Funding the Future

This time the need is to review limited liability from ...

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It’s been a hectic couple of days — hence low volume blogging.

That’s been an opportunity missed regarding Ernst & Young (E&Y) and Lehman. It’s also been an opportunity for reflection.

The reality is that there is nothing surprising about what E & Y have done. It seems that a senior partner from an audit form joined a client, devised an off-balance sheet accounting ruse, cleared it with his former colleagues, who then signed it off for audit purposes, and it was used thereafter without further question arising to deliberately misrepresent the true nature of the balance sheet of the entity.

That sounds shocking expect for one thing — this is what happens day in, day out, the whole world over.

This is what securitisation was about.

This is what a lot of offshore is about.

Derivative trading is often intended to achieve such goals — and most finance directors have no clue what they’re doing when engaging in them, and nor do their auditors.

In issues as straightforward as deferred taxation the balance sheet is knowingly and deliberately misstated by companies and auditors with the connivance of auditing and accounting regulators — in this case to overstate a liability that will in most cases never be settled — all to achieve a political objective of conning the world into believing that more tax is being paid than is ever settled..

In the case of fair value accounting myths were created that there were markets in assets for which there was no effective trading.

The E & Y / Lehman case is not an isolated incident. It is indicative of a pandemic of abuse by the accounting profession.

It's an abuse that starts at the very top. The International Accounting Standards Committee Foundation — the body ultimately responsible for ensuring that accounts showing a true and fair view are prepared says in its constitution that its main objective is

to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparency and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;

Note the "and other users" — something that is then blatantly ignored by the International Accounting Standards Board when it says that the main users of financial statements are "present and potential investors, lenders and other creditors in making decisions in their capacity as capital providers". They then conclude that because investors are providers of risk capital to the entity, financial statements that meet their needs will also meet most of the general financial information needs of other users.

And despite this extraordinary claim, and attention on one small group of users alone, the Big 4 have also engineered that they have almost no liability to providers of capital in the exercise of their duties.

The consequence was always going to be a disaster: it's a disaster that is unfolding.

Treating that disaster as specific would however compound the error: the problem is systemic. It has to be tackled that way.

The key issues are, I suggest, in no particular order:

1. Why we gave up control of accounting disclosure to the accounting profession

2. Why we gave up control of auditing regulation to the auditing profession

3. Why we allowed the definition of an audit to be limited to confirmation of compliance with an accounting framework and abandoned the true and fair override

4. Why we allowed the users of financial statements to be considered the providers of capital alone

5. Why we don't demand financial statements that meet the needs of other major user groups including:

   a. Employees

   b. Suppliers

   c. Customers

   d. Regulators

   e. Tax authorities

   f. Civil society groups

   g. People at large

6. Why we limited auditor liability so much

7. Why we allowed the concept of limited liability to be porous when it comes to failure and yet so restrictive when it comes to sharing information and reward

8. Why we allow limited liability within limited liability i.e. subsidiaries have limited liability distinct from parent companies

9. Why we consider group accounts the only useful perspective on corporate activity

10. Why we allow off balance sheet accounting

11. Why we still allow auditors to undertake other commercial activities

12. Why we don’t increase company registration fees to ensure auditors can always be fairly remunerated from a communally managed purse

13. Why we allow companies to not file accounts on public record

14. Why we accept a lack of transparency on group structures

15. Why we don’t demand full accounts on public record from all entities created under law wherever they are in the world, whether they be companies, partnerships, all variations on these, trusts, charities, foundations and other such entities. Such information to include full information on ownership, entitlement to assets, establishment, constitutions, management and accounts.

16. Why we allow companies to be struck off public registers without questions being asked and substantial fees being paid in lieu of accounts.

17. Why fit and proper tests aren’t conducted for all persons incorporating and owning companies.

Of course the list goes on, and on. So it should.

Now is the time for the most fundamental review of what the limited liability entity is, why we allow it, what its rights and obligations are and how we regulate it.

Surely this time we appreciate the need to do this?

Don’t we?