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Lab project report:

# Disclosure of dividends – policy and practice

November 2015

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### What is the Lab?

The Financial Reporting Lab has been set up by the Financial Reporting Council to improve the effectiveness of corporate reporting in the UK. The Lab provides a safe environment for companies and investors to explore innovative reporting solutions that better meet their needs.

Lab reports do not form new reporting requirements. Instead, they summarise observations on practices that investors find useful to their analysis and encourage companies to consider adopting the practices if appropriate in the context of their own reporting. It is the responsibility of each reporting company to ensure compliance with relevant reporting requirements.

Published reports and further information on the Lab can be found on the FRC's website:

[www.frc.org.uk/Lab](http://www.frc.org.uk/Lab)

### Do you have suggestions to share?

The Lab encourages readers of this report to provide comments on its content and presentation. As far as possible, comments will be taken into account in shaping future projects. To provide comments, please send us an email at:

[FinancialReportingLab@frc.org.uk](mailto:FinancialReportingLab@frc.org.uk)

## Quick Read

### Why dividend disclosures are important

Dividend disclosures are fundamental to companies and investors as they are important in demonstrating and assessing board stewardship and the investment case.

This report focuses on dividend disclosures which both companies and investors feel can improve. This is reflected in the level of participation in the Lab's project, including 19 companies and 31 investors.

Investors consider that good dividend disclosures should answer the following questions:

- Why this policy?
- What will the policy mean in practice?
- What are the risks and constraints associated with this policy?
- What was done in practice to deliver under the policy?

They also prefer that the disclosures are brought together in one place, presenting a coherent message.

### Dividend policy disclosure

#### Why this policy?

Setting of the dividend policy (including a policy not to pay dividends) is one output of the company's cash and capital management process. Both equity and debt investors want to understand how the cash generated is allocated, and why this is appropriate. This is often characterised as 'dividing the pie'. Investors welcome disclosure on how companies balance competing priorities, such as capital expenditure and other investment needs, debt and credit rating targets, and other forms of returns to shareholders.

Good dividend disclosure provides an understanding of the board's considerations in setting the policy, including the rationale for the policy selected. Good disclosure relates the policy to the company's strategy; explains how it will be implemented; and makes clear the associated risks, constraints and judgements. This disclosure promotes an understanding of the board's stewardship, including how capital is being maintained.

The good practice identified in this report is also relevant to companies without a formal dividend policy, in communicating their approach to capital management and shareholder return.

#### What will the policy mean in practice?

Project participants identify two main types of policy: progressive and payout ratio. Good disclosure is specific enough to understand what the policy will mean in practice. Elements of good disclosure include:

- Progressive: clarity on the level and period of progression i.e. maintaining the dividend; or a minimum, range, target or specific level of increase.
- Payout ratio: the defined basis for the ratio (e.g. IFRS or adjusted measure), its rationale, and whether a minimum, range, target or specified ratio is adopted.

Investors also want to understand the timeframe over which the policy is expected to operate, and the governance process in determining the policy.

#### What are the risks and constraints associated with this policy?

For some companies, the binding constraint in respect of dividends may be related to availability of cash, gearing levels, debt covenants or regulatory capital requirements. For others, it may be distributable profits (the level of reserves legally available for distribution). Investors want to understand the nature of the material risks and constraints that the board considered in setting the policy.

### Disclosure of practice under the policy

#### What was done in practice to deliver under the policy?

Participants agree that disclosure around the declaration of dividends, linking back to the policy and elements of the progressive or payout ratio approach, could be improved. Participants suggest disclosing the key judgements and constraints considered in applying the policy (including the "dividend resources" - see below), and highlighting any changes made to, or departure from, the policy.

The disclosure of available cash and/or distributable profits (referred to as dividend resources in this report) can be proportionate to the level of resources at the parent company which if:

- abundant in comparison to the proposed dividend – might include a statement indicating that there is an abundance of dividend resources or the year end balance of dividend resources;

- sufficient in comparison to the proposed dividend – might include a statement indicating that there are sufficient dividend resources, and the year end balance of dividend resources;
- insufficient to deliver the dividend in accordance with the policy – might include a statement that the dividend has been reduced, explaining the steps being taken to address the issue, and the year end balance of dividend resources.

When the parent company is reliant on entities below it for dividend resources, additional disclosures can help explain where resources exist and the company's approach to moving cash to and/or generating distributable profits at the parent company level.

While most investors consider that distributable profits disclosures are useful in certain circumstances (as above), some investors believe that distributable profits are always required to be disclosed in the financial statements. Company practice in this area is diverse. 23 FTSE 350 companies disclosed the distributable profits balance (of the parent company) in their 2014 annual report and accounts (annual report).

Investors find the disclosure of the parent company's distributable profits useful because it:

- enhances confidence in the board by demonstrating that dividends are not being proposed from capital;
- clarifies the headroom between the level of distributable profits and the proposed dividend to assist in the shareholders' vote on the approval of the dividend;
- provides some insight into the company's ability to cover the future dividend stream; and
- may provide 'something of a proxy' for realised profits.

Investors value external assurance on information on distributable profits. Some companies consider that it may not be practical to obtain assurance on the distributable profits balance due to complexity and the related cost. Investors understand this, and nonetheless value disclosure. Those investors who believe that disclosure of distributable profits is required also believe that this disclosure must be audited.

### Bringing disclosures together

Dividend disclosures are often spread across a wide range of company communications, making it difficult to locate information and understand a coherent

message. Investors would find it helpful to group together similar or related disclosures where possible, or draw links between disclosures.

In addition to annual report disclosures, having the up-to-date and historical information on policy and practice on the company's website makes the information easy to locate.

### Additional insight: special dividends and share buybacks

The report provides additional insight from discussion on special dividends and share buybacks. Similar themes on the disclosure of policy and practice were identified for these types of returns. Investors want disclosure of the circumstances in which companies expect to pay special dividends or buy back shares.

In respect of buybacks, investors are looking for disclosure of the maximum price the company is prepared to pay, and the target minimum rate of return. Summary information on the weighted average cost of shares bought, total cost, and the effect on key metrics for buybacks undertaken during the year, also help investors assess the interaction between buybacks and management performance metrics. Retail investors, in particular, also want boards to explain their assessment of how buybacks benefit shareholders.

### Additional information

Additional information is provided in appendices to the main report:

**Appendix 1:** UK accounting and regulatory framework – reserves and distributable profits

**Appendix 2:** Interaction between the dividend and reporting cycles

**Appendix 3:** Sources of disclosure

**Appendix 4:** Lab illustration: Distributable profits of the Parent Company.

# Project introduction

## Background to the project

The Lab project on the disclosure of dividends was initiated following interest from a group of long-term institutional investors who consider that the disclosure of distributable profits is always required. The FRC considers that such disclosure may in certain circumstances be useful. However, disclosure is not common practice, with 23 FTSE 350 companies disclosing the balance of distributable profits (or reserves) of their parent company in their 2014 annual report<sup>1</sup>.

Given the range of practice and views in this area, it was agreed that it would be worthwhile for the Lab to explore aspects of distributable profit disclosure that would be helpful and practical.

Following discussions with additional investors and companies, the scope of the project was broadened to include wider aspects of disclosures relating to dividends. The importance of capital management in driving dividend decisions was recognised; however, it was agreed that this project would focus on good dividend disclosure.

## Project report

The issues raised in this report are likely to be relevant to all listed and AIM quoted companies, irrespective of size and dividend policy (formal or not). The report focuses on the annual report, but also considers other channels that companies use to communicate dividend policy and practice.

The report presents a wide range of views from participants in the project, and provides practical suggestions to help companies communicate relevant and proportionate information to investors.

The views described are not necessarily supported by all participants.

The report covers disclosures in relation to ordinary dividends, including:

- dividend policy;
- practice under the policy; and
- bringing disclosures together.

The report also considers other common forms of distribution (special dividends and share buybacks).

Appendices set out details of key regulatory and other background information.

19 companies and 31 members of the investment community participated in the project. Company participants included FTSE 100, 250, and AIM quoted companies. Institutional investors, both UK and international, were represented in the project. Members of two retail investor associations also participated.

A combination of individual interviews and round table discussions were held with both company and investor participants (see **Participants and process section**).

## Why dividend disclosures are important

Information on dividend policies and practices is important to a wide range of investors, including equity investors seeking income or growth potential, as well as bond investors considering a company's creditworthiness. Both equity and debt investors want to understand how the cash generated by a company is allocated, and why this is appropriate.

Many companies and investors agree that disclosure of dividend policy and practice provides useful information in assessing both the case for investment and stewardship in holding the board to account.

While virtually all project participants agree on the importance of good disclosure, views are diverse in relation to the nature and necessary detail of such disclosures.

Most investors consider that the level of disclosure should be dependent on the individual circumstances of the company, balanced by the need for clear and concise reporting.

Given the complexity for boards in establishing and implementing a dividend policy, participant companies consider that ensuring that communication is clear and relevant is a priority.

Dividend information is currently provided across a range of external corporate communications, including the annual report and preliminary announcements. However, the dividend story – from policy development, to declaration and payment (practice) – is not always clearly articulated.

*“Dividends are only one part of the total return that investors receive, but for many it is the most important part, and therefore good disclosure is fundamental.”*

Investor

<sup>1</sup> Source: PortAlchemy.com

# Dividend policy disclosure

Investors note that there is a very wide range of practice across companies in terms of dividend policy disclosure. They consider that good policy disclosure should answer the following questions:

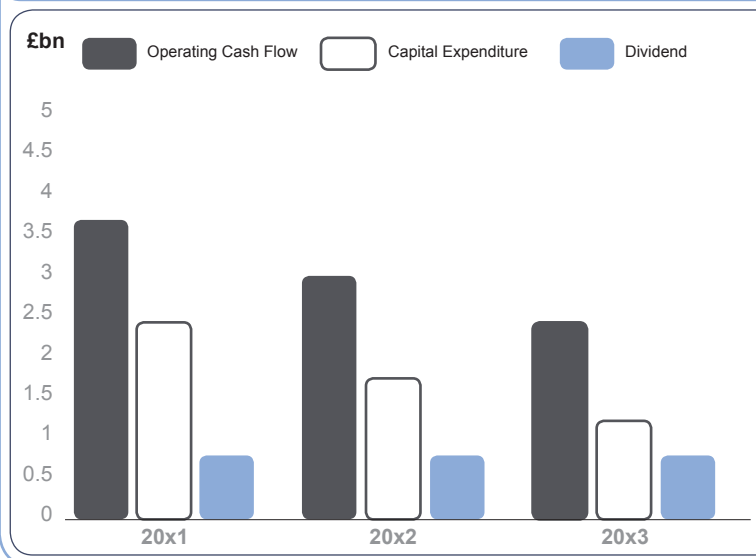
- Why this policy?
- What will the policy mean in practice?
- What are the risks and constraints associated with this policy?

Boards are responsible for setting the dividend policy. As part of this process, they consider the type of policy in the context of the business and the capital management strategy. Investors want to understand how the dividend policy fits into the capital management strategy. If a company does not have a 'formal' dividend policy, investors still wish to understand the approach to deciding on the dividend.

Building on some existing disclosures, the Lab has tested with participants the example disclosure set out in Figure 1. Investors value this disclosure as it provides a sense of how the 'pie' is divided, giving some trend information to allow assessment over time.

Debt investors are also looking for information on cashflow adequacy relative to debt, and the allocation of capital expenditure between maintenance and new spend.

Figure 1: Lab generated example disclosure



## Group use of cash

When determining the level of dividend each year, the board considers the ability of the group to generate cash; the availability of that cash in the parent company; and the level required to invest in the business.

In 20x3, the level of operating cash generated has continued to fall. However, this is balanced by the lower level of investment required. Accordingly, the board is recommending maintaining the dividend at the 20x2 level. For more details about 20x3 capital management activity, see Strategic Report, and for details about the 20x3 dividend see note.

## Why this policy?

Investors want to know the rationale for the policy selected, irrespective of whether the policy is in transition or short-term. They consider that good policy disclosure promotes an understanding of the board's stewardship and includes:

- how the policy relates to the company's business model, strategy and capital management strategy;
- how the policy is to be implemented and any discretion inherent in the policy;
- how capital is maintained;
- the process that the board has been through in setting the policy; and
- the risks and constraints associated with the policy, including any significant judgements and assessments made as part of deciding the policy.

Companies express some concern that very detailed dividend policy disclosure may reduce the ability of the board to respond to future events and situations, as they consider that investors may expect rigid adherence to the stated policy. However, investors say they appreciate a board's need to maintain flexibility, which could be built into the policy, or if directors need to go outside the policy, the rationale for this can be explained.

*"Management teams are not painting themselves into a corner when providing detailed disclosures; we know that the unexpected can and does happen to companies in the real world"*

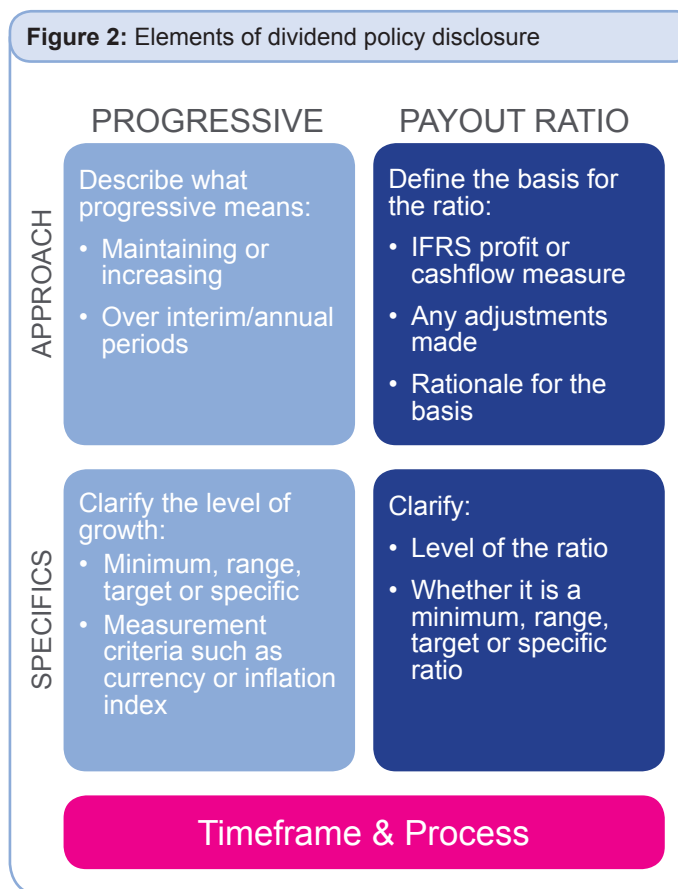
Investor

## What will the policy mean in practice?

There are many different types of dividend policy (including the policy to not pay a dividend). However, both companies and investors consider that the main approaches are progressive and payout ratio. Policies that are a hybrid of these types are also used by companies.

Regardless of approach, investors want disclosure to be specific enough so they can understand what the policy is likely to mean in practice. This enables them to estimate future cashflows, for valuation purposes and to assess the risk profile.

Defined parameters that are well understood by a company's key stakeholders can help build common expectations of the company's likely behaviour, and help to strengthen its profile in the eyes of investors.



## Progressive

Many companies describe their dividend policy as being progressive. Some believe that describing their policy as progressive provides sufficient detail regarding their intentions. However, investors and companies describe progressive in a number of ways, including dividends which are:

- increasing or at least maintained;
- increasing steadily or at a defined rate; or
- increasing in real terms.

Investors are concerned about ambiguity. They want to understand what 'progressive' means for the company, including whether the company intends to maintain or increase the dividend annually, and if increasing, by how much.

A number of investors comment positively on how BHP Billiton's 2014 disclosure defines 'progressive', and provides detail on currency and timing.

### BHP Billiton 2014 Annual Report and Accounts p16

#### Progressive base dividend

BHP Billiton has a progressive dividend policy. The aim of this policy is to steadily increase or at least maintain our base dividend in US dollars at each half-yearly payment. Our progressive base dividend is the minimum annual distribution that a shareholder should expect and is expected to grow broadly in accordance with the growth of our business.

### Payout ratio

Some companies define their dividend strategy in terms of a payout ratio, where dividends are set as a percentage of a defined metric (such as earnings or free cash flow). Where such a payout ratio approach is used, investors want clarity on the basis and calculation of the ratio.

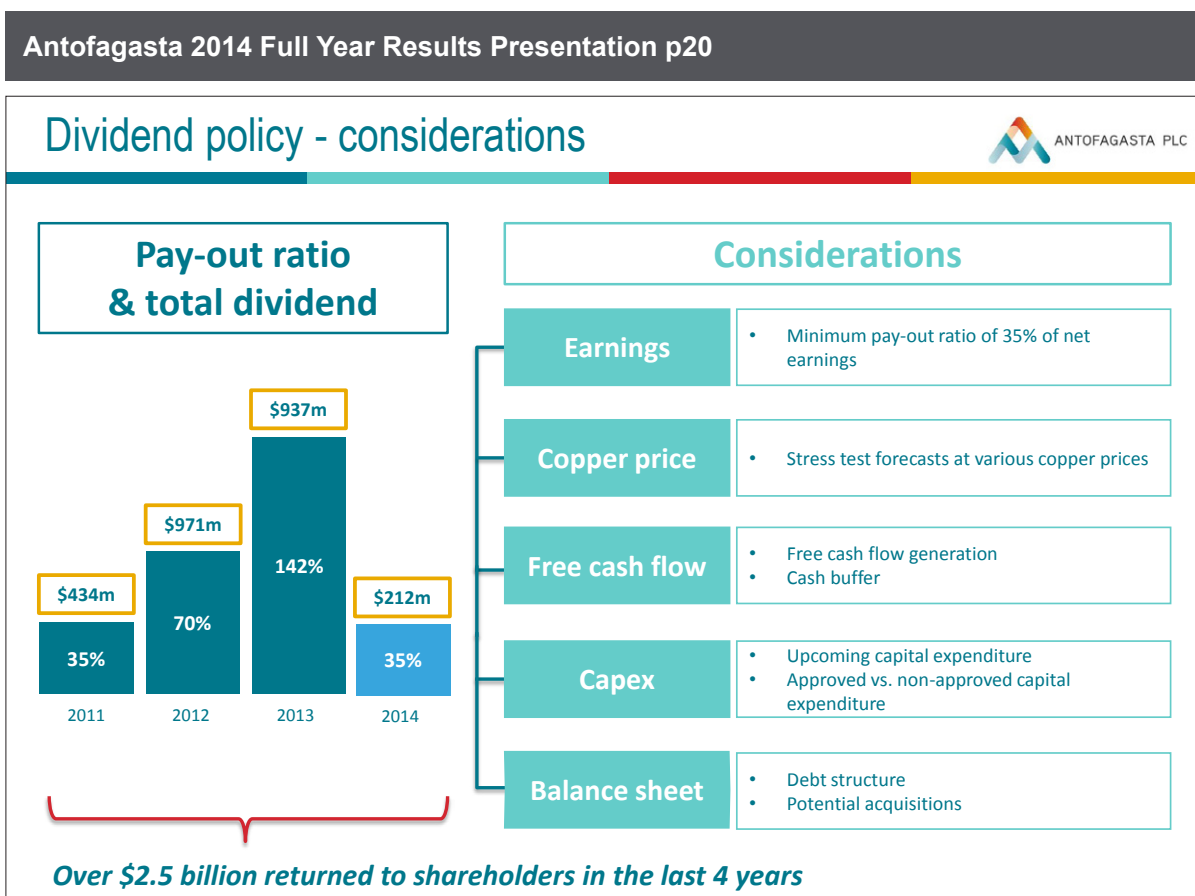
Investors highlight that clarity is even more important when the ratio is not based on a defined IFRS metric. If the base figure is an adjusted IFRS metric (e.g. earnings or cash flow), investors want to understand the rationale for its selection and expect adjustments to be highlighted and described.

Although dividends are paid by the parent company to its shareholders, the base metric is typically expressed relative to the group level (for example, group profit); some investors consider that this adds to the lack of transparency. Investors consider that disclosure which addresses how the group manages and accesses resources helps in this situation (see page 14).

Investors want visibility as to how the dividend might respond as circumstances change. One way of achieving this is through explaining if the ratio selected is fixed (in proportion to the denominator); a minimum; a target; or a range.

Investors consider Antofagasta’s dividend policy (introduced in 2014), is clearly articulated. The disclosure sets out:

- details of the return, indicating the basis is the company’s net earnings, and specifying that the minimum payout ratio is 35% of net earnings;
- the board’s considerations in developing the policy; and
- the trend, which allows investors to put the selected ratio in context.





### Timeframe & process

Investors consider that good policy disclosure should provide clarity regarding the timeframe over which the policy is expected to operate, even when that timeframe is not defined; or the policy is in transition (before the determination of a longer-term policy). For example National Grid in its 2015 report, provides an indication that resources will support the dividend currently and “for the foreseeable future.”

When a dividend policy is in transition, investors want to understand the period of the transition and why it was selected.

In the absence of a disclosed timeframe, investors assume that a policy applies at least over the medium term (often expressed as 3 – 5 years) or an even longer period.

Under the UK Corporate Governance Code, UK premium listed entities are required, on a comply or explain basis, to disclose a longer term ‘viability statement’<sup>2</sup>. This provides information on the period over which the directors assess that there is a reasonable expectation that the company will be able to continue in operation and settle its liabilities as they fall due. Some investors assume and expect that the dividend policy will be in place at least over the period set out in the viability statement.

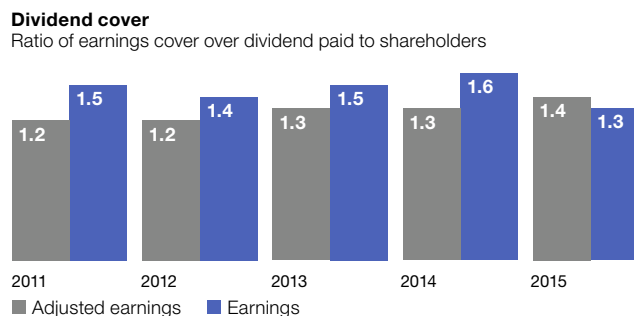
Investors also want to understand the board’s regular (often annual) process in assessing the continued appropriateness of the policy and in approving or changing the dividend policy.

#### National Grid 2015 Annual Report and Accounts p112

##### Unaudited commentary on dividends

Following the announcement of our dividend policy in March 2013, the Board remains confident that National Grid is able to support a dividend growing at least in line with RPI inflation for the foreseeable future, while continuing to invest as required in our regulated assets.

With the exception of the 2013/14 interim dividend paid in January 2014, a scrip option has been offered for all interim and final dividends in the last four years. The scrip take-up as a percentage of total shares outstanding (excluding treasury shares) since 2012/13 was as follows: 2014/15 interim 5%; 2013/14 final 28%; 2013/14 interim n/a; 2012/13 final 46%; and 2012/13 interim 35%.



<sup>2</sup> Applicable to accounting periods beginning on or after 1 October 2014.

## What are the risks and constraints associated with the policy?

### Constraints on the policy

Investors want disclosures to cover the constraints which the board considers in setting the policy. For example, meeting debt or pension funding obligations, regulatory capital requirements, the availability of distributable profits, or trapped cash.

However, investors highlight that they do not value a list of boilerplate constraints. They are looking to understand the constraint(s) which is (are) significant or most pertinent to the company’s dividend policy.

Investors want to understand:

- the nature of the constraint(s);
- how the constraint(s) were considered in setting the policy;
- the current status of the constraint(s); and
- how the constraint(s) may impact the policy in the future.

### Risks to the policy

Investors want to understand the sustainability of the policy. They consider that disclosure of risks which might impact the dividend strategy in the future (e.g. industry cyclicalities, changes in regulation and tax, etc.) is key to this understanding.

Investors note that the link between companies’ principal risks disclosures and risk to the dividend policy is often not well articulated. They consider disclosure could be improved, in particular where there is a specific risk which could materially impact the payment of dividends in the future. Disclosures may be qualitative or quantitative depending on the circumstances.

Investors value disclosure on risks to the dividend being presented within, alongside or clearly referenced from, the dividend policy disclosure, as it allows them to weigh up the implications of a risk crystallising. One suggestion is that companies which provide sensitivity analysis disclosure in accordance with IFRS 7 may consider referring to this in their dividend policy disclosure, where such risks represent a direct risk to the dividend policy.

Investors find the disclosure in BT’s accounts helpful, as it highlights, together with context, that any future increases in funding obligations of the pension scheme are a risk to the level of future dividend payments.

*“If risks to the dividend policy are not obvious or generic then they should be disclosed.”*

Company

#### BT 2015 Annual Report and Form 20-F p44

Risk description	Impact
<p><b>Pensions</b></p> <p><b>We have a significant funding obligation in relation to our defined benefit pension scheme in the UK, the BT Pension Scheme (BTPS or Scheme).</b></p> <p>The BTPS faces similar risks to other defined benefit schemes. Future low investment returns, lower interest rates, high inflation, longer life expectancy and regulatory changes may all result in the cost of funding the BTPS becoming a more significant burden on our financial resources.</p>	<p>The next valuation of the BTPS is scheduled to take place as at 30 June 2017 and an increase in the pension deficit may have an impact on the level of deficit payments we are required to make into the Scheme. Indirectly it may also have an adverse impact on our share price and credit rating.</p> <p>Any deterioration in our credit rating would increase our cost of borrowing and may limit the availability or flexibility of future funding for the group, thereby affecting our ability to invest, pay dividends or repay debt as it matures.</p>

Investors also like Legal & General’s disclosure of how its regulatory capital requirements interact with its dividend policy. This disclosure is set out on the company website and in the annual report.

Legal and General website: [www.legalandgeneralgroup.com/investors/dividend.html](http://www.legalandgeneralgroup.com/investors/dividend.html)

Our Group | Financial information | Share price | Investor news | Shareholder centre | Financial

AGM  
**Dividend**  
 Dividend history  
 Manage your shares online  
 Shareholder Tools  
 Share dealing  
 Corporate sponsored nominee  
 Electronic communications  
 Ownership profile  
 Fraud warning  
 Shareholder benefits  
 Shareholder FAQs  
 Shareholder contacts

## DIVIDEND.

### PROGRESSIVE DIVIDEND POLICY

We announced new dividend guidance in 2014. Should our Solvency II surplus be no lower than Solvency I, we expect that we will move towards returning two thirds of net cash to shareholders via dividends. (1.5 times cover) by the end of 2015.

Year	Full year dividend (Pence)	Dividend cover
2009	3.11	3.11
2010	2.72	2.72
2011	2.26	2.26
2012	1.91	1.91
2013	1.82	1.82
2014	1.65	1.65
2015	-	Target 1.5

■ Full year dividend — Dividend cover

Source: (Annual Report & Accounts 2014)

"We've consistently grown cash, giving our shareholders a 300% return over this time, making us the top performer from all major life insurers across the globe. In the last five years we've nearly trebled our dividend payments, with 2014's full year dividend 21% higher than in 2013."

**Nigel Wilson**  
 Chief Financial Officer,  
 Legal & General

## Special dividends and share buybacks

### Special dividends

Companies consider that special dividends provide flexibility in allowing ad-hoc returns without creating future expectations. However, some investors consider that companies opting to make regular (or annual) special dividends, are creating an expectation that this payment forms part of the recurring dividend return.

In order to help assess future dividend streams, where companies have a practice of using special dividends, investors want to understand when they will be used and their relationship to ordinary dividends. Investors are seeking disclosure of policy and practice in much the same way, as for ordinary dividends.

### Share buybacks

Investors highlight that many companies have sought, and received from shareholders, a mandate to undertake share buybacks up to a stated level. Where companies hold such authority, investors are looking for disclosure on the role that buybacks play in the overall use of cash, and on the company's considerations in conducting the buyback.

Such disclosures include:

- information about the process the company uses to identify when it is appropriate to undertake a buyback;
- the maximum price the company is prepared to pay;
- the rate of return for any alternative investment used to determine whether to proceed with the buyback, linking it to the overall capital management framework of the company; and
- any other specific criteria such as what the board expects to achieve by the buyback.

### Next plc 2015 Annual Report and Accounts p19

#### CASH GENERATION, SHARE BUYBACKS AND SPECIAL DIVIDENDS

##### CASH GENERATION

Over the last year we generated £363m of surplus cash after capex, interest, ordinary dividends and tax. We returned £361m of this to shareholders, through special dividends of £223m and share buybacks of £138m.

We expect to generate around £360m surplus cash in the year ahead and, again, we intend to return this to shareholders. We paid a £74m special dividend in February and have committed to a further £90m which will be paid in May. If our share price remains above our maximum limit for buybacks and our profit expectations remain unchanged, then we intend to pay further quarterly special dividends in August and November this year.

##### SHARE BUYBACK LIMIT GOING FORWARD

We have, on several occasions, set out the criteria by which we would decide the maximum price the Company would pay to buy back shares. We use the concept of Equivalent Rate of Return (ERR). This is the pre-tax return required from an alternative investment, if that investment were to produce the same level of earnings enhancement as the proposed buyback. We set the minimum ERR at 8%, which we consider a reasonable target for a return on equity investments.

For the year to January 2016, the mid-point of our guidance for profit before tax is £810m. On this basis an 8% ERR gives a new upper limit for buybacks of **£68.27**.

Investors consider that Next provides a good example of disclosure that identifies the:

- capital management context;
- expectations of future surplus cash generation;
- relationship between share buybacks and special dividends; and
- criteria for share buybacks, including an upper limit price and how it is determined.

When a company has undertaken a buyback, investors are looking for detailed disclosures to help understand the impact of the buyback and assess whether it was ultimately in the best interests of shareholders.

Information for each buyback transaction is available in stock exchange announcements, press releases, etc.

However, investors want to see aggregated information on buybacks in the context of capital management, in order to understand the impact of the programme on the company, and on the investor's individual holding.

Aspects of disclosure include:

- weighted average cost of the shares bought;
- overall cost to the company; and
- impact on key metrics such as earnings per share.

Investors consider that the interaction between buybacks and management performance metrics (and therefore directors' remuneration) also needs to be made clear.

Some investors would also like disclosure of the board's view on the overall success of the buyback, to support reporting on company stewardship. Retail investors, in particular, want boards to explain their assessment of the benefit of the buyback programme undertaken.

# Disclosure of practice under the policy

## What was done in practice to deliver under the policy?

Companies tend to produce very succinct dividend declaration disclosure in interim accounts, preliminary announcements, press releases and annual reports. Annual report disclosure typically covers the board's overall recommendation for the current year's proposed final dividend and paid interim dividend, with an indication of how the level of dividend compares to the prior year.

When reviewing dividend declaration information, investors would welcome disclosure which answers: what was done in practice to deliver under the dividend policy?

The following are important to investors in assessing the application of the dividend policy:

- period to which the dividend relates;
- amount per share and aggregate amount;
- date of payment and the record date (date that shareholder must be on the share register to receive dividend);
- remaining steps needed to approve the dividend such as the shareholder vote at the annual general meeting (AGM) (see **Appendix 2**);
- link between the dividend declared and the policy, explaining:
  - the relevant progression level or payout ratio;
  - any adjustments made to the approach used;
  - any departure from the policy and the circumstances; and

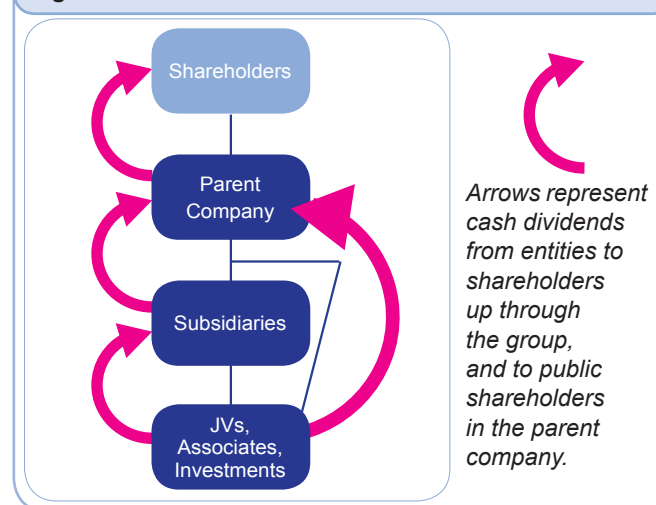
- how judgements were made and discretion exercised, and how constraints or key risks to the policy were addressed and considered in determining the dividend.
- dividend cover (irrespective of the approach taken).

Where the declaration process has resulted in a dividend which is not in line with the stated policy, investors value disclosure explaining why, and the likely impact on future dividend policy and practice.

Investors note that while much of the above information is currently disclosed by companies, it is located in various sections of the annual report and other communications, making it difficult for investors to see a coherent picture. This is discussed further in the section on bringing disclosures together.

In addition, investors like information on the level of resources at, or available to, the parent, including an indication of how the dividend payment will be funded.

**Figure 3: Illustrative dividend cashflows**



### Lab comment: Dividend flows

Group structures can be complicated. Ownership interests across the group may be held in differing proportions and across jurisdictions. They may also differ to the extent of the rights or influence the shareholder may have, including the ability to influence dividend payments. A variety of shareholder or other documents (e.g. articles of association) may exist, resulting in different rights and obligations for each investment relationship within a group.

The parent needs distributable profits and cash to pay dividends to its shareholders. Unless the parent is also the main operating entity, cash will often be passed up from subsidiaries, joint ventures (JVs) or other investee companies in which the parent directly or indirectly holds shares. Cash can also be transferred through intercompany loans, or can be obtained through external borrowings.

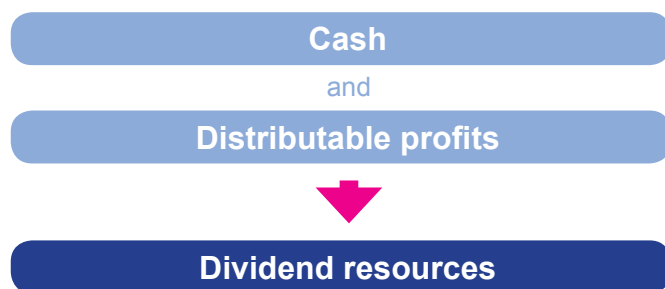
Some groups maintain dividend resources centrally at the parent level in excess of the proposed and future dividends. Others have more of a decentralised approach and aim for dividends to be paid through to the parent company, in order to fund dividend payments to the company's public shareholders.

## Disclosure of dividend resources

Investors use dividend resources disclosures to support:

- their voting decision on the approval of the proposed dividend at the AGM; and
- their assessment of the sustainability of the dividend.

There needs to be sufficient dividend resources for a company to be able to pay its proposed dividend.



There are differing views as to the usefulness and practicality of making disclosures on dividend resources, and in particular, distributable profits. Many investors consider that disclosure should be proportionate to the company’s circumstances. Some other useful sources of disclosure can be found in **Appendix 3**.

Investors consider that the disclosure of dividend resources is useful in circumstances where the ability of the company to pay dividends is, or might be, constrained. However, some investors believe that the disclosure of distributable profits is a requirement, and therefore disclosure should always be made irrespective of circumstances.

Given the complexity of individual groups and circumstances, the generation of a single set of best practice disclosures applicable to all companies is

not practical. However, boards may wish to consider how their disclosures answer investors’ questions, and if they provide relevant and easy to understand information, including:

- Is cash or distributable profits a short or medium term issue for the dividend?
- If so, how much of an issue?
- What is management proposing to do about it?

In respect of the proposed final dividend, investors like scalable disclosure, dependent on the company’s circumstances. Dividend resources of the parent company may be:

- **Abundant:** in such circumstances disclosures can be relatively limited.
- **Sufficient:** additional disclosure is helpful in understanding capacity.
- **Insufficient:** expanded disclosure is important including actions planned to address the situation.

In addition to information on the proposed final dividend, investors value information on the forward dividend policy, and whether the dividend will be funded out of historical or future dividend resources.

## Information that helps investors understand dividend resources of the parent company

Most investors expect the level of disclosure to increase as dividend resources become more constrained

Dividend resources at Parent Company	Abundant resources in comparison to proposed dividend	Sufficient resources in comparison to proposed dividend	Insufficient resources available to deliver dividend in accordance with the policy
<b>Cash</b>	Disclosure that puts cash resources in context of dividend e.g. refers to cash disclosures (or provides disclosure) that helps indicate sufficient cash available at parent.		Statement that confirms there are insufficient accessible cash resources available to pay the proposed dividend, and actions planned to source cash, to fund the proposed dividend.
<b>Distributable profits</b>	Statement that the company has distributable reserves to pay 'x' years of dividend at the current level (or in line with the dividend policy); or  Numerical: distributable profit balance.	Statement that the board has assessed the level of distributable profits and is satisfied they are sufficient to support the proposed dividend; and/or  Numerical: distributable profit balance; and See table below (if applicable).	Statement that confirms the dividend has been modified, due to limited distributable profits and;  Statement that provides understanding of the context (e.g. indicate actions being taken to address the issue); and  Numerical: distributable profit balance; and See table below (if applicable).

### Other disclosure which may be helpful when the parent company is reliant on entities below it for dividend resources:

<b>What</b>	Narrative disclosure which gives context as to the capacity of the group to pass cash to the parent and generate distributable profits at the parent.
<b>Where</b>	Narrative or numerical disclosure which gives context to the entities that are significant to providing the parent company with cash and/or distributable profits (linking to risks as appropriate).
<b>How</b>	Narrative disclosure which gives insight into the group's processes around moving cash and/or generating distributable profits at the parent company level.

## Cash resources

Disclosures on cash resources can help investors to understand impacts on capital management and dividend capacity and sustainability. Investors are trying to answer the question ‘what is the group’s capacity to pay dividends now and in the future?’

For many companies, the lack of availability of cash or competing priorities for its use, act as a constraint on dividends. Companies often provide detailed information around cash (and liquid) resources which investors find helpful.

Investors value disclosures which indicate the group’s aggregate excess and accessible unconstrained cash at year end; they consider it to be one indication of the maximum amount a company could distribute. Investors want to understand the actual cash balance and suggest not complicating such disclosures by trying to incorporate unused borrowing facilities that could be utilised to fund a dividend or distribution.

Many companies disclose detailed information about group availability of cash and cash generation; some express this in terms of cash available to be passed to the parent company. Where there is surplus cash, investors would like to understand its likely use.

Aviva discloses the amount of cash that the significant operations below the parent have remitted to the parent company. This gives information about the group’s ability to generate cash and how this has changed over time.

### Aviva plc 2014 Full Year Results Presentation p20

## Cash remittances & dividend cover



£ million	Excess Centre Cash <sup>2</sup>		
	2013	2014	Change
UK & Ireland Life	370	437	18%
UK & Ireland GI	347	294	(15)%
Europe	388	454	17%
Canada	130	138	6%
Asia	20	23	15%
FM & Other <sup>1</sup>	14	66	371%
<b>Total</b>	<b>1,269</b>	<b>1,412</b>	<b>11%</b>
Debt costs	(647)	(576)	11%
Centre costs	(202)	(144)	29%
<b>Excess centre cash flow</b>	<b>420</b>	<b>692</b>	<b>65%</b>

£ million	Dividend Cover		
	2013	2014	Change
<b>Operating EPS</b>	<b>42.6p</b>	<b>47.0p</b>	<b>10%</b>
<b>Dividend per share</b>	<b>15.0p</b>	<b>18.1p</b>	<b>21%</b>
<b>Dividend cover</b>	<b>2.8x</b>	<b>2.6x</b>	

### Move dividend cover to 2x over the medium term

1. FM & Other includes AI, Aviva Reinsurance and Group activities  
 2. Excess centre cash flow excludes non-operating cash movements such as disposal proceeds or capital injections.

Unite discloses that cash resources generated will cover the proposed dividend by 1.6 times. Investors consider that simple disclosure such as this, can be an effective way of communicating the level of dividend resources relative to the dividend.

### Unite plc 2014 Annual Report and Accounts p129

The Board monitors the ability of the Group to pay dividends out of available cash and distributable profits. The Operations segment generated cash of £35.0 million (2013: £23.2 million) during the year, thereby covering the proposed dividend of £22.5 million, 1.6 times (2013: £8.5 million, 2.7 times).



## Distributable profits

Many investors and companies consider that the extent of disclosure on distributable profits should be dependent on the company's individual circumstances. They consider that disclosures are important when distributable profits are, or are likely to become, a significant constraint on the payment of dividends under the policy.

What is important to these investors is the quality of the understanding that the disclosure provides, and not the format; as such they consider that disclosures could be quantitative (i.e. the distributable profits balance of the parent) and/or narrative.

The commonly held view is that UK legal requirements associated with distributable profits operate at an entity level (see **Appendix 1**). Disclosure of parent company distributable profits is seen by some investors as a good starting point to help answer questions about capacity of the parent to pay dividends.

Some of the reasons given by investors as to why disclosing the parent company distributable profits balance is always informative are that it:

- enhances confidence in the board by demonstrating that dividends are not being proposed from capital, given the legal restrictions against this;
- clarifies the headroom between the level of distributable profits and the proposed dividend therefore providing information to assist in the AGM vote on the approval of the dividend;
- can give some insight into the company's ability to cover the future dividend stream; and,
- may provide 'something of a proxy' for realised profits.

As noted previously, some investors believe that the disclosure of distributable profits is a legal requirement; although this is not common market practice.

The range of practice on disclosure of distributable profits, includes statements that:

- parent company distributable profits are sufficient to support a multiple of the current year dividend (or dividends implied by the policy);
- parent company distributable profits are sufficient to support the proposed level of dividend with respect to the year;
- the parent has at least a specified amount of distributable profits;
- the parent has a specified amount of distributable profits or that a specified amount is not distributable;
- specific parent company reserves are either distributable or not distributable; and/or
- the parent has a specified amount of distributable profits, showing a breakdown of the components.

It is not uncommon for groups to undertake structuring activities, permitted under law, to generate distributable profits in the parent company. Where current or future dividends are reliant on structuring activity, investors want to understand the amounts involved and the related risks.

While most participants consider the concept of distributable profits operates at an individual entity level as a matter of law, some investors think that the requirement to consolidate reserves implies that the disclosure of consolidated distributable profits is required.

Many companies would find this challenging given the level of judgement and estimation that would be required, and it may not be relevant for groups operating outside the UK, having subsidiaries and other investees subject to requirements of other jurisdictions. However a number of companies provide cashflow disclosures (see previous page) to help provide some relevant insight as to dividend resources.

HSBC provides narrative and numerical disclosure of the level of distributable profits within the parent company. This disclosure (which is required by the Hong Kong listing authority) provided clarity to investors that the 2014 proposed final dividend of approximately US\$9.6bn (disclosed elsewhere in the strategic report) is significantly less than the available distributable profits (reserves).

### HSBC 2014 Annual Report Strategic report p39

Dividends recorded in the financial statements are dividends per ordinary share declared in a year and are not dividends in respect of, or for, that year..... The reserves available for distribution at 31 December 2014 were US \$48,883m.

Investors consider that clarity can be enhanced by providing disclosure on distributable profits alongside a parent company's reconciliation of movements in equity shareholders' funds, showing the distributable/non-distributable split of the company's reserves.

To facilitate consideration of the dynamics of parent company reserves and changes in them over time, the Lab tested with participants an illustration of changes in shareholders' equity and of profit or loss account showing the distributable and non-distributable components. This is included in **Appendix 4**.

One real life example is that of Vodafone's 2015 annual report. The parent company's audited financial statements provide some clarity as to which of its reserves are not distributable, through labelling of specific reserves.

This disclosure is further enhanced by management's commentary (unaudited) in the strategic report, which clarifies the approximate amount of the profit and loss reserve which is distributable.

### Level of assurance

Investors value external assurance on information on distributable profits. Some companies consider it may not be practical to obtain assurance on the distributable profit balance due to complexity and the related cost. Some investors understand this, and nonetheless value disclosure. Those investors who believe that disclosure of distributable profits is required also believe that this disclosure is required to be audited.

## Vodafone 2015 Annual Report and Accounts p184

### 8. Reserves and reconciliation of movements in equity shareholders' funds

	Share capital £m	Share premium account <sup>1</sup> £m	Capital reserve <sup>1</sup> £m	Other reserves <sup>1</sup> £m	Own shares held <sup>2</sup> £m	Profit and loss <sup>3</sup> £m	Total equity shareholders' funds £m
1 April 2014	3,792	16,109	88	758	(7,289)	33,900	47,358
Allotment of shares	–	2	–	–	142	–	144
Loss for the financial year	–	–	–	–	–	(934)	(934)
Dividends	–	–	–	–	–	(2,930)	(2,930)
Capital contribution given relating to share-based payments	–	–	–	88	–	–	88
Contribution received relating to share-based payments	–	–	–	(126)	–	–	(126)
Other movements	–	–	–	–	–	(4)	(4)
<b>31 March 2015</b>	<b>3,792</b>	<b>16,111</b>	<b>88</b>	<b>720</b>	<b>(7,147)</b>	<b>30,032</b>	<b>43,596</b>

Notes:

- 1 These reserves are not distributable.
- 2 Own shares relate to treasury shares which are purchased out of distributable profits and therefore reduce reserves available for distribution.
- 3 The Company has determined what is realised and unrealised in accordance with the guidance provided by ICAEW TECH 2/10 and the requirements of UK law. In accordance with UK Companies Act 2006 s831(2), a public company may make a distribution only if, after giving effect to such distribution, the amount of its net assets is not less than the aggregate of its called up share capital and non-distributable reserves as shown in the relevant accounts.

### Lab comment:

Vodafone's note 8 to the company financial statements gives some clarity as to whether the parent's reserves are distributable or not.

## Vodafone 2015 Annual Report and Accounts p47

At 31 March 2015, Vodafone Group Plc had profits available for distribution of approximately £20 billion.

## Bringing disclosures together

Investors and companies note a wide range of locations for dividend disclosures across different media. While investors generally review all elements of dividend reporting, they focus primarily on the preliminary announcement, investor presentations, annual report and AGM notices to understand the interim and final proposed dividend and/or any changes to the policy.

Investors consider that once the annual report has been released, it becomes the most important source of dividend disclosure.

Investors note that disclosures in annual reports are often spread throughout the strategic report, financial statements, and shareholder information sections. They find that the dispersal of disclosures results in repetition, and makes it difficult to understand the coherent story.

Investors consider that companies have an opportunity to improve the disclosure of current policy and practice through bringing information together (where possible) and referencing relevant information to reduce duplication.

Companies highlight practical issues in respect of drafting disclosures made through different media which are often prepared by different teams within the company. Drafting can be even more challenging for the annual report as disclosures might be spread across sections written by company secretarial, finance, investor relations and corporate communications departments. However, all recognise the benefits of consistency and some consider that bringing all the disclosure together may bring efficiencies.

While investors view annual report disclosures as crucial, they suggest that in addition, some elements of dividend reporting might be more useful online. The investor relations section of the website is ideal for providing detailed historical information and, outside of the reporting cycle, updates to the current dividend policy, information on active buybacks and information to help support an upcoming vote.

### Lab comment

The recent reports from the Lab on digital reporting and accounting policies ([www.frc.org.uk/Lab](http://www.frc.org.uk/Lab)) demonstrate that investors prefer to have all relevant information together within one document (even if in an appendix). This assists investors in locating relevant information and allows easier comparison across companies.

*“Information on dividends is scattered. Users and preparers would benefit from having the information together, in one place”.*

Company

## Participants and process

Project participants join Lab projects by responding to a public call or being approached by the Lab. An iterative approach is taken with additional participants sought during the project to obtain input from various types of investors and analysts, and ensure a range of company examples and input.

A range of companies participated (from AIM through to FTSE 100); and views were received from a range of UK and international institutional investors, analysts and retail investor associations.

References made in this report to views of ‘companies’ and ‘investors’ refer to the individuals from companies and investment community organisations that participated in this project. Views do not necessarily represent the views of the participants’ companies or organisations. The term ‘investors’ includes a broad range of individuals in their capacity as investors or their role in analyst organisations that work in the interest of investors in the UK and overseas markets.

### Involvement of companies

The following companies participated in the project:

- Admiral Group plc
- Animalcare Group plc
- Antofagasta plc
- BG Group plc
- BHP Billiton Ltd
- BT Group plc
- easyJet plc
- GlaxoSmithKline plc
- HSBC Holdings plc

- Legal & General Group Plc
- Lloyds Banking Group plc
- National Grid plc
- Next Plc
- SSE plc
- Vodafone Group Plc

### Involvement of investors

The following members of the investment community participated in the project:

- Aberdeen Asset Management
- Allianz Global Investors
- CFA UK
- CFA Global
- Eumedion
- Evenlode
- Fitch Ratings
- Go Investment Partners
- Invesco Asset Management Limited
- Institutional Shareholder Services
- Legal & General Investment Management
- M&G Investments
- Manifest Information Services Ltd
- Moody’s Investors Services Ltd
- Pensions and Lifetime Savings Association (formerly National Association of Pension Funds)
- RPMI Railpen
- Royal London Asset Management
- Sarasin & Partners
- Schroders
- ShareSoc
- Standard & Poor’s Ratings Services

- Standard Life Investments
- The Investment Association
- The National Employment Savings Trust
- The UK Shareholders’ Association
- USS Investment Management Ltd

There were another four company and five investor participants.

### Project process

Meetings were held with each company participant to understand their process and challenges in making dividend disclosures, including the monitoring of actual and potential constraints to dividends. The Lab met with a number of investors separately, and held group meetings with some long-term investors with a particular interest in the disclosure of distributable profits. In addition, several round table meetings were held with investors and company participants together, to explore views and practical solutions.

The individual views described are not necessarily supported by all participants.

The reporting suggestions provided in this report should be considered by companies in the context of their own circumstances and audience for reporting.

# Appendix 1

## UK accounting and regulatory framework – reserves and distributable profits

One area of complexity identified by companies and investors is the interaction between group and parent reported reserves, and the legal concept of distributable profits at the parent company that pays dividends to its shareholders.

UK incorporated companies listed in the UK must include within their annual report both consolidated accounts, and individual parent company accounts. The majority of UK companies take advantage of the exemption from the publication of the parent company income statement.

### Consolidated accounts and reserves

In line with EU law, consolidated accounts for UK listed companies must be prepared under IFRS (as adopted in the European Union). This means that a group's reported shareholders' equity (sometimes referred to as 'reserves') reflect IFRS requirements on:

- consolidation of subsidiaries;
- equity method accounting for JVs and associates;
- accounting for other investments (in accordance with a range of practices from cost to fair value through the profit or loss statement); and
- adjustments to:
  - ensure the application of consistent accounting policies across group entities;
  - reflect different reporting year ends; and
  - eliminate intercompany profits.

However, distributions of dividends by UK companies are not made from reserves at a consolidated level, rather they are made from the parent company's distributable profits.

### Parent company accounts and reserves

The parent company accounts can be prepared using either IFRS or UK GAAP. Both IFRS and UK GAAP provide certain options on the accounting policies applied. For example, there is a choice as to whether to account for investments in subsidiaries at cost or at fair value through the profit or loss account.

Accordingly, the parent company of a group might prepare its financial statements using a different convention to that used by the group. The choice of convention for the parent company can also have an impact on its distributable profits.

The parent company reserves include dividend distributions received from subsidiaries, while the group reserves reflect profits made by such subsidiaries irrespective of intragroup distributions.

It is common for groups to be comprised of companies incorporated in numerous jurisdictions, and subject to their laws, accounting standards, currency controls and tax regimes. This results in the flow of dividends from companies in a group structure having to comply with a variety of requirements of the legal jurisdictions of each incorporated entity. In addition, companies within a group may also have different reporting year ends.

These issues all add complexity for those trying to communicate or understand how overall group reserves relate to the parent company's reserves and distributable profits, and to the declared dividend.

The following points illustrate some of the legal and regulatory requirements that may apply:

**EU incorporated:** The capital maintenance regime for EU companies was established in 1976. Under EU law, companies cannot lawfully make distributions out of capital. Both the Second Company Law Directive and the new Accounting Directive<sup>3</sup> refer to profits 'made'. The Second Company Law directive restricts distributions to profits 'made' in the year plus or minus profits or losses brought forward from the previous year.

Some member states take 'made' to mean those profits and losses recognised in the profit and loss account. However, of those member states that permit or require some or all entities to prepare individual company accounts under IFRS, a number require adjustments to be made to IFRS net income, to determine distributable profits. These mainly remove unrealised profits and losses.

**Additional considerations for the UK:** The Companies Act provides that a company can make a distribution (including cash dividends) only out of 'profits available for distribution' by reference to the 'relevant accounts' drawn up in accordance with applicable UK law and accounting standards, and if directors consider that the company can meet its liabilities as they fall due. Profits available for distribution are a company's accumulated realised profits less its accumulated realised losses. Further, a public company must apply the net asset test: it may make a distribution only, if after giving effect to such distribution, the amount of its net assets is not less than the aggregate of its called up share capital and undistributable reserves (in practice, this means deducting accumulated unrealised losses).

Directors also need to take account of other restrictions arising from the company's articles or common law.

<sup>3</sup>Applicable to accounting periods beginning on after 1 January 2016

Realised profits and losses are determined by generally accepted accounting practices, guidance on which is set out jointly by the ICAEW and ICAS in a Technical Release – ‘TECH 02/10 Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006’. This provides guidance for determining when profits are realised and unrealised, together with various examples. One such example is the revaluation of investment property. Under IFRS, the fair value movements are recorded in the income statement. However under TECH 02/10, these gains and losses are unrealised, and are therefore excluded from realised profits and cannot be distributed.

**Non EU incorporated:** While some countries have capital maintenance approaches as in Europe, many (including Jersey, Guernsey, Australia and the USA) have a solvency based approach. Under this approach, there is no concept of distributable profits, but a focus on a company’s ability to meet its ongoing obligations after the payment of dividends.

## Appendix 2

### Interaction between the dividend and reporting cycles

The dividend cycle and the reporting cycle operate in parallel, and the interaction between the two can cause some confusion to those looking at company communications to understand dividends.

The dividend cycle comprises two main components:

- Dividend policy decision; and
- Dividend declaration decision.

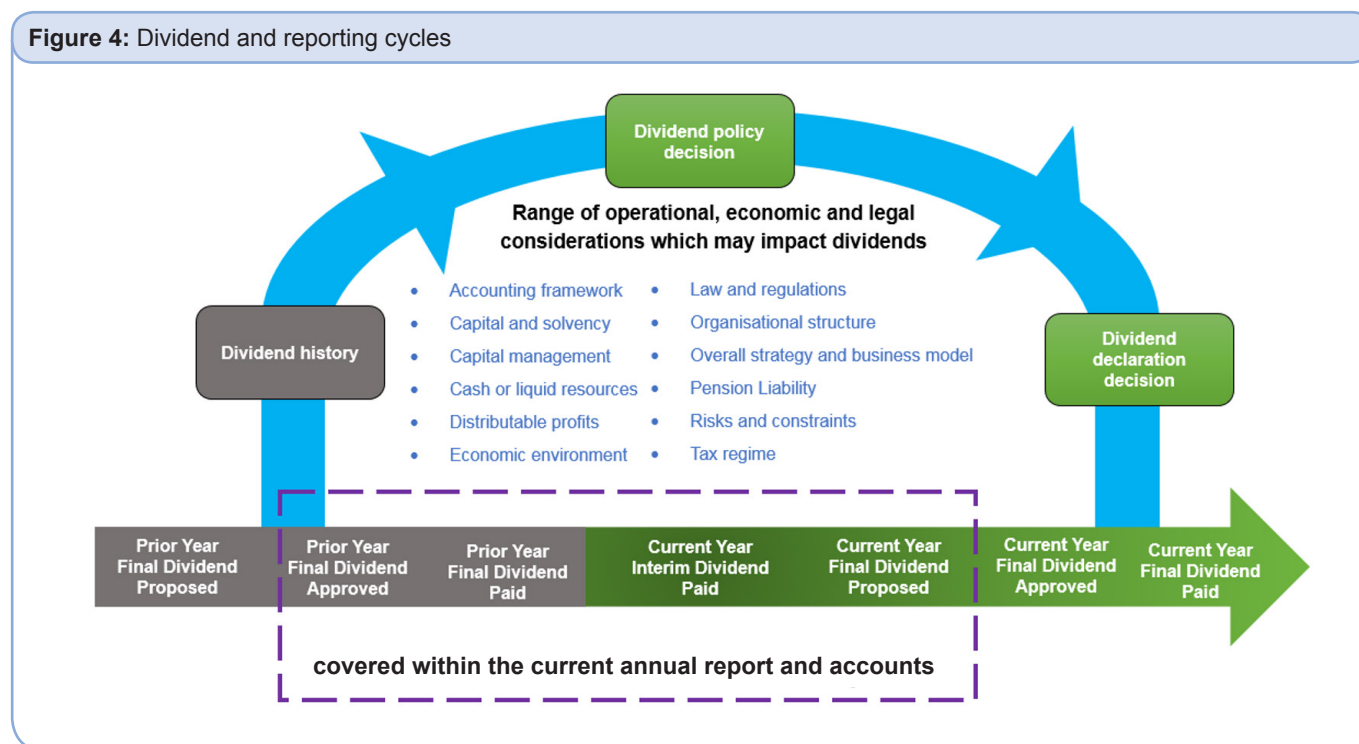
Companies communicate the key decisions from the dividend cycle through a multitude of corporate reporting mechanisms; however, it is the annual report which brings together elements of the past (history), current (declaration) and future (dividend policy).

The annual report generally covers information in respect of the dividend policy and/or changes to that policy. The annual report also includes information on the dividends including the:

- payment of the final dividend made in the current year of account (which represents the final dividend declared in respect of the prior year);
- payment of the interim dividend made in the year (which represents the interim payment of dividend declared for the current year); and
- proposal for the final dividend for the current period.

Because the annual report is trying to cover elements of past, current and future dividends, disclosure is often spread throughout the report, with some elements being disclosed in the strategic report, some in the shareholder information, and some in the financial statements and notes.

Figure 4: Dividend and reporting cycles



For a UK incorporated company, the requirements for the approval and payment of dividends are set out in the articles of association. Dividends are usually referred to as either ‘final’ or ‘interim’. A final dividend is recommended by the directors and approved by shareholders by ordinary resolution (‘declared’), usually at the AGM. A final dividend becomes a debt from the time it is approved.

An interim dividend is one approved by the directors and there is usually no limit on the number of interim dividends that the directors may decide to pay. Interim dividends are not, strictly speaking, ‘declared’ and do not become a debt of the company but are simply paid. Nevertheless once an interim dividend is announced it would only be in exceptional circumstances that a company would not go on to pay the dividend.

## Appendix 3

### Sources of disclosure

Annual reports provide a range of information to those wishing to understand capital management, cash, and profit realisation. These disclosures can be helpful for those wishing to understand dividends.

#### Capital management

Under IAS 1, a company must disclose information that enables users of its financial statements to evaluate its objectives, policies and processes for managing capital. This would generally include:

- a description of what an entity manages as capital;
- summary quantitative data about what it manages as capital;
- when an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital; and
- how it is meeting its objectives for managing capital.

Disclosures under IFRS 7 are also intended to provide insight on a range of risks, including liquidity risk, and debt terms and maturities.

#### Availability of cash and intra-group dividends

Existing requirements call for disclosure of:

- cash and cash equivalent balances held by the company that are not available for use by the group, i.e. restricted cash (IAS 7 paragraph 48);
- the nature and extent of any significant restrictions on the ability of joint ventures (JV's) and associates to transfer funds in the form of cash dividends (IFRS 12, Disclosure of interests in other entities); and

- the tax consequences when a company expects it will fund future dividends by way of distributions from underlying subsidiaries (IAS 12).

Additionally, parent company accounts prepared under IFRS require a statement of cash flows, which include dividends received by the parent from subsidiaries, JVs, associates and other investments.

#### Profit realisation

TECH 02/10 (which is applicable to individual entities) considers realised profits which may encompass profits relating to assets that are “readily realisable” i.e. convertible to cash, in addition to those already realised in cash.

Under IFRS, ‘realisation’ is not used as a criterion to trigger accounting consequences. However, there are several elements of disclosure in consolidated accounts that may provide insight into whether profits reported under IFRS have been realised in cash or cash equivalents.

Many items on the consolidated balance sheet reflect timing differences between recognition for profit purposes and the realisation in cash. The statement of cash flows, in particular the section on operating cash flows, is a good place to look for such differences. Operating cash flows are generally shown as being derived from profits, under the indirect method. As a result, the statement provides insight on differences between recognition in the profit or loss statement and recognition in cash and cash equivalents, e.g. differences relating to:

- working capital items;
- assets or liabilities relating to long term contracts; and
- provisions and other assets or liabilities considered to have cash flows that are operating in nature.

#### Other relevant disclosures

There are also other disclosures that may provide insight on items likely to be relevant to understanding risks related to future levels of dividends, such as:

- disclosure of financial assets valued using Level III methods (e.g. model priced using unobservable inputs) that are not considered readily realisable;
- disclosures on contingent liabilities under IAS 37;
- disclosures in accordance with IAS 19 on pension funding obligations; and
- information on the separate components of other comprehensive income reserves e.g. (available for sale, pension, own credit, derivative cash flow hedges, and revaluation reserves, etc.).

#### Lab comment

The Lab published three reports addressing disclosure of cash flows and debt. Company reporting suggested in these reports is also beneficial to investors’ assessment of capital management relative to debt terms and maturities, conversion of profits to cash flows, and the availability of cash. The reports are located at [www.frc.org.uk/Lab/Reports](http://www.frc.org.uk/Lab/Reports)



## Appendix 4

### Lab illustration: Distributable profits of the Parent Company

Throughout this project, the Lab worked with companies and investors to understand elements of reporting on distributable profits that may be enhanced to provide better information for investors.

Companies have adopted different approaches to disclosure of distributable profits; examples of these are set out on pages 17 and 18.

In addition to these examples, and to facilitate consideration of the dynamics of parent company reserves and changes in them over time, the Lab created and tested an illustrative reconciliation of shareholders' funds that shows distributable and non-distributable components (see **Figure 5**). This illustration mirrors information that some companies use internally for the purpose of monitoring their distributable profits relative to reported profits.

The illustration also includes an analysis of the parent company profit and loss account (see **Figure 6**). This provides an understanding of the sources of the parent company's profit and loss reserve.

While the profit and loss statement has been included in the illustration, it is rarely disclosed by companies in UK group accounts, as the Companies Act provides exemption from the publication of the parent company profit and loss account within a consolidated group annual report. The majority of FTSE 100 companies take advantage of this exemption, and therefore the profit and loss account of the parent company is generally not publicly available.

Some investors consider that disclosures similar to the illustrative examples would be very helpful in all circumstances (i.e. where distributable and non-distributable components are clearly separated). Some also believe that disclosure of distributable profits is always required. However, the majority of investors consider that this detailed level of disclosure is useful principally when distributable profits is a binding constraint on a company's ability to pay dividends.

Additional insight may be provided by companies identifying distributable and non-distributable components of profit for the period. Providing a description of the key sources of the parent company's distributable profits (such as from dividends of significant subsidiaries) is an alternative approach.

**Figure 5:** Lab illustration – Parent Company reconciliation of shareholders' funds

all in £ Millions	Share Capital	Share Premium Account	Capital Redemption Reserve	Revaluation Reserve	Own Shares	Merger Reserve	Available for Sale			Profit and Loss Account			Shareholders' Funds		
	Non-Distributable	Non-Distributable	Non-Distributable	Non-Distributable	Distributable	Non-Distributable	Total	Distributable	Non-Distributable	Total	Distributable	Non-Distributable	Total	Distributable	Non-Distributable
At 1 January 201X	500	45	22	25	(150)	256	100	45	55	380	350	30	1,178	245	933
Profit for the financial year	-	-	-	-	-	-	-	-	-	155	135	20	155	135	20
Other comprehensive income	-	-	-	-	-	-	(15)	(10)	(5)	-	-	-	(15)	(10)	(5)
Dividends paid	-	-	-	-	-	-	-	-	-	(84)	(84)	-	(84)	(84)	-
<b>At 31 December 201X</b>	<b>500</b>	<b>45</b>	<b>22</b>	<b>25</b>	<b>(150)</b>	<b>256</b>	<b>85</b>	<b>35</b>	<b>50</b>	<b>451</b>	<b>401</b>	<b>50</b>	<b>1,234</b>	<b>286</b>	<b>948</b>

**Public company net asset test**  
all in £ Millions

Net realised profit available for distribution as above	286
Less unrealised losses	(25)
<b>Profits available for distribution</b>	<b>261</b>

**Figure 6:** Lab illustration – Parent Company profit and loss account analysis

all in £ Millions	20x1		
	Total	Distributable	Non-Distributable
Turnover	210	210	-
Operating costs	(10)	(10)	-
<b>Operating profit</b>	<b>200</b>	<b>200</b>	<b>-</b>
Dividends received from subsidiaries	10	10	-
Fair value gains on investments in subsidiaries and joint ventures	40	-	40
Interest receivable and similar income	30	30	-
Interest payable and similar charges	(75)	(75)	-
Revaluation of investment property	(10)	-	(10)
<b>Profit on ordinary activities before taxation</b>	<b>195</b>	<b>165</b>	<b>30</b>
Taxation on profit on ordinary activities	(40)	(30)	(10)
<b>Profit for the financial year</b>	<b>155</b>	<b>135</b>	<b>20</b>

The shaded sections separate out the distributable and non-distributable components. This disclosure is not currently common practice in the UK.

# Lab project reports

The Lab's project reports provide practical suggestions from our work with the corporate and investment communities.

## Thematic:



Digital present: Current use of digital media in corporate reporting



Insight report: Towards Clear & Concise Reporting

## Governance:



Reporting of Audit Committees



A single figure for remuneration



Reporting of pay and performance

## Financial and Corporate Reporting:



Accounting Policies and integration of related financial information



Debt terms and maturity tables



Net debt reconciliations



Operating and investing cash flows



Presentation of market risk disclosures

## Clear & Concise Case Studies:



William Hill plc – accounting policies

All reports, and further information about the Lab are at: [www.frc.org.uk/Lab](http://www.frc.org.uk/Lab)

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