Financial Reporting LAB

Lab implementation study:

Disclosure of dividends – policy and practice

December 2016

FRC Financial Reporting Council

Introduction

The objective of this report is to examine how companies have responded to investor calls for better disclosure of dividends, as highlighted in the Financial Reporting Lab's (Lab) project report.

This report comprises four areas:

- A summary of the findings from the '*Disclosure of dividends - policy and practice'* report;
- How practice is changing based on the Lab's review of dividend disclosures in annual reports published between December 2015 and July 2016;
- Examples of good practice; and
- Areas for further improvement.

Summary of project report

In November 2015, the Financial Reporting Lab published a report *'Disclosure of dividends – policy and practice'.*

The project involved input from **19** companies and **31** investment organisations. The report recommends enhancements to dividend policy and dividend practice disclosures.

Dividend policy disclosures - Lab project participants identify good disclosure as providing:

- an understanding of the board's considerations in setting the policy,
- the rationale for the approach selected, and
- sufficient detail to understand how the policy will operate.

Dividend practice disclosures - Lab project participants identify good disclosure as including:

- the key judgements and constraints considered by the board in applying the dividend policy,
- the availability of dividend resources (cash and distributable profits) to pay dividends, and
- clear linkage from the disclosed policy to the application of the policy in the period.

Bringing together various elements of disclosure to provide a focused narrative is helpful to investors.

Summary of project report

Dividend resources

An area of particular interest to investors is the availability of resources needed to pay a sustainable dividend stream. Investors highlight that, they:

- consider that disclosure of dividend resources (cash and distributable profits) is useful.
- consider the information particularly relevant in circumstances where the ability of the company to pay dividends is, or might be, constrained.
- suggest a range of disclosure reflecting overall position of the company, they describe the following scenarios where dividend resources of the parent may be: ‘Abundant’, ‘Sufficient’ or ‘Insufficient’. The Lab produced the following aide which companies might like to use when considering relevant disclosure.

Summary of project report – Dividend resources aide

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
Cash	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.
Distributable profits	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: distribution 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:

What	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.
Where	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).
How	Narrative disclosure which gives insight into the group's processes around moving cash and/or generating distributable profits at the parent company level.

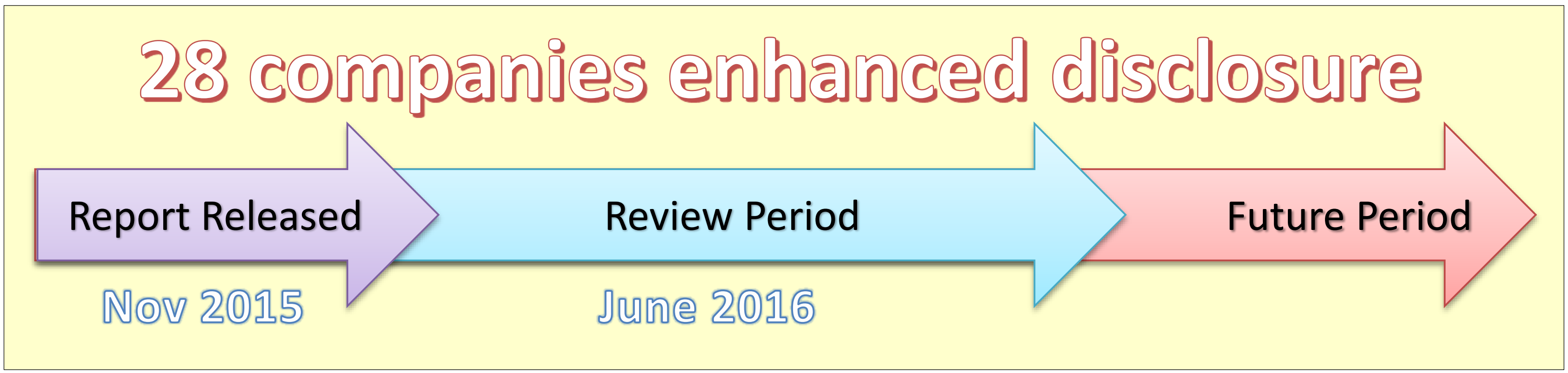
How practice is changing

Scope of the review

In Summer 2016 the Lab undertook a review of FTSE 350 dividend disclosures to assesses how practice changed following our November 2015 report.

In order to identify change the Lab used key search terms to indicate development in company disclosures between December 2015 and July 2016.

177 companies published their annual reports in the scope period, our key term search identified 120 annual reports for detailed review, of which the Lab noted enhancements in reporting from 28 companies.



How practice is changing

Key areas where companies enhanced disclosure include examples that:

1. explain the details of the dividend policy and how it is intended to operate (11 companies);
2. add context on factors considered in adopting the policy with some including the approach to capital management (4 companies);
3. explain the relevance of dividend resources (16 companies) by:
    I. providing a distributable profits figure for the parent company, or;
    II. confirming the sufficiency of distributable profits (and for some cash) for dividends, or;
    III. providing insight on availability of distributable profits at the level of significant operations below the parent;
4. bring together disclosure related to dividends (1 company).

Examples of good practice - disclosure that details the policy and provides insight into factors relevant to the setting of the dividend

Dividend policy

The Group has a progressive dividend policy which aims to increase the dividend each year broadly in line with the growth in underlying earnings per share. The Board has adopted this baseline policy in order to align shareholder returns with the underlying growth achieved in the profitability of the business. This policy has seen the Group deliver 15 years of successive dividend growth since the formation of the Company in 1999.

In determining the level of dividend in any year in accordance with the policy, the Board also considers a number of other factors that influence the proposed dividend, which include but are not limited to:

- the level of available distributable reserves in the Parent Company;
- future cash commitments and investment needs to sustain the long-term growth prospects of the business; and
- the level of dividend cover.

Carillion plc, the Parent Company of the Group, is a non-trading investment holding company which derives its distributable reserves from dividends paid by subsidiary companies. The Board reviews the level of distributable reserves in the Parent Company bi-annually, to align with the proposed interim and final dividend payment dates, and aims to maintain distributable reserves that provide adequate cover for dividend payments. The distributable reserves of the Parent Company approximate to the balance on the profit and loss account reserve, which at 31 December 2015 amounted to £296.6 million (as disclosed in the Company balance sheet on page 123).

The Group is well positioned to continue to fund its dividend which continues to be well covered by cash generated by the business. Furthermore, with around £1.4 billion of funding available to support our strategy and objectives, of which only £131 million matures before the end of 2018, the Group is also well positioned to support its strategy for growth. Further details on the Group's funding position can be found on page 39 and details on its continuing viability and going concern can be found on pages 27 and 40.

The ability of the Board to maintain future dividend policy will be influenced by a number of the principal risks identified on pages 28 to 31 that could adversely impact the performance of the Group. The risks that could specifically have an adverse impact on the dividend policy include work-winning, contract management, pension liabilities, new markets and services and low oil prices, although we believe we have the ability to mitigate those risks as outlined on pages 28 to 31.

<u>What is useful</u>

Carillion describe what progressive means in the perspective of the company and give some historical context.

Carillion note the factors and risks the board consider in setting the policy.

Carillion discuss the dividend resources; distributable reserves and cash resources available to support the dividend.

Carillion plc Annual Report and Accounts 2015

Examples of good practice - disclosure which provides information on dividend resources

Drax Group plc
Annual report and accounts 2015

Distributable profits

The capacity of the Group to make dividend payments is primarily determined by the availability of retained distributable profits and cash resources.

The immediate cash resources of the Group are set out in note 4.2 and the recent history of cash generation within note 4.5. The majority of these cash resources are held by the principal operating subsidiaries of the Group, in particular Drax Power Limited.

The Parent Company financial statements, set out on pages 146 to 151 of this report, disclose the Parent Company's distributable reserves of £222 million. Following a reorganisation of the subsidiary companies undertaken during the year (described in note 4 to the Parent Company financial statements) the wider Group has, relative to previous dividend payments (note 2.7), sufficient retained profits available for future distributions in accordance with the Group divided policy.

What is useful

Drax provide a link through to disclosures around availability of cash within the group, and provides an indication of where the cash resources sit.

Drax disclose the value of distributable reserves within the parent and provide a statement relating to availability of distributable reserves within the wider group.

Examples of good practice - disclosure which confirm sufficiency and availability of distributable reserves, narratively

SIG plc Annual Report and Accounts for the year ended 31 December 2015

DIVIDENDS

The Board is committed to a progressive dividend policy while maintaining a dividend cover of 2x–3x (on an underlying basis) over the medium term. SIG continued to increase its dividend payments in 2015 with an interim dividend of 1.69p per share (2014: 1.42p). SIG has proposed a final dividend of 2.91p per share (2014: 2.98p), taking the 2015 full year dividend to 4.60p per share (2014: 4.40p), representing a 4.5% increase in total dividend year on year. A total dividend of 4.60p represents a dividend cover of 2.43x in 2015 on an underlying basis.

The Company has sufficient distributable reserves to pay dividends for a number of years, and when required the Company can receive dividends from its subsidiaries to further increase distributable reserves.

What is useful

SIG shows how the current year dividend relates to their policy.

SIG confirm succinctly the sufficiency of distributable reserves, giving some perspective on forward availability and the source of reserves.

Examples of good practice - disclosure which brings relevant dividend information together


UNITED UTILITIES GROUP PLC ANNUAL REPORT AND FINANCIAL STATEMENTS 2016

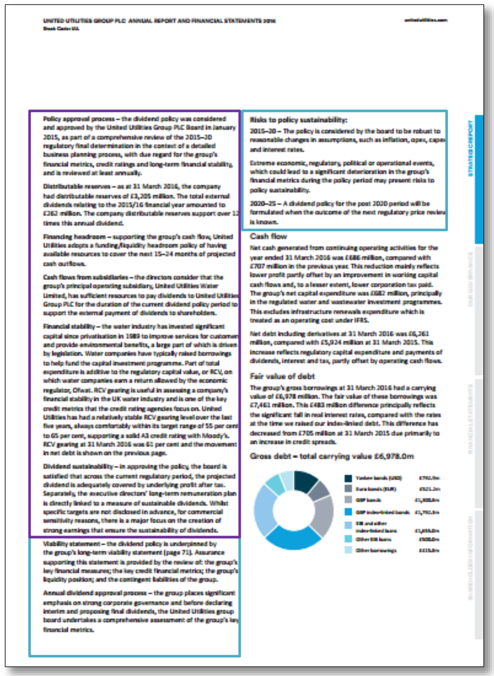
Our performance 2015/16

Earnings per share

Dividend per share

Profit after tax

Summary of net debt movement


UNITED UTILITIES GROUP PLC ANNUAL REPORT AND FINANCIAL STATEMENTS 2016

Cash flow

Fair value of debt

What is useful

United Utilities have introduced a comprehensive section which brings key aspects of disclosure about dividends together. The disclosure covers:

- The nature of the policy
- The approval process
- The level of distributable reserves
- The flow of cash from subsidiaries
- The sustainability of the dividend; and,
- The risks to the dividend policy.

NB: The relevant text extracts are enlarged on the next page.

Examples of good practice - disclosure which brings relevant dividend information together

Dividend per share

The board has proposed a final dividend of 25.64 pence per ordinary share in respect of the year ended 31 March 2016. Taken together with the interim dividend of 12.81 pence per ordinary share, paid in February, this produces a total dividend per ordinary share for 2015/16 of 38.45 pence. This is an increase of 2.0 per cent, compared with the dividend relating to last year, in line with the group's dividend policy of targeting a growth rate of at least RPI inflation each year through to 2020. The inflationary increase of 2.0 per cent is based on the RPI element included within the allowed regulated revenue increase for the 2015/16 financial year (i.e. the movement in RPI between November 2013 and November 2014).

The final dividend is expected to be paid on 1 August 2016 to shareholders on the register at the close of business on 24 June 2016. The ex dividend date is 23 June 2016.

In light of the Financial Reporting Lab's recent report entitled 'Disclosure of dividends – policy and practice' which provided best practice guidance, we have enhanced our dividend policy disclosure as outlined below.

Dividend policy – a growth rate target of at least RPI inflation each year through to 2020.

Policy period – the dividend policy aligns with the five-year regulatory period which runs from 1 April 2015 to 31 March 2020.

Policy approval process – the dividend policy was considered and approved by the United Utilities Group PLC Board in January 2015, as part of a comprehensive review of the 2015–20 regulatory final determination in the context of a detailed business planning process, with due regard for the group's financial metrics, credit ratings and long-term financial stability, and is reviewed at least annually.

Distributable reserves – as at 31 March 2016, the company had distributable reserves of £3,205 million. The total external dividends relating to the 2015/16 financial year amounted to £262 million. The company distributable reserves support over 12 times this annual dividend.

Financing headroom – supporting the group's cash flow, United Utilities adopts a funding/liquidity headroom policy of having available resources to cover the next 15–24 months of projected cash outflows.

Cash flows from subsidiaries – the directors consider that the group's principal operating subsidiary, United Utilities Water Limited, has sufficient resources to pay dividends to United Utilities Group PLC for the duration of the current dividend policy period to support the external payment of dividends to shareholders.

Financial stability – the water industry has invested significant capital since privatisation in 1989 to improve services for customers and provide environmental benefits, a large part of which is driven by legislation. Water companies have typically raised borrowings to help fund the capital investment programme. Part of total expenditure is additive to the regulatory capital value, or RCV, on which water companies earn a return allowed by the economic regulator, Ofwat. RCV gearing is useful in assessing a company's financial stability in the UK water industry and is one of the key credit metrics that the credit rating agencies focus on. United Utilities has had a relatively stable RCV gearing level over the last five years, always comfortably within its target range of 55 per cent to 65 per cent, supporting a solid A3 credit rating with Moody's. RCV gearing at 31 March 2016 was 61 per cent and the movement in net debt is shown on the previous page.

Dividend sustainability – in approving the policy, the board is satisfied that across the current regulatory period, the projected dividend is adequately covered by underlying profit after tax. Separately, the executive directors' long-term remuneration plan is directly linked to a measure of sustainable dividends. Whilst specific targets are not disclosed in advance, for commercial sensitivity reasons, there is a major focus on the creation of strong earnings that ensure the sustainability of dividends.

Viability statement – the dividend policy is underpinned by the group's long-term viability statement (page 71). Assurance supporting this statement is provided by the review of: the group's key financial measures; the key credit financial metrics; the group's liquidity position; and the contingent liabilities of the group.

Annual dividend approval process – the group places significant emphasis on strong corporate governance and before declaring interim and proposing final dividends, the United Utilities group board undertakes a comprehensive assessment of the group's key financial metrics.

Risks to policy sustainability:

2015–20 – The policy is considered by the board to be robust to reasonable changes in assumptions, such as inflation, opex, capex and interest rates.

Extreme economic, regulatory, political or operational events, which could lead to a significant deterioration in the group's financial metrics during the policy period may present risks to policy sustainability.

2020–25 – A dividend policy for the post 2020 period will be formulated when the outcome of the next regulatory price review is known.

Areas for further improvement

The Lab is encouraged by the improvements made by the 28 companies identified in this study. However, there remain a large number of companies who might benefit from implementing the Lab’s findings, improving their communication with investors. We hope more companies improve their disclosure in the coming reporting season.

The study notes that improvements identified often focus on additional disclosure around distributable profits; however, enhancements in the following areas would also be welcomed by investors:

- more detailed disclosure of how dividend policies operate in practice, with more clarity on factors considered in both the setting of the policy and in dividend declaration; and
- disclosure of risks and constraints where they impact dividend policy and declaration decisions (especially pertinent to concerns around pension deficits, the potential impact of Brexit and other factors that may have a bearing on capital management decisions).

Published reports

Financial Reporting:

- Business model reporting
- Accounting policies and integration of related financial information
- William Hill plc – accounting policies case study
- Debt terms and maturity tables
- Net debt reconciliations
- Operating and investing cash flows
- Presentation of market risk disclosures

Governance:

- Reporting of Audit Committees
- A single figure for remuneration
- Reporting of pay and performance

Thematic:

- Corporate reporting in a Digital World - Digital present
- Towards Clear & Concise Reporting
- Disclosure of dividends – policy and practice

Reports and information about the Lab can be found at:

https://www.frc.org.uk/Lab

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