Progressive Economics Group (PEG)
Policy Brief #1

Financial Reporting & Disclosures

Reinstating Social Licence of Limited Liability

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Policy Issue

Limited liability has now a become shield employed to protect value extraction and behaviour that is hollowing out the capacity of UK companies to absorb financial risk and this now presents a moral hazard to society.

How should limited liability status be reformed to end its abuse by companies?

Analysis

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 conditions have changed in the intervening decades. The social purpose of limited liability has eroded. Companies are arbitraging and abusing limited liability.

Limited Liability was enshrined in the Companies Acts. Shareholder liability was limited to their unpaid share capital and in return shareholders forfeited claims to outright company ownership. Each company was granted a separate legal identity with an overriding obligation to itself, including all of its other stakeholders. The rise of financial engineering by investment banks, private equity and hedge funds has generated not only lucrative transaction fees but also increased capital gains for shareholders. Companies now move funds around a complex network of tiered wholly-owned subsidiaries to financially engineer returns on capital for shareholders.

Accounting Standards & Financial Reporting

The UK Government has delegated regulatory governance over financial reporting and standard setting to the International Accounting Standards Board (IASB). The IASB's agenda has been framed by two central organising concepts: first, that general purpose financial statements should present a *'reporting entity's'* financials; and second, the information disclosed by reporting entities should be '*decision useful'* to investor-shareholders.

The economist's 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***'. A reporting entity is a company that can consolidate the financial activity of many firms.[1] A parent company can benefit in its own right from limited liability. It can also insulate itself from financial risks in wholly or partially owned subsidiaries because these subsidiaries can also claim the entitlement of limited liability if they become insolvent.

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

A key objective of general purpose financial reporting is to provide financial information that is 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 out reserves because they pay out very high dividends and fund share buy-backs. This erodes the financial capacity of companies to absorb impairments to asset value and could, like the banking crisis, put UK economic stability at risk.

The IASB's financial reporting project is no longer confined to just public limited companies but is spilling over into other spheres of the economy to small and medium enterprises, and the public sector (both central and local government enterprise accounts).

Policy Framework

The Labour Party should reorganize the institutions regulating financial reporting into a new institution that reinstates the 'social licence' of limited liability.

1. Companies are key actors and institutions in Britain. The objective of policy will be to restrict corporate opportunism and rebalance corporate governance in the public interest. Limited liability was not created to facilitate fiduciary opportunism in companies for shareholder interests.

2. Consolidated parent-subsidiary networks should be kept as simple as possible to promote financial transparency from financial reporting.

3. Restrictions should be placed on the extent to which a parent company and its network of subsidiaries can benefit from mutually exclusive limited liability. This may include restrictions over the right to limited liability.

4. There should be controls placed on shareholder payments that damage equity reserves. This would need a new definition of capital maintenance including restrictions on the pooling out of assets, dividends and share buy-backs if the assets/liabilities ratio falls below original and additional paid in capital.

5. Limits should be set on the types of asset classes that can be adjusted to a fair value.

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