Rethinking Financial Reporting: Reinstating the Social License of Limited Liability

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Abstract

Shyam Sunder’s monograph ‘Rethinking Financial Reporting: Standards, Norms and Institutions’ explores the extent to which it is possible to deliver ‘better financial reporting’ so as to support investment decision making and valuation. In this review paper it is argued that a more fundamental and radical challenge is required in a world where financial reporting is politically and socially constructed. The institutions governing financial reporting have pursued a project that has been complicit in undermining the social license granted by limited liability. The priority is to explore how financial reporting might contribute to securing the social license granted by limited liability.

Introduction

In Shyam Sunder’s monograph ‘Rethinking Financial Reporting: Standards, Norms and Institutions’ there is an explicit project to define and outline a process by which financial reporting can be improved. For example, improvements to financial reporting could be about the need to generate information for better decision-making surrounding: funding and valuation(s) and predictions about financial distress and bankruptcy. In this respect Sunder’s objective is to improve the provision of accounting information so as to promote a more effective allocation of capital.

In order to support this broad objective Sunder frames an understanding of the nature of financial reporting employing three organising elements: attributes, goals, and practice (social/institutional norms). Attributes include: comparability, conservatism, consistency, predictive value, relevance
and reliability. Whilst the goals of financial reporting might be concerned generating greater wealth and enabling organizations to operate more efficiently (for example reducing their cost of capital) but also taking into account the need for distributive justice. The objectives and purpose of financial reporting are also conditioned by accounting in practice and its associated social and institutional norms which are the product of myriads of interactions that help to define and dynamically adjust the nature of financial reporting.

In *Rethinking Financial Reporting: Standards, Norms and Institutions* Sunder explores how contradictory forces are in play both within each of these organising elements and across elements. Maintaining alignment between attributes governing financial reporting is problematic. For example, adjusting asset values from their historic to their market value might improve the relevance of information disclosures to investors but then undermine a commitment to conservatism and prudence in financial reporting. The drive to adjust valuations to a ‘fair value’ might also compromise their reliability if they are based on exotic modelling where a wide range of judgements and scenarios are possible. Moreover, as between these organising elements Sunder observes that, in an era of shareholder value, accounting practice underpinning the preparation of financial statements will tend to focus on the information needs of shareholder-investors and that could compromise the information needs of stakeholders in general. The purpose and objectives of financial reporting have historically struggled to reconcile a tension between the information needs of a narrow or broad group of stakeholders. However, financial reporting and the practice of accounting are now governed by monopoly institutions such as the International Accounting Standards Board (IASB) and in the US the Financial Accounting Standards Board (FASB). Further, these organisations tend to focus on the narrow interests of investors. The contradictory and ambiguous forces impacting upon the financial reporting process are explored in terms of how accounting standards are developed, modified and implemented by the governing institutions of accounting. According to Sunder we seem not to be aware that social norms, or the common law approach to accounting (from an earlier period) have been progressively replaced with the institutionalised regulation of standards and formal enforcement.

The significance of this monograph is that it explores how contradictory forces are in play between attributes, goals and the social /institutional norms governing the purpose and utility of financial reporting. Sunder concludes that: ‘it is his hope that some configuration of rules, norms and institutions’ may help us find a way out towards ‘better financial reporting’.

However, a fundamental and more radical challenge to the profession and institutions governing accounting and financial reporting could be constructed. This alternative must start with the position that financial reporting is the product of socio-political settlements that represent dominant vested
interests. These interests, embedded within the governing institutions of financial reporting, are complicit in ‘gaming’ the social licence of limited liability (Haslam et al 2016). Limited liability sought to decouple shareholder interests from the stewardship of a firm’s resources but it has now become a shield employed to protect shareholder-value extraction that is hollowing out the capacity of companies to absorb financial risk. This gaming of the social license of limited liability presents a moral hazard to society because the principle of accounting for a ‘going concern’ has been sacrificed (Haslam et al 2015, 2017a).

Financial reporting: Undermining the social license of limited liability

As Sunder observes, governments have delegated regulatory governance over financial reporting and standard setting to monopoly standard setting agencies such as the International Accounting Standards Board (IASB) and in the US the Financial Accounting Standards Board (FASB). The financial reporting project managed by these regulatory institutions can, alternatively, be framed and understood within two rather different organising elements: first, that the general purpose financial statements should be that of presenting a ‘reporting entity’s’ consolidated financials; and second, that the information disclosed by these consolidating reporting entities should be ‘decision useful’ to investor-shareholders.

The economic notion of the firm as a unit of account has long since been abandoned by accountants who now operate with the concept of a ‘reporting entity’ (Biondi, 2013). A reporting entity is a company that can consolidate the financial activity of many firms (Strasser and Blumberg, 2011). A parent company can benefit in its own right from limited liability as a shareholder investing in subsidiaries. Limited Liability was enshrined in the UK Companies Acts whereby shareholder liability was limited to their unpaid share capital, and in return shareholders, forfeited any claims to outright company ownership. However, where a parent company has shareholdings in a subsidiary network this creates the opportunity for the parent company to move funds around a complex network of tiered subsidiaries that are protected by their own entitlement to limited liability. A parent consolidating company can employ its subsidiary networks to financially engineer returns on capital for parent company shareholders at the expense of its subsidiaries (Bowman et al 2015).

A key objective of general purpose financial reporting is to provide financial information that is decision useful to existing and potential investors, lenders and other creditors. The shift from Historic Cost Accounting (HCA) to Fair Value Accounting (FVA) has, for example, been justified because it generates value relevant information for investor-shareholders. However, many companies are
depleting equity reserves because they paying out both high dividends and funding share buy-backs for treasury stock. In European and US large corporations FVA is adjusting asset values to a market value including: tangible, financial, property, biological assets and goodwill. Goodwill, for example, accounts for the difference between the market value and book value of assets acquired and it will steadily accumulate on a company’s consolidated balance sheet. However, an increasing number of European and US corporations are distributing more of their shareholder equity to shareholders as dividends and share buybacks. Roughly one-third of the top FTSE300 European companies and half of the S&P 500 group of companies report goodwill that is now in excess of their shareholder equity (Haslam et al, 2015 and 2017a). There is a growing risk that the fair value of a range of asset-classes could become impaired if, for example, cash earnings, market valuations or value modelling assumptions deteriorate. Writing down the value of assets could quickly compromise the financial viability and solvency of an increasing number of large corporations that have hollowed out their equity reserves.

These risks arise from a financial reporting project that is geared towards the preparation of reporting entity consolidated accounts and provision of decision useful information for ‘shareholder-investors’ and this exposure is no longer confined to just public limited companies. The governing principles of accounting practise are spilling over into other spheres of the economy with the publication of financial reporting standards for small and medium enterprises (SMEs), and public sector enterprises both at a local and central level.

Towards financial reporting that secures the social license of limited liability

If we are to get closer to Saunders ambition for ‘better financial reporting’ we should start by charging the accounting profession, and its associated institutions, with a general responsibility: that of protecting the social license of limited liability from misuse. Limited liability sought to decouple the speculative interests of shareholder investors from the stewardship of a company’s resources. It was not created to facilitate fiduciary opportunism in companies for parent company shareholders.

Reporting entity consolidated financial statements should be kept as simple as possible to promote transparency because it is always possible for the parent company-shareholder to insulate itself from financial risks embedded in its subsidiary networks.

The institutions governing financial reporting need to redefine the nature and purpose of capital maintenance especially where asset valuations are being continuously recalibrated to speculative market values. Capital maintenance through higher equity reserves will be required not only because
they provide a buffer against normal earnings losses from trading but also asset valuation impairments which can very quickly undermine a reporting entity’s viability.

In a modern economy companies are also important governing institutions that have been granted a social license in the form of limited liability. The institutions regulating financial reporting have an important role to play in securing and preserving the social license of limited liability because viable going concern companies underwrite a wide array of stakeholder interests and settlements.

References


