How hollowed-out firms manufacture their distributable profits

Adam Leaver and Richard Murphy

February 2020

To be published by Centre for Research into Accounting and Finance in Context (CRAFiC), University of Sheffield

---

1. Introduction

The 'hollowed-out firm' has been identified as a significant social and economic problem (Baker et al 2020). Hollow firms[1] have a number of common characteristics, of which three, are key: high levels of dividends and buybacks which, in many cases exceed earnings; the growth of low-prime debt on the balance sheet, which risks being downgraded to junk; and a build-up of 'fair valued' assets, including intangible assets such as goodwill, which are vulnerable to write downs that could push firms into negative shareholder equity. Many firms now face a perfect storm: the prospect of realising fair value impairments on top of their operating losses whilst also trying to find liquidity from the capital markets just as company credit ratings fall and equity markets dry up.

Hollowed-out firms highlight the extraordinary disregard of the basic principles of financial resilience that emerged as the 2010s progressed. This is of real concern since many such entities are what are now commonly called Public Interest Entities (PIE)[2] – i.e. companies with shares quoted on stock exchanges, or that engage in banking, credit and insurance activities, plus those additional entities deemed to be PIEs by government because of their public significance. As a result, many hollowed-out forms are now integral to the management of national economies.

The processes by which firms are hollowed out are usually to be located in the arcana of creative accounting. This may involve the exploitation of the rules on what might represent distributable profits (Leaver and Murphy 2021), or the exploitation of revenue recognition and fair value rules

---

[1] In this note the term 'firm' refers to commercial activities undertaken in pursuit of profit in the course of a trade, whatever that trade might be. In general, the term is used to refer to the activities of a group as a whole i.e. the firm is considered to be the sum total of the activities undertaken by all the entities making up a group as represented in the consolidated financial statements that it produces annually for the benefit of its shareholders and published on public record. In contrast the term company is used to refer to a particular legal entity within that group, whether or not its activities contribute to the overall result of the firm as a whole, or not. This differentiation is of particular significance in the case of the group parent company i.e. that legal entity that acts as the legal owner, whether directly or indirectly, of all those other entities that are together grouped together to undertake the trading activities of the firm. This particular company is possessed of a dual personality: it is both a constituent member of the firm, where its trading activities might, in practice, be insignificant, but it is also a legal company undertaking activity in its own right quite distinct from the firm as a whole, and therefore capable of recording a profit or loss independent of that which the firm might recognise, largely as a consequence of the income that it does, or does not (at the discretion of the firm's directors) enjoy as a consequence of the distribution of profits to it by the subsidiary entities that it controls.

[2] PIEs are defined in EU law, See https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0196.01.ENG

(Baker et al 2020). In Baker et al (2020) we raised the idea that some of the accounting techniques conventionally understood as tax planning practices may – in fact – be used to maximise distributable reserves through other means. In this note we explore the potential role played by what is known as 'transfer pricing' (Eden 1998) in maximising distributable reserves. Examples of how this abuse might work, and what the consequences might be are provided before conclusions are drawn and recommendations for the steps required to both verify this possible abuse and to prevent its recurrence are made.

2. Background

As we have argued previously, firms which pursue aggressive shareholder value-oriented strategies prioritise the maximisation of 'distributable reserves' and not necessarily profit (Baker et al 2020; Leaver et al forthcoming). Distributable reserves place a legal limit on what can be distributed to shareholders, but are normally calculated as the retained earnings or profit and loss reserve of the parent company and not that of the consolidated group entity. This principle is enshrined in the 2006 Companies Act as elaborated in the guidance issued by the Institute of Chartered Accountants in England and Wales (ICAEW 2017). The consequence is that it is likely that the directors of firms seeking to maximise returns to the shareholders of the parent company will pay particular attention to the reporting of retained earnings on the parent balance sheet, and not that of the consolidated group entity that represents the firm as a whole.

There are significant consequences to this confusing duality in accounting. In particular, it may foster (broadly legal) forms of creative accounting and financial engineering. We are aware, for example, that there are many firms where the distributable retained reserves of the parent company are substantially greater than those of the group as a whole as shown by its consolidated accounts. This can lead to outcomes which appear perverse to the lay person, most especially when it appears firms are able to pay out more in dividends and share repurchases than they generate in net income. In the accounting year before Covid-19 our research shows that 37% of S&P 500 firms distributed more via dividends and share buybacks than they generated in group net income; the equivalent figures for the FTSE100 and S&P Europe 350 were 28% and 29% respectively.

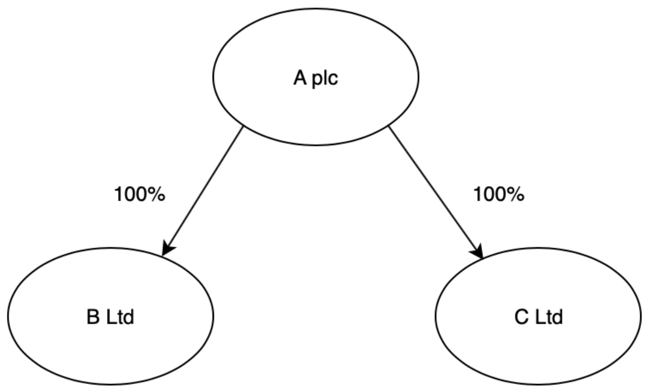
To explain these outcomes we need a sharper understanding of the legal interaction between that parent company and the subsidiary entities it controls. In particular, it requires that we look at the generation of profit 'overloads' in the subsidiary network which allow individual entities within a group to pay large dividends to their parent company, providing directors with the opportunity to generate realised reserves available for distribution from that parent company that are higher than the retained earnings of the consolidated group.

3. The generation of realised profits for distribution

Identifying the mechanisms through which firms create large discrepancies between group and parent reserves is difficult in a context where subsidiaries can submit micro-accounts with minimal disclosure obligations in the UK, and no accounts at all in some other jurisdictions. The lack of transparency is also exacerbated by the fact that the relationships between entities within the wider corporate network are hidden, and that intra-group trading generally does not need to be disclosed because it is treated as if it is not a related party transaction. There is thus always an element of speculation in working out what is happening and why when forensically examining a firm. We therefore prefer to use hypotheticals and simple schemas to illustrate what we *think* is happening and which would explain the outcomes we observe – namely the discrepancy between group and parent reserves, which allow firms to pay out more dividends or buybacks than their consolidated position might suggest would be prudent. These schemas are kept simple for ease of understanding and are designed to illustrate a process rather than describe any real-life example.

As a precursor - we have previously discussed how available profits for distribution can be generated via fair value revaluations within the subsidiary network (Baker et al 2020). This trend appears to be associated with higher degrees of leverage (Leaver and Murphy 2020). There is, however, another way we believe realised profits for distribution can be generated, which is by transfer mispricing.

To demonstrate this possibility, presume that there is a group parent company of a firm, called A plc. A plc has two subsidiaries. B Ltd sells the products that the group creates, and C Limited manufactures them. This is the group structure:



A plc does not trade. It is a holding, and if necessary, borrowing company.

Now suppose C Limited makes product that costs £100 million to make which it sells to B Limited for £80 million, which B Limited then sells to third party customers for £110 million. These are the only transactions of the firm for the year. These figures are intentionally exaggerated for the sake of example.

As a result, and assuming no tax, B Limited has retained reserves of £30 billion at the end of the year. A plc, acting as parent of the firm, has retained reserves of £10 million in its consolidated accounts, and C Limited has retained losses of £20 million, all stated before dividends are taken into account. Assume that no company had reserves brough forward.

Then assume that A plc borrows £20 million which it in turn lends to C Limited, leaving B Limited with funds to match its supposed retained reserves having settled the price charged by C Limited. The £30 million of funds in B Limited are then used to pay a dividend to A plc, acting as the group parent company, and A plc in turn then pays a dividend of equivalent value to its shareholders. A plc can do this because the dividend received from B Limited will then constitute its sole distributable reserves in its capacity as a parent company, and not as a group entity.

As a consequence, B Limited and A plc (as a parent company) have no reserves, and the group has negative reserves of £20 billion, as does C limited. Yet dividends have been paid legally even though they are in excess of real profits arising because the reserves in A plc, acting as a parent company, are recognised as realised and distributable despite the fact that most of the retained reserves used to manufacture that dividend arose as a result of the use of we what we might think of as *transfer mispricing*.

This has implications for consolidated group and parent company positions. The consolidated accounting required of the firm demands that both profits and losses within the firm be taken into account when determining the realised reserves of the group. However, this is not the case within the group parent entity. Given that parent companies are effectively a container for dividends paid to them by their subsidiaries, with few ever trading in their own right, their realised reserves are determined by the level of dividend paid to them by the subsidiary entities they control. Since the ability to pay a dividend out of realised reserves is determined independently for each such subsidiary, that capacity to pay a dividend is determined by their own accounting, treated in isolation. A company that does not have realised reserves cannot, of course, pay a dividend. The consequence is that C Ltd can be ignored by A plc in its role as group parent company, so letting it make payment of excessive distributions[3].

Within this very simple schema, the ownership relations and the ordering of the income flow between the different entities is important. For example, since both B Ltd and C Ltd are direct subsidiaries of A plc, B Ltd is able to distribute its excess realised distributable reserves to A plc, acting in its capacity as group parent company, irrespective of C Ltd having realised losses. This would also remain true if B Ltd owned C Ltd. However, if C Ltd owned B Ltd then the £30 million dividend from B Ltd would have to be paid to C Ltd before it could be onward transmitted to A plc, but within C Ltd that dividend received would be diluted by C Ltd's retained losses, reducing the capacity of C Ltd to pay a dividend to A plc to £10 million, which would be the retained reserves of the firm. Group structure is thus critical to the successful delivery of this technique of creating realised reserves in parent companies through transfer mispricing for the purposes of making dividend and share buyback distributions in excess of group profits.

It is important to note that this transfer mispricing might have to be adjusted for tax purposes to ensure that the tax liabilities of the companies (and so firm) are correctly stated across both national and international boundaries. But this does not alter the effectiveness of this strategy for the

[3] It could be argued that this example would be wrong if C Ltd had been acquired by A plc with goodwill being recognised on acquisition. In that case it would be reasonable to assume that the losses that C Ltd is making would impair the value of that goodwill. However, there is no reason why either B Ltd or C Ltd need have been acquired as going concerns by A plc for the noted scheme to work. Both could have been incorporated by it with minimal capital with the intention of bifurcating the trade to achieve the noted outcome. In fact, observation would suggest that most subsidiaries appear to be held at cost and a great many subsidiaries are not the product of merger and acquisition activity and so have practically no value attached to them anyway, meaning that the example used is appropriate and indicative of what might happen in practice.

purposes of corporate profit reporting. A tax adjustment need not be reflected in an accounting adjustment[4]. Directors of companies, including those that are part of larger firms, can make 'bad bargains' that result in losses, and so long as their accounts properly reflect the bad bargains they have made, their accounts are true and fair under current law. The consequence is that the realised profits of the parent company may exceed that of the consolidated group as a result of transfer mispricing and that outcome would be entirely legal under existing rules.

4. Transparency and disclosure

Another issue of concern when considering this issue is that subsidiary entities used for this purpose often have their accounts prepared under differing generally accepted accounting principles from those used for the parent entity of the group. Hence, much of what we describe above is largely hidden from view in the accounts of the subsidiaries involved. For example, the UK's Financial Reporting Standard 102, which is the alternative generally accepted accounting principle most likely to apply in this situation to a UK subsidiary company of a parent entity that for group accounting purposes uses International Financial Reporting Standards merely requires[5] that the subsidiary provide 'a reconciliation between (i) the tax expense (income) included in profit or loss; and (ii) the profit or loss on ordinary activities before tax multiplied by the applicable tax rate.' This reconciliation need not be provided in detail and the language used is often vague, and non-descriptive, with the term 'other items' or 'other adjustments' frequently appearing, meaning that no effective disclosure is made. In that case transfer pricing adjustments for tax purposes that might disclose that activity of the sort described is taking place can very often be hidden from view within accounting disclosures made.

The creation of realisable profits available for distribution to shareholders at rates in excess of the earning capacity of the consolidated group is, in this case, easy to achieve. All that is required to fulfil that goal is a capacity to borrow, and most large firms have that. The ability to bifurcate profits to create a small number of very profitable subsidiaries, in a context of cheap debt and unchallenging auditors are the conditions which allow hollowed-out firms to thrive. In the good times their presence may go unnoticed. But when the market turns down and state subvention is withdrawn, as is now likely, many problems will reveal themselves.

5. The consequences of artificial realised profit generation

Our schematic example shows how transfer mispricing can be used to create profit overloads in individual subsidiary companies, allowing them to pay dividends to parent companies which create distributable reserves in excess of the retained earnings of the consolidated group. This relatively simple schema demonstrates how easy it is to manipulate the reported capacity of a group of companies to pay dividends within the existing legal framework. This framework is no longer fit for

[4] See, for example, page 804 here https://www.pwc.com/gx/en/international-transfer-pricing/assets/united-kingdom.pdf
[5] See paragraph 29.27 here https://www.frc.org.uk/getattachment/69f7d814-c806-4ccc-b451-aba50d6e8de2/FRS-102-FRS-applicable-in-the-UK-and-Republic-of-Ireland-(March-2018).pdf

purpose: it incentivises what Jim Chanos has called 'legal fraud'[6]. And when management are remunerated in stock options on the basis of their ability to create shareholder value, they have both the incentive and the means to achieve this through the processes outlined above. The theory of shareholder primacy that usually informs the directors' reward, thus has the potential to create a different kind of moral hazard to that normally understood within agency theory arguments. A true and fair financial reporting system would provide the necessary disclosure to highlight these practices so that informed judgements could be formed as to their sustainability or otherwise.

It follows that if risks of this type exist then they should be made visible in reporting obligations and audited accordingly. However, existing frameworks of accounting and related disclosure requirements do not recognise this risk or encourage reporting with regard to it. As such the inherent risk of audit failure within existing accounting frameworks is significantly increased. We are aware that there are many companies, PIEs included, where the retained reserves as shown on the balance sheet of the group parent company are substantially different to, and almost invariably higher than, those shown on the balance sheet in the group consolidated accounts of the firm. It is our belief that all stakeholders might want to know why this situation has arisen and to know whether as a consequence the capacity that it implies for the group parent company to pay dividends in its own right in excess of the apparent capacity of the firm to do so prejudices the interests of creditors and other stakeholders of the firm who have interests in the group entity surviving as a going concern.

6. Conclusions and suggestions for further action

The risks posed by hollow-firms are significant as we move into a post-Covid world. We should thus strive for policies aimed at reducing the social harms that accompany them. A number of problems are highlighted by the example used.

The first is that the privileging of the consolidated group accounts in accounting and audit can detract from the activities of the parent company and its subsidiary network. We believe that there is very good reason as a consequence to secure information on the activities of the subsidiary companies of the patent entity, and to require disclosure of the way in which they are organised into the structure of the group.

Second, it is also apparent that to presume that the shareholders and other providers of capital to a firm are a single stakeholder group whose interests are aligned is also wrong: there is an inherent tension between providers of capital (as well as all other stakeholders). The needs that these differing perspectives give rise to need to be reflected in accounting.

---

[6] Section 2(1) of The Fraud Act 2006 says that 'A person is in breach of this section if he (a) dishonestly makes a false representation, and (b) intends, by making the representation (i) to make a gain for himself or another, or
(ii) to cause loss to another or to expose another to a risk of loss.' It could be argued that a director approving a dividend when they know that the firm for which they are responsible does not have realised reserves available for this purpose, and that it is dependent upon borrowed to make the payment that would otherwise not be possible might be committing a fraud on either the particular creditor that is the loan financier or the creditors in general under the terms of this provision. See https://www.legislation.gov.uk/ukpga/2006/35/section/2

Third, there is a pressing need for information that would allow all stakeholder groups to appraise whether the decisions of directors prejudice the capital base of the firm which ultimately sustains all stakeholder claims, both present and future. In that case the entire conceptual framework of the International Financial Reporting Standards Foundation, which conflates the interests of these groups, is based on a false premise (IFRS 2018, 1.2).

How might these issues be addressed? And how might evidence to address these needs be supplied?

In the first instance, and most obviously, a simple change to the rules determining the extent of distributable profits within group parent companies is required, so that these may not, whatever other accounting might imply, be used for the purposes of determining legal dividend and share buyback distributions that exceed the retained reserves of the firm as a whole as evidenced by its consolidated group accounts.

Second, for the purposes of ensuring that this requirement is complied with it must be required that disclosure be made of the retained reserves of the firm split between those that are realised, and therefore available for distribution to the members of the parent company by way of either divided or share buyback, and those that might not be realised e.g. because they arise as a result of fair value asset revaluations. Critically, any reserve that requires imputation of future valuation in its calculation should not be distributable.

Third, there remains the issue that ultimately the availability of realised reserves within the parent company does determine its capacity to make legal dividend payments. If the parent company has not had funds distributed to it by its subsidiary entities then even if the firm shows that such funds are available on its group consolidated financial statements a dividend may not be paid by the group parent company. This does in that case require that the accounts of the parent company acting in its own right (published as a part of, but distinct from the consolidated accounts of the firm as a whole for which it is responsible) must be always be made available, in full. In addition, it is important that disclosure of the name, place of incorporation, place of trading and trading activity of each of the subsidiaries of the group (without exception) be made available on the group website together with an organisation chart so that the manner in which the group [parent company might get to access the retained reserves of subsidiary companies might be understood.

Fourth, the directors of the firm should be required to state what their dividend policy might be, and how it might be considered sustainable given the constraints now imposed by the above suggestions. This review should make explicit the assumptions inherent within it, including on future group funding and the reasons why that policy has been adopted.

Fifth, it should be a requirement that the group's auditors to explicitly review and report on that statement, making clear whether they consider it, and the assumptions underpinning it, sustainable given the overall circumstances of the group.

Sixth, the auditors should be explicitly required to note that if the retained realised reserves of the parent company exceed those of the group as shown by the consolidated balance sheet then that excess if not distributable.

Finally, it should be required that disclosure be made of all the transfer pricing adjustments required of the group in the period to which the accounts relate with regard to past financial statements, with their cause being given, so that the risk of misstatement of current realisable reserves can be appraised based on past evidence supplied by third party tax authorities.

There exists significant risk that many of the dividends paid by PIEs have been manufactured and have been in excess of those that might have been prudently paid by any entity managed to have a long-term sustainable future consistent with the concept of going concern that is supposedly inherent in financial reporting. The recommendations made seek to address this risk, but there remains a final point to make. This is that now that it is clear that the risk of distributable reserves being created by transfer mispricing exists research is required to establish to what extent that process might have distorted corporate distribution policy and so contributed to the phenomenon of hollowed-out firms.

References

Baker, A., Haslam, C., Leaver, A., Murphy, R., Seabrooke, L., Stausholm, S., Wigan, D., 2020. *Against hollow firms : repurposing the corporation for a more resilient economy*. Sheffield: Centre for Research into Accounting and Finance in Context (CRAFiC), University of Sheffield https://www.sheffield.ac.uk/media/15425/download

Eden, L. 1998. *Taxing multinationals: Transfer pricing and corporate income taxation in North America*. Toronto: University of Toronto Press

Haslam, C., Leaver, A., Murphy, R and Tsitisanis, N. 2021. *Assessing the impact of shareholder primacy and value extraction: Performance and financial resilience in the FTSE350.* Sheffield: Centre for Research into Accounting and Finance in Context (CRAFiC), University of Sheffield, forthcoming.

ICAEW. 2017. *Guidance on realised and distributable profits under the Companies Act 2006*. London: Institute of Chartered Accountants in England and Wales Guidance note 02/17BL. https://www.icaew.com/groups-and-networks/local-groups-and-societies/london-ds/london-accountant/tax-and-financial-reporting/jul17-technical-committee

IFRS. 2018. *Conceptual Framework for Financial Reporting*. London: International Financial Reporting Standards Foundation. https://www.ifrs.org/issued-standards/list-of-standards/conceptual-framework/

Leaver, A. and Murphy, R. 2020. *Financial engineering and the productivity crisis*. Sheffield: Centre for Research into Accounting and Finance in Context (CRAFiC), University of Sheffield. http://eprints.whiterose.ac.uk/163162/1/Final_Report_Leaver-and-Murphy.pdf

Leaver, A. and Murphy, R. 2021. *Creative accounting and shareholder value: why the accounting rules on distributable reserves must change.* . Sheffield: Centre for Research into Accounting and Finance in Context (CRAFiC), University of Sheffield, forthcoming.

Robé, J.-P., 2011. *The Legal Structure of the Firm. Accounting, Economics, and Law: A Convivium 1*.