School of Business and Management

Financial reporting:
Gaming or reinstating the social licence of limited liability.

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Introduction

- The mid 19th century reform of limited liability and company law conferred privileges on shareholder-investors.
- These privileges encouraged shareholders to invest in infrastructure projects that were financially high risk but socially beneficial
- But things have changed in the intervening decades. The social purpose of limited liability has been eroded.
- What we now have are narratives about how companies are arbitraging and gaming limited liability.
- Companies now shift the money around through tiers of wholly-owned subsidiaries to lever returns on capital for shareholders.
- In the intervening years the social purpose of limited liability has been forgotten.
- Ltd liability is now a shield employed to protect value extraction and behaviour that is hollowing out the capacity of company's to absorb financial risk and this presents a moral hazard to society

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Introduction

- In this ELI SIG on Business and Financial Law

- I will employ a framing device to organise thoughts about how financial reporting is complicit in gaming the privilege of limited liability which is a reciprocal relation between shareholder-investor and society: a form of social licence.

- There are two key framing elements to be employed to construct this argument.
  - The transition from firms to reporting entities
  - The promotion of decision useful information to facilitate capital market efficiency and value extraction for shareholder interests

- These two framing elements: the reporting entity perspective and decision useful information can also be found in arguments supporting the need for the reform of financial reporting in:
- Public sector entities and
- SME's

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Limited liability: A social licence

- The historic genius of the 1862 Companies Act was to enshrine a bargain in which shareholders won the controversial prize of a limit to their liabilities if the company got into trouble, while the company was granted a distinct legal personality.
- In return for a lessening of their responsibilities, shareholders forfeited the claim to outright company ownership …the company's overriding obligations are to itself, including all its stakeholders.
- Salomon V A Salomon And Co Ltd [1897]
- *The House of Lords desired to reaffirm the principle which the lower courts abstained to adhere; the principle of independent existence of corporations separate from that of their corporators*
- ‘It is to this delicate balance of interests that the company owes its resilience, its ability to co-opt and amplify diverse inputs, and its record of distributing its benefits widely’ .
- However financial reporting and its emphasis on reporting entities and of providing decision useful information for shareholder-investors has become co-opted into a project that undermines the privilege granted by limited liability and this, in turn, presents a moral hazard to society.

From firm's to reporting entities

- The economist's notion of the firm as the unit of account has long been abandoned by accountants who now operate with the concept of a 'reporting entity'
- A reporting entity consolidates economic activities that lie within its boundary.
- Financial statements provide information about the assets, liabilities, equity, income and expenses generated by the set of economic activities that lie within the boundary of the reporting entity (IASB)
- This boundary is loosely specified.
- The consolidated financial statements of a reporting entity will include other firms over which both direct and indirect control are possible.
- The financial relations between parent and subsidiary networks are complex and netting out arrangements conceal how regulatory arbitrage and risk transfer arrangements are operating across regions and jurisdictions.

http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/May%202015/ED_CF_MAY%202015.pdf

From firm's to reporting entities

- A parent can benefit in its own right from limited liability whilst also insulating itself from the risk embedded in the operations of wholly or partially owned subsidiaries which also capture the benefits enshrined in limited liability.
- The parent company can exploit and conceal risks and arbitrage differences in national regulatory arrangements and social settlements through its subsidiary network.
- A parent company might choose to load its subsidiary with bond financing arrangements exposing this 'Ltd company' to higher interest charges, forcing it into losses.
- National government's receive less in tax, employees face uncertain futures, bondholders /creditors put at risk.
- But the cash raised from the bond is repatriated, as a special dividend, to the parent company to be distributed to its shareholders.

Financial reporting: Representing investor interests

- The idea of limited liability is that shareholder-investors would be granted loss limits on their investment thereby limiting their financial risk in return for sacrificing control rights
- The firm/company takes on a separate legal identity with an overriding obligation to itself, including all of its stakeholders.
- The corporate legal form as presently constituted is not an economic necessity but a political construct representing the interests of particular groups.
- The International Accounting Standards Board (IASB) has <u>not</u> sought to decouple the control rights of company shareholders but has consolidated the interest's of the 'investor-shareholder'.

https://kar.kent.ac.uk/11406/1/Limited_Liability.pdf

Financial reporting: Representing investor interests

- The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

- Where the accounting standards are applied rigorously and consistently, capital market participants will have higher quality information and can make better capital allocation decisions. Thus, the function of accounting is to facilitate capital market efficiency and generate a lower cost of capital .

- Recent projects surrounding the preparation of financial statements such as proposed by the IIRC: <IR> are about helping businesses to think holistically about their strategy and plans to make informed decisions.

- Although these financial reporting projects include the need for company's to provide non-financial disclosures. These are still focused on reporting risk (s) to shareholder-investors.

https://kar.kent.ac.uk/11406/1/Limited_Liability.pdf
http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/May%202015/ED_CF_MAY%202015.pdf
http://www.ifrs.org/Use-around-the-world/Documents/Case-for-Global-Accounting-Standards-Arguments-and-Evidence.pdf
https://integratedreporting.org/

From Historic Cost to Fair Value Accounting

- The financial reporting project has focussed on how 'reporting entities' generate 'decision useful' financial disclosures that enhance value relevance, capital market efficiency and lower the costs of capital for investors.
- The shift from Historic Cost Accounting (HCA) to Fair Value Accounting (FVA) justified because it generates value relevant information for investor-shareholders and improves capital market efficiency.
- Recalibrating the value of assets held on balance sheet to their market values treats the reporting entity as if it is a financial instrument that can be continually 'marked to market'.
- Adjusting assets values such as: tangible assets, property, brands, biological assets and goodwill involves taking on board speculative valuations, bringing forward expectations about cash flows and discount rates.
- These speculative valuations depend upon a liquidation assessment of an asset's value rather than valuing assets in 'productive' use and consumed to maintain a 'going concern'.
- Inflating asset values also amplifies the risk of value impairments which, when triggered, will undermine: credit ratings, leverage ratios and balance sheet solvency.

Financial reporting migrating into other spheres of the economy

- The IASB' s financial reporting project threatens to spill over into other spheres of the economy: SMEs and the Public Sector and whole of Government accounts
- This expanding project maintains the identity of a 'reporting entity' within which financial statements are produced for 'investors'.
- It is possible for SMEs and Public Sector reporting entities to exploit control arrangements between parent and subsidiary undertakings. Look at the growth in public reporting entities that are also increasing their subsidiary networks.
- The importation of IFRS accounting standards into SME and public sector reporting entities is also about mimicking arrangements in the private sector.
- A significant impact here is the relative ease by which the adoption of IFRS accounting standards has found its way into public sector accounting
- More spheres of the economy are now exposed to accounting standards that treat more of the non-corporate sector as if they are corporatized and exposed to fair value impairment risks.

Summary

- Financial reporting is concerned with ‘reporting entities’ and presentation of general purpose of financial statements to inform shareholder-investors.
- The primary objective is to promote capital market efficiency and reduce the costs of capital.
- However, consolidated financial statements conceal how regulatory conditions and social settlements are being arbitraged between parent companies and complex subsidiary networks.
- And whilst Limited Liability sought to decouple the control rights of shareholders over the resource stewardship of the company: this is being eroded
- We must remember that loss limits for shareholders was accompanied by a decoupling of shareholder interests from ‘companies’
- The Ltd company is not only a separate legal identity but has an overriding obligation to itself, including all of its contiguous stakeholders.
- The challenge we face is how legislation and regulations can be deployed to reinstate the social purpose of limited liability in companies that are so key to the functioning of the modern economy they are de facto ‘governing institutions’.

Summary and policy framing principles

- Financial reporting is a key ingredient that can be deployed to limit corporate opportunism and re-balance corporate governance. Reinstating the 'social licence' attached to limited liability
- This needs to be underwritten by putting the idea of a 'social licence' at the heart of a modern understanding of limited liability where companies are key actors and governing institutions.
- Limited liability is a central feature of the modern corporation but it was not created to facilitate fiduciary opportunism and risk displacement by company's as shareholder-investors
- How might a 'social licensing' of limited liability work:
  - > Consolidated reporting entity structures should be kept simple to promote financial transparency
  - > Restrictions placed on the extent to which limited liability can be extended into a network of subsidiaries.
  - > Limits on earnings extraction to promote capital maintenance (e.g. pooling out assets or dividends if the assets/liabilities ratio is under the original and additional paid in capital.
  - > Limits as to type of asset classes that can be subjected to fair value adjustments.