Funding the Future

The government has made shareholders the focus of its a...

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The government has published its long-awaited proposals for accounting and auditing reform this morning. They are underwhelming, despite running to 232 pages.

At the core of the failure by the government on this issue is their adherence to a mid-twentieth-century view of what the company is all about. As they put it in their White Paper:

Shareholders, as the owners of companies, have a vital role to play in the corporate governance framework. They do not run companies — that is the job of the directors — but they do vote on director appointments, approve final dividends, approve the appointment of auditors and vote on directors' remuneration and other matters. Institutional investors, in particular, have a stewardship role, seeking to create long term value for their clients through oversight of the companies in which they are invested. Shareholders are the primary users of company reporting and audit. They should have a strong interest in its quality, accuracy and reliability because it provides a basis for informed investment decisions and the efficient allocation of investment capital across the economy.

This is so wrong. The reality is that even existing accounting standards setters accept that this is not true. The likes of the International Financial Reporting Standards Foundation do, for example, suggest that the primary users of accounts are the suppliers of capital to a company, which puts them many steps ahead of where the company are by also including other financiers apart from shareholders into the user group, but they too miss the point.

The reality is that the real stakeholders of companies, whose needs must be met if the corporate reporting that they prepare is to meet the needs of society, are the following:

* The providers of capital to the company
* The company's trading partners
* Its employees, past, present and future

* Regulators
* Tax authorities
* Civil society that is impacted by its activities in any way, plus researchers and others.

The odd token gesture apart, none of these get much attention. Employees are mentioned 26 times, pensioners not at all, suppliers eight times, and civil society not at all. Shareholders get 137 mentions.

The last is despite the fact that the report notes that:

There are concerns, however, that asset managers and asset owners do not sufficiently prioritise audit as a stewardship issue of importance2. Institutional shareholders have also been criticised for poor stewardship in the period before the collapse of some prominent companies. The FRC Review took a strong interest in the Stewardship Code, urging improvements to its effectiveness to increase the quality of investor engagement. These improvements are now in progress through recent revisions to the Code.

In other words, those institutions who represent most shareholders do not engage with audit issues, or the companies that they supposedly own. In other words, they are not the people who hold them to account.

This is completely unsurprising. Of all the stakeholders of a company the shareholders have the least engagement with it, and the greatest protection from it. They do, after all, enjoy the benefits of limited liability, which no other stakeholder does. In addition, they can, at a moments notice, sell their interest in the company, and cease to have any concern for its well-being.

Employees, suppliers, regulators and civil society have no such opportunity. For them the engagement can be vastly more serious, and the consequence of audit failure as a result much more significant.

Despite that, the report focuses almost all its attention on the wrong party. Shareholders should not have been the focus of interest when thinking about audit reform and yet the government has put them right at the centre of its concerns. As a consequence, it has shown that it does not understand the issue that it is addressing, and that is the biggest failing in this whole report.