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Document Version
Final published version

Publication date:
2021

License
Unspecified

Citation for published version (APA):
Leaver, A., & Murphy, R. (2021). *How to Estimate Distributable Reserves*. University of Sheffield. https://www.sheffield.ac.uk/media/28677/download

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How to estimate distributable reserves

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November 2021

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Summary

This note has been prepared in response to the notion that the recommendations on the group disclosure of distributable reserves in the government White Paper, '*Restoring trust in audit and corporate governance*', are too complicated for large UK based public interest entities to implement.

In this note we suggest that this argument is unsustainable. We suggest three methods by which the realised reserves of group entities might be estimated if they cannot be calculated precisely.

It is our suggestion that the last of our proposals, which is a bottom-up calculation of available realise reserves undertaken on a subsidiary-by-subsidiary basis, with supporting disclosures made, should be the basis on which corporations report what they may legally distribute. This would supply the core stakeholders of a public interest entity, as identified by the International Financial Reporting Standards Foundation (2018), with that information required to appraise the likely income streams they might enjoy because of their share ownership.

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Background

UK company law presumes that UK limited companies exist for the benefit of their members, subject to the consideration of some other issues[4]. It is also commonly argued that in the case of a public interest entity (PIE), the primary concern of the shareholder is with the dividend stream they might enjoy because of the ownership of their shares, or the alternative increase in capital value of those shares.

One of the primary concerns of law is the possibility that directors, being aware of this primary interest of their shareholders, might abuse the interests of the company's creditors by making shareholder distributions more than the sums really available for this purpose, which are defined as the realised distributable reserves of the company in question.

We note that despite the apparent significance of this definition, there is considerable ambiguity when estimating this figure. We then note that the estimation of the distributable reserves available to a PIE is both possible as well as desirable. As a consequence we argue that the publication of audited data in support of this estimate would considerably enhance the quality of the information available to the shareholders of any PIE when it comes to their decisions as to capital allocation, which the International Financial Reporting Standard Foundation states be the primary purpose for the use of audited financial statements[5].

Definitions

Despite the significance off distributable realised reserves within UK company law there is at present no widely accepted definition of what this sum might represent at least within either legislation or available legal precedent.

The profits available for distribution by a company are defined by section 830 Companies Act 2006, which says:

> *Distributions to be made only out of profits available for the purpose*
> *(1) A company may only make a distribution out of profits available for the purpose.*
> *(2) A company's profits available for distribution are its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.*
> *(3) Subsection (2) has effect subject to sections 832 [F1, 833A] and 835 (investment companies [F2and Solvency 2 insurance companies]).*

[4] s172 Companies Act 2006.
[5] IFRS (2018)

With regard to companies whose shares are publicly quoted on a Stock Exchange there is guidance within Section 831 of the Companies Act 2006. This notes that[6]

> A public company may only make a distribution
> (a) if the amount of its net assets is not less than the aggregate of its called-up share capital and undistributable reserves, and
> (b) if, and to the extent that, the distribution does not reduce the amount of those assets to less than that aggregate.

That section then notes that for these purposes a company's net assets means the aggregate of the company's assets less the aggregate of its liabilities, with liabilities including provisions of any kind, before adding that a company's share premium account, capital redemption reserve account and unrealised profits less unrealisable losses cannot contribute to this estimation of realised distributable reserves. Any other named reserve may, apparently, be distributable as a consequence. Given the looseness of this definition statute does, in practice, add little to understanding. Worse, it leaves the situation open to abuse if other undistributable reserves, such as merger reserves, avoid some of the restrictions imposed on those undistributable reserves listed. Nevertheless, those drafting this law did appear to think that it should reflect the principle of prudence. And some argue, therefore, that this clause defines what is meant by a true and fair view within the accounts of any company because it creates the framework by which the relationship between the company, its creditors and its members is measured.

Yet section 831is ambiguous in one key respect. The title of the section is *'Net asset restriction on distributions by public companies'*. It therefore does not make explicit whether it refers to the consolidated group accounts or those of the parent company. Public companies are, invariably, group entities and hence present fully consolidated accounts, with only abbreviated data on the balance sheet of the parent entity to their members. No indication is given within section 831 as to why distributable reserves should be calculated via the abbreviated balance sheet of the parent entity, particularly when, for all other purposes, the accounts referred to in the statute are presumed to be those of the consolidated group. It would seem that by convention alone, and not because of any statutory requirements, that distributable reserves are calculated at the level of the parent and not the group.

The focus on the balance sheet of the parent entity is emphasised in the guidance on distributable profits written by the Institute of Chartered Accountants in England and Wales.

[6] https://www.legislation.gov.uk/ukpga/2006/46/section/831/data.htm?wrap=true

In their latest version of this (ICAEW 2017) they note that subject to minor exceptions relating to the reduction in the capital of a company that:

> *A company's profits available for distribution are its accumulated, realised profits (so far as not previously distributed or capitalised) less its accumulated, realised losses (so far as not previously written off in a reduction or reorganisation of its share capital.*

They continue:

> *Under both the Act and common law, distributions are made by individual companies and not by groups. The group accounts are therefore not relevant for the purpose of determining a company's profits available for distribution.* (ICAEW 2017, para 2.12):

It is, of course, true that it is only an individual entity within the group that can make a payment of a dividend to that group's third-party shareholders. This must, of course, be the group parent entity. However, the ICAEW make what we think is a logical fallacy when then assuming that this means that the group accounts are not relevant for the purposes of determining what reserves are available for the purposes of making that payment. As a matter of fact, no group entity undertakes all the sales that are recorded within a set of group consolidated accounts. Likewise, no group entity is responsible for all the liabilities owing by the group. Nor is it likely that any one company within the group will employ all those working for it. However, single figures for all these sums are published in the group consolidated accounts because it is believed this is the best representation that can be made of the position of the group as a whole that is under the direction and control of the parent group entity and its board of directors who are responsible for the preparation of those accounts. We contend that the same is true for reserves.

With regard to the obligation of those directors of that parent entity section 393 of the Companies Act 2006 says under the heading '*Accounts to give true and fair view*':

> 1. *The directors of a company must not approve accounts for the purposes of this Chapter unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss—*
> *(a)in the case of the company's individual accounts, of the company;*
> *(b)in the case of the company's group accounts, of the undertakings included in the consolidation as a whole, so far as concerns members of the company.*

That section then continues by noting that:

2. *The auditor of a company in carrying out his functions under this Act in relation to the company's annual accounts must have regard to the directors' duty under subsection (1).*

In that case statute law is unambiguous. It is only the group consolidated accounts that are to be considered true and fair under the terms of the Companies Act 2006, and it is only those group consolidated accounts that an auditor might also consider give a true and fair view. **In our opinion it simply cannot follow that the directors might ignore this direction given in statute law when deciding which reserves to take into consideration when determining the legitimacy of the payment of a dividend**. Consequently, it must follow that the provisions of section 830, 831 and 854 of the Companies Act 2006, as previously noted, must also refer to those group consolidated accounts. The option for the directors to think otherwise is not provided by section 393 of that same act.

Clearly, the ICAEW do not agree: in paragraphs 10.1 to 10.3 of their guidance on this issue (ICAEW 2017). They argue (Para 10.1) that:

> *The balance of profits available for distribution is that available to the company, not to its group. The availability of such profits is to be judged by reference to accounts, which must therefore be the company's individual accounts.*

We do not dispute that the distribution to be made will be the liability of the group parent company acting in isolation. However, as previously noted, we do not think that section 393 Companies Act 2006 permits the directors to determine the quantum of the reserves that might be available for this purpose by referring only to the reserves available to that group parent company acting in isolation. We would instead suggest that the sum that might be paid are those realised distributable retained reserves available to that group parent company acting in isolation subject to the constraint that those reserves must also be available within the group as a whole. We would additionally suggest that this second condition is the primary concern of the group directors and of the auditors of that group for the reasons already noted based upon the conditions laid down by section 393, Companies Act 2006.

Saying this, we note the provisions of section 836 Companies Act 2006, which says that:

> *Justification of distribution by reference to relevant accounts*
>
> 1. *Whether a distribution may be made by a company without contravening this Part is determined by reference to the following items as stated in the relevant accounts—*

(a)profits, losses, assets and liabilities;

(b)provisions of the following kinds—

(i)where the relevant accounts are Companies Act accounts, provisions of a kind specified for the purposes of this subsection by regulations under section 396;

(ii)where the relevant accounts are IAS accounts, provisions of any kind;

(c)share capital and reserves (including undistributable reserves).

2. *The relevant accounts are the company's last annual accounts, except that—*

(a)where the distribution would be found to contravene this Part by reference to the company's last annual accounts, it may be justified by reference to interim accounts, and

(b)where the distribution is proposed to be declared during the company's first accounting reference period, or before any accounts have been circulated in respect of that period, it may be justified by reference to initial accounts.

It is to be regretted that this section does not make clear what it means by the term 'relevant accounts', but in our opinion section 393 of that same Act very clearly does so. As a consequence, we do not think that it would ever be possible to reasonably conclude that the accounts of the parent company acting in isolation from its group could ever be considered appropriate for this purpose. Saying this, we note that section 394 of that same Act says that:

Duty to prepare individual accounts

The directors of every company must prepare accounts for the company for each of its financial years

We then note that Section 396 Companies Act 2006 says:

A1. Individual accounts must state—

(a) the part of the United Kingdom in which the company is registered,

(b) the company's registered number,

(c) whether the company is a public or a private company and whether it is limited by shares or by guarantee,

(d) the address of the company's registered office, and

(e) where appropriate, the fact that the company is being wound-up.]

1. Companies Act individual accounts must comprise—

(a) a balance sheet as at the last day of the financial year, and

(b) a profit and loss account.

2. The accounts must—

> *(a) in the case of the balance sheet, give a true and fair view of the state of affairs of the company as at the end of the financial year, and*
> *(b) in the case of the profit and loss account, give a true and fair view of the profit or loss of the company for the financial year.*

The ICAEW argue that (ICAEW 2017, 10.2 and 10.3) that the individual accounts of a group parent company are its unconsolidated accounts. However, as section 396 makes clear individual company accounts must include a profit and loss account, and those for a group parent company prepared in isolation do not do so; they are only required to publish a balance sheet. As such they cannot meet the criteria established by section 396 and it is the group consolidated accounts that must, by default, therefore be used for this purpose, and it becomes clear therefore that this is the intention of statute.

For these primary reasons we think that the direction provided on this issue by the Institute of Chartered Accountants in England and Wales is wrong.

We have a secondary reason for saying so. We note that it is commonplace for the accounts of a group parent company, considered in isolation and located in the UK, to be prepared in accordance with the provisions of the accounting standards issued by the Financial Reporting Council. In contrast the consolidated accounts for the group that the parent company in question controls will almost invariably be prepared in accordance with the provisions of International Financial Reporting Standards. It is actually very hard to imagine why it might be appropriate that two sets of accounts prepared in accordance with different financial reporting standards that can conflict with each other (or their separate existence would not be necessary) can be included in what is, nonetheless, claimed to be one set of financial statements the are subject to one audit report which does, singularly, confirm compliance with an appropriate accounting framework when two are in use. We leave further discussion of that issue aside but note but this does necessarily mean that a choice has to be made between these two differing accounts when deciding which might represent a true and fair view for decision-making purposes with regard to matters relating to the members and as Section 393 Companies Act 2006 makes clear the directors are instructed by statute as to which choice they should make: it is the consolidated accounts that must take precedence.

Additional complications

There are several complicating factors to take into account when considering what realisable distributable reserves might be. In particular:

a. Within a group entity there are very likely to be subsidiary companies who have reserves that might appear distributable in their own right but which are not available for this purpose to the group parent entity because they were earned prior to acquisition, with such reserves and any potential distribution from them therefore being properly reflected in the accounting for that acquisition cost, including goodwill and capital reserves arising as a consequence. In these cases, knowing what the distributable reserves of a subsidiary might be is in itself insufficient indication in itself to a group parent entity as to the reserves that it might access to support those payments that it might wish to make to its shareholders.

b. When using International Financial Reporting Standards, not all the movements in reserves reported by an entity necessarily relate to trading transactions taking place during that period. Movements on reserves might arise from matters reflected in the income statement, the statement of comprehensive income or loss and the statement of changes in equity. Whilst it might be hoped that the latter statement only relates to unrealised transactions that is often not the case, and the chance that both realised and unrealised movements on reserve might arise through the other two statements is real. As such none of these three statements provides clear indication of the movement on realised or unrealised reserves during a reporting period.

c. Because a subsidiary has realised reserves does not mean that there is an unimpeded route for their distribution to the shareholders of a parent entity. Consider the case of a subsidiary with realised distributable reserves owned by an intermediate holding company that reports retained realised losses. In that case the distributable reserves of the sub-subsidiary would have to be offset against these realised losses in the intermediate holding company before any calculating any sum available to the ultimate parent company for distribution to group shareholders.

d. Within group subsidiary entities it is entirely possible that profits realised within its own accounts are unrealised within the group as a whole. This can occur in numerous situations, commonly in capital transactions within a group, e.g., upon the transfer of assets after a fair value revaluation. The gain arising might be appropriately recorded as 'realised' in the entity making the disposal but cannot (in many situations) be recognised as such by the group as a whole because a third-party transaction has not taken place. It is also important to note that similar issues arise in the normal course of trading. For example, items sold by one entity in the course of trade at a profit to another group entity that still holds it in stock at the year-end date, create an unrealised profit for the group as a whole that cannot be distributed and which should be cancelled on consolidation for group accounting purposes. The accounts of individual group entities

are unreliable indicators of realised distributable reserves available to a group in this case.

e. Auditors also need to be aware that it is at least technically possible for a group parent entity to create group subsidiary structures where transactions might be bifurcated for the purpose of generating artificially inflated distributable realised reserves in some parts of a group that, through the outcomes of transfer pricing, are matched by realised losses in other parts of that same group[7]. If loan funding was then used to finance the distribution of those realised reserves in some group subsidiaries to the group parent company, whilst the realised losses of other group entities were ignored in the unconsolidated accounts of the group parent entity because they cannot, of course, be distributed, then the possibility that the realised profits of the group parent entity are artificially overstated to provide a basis for distributing reserves using the guidance provided by the ICAEW (2017) has to exist and is not corrected for by the group consolidation process even though, of course, the group consolidated accounts will remain fairly stated.

There are other issues of concern but the above are considered sufficient for the purposes of this note.

As noted previously, at present the reserves available for distribution by a group are deemed not to be determined by the group consolidated accounts of that entity although for all other purposes these accounts are expected to show a true and fair view for accounting purposes. There is an issue of particular concern to auditors arising as a consequence. They have a duty to report under the provisions of section 837(4) whether any qualification that they make within their report on the company accounts, might have an impact upon its ability to make a distribution (whether by dividend or otherwise) to company shareholders. The qualified audit report to which that section refers must, by default, be that on the accounts of the group as a whole (Section 393, Companies Act 2006 requires this) and yet the distributable profits to which the auditors must then refer, will be those of the parent company in isolation. The conflict that the auditor faces is readily apparent. Not only will the auditor be required to consider the consequence of their qualification for both sets of accounts, they must be able to reconcile the reserves that are available within each to ensure that the report that they provide is meaningful within the context of two, potentially conflicting, accounting frameworks, both of which may well be

[7] A discussion of how this might be achieved is available here https://www.taxresearch.org.uk/Blog/2021/07/05/how-large-companies-can-manufacture-profits-to-permit-dividend-payments/

applicable to the opinion that they form. No guidance as to how an auditor should resolve this conflict appears to have been provided[8].

Estimating distributable reserves

What all these various issues suggest is that it is vital that full disclosure of the realisable distributable reserves of a group of companies should be disclosed in its consolidated financial statements and that the method by which those reserves have been calculated should also be disclosed so that those who are dependent upon this figure when making informed decisions on the allocation of capital have sufficient relevant, reliable and comparable information to undertake that activity on a rational basis, as the International Financial Reporting Standards conceptual framework (2018) suggests is necessary.

The methodologies

There are at least three possible methods for estimating the distributable reserves for a group parent entity. Two are top-down methodologies of varying quality and the last a bottom-up methodology.

a. Top-down methodologies

1. Using the group reserves.
2. Using adjusted group reserves.

b. Bottom-up methodologies

3. Reporting distributable reserves per subsidiary, with adjustments then being made for intra-group transactions.

What we do not consider here is the current method of using the reported realised distributable reserves of the parent entity considered in isolation from the group. This is for all the reasons previously considered in this note.

Using the group reserves

In the first instance the most obvious alternative to the figure currently used for distributable reserves available to a group is that figure for retained earnings published on the consolidated balance sheet of a group entity.

[8] https://www.legislation.gov.uk/ukpga/2006/46/section/837/wales .

As a matter of fact, the auditors of that group entity have, when delivering their audit report, confirmed that they are of the opinion that this figure represents a true and fair view of the cumulative reserves generated by that group as a consequence of the transactions undertaken by its constituent members during the period that they have been under its control. There are several advantages to using this figure:

a. The problem of eliminating pre-acquisition reserves from consideration should not arise since this will have already happened upon consolidation: no such reserves should be included in this figure as a consequence;
b. This figure is prepared on the same basis as that for creditors of the group entity given that a consistent accounting framework is supposed to be used for the preparation of both. As such it provides the relevant data required when considering whether the directors of that group entity have over-distributed the resources available to them with consequent prejudice to the creditors of that entity potentially arising as a result;
c. The origins of the figure in question should be traceable through the movements over time within the reported financial statements of the group parent entity;
d. Intra-group profits and losses arising should have been removed from this figure during the course of the preparation of the consolidated group accounts eliminating one potential cause for overstated distributable group reserves;
e. Some of the conflicts of interest that auditors currently face (as previously noted) when reporting on issues relating to distributable reserves and dividend distributions are eliminated by the use of this figure.

Other advantages arise, but the above are, we suggest, the most immediately notable.

This being said, problems would still arise from the use of this figure. In particular, this figure for group revenue reserves is, at best, an approximation to realised reserves. For a wide variety of reasons reserves that are unrealised i.e., they have not as yet given rise to consequences likely to result in cash being receivable or payable, may be included in this figure. As such use of this figure could not be said to comply with the spirit of the law, and an auditor relying upon it for reporting purposes may be in breach of their specific obligations laid down in law.

This figure might be a much better guide to likely realised distributable reserves than the figure included on the unconsolidated group parent company accounts. Yet, whilst a group figure is likely to provide significantly better protection to the creditors than the use of a parent figure, there are other measures which may be superior.

Using adjusted group reserves

One alternative measure of realised distributable reserves could be calculated by adjusting group reserves to eliminate all those unrealised profits and losses reflected within them. After undertaking this exercise on a one-off basis so that the figure for revenue reserves reflected in the consolidated group balance sheet could be initially split based on their being realised or unrealised it would then become rather more straightforward to keep this figure up to date on an annual basis by providing an analysis of the movement of revenue reserves arising during the year between these two categories.

In principle this idea is appealing. In practise it is problematic for a number of reasons:

a. Whilst it is to be hoped that recent records regarding the split between realised and unrealised reserves might be available, this does not provide any assurance that this will be the case for earlier periods. This will be a particularly problematic issue for group entities with long trading histories. Companies are only required to keep accounting records and supporting notes for a period of six years. Many will have destroyed accounting records relating to earlier periods.

b. The preparation of this data will be required at three levels. In the first instance it will be necessary for the entities within the group to recategorise their reserves between those which are realised and unrealised. Secondly, it will be necessary to split those reserves between those realised before and after entry into the group if the subsidiary entity was acquired as a consequence of merger and acquisition activity. Third, the impact of group consolidation journals will have to be taken into consideration, also allocating these between those that reflect realised and unrealised reserves. Whilst in principle all such issues should be capable of being addressed there may, again, be a problem with records not being available for earlier periods.

c. In addition, as is noted in statute, understanding of what is and is not a realised reserve has changed over time as a consequence of the adoption of differing accounting frameworks. This change might be particularly noticeable upon the introduction of International Financial Reporting Standard, but changes in individual standards, both before and after that event, could have impacted upon this issue, whilst noting that accounting standards in general use before 2005 were significantly more prudent in this regard.

The possibility exists that this split of reserves might be estimated despite the absence of records for earlier periods. The suggestion could be made that there might be a 'grandfathering' basis for this estimation. The following assumptions could be made:

1. That all reserves recorded prior to the adoption of IFRS were realised and so distributable. Although there are reasons why this need not be true, it is undoubtedly the case that the proportion of unrealised to realised reserves has increased since the adoption of IFRS, and so this could be used as a working assumption. For these purposes, and given that IFRS was generally adopted from 2005 onwards, this means that reserves as shown on the group consolidated accounts published for financial periods ending in 2004 should be assumed to have been realised.

2. Dividends and other distributions paid since 2004 have all been distributed out of realised profits. Unless there is very strong evidence to the contrary it might be reasonable to assume that companies have acted legally.

3. Companies should be able to differentiate the recorded movements on retained reserves as recorded on the group consolidated balance sheet during the period when they are required to have retained accounting records i.e., from at least 2015 onwards.

4. During the intervening period, from 2005 to 2014 a number of matching rules will have to be used. It is suggested that these are as follows:

    i. That all dividends and distributions will have been paid out of the earliest recorded reserves available for this purpose i.e. given the assumption already made dividends and distributions will in the first instance be matched against those reserves recorded on the group consolidated financial statements for the financial period ending in 2004 before they are then offset against reserves recorded arising after that date until all distributions arising during the course of this period have been matched. There should be a residual figure for reserves arising prior to 2015 available at the end of this calculation;

    ii. If distributions in the period from 2015 onwards exceed those realised reserves now identified as available for this purpose arising during that same period then that excess shall be carried back against any residual sum of reserves calculated for the period from 2005 to 2014 on the basis noted in the previous paragraph;

    iii. There will at the conclusion of this exercise be three potential remaining figures for reserves:

        - Reserves arising from periods before 2015 which cannot determined with certainty to be either realised or unrealised;
        - Realised reserves arising since 2015;
        - Unrealised reserves arising since 2015.

The treatment of the figures arising since 2015 is clear: they should be recorded upon the group consolidated balance sheet in the category that investigation has shown to be appropriate.

The problem arises with the residual figure for reserves relating to periods prior to 2015. In the absence of alternative evidence it is suggested that a prudent approach is required to the categorisation of these reserves. In accordance with the assumptions already made, if any can be shown to relate to periods prior to 2005 then it would be appropriate to assume them to be realised. Otherwise, and prudently, it would seem that these reserves should be considered unrealised in the interests of protecting the creditors of the company, which is the whole intention of legislation in this area.

Because of this pragmatic approach to grandfathering reserves it is possible that a presentation of reserve split between those that are realised and unrealised could be made up on any balance sheet, and that auditors could, based on the assumptions made, declare them to be true and fair. Henceforward, the categorisation could be made annually.

There is, however, a conceptual difficulty with this approach. Section 386 of the Companies Act 2006 says:

> *Duty to keep accounting records*
>
> 1. *Every company must keep adequate accounting records.*
> 2. *Adequate accounting records means records that are sufficient—*
>   a. *to show and explain the company's transactions,*
>   b. *to disclose with reasonable accuracy, at any time, the financial position of the company at that time, and*
>   c. *to enable the directors to ensure that any accounts required to be prepared comply with the requirements of this Act*
> 3. *Accounting records must, in particular, contain—*
>   a. *entries from day to day of all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place, and*
>   b. *a record of the assets and liabilities of the company.*

The sum estimated on the basis of the assumptions noted in this section is unlikely to comply with this rather basic accounting demand that underpins all aspects of accounting required by that Act. In particular:

a. Estimation of a sum that is particularly required to be known by the Act is unlikely to meet the criteria for being an adequate accounting record;

b. The preparation of an estimate of this sort is unlikely to meet the requirement that reasonably accurate disclosure be made;

c. Given the significance of realised reserves, and the specific references made to them within the Act that must require that the directors and auditors be aware of the truth and accuracy of the disclosure in question there must be doubt as to whether an estimate of the sort made ensures that the directors would have complied with the Act by using an estimate of the sort noted;

d. This opinion is reinforced by the specificity of the provisions of subsection 3.

in that case it could be suggested that the use of such an estimate would represent a failure to keep proper books and records contrary to the requirements of the Act. As a result another method of calculation might be considered desirable.

Reporting distributable reserves per subsidiary

An alternative method for estimating the realised distributable reserves available within the group might be based upon a calculation that takes into consideration the situation of each of the subsidiary entities that make up that group at the time that reporting first takes place. The method might be as follows:

1. The group would have to publish an organisation plan for the all the entities that make up the group at the date of consolidation. This plan would show, in patterns consistent with recommendations in the White Paper:
    a. The name of each subsidiary entity;
    b. The country of that entity's incorporation and the location in which it actually trades, if different;
    c. The means by which control is recognised e.g. by percentage shareholding or by entitlement to appoint representatives to its board;
    d. That percentage part of the entity which is considered to be controlled both by the immediate parent company of the entity question and by the group as a whole;
    e. The reserves of the entity split between:
        i. Those arising prior to acquisition;
        ii. Those arising since acquisition which remain unrealised;
        iii. Those realised since acquisition, less distributions made.

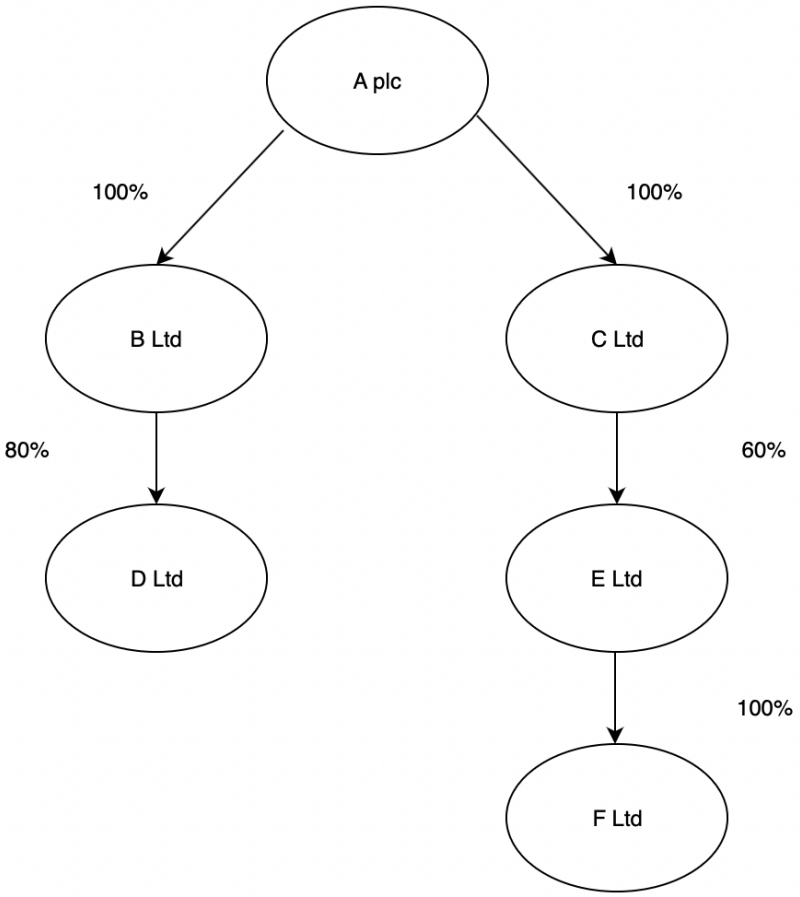
2. This plan will need to be organised hierarchically. What that means is that the layers of control that can be exercised by a group parent company over its subsidiaries must be demonstrated through the tiers of sub-parent companies that must coordinate their action to deliver control of any particular subsidiary. Critically, what this will also show is the route through which any distributable reserves must pass before they reach the group parent company which is the only entity which has the legal right to distribute them to the external shareholders of the group as a whole.

An example might be useful for the purposes of demonstration. Suppose that:

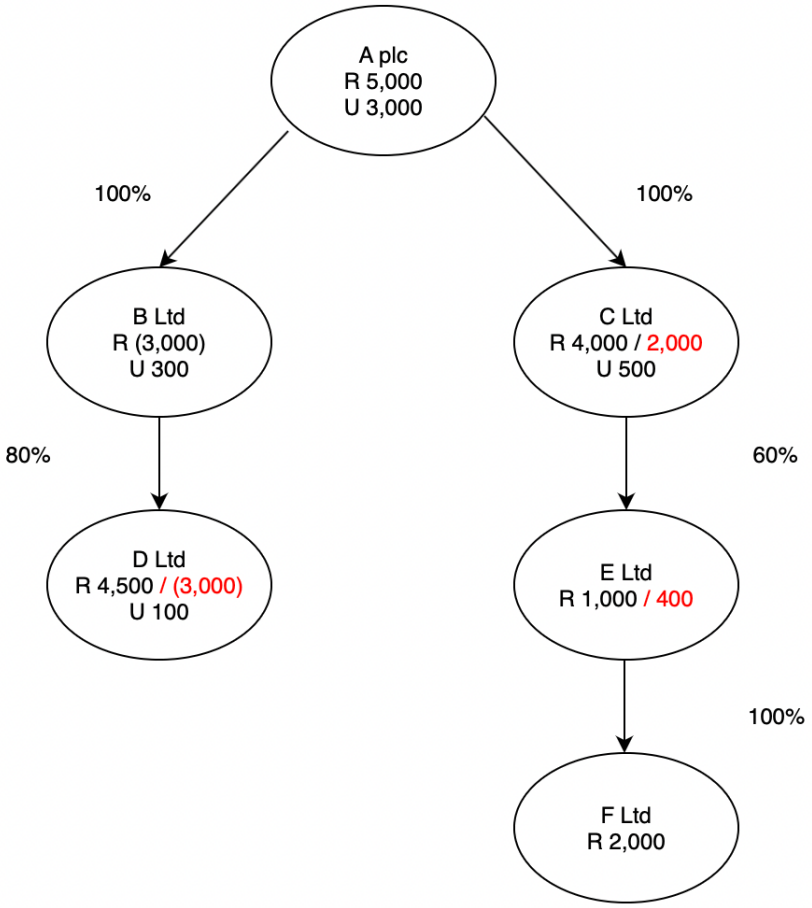
a. A plc is A group parent company;
b. A plc 100% owns two subsidiary entities, B Ltd and C Ltd.
c. B Ltd has one subsidiary, D Limited. It controls 80% of D Ltd.
d. C Ltd controls 60% of E Ltd which in turn controls 100% of F Ltd.

All the companies are Incorporated in the UK, and all have their trades based there.

The group organisation chart is as follows:



Now suppose that the reserves of the various group entities are added to the chart as follows:



Figures in brackets are negative sums. Figures in red are pre-acquisition reserves. R refers to a realised reserve and U to an unrealised sum

The distributable reserves are now calculated as follows, working from the bottom up (which is why this is described as a bottom-up methodology):

Company	Basis of calculation	Realised	Unrealised	Realised available to group	Unrealised available to group
F Ltd	2,000 realised reserves without restriction applying of which 60% can be distributed to the group via E Ltd	2,000	0	1,200	0
E Ltd	600 post acquisition realised reserves * 60%	600	0	360	0

C Ltd	2,000 post acquisition reserves	4,000	500	2,000	500
D Limited	7,500 post acquisition reserves restricted to those that can be distributed legally by the company which are 4,500, restricted by 80% ownership stake and restricted by 3,000 of losses in B Limited which would have to be offset against any divided from D Ltd before it could be onward transmitted by that company to A plc.	4,500	100	600	80
B Ltd	3,000 of losses that must be offset before potential distributions of 3,600 from D Ltd could be onward distributed leaving no loss to recognise if reserves in D Ltd reflect the offset	(3,000)	300	0	300
Sub total		8,100	900	4,160	880
A plc	Per own accounts	5,000	3,000		
A plc	Per group accounts			9,160	3,880

Note that if there are any intra-group profits realised in subsidiaries which are still reflected within asset cost recorded in other group subsidiaries e.g., because of transfers of assets or because of unrealised stock transfer between group entities before final sale to a third-party customer, then these would still need elimination after the above calculation had taken place to ensure that group retained reserves were properly stated. This, however, should be a fairly straightforward exercise because the journals written within the accounting ledgers of the group consolidated entity to undertake this exercise should be readily identifiable, and auditable, and therefore the identification of the profits requiring elimination for this purpose should always be possible within that documentation on any occasion that an adjustment for this purpose is required and as such this is not an issue of concern.

Also note that it has been assumed that each of these companies can accurately differentiate realised and unrealised reserves without any of the problems noted in the preceding section arising i.e., without it being necessary to grandfather the reserves calculation for any of them. For the reasons noted in that preceding section, this may be an optimistic view to take. It may still be necessary to undertake such an exercise in group subsidiary companies where records cannot prove this split. In those cases it will be necessary to also take a prudent view of any reserves arising after 2005 where definitive records are not available, categorising any residual reserves as unrealised in this case. As a consequence it could be argued that some of the audit issues arising as noted in that previous section are replicated within this proposal but there are still reasons to think that this methodology is by far the best of those proposed. There are a number of reasons for saying so.

Firstly, this calculation has a granularity absent in its entirety from the previously proposed methods. Those methods only seek to adjust figures in the group consolidated accounts, which are themselves actually outside the books and records that are maintained for the purposes of recording the transactions undertaken by any individual entity within the group. This is important: the obligation to keep books and records is imposed at a subsidiary and not at a group consolidated level. Consequently, this bottom-up methodology reflects the requirements of law.

Secondly, it is very likely that the calculations undertaken will be more accurate if undertaken on the basis of reserves available to individual subsidiaries. The number of entities where grandfathering may be required will be considerably reduced as a consequence.

Thirdly, because group consolidation journals for each entity should retain precise information as to the pre-acquisition reserves to be eliminated on consolidation it is likely that any adjustment required for this reason will be considerably more accurately undertaken if done at a subsidiary level.

Fourthly, calculation on this basis is very much more likely to indicate those reserves in subsidiary companies which should be eliminated from consideration from a group perspective because the opportunity to distribute them to the group parent company is not available because of the nature of their intermediate holding company's reserves, as the example indicates.

Fifth, if prudence is required as a consequence of a grandfathering estimate then management will know where this is necessary, and what potential dividend flows are impacted.

Sixth, and perhaps most importantly, given that it is a legal requirement that UK companies disclose all their subsidiary entities, if this data was to be published in the audited accounts, which only slightly extends that information currently required to be available, those who are seeking to determine the potential value of future dividend streams from a company as the basis for its valuation, which is what economic theories suggest that they should do, will have the information necessary for this purpose readily available to them. Whilst future dividend streams are not necessarily based solely on past performance, the availability of retained reserves can have a significant impact on the sustainability of those dividend streams during periods of economic stress, and knowledge of that capacity to pay is, therefore, critical to the process of valuation that rational investors should undertake when considering any investment. The provision of this information to them is, therefore, a matter of significance. We would, for example, expect simpler group structures to result from the proposals that we make as by adding an audit cost it would disincentivise overly complex corporate structures. This would have all significant benefits including greater transparency, and a possible reduction in tax avoidance.

Having said all this, it would also be necessary to note those items additionally eliminated on consolidation (over and above those relating to pre-acquisition reserves, which have already been identified in the calculation noted) but it likely that these will be of less significance in the estimation of the value of future potential dividend streams then the information noted above.

Conclusion

This note was prepared in response to the view that it is too complicated for UK PIEs to prepare realistic estimates of their likely realised and unrealised retained reserves at group level. The alternative – that we continue with the existing system for identifying distributable reserves proposed by the ICAEW (2017), wherein the retained reserves of the group parent entity prepared on an individual company basis represent the realised distributable reserves of the group – is, in our view incompatible with existing company law and leads to the risks outlined in our sister paper with which this note is submitted.

It is our suggestion that the last of our proposals, which is a bottom-up calculation of available realised reserves undertaken on a subsidiary-by-subsidiary basis, including our suggestions for related disclosures, should be the basis on which definitions of distributable reserves progress. This is because it is this proposal above all others that supplies the core stakeholders of a public interest entity, as identified by the International Financial Reporting Standards Foundation (2018), with the information they require to properly appraise the likely potential future income stream that they might enjoy because of their ownership of

shares issued by that public interest entity. It is that congruence with the existing aims of IFRS that is at the heart of this suggestion.

References

ICAEW. 2017. *Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006.* London: The Institute of Chartered Accountants in England and Wales available from https://www.icaew.com/-/media/corporate/files/technical/technical-releases/legal-and-regulatory/tech-02-10-guidance-on-realised-and-distributable-profits-under-the-companies-act-2006.ashx

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