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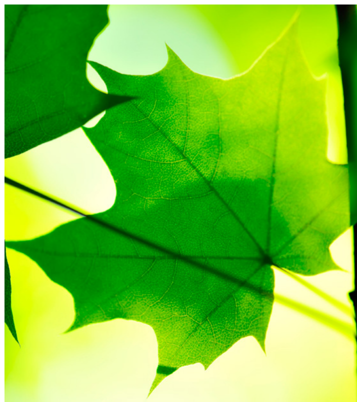

Need to know
FRC's Financial Reporting Lab issues report on disclosure of dividend policy and practice

In a nutshell

- Investors and companies consider dividend disclosures to be relevant when evaluating investment decisions and assessing management's stewardship.
- The FRC has confirmed their understanding that the Companies Act 2006 does not require companies to identify separately distributable profits on their balance sheet.
- In addition to relevant disclosure being made relating to dividend policy, investors are calling for more information from companies about their ability to pay dividends now and in the future.
- Dividend disclosures are frequently dispersed throughout a company's annual report leading to repetition and a lack of transparency.
- The report provides practical guidance to help companies provide information that is of relevance to investors. It recognises the practical issues in determining the level of profits a company can legally distribute and that the type of disclosure will depend on the level of resources a company has compared to its proposed dividends.

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Background

The FRC's Financial Reporting Lab has published the findings from its project *Disclosure of dividend policy and practice.* The project was prompted by an interest from a group of long-term institutional investors in the capital maintenance regime and then broadened to cover best practice disclosure of dividend policy and practice.

Investors consider disclosure of distributable profits to be helpful in certain circumstances. A group of long-term institutional investors and the UK Shareholders Association wrote to all FTSE 100 Audit Committee Chairs to convey their desire for clear and consistent disclosure of the accumulated distributable and non-distributable reserves in published financial statements, including greater clarity over the split between unrealised and realised income included in these reserves. Some investors believe it is always required to disclose distributable profits. The FRC understands that under the Companies Act 2006 there is no requirement for companies to separately identify distributable profits on their balance sheet, although they recognise that such disclosure may be useful in particular circumstances. Company practice in this area is diverse with only 23 FTSE 350 companies disclosing the distributable profits balance of the parent company in their 2014 annual report. *Deloitte's Annual Reporting Survey 2015*, which reviewed 100 annual reports, found that 40% of companies surveyed provided some information about distributable profits.

The report covers issues relevant to all sizes of listed company and focuses primarily on disclosures in the annual report, although a range of company communications is considered.

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The report is intended to provide practical guidance to assist listed companies in disclosing relevant information to investors and incorporates many useful examples of current better practice. Participants in the project included 19 companies (FTSE 100, 250 and AIM listed) and 31 members of the investment community working across the UK and global market.

Why are dividend disclosures important?

Both companies and investors agree that dividend policy and practice disclosures provide useful information that can affect investment decisions and assessment of company stewardship. For investors, information on dividend policy reveals how a company balances its capital expenditure needs with returns to its shareholders.

Currently some information on dividends is provided in a range of corporate communications, principally the annual report but also in preliminary announcements. However, there is consensus that dividend disclosures are not clearly articulated and that there is frequently a disconnect between any description of the dividend policy and how that policy has been implemented in practice.

What areas are covered by the report?

Dividend policy disclosure

Investors believe that good dividend policy disclosure should address the following points:

- *Why this policy?*
  Why the particular policy has been selected and how it ties into the company's overall business model, strategy and capital management processes. It should go on to describe how the policy is implemented in practice, including any significant judgements and assessments made as part of its implementation.

- *What will the policy mean in practice?*
  Both investors and companies see the main types of dividend policy as either progressive or payout ratio approaches.

  Progressive – investors want to understand what 'progressive' means for that particular company, in addition to information describing how the board expects the dividend will change in the future.

  Payout ratio – investors want to understand the basis and calculation of the ratio used, particularly if this is based on a non-IFRS metric or at a group, rather than parent company, level.

  In addition to describing how the policy operates in practice, investors want to understand the timeframe over which the particular dividend policy is likely to apply. Some investors would expect there to be a relationship between the timeframe of the dividend policy and that expressed in the viability statement required under the 2014 Corporate Governance Code.

- *What are the risks and constraints associated with this policy?*
  Companies should avoid the use of boilerplate in disclosures of dividend policy and instead focus on those constraints pertinent to their individual circumstances e.g. distributable profits, debt covenants or regulatory capital. An area of noted weakness is the link between dividend and principal risks disclosures.

Special dividends and share buybacks

Investors agree that there should be improved disclosure of the circumstances in which companies will pay out special dividends, particularly when companies are paying these out regularly (in some cases even annually). Improvements could also be made to disclosures regarding share buybacks, including detail on considerations made to conduct the buyback and the impact of the buyback on the company's use of cash.

What was done in practice under the policy?

Currently disclosures in relation to the declaration of dividends tend to focus solely on the board's overall recommendation for the year's proposed final dividend and paid interim dividend, with a comparison to the previous year.

Investors would like to see the quality of information in such disclosures enhanced to include the following information:

- the period to which the dividend relates;
- the amount per share and aggregate amount;
- date of payment and the date that the shareholder must be on the share register to receive the dividend ("record date");
- remaining steps necessary to approve the dividend e.g. shareholder vote at AGM;
- link between the dividend declared and the dividend policy explaining any departures made from the policy;
- level of resources available to the parent including detail on how the dividend will be funded; and
- resulting dividend cover.

Dividend resources and distributable profits

Investor and company project participants differed in their views as to the usefulness and practicality of making disclosures on dividend resources (cash and distributable profits) and in particular distributable profits. This is because the level of realised profits can be significantly different to the balance in retained earnings. Due to the complexity of individual groups and circumstances, it would not be practical to produce a single set of best practice disclosures for this area and companies will need to consider what would be appropriate for their particular conditions and useful for their specific investors. In general, investors would expect the level of disclosures to increase as company dividend resources become more limited:

Company circumstance	Disclosure
Abundance of resources vs proposed dividend	Minimal disclosure such as statements indicating abundance of resources
Sufficient resources vs proposed dividend	Enhanced disclosure providing context to source and quality of distributable profits and year-end balance of resources
Insufficient resources to deliver the dividend in accordance with the policy	Further disclosure on action being taken by the company

The report highlights useful areas of disclosure to be considered in assessing dividend resources that exist in entities below the parent:

- **What** – narrative disclosures giving context as to the capacity of the group to pass cash up to its parent and generate distributable profits in the parent.
- **Where** – narrative/numerical disclosures giving context to those group entities that are significant to providing parent company distributable profits.
- **How** – narrative disclosures giving insight into the group's processes for moving cash and/or distributable profits to the parent entity.

Distributable profits are governed by UK company law requirements and are summarised in ICAEW and ICAS Technical Release 02/10 *Guidance on the Determination of Realised Profits and Losses in the Context of Distributions Under the Companies Act 2006* (the FRC Lab also provide an overview of these in *Appendix 1* of the report). Tech 02/10 states that there are currently no legal or regulatory requirements for disclosure of distributable profits.

Participants in the FRC Lab project indicated that the parent company's statement of changes in equity is a useful place to provide disclosure as it can clarify the distributable/non-distributable split of the company's reserves and/or profit. In Appendix 4 of the report, the FRC Lab tested with participants an illustrative statement of changes in shareholders' equity and corresponding profit or loss statement, showing distributable and non-distributable components of these. The illustrative example could provide a useful internal aid for companies to monitor their levels of distributable profits relative to their reported profits. However, the majority of investors consider that public disclosure with such a level of detail would only be necessary when transparency of the make-up of distributable profits was essential i.e. if there are insufficient resources available to deliver a dividend in accordance with the prescribed policy.

Observation

Distributable reserves are based on the separate financial statements of a parent company. Amounts disclosed in the consolidated financial statements have no relevance to the amount which may lawfully be distributed to shareholders as dividends. However, in all but the simplest situations, investors are likely to be interested in more than just the amount of distributable reserves in the parent company.

For complex international groups, the parent's own reserves will be only part of the story. Investors will be interested in the amount of reserves elsewhere in the group that are available to pay up to the parent. However, the ability to make use of these reserves may be subject to a variety of risks and uncertainties. These could include local regulatory requirements in the jurisdictions concerned and adverse taxation consequences.

Explaining these issues clearly and concisely may prove a challenge for some groups. However, it is important to remember the objective of the disclosures and avoid excessive detail. As the FRC Lab Report explains, the extent of disclosure should be linked to the margin between available reserves and the expected level of dividends. As the report also mentions, the availability of cash will often be a greater restraint than the level of distributable reserves.

Bringing disclosures together

Disclosures on dividends are spread across a wide range of company information with investors focusing primarily on preliminary announcements, presentations and annual report disclosures. Appendix 2 of the report highlights the importance of the interaction between the dividend and reporting cycles when providing dividend disclosure.

The annual report is consistently viewed as the most important source of dividend disclosures. However, disclosures in the annual report are frequently spread throughout the strategic report, financial statements and shareholder information sections with no inter-linkage provided. A previous report from the FRC Lab highlighted the importance of having a 'clear and concise' annual report. Therefore, companies should seek to consolidate and link their dividend disclosures in order to enhance clarity and prevent repetition of information.

Deloitte View

- The FRC Lab Report provides useful guidance for all listed companies, irrespective of size, by reflecting the views of investors on disclosures of dividends and distributable profits.
- Careful consideration should be given to providing disclosures that are relevant to the specific circumstances of the company and that will be useful to their investors.
- Linking dividend disclosures to relevant information within the annual report, including principal risks disclosures, can contribute to making the annual report more clear and concise and avoid repetition of similar information.

For further information

The Lab project report: *Disclosure of dividend policy and practice*.

Information on previous pronouncements from the FRC as well as other UK accounting, reporting and corporate governance news and publications, can be found at www.ukaccountingplus.co.uk.

ICAEW and ICAS Technical Release 02/10 *Guidance on the Determination of Realised Profits and Losses in the Context of Distributions Under the Companies Act 2006*

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