Who are the stakeholders of public interest entities (PIEs)

1. Background

The future of audit is being debated in the UK[1] [2]. Whilst audit is not just an issue for what the government calls public interest entities (PIEs)[3], the focus of their concern is on such entities because they are the ones whose failure might cause greatest disruption within the economy, and loss to those involved with them.

The Corporate Accountability Network believes that audit does need reform within the UK[4]. However, it is our belief that the audit of a set of accounts or financial statements[5] cannot be considered as an issue that can be addressed independently of those accounts. It is our opinion that audited accounts are ultimately an inseparable whole. As such we suggest that the success or failure of auditing and accounting in meeting the needs of the users of those accounts cannot be separately appraised.

The question is, who are the users of accounts? That is the issue that this Audit Briefing addresses, coming up in the process with an answer that is very different to that offered by existing accounting and audit regulators[6]. It is in this differing perception on this issue that

[1] https://beisgovuk.citizenspace.com/business-frameworks/audit-and-corporate-governance-review/

[2] The consultation papers relating to this process are noted in the references noted at the end of this Briefing.

[3] The Corporate Accountability Network has issued a separate Audit Briefing on what it considers an appropriate definition of a PIE might be.

[4] See our separate Audit Briefing on the reasons why audit might need reform.

[5] We treat these terms interchangeably.

[6] See references supplied to the thinking of the Financial Reporting Council, Department for Business, Energy and Industrial Strategy and International Financial Reporting Standards Foundation in the final section of this Audit Briefing.

we suggest that the misunderstandings on the true nature of audit failure lie[7]. If the true nature of the stakeholders of accounts was properly understood by those who regulate their production and audit then we suggest that audited financial statements might not fail as often as they seem to do at present, by those regulators' own admission. That is why the issues addressed by this Audit Briefing is so important[8].

2. Who are the stakeholders of PIEs who have an interest in their financial statements?

The Corporate Accountability Network thinks that every company, wherever it is incorporated its size, and whatever its size, has six groups of stakeholders, all of whom are at risk as a result of its existence. This is especially true of public interest entities (PIEs). These six groups are:

a. Those who provide capital to the company

This group includes the company's shareholders. It also includes those who provide it with loan capital as well as banks, hire purchase, factoring and leasing companies and those who provide credit card facilities. We believe that these two groups have overlapping but sometimes dissimilar issues in which they are interested when it comes to appraising the activities of any entity. Whilst they constitute one stakeholder group we highlight their differing interests in a separate Audit Briefing on their information needs[9].

b. Those who trade with the company

Most obviously this group includes those who sell to the company who are at risk that they may not be paid if, as is commonplace, those goods or services are supplied on trade credit terms with payment being made some time after delivery.

This stakeholder group does, however, also include an entity's customers. They too can be creditors of the company, either because of deposits paid or because of guarantees offered which the company has an obligation to fulfil.

All those who trade with a company have a right to know the risk that they face from doing so.

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[7] See our separate Audit Briefing on what audit failure might be considered to be.

[8] This briefing is based upon submissions made by Professors Richard Murphy and Adam Leaver of both Corporate Accountability Network and Sheffield University Management School to the BEIS consultation referenced in this Audit Briefing.

[9] Please refer to our Audit Briefing of the information needs of stakeholders of a PIE.

c. Employees of the company.

Employees are almost always at risk for their unpaid wages since very few employees are paid in advance. As a result this risk is suffered by almost every employee of every company except on the day that they are paid. But employees also face other risks because of their employment. Some pay is deferred, for example. Bonuses fall into this category. And there are also pension obligations to consider, many of which are deferred over many years. All companies have a duty to account to their employees as a result.

d. Regulators

Companies are, by definition, always subject to regulation. Their very nature as legal constructs requires this, but so too does the fact that they usually exist to trade and that activity usually has associated with it many legal obligations which a wide variety of regulators might seek to enforce.

Regulators are always at risk because of the existence of limited companies. Some companies may be formed so that those setting them up can avoid those obligations to society as imposed by regulators that they might have personally if they were to trade in their own names. Those incorporating for this reason know that they will have either no or very limited personal risk arising if they use a company instead. The very essence of the company does, as a result, pose a threat to regulators.

Regulators are also at risk because when they find fault at a company the chance always exists that any penalty that they impose might be evaded by a limited company simply ceasing to trade. In this way regulators can suffer a loss which at least in part creates a risk to their overall credibility as enforcers of the law. As such regulators need to be able to identify generic risk within companies as well as the specific risks that they might be established to address.

e. Tax authorities

Tax authorities are at risk from the existence of all companies.

Some of this risk might be mitigated if the tax rates due on the profits of companies were the same as those owing by individuals undertaking similar transactions in their own names. This, however, is rarely the case, with the bias now being heavily in favour of companies. That means that many companies are specifically created to avoid tax. That gives a tax authority a very good reason to be interested in them.

In addition, the ability of companies to cease trading leaving tax liabilities owing without any possibility of recourse to the owners of the company, who may have gained from this outcome, means that limited liability companies are always a threat to the revenues of tax authorities and that is before the ability of some to manipulate limited companies to mitigate their tax liabilities e.g. by relocating profit to locations where little or no profit is payable, is taken into account.

All these factors make tax authorities stakeholders who face a high degree of risk from the activities of limited companies who have a very significant reason to be interested in the financial statements that they produce.

f. Civil society

Civil society in all its many forms may suffer a loss from the existence of a company. That company may pollute the atmosphere. It may corrupt the political environment. It could disrupt communities by its divisive activities. It may discriminate. It could promote activities that undermine communities. It may sell harmful products. And it might not disclose any of these activities when they occur, leaving a legacy that persists long after it has ceased to exist, with its owners taking their profits long before the consequences of the actions that gave rise to them were appreciated. These are very real and to the company unaccountable costs which civil society needs information on if it is to appropriately appraise them.

3. Who do existing account standard setters assume the stakeholders of accounts are?

Two conflicting views on the stakeholders of PIEs are to be found in accounting standards commonly used in the UK.

a. International Financial Reporting Standards

The International Financial Reporting Standard Foundation (IFRS) says in their Conceptual Framework[10] that the purpose of accounting is:

[10] https://www.ifrs.org/issued-standards/list-of-standards/conceptual-framework/

Objective, usefulness and limitations of general purpose financial reporting

1.2 The objective of general purpose financial reporting[1] is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity.[2] Those decisions involve decisions about:

(a) buying, selling or holding equity and debt instruments;

(b) providing or settling loans and other forms of credit; or

(c) exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.

1.3 The decisions described in paragraph 1.2 depend on the returns that existing and potential investors, lenders and other creditors expect, for example, dividends, principal and interest payments or market price increases. Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity and on their assessment of management's stewardship of the entity's economic resources. Existing and potential investors, lenders and other creditors need information to help them make those assessments.

1.4 To make the assessments described in paragraph 1.3, existing and potential investors, lenders and other creditors need information about:

(a) the economic resources of the entity, claims against the entity and changes in those resources and claims (see paragraphs 1.12–1.21); and

(b) how efficiently and effectively the entity's management and governing board[3] have discharged their responsibilities to use the entity's economic resources (see paragraphs 1.22–1.23).

IFRS standards are those most commonly used by public interest entities in the UK. It will be noted that:

- These standards are designed solely for use by limited liability corporate entities, but PIEs may include other types of entity[11];
- It is assumed that the equity and debt instruments of the entity preparing accounts can be traded, but in the vast majority of cases this is not true, and it need not be the case amongst PIEs[12];
- It is assumed that the entity has loans or other forms of debt instrument;
- It is assumed that the entity has a voting membership;
- It is assumed that accounts are produced to inform investment decision making decisions;
- It is assumed that no other interests in accounting data are of significance (para 1.10, that follows the extract quoted makes this clear).

[11] See the Corporate Accountability Network Audit Briefing on the nature of a public interest entity (PIE).
[12] There are roughly 4.7 million companies in the UK https://www.gov.uk/government/statistics/companies-register-activities-statistical-release-2020-to-2021/companies-register-activities-2020-to-2021
of which around 2,000 are quoted on a stock exchange https://www.statista.com/statistics/324547/uk-number-of-companies-lse/

b. The Financial Reporting Council (FRC)

In contrast, UK Financial Reporting Standard 102 issued by the Financial Reporting Council[13] (FRC) makes clear that in its opinion the objectives of accounting are:

> **Objective of financial statements**
>
> 2.2 The objective of financial statements is to provide information about the **financial position**, **performance** and **cash flows** of an entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs.
>
> 2.3 Financial statements also show the results of the stewardship of management – the accountability of management for the resources entrusted to it.

This accounting standard in question is largely used by medium sized entities located in the UK.

c. Discussion

As is apparent, these two statements conflict with each other. The FRC accepts a broad range of users of a set of financial statements whilst the IFRS defines a narrow user group. The FRC thinks that a there are a wide range of uses for the data in accounts, and the IFRS disagrees. As a consequence the purpose of a financial statements apparently varies depending on which generally accepted accounting framework is used by an entity.

Just to confuse matters, some entities use IFRS for their consolidated accounts and UK generally accepted accounting principles for their parent company reporting, both being published in the same financial statements[14]. In that case the auditors are required to report on accounts prepared under two conflicting accounting frameworks that are published as one set of financial statements. It is hardly surprising that there might be audit risks arising as a consequence, and considerable uncertainty as to the purpose of any account and the attached audit report.

It is for this reason that we think a broadly based definition of the stakeholders of a PIE (and all other corporate entities, come to that) is required or accounting and audit conflicts leading to audit failures as a result of a broadly based audit expectations gap will persist.

4. Summary

[13] https://www.frc.org.uk/document-library/accounting-and-reporting-policy/2018/frs-102-frs-applicable-in-the-uk-and-republic-of-i

[14] GlaxoSmithKline plc is an example of a company doing this. https://www.gsk.com/media/6662/annual-report-2020.pdf

Many of the stakeholders referred to in this Audit Briefing are not at present recognised as having information needs from the accounts of public interest entities. This not by chance. It is, in fact, completely deliberate. It is currently assumed (as is clear from the IFRS definition of the purpose of accounting[15]) that PIEs, like all other accounting entities, only have consequence for a limited range of 'insiders' within the entity itself. These insiders include shareholders who can clearly be defined in this way since they are viewed as the owners of the entity. The result is that any broader responsibility of the PIE or consequence of its existence for other stakeholders is ignored during the accounting process as defined by IFRS. And, since audit is currently defined by audit regulators as being an activity that simply confirms that accounts have been prepared in compliance with an accounting framework like IFRS[16] the audit also ignores the needs of most stakeholders as well.

It is our suggestion that this is wrong. As we have noted in our Audit Briefing on the definition of public interest entities, we are of the opinion that such entities always have macroeconomic impact and as such have inevitable consequence for those many stakeholders that they might engage with. This Audit Briefing seeks to broaden the understanding of both accounting and auditing so that those impacted by the macroeconomic obligations of PIEs might be recognised within the financial statements of all PIEs, with their interests being met.

We believe it is time that accounting standards reflected the needs of all the stakeholders that we note in this Audit Briefing and that auditors be required to ensure that those stakeholders receive all the information that they need from entities that have an impact upon them.

5. About the Corporate Accountability Network

This briefing has been published by the Corporate Accountability Network[17].

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[15] See references for elaboration as to source

[16] See the Corporate Accountability Network Audit Briefing on the nature of audit for further explanation on this issue

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The Corporate Accountability Network (CAN) recognises that accounting as a whole is facing a crisis of relevance since it is failing to meet the demands made of it by the users of the financial statements that the accounting profession produces. The Corporate Accountability Network exists to identify the causes of that crisis and offer solutions to it.

CAN is pro-business and it is pro-accountancy. What it does not accept is the idea that accounts, accountancy and accounting exist solely to serve the interests of one group in society. They do not. Accountancy was created with a public purpose. CAN believes that it should fulfil that public purpose.

What CAN argues is that accountancy can never fulfil that purpose unless it fulfils its obligation to account to all the stakeholders of a company, whether they be the suppliers of its capital; its trading partners; its employees; regulators; tax authorities and civil society – who are everyone it impacts whether or not it has a contract with them.

CAN recognises that we live in a mixed economy where the state and private sectors co-exist to meet our needs. That economic model has worked, and could survive long into the future, even with the challenges that issues such as climate change create. But that will only be true if business continues to enjoy the confidence of those who provide it with its licence to operate – which is society at large. It will not do that unless business accounts to everyone in society. The Corporate Accountability Network exists to show that accounting in this way is possible, necessary and achievable.

6. About the author of this Audit Briefing

This Audit Briefing has been produced by Professor Richard Murphy. Richard is Professor of Accounting, Sheffield University Management School[18] having previously been Professor of Practice in International Political Economy at City, University of London. He is a Fellow of the Institute of Chartered Accountants in England and Wales, from whom he holds a UK practicing certificate, entitling him to practice as a chartered accountant.

Richard was senior partner of an accounting firm for more than a decade before becoming involved in tax justice campaigning. He co-founded the Tax Justice Network[19], the Fair Tax

[18] https://www.sheffield.ac.uk/management

[19] https://taxjustice.net/

Mark[20] and Finance for the Future[21]. He founded Tax Research UK[22]. He co-created the Green New Deal[23]. He is founder-director of the Corporate Accountability Network[24].

Richard created the concept of country-by-country reporting[25], which is now in use in more than 90 countries around the world to identify tax abuse by multinational corporations as a result of backing for it provided by the Organisation for Economic Cooperation and Development[26].

Richard has created the concept of sustainable cost accounting[27].

Richard has authored a number of books including The Courageous State and The Joy of Tax. He blogs, usually daily, at Tax Research UK[28] and is a frequent commentator in the media on tax and accounting issues. In both 2019 and 2020 the Institute of Chartered Accountants in England and Wales named him as the top social media influencer on accounting issues in the UK[29].

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