Funding the Future

Hollowed out corporations and the need to build back be...

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I am one of a team from the University of Sheffield, Copenhagen Business School and Queen Mary, University of London who have published a new report entitled ' Repurposing 'the Corporation' for a more resilient economy'

As the University of Sheffield press release (acting as lead on this) says:

The COVID-19 pandemic has revealed weaknesses within large, well-established companies. But are those weaknesses caused by the pandemic, or are they the consequence of excesses in the non-financial (or non-banking) corporate sector post-2008?

Professor Adam Leaver from Sheffield Management School and Professor Andrew Baker from the Department of Politics have teamed up with academics at Queen Mary, University of London and Copenhagen Business School to consider how we can repurpose 'the corporation' to build a more resilient economy in the years to come.

The researchers argue that company reserves have become 'hollowed out' leaving them more vulnerable to collapse in economic downturns. They identify three processes as part of this hollowing out: excessive shareholder distributions, over-borrowing and the growth of 'marked to market' assets which may now be written down. Companies now face the prospect of booking asset impairment losses on top of falling operating profits, while trying to find liquidity from the capital markets as company credit ratings fall and equity markets dry up.

"This is going to make recessions even deeper, costs to governments much larger, and will extend the need for central bank intervention into non-financial corporate markets, just as they did financial markets in 2008," said Professor Leaver.

Their findings show that in the latest available accounting year, a significant minority of firms are paying out more to shareholders than they generate in

net income. 37 per cent of S&P500 firms distributed more via dividends and share buybacks than they generated in group net income. The figures for the FTSE 100 and S&P Europe 350 were 28 per cent and 29 per cent respectively. A sizable number of firms borrow heavily in order to do this. Firms have also used debt and their treasury stock to finance merger and acquisition activity which generates 'goodwill' that will now be written down.

These practices have produced winners and losers. There are many boardroom 'winners' but as Professor Leaver notes, many workers are now left with an insecure subsistence stake in organisations whose survival is now in doubt because there is not enough equity to soak up the losses, and access to cash has dried up. Many long-term shareholders will also lose out.

"This raises fundamental questions about social justice," said Professor Baker. "In a minimally just society, there must be some level of protection for its citizens who, through no fault of their own, bear much of the risk of firm fragility and a declining return on firm proceeds.

"That protection should begin with a repurposing of the corporation to promote the 'just economy', improving economic resilience and social wellbeing, where citizens can reasonably expect regulatory authorities to offer protections from these types of vulnerabilities."

To do that, the team have recommended a series of 'maintenances' in order to influence policy makers and accounting standards setters to restore system resilience for the future.

Capital Maintenance

Repurposing the corporation through a recognition in company law and accounting rules that ensure management's core obligation is to protect the capital base of the company so that it may withstand shocks and serve the needs of multiple stakeholders.

Measurement Maintenance

Repurposing accounting rules to reduce opportunities for gaming and ensure that asset valuations so that value is based on actual transaction costs rather than often optimistic estimates of what future cash flows might look like, which give management too much discretion and do not factor in long tail events.

Diversity Maintenance

Ensuring a balanced, mixed ecology of firms, consisting of more diverse forms of ownership and governance, with an aim of protecting, or ring-fencing,

essential or 'foundational' businesses (i.e. energy provision, water suppliers, education, food services). This would also remove the cost on governments who currently have to bail out these essential businesses.

These recommendations were written as governments across the world are involved in interventions to stabilise an economy turned upside down by the Covid-19 outbreak.

Professor Leaver said: "At first glance the Covid-19 pandemic could be understood as a classical 'exogenous shock': an event from outside the economic system that causes economic disruption and breakdown.

"Our report shows that understanding is partial. We argue that the crisis should be understood as an interaction between this event and pre-existing financial and corporate fragilities that have built up within the economic system in the post-2008 period. In economic parlance these fragilities emerge from 'procyclical' processes - the accumulated collective priorities, decisions, behaviours, risk perceptions and reporting practices of market participants which, individually and at the aggregate produce weaknesses that amplify economic instability.

"A new relation or contract between the workforce, employers, investors and the state is needed, and it is one that must put the social and moral purpose of the firm centre stage. As we move towards climate-led volatility and disruption, we must think seriously about the compacts that must be forged and the sacrifices that must be made in order to build social and economic resilience to shocks, and enable our firms to work more effectively for a wider, more inclusive range of stakeholders."

This project originally began as a 'quick and dirty' reaction paper and rapidly developed into something into a lot more heavyweight into which a lot of effort was poured, most especially by Adam Leaver as lead author, it has to be said.

That happened because we realised just how important the concept of maintenance now is. It was once at the core of accounting, with the aim of protecting society. But that idea has largely been forgotten by society now. So we see companies stripped of cash, publishing accounts that do not represent what we as a team think to be a true and fair view, and which provide no basis for a sustainable future. This report is not put manifesto for change in accounting, but it is certainly a step on the way.

The ***full report is here.***