend policies are principal decisions to a company, then the Section 172(1) statement should 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.

What's proposed to change?

There are four key areas that directly impact businesses in relation to increasing directors' accountability over dividends, distributable reserves and capital maintenance.



²FRC Lab project report: [Disclosure of dividends policy and practice](#) (November 2015) and [The Investment Association Long Term Reporting Guidance](#) (May 2017)

Who is it relevant for?

It is necessary for all companies to be able to determine what profits they have available for distribution in order to ensure that any dividend paid is lawful. The recent corporate failures and investigations have highlighted some listed companies have failed to comply with the Companies Act requirements and as such have made unlawful distributions.

This evidences that this issue is relevant to all stakeholders within a company, ranging from finance teams, directors, audit committees, shareholders and creditors.

The proposed new requirements would potentially only be applicable to listed and AIM companies, however they may also be extended to all public interest entities (PIEs) or even certain large private companies.

What can be done now – getting ready for change

It is important for all companies, and particularly directors, to have assurance that the dividends they are declaring to shareholders are lawful. The requirements and guidance under the Companies Act and the TECH 02/17BL are not new; they have been in place for companies to comply with for many years, however, they are complex to understand, lengthy and often difficult to apply in practice.

Companies may wish to get more comfortable with understanding the requirements surrounding distributable reserves and realised profits to be able to gain assurance of the company's distributable reserves position.

Companies can therefore act now to ensure they are compliant with current legislation, are in line with best practice guidance and have a sound technical starting point on which the new requirements are proposed to be based.

How can we support you?

Mazars has a dedicated Accounting Technical Services (ATS) team that has extensive knowledge and experience in assisting clients to understand and apply the complex requirements surrounding distributable reserves and realised profits.



Benefits

- Compliance with company law legislation
- Prevention of making an unlawful dividend
- Assurance of having adequate dividend headroom
- Improve investor confidence
- Enhance board focus
- Alignment with best practice guidance



How we can support you

We can develop an approach that is tailored to your business needs, whether on an individual company or group basis:

- **Considerations analysis** – This provides you with a high-level technical paper that sets out the specific areas of consideration that will impact the level of profits available for distribution within the business.
- **Checklist approach** – This tailored checklist approach, with guidance, provides a series of questions for you to complete, with our support, in order to carry out your own assessment of what profits are available for distribution within the business.
- **Integrated project support** – This approach involves full project management support, including producing a tailored checklist setting out all the relevant areas for consideration, management of the checklist completion within your business, assistance with calculations, where applicable, and documenting findings and conclusions for your records.
- **Training and board briefings** – This provides you with tailored training courses for your finance team, or briefing sessions for the board, to help you understand the requirements and the implications for your business.
- **Policy and practices disclosure review** – We can carry out a compliance and best practice disclosure review of your existing policy and practices, in line with Section 172 reporting, regulatory best practice guidance and benchmark analysis with other organisations within your section, to improve the disclosures within your annual report.



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