Hollow Firms & Governance Failure

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1. Governance:

The problem of shareholder primacy & fair value accounting

Shareholder primacy & new pathologies

- How shareholder primacy governance model & a fair value accounting regime facilitated unsustainable distributional behaviours by large listed corps post-crisis.
- The highest distributing companies are characterized by:
  - Weak productivity and investment growth
  - Weak operating performance
  - Indebtedness
  - Intangibility (goodwill impairment risk)
- Two relevant factors: enabling accounting rules & weakening legal capital rules.

Fair value weakened ‘realization’ concept & increased subjectivity

- Financial economics **legitimized shareholder-primacy** approach & pivoted temporal focus of accounting towards future (Ezzamel et al 2008; Nolke & Perry 2007).
- Estimating future states changed meant valuing a range of items using capital market-like valuations/DCF expectations - this **undermined concept of realization** (Power 2010).
- **Increased subjectivity** & **‘managerialised’ production of accounting info** (Mennicken & Millo 2013)
- And **empowered consulting arms of Big Four** who advise on how best to represent economic activity efficiently (Seabrooke & Wigan 2016).

Capital maintenance regime watered down by permissive ‘realization’ test

- Capital maintenance regime i) protects creditors from over-distribution & ii) protects shareholders from ponzi-like payments (cant pay from capital)
- Companies Act 2006: legal limit on distributions = the net assets that exceed paid-in capital plus other ‘undistributable’ reserves (share premium account, merger reserve etc).
- Distributable vs undistributable profits determined by a ‘realisation test’; the detail of that test (in UK) set by ICAEW (2017) TECH02/17BL.
- Three key points: distributable reserves i) determined on **accruals** not cash basis ii) permit some fair value **revaluations** iii) are set at **parent company** not group level

2. The UK case

Evidence on distributions, productivity, investment, operating performance, indebtedness & intangibility

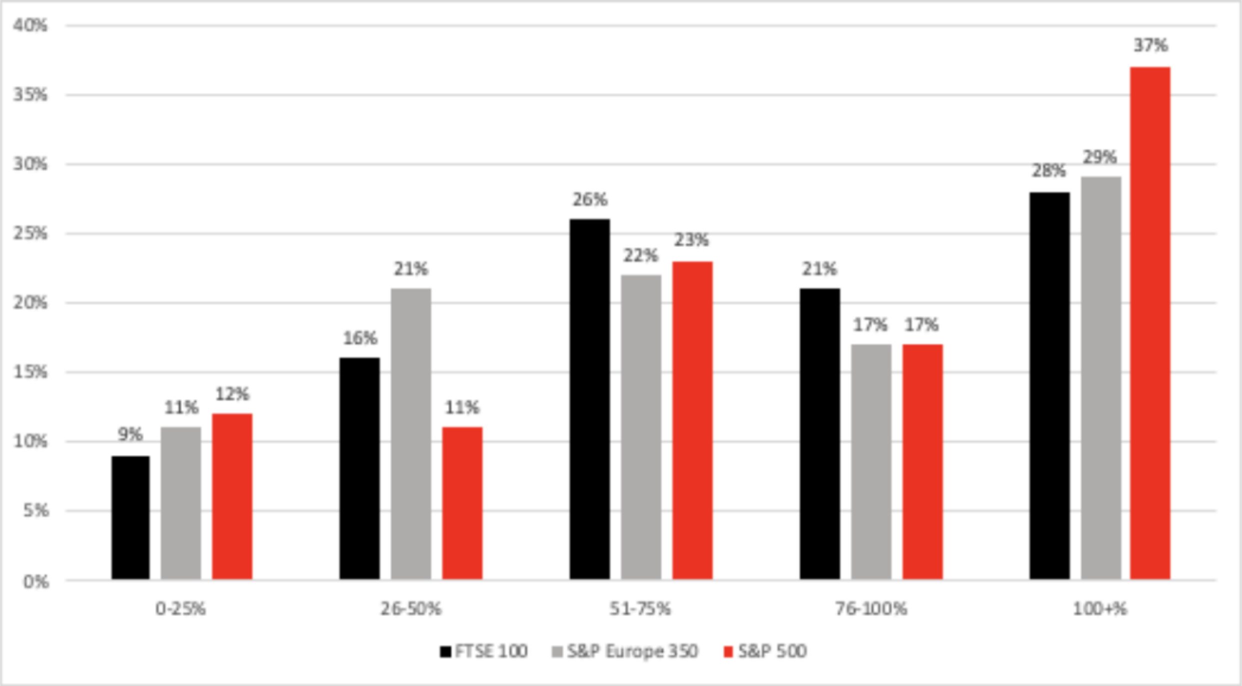
The top 20% highest distributors in the UK FTSE350 (182) paid out 178% of their net income between 2009-19

	Share Buy-Backs and Dividends in Net Income	Market Value share	Revenue Share	EBITDA share
	2009 to 2019	2009 to 2019	2009 to 2019	2009 to 2019
	%	%	%	%
1-TOP	178	28	24	22
2	88	32	32	31
3	78	17	26	23
4	57	16	13	19
5 BOTTOM	37	7	5	5
Totals		100	100	100

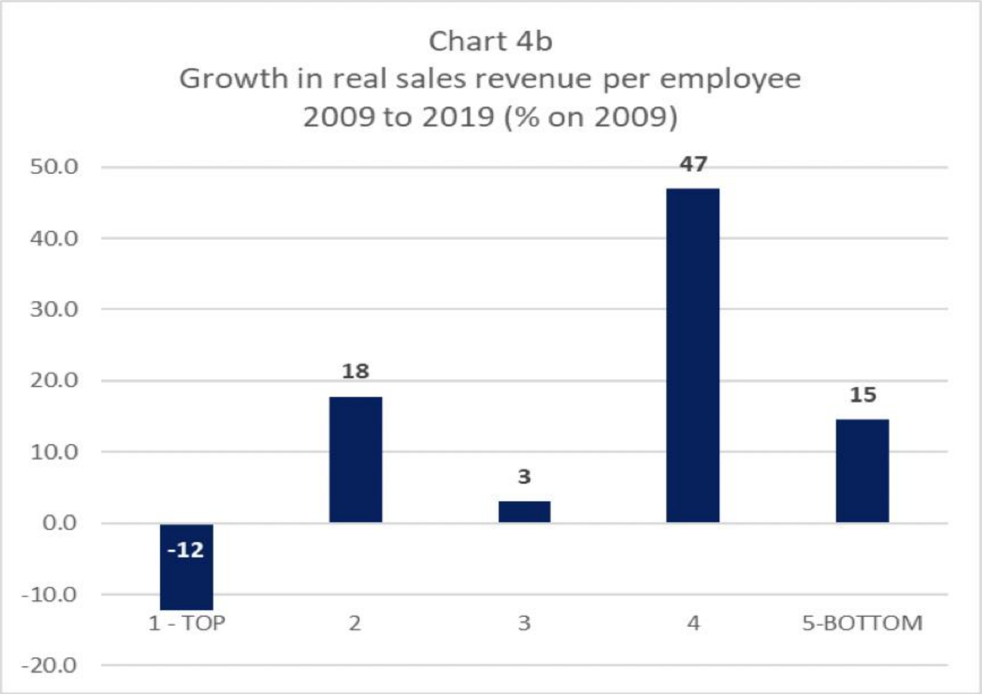
Source: Thomson EIKON datasets

…this is comparable with other indexes…

Figure 2: Proportion of FTSE100, S&P Europe 350 and S&P500 Companies by Different 'Shareholder Distributions to Net Income' Bands (0-25%, 26-50%, 51-75%, 76-100%, 100+%); in 2019

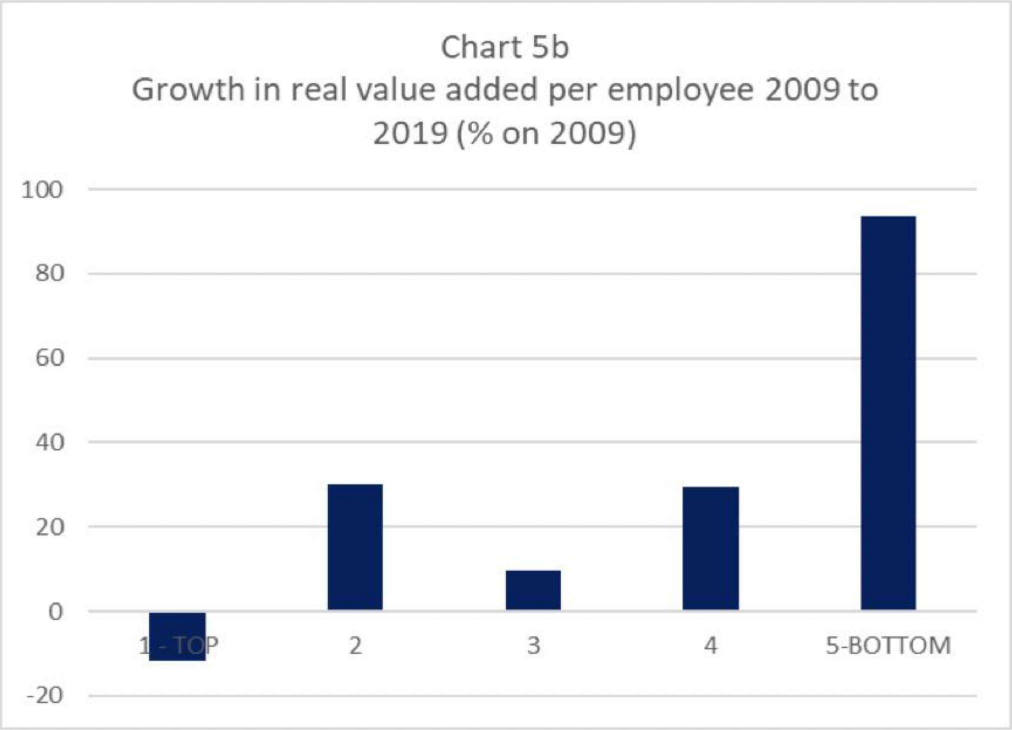


High distributors have lower real sales per employee growth...



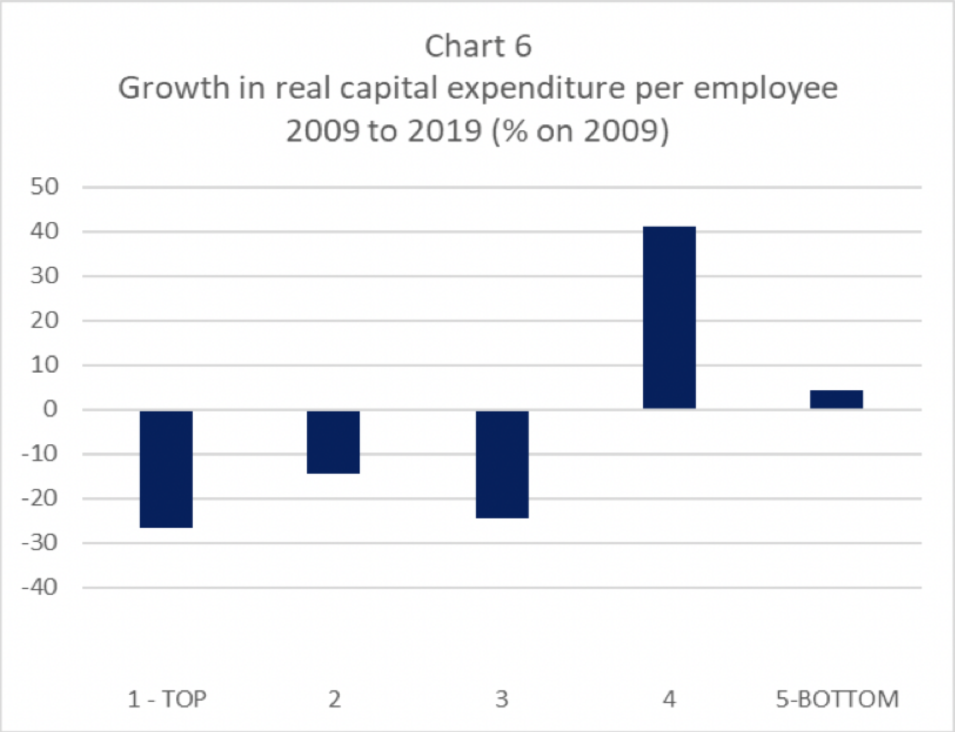
Source: Thomson EIKON datasets

...lower real VA per employee growth



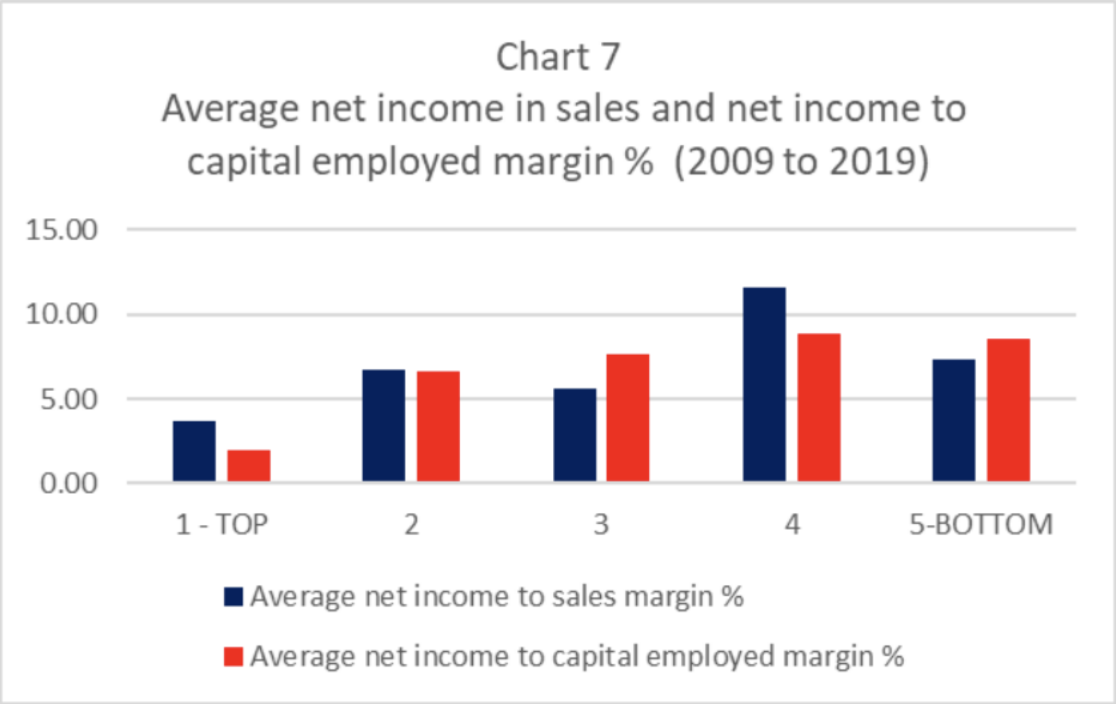
Source: Thomson EIKON datasets

…lower real capex per employee growth…

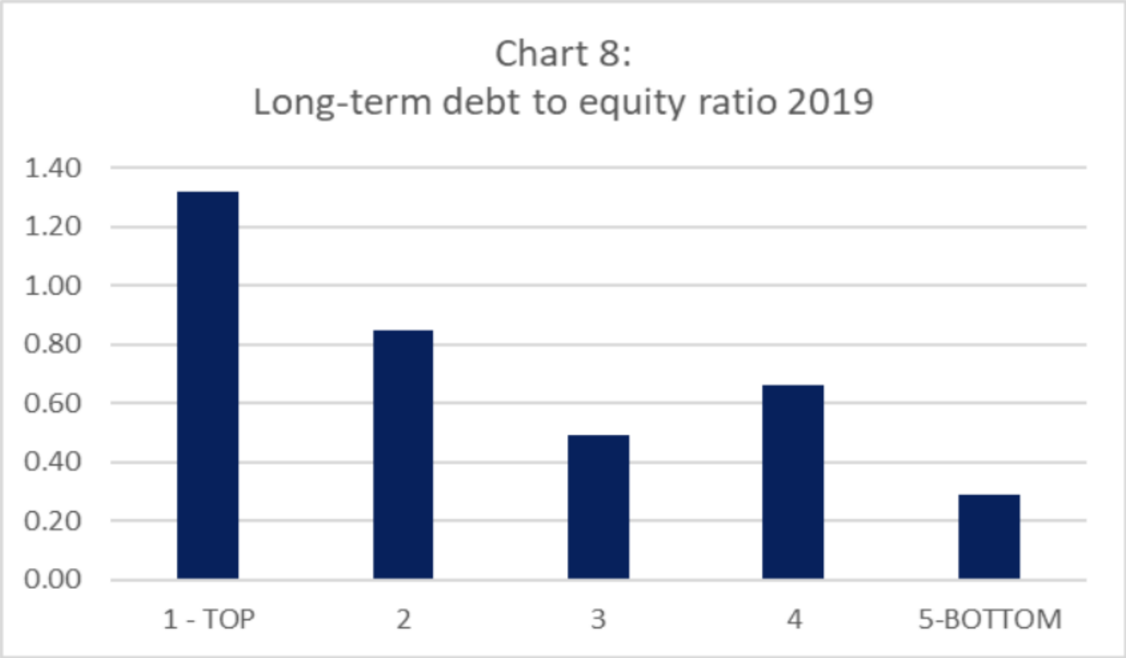


Source: Thomson EIKON datasets

…lower margins and ROCE…



...are more highly levered...



…more intangible, and carry greater ‘impairment’ risk…

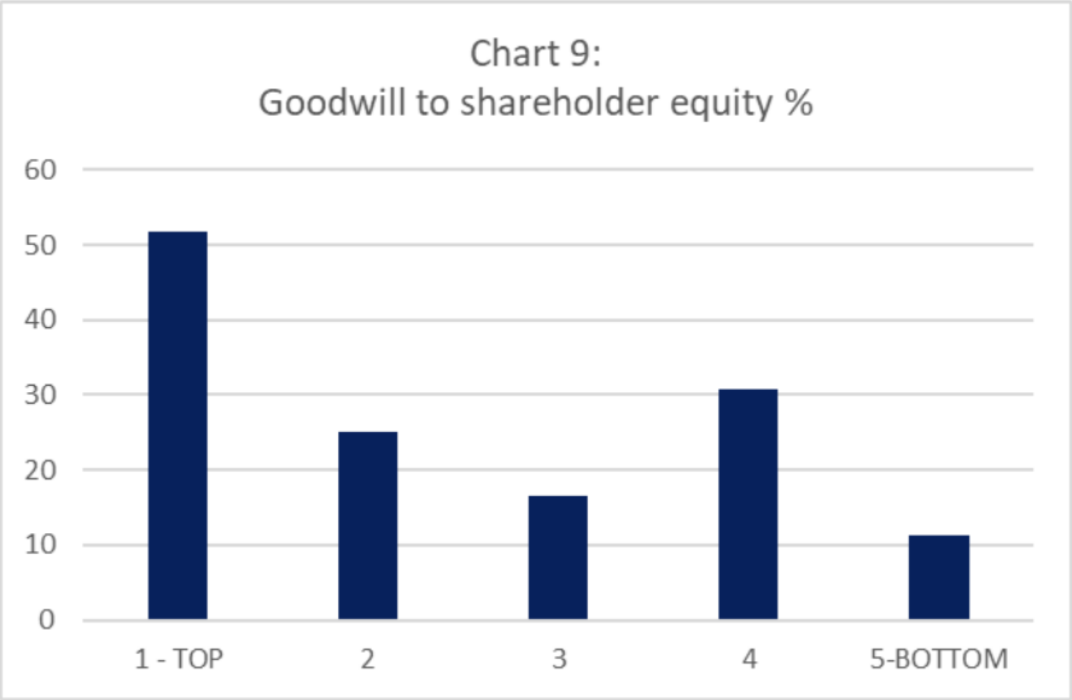


Table 5: Impact of goodwill impairments on net earnings and equity reserves in FTSE182

	Net income £bn 2019	No. of companies where 20% goodwill write down reduces net income by over 50%	No of companies with complete shareholder equity loss with 100% goodwill write down
1-Top	10.5	20	14
2	32.2	12	7
3	28.4	9	3
4	24.2	16	2
5-Bottom	10.2	8	2
Total		65	28
Proportion of FTSE 182		35.7%	15.4%
Proportion of companies in the Top quintile impacted		54.9%	38.5%

Source: Thomson EIKON datasets

3. Conclusion

Conclusion

- There are a rump of high distributing, low productivity, low investment, weak performing, indebted, intangible firms in FTSE350.
- Need a governance regime that better balances stakeholder interests
- Need an accounting regime that takes the punchbowl away from firms who lean on financial engineering and creative accounting instead of doing the ‘difficult stuff’ of management.
- Need a capital maintenance regime that creates greater resilience and provides the necessary buffers for its stakeholders
- And an auditing regime that reinforces the protection of firm capital.