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# The Social Function of Accounts

Reforming Accountancy to Serve Mankind

John Flower



# The Social Function of Accounts

*The Social Function of Accounts: Reforming Accountancy to Serve Mankind* argues that accountancy, as currently organized and practiced, is failing society, both in Britain and in the world as a whole. Examining the current problems afflicting the world—financial crises and instability, global warming, degradation of the environment, growing inequality—this book asks the question, What contribution does accountancy make to the solution of these problems? The book argues that the accountancy profession does not serve the public interest, notwithstanding its claim to this effect. It is tied to the paradigm of modern financial capitalism with its reliance on market solutions and the maximization of the firm's profits, which are the fundamental causes of most of these problems.

*The Social Function of Accounts* analyzes the moral responsibility of the accountant with reference to the principal theories of ethics. It argues that the individual accountant has a moral responsibility to consider the impact of his or her actions on other people and on society as a whole. For accountants to properly fulfil this responsibility, it is necessary that they develop new forms of financial reporting that measure the impact of businesses on stakeholders, on society and on the environment. The book sets out the principles on which a reformed accountancy should be based. Concluding with a call for the accountancy profession to adopt a new ethic of service to the public, *The Social Function of Accounts* redraws the boundaries of current accounting literature and will be vital reading for academics, researchers and policy makers in accounting and related disciplines.

**John Flower**, now retired, was formerly Professor of Accounting at the University of Bristol and Director of the Centre for Research in European Accounting, Brussels.

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Reforming Accountancy to Serve Mankind  
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John Flower

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# Preface

The argument in this book is based on a very simple premise—that accountancy (my profession) should serve the whole of mankind, and not solely a limited group of capitalists. The book’s focus is on the financial statements of business firms (financial reporting), and I am strongly of the opinion that the accountants who prepare and audit these financial statements have excessively modest objectives—they should be more expansive and more ambitious. They should strive to serve not only the people who provide the capital (the shareholders) but, in addition, all people connected with the business—referred to in this book as stakeholders.

The impulse that led to the writing of this book was a thought that suddenly struck me some 18 months ago. I was reflecting on the world’s problems: world poverty and hunger, climate change, growing inequality and so on—a depressingly long list. I asked myself what contribution accountancy was making to the solution of these problems, and the answer shocked me. After considering all sides of the matter, I came to the conclusion that accountancy was making them worse! Accountancy was, on balance, a destructive force, both of society and of the environment. As an accountant I was profoundly embarrassed by this discovery and asked myself what could I do to change the situation—to turn accountancy from a destructive force into one that served mankind. I decided that, in my situation, being over 80 years of age and having retired from active life over 20 years previously, the best I could do was to write a book.

So here is the book. It is addressed to my fellow accountants. I do not expect them to agree with every word. But I would ask them to give serious consideration to my arguments, for I am convinced that, in this book, I set out a strong case for the fundamental reform of accountancy that would be necessary to transform accountancy into a force that serves the whole of mankind.

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# 1 Capitalism in Crisis

The themes of this book are that the present economic system, based on capitalism, is failing mankind, that it should be reformed and that accountancy, my profession, can make a significant contribution to its reform. In this opening chapter, I analyse capitalism's current failings, which I consider to be so serious as to merit the label 'crisis'. The analysis relates principally to the position in Britain and the USA, with occasional references to the other parts of the world.

## 1. Capitalism's Successes

Although I consider that capitalism in Europe and America is currently in crisis, I do not deny that, in earlier periods, it was a force for good. This case is well put by Edmund Phelps in his book *Mass Flourishing*.<sup>1</sup> Phelps bases much of his argument on historical analysis, particularly on movements in real wages. He cites recent research which indicates that, in England, there was no significant increase in output per worker between 1500 and 1800, but that output per head started to increase rapidly around 1820. Two British researchers claim that '*after prolonged stagnation, real wages . . . nearly doubled between 1820 and 1850*'.<sup>2</sup> A similar increase occurred at around the same time in the USA, followed in the 1830s by Belgium and France and in the 1850s by Germany. These increases in output per head were extraordinarily rapid and quite unprecedented. They were dubbed by Walt Rostow, the economic historian who first drew attention to them, as 'take-offs'—take-offs from flat economic performance to sustained economic growth.<sup>3</sup> Phelps sings a hymn of praise to the results of this take-off: '*To countries where it came . . . [it] brought immense material benefits. In raising wage rates, it provided increased numbers the dignity of self-support, it liberated them to get out into society, and it opened up city life as an alternative to rural ways. In raising incomes, it improved living standards in very basic ways, reducing risks of early death through disease*'.<sup>4</sup>

There is no doubt that the early nineteenth century witnessed a significant increase in output in certain countries. But there is continued controversy as to the causes of this increase. Phelps attributes the increase in output to

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the business environment in Britain and the USA, the two countries that led the charge. In both countries, a businessman who had an idea for a new product or process had the opportunity, the means and the freedom to put it into practice. In effect, three indispensable elements of a successful capitalist economy came together: a set of enterprising and determined businessmen with ideas that they sought to implement; a stable state with an independent and effective judicial system which greatly increased the chances that contracts would be honoured; and a financial system which provided finance for the new ventures, at least in the quantities demanded by the relatively small enterprises of the period. Phelps rejects two other putative causes: increases in basic scientific knowledge and practical inventions, such as Hargreave's spinning jenny and Watts's steam engine. Personally, I do not fully agree with Phelps on this point, as I consider that both increased scientific knowledge and inventions were important factors. But I accept that, without the contribution of enterprising capitalists, their impact would have been far less. In my view, entrepreneurial capitalism was a necessary but not a sufficient condition for the take-offs in the early nineteenth century.

There can be no doubt that capitalism as practised in the period of take-off was an extremely powerful force, both in stimulating industrial output and in destroying antiquated social structures. Even Karl Marx was extremely impressed with capitalism's energy and creative power. In the late twentieth century, a vivid demonstration of capitalism's productive power was provided by China, when the ruling Communist party decided to allow businessmen to set up and operate their own enterprises and to benefit personally from their success. The Chinese leader was reported to have said that he had nothing against a successful businessman becoming 'filthy rich'. There followed an extraordinary increase in national output from which the Chinese people have undoubtedly benefited. Clearly, the recent growth in China's GDP can be attributed, almost entirely, to the working of the capitalist system as analysed by Phelps, in particular the freedom given to businessmen to set up enterprises to put into practice their plans to enrich themselves. A similar case can be made for the role of capitalism in promoting the recent growth in national output in India and in other, smaller Asian countries, such as South Korea, Taiwan and Singapore.

## 2. The Rise of Neo-Liberalism

There can be no doubt that capitalism was, on balance, a positive force in Europe and North America in the nineteenth century, and that this is still largely the case in China and India today. But, in recent years, in certain developed countries (most notably Britain and the USA), the character of capitalism has changed, with the increasing acceptance of a radical new philosophy: neo-liberalism.

### 2.1. *The Intellectual Origins of Neo-Liberalism*

Neo-liberalism was first developed over 50 years ago, by a small group of philosophers and economists; prominent among the group were Friedrich Hayek and Milton Friedman. Both won Nobel Prizes and both wrote books,<sup>5</sup> which set out very clearly and cogently the principles of neo-liberalism. These principles may be summarised as follows:

1. The freedom of the individual is paramount, with, in the words of Milton Friedman (2002, p. 5), *'freedom as the ultimate goal and the individual as the ultimate entity in the society'*.
2. The economy should be based on transactions between free individuals. Provided the transaction is voluntary, both parties benefit, for no party is obliged to agree to a transaction from which he does not benefit.
3. Transactions between individuals should be conducted on a free market, where prices are determined by the interaction of supply and demand. Market participants (both producers and consumers) should be motivated solely by their own self-interest, and, guided by Adam Smith's 'invisible hand', they will achieve the best result for mankind.
4. The owners and managers of firms<sup>6</sup> should seek to maximize the firm's profit. The firm makes a profit from its operations when the revenue that it receives from the sale of its output is greater than its outlay on its input resources. But, at the same time, the firm has increased the total market value of goods and services in the economy, in that it has converted a set of resources with a certain market value into a set of finished goods and services with a higher market value.
5. Competition between market participants assures that resources are allocated in a way that best serves mankind's needs. Competition also ensures that no individual is subject to domination by others. Friedman (2002, p. 15) argues that *'the consumer is protected from coercion by the seller because of the presence of other sellers with whom he can deal. The seller is protected from coercion by the consumer because of other consumers to whom he can sell. The employee is protected from coercion by the employer because of other employers for whom he can work, and so on'*. Competition also assures that market participants (both capitalists and workers) receive their just rewards: the capitalist's profit represents the increase in the value of society's goods and services created by his actions; the worker's wages represent (in the jargon of economists) the marginal value product of his labour—that is, the increase in the firm's output of goods and services attributable to his effort.
6. The principal economic role of the government is to ensure that the free market operates smoothly. The government should set up and maintain a legal system, consisting of legislators who define the law, judges who apply the law in specific cases and the police who enforce

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the law. An effective legal system is a necessary condition for the operation of a free market in that (i) it protects the freedom of the individual and enables him to play his allotted role in the market (whether as businessman, worker or consumer) free from the threat of violent coercion from others, (ii) it assures that contracts are honoured and (iii) it defines and enforces property rights. All three points are essential for the proper functioning of the capitalist economy. Businessmen must be able to operate without fear of violence; they must be able to rely on the promises of people with whom they deal (especially with incomplete contracts—promises to do something in the future), and they must have the confidence that they will be able to enjoy the fruits of their labours (that their property rights will be respected). Neo-liberals accept that a state with these limited functions (often termed ‘the night-watchman state’) is absolutely necessary for the economy to flourish.

7. Some neo-liberals consider that it is appropriate to extend the government’s function to include action to *improve* the functioning of the free market—for example, by curbing monopolies. But, in general, neo-liberals are opposed to the government assuming further functions in relation to the economy, for example, in setting prices or undertaking specific economic activities through state bodies, such as nationalized industries. They argue that such government actions interfere with the functioning of the market, leading to inefficiency. One thing on which all neo-liberals agree is that taxation is a bad thing, because it deprives the individual of his property; it should therefore be kept to a minimum by limiting the role of government to its basic functions. Neo-liberals deny that the government should play an active role in the economy. In economic matters, the only justification for the government to restrict the freedom of the individual is to improve the operation of the free market. Hence, government action to protect the environment or to increase demand in a recession is illegitimate.

A fundamental principle of neo-liberalism is that the firm’s managers, in reaching decisions concerning the firm’s operations, should be motivated solely by the imperative to maximize the firm’s profits. The firm should have no other objective; in particular, it should not attempt to ‘do good’ by promoting the welfare of anyone other than the firm’s owner—the owner is the personification of the firm. Milton Friedman (2002) made this very clear in the following passage: *‘There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engage in open competition, without deception or fraud’*. Milton Friedman offered two arguments in support of his proposition. Firstly, that any interference in the functioning of the free market would lead to

inefficiency and a fall in the value of output, from which everyone would suffer; secondly, that the managers of firms are not morally entitled to use the resources entrusted to them by the owners for any purpose other than for the owners' benefit.

## *2.2. Neo-Liberalism in Practice*

With the elections in 1979 of Margaret Thatcher in Britain and Ronald Reagan in the USA, the governments of both countries enacted economic policies based on neo-liberal policies. These included:

- Measures to improve the functioning of free markets, notably by limiting the power of trade unions. In both Britain and the USA, the governments used the power of the state to defeat strikes by militant trade unions—the coal-miners in Britain and the air-traffic controllers in the USA.
- Scrapping many government regulations that limited the freedom of action of businessmen, with particular emphasis on lifting restraints on the financial sector. In Britain, the Thatcher government deregulated foreign currency transactions and oversaw the 'Big Bang'—the wholesale removal of restrictions on the trading of securities on the London Stock Exchange in October 1983.
- Curtailing the role of the government in the economy, for example, by privatising nationalized industries and by cutting the level of state aid and subsidies to industry.
- Reducing the level of taxation, particularly on higher incomes and on business profits.

The basic principle followed by both governments was that the growth of the economy should be encouraged by stimulating the enterprise of businessmen; this was to be achieved by removing restraints on their actions and allowing them to retain a greater share of their profits.

## *2.3. The Case for Neo-Liberalism*

Neo-liberalism's advocates use two arguments to justify their position:

- That the freedom of the individual to undertake economic activity is of fundamental importance. It should be limited only in exceptional circumstances, principally to prevent harm to other people, in accordance with John Stuart Mill's harm principle.<sup>7</sup> Hence, it is claimed that neo-liberalism has a sound moral basis.
- That the operations of the free market lead to the maximization of the output of goods and services from which everyone benefits. Hence,

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neo-liberalism is economically efficient. It leads to sustained economic growth, which is in everyone's interest.

I deal with the issue of the morality of neo-liberalism later, after I have considered the question of economic growth.

### 3. Is Economic Growth Good for Mankind?

I now consider the question of whether economic growth is good for mankind. Many people consider that an increase in the output of goods and services is highly desirable, for the overall material standard of living of the population depends on this output. But I am very sceptical that a continuous increase in GDP (as currently measured) is in mankind's best interest. I consider that continuous economic growth has at least three negative consequences for mankind:

- It promotes materialism;
- It harms the environment;
- It is unsustainable and thus harms future generations.

#### 3.1. *The Promotion of Materialism*

Economic growth is clearly a 'good thing' when it enables people's basic needs to be more fully met: needs for food, clothing, shelter and so on. But capitalism recognises no limits; each year, it is obliged to invest in further productive capacity in order to avoid a slump caused by insufficient demand.<sup>8</sup> This entails that, even when their real needs have been more than fully met, the people must be persuaded to buy more goods and services—newly created goods and services which they do not really need and are only induced to buy through manipulative advertising, which in its use of psychological techniques borders on brain-washing. The result is a society obsessed with the acquisition of material goods, where the population is engaged in a never-ending pursuit of the latest gadget that will bring (all too brief) happiness. As through economic growth, more and more of mankind's real needs are met, the innovative goods and services developed by capitalist firms become ever more trivial.<sup>9</sup>

Personally, I hold that the really important things in life are not material goods. I prefer immaterial experiences, such as listening to Beethoven's Ninth Symphony or reading a Jane Austen novel. The standard answer of the economist to this comment is that 'you can't eat a novel', but the economic output in Britain and the USA has reached a level where man's basic needs have been more than adequately met: for example, the need for food is met with such excess that obesity is a far greater social problem than malnutrition. We desperately need an economic system that put the emphasis on the really important things in life.

### 3.2. *The Harm Inflicted on the Environment*

For mankind to flourish, the earth's biosphere (the narrow band of atmosphere, sea and land that supports all life on this planet) must be maintained in good condition. But there is strong evidence that the biosphere is becoming increasingly degraded, with the consequence that it is becoming less capable of supporting human life. The most worrying aspect of this degradation is climate change.

*Climate change:* The earth is becoming warmer. Incontrovertible evidence of this fact is provided by the reports of the Intergovernmental Panel on Climate Change (IPCC), a UN body which draws on the expertise of over 800 scientists world-wide. According to its latest report (IPCC, 2014), the period 1983–2012 was the warmest 30-year period of the last 1,400 years. More recent measurements indicate this trend has continued, with 2015 being the hottest year on record. The consequences for the welfare of mankind are already apparent and are almost entirely negative. They include: a significant rise in the sea level; an increase in the frequency and intensity of severe weather events, such as hurricanes; and a change in weather patterns, with some regions becoming more prone to drought, with, on balance, a negative impact on agricultural crop yields.<sup>10</sup> Up to now, the impact of climate change has been relatively benign, but the future impact will certainly be much more severe. If present trends continue (if mankind does not radically change its behaviour), the IPCC estimates that, by 2100, the global temperature will have increased by a further 3°–4°C. The forecast consequences of such a rise are dramatic. They include: a further rise in sea levels of up to 0.82 metres, leading to the disappearance of many island states (for example, the Seychelles), the inundation of vast coastal areas that are home to millions of people (for example, in Bangladesh) and the flooding of many important cities (for example, New York and London), a further pronounced increase in the frequency and intensity of extreme weather events and, most worryingly, great risks for food production, leading to widespread starvation.

The IPCC's findings are disputed by 'climate-change sceptics', whose principal arguments seem to be that weather is inherently variable, that current developments can be explained by this variability and that, given that it is impossible to know the future, the catastrophe predicted by the IPCC may never happen. I reject these arguments. The IPCC bases its findings on the work of over 800 scientists from around the world. Evidence for current climate change is based on observation of long-term trends, in some cases going back more than 200 years. Estimates of future developments are based on reasoned extrapolation of current trends, using models that have been thoroughly tested. There is a remarkable degree of consensus among scientists as to the reality of global warming, as is made very clear in the IPCC's report, which specifies very clearly the high degree of confidence that may be attached to each of its predictions. Climate-change sceptics are a tiny idiosyncratic minority.

There is no dispute about the cause of climate change. It is the consequence of the build-up of greenhouse gases in the atmosphere which trap the sun's heat. The principal greenhouse gas is CO<sub>2</sub>, which is emitted in the burning of fossil fuels, notably coal, oil and natural gas. Increased economic activity leads to increased demands for energy, which is won principally from the earth's reserves of fossil fuels. The concentration of CO<sub>2</sub> in the atmosphere has increased from 315 parts per million in 1957 to 407 parts per million in 2016.<sup>11</sup> Economic growth inevitably leads to increased demand for energy, which leads to further emissions of greenhouse gases, which lead to climate change. Renewable sources of energy, such as hydro-electricity and wind turbines, which do not pollute the atmosphere, provide only a negligible proportion of mankind's energy demands. Neo-liberalism, with its emphasis on continued economic growth, is thus a principal factor in stimulating climate change.

Climate change is only one aspect of the global environmental crisis. Other disturbing elements are:

- *Loss of biodiversity:* The earth is host to an enormous variety of life: mammals, reptiles, birds, fish, molluscs, worms, insects, trees, plants, fungi, algae and a profusion of micro-organisms. The health of the biosphere depends on maintaining an equilibrium between these various organisms. Although, in many cases, scientists are unsure of the role that any specific organism plays in maintaining the equilibrium of any particular eco-system, it is nevertheless clear that the elimination of any organism may have unpredictable and probably negative impact of the eco-system's functioning. Hence, the extinction of any life form, however insignificant, represents a potential threat to man's well-being. It is true that, over the four billion years of the earth's history, many species (such as the dinosaurs) have become extinct, but the present rate at which extinction is occurring far exceeds past rates. It is abundantly clear that the cause of the current mass extinction is human economic activity, notably the destruction of natural habitats in order to provide land for cities and agricultural production. Many scientists are concerned that ultimately mankind will suffer, perhaps profoundly, through this wanton reduction in the variety and diversity of nature.
- *Degradation of the oceans:* Over the last 50 years, there has been a significant decline in the ability of the oceans to support marine life, with serious consequence for their capacity to serve as a source of food. A major factor is increased acidification; the IPCC estimates that, since the beginning of the industrial age (c. 1750), the oceans have become 26% more acidic.<sup>12</sup> This development is linked to the increased concentration of carbon dioxide in the atmosphere and hence to climate change. Other factors have aggravated the damage caused by acidification, notably

the destruction of fish stocks caused by uncontrolled over-fishing and the pollution of the oceans, as they have become the dumping ground for mankind's waste (ranging from plastic bags to radioactive materials from nuclear power stations<sup>13</sup>) and the toxic by-products of industrial and agricultural production.

- *The abused land:* In very much the same way as has happened with the oceans, much of the earth's land surface has been damaged by human economic activity. This is particularly the case with the Amazon and Congo basins, where vast tracts of rainforest have been cleared to release land for agriculture. The long-term results are generally negative. Certainly, initially the virgin soil produces high yields, but these drop off as the soil's fertility is depleted through continued intensive cropping. Elsewhere, whole regions have been ravaged by industry's demand for raw materials: for example, the development of the Athabasca oil sands in Canada has created an artificial lake of toxic wastewater over 77 km<sup>2</sup> in area,<sup>14</sup> and strip mining in Appalachia literally destroys the landscape, with whole mountaintops being removed in the search for coal.<sup>15</sup> In many parts of Africa, vast tracts of land have been used as the dumping ground for the richer countries' waste and discards, such as used television sets. In the graphic word of Pope Francis, '*the earth, our home, is beginning to look more and more like an immense pile of filth*'.<sup>16</sup>

The principal cause of the damage to the environment is human economic activity. There can be no doubt that, in recent years, human activity has caused significant damage to the biosphere, with very serious consequences for mankind's future welfare.

The above analysis implies that capitalism, through the stimulus that it gave to the development of industrialization (see Phelps's thesis in section 1 above), has been a major factor in causing the current environmental crisis and, with its emphasis on ever-increasing output, is likely to remain a negative influence in the future. More seriously, for reasons that I set out later (see section 4), I consider that capitalism is incapable of modifying its behaviour so that the increased output is produced in ways that do not harm the environment.

### 3.3. *The Harm Inflicted on Future Generations: The Need for Sustainability*

Continuous economic growth cannot be sustained in the long run, because it fails to take into account the limits of planet Earth. There are two types of limits: the limited quantity of the non-renewable resources (such as fossil fuels) which are used up in the production process, and the limited capacity of the earth to absorb the waste generated by economic activity (both

industry's unwanted by-products—for example, the toxic effluent of a chemical factory—and the discards of the consumption-obsessed society created by capitalism, such as the plastic bags that presently befoul the oceans).

The coal, oil and natural gas which currently supply industry's energy requirements were created over several million years; they are now being consumed at such a rate that the entire stock will be used up in a few hundred years. This rate simply cannot be sustained.<sup>17</sup> Jonathon Porritt (2005, pp. 46–50) points out that the economy depends on the biosphere—the economy is a subsystem of the biosphere's ecosystem. He concludes, *'It is the physical limits of the ecosystem which will constrain the speed and scale at which the economic subsystem can expand. In the long run, it cannot grow beyond the capacity of the surrounding ecosystem to sustain that growth—and the planet (or overarching ecosystem) cannot grow'*.

The gravest threat to future generations is posed by climate change resulting from the build-up of greenhouse gases in the atmosphere. It is estimated that, with the present concentration of CO<sub>2</sub> in the atmosphere of more than 400 parts per million, the average global temperature will increase by over 4° C by the end of the present century, with devastating consequences, such as the flooding of coastal regions (and the disappearance of some island states) caused by a rise in the sea level, and famines caused by changes in the weather pattern.

Porritt also points out the implications of compound growth. If the economy grows 3% this year, and at the same rate in future years, in 25 years it will be more twice its present size,<sup>18</sup> and, with no change in the behaviour of firms, there will be double the consumption of oil and other raw materials and double the creation of waste.

The first thinker to draw attention to the dangers of compound growth was Thomas Malthus, who, in 1799, published an essay which analysed the consequences of population growth.<sup>19</sup> He pointed out the incontrovertible fact that, if population grew at a compound rate, it must at some point outstrip the earth's capacity to feed itself, leading inevitably to famine. In Malthus's day, Britain's population was growing at about 1.4% per year. At that rate the world's population would grow from about 1 billion in 1800 to about 17,000,000 billion in the year 3000, which would leave less than 10 square centimetres of land for every man, woman and child to stand on! Of course, this cannot happen and, in fact, largely due to the spread of contraception, the world's population is expected to stabilise at around 10 billion in the year 2100. But this analysis vividly illustrates that compound growth is incompatible with finite resources.

It seems abundantly clear that the current rate of economic growth cannot be maintained even for more than a few decades without a fundamental change in the way the economy functions. But the people who will suffer most are future generations; by contrast, the current generation may probably suffer only relatively minor inconveniences, such as more frequent heat waves and hurricanes. But it is thoroughly immoral for the present

generation to enjoy the pleasures of an extravagant lifestyle (including such energy-consuming activities as air-conditioning and air travel to exotic holiday-destinations) when it is future generations which will have to bear the cost in the form of climate change.

What is needed is not a growing economy, but a stationary economy, as first proposed by the English philosopher John Stuart Mill in 1850 and in this generation by the economist Herman Daly.<sup>20</sup> But I contend that, for reasons to be given in section 4, neo-liberalism is incapable of weaning itself from continuous growth.

### 3.4. *Neo-Liberalism's Answer*

The answer of the neo-liberals to my predictions of imminent catastrophe is basically similar to the reaction of Mark Twain to newspaper reports of his death—‘greatly exaggerated’. The catastrophe has not yet happened and may never happen. In fact, currently, more people enjoy a higher material standard of living than ever before in the history of the world. For example, over the past two years, the number of people suffering from malnutrition has declined by 20%. This has been achieved by mankind’s genius for invention and innovation, for example, in developing new strains of cereals that give higher yields per acre. Given man’s experience over the past 200 years, there is every reason to expect that mankind will continue to enjoy ever increasing prosperity: for example, that he will develop new forms of energy that are less polluting and thus reduce his dependence on fossil fuels. New modes of living can be developed that provide increased satisfaction for everyone but are less dependent on the production of material goods; for example, computers and smartphones have become progressively more powerful, as they have become smaller and thus use fewer materials. The dire predictions of Thomas Malthus have not been realised (at least, not in the two centuries since they were made), and the same will be the case with my predictions.

### 3.5. *My Response*

I concede that the neo-liberals may well be correct. Both they and I are talking about the future and, in the immortal words of Yogi Berra, *‘it is always difficult to make predictions, particularly about the future’*. But I stick by my contention that unchecked capitalism is driving mankind to catastrophe—for two reasons:

- I do not believe that the developments on which the capitalists pin their hopes (new forms of energy and less material-intensive modes of consumption) can be achieved in time to save the world from disaster. If the billions of people in China, India and other developing countries realise their aim of a standard of living equal to the current level of America and Europe, then pollution created by the extra billion cars,

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air conditioners and other material attributes of a high standard of living will surely make global warming even more likely and even more destructive.

- I believe that it is prudent and rational to take action to prevent a catastrophe, even if the probability of a catastrophe is small. This is known as the precautionary principle. It is logical to incur a certain small cost now in order to avoid a far greater (but uncertain) harm in the future.

I do not advocate abandoning completely the aim of further material progress, but I do consider that the type of unrestrained economic growth induced by neo-liberal policies must be stopped. I believe that neo-liberalism is incapable of achieving this.

### 4. Neo-Liberalism's Fatal Flaws

It should be noted that the arguments against economic growth set out in the previous section apply not only to neo-liberalism, but to all forms of capitalism. But the potential harm to mankind from neo-liberalism is far greater than that from traditional capitalism because of two flaws in neo-liberalism's fundamental principles:

- The limitation of the role of the state;
- The absolute freedom of the businessman.

#### 4.1. *The Limited Role of the State*

It is a fundamental principle of neo-liberalism that the state's functions should be limited to those of the night-watchman state—to defend its citizens from aggression (either from foreigners or from their fellow citizens), to ensure that contracts are honoured and to protect property rights. State action beyond these functions is illegitimate. Hence, when the application of neo-liberal policies leads to consequences that may be considered to be undesirable, there is no way of correcting the position. It is my contention that traditional capitalism (as practised before the introduction of neo-liberalism a generation ago) was prevented from causing serious harm to society through the timely intervention of the state. A pertinent example is the recovery from the Great Depression of 1929–1933 through government action: for example, Roosevelt's New Deal. A somewhat similar situation arises currently in relation to climate change, as explained in the next section.

#### 4.2. *The Unfettered Freedom of the Businessman*

One of neo-liberalism's fundamental principles is that the individual businessman (and firm) has an absolute right to increase his wealth by exploiting the opportunities available to him on the market—to buy resources (such

as materials and labour) at market prices, convert them into finished goods and services using any available technology and sell them to consumers and other firms at the highest price that he can get. The principal constraints that he has to respect in the pursuit of his private wealth are those imposed by the market—for example, he cannot force other firms to sell him materials at less than the market price. Of course, in addition, he is obliged to obey the law. But the law originates from government, and, as pointed out above, neo-liberals reject the legitimacy of government action that restricts the freedom of firms to maximize profits; the only legitimate constraints are those imposed by the market.

The implication of this ideology is that the businessman, in making decisions about what to produce, how to produce it and how much to produce, takes into account only the impact of his decisions on his own wealth and ignores the impact on the welfare of other people; he considers the impact on other people *only* to the extent that it has an impact on his own wealth—for example, a businessman would not market a dangerous product, if, this fact becoming widely known, customers organized a boycott.

The implications of such behaviour may be demonstrated with the following example. A firm uses a large quantity of electricity in its production process. The generation of electricity entails the production of CO<sub>2</sub> which, when released into the atmosphere, causes climate change. But the quantity of CO<sub>2</sub> emissions varies according to the method used to generate electricity, from negligible, in the case of wind-turbines, to considerable, for a coal-fired power station. But the market price of electricity does not reflect these differences; in fact, in most European countries, the user has to pay a premium if he wants to be certain that the electricity that he consumes has been generated in a less polluting way. The capitalist businessman has no incentive to pay this premium. His sole interest is to acquire the electricity required by his firm at the lowest price available on the market. Certainly, he and his firm will suffer the consequences of climate change in the far future, but the relatively small quantity of CO<sub>2</sub> produced in generating the electricity that his firm uses will have a negligible impact on the climate; his present behaviour will have virtually no impact on his future suffering, which will be determined by the behaviour of millions of other people.

The fundamental flaw in neo-liberalism is that decisions on resource allocation are taken at the level of the manager of the individual firm. In very many cases, this is not the level that leads to the best decision for mankind. Other levels are more appropriate: the community, the country and (in the case of climate change) the level of the planet.

#### 4.3. *The Consequences of These Flaws*

I contend that, because of these flaws, the performance of the British economy over the past generation (when economic policy was based on neo-liberal

principles) has been seriously deficient and harmful to society. I will justify this claim with reference to the following matters:

- Unemployment;
- Inequality;
- Financialization;
- The global financial crisis of 2007/8.

## 5. Unemployment

Over the last 40 years, unemployment in Europe has been getting worse. Over this period, the unemployment rate in Britain worsened from 3.4% in 1974 to 5.0% in 2016 and in Germany from 1.7% in 1974 to 4.2% in 2016. The date of 1974 has been chosen as it represents the end of a remarkable 30-year period in the economic history of Western Europe and North America, known to the French as the ‘Trente Glorieuses’, which was marked both by a substantial increase in output and by a significant improvement in the living conditions of the poorest members of society. Since 1975, the unemployment rate in Europe has fluctuated significantly; for example, in Britain, it reached a high point of 11.9% in 1984 and a low of 4.7% in 2004,<sup>21</sup> but it has never recovered the very low levels (around 2%) experienced in the 1950s and 1960s.

The evidence that neo-liberalism has caused unemployment is not wholly convincing. Thus, the level of unemployment in Britain in 2016 was lower than that in France, notwithstanding that Britain has adopted a far more aggressive form of neo-liberalism. But I feel that the longer-term development since 1974 gives the more substantive picture. It is surely no coincidence that unemployment started to increase with the adoption of neo-liberal policies by Margaret Thatcher (who became Britain’s Prime Minister in 1979) and Ronald Reagan (elected US President in the same year).

The evidence that neo-liberalism has caused a deterioration in the conditions of employment is much more convincing. In Britain, the current level of unemployment is not excessively high at 5% (although far higher than the average rate of 2%–3% enjoyed during the ‘Trente Glorieuses’). But there is no doubt that the working conditions for the great majority of those in employment have worsened considerably, as demonstrated by the following developments:

- A significant reduction in the security of employment. Thus, many people are employed on temporary contracts, some even on ‘zero-hours’ contracts, where the employer pays only for the hours worked and offers no guarantee that work will be forthcoming.
- A significant increase in the number of hours worked by those in permanent employment. This is a paradoxical trend, given the continued spread of labour-saving technology. Possibly it can be explained by the desire

of managers to reduce to a minimum the number of their permanent employees (those which they are obliged to employ even when business is slack), with the consequence that those who escape being sacked have to work even harder. It would seem that, in Britain, the working population is divided into two disparate groups: the overworked permanent employees and the underworked employees on zero-hours contracts.

- A change in the form of pension schemes offered by firms to their permanent employees. There has been a pronounced shift from defined-benefit pension schemes (where the risk is borne by the employer) to defined-contribution pension schemes (where the risk is borne by the employee).

There is no doubt that, with neo-liberalism, the employment experience of the great majority of the British population has worsened.

## 6. Inequality

The argument is that neo-liberalism creates a more unequal society, with greater differences in wealth between the rich and the poor. Neo-liberals acknowledge that, for them, a more equal society is not an important aim. In the choice between a more free society and a more equal society, neo-liberals come down unequivocally in favour of a more free society; the freedom of the individual should never be constrained in the interests of equality. Hence, for the neo-liberal, redistributive taxation—taking from the rich to give to the poor—is anathema.

But neo-liberals claim that, in their ideal economy, in which firms have complete freedom to maximize their profits, all (including the poor) benefit from the increased output of goods and services. The neo-liberal position was very well expressed by the British vice-chairman of Goldman Sachs, when, in defending the bonuses totalling \$16 billion which his firm planned to pay, asserted that the public should ‘*tolerate inequality as a way to achieve greater prosperity for all*’.<sup>22</sup> The neo-liberals claim that wealth will ‘trickle down’ to the poorer elements in society or (to change the metaphor) ‘a rising tide lifts all boats’. This certainly seems to have been the case in China, where millions of citizens, who previously lived a very basic life in the countryside, have undoubtedly benefited from the surge in prosperity resulting from the introduction of capitalism. But the critics of neo-liberalism have two counter-arguments:

- ‘Trickle down’ does not always work;
- There are other failings of an unequal society.

### 6.1. *The Failure of ‘Trickle Down’*

The neo-liberals’ principal justification of an unequal society is that, in practice, it leads to a higher material standard of living for everyone, including

the poorest. This is an empirical claim and, if true, would meet with the approval of John Rawls, the distinguished American philosopher, the author of the difference principle—the idea that inequalities in society are justified, provided that they are for the benefit of the least advantaged.<sup>23</sup> And it is undoubtedly true that capitalism, in many countries and in many periods, has benefited the poor—for example in China in recent years, and in Britain over the long time span since the onset of industrialization.

But, in recent years following the adoption of neo-liberal policies, the level of inequality in America and Europe has undoubtedly increased. There are various facets of inequality. Unemployment is one: the available jobs are distributed unequally, with the unemployed being worse off than the employed. Other dimensions are inequality of wealth, inequality of income and inequality of opportunity. There is considerable evidence that inequality in the developed countries of Europe and the Americas is getting worse on all three dimensions. This section considers the evidence relating to inequality of income.

The OECD (the international organization that represents the richer, developed nations) has analysed trends and concludes: *'Income inequality . . . first started to increase in the late 1970s and early 1980 in some English-speaking countries, notably the United Kingdom and the United States . . . from the late 1980s, the increases in income inequality became more widespread. The latest trends in the 2000s showed a widening gap between rich and poor'*.<sup>24</sup> It is significant that inequality started to increase shortly after the coming to power of Margaret Thatcher in Britain and Ronald Reagan in the USA. Some statistics from the OECD's report are presented in Table 1.1. This table presents two measures of inequality: the Gini coefficient and the 90/10 decile income ratio.

Table 1.1 presents the income Gini coefficients for Britain, the USA and Sweden for two dates: 1975 and 2012.<sup>25</sup> In simple terms, a Gini coefficient of zero represents perfect equality: the attribute in question (in this case income) is spread evenly over the members of the population. Each member of the population has the same income.<sup>26</sup> A Gini coefficient of one represents perfect inequality: one member of the population has all the income. The date of 1975 has been chosen as it represents the end of the 'Trente Glorieuses'.<sup>27</sup> By contrast, the next 40 years have been marked by a substantial increase in inequality, as measured by the increase in the Gini coefficient since 1975. Although there is scope for argument as to whether a Gini coefficient of a certain figure (say, .35) represents an acceptable level of inequality, it is indisputable that an increase over time represents a trend towards greater inequality.

A more easily understood measure of inequality is the 90/10 decile income ratio, which is also shown in Table 1.1. It measures the ratio of the average income of the highest decile (the top 10% of the population) to that of the lowest decile. The higher the figure, the greater the inequality. This statistic

Table 1.1 The Growth of Inequality

	<i>Britain</i>	<i>USA</i>	<i>Sweden</i>
Gini income coefficient			
1975**	.201	.337	.201
2012	.269	.401	.274
90/10 decile income ratio			
1975**	3.2	5.5	2.6
2012	4.2	6.2	3.3

Source: OECD database on household income distribution and poverty

\*\* For the USA, the year is 1984.

tells much the same story as the Gini coefficient, which further strengthens the judgement that inequality has increased in recent years.

An increase in inequality does not necessarily imply a reduction in the material standard of living of the least well-off. It simply shows that the income of the most well-off has increased more quickly than that of the least well-off. But in recent years, in both Britain and the USA, the real wages of the lowest-paid have stagnated. In the USA, in the period 2000–2015, the real wages of the bottom fifth increased by just 0.1% per year, whereas the real wages of the top 1% increased by 2.3% per year.<sup>28</sup> A non-income measure is very revealing of how well a society treats its most disadvantaged: the number of homeless people. In London, the number of homeless people sleeping on the streets has increased massively since the onset of the global financial crisis;<sup>29</sup> the same phenomenon has occurred in the USA, where the homeless, being somewhat more affluent, sleep in their cars.

## 6.2. *The Failings of an Unequal Society*

Inequality is undesirable because of its negative impact on the lives of all members of society—not just those at the bottom. The failings of a society marked by great inequality have been thoroughly analysed by Richard Wilkinson and Kate Pickett in their ground-breaking book *The Spirit Level*.<sup>30</sup> They analysed the data relating to 23 developed countries (the USA, Canada, Japan, Singapore, Israel, Australia, New Zealand and 16 European countries) to establish the relationship between income inequality and a number of indicators of a good society, covering a very diverse field: life expectancy, infant mortality, obesity, mental illness, educational performance, teenage pregnancies, rates of homicides and imprisonment. In almost all cases, there is a strong correlation between income inequality and the undesirable statistic (such as lower life expectancy<sup>31</sup> or more teenage pregnancies<sup>32</sup>). What

is more remarkable is that the correlation with the social statistics is much stronger with income inequality than it is with the absolute measures of national income. This indicates that equality is of value in itself. It leads to an improvement in the quality of life, even in a country with a relatively low national income.

Wilkinson and Pickett's analysis demonstrates conclusively that there is a definite correlation between greater equality and a better society. Wilkinson and Pickett do not claim that there is a relationship between *neo-liberalism* and inequality. All 23 countries that they analysed are democracies with a broadly capitalist economic system. However, I feel that there are significant differences between the 23 countries in the degree of freedom granted to the managers of firms to pursue their own interests; this ranges from very wide freedom in Britain and the USA to much more limited freedom in Germany and the Scandinavian countries, where the law obliges managers to take into account the interests of other parties, notably workers and customers. I feel that it is no accident that the degree of equality in these countries, as measured by the 80/20 income ratio, is far higher.<sup>33</sup> Hence, I interpret Wilkinson and Pickett's analysis as further proof of neo-liberalism's shortcomings.

It is surely no coincidence that inequality has grown so much since neo-liberal policies started to be implemented in the 1980s and has grown most strongly in those countries that applied these policies most rigorously, notably Britain and the USA.<sup>34</sup> To summarise my argument, capitalism promotes inequality (with neo-liberalism having the stronger impact) and inequality leads to a deterioration in those immaterial aspects of society studied by Wilkinson and Pickett: health, drug abuse, obesity, educational performance, teenage pregnancies, crime and punishment.

The neo-liberalism counter-argument is that the least well-off benefit from the increased output of goods and services. But this concerns solely the material aspects of a good society. It neglects the immaterial aspects (analysed by Wilkinson and Pickett), which is a grave fault. Moreover, even with respect to the material aspects, neo-liberalism exhibits a serious failing. In seeking to maximize the output of goods and services, neo-liberalism may contribute to increasing the total wealth in a society, but it ignores the distribution of that wealth between the members of society. The champions of neo-liberalism deal with the question of the distribution of wealth and income in one of two ways: either they claim that distribution is determined by market forces which should not be interfered with (i.e., the actual distribution is inevitable) or that distribution is determined by the contribution that the individual society member makes to total output (i.e., the actual distribution is morally justified).

I reject this reasoning. I consider that distribution is of fundamental importance in determining the welfare of society's members; thus, for any given level of income and wealth in a society, the overall level of welfare of the society's members will be higher when the income and wealth is spread more evenly than when it is concentrated in the hands of a small minority.

This is the logical consequence of the law of diminishing marginal utility. If one unit of wealth or income is transferred from a rich man to a poor man, the decrease in the rich man's welfare is less than the increase in the poor man's welfare. I have dealt with the question of distribution in my previous book, *Accounting and Distributive Justice*.<sup>35</sup> In this book, I return to the subject in chapter 5. I am convinced that neo-liberalism's neglect of the distribution of wealth and income is a most serious failing.

## 7. Financialization

The argument is that neo-liberalism has led to the development of financialization. Financialization is an ugly word which has been invented to denote a relatively recent phenomenon—the growing dominance of finance, which many consider not to be in the best interests of society or of the economy. But there is general agreement that finance can play a positive role. Even John Kay, a fierce critic of finance as currently practised, agrees. He lists four ways in which finance can contribute to society and the economy:<sup>36</sup>

- To provide people and firms with a means of payment, including complex and difficult payments, such as settling a debt in a foreign currency to a supplier on the other side of the globe;
- To match lenders and borrowers and thus facilitate productive investment;
- To enable people to manage their flows of income and expense over their lifetime and across generations (for example, with student loans and pensions);
- To help people and firms to mitigate the risks arising in life and economic activity (for example, with fire insurance).

Clearly, finance plays a vital role in the functioning of capitalism, but John Kay and many other contemporary critics consider that, in recent years, finance has become too important—too dominant for the good of society. This dominance of finance can be attributed largely to the neo-liberal policies of the British and American governments in scrapping many regulations that previously restricted the growth of the financial sector. There are two aspects of this dominance:

- A macro aspect: the place of finance at the level of the economy;
- A micro aspect: the place of finance within the firm.

### 7.1. *The Role of Finance in the Economy*

Finance is the principal activity of financial institutions, such as banks, insurance companies, investment trusts, pension funds and so on. Over the past 30 years, these organizations have come to play an increasingly

dominant role in the British economy; they currently employ some 1.1 million people—about 4% of the labour force. The scale of the business carried out by financial institutions is phenomenal, as measured by the number and scale of financial transactions. Most of these transactions are effected between financial institutions and are not related to the four socially useful functions of finance listed above. Thus, the annual volume of payments processed by British banks is about 40 times the country's national income, and trades in foreign currencies world-wide are almost a hundred times the international trade in goods and services.<sup>37</sup> As John Kay points out, most of the activity of financial institutions consists of exchanging bits of paper with other financial institutions, an activity that seems to create very little value for society. Thus, the greater part of the assets of British banks consists of obligations of other financial institutions; only 3% consists of loans to business. Most of the activities of financial institutions have nothing to do with socially useful functions. But they would seem to be very profitable, at least, as evidenced by the very high salaries and bonuses paid to the senior staff of financial institutions. For example, in 2013, 1,443 employees of the British bank, Barclays, received remuneration (I hesitate to use the word 'earned') of more than £500,000.<sup>38</sup> These salaries attract many of the best brains in the country, particularly among young people. It is the career of choice for many of the best graduates from elite universities.

John Kay argues that much of the profits reported by financial institutions are the outcome of speculative transactions that he terms 'martingales':<sup>39</sup> transactions with a very high probability of a small profit and a very low probability of a devastating loss. In absolute terms, they generally yield a large profit, because the banks deal in vast sums—in tens or hundreds of millions of pounds, which, of course, magnifies the impact of the loss when it inevitably comes. John Kay's analysis seems convincing. The very high profits that financial institutions reported in the early years of this century were more than offset by the vast losses that they suffered in the global financial crisis of 2007/8. Of course, a large part of these losses were borne, not by the banks, but by the state in the form of government bail-outs, so that most financial institutions survived the global financial crisis; they are again reporting profits and paying extravagant bonuses to their senior staff. This development highlights a further way in which the financial sector in Britain and the USA harms society; it subverts democracy, as financial institutions are able to blackmail governments to rescue them from the consequences of their ultimately unprofitable and antisocial activity by claiming that they are 'too big to fail'.

It is abundantly clear that much financial activity serves no useful social purpose. A pertinent example is the construction by a telecoms company of a high-speed link through the Appalachian Mountains that reduces the time to transmit data from Chicago to New York by less than one millisecond. It is profitable for certain traders<sup>40</sup> in financial institutions to pay money for this quicker data, as it gives them an edge against their competitors in a field

known as ‘high-frequency trading’. It is obvious that any gain made by the trader in exploiting this quicker data is at the expense of other participants in financial markets. It is a zero-sum game. From the viewpoint of society, the construction of the high-speed link represents a waste of resources. But I feel that the greatest misallocation of resources is the employment of the country’s best brains in what is essentially a zero-sum game.

### 7.2. *The Role of Finance in the Firm*

The growth of financialization has been accompanied by a great increase in the influence of the shareholders over the management of the firm. Very many firms have adopted a policy of increasing shareholder value. The interests of the shareholders take precedence over those of all other stakeholders: employees, suppliers, even customers. All the firm’s activities are subordinated to the imperative to increase returns to shareholders. According to the theory of Michael Jensen,<sup>41</sup> one of the original advocates of shareholder value, a firm should maximize its profit, which is both the source of its dividends and the major factor determining the market price of the firm’s shares. Jensen’s principal concern was to improve the allocation of capital so as to maximize output—he accepted fully the analysis of capitalism’s benefits that is set out in section 1 above. He argued that the management of the firm has a moral obligation towards its shareholders to earn a return on its capital that is at least as high as that earned by other firms in which the shareholders could invest. For the firm’s management, this obligation to maximize shareholders returns entails that they follow a three-stage process: firstly, to seek to maximize the profit on the firm’s current activities; secondly, if a particular activity (for example, that carried out by a particular branch or division) fails to earn the return required by the shareholders, then that activity should be subcontracted; thirdly, if subcontracting is not available or unprofitable, the activity should be sold and the money returned to the shareholders, for they can make more productive use of the capital. The implications of this analysis will now be considered.

### 7.3. *The Maximization of Profit*

In operational terms, the neo-liberal principle of profit-maximization has been translated into the requirement that managers should seek to maximize ‘shareholder value’. Clifford Longley, in his book *Just Money*, has analysed the effect of the adoption of ‘shareholder value’ by ICI (a leading British company), using quotes from its annual reports. In 1987, ICI was Britain’s largest company. Its annual report for that year set out its aims in the following terms:

*ICI aims to be the world’s leading chemical company serving customers internationally through the innovative and responsible application of chemistry and related science. Through the achievement of our aim we*

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*will enhance wealth and well-being of shareholders, employees, customers, and communities which we serve and in which we operate.*

By 1994 ICI's objective had changed radically, as demonstrated by the following extract from the company's annual report for that year:

*Our objective is to maximize the value for our shareholders by focusing on businesses where we have market leadership, a technological edge and a world competitive cost base.*

Clifford Longley comments, '*So employees, customers and communities had been eliminated as objects of ICI's concern, except in so far as they affected profitability*'.<sup>42</sup>

Between 1987 and 1994, a lot of things had happened, but they all reflect the fact that ICI's management had been converted to shareholder value. Essentially, any business sector that was not earning a satisfactory profit was sold off. In 1991, it sold its agricultural business and, in 1992, its nylon business. It hived off its (very profitable) pharmaceutical business to a separate company, Zeneca PLC. After 1994, it continued the process of disinvestment, selling its bulk chemicals business in 1997 and its speciality chemicals business in 2000. The process of maximizing shareholder value reached its logical conclusion when, in 2008, ICI, having divested itself of all its businesses other than its Dutch paint company, ceased to be an independent company when it was taken over by the Dutch firm, AkzoNobel. ICI was condemned to die, because, in accordance with the precepts of 'shareholder value', if a company is unable to earn a satisfactory return on its funds, it should return them to its shareholders.

It is remarkable that a management team that in 1987 aimed to make ICI the world's leading chemical company should over the next 20 years preside over the dismemberment of the company. I doubt whether the managers were suddenly converted to the principles of neo-liberalism. I feel that a more realistic explanation was that they were concerned about their jobs. A most significant event during this period was the hostile takeover bid from James Hanson, a corporate raider with a reputation of taking over companies in order to sell off their assets. ICI's managers managed to defeat the bid, but, fearful that a subsequent bid would be more successful, they then proceeded to do Hanson's work for him!

### **7.4. *Why Financialization Is Not in Society's Interest***

I consider that financialization is not in the general interest, for the following reasons:

- It is unproductive. It diverts the efforts of the firm away from its proper business of producing goods and services.

- It is very often a zero-sum game. One firm gains at the expense of another firm. This became abundantly clear when the global financial crisis of 2007/8 demonstrated that the profits previously reported by financial institutions were illusory.
- It diverts the efforts and energy of many of the country's most talented people into essentially unproductive activity. Hence, finance is not so much a zero-sum game as a negative-sum game, given the opportunity cost of these people's labour.
- It tends to subvert democracy, both through the influence that financial institutions play in the political process and through the way that, being 'too big to fail' they can blackmail the state to bail them out in a crisis, thus privatising gains and socializing losses.
- It promotes inequality through the very high rewards paid to a tiny number of senior men (few women) in financial institutions. John Kay is especially critical of the high rewards paid to people who not only do not deserve them, but whose behaviour is often thoroughly immoral, commenting: *'All inequality is to some degree socially corrosive, but inequality which seems unconnected to deserts is particularly corrosive. The most disturbing downside of the global success of the City of London is the corrupting effect on society at large of a depreciation of ordinary morality and human values. The ethical standards associated with parts of the finance sector have been deplorable'*.<sup>43</sup> He refers in particular to the LIBOR scandal, which I analyse later.
- It promotes crises by creating a false picture of reality.

It is abundantly clear that neo-liberalism has been a major contributory factor in the development of financialization, which benefits a tiny elite at the expense of the rest of society.

## 8. The Global Financial Crisis of 2007/8

The facts relating to the global financial crisis are well-known. Millions of American house-owners took out mortgage loans on their properties. These loans were bundled together in derivatives known as collateralised debt obligations (CDOs). Typically, a single CDO would be backed by several hundred individual loans. The theory was that 'the law of large numbers' would ensure that the risk attached to the CDO would be less than that of the individual loans. Hence, the CDOs were given a high credit rating by the rating agencies. Attracted by the high credit rating, many banks and other financial institutions invested in these CDOs, as they offered a higher return than other more boring securities, such as government loans. Unfortunately, many of the house-owners were unable to keep up the payments on their loan contracts and defaulted. The high rate of default on the mortgage loans caused a catastrophic fall in the market value of the related CDOs, leading to the failure of certain important financial institutions, notably Lehman

Brothers, the American merchant bank, which was declared bankrupt in September 2007. The resulting loss of confidence in the solvency of all financial institutions led to a general crisis, which affected many other countries whose banks had invested in American CDOs. The crisis was only resolved by massive intervention by the state, notably by the Federal Reserve, which lent billions of dollars to financial institutions. Although some eight years later, the world has largely recovered from the disruption caused by the crisis, the damage inflicted on the economy and society in the interim has been considerable—as measured by the misery of those who lost their homes through repossession and in the suffering of those who lost their jobs.

Essentially, what happened in 2007 was a conventional crisis of capitalism—an attempt to create additional demand that went disastrously wrong. But I feel that the neo-liberal policies followed by the American government in the years leading up to the crisis were a most significant factor, both in making such a crisis more likely and in intensifying the severity of the crisis. The American government's principal fault was that it failed to regulate the financial markets in a rigorous fashion. This failure extended to many aspects of the crisis:

- Right at the start of the process, the selling of the mortgage loans to the house-owners was conducted in a fraudulent fashion, with collusion between lender and borrower in providing false information.
- The CDOs were a novel form of derivative. Their complexity made them very difficult to evaluate. Yet, they were specifically exempted from regulation by state agencies.
- The regulation of the banks was slack. The authorities failed to ensure that the banks held sufficient high-quality liquid assets to ensure continued solvency in a crisis.

In my opinion, the refusal of neo-liberal politicians to accept a meaningful role for the state in managing the economy (see section 4.1 above) was a major cause of the crisis. Effective regulation by the government in the prior years could have prevented the crisis. Furthermore, financialization (the dominant position of the financial sector) entailed that the impact of the crisis on the overall economy was much greater than it should have been.

## 9. The Morality of Neo-Liberalism

In this penultimate section, I consider the question of whether neo-liberalism is moral—that it can be morally justified. Neo-liberalism is essentially founded on the selfish behaviour of capitalists—they should be motivated solely by the desire to increase their personal wealth. For this reason, many argue that neo-liberalism is immoral, but, in my opinion, a more nuanced judgement is that it is amoral. Questions of morality play no part in the capitalist's decision-making—at least, in decisions that concern the management

of the firm. For example, it is standard neo-liberal theory that the capitalist, in managing the firm, should seek to maximize his profit—how he spends the profit is a private matter; whether he spends it all on private consumption or, alternatively, gives it all to charity is for the capitalist to decide. This question is not covered in the theory of neo-liberalism.

Neo-liberalism's advocates would probably reject this judgement. They would argue that neo-liberalism has a moral justification, based on the philosophical principle of consequentialism—that the morality of an action should be judged by its consequences. Neo-liberalism leads to greater prosperity from which all benefit.

Whether the consequences of the neo-liberal policies followed by the British and American governments have been positive is a pragmatic question on which opinions can differ. My position, based on the analysis presented in sections 5 to 8, is that neo-liberalism's consequences have been generally negative.

Personally, I consider that consequentialism offers inadequate guidance to the individual on how to lead a virtuous life; I favour the philosophy of Immanuel Kant, which emphasises the obligations of the individual to consider the welfare of those with whom he has dealings. By contrast, I feel that neo-liberalism fosters a selfish attitude towards others. To my view, the success of neo-liberalism has led to a decline in standards of personal behaviour.

It is commonplace for older people to complain about the declining moral standards of the younger generation. But there does seem to be evidence that, at least in Europe, neo-liberalism has led to society becoming more selfish, in that individuals have become more concerned to promote their own interests and less concerned to take into account the welfare of other people. One indication of this tendency has been the increase in the remuneration of the chief executives of large companies (who are, in practice, often able to set their own pay). In 2014, the average annual remuneration of the chief executives of the FTSE 100 companies was £4.7 million, being 180 times the pay of the average worker, having risen from 35 times in the 1980s.<sup>44</sup>

Two recent scandals provide evidence for the thesis that people are becoming more unscrupulous in pursuing their own selfish interests, regardless of the harm that such behaviour inflicts on other people: the LIBOR scandal and the Volkswagen scandal.

- (a) *The LIBOR scandal*: LIBOR (the London Inter Bank Offer Rate) is a published interest rate that is used as a reference in a vast number of financial contracts, such as mortgages, loans and derivatives. Given the total value of these contracts (estimated by *The Economist* at about \$800 trillion<sup>45</sup>), a small change in LIBOR (say, of 0.01%) can lead to very substantial changes in the profits or losses on these contracts—of the order of millions of dollars. LIBOR is set by a central authority on the basis of information provided by a small number of large

banks. In 2012, it became known that some major banks had deliberately provided false information with the aim of securing a favourable LIBOR—that is, a rate that would secure higher profits (or lower losses) on the banks' own financial contracts. Commenting on the LIBOR scandal, John Kay (2015, p. 268) wrote: *'The ethical standards associated with parts of the finance sector have been deplorable. Read the email exchanges among those responsible for interest rate submissions . . . what were these people thinking?'* Ultimately, a few of these bank employees were found guilty of fraud and sentenced to terms of imprisonment, and the regulatory authorities in Europe and North America levied fines totalling billions of dollars on some ten banks. The behaviour of those involved was thoroughly immoral—it involved telling lies and it was motivated solely by the desire to increase the bank's profits and their own bonuses.

- (b) *The Volkswagen scandal:* In September 2015, the US government announced that it had discovered that Volkswagen diesel cars sold in the USA were fitted with a 'defeat device' which ensured that the cars gave false figures for NOx (nitrogen oxide) emissions when examined at a testing station, thus formally meeting the stringent US pollution standard. In fact, under normal operations, the car emitted up to 40 times the standard. It would seem that the Volkswagen management sanctioned the installation of the 'defeat device' because to meet the pollution standard in any other way would have proved too costly. The firm's behaviour mirrors that of the bankers in the LIBOR scandal—it involved falsifying information and the motivation was to reduce the firm's costs (and hence increase its profits).

Of course, these two scandals do not prove that all firms are corrupt, but they do provide evidence of a decline in business morality—that, at least for some firms, anything is permitted in the pursuit of profit. Neo-liberalism's lack of a moral basis is surely a principal cause of this development.

## 10. Summary and Conclusion

In this opening chapter, I argue that the current economic system in Europe and America is failing mankind. I identify the current system as the neo-liberal version of capitalism, which is based on the principle that the best result for everyone (both producers and consumers) is achieved by allowing them to engage in economic activity in a completely free market, without interference from the state. The governments of Britain and the USA began to implement neo-liberal policies in the 1980s, under the Thatcher and Reagan administrations, and, over the following decades, such policies have continued to dominate the economies of these countries. I acknowledge that, prior to the shift towards neo-liberalism, capitalism had been very successful

in bringing prosperity to Britain and the USA, and this is still true today of China and other countries that have recently adopted capitalism.

I consider that the neo-liberal experiment has been a failure. Neo-liberalism has been a major contributory factor in the following negative developments of the past 30 years:

- The ongoing degradation of the environment caused by unrestrained economic growth;
- The increasing probability of severe climate change, whose ill effects will be felt by future generations;
- The failure to develop a form of production that is sustainable in the long run, thus putting in jeopardy the welfare of future generations;
- The spread of materialism and individualism in society;
- The persistence of high levels of unemployment and a general deterioration in the quality of employment;
- The growing levels of inequality in society, with the bulk of the rewards of economic growth being appropriated by a tiny elite;
- The growth of financialization, which brings no benefit to the great mass of the population and which was a major factor in the global financial crisis of 2007/8, which has brought misery to millions.

My position is that, in principle, capitalism is an economic system that benefits mankind as a whole, but the extreme version of capitalism, neo-liberalism, benefits the few at the expense of the many. In short, the present economic system is failing to meet the needs of the mass of the population, and it should be reformed. But, before considering how capitalism should be reformed, I need to introduce the principal subject of this book—accountancy. I do this in the next two chapters, which analyse the role that accountancy plays in the current system.

## Notes

1 Phelps (2013).

2 Lindert and Williamson (1983) quoted in Phelps (2013, p. 45).

3 See Phelps (2013, p. 6).

4 See Phelps (2013, p. 52).

5 Hayek: *The road to serfdom*. Friedman: *Capitalism and freedom*.

6 In this book, I use the word ‘firm’ in the sense employed by economists to denote any form of business entity—such as a corporation, a company, a partnership, sole trader or a cooperative—other than state-controlled enterprises.

7 John Stuart Mill (1991), ‘On liberty’.

8 The argument is that capitalism is faced with a chronic insufficiency of demand for the goods and services that it produces. Hence, to prevent a slump caused by lack of demand, extra demand has to be created by investing in new productive capacity. This extra capacity leads to an increase in the output of goods and services, i.e., economic growth. The best analysis of this problem is provided by David Harvey in his book *The enigma of capital*.

- 9 For a detailed analysis of the shortcomings of the present consumerist society, see two books by Hamilton (2003) and (2005).
- 10 See IPCC(2014, section 1.3). The FAO (2016) estimates the impact of climate change in the following terms: *'Long-term projections point to negative effects on food production that will become increasingly severe after 2030 . . . As the impact of climate change on agricultural production and productivity deepens, an increase in both international food prices and the number of people at risk of food insecurity is expected'*.
- 11 Source, Scripps Institution of Oceanography (2016).
- 12 IPCC (2014, section 1.1).
- 13 It is estimated that the accident at the Fukushima nuclear power station has resulted in the discharge into the sea of several million litres of radioactive water.
- 14 Fact sheet *'Oil sands tailings'*, Government of Alberta, September 2013. Reference [www.oilsands.alberta.ca/FactSheets/Tailings\\_Fsht\\_Sept\\_2013\\_Online.pdf](http://www.oilsands.alberta.ca/FactSheets/Tailings_Fsht_Sept_2013_Online.pdf) retrieved 31 May 2016 17.31
- 15 *'Mining battle marked by peaks and valleys'*, *USA Today*, 18 April 2007
- 16 Pope Francis (2015, p. 7).
- 17 The apologists of capitalism point out that shortages in the supply of oil resulting from the exhaustion of the earth's oil reserves ('peak oil') has been forecast many times—each time, oil supplies have been maintained or even increased through the discovery of new reserves or through the development of new techniques, such as fracking. But these developments do not alter the incontrovertible fact that the earth's reserves of oil are finite—if they are not used up in this century, they will be used up in some future century.
- 18  $1.03^{25}$  equals 2.09
- 19 See Malthus (1976).
- 20 Daly (1974).
- 21 Source: ONS, Labour market statistical bulletin, April 2014
- 22 See *'The Guardian'* newspaper, 21 October 2009, *'Public must learn to tolerate the inequality of bonuses'* by Kathryn Hopkins.
- 23 See Rawls (1971).
- 24 OECD (2011).
- 25 *'Income'* is disposable income after social security transfers and taxes.
- 26 One of the trickiest problems in inequality analysis is whether the unit of analysis should be the individual or the household. Most scholars prefer, in principle, the household, although this creates problems of data collection and definition of the household. The data in Table 1.1 are based on household income divided by the number of persons in the household. For further discussion on this matter, see Bojer (2003, chapter 10).
- 27 See Piketty (2014, p. 9).
- 28 Nordhaus (2016, p. 66).
- 29 According to the charity the Connection at St. Martins, which offers temporary accommodation to homeless people, rough sleeping in England is up 55% in five years due to the shortage of housing and the ongoing effect of the economic downturn. See the website [www.connection-at-stmartins.org.uk/facts-about-homelessness](http://www.connection-at-stmartins.org.uk/facts-about-homelessness)
- 30 Wilkinson and Pickett (2010)
- 31 Figure 6.3 in Wilkinson and Pickett (2010) shows that life expectancy is highest in Japan, at 81 years, and lowest in Portugal, at 76 years. Japan is a more equal society than Portugal, according to Wilkinson and Pickett's chosen statistic: the *'Quintile income ratio'*—the ratio of the income of the top 20% to that of the bottom 20%: Japan 3.4 and Portugal 7.9.
- 32 Figure 9.2 in Wilkinson and Pickett (2010) shows that teenage births in the USA at 52 per 1,000 women were ten times higher than in Japan (5 per 1,000 women). The USA, with a quintile income ratio of 8.5, is even more unequal than Portugal.

- 33 The UN's Human Development Report 2015 presents the following figures for the Quintile income ratio: USA 8.5, UK 7.2, Germany 4.3, Sweden 4.0, Norway 3.9, Finland 3.8.
- 34 For a good analysis of the recent growth of inequality, see Stiglitz (2011)
- 35 See Flower (2010), chapter 2.
- 36 Kay (2015, p. 6).
- 37 Kay (2015, p. 2).
- 38 The astronomical salaries are limited to a small number of senior staff and executives. At Barclays, more than half the staff earned less than £25,000 per year. John Kay (2015) estimates that the 3,000 best paid of the 150,000 staff at Barclays received more than half of the total employee remuneration.
- 39 A martingale is a strategy in which a gambler makes an evens bet. If he wins, he stops and departs with his winnings (which are double his stake). If he loses, he doubles his first stake. If he now wins, he will have recovered his losses and made an overall profit. If he loses again, he plays a third time, again doubling his stake. He carries on betting until he finally wins. The drawback of the strategy is that if the gambler encounters a run of bad luck, the stakes become extremely high. Thus, if he loses nine times in succession in an effort to win £10, on the tenth play he has to stake £1,024—if he loses 20 times in succession, he has to stake over £2 million—to win £10! This was essentially the strategy followed by 'rogue traders' (such as Nick Leeson, whose losses led to the bankruptcy of Barings) who attempt to recover past losses by ever larger trades.
- 40 In fact, the trading is done by computers as human beings cannot react quickly enough.
- 41 Jensen and Meckling (1976).
- 42 Longley (2014, p. 18).
- 43 Kay (2015, p. 268).
- 44 Hutton (2015, p. 3).
- 45 'The rotten heart of finance', *The Economist*, 7 July 2012.

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## 2 Accountancy

### Capitalism's Handmaiden

In the last chapter, I sought to demonstrate that many of the problems currently faced by mankind are caused (or at least made worse) by the malfunctioning of the capitalist system as currently practised, with the more recent variant, neo-liberalism, being especially culpable. In this chapter, I reach the principal subject matter of this book—accountancy. I use the term ‘accountancy’ to cover two subjects: firstly, the behaviour of people (accountants) who prepare accounts and perform associated operations (such as audit) in relation to them, and secondly, the rules and principles that govern the form and content of these accounts. The accounts that are my principal concern are the financial statements of the business firm: the balance sheet which reports the firm’s financial position, and the income statement which reports the firm’s financial performance.<sup>1</sup> This chapter deals principally with this second aspect of accountancy; the other aspect (accountants and the accountancy profession) is the principal subject of the next chapter.

In these two chapters, I seek to demonstrate that accountancy, as currently practised, is devoted to serving the current neo-liberal capitalist system—accountancy is capitalism’s eager helper or handmaiden.<sup>2</sup> I start my analysis by considering how accountancy has changed in the last 40 years, starting with developments in accounting theory.

#### 1. The Beaver Revolution

The title of this section refers to one of the most influential books in the history of accounting theory, *Financial Reporting: An Accounting Revolution*, written over 30 years ago by William Beaver, a distinguished professor at Stanford University, California.<sup>3</sup> In his book, Beaver analysed and championed the changes in the practice of financial reporting<sup>4</sup> that had been occurring over the previous decade, changes which he characterised as a ‘revolution’.<sup>5</sup> The ‘Beaver revolution’ consisted of two elements:

- The rejection of the former approach to financial reporting which Beaver judged to have failed;

- The adoption of the radically different approach: an approach that Beaver championed.

### *1.1. The Former Function: Stewardship*

According to Beaver (1989, chapter 1), up to the 1960s, the dominant view as to the function of financial statements was that they should perform the stewardship function. Under this view, the firm's management is considered to be a steward to whom the firm's owners (the shareholders, in the case of a company) have granted control over their financial resources. The management reports to the owners on how well it has fulfilled its stewardship responsibilities. Traditionally, this was done by means of an income statement, which reported on the firm's profit, and a balance sheet, which reported on the firm's resources (its assets). If the firm's financial statements reported a high level of profit and a high value for the firm's assets, then it would generally be assumed that the management had fulfilled its stewardship responsibilities in a satisfactory manner. The emphasis in accounting theory was on devising methods by which the amount of the firm's profit and the value of the firm's assets could be measured as accurately as possible. Beaver claims that in the late 1960s, the perspective shifted from income measurement and asset valuation to an approach based on the transmission of information. He gives, as the reason for this change, the failure of accountants to devise theoretically sound methods of income measurement and asset valuation that were acceptable to the different parties concerned with financial reporting (investors, management, and so on). The result was a lack of uniformity in the accounting methods used by firms, which led to doubts on the accuracy and reliability of the reported figures. Beaver mentions specifically the choices between LIFO and FIFO, between straight-line and accelerated depreciation, and between the historical cost and replacement cost of assets. Consequently, those responsible for financial reporting gave up, at least temporarily, the task of devising reliable methods of measuring the firm's financial performance and position, a task which many considered to be ill defined and unlikely to be solved in the foreseeable future. Instead, they assigned to financial reporting the much more practical and achievable function of providing information about the entity: the information function.

### *1.2. The Information Function*

Most people would agree with Beaver that financial statements should provide information. Although one can conceive of bizarre functions that may be assigned to financial statements (such as acting as a doorstop or a fly swatter), there is widespread agreement that an important function is to provide information about the firm. But what is controversial about Beaver's position is the very narrow scope that he gives to the information function

of financial reporting. Beaver's version of the information function is limited in two important respects: firstly, as to the persons for whose benefit the information is produced and, secondly, as to the purpose for which these persons need the information.

### 1.3. *Information for the Investor*

Beaver defines 'the financial reporting environment' as comprising investors, information intermediaries, regulators, management and auditors.<sup>6</sup> Of these parties, management is the creator of financial information, and regulators and auditors provide services connected with this information. The only users of information are the investors and the information intermediaries. The information intermediaries, as defined by Beaver, are persons and firms (such as brokers and financial analysts) who provide investors with information about the firm. Hence, the ultimate destination of the firm's financial reporting is the investor. Beaver's analysis of financial reporting is exclusively in terms of the information needs of investors.

The most regrettable aspect of Beaver's stress on the investor is that he ignores all other parties that have a legitimate interest in the firm's activities, such as employees, customers, suppliers, the state and the general public. Beaver admits to the existence of groups other than investors, notably creditors and labour, but he states that he does not give them explicit treatment and in fact makes no further mention of them.<sup>7</sup>

### 1.4. *The Investor's Information Needs: Cash*

The second way in which Beaver limits the scope of financial reporting relates to the purpose for which investors require information. For Beaver, the sole reason why individuals acquire securities is to make a future monetary gain. He defines investment as '*the giving up of current consumption for securities, which are claims to future, uncertain cash flows*'.<sup>8</sup> The investor, as a rational person intent on maximizing his own utility, will only forgo current consumption if he can expect a greater return in the future. The investor's sole interest in the firm that issued the security is in the firm's capability to generate cash, which will enable the firm to make future cash distributions to its shareholders. These cash distributions may take a number of forms: annual dividends, occasional returns of capital and/or the redemption of the security at the end of its life. For the investor, the firm is a cash-generating machine. The purpose of the firm's financial reports is to inform the investor of the likely future functioning of this machine.

The investor is interested both in the cash that he receives from the firm and in the firm's own cash flow, for that is the source of the firm's payments to him. Beaver quotes, with approval, the Financial Accounting Standards Board's (FASB) statement that '*financial reporting should provide*

*information to help investors . . . assess the amounts, timing and uncertainty of prospective net cash inflows to the related enterprise*.<sup>9</sup> As indicated in this statement, the investor is interested, not only in the amount of these cash flows, but in their timing (because of the impact of discounting on the present value of a receipt) and the degree of uncertainty (all future events are uncertain, and the greater the uncertainty attached to a receipt, the lower its value to the investor, who is typically risk-averse). The firm's future cash flow is influenced by an enormous number of factors, such as its present resources (its productive capacity, its customer base, its skilled labour force, its relationships with reliable suppliers and so on), its ability to develop new products and revenue earning opportunities in the future and the impact of factors outside the firm's control (the general state of the economy, the market rate of interest, the weather and so on). Beaver points out that many investors hold not a single security, but a portfolio of securities, and are therefore interested in the relationship between the cash flows of the different firms in the portfolio: for example, whether the cash flows are positively or negatively correlated. Hence, the investor's information needs are in no sense limited to information about the firm. The investor's information demands would seem to be almost infinite.

In relation to a specific firm, the investor would like information about a wide range of topics covering both specifically financial information, such as the forecast sales, and non-financial information, such as the level of skills of the workforce. The investor certainly has an interest in informing himself broadly about the firm's activities. But, according to Beaver, the investor is interested in the firm's activities *only* in so far as they impact its cash flows. For example, the investor would be totally unconcerned that the firm earned its profits by illegal means, provided he could assure himself that the authorities would not discover the firm's criminal activity and hence terminate the cash flow. Similarly, the investor is not concerned with the morality of the firm's actions. If the firm made profits through exploiting sweated labour in a developing country, the investor would be interested in this fact solely as an input to his assessment of the reliability of the cash flow: for example, in assessing the danger of an NGO organizing a boycott of the firm's goods. The investor has no direct interest in the legality or morality of the firm's operations; his interest is limited to their impact on the firm's cash flows.

A further disadvantage of concentrating on the cash flow of the specific firm is that the impact of the firm's activities on persons and systems outside the firm is largely ignored. Consider the case of a firm that discharges a polluting chemical into a local lake. Other people, such as local fishermen, suffer harm from this pollution. But this harm would normally not be reported in the firm's financial statements, on the grounds that the lake is not the firm's property and therefore is not an asset of the firm and that the local fishermen are not part of the firm. The firm's financial statements would reflect the pollution only if it impacted the firm's cash flow: for example, if the state levied a fine, or the fishermen successfully sued the firm for damages,

or the firm itself drew water from the lake and was obliged to install water purification equipment.

To summarise, Beaver assigns a very limited function to financial statements—to enable an assessment of the firm's future cash flows, on which the stock market value of the firm depends. This represented a fundamental break with previous approaches to financial reporting in three areas:

- The break with the past: Previous approaches made much use of information about the past, for example, in valuing certain assets at historical cost. Beaver rejected such information as irrelevant. Value depends on the future. This represents a dogmatically economic approach to valuation based on the work of William Stanley Jevons (who claimed that 'bygones are forever bygones') and of Irving Fisher (who developed the principle that the value of an asset is the present value of its future revenue). One can characterise Beaver's approach as the triumph of pure economic theory over pragmatism.
- The neglect of the firm's operations: Beaver treats the firm as a cash-generating machine. He is largely indifferent as to the source of the cash inflow—whether it comes from the firm's operations in producing the goods and services for which it was founded or from some quite unrelated action, say, the sale of a surplus plot of land. Beaver's sole interest in the source is whether this information helps in assessing the characteristics of the future cash flow, for example, its regularity. The shareholders' interest is in cash. The cash from the firm's regular operations has the same value in the shareholders' pockets as the cash from the sale of the surplus plot.
- The renouncing of accountability: Beaver privileges the information needs of investors and neglects the interests of the firm's other stakeholders. He is blind to the proposition that the firm has a duty to account, through its financial statements, to a much wider group. Previous approaches to financial reporting favoured providing much detail about the firm's position and operations with the aim of meeting the information needs of this wider group.

### 1.5. *Beaver and Shareholder Value*

Beaver's information function of financial reporting represents the logical application to accountancy of the neo-liberal's theory of shareholder value. Beaver asks how best accountancy can serve the interests of shareholders and decides that the best that accounts can do is to provide information—not simply information in general, but information specifically directed at furthering the interests of shareholders. The 'Beaver Revolution' represented a 'paradigm shift' in financial reporting: a fundamental change in the basic principles on which financial reporting is based.<sup>10</sup> This shift is the subject of the next section.

## 2. The Two Competing Ideal Types of Financial Reporting

Beaver's rejection of stewardship and advocacy of shareholder value is presented by Julian Müller (2014) as reflecting a choice between two fundamentally different approaches to financial reporting. Müller uses the term 'ideal type' to denote the different approaches. Following Weber (1988), Müller (2014, p. 541) defines ideal types as '*heuristic artefacts that describe the characteristic aspects of a wide range of similar social phenomena in a purified way so as to render them intelligible to the scientific observer*'. Hence, an ideal type is not a representation of reality, but rather, an aid for the analysis and understanding of reality. In financial reporting, the ideal type can be understood as the set of principles that accountants generally follow in their work—not invariably (as practice is messier than theory) and often not consciously, for, as Müller points out, '*practising accountants need not even be aware of the existence of a set of principles that inform their practice*'.

Müller identifies two ideal types of financial reporting. Ideal type I dominated the financial reporting of firms from the end of the nineteenth century until around 1980, when it began to be supplanted by ideal type II. The fundamental characteristics of the two types are presented in Table 2.1.

*Table 2.1* The Two Ideal Types of Financial Reporting

	<i>Ideal Type I</i>	<i>Ideal Type II</i>
Function of the firm	To produce goods and services	To make money for the owners
Function of financial reporting	To report the economic performance of the firm	To report the wealth of the owners (shareholders)
How the firm's success is measured.	By net profit	By the value of equity
Primary financial statement	The income statement	The balance sheet
Determination of income (profit)	Revenues less costs	Increase in value of net assets
Nature of income (profit)	Net profit	Comprehensive income
Nature of a cost	An outlay recognized as a cost	A decrease in value of an asset
Nature of an asset	An outlay to be carried forward to be set against (matched with) future revenues	A resource of the firm
Measurement of assets	Historical cost	Current value
Theory of the firm	The entity theory	The proprietary theory

The entries in this table may be explained as follows:

1. *The function of the firm*: According to ideal type I, this is to produce goods and services to be sold to consumers and other firms; according to ideal type II, it is to make money for the firm's owners (the shareholders in the case of a company). Note that, in the justification of capitalism that is set out in chapter 1, reference is made to the production of goods and services, but the basic motivation of the capitalist is to make money—to quote Karl Marx's graphic aphorism, '[in the capitalist firm] *the production process appears simply as an unavoidable middle term, a necessary evil for the purpose of money-making*'.<sup>11</sup> The emphasis in ideal type II on the shareholders' wealth is consistent with the theory of 'shareholder value'.
2. *The function of financial reporting*: In essence, the function of financial reporting is to report how well the firm has fulfilled its function (as set out in paragraph 1). Hence, for ideal type I, this is to report the economic performance of the firm, and, for ideal type II, it is to report the wealth of the firm's shareholders—the value of their interest in the firm.
3. *How the firm's success is measured*: This is also determined by the firm's function. Whereas with ideal type I the function is to produce goods and services, the firm will have made a net contribution to the economy, if the value of the output is greater than the value of the goods and services consumed in producing the output. Hence, the firm's success is measured by the amount of net profit. With ideal type II, the firm's success in increasing the owners' wealth is measured by the value of the equity. Note that the net profit relates to a period (often the accounting year), and the shareholders' equity relates to a point in time. This was the justification for the distinguished German academic Eugen Schmalenbach, an articulate advocate of ideal type I, calling his brand of accounting 'Dynamic Accounting', whilst denigrating the alternative as 'Static Accounting'.<sup>12</sup> Dynamic sounds much more positive than static.
4. *The primary financial statement*: The identification of the primary financial statement follows logically from the previous analysis. For ideal type I, this is the income statement (which presents the net profit); for ideal type II, it is the balance sheet (which presents the firm's equity). This raises the intriguing question of whether, ideally, the firm should present its income statement according to ideal type I and its balance sheet according to ideal type II. To do this would involve dropping the articulation between the income statement and the balance sheet, which is the fundamental principle of double-entry book-keeping. No respectable accountant would even dream of dropping double-entry, which suggests that behind the two ideal types lies an even more basic principle: double-entry book-keeping.
5. *The determination of income (profit)*: According to ideal type I, profit is calculated as revenue less costs (the constituent elements of the income

statement). According to ideal type II, profit is calculated as the increase in the value of net assets (the constituent elements of the balance sheet); this reflects the primacy of the balance sheet, which determines the amounts to be recorded in the income statement.

6. *The nature of income (profit)*: According to ideal type I, profit is the surplus (revenue less costs) arising from the operations of the firm. According to ideal type II, profit is 'comprehensive income': the total increase in the shareholders' wealth arising from all sources. The difference between these approaches is best illustrated in how they treat unrealised gains. For ideal type I, an increase in the value of an asset is not included in the firm's profit until it is realised—the production process is complete, and the asset has left the firm. For ideal type II, all increases in the asset values should be reported, irrespective of their source. Hence, comprehensive income is an aggregate of profit from the firm's operations and other unrelated increases in asset values.
7. *Nature of a cost and nature of an asset*: It is helpful to consider these two items together. For once, ideal type II has the simpler concepts. An asset is a resource—something of value to the firm—and a cost is a decrease in the value of an asset. According to ideal type I, both costs and assets arise as a result of an outlay by the firm—the outlay will generally involve the giving up of a resource, such as cash. This outlay is reported either as an asset or as a cost. The outlay is reported as an asset if it should be carried forward (in the balance sheet) to be set against (or matched with) a future revenue. If this is not the case (if there is no expected future revenue relating to the outlay), then the outlay is reported as a cost in the current income statement. This curious procedure has as its justification the need to report the firm's profit for specific periods—outlays are allocated to the period to which they relate. The logic of this the process is explained very well in the following quote from William Paton and A.C. Littlewood, two American academics, who, more than anyone else, laid the theoretical foundations for ideal type I: *'The fundamental problem of accounting . . . is the division of the stream of costs incurred between the present and the future in the process of measuring periodic income . . . The income statement reports the assignment to the current period; the balance sheet exhibits the costs incurred which are reasonably applicable to the years to come. The balance sheet thus serves as a means of carrying forward unamortized acquisition prices, the not-yet-deducted costs; it stands as a connecting link, joining successive income statements into a composite picture of the income stream'*.<sup>13</sup>
8. *Measurement of assets*: According to ideal type I, assets are reported at historical cost—the outlay incurred to acquire the asset. Under ideal type II, assets are stated at current value. There are many different ways of determining current value; two commonly used methods are the price at which the asset can be sold on the market and the net present value

of future cash flows. Ideal type I is based on cost and ideal type II on value. The supporters of ideal type II may well counter Schmalenbach's contention that they are not dynamic with the observation (to adapt Oscar Wilde's aphorism) that the ideal type I accountants know the cost of everything and the value of nothing.

9. *The theory of the firm*: Ideal type I is based on the entity theory. The fundamental focus of accounting is on the firm as a separate entity as expressed in the formula: assets = sources of finance (equity plus liabilities). Ideal type II is based on the proprietary theory: the focus is on one aspect of the firm—the owners—as expressed in the formula: equity = assets less liabilities. With ideal type I, equity and liabilities are treated equally; they are both sources of finance. With ideal type II, equity is of a fundamentally different nature compared with liabilities. Equity represents the owners' interest, and the function of financial reporting is to inform the owners.

Ideal type II represents the application to financial reporting of neo-liberalism's shareholder value theory, and the arguments in favour of this theory have already been considered in chapter 1. The case for ideal type I was well put by Eugen Schmalenbach in his book *Dynamic Accounting*, which is the Continental European equivalent of Paton and Littleton's work. The following passage is particularly striking: '*A business is part of the totality of economic life which is called upon to take over a share of the tasks of the economy as a whole. As part of the economy it receives raw materials and services of various kinds, and gives back to the economy its manufactures or other services. In the process it must produce a surplus value, otherwise the business is not contributing to the economy as a whole, but is diminishing it. That which is taken out of the total economy is expense of the business. That which is contributed to the total economy in goods, services or other acts is revenue of the business. The success [Erfolg] is the difference between revenue and expenditure. Its determination is the task of business accounting*'.<sup>14</sup>

It seems to me that measuring the contribution that the firm makes to the total economy is a far nobler task for the accountant, compared with that of increasing the wealth of shareholders, which critics charge to be the task of ideal type II accountants.

Both ideal types are based on capitalism, but, in my judgement, ideal type II, with its emphasis on shareholder value, is based on the more extreme, and therefore more dangerous, form of capitalism, represented by neo-liberalism.

It is remarkable that, with both ideal types, academics made very substantial contributions both to the conception of the idea and to its development into a coherent theory: Paton, Littleton and Schmalenbach for ideal type I and Hayek, Friedman and Beaver for ideal type II. It would seem that Keynes was right when he claimed that '*practical men, who believe themselves to be quite exempt from any intellectual influences, are usually slaves to some defunct economist*'.<sup>15</sup>

It is important to appreciate that these two ideal types have rarely (if ever) existed in their pure form. This will become clear when, in the next section, I consider the impact that accounting theory has had on the process of standard setting.

### 3. The IASB's Approach to Financial Reporting

The International Accounting Standards Board (IASB) is the body that sets the standards (rules) that govern the financial reporting of firms throughout much of the world. It is a private body, but many countries give legal recognition to its standards. For example, the European Union has adopted the IASB's standards as its own rules and requires that European-listed companies should follow them for their accounts. With one exception, all the major developed countries have adopted the IASB's standards; the exception is the USA, where large corporations are required to use US Generally Accepted Accounting Principles (US GAAP), which is set by the FASB, a private body, under the supervision of the Securities and Exchange Commission (SEC), a government agency. The IASB and the FASB have sought to achieve convergence between their standards and, in most important matters, the differences are not significant. The analysis in this section is based on the IASB's approach.

In my opinion, the IASB, in setting its standards, has adopted, as its own, Beaver's approach to financial reporting, i.e., ideal type II. I will now attempt to justify this claim by an analysis of the IASB's Conceptual Framework.

#### 3.1. *The IASB's Conceptual Framework*

The IASB's Conceptual Framework sets out the fundamental principles that the organization generally follows in developing its standards. The current document was issued in September 2010, but in May 2015, the IASB issued the exposure draft of a revised document.<sup>16</sup> At the time of writing, the IASB has not issued the definitive text of the revised document, and hence, in principle, the 2010 text is still valid. But I expect that the definitive text of the revised Conceptual Framework (which is scheduled to be issued in early 2017) will not differ substantially from the exposure draft, and, for this reason, I base the following analysis on the exposure draft's text. In fact, for most of the matters analysed in this section, the differences between the exposure draft's text and the 2010 text are not significant, which increases my confidence that the final text will not be materially different.

The exposure draft defines the objective of financial reporting in the following terms:

Paragraph 1.2: *'The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful*

*to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. These decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit*’.

The following paragraphs clarify this objective:

Paragraph 1.3: *‘Decisions by existing and potential investors about buying, selling or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments, for example dividends, principal and interest payments or market price increases . . . Expectations about returns depend on their assessment of the amount, timing and uncertainty of future net cash inflows to the entity’*.

Paragraph 1.5: *‘[M]any existing and potential investors, lenders and other creditors cannot require reporting entities to provide the information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reporting is directed’*.

Paragraph 1.18: *‘Information about a reporting entity’s financial performance during a period . . . is useful in assessing the entity’s past and future ability to generate net cash flows’*.

These citations make clear that the IASB has adopted Beaver’s position that financial reporting should provide information for investors, especially information that enables an assessment of future cash flows. The most significant (and controversial) element of Paragraph 1.2 (which defines the objective of financial reporting) is the very first word—‘*The*’. The IASB recognizes only one objective of financial reporting: information for investors. It briefly mentions (in paragraph 1.10) parties other than investors, specifically *‘regulators and members of the public’* but asserts that financial reporting is *‘not primarily directed to these other groups’*. The IASB makes absolutely no mention of the numerous other parties who have a legitimate interest in the firm’s activities, such as employees, suppliers and customers. This represented a significant shift from the IASB’s former approach as reflected in a previous conceptual framework (of 1989), which defined the primary users of financial reporting as *‘present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public’*.<sup>17</sup>

The other respect in which the IASB has adopted Beaver’s approach is in the emphasis on reporting cash flows; see, in particular, the reference to *‘the entity’s past and future ability to generate net cash flows’* in the Framework’s paragraph 1.18, cited above.

### 3.2. *The IASB's Embrace of Neo-Liberalism*

Clearly, the IASB's approach serves the interests of investors. But the IASB fails to make a clear case for why such an approach is also in the interest of society as a whole. However, it can be argued that the IASB's approach is based on a particular economic theory which has as its aim the greater welfare of mankind, as is made clear in the following extract:

Paragraph 2.4: *'Reporting financial information that is relevant and faithfully represents what it purports to represent helps users to make decisions with more confidence. This results in more efficient functioning of the capital markets and lower cost of capital for the economy as a whole'.*

This citation makes clear that the underlying economic theory is capitalism and, more precisely, neo-liberalism, with its emphasis on the need to ensure the efficient functioning of markets for the benefit of everyone. The growth of neo-liberalism and its impact on the world through financialization have already been analysed in chapter 1. With respect to the IASB's prioritisation of information for investors, Zang and Andrew (2014) comment, *'the decision to exclude broader users from the [conceptual framework] is symbolic of the success of financialization, where financial markets became a proxy for the public interest. This is reflected in the belief that good investment and lending decisions, made possible through good accounting practice, will trickle down and be good for all of us'.*

In summary, the IASB follows Beaver in two important respects: the objective of financial reporting is to provide information for capital providers and, in providing information, the emphasis is on cash—information that (to quote paragraph 1.18) *'is useful in assessing the entity's past and future ability to generate net cash flows'*. This quotation refers to *'the entity'*. This is a central concept in financial reporting and is the subject of the next section.

### 3.3. *The IASB's Concept of the Entity*

The term 'the entity' appears many times throughout the Conceptual Framework, for example, in paragraph 1.2, which defines the objective of financial reporting. In the Conceptual Framework's chapter 3, the IASB introduces the concept of the entity's financial statements and defines them as a subset of financial reporting. They consist of a statement of financial position (the balance sheet) and a statement of financial performance (the income statement). The elements of financial statements are defined as:

1. Assets: *'An asset is a present economic resource controlled by the entity as a result of past events'.*

(paragraph 4.5)

2. Liabilities: *'A liability is a present obligation of the entity to transfer an economic resource'*.  
(paragraph 4.24)
3. Equity: *'Equity is the residual interest in the assets of the entity after deducting all its liabilities'*.  
(paragraph 4.43)
4. Income: *'Income is increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from holders of equity claims'*.  
(paragraph 4.48)
5. Expenses: *'Expenses are decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims'*.  
(paragraph 4.49)

The definitions of income and expenses are virtually identical to those for ideal type II in Table 2.1. This leaves no doubt that the IASB has adopted Beaver's approach. Central to these definitions is the concept of *'the entity'*. This is covered in the following paragraphs:

Paragraph 3.11: *'A reporting entity is an entity that chooses, or is required, to prepare general purpose financial statements'*.

Paragraph 3.12: *'A reporting entity is not necessarily a legal entity. It can comprise a portion of an entity, or two or more entities'*.

Paragraph 3.13: *'Financial statements provide information about the assets, liabilities, equity, income and expenses generated by the set of economic activities that lie within the boundary of the reporting entity'*.

The first paragraph is essentially a tautology—the paragraph's words reduce to 'a reporting entity is an entity which reports'.

The second paragraph essentially gives the preparer or legislator a free choice in defining the boundaries of the reporting entity. It simply removes possible limitations on their freedom.

The third paragraph is the most significant in that it explains why it is important to define the boundaries of the reporting entity: the entity's financial statements report on the assets etc. that lie within the boundaries of the reporting entity and ignores those that lie outside these boundaries.

The significance of limiting the reporting of assets etc. to those that lie within the boundaries of the reporting entity has already been demonstrated

in the example (in section 1.4 above) of the polluted lake. A firm's factory discharges the toxic by-product of its production process into a public lake. The consequent pollution damages the lake, for example, by killing fish. The local fishermen suffer a fall in income, reflecting their reduced catches. The firm does not report the damage to the lake (a fall in its value) because the lake is not an asset of the entity (the firm), and, consequently, the fall in value of the lake is not an expense. Similarly, the losses suffered by the local fishermen are not reported in the firm's financial statements. The damage caused to the environment and to the rest of society would only be reported by the firm if it rebounded onto the firm and thus impacted its cash flow: for example, if the firm itself drew water from the lake and was obliged to install water purification equipment. Essentially, this firm's financial statements overstate the value of assets and understate costs from the viewpoint of mankind as a whole. The firm's financial statements reflect capitalism's fatal flaw, as identified in chapter 1, that decisions are taken—and their impact reported—at the level of the firm and not at the level of society as a whole or of a subset of society (the affected fishermen). This is the inevitable outcome of prioritising the shareholders' interest: the shareholders' gain is reported; the fishermen's loss is ignored.

### *3.4. The IASB's Standards for Asset Measurement*

The IASB's Conceptual Framework's principal function is to assist the IASB in the development of its standards, notably in assuring that they are consistent, coherent and based on a sound foundation of theory. The conceptual framework is not formally a standard, and, for this reason, its principles are not binding on the preparers of accounts. In contrast, the IASB's standards are legally binding in many countries (for example, those of the European Union). I now examine how the conceptual framework's principles have been translated into the IASB's standards, with particular reference to asset measurement.

The IASB sets out the rules that govern asset measurement in a number of standards, including:<sup>18</sup>

- IAS 16: Property, plant and equipment (PPE);
- IAS 38: Intangible Assets;
- IAS 39 and IFRS 9: Financial Instruments;
- IAS 40: Investment Property;
- IAS 41: Agriculture;
- IFRS 13: Fair Value Measurement.

Of this range of different assets, I will concentrate on just two as demonstrating the IASB's approach to asset measurement: PPE and Financial Instruments.

### A. PPE (*Property, Plant and Equipment*)

The IASB defines PPE as tangible assets that ‘are held for use in the production or supply of goods and services or for rental to others or for administrative purposes, and which are expected to be used for a period greater than a year’.<sup>19</sup> The IASB offers firms a choice of how to account for them: the cost method or the revaluation method.

*The cost method:* The asset is reported in the balance sheet at its acquisition cost less accumulated depreciation. The idea behind the charging of depreciation is to allocate the cost of the asset to accounting periods over the asset’s useful life. This is pure ideal type I. But this pure theory is subverted by the requirement to consider impairment. Under the IASB’s standards (IAS 36), an asset’s value is impaired if its carrying amount (the amount at which it is reported in the balance sheet) is greater than its recoverable amount. Its recoverable amount is measured as the greater of its net selling price and its value in use, which is calculated as the net present value of future cash flows expected to arise from the use of the asset and from its final disposal. If the asset’s recoverable amount is less than its carrying amount, the asset is reported at its recoverable amount, and the difference charged as an expense in the income statement. In this way, value can, on occasion, influence the measurement of the amount at which the asset is reported in the balance sheet. Hence, the cost method is an amalgam of ideal type I and ideal type II, but with ideal type I dominating, as the need to record an impairment loss will generally arise relatively infrequently.

*The revaluation method:* The asset is reported initially at acquisition cost, but subsequently, it is reported at fair value. The asset should be revalued whenever its carrying value differs materially from its fair value. A negative revaluation difference (its fair value is less than its carrying value) is charged to the income statement as an expense. A positive revaluation difference is credited to other comprehensive income. Two terms in this paragraph should be explained more fully.

*Other comprehensive income:* The reporting of other comprehensive income is a means of combining the reporting of income under the two ideal types. As shown in Table 2.1, ideal type I reports the firm’s profit, excluding elements not recognized with this type, such as unrealised gains. Ideal type II reports comprehensive income, which covers all increases in asset values, irrespective of source. The IASB, in setting out formats for the income statement in IAS 1, seeks to report both figures by dividing total comprehensive income into two elements with the formula: total comprehensive income = profit plus other comprehensive income. Hence, with the revaluation method for PPE, a loss is

charged to profit and a gain (which is unrealised) is reported in other comprehensive income. Hence, profit is calculated as per ideal type I and (total) comprehensive income per ideal type II.

*Fair value:* The method of determining fair value is governed by IFRS 13, which defines fair value as *'the price that would be received on the sale of an asset in an orderly transaction between market participants at the measurement date'*.<sup>20</sup> It is an exit price. This price is easy to establish for an asset for which there is an active market for identical assets (for example, for used cars). To deal with the situation where no such market exists, IFRS 13 specifies a 'fair value hierarchy' of three levels, where the lower levels have priority over higher levels. The hierarchy is made up of level one: the active market for identical assets; level two: a calculation based on observed prices for similar assets; and level three: a calculation based on a model that does not use observed (publicly available) prices. Levels one and two are often termed 'mark to market' and level three as 'mark to model'.

The revaluation method is clearly based on ideal type II. Hence, in respect of the measurement of PPE, the IASB offers the reporting firm a choice between the two ideal types. That is the formal position. But, in practice, reporting is strongly biased towards ideal type I. A survey carried out by the Institute of Chartered Accountants in England and Wales in 2005<sup>21</sup> indicated that only 4% of EU companies used the revaluation method for buildings (and none for the other items of PPE). Another survey of 1,539 publicly traded companies in Germany and the UK found that only 3% used fair value accounting for at least one asset class of PPE.<sup>22</sup>

### *B. Financial Instruments*

The IASB defines a financial instrument as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Informally, and in very rough terms, a financial instrument may be considered to be a contract which provides for the exchange of cash (or cash equivalent) and not of goods or services. Financial instruments are the raw material of the financialization process that was analysed in chapter 1. Examples of financial instruments are:

- An overdraft from a bank to a customer.
- A bond issued by a firm. The firm receives cash on the issue of the bond and, over the bond's life-time, pays interest and, at the end, repays the principal.
- A share in the equity of a company.
- A futures contract for the purchase in the future of a commodity (say, wheat) at a price fixed in the contract, where the parties to the contract expect to settle in cash and not by the delivery of the commodity.

- A security which consists of a package of financial instruments: for example, the securities made up of subprime mortgages which were the principal cause of the global financial crisis. The value of these securities depended on the cash flow from the borrowers. When it became evident that many borrowers would default on their contractual obligations, the market value of these securities fell dramatically, contributing to the failure of Lehman Brothers and other banks which had invested heavily in them.

The IASB's rules for financial instruments are extremely complex; the relevant standards (IAS 37, IFRS 7, IFRS 9 and IFRS 13) run to several hundred pages. These rules are so voluminous that it is not possible to cover them in detail in this book. Instead, I concentrate on those aspects of the rules that best illustrate the IASB's approach to asset valuation.

As with PPE, the IASB specifies two methods of asset valuation: historical cost and fair value. But, in contrast to PPE, the preparer does not have a free choice of method. Instead, the IASB prescribes different methods for different categories of financial instruments.

*Historical cost:* The IASB requires that certain financial instruments should be reported at historical cost less impairment losses. In very broad terms, these are financial instruments that the firm will generally hold so that it may benefit from the annual cash inflow of interest and the final repayment of principal. A common example of such an asset is a loan from a bank to a customer. The bank's normal practice is to earn a profit from the annual interest payments. It would sell the loan (assign it to a third party) only in quite exceptional circumstances—for example, if the bank were on the verge of bankruptcy. Hence, the market value of the loan (what the bank would receive if it assigned the loan to a third party) is irrelevant. But the bank must also take into account the possibility that the customer might fail to make the payments of interest and principal. Hence, there is a need to take into account impairment. Where there is a risk of default, the carrying amount of the loan must be reduced to reflect reality, reporting an impairment loss which is charged against profit. For this category of financial instruments, the IASB's rules are essentially similar to those for the cost method for PPE: historical cost less impairment losses.<sup>23</sup>

In fact, the reporting of bank loans at historical cost is a highly controversial subject. In the wake of the global financial crisis, many European banks objected strongly to being obliged to report many of their assets at fair value as required by the IASB's then current rules (under IAS 39). The IASB attempted to meet this criticism by replacing IAS 39 with IFRS 9. The result is a highly complex standard which represents a messy compromise between the need to satisfy the banks and the IASB's concern that reporting at historical cost should not be a means of hiding genuine and permanent falls in value.

*Fair value:* The IASB specifies fair value as the measurement method for all other financial instruments. For the IASB, the basic rule is fair value, and historical cost is an (undesirable) exception, which is permitted only when one can be sure that it is not used to hide permanent losses. The calculation of fair value is governed by IFRS 13; the general principles have already been outlined in connection with the fair value of PPE. The significant point is that, where there is no active market for a particular financial instrument held by a firm (or a market for similar instruments), its fair value is calculated according to the rules for level 3 of the hierarchy, which calls for a method that uses inputs that are not publicly observable, and which, for the outside observer, lack objectivity. An example is where a firm values a financial instrument as the net present value of its estimate of the instrument's future cash flows.

The conclusion of this analysis of the IASB's standards is that, for both PPE and financial instruments, the IASB uses a hybrid model: it specifies both historical cost (ideal type I) in certain circumstances and fair value (ideal type II) in other circumstances. But with PPE, historical cost is clearly the dominant method, whereas with financial instruments, fair value dominates. The significance of the use of fair value is the subject of the next section.

## 4. The Role of Fair Value Accounting in Capitalism

### 4.1. *The Bringing Forward of Profit*

When a financial instrument is reported in a firm's accounts at fair value, the effect is to bring future profit forward to the present. The effect may be illustrated with a simple example. A bank makes a loan of £1,000 to a customer. According to the contract, the interest rate is 5%, and the loan is repayable in five years' time. The loan was made on 31 December 2017 and is repayable on 31 December 2022. The bank's cost of capital is 3%. Assume that the customer fulfils his contract to the letter.

Let us see how the bank would account for the loan under the two alternative ideal types.

#### *Ideal Type I*

The bank would report revenue of £50 per year for five years to be set against cost of capital of £30 per year, giving an annual profit of £20. The loan would be reported in the firm's balance sheet at its historical cost of £1,000—the amount of cash transferred to the borrower when the loan was made.

*Ideal Type II*

This is represented by fair value accounting as specified in the IASB's standards.<sup>24</sup> Assuming that there is no market for similar loans, the bank would be obliged to use level 3 in the valuation hierarchy ('mark-to-model') to calculate the loan's fair value. A commonly used method is the net present value of future cash flows discounted at the bank's cost of capital. This calculation gives a fair value of £1,091.59.<sup>25</sup> Table 2.2 presents how the firm would report the loan over the five years. The difference between the loan's net present value and its historical cost (£91.59 being £1,091.59 less £1,000) is reported as profit of the year in which the loan was granted. All the profit on the loan is brought forward to the first year. The profit on the loan in all subsequent years is zero. This is obvious when the bank sells (assigns) the loan in the first year, as it no longer owns the asset or receives the annual interest. But it is also true when the bank retains the loan and continues to receive interest each year. In this case, the calculation of the subsequent year's profit involves three items: the interest revenue of £50, the fall in value of the loan (the fair value of the loan declines over time as the future cash flow diminishes) and the cost of capital on the capital tied up in the loan (which also diminishes each year).

Note that, as the loan was made on 31 December 2017, with ideal type II, the entire profit of £91.59 on the five-year loan is reported in 2017—for a single day's activity. Under ideal type I, no profit is reported for this year. Readers may reasonably doubt that it makes sense to report any profit in 2017. But this is exactly what Enron did, as explained in the next section.

The net present value of the profit of £20 per year under the ideal type I method is £91.59—equal to the net present values of the cash flows, as I

Table 2.2 Accounting for the Loan at Fair Value

<i>Year</i>	<i>Cash flow</i>	<i>Fair value of loan*</i>	<i>Fall in fair value</i>	<i>Cost of capital**</i>	<i>Profit</i>
	£	£	£	£	£
2017		1,091.59			91.59
2018	50.00	1,074.34	17.25	32.75	0.00
2019	50.00	1,056.57	17.77	32.23	0.00
2020	50.00	1,038.27	18.30	31.70	0.00
2021	50.00	1,019.42	18.85	31.15	0.00
2022	1,050.00	0.00	1,019.42	30.58	0.00

\* NPV of future cash flows

\*\* 3% of loan value

demonstrated in an article published over 40 years ago.<sup>26</sup> Hence, in present value terms, the two methods give identical figures.

#### 4.2. *The Consequences of Bringing Forward Profit*

What is wrong with bringing future profits forward? Surely it is more realistic to value the loan in Table 2.2 at around £1,090 rather than £1,000. The latter figure is a past cost which is no longer relevant. The real value of the asset is measured by what other people will pay for it, either the market value or an estimate of the market value based on theoretically sound methods endorsed by economists.

That was essentially the argument of Jeff Skilling, who in 1990 was recruited by Enron to devise ways to improve its profits. At that time, Enron earned its money by supplying gas to customers on long-term contracts. With such a contract, Enron could expect a steady stream of revenue from the sale of the gas and a stream of costs from the purchase of the gas. Under conventional accounting (ideal type I), Enron would expect to report a relatively small profit each year, in a similar fashion to the bank in the previous example, which reports a profit of £20 each year. Skilling proposed that Enron's gas contracts should be converted into securities which could be traded on the market and, in a remarkable coup, persuaded the US regulator that mark-to-market accounting should be used for these securities.<sup>27</sup>

The rest is history.<sup>28</sup> Jeff Skilling became Enron's CEO and rapidly converted the company from an energy company into a gas bank, offering a wide range of contracts relating to gas, not only for supply, but sophisticated contracts, such as options, futures and swaps. And not just gas. Over time, Enron became ready to create a market for anything that could be traded: electricity, coal, steel, water, broadband—even the weather. Enron made extensive use of 'mark-to-market' accounting. One example is the reporting of a partnership with Blockbuster LLC to supply Blockbuster's videos over Enron's fibre-optic lines. According to a report in the *Wall Street Journal* (Smith, 2002), '*Enron assigned the partnership a value of \$124.8 million based on its projections of the revenue and earnings potential of the Blockbuster venture . . . for the fourth quarter of 2000, Enron claimed its ownership of Braveheart resulted in a \$53 million profit, even though the Blockbuster venture was only two weeks into its pilot programme and not generating any profit at all*'. In fact, the partnership with Blockbuster was a failure, earned no profits and was soon dissolved.

It is now known that Enron's financial statements for the period 1997–2001 were seriously misleading, overstating profits and assets and understating liabilities. Enron used many devices, in addition to 'mark-to-market' accounting, to manipulate its accounts, including using special-purpose entities to generate fictitious profits and to hide losses. In the end, Enron was unable to hide its worsening financial position. In 2001, it announced

corrections to its published accounts of over \$1.5 billion (including \$110 million relating to its partnership with Blockbuster) and in December 2001 declared itself bankrupt.

Mark-to-market accounting was an important factor, if not the only factor, in Enron's failure. In the opinion of many observers, mark-to-market accounting is a thoroughly inappropriate way to report the results of long-term projects, for a number of reasons:

- *Uncertainty*: Mark-to-market accounting is based on estimates of the future; the future is unknown, and these estimates may be wrong. This is obviously the case with 'mark-to-model' (level 3 of the valuation hierarchy), where the valuation is based on unobservable variables, such as estimated future cash flows. But it is also true when the valuation is based on observed market prices; the difference is that the forecast of the future is made by the market participants and not the firm. Hence, market values are more objective than level 3 calculations (and, for this reason, are favoured by the IASB), but not necessarily more accurate measures of current value, for the market is often wrong.<sup>29</sup>
- *Wrong time scale*: Profit is reported on a yearly basis or even shorter, as in quarterly reporting. But the time scales of many projects are much longer than one year. For such projects, the success can only be measured with complete accuracy when the project is completed. For example, the profitability of the loan presented in Table 2.2 can only be definitively determined after the borrower repays the principal in year five. Thus, if the borrower were to unexpectedly become bankrupt in year five, the loan would become a source of loss and the previous reporting of a profit a serious mistake. Hence, it is quite inappropriate to report all the profit in the first year. The impact of this misreporting on how firms are managed can be catastrophic. John Kay<sup>30</sup> tells the sorry tale of the Bank of Scotland, which failed in 2008 and had to be rescued by the British government. The remuneration of the top management consisted largely of bonuses calculated as a percentage of annual profits. By engaging in highly risky trades with uncertain future returns, the bank was able to report large profits, with a substantial proportion of these profits paid out as bonuses to senior employees. But, to quote John Kay, *'the profits had been imaginary'*, or, in the words of Nassim Taleb, *'their profits were simply cash borrowed from destiny with some random payback time'*.<sup>31</sup> A significant contributing factor in this sorry tale is that, by the time that the trades made by the senior management were shown to be unprofitable, those responsible had left the bank, taking their bonuses with them.
- *Self-referential*: According to Beaver, the function of the financial statements of a firm is to provide information for decision making by capital providers. In the case of shares and other securities quoted on the stock exchange, this information influences the decisions of inves-

tors to buy or sell, and thus is an important factor in determining the quoted price. But, with ‘mark-to market’ accounting, the figures in the financial statements are determined by the prices quoted on the stock exchange, which are determined by the figures in the financial statements, a feed-back loop that can lead to excessive fluctuations in prices. For example, a bank is obliged to sell a security because of a shortage of liquidity. This leads to a fall in the security’s market price. Another bank (or even the same bank) holds the same security, which it reports at market price. The fall in the value of this asset in the bank’s accounts triggers a clause in a bond covenant or a regulation which obliges the bank to seek greater liquidity. To meet this liquidity shortfall, the bank sells more securities and so on—a vicious circle caused by the circular flow of information between the bank and the market. Many commentators consider that mark-to-market leads to heightened instability in the market, inducing higher prices in booms and lower prices in busts. This claim is controversial. For example, Laux and Leuz (2009) consider that the principal cause of the instability is inappropriate regulations. But, there is no doubt that it is fundamentally wrong that information that is intended to inform the market should be derived from the market itself.

#### 4.3. *The Promotion of Short-Termism*

The bringing forward of profit has certainly been a major factor in the short-termism that has been identified as one of the British economy’s most serious weaknesses. The profit on a long-term project should be spread over the life of the contract.

#### 4.4. *The ‘Bezzle’ and Fictitious Capital*

John Kay<sup>32</sup> describes the profit reported using ‘mark-to-market’ accounting as a ‘bezzle’, a term invented by John Kenneth Galbraith for the outcome of an embezzlement.<sup>33</sup> Consider the following example: an accounts clerk steals £1,000 from a firm; he pockets a remittance of £1,000 from a customer but fails to record the receipt in the ledger so that the customer continues to be recorded as a debtor owing the firm £1,000. The account clerk’s wealth has clearly increased by £1,000, but the firm’s owner does not appreciate that his wealth has decreased by £1,000. He still thinks that he has an asset worth £1,000. For society as a whole, it appears that total wealth has increased by £1,000. And this misapprehension continues until it becomes clear that the firm’s accounts, which report an asset of £1,000, are false. The point is that accounts that report an asset valued at ‘mark-to-market’ may be equally false. No one knows for certain until the asset is realised. The shareholders in the Bank of Scotland certainly experienced a bezzle. For years, in the early 2000s, the market value of their shares remained high, buoyed by large

reported profits. But the profits were illusory and, when the bank collapsed, the shares became virtually worthless.<sup>34</sup>

The bezzle has much in common with Karl Marx's concept of 'fictitious capital', which has been defined as '*any form of investment (for example bonds, stocks, derivatives . . .) which is based upon the expectations of future returns. Since the expected returns might be produced in the future, they do not currently exist, and, so are fictitious*'.<sup>35</sup> This definition does not depend on the returns failing to materialise in the future; the important point is that the capital does not exist *now*. Marx did not dispute the importance of fictitious capital in the development of capitalism and considered that the credit system was essential for the expansion of capitalism. Marx distinguished between 'real' capital and 'fictitious' capital, as is clear from the following quotation: '*The stocks of railways, mines, navigation companies and the like, represent actual capital, namely, the capital invested and functioning in such enterprises, or the amount of money advanced by the stockholders for the purpose of being used as capital in such enterprises . . . But this capital does not exist twice, once as the capital-value of titles of ownership (stocks) on the one hand and on the other hand as the actual capital invested, or to be invested, in those enterprises. It exists only in the latter form, and a share of stock is merely a title of ownership to a corresponding portion of the surplus-value to be realised by it*'.<sup>36</sup> The reference to surplus value in this passage is to the surplus (profit) to be realised in the future, which arises from the capitalists not paying the workers the full value of their labour. One does not have to be a true believer in Marx's labour theory of value to appreciate the force and the relevance of his concept of fictitious capital. The important insight is the distinction between real capital and fictitious capital. Marx's analysis draws one's attention on the proper function of investment and (to quote David Harvey, one of capitalism's most articulate critics) '*alerts us to the insanity of a society in which investment in fictitious capital appears just as important as investment in real capital*'.<sup>37</sup>

There can be no doubt that much of current financial activity results in securities which may correctly be described as fictitious or a bezzle. That was certainly true of the packages of subprime mortgages and associated derivatives that set off the global financial crisis in 2007. But the bezzle is still with us, as demonstrated by the market value of currently traded securities, estimated to be over \$800 trillion.<sup>38</sup> These values are created out of thin air with the active support of accountants, who provide what appears to be an authoritative basis for what are essentially fictitious values.

## 5. The Role of Accountancy in Promoting Capitalism

Accountancy is essential for the proper functioning of capitalism. Capitalism depends on profits to motivate the capitalist and, without the accountant to give shape to these profits—to make them visible—the capitalist would be unable to make out his best course of action; he would be blind. Jacques

Richard, a distinguished professor at the University of Paris, Dauphine, has analysed accounting's role in an important paper, 'The dangerous dynamics of modern capitalism' (Richard, 2015). According to Richard, the role that accountancy has played in the development of capitalism has changed over time. Based on his analysis of accountancy since 1800 in four developed capitalist countries (Britain, Germany, France and the USA), Richard distinguishes three historical periods in each of which accountancy played an important but different role:

- 1800 to circa 1870: The period of static accounting;
- Circa 1870 to circa 1980: The period of dynamic accounting;
- Circa 1980 to the present day: The period of futuristic accounting.

#### **(a) Static Accounting**

In the early years of the Industrial Revolution, most enterprises were small, and their capital was provided by the owner-manager and his family. His greatest fear was bankruptcy, which would entail not only the loss of his business, but possibly also the whole of his private wealth and even imprisonment. These were the consequences of the personal liability of a businessman for his debts (limited liability was a privilege granted only to a few semi-public corporations, such as the East India Company) and the draconian bankruptcy laws, which prescribed imprisonment for debt.<sup>39</sup> The businessman sought from his accountant the assurance that bankruptcy was not an imminent danger. The accountant therefore reported the business's assets at the amount that they would fetch if sold; if their total exceeded the amount of the debts, the businessman could sleep soundly. Richard termed this approach to reporting static accounting. The word 'static' is derived from the Latin 'stare', to stop. The balance sheet reported the position if the business were to stop.

#### **(b) Dynamic Accounting**

The period of static accounting came to an end when businesses became larger and required more finance than could be provided from the resources of the owner-manager and his family. Additional finance had to be provided from third parties, who generally had neither the time nor the inclination to play a significant role in the management of the business. The owner-manager firm had to be transformed to the company, with its capital provided by shareholders. To make this feasible, significant changes in the law were necessary—to make the corporate form available for businesses in general and to provide for limited liability for shareholders. In the four countries covered by Richard, these legal changes were realised in gradual steps over the course of the nineteenth century and were largely completed by the 1870s.

But static accounting proved thoroughly unsuitable for this new form of business organization. The problem was that, with static accounting, investments in buildings, machinery and similar long-lasting assets had to be written down to their resale value in their very first year. Generally, the resale value of assets such as railway tracks and bridges was low and much lower than their acquisition cost. This entailed that the new company generally started off with a massive loss in its first year. There was a second complication. Since the owners (the shareholders) enjoyed limited liability, the sole assets available for the payment of creditors in the event of bankruptcy were those belonging to the company. In order to give the creditors as much protection as possible, it was essential that these assets should not be depleted by unwarranted payments to shareholders. Hence, the law provided that no dividend should be paid that reduced the company's capital to below the amount subscribed by the shareholders at the company's formation—its base capital. Hence, a new company, with its large loss in its first year, could not only have to forego a dividend in that year, but also in future years, until it had restored its capital to its initial amount out of retained profits. This was not at all to the liking of the shareholders, who expected an annual income from their shares to meet their annual living expenses. It should be noted that, at this time, investors had a readily available alternative outlet for their savings, which offered a regular annual income: government bonds. The new companies also had to offer a regular income, if they were to compete with government bonds.

Theoretical economists, such as Modigliani and Miller (1961), would no doubt claim that the shareholders could maintain their annual consumption by realising the capital gain on their shares, but this ignores the attitude towards consumption of the nineteenth-century middle class. Income could be consumed but to break into capital to support consumption was taboo—the road to perdition. The idea that capital gains were the equivalent of income would be dismissed as sophistry.

The solution to this conundrum was to report fixed assets at historical cost with the cost spread over the life of the asset through systematic depreciation—the ideal type I accounting already set out in section 2 above. This permitted the distribution of a steady stream of dividends to shareholders (provided the annual revenue exceeded the annual expenses, including depreciation) but precluded excessive dividend payments (which might have put the repayment of creditors at risk) by insisting that assets should not be valued at above historical cost.

Richard termed this type of accounting 'dynamic accounting' as a tribute to Eugen Schmalenbach. In my opinion, it represented an acceptable compromise between the conflicting interests of shareholders and creditors. Dynamic accounting was the dominant form of financial reporting for over a century until it was challenged by the latest form, which Richard terms 'futuristic accounting'.

**(c) Futuristic Accounting**

Futuristic accounting, as defined by Richard, is essentially the ideal type II set out in section 2 above and advocated by Beaver. Richard traces its intellectual origins to the founders of neo-classical economics (Jevons, Walras and Menger), but finds that it only began to influence accounting practice in the 1990s, first in the USA, with the issue by the FASB of a series of accounting standards that permitted or even required the use of fair value. In particular, the FASB's standard, which replaced the requirement to amortise goodwill with an impairment test in which goodwill's carrying amount should be compared with its fair value, is a clear example of ideal type I accounting (with its emphasis on the systematic depreciation of fixed assets) being superseded by ideal type II. The IASB quickly followed the FASB's lead in these matters.

Richard attributes the rise of futuristic accounting to a change in the character of shareholdings over the last forty years. In the 1930s, Berle and Means (1932) wrote of the inability of shareholders to control the management of large corporations. A major reason was that, in general, each individual, shareholder owned only a very small proportion of the corporation's shares; they were dispersed and not able to organize themselves so as to exercise effective power over the corporation's management. That all changed with the emergence of powerful individual investors with large resources, who were prepared to use their power to extract wealth from the companies in which they invested. A prime technique used by this new type of aggressive investor was the hostile take-over bid. This was virtually unknown before 1970 but became increasingly common in the later years of the twentieth century. Richard identifies two types of these new investors: very wealthy individuals (such as Hansen in Britain and Boone Pickens in the USA) who used their private wealth supplemented by bank loans to build up holdings in target companies, and funds, both pension funds and hedge funds, which were able to command very substantial financial resources, as they pooled the wealth of many individuals. These new aggressive investors demanded and obtained enhanced returns from their shareholdings, notably in the form of higher dividend payments.

Richard places great emphasis on the need for corporations to provide legitimacy for the higher dividends by reporting higher profits. In most countries, it is a legal requirement that dividends can only be paid out of the profits reported in the financial statements. Hence, it is important that the rules governing the financial statements should be changed to enable the reporting of higher profits. This was achieved by changing the rules so that future profits could be reported currently, as with mark-to-market accounting—hence his term, futuristic accounting. Richard dismisses Beaver's argument in that it is sufficient simply to provide information, for that could be achieved by providing information on fair values in the notes to the accounts. Yet the FASB, followed by the IASB, changed the rules that

governed the amounts reported for assets and profits, which indicates that, for them, the reported profit (which regulates the amount of legally permitted dividends) is important.

Richard draws the following conclusions from this analysis of developments in accounting over the last two centuries:

1. In any period, the prevailing accounting rules and practice are those that best serve the needs of capitalists. In the period of static accounting, the owner-manager wanted assurance that he would not become bankrupt. That was provided by reporting assets at resale value. In the period of dynamic accounting, small shareholders had replaced the owner-manager as the principal source of finance for business. So the accounting rules were changed so as to allow companies to pay regular dividends, even in a year of high capital expenditure. In the most recent period of futuristic accounting, the rules were changed to permit firms to increase reported profits still further by reporting future profits as current profits.
2. The effect of the rule changes over the past two centuries has been that capitalists are able to enjoy the profits earlier. Both of the significant rule changes, from static accounting to dynamic accounting, and from dynamic accounting to futuristic accounting, has led to reported profits being brought forward in time.
3. Capitalists have been able to achieve the changes in the accounting rules that serve their interests. In the nineteenth century, this power can be attributed to the influence of capitalists over national legislatures. In more recent years, the rules have been set by standard-setting bodies, such as the IASB and the FASB. The composition of these bodies is dominated by representatives of the accountancy profession and of multinational enterprises: representatives of civil society, such as trade-unionists and consumer organizations, are notably absent. Richard points out that, in France, the national standard-setting body rejected the use of mark-to-market accounting for the financial statements of companies under its jurisdiction (the individual accounts). He attributes this to the standard-setting body including representatives of the whole of society (such as trade-unionists) and not just the accountancy profession. It is understandable that the representatives of business on the standard-setting bodies should press for rules that favour their interest, but it is less obvious why the accountancy profession should support them. The position of the accountancy profession in this matter will be considered in the next chapter.

## 6. Summary and Conclusion

The argument in this chapter may be summarised as follows:

- Accountancy is essential for the proper functioning of capitalism, because, without information on the firm's profit, the capitalist would

not know what action he should take. But, in recent years, accountancy has taken as its function to favour an extreme form of capitalism: neo-liberalism.

- This development occurred first in accounting theory with the writings of William Beaver, who proposed that the function of accounting was to provide information for investors. Beaver's analysis was interpreted in terms of ideal types of accountancy: a shift from ideal type I, which dominated in most of the past century, to ideal type II, which favours neo-liberalism.
- The IASB accepted Beaver's thesis in developing its Conceptual Framework and has followed it in its standard for financial instruments. The effect is to bring forward future profits and thus enable firms to report profits that many consider to be fictitious. But the IASB follows the principles of ideal type I for the reporting of other assets, such as PPE (property, plant and equipment). Hence, the triumph of ideal type II (and neo-liberalism) is not complete.

This chapter has been primarily concerned with the principles that govern the form and content of the financial statements of business firms. But the people who prepare these financial statements (the accountants) have a determining influence over the whole process. They are the subject of the next chapter.

## Notes

- 1 I acknowledge that, in concentrating on the financial statements of the business firm, I am excluding two important aspects of accountancy: firstly, the firm's internal accounting (notably book-keeping and management accounting) and secondly, the financial reporting of non-business entities, such as charities and public bodies. I leave to the reader the application to these other aspects of accountancy of the ideas and principles set out in this book
- 2 The first person to describe accounting as 'the handmaiden of business' was J. Wheeler, as quoted in Bailey (1990).
- 3 Beaver's book was published in 1981, but all references in this book are to the second edition, which was published in 1989.
- 4 The term 'financial reporting' (as used by Beaver and also in this book) refers to the process by which a business entity informs persons outside the entity about the entity's position and performance.
- 5 Other scholars have used the word 'revolution' to describe recent developments in financial reporting, for example, Barker (2003) and Müller (2014).
- 6 Beaver (1989, p. 8).
- 7 See Beaver (1989, p. 8, footnote 8).
- 8 See Beaver (1989, p. 8).
- 9 FASB (1978, p. viii).
- 10 The Oxford English Dictionary defines '*paradigm*' as '*a conceptual or methodological model underlying the theories and practice of a science or discipline at a particular time*'. For example, prior to the writings of Copernicus in the sixteenth century, the paradigm on which astronomy was based was that the earth was the centre of the universe and that the sun, moon, planets and stars circled the earth.

- 11 Paton and Littleton (1957, p. 67), cited in Müller (2014, p. 549).
- 12 For more information on Schmalenbach, see Flower (1996).
- 13 Cited in Müller (2014, p. 544).
- 14 Schmalenbach (1959) being a translation of Schmalenbach (1962), cited in Müller (2014, p. 546).
- 15 Keynes (1936, p. 383).
- 16 IASB (2015).
- 17 Quoted in (Zang & Andrew, 2014, p. 20).
- 18 The IASB's standards fall into two categories: International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs). The difference is that an IAS was originally issued by the IASC (IASB's predecessor). However, the IASB, on its formation, adopted the IASs as its own standards and, in many cases, has subsequently amended them. Hence, the IASs may be considered to represent fully the IASB's own views on the subject.
- 19 IAS16, paragraph 6
- 20 IFRS13, paragraph 9
- 21 See ICAEW (2007).
- 22 See Burton and Jermakowicz (2014, p. 335).
- 23 Depreciation may also be appropriate, where the repayments of principal are either spread over the loan's life or do not equal the loan's historical cost.
- 24 Under IFRS 9, a simple bank loan would normally be valued at historical cost. But, if the bank created a derivative which entitled the holder to receive the cash flow from the loan, the derivative would be reported at fair value.
- 25 The present value of £1,091.59 is made up of the present value of an annuity of £50 per annum for five years, plus the present value of £1,000 in five years' time, both discounted at 3% per annum.
- 26 See Flower (1971).
- 27 The whole story is told in an entertaining way in John Kay (2015, p. 126).
- 28 For a fuller analysis of the rise and fall of Enron, see Flower (2004, chapter 9).
- 29 An interesting example of a case where the mark-to-model estimate was right and the market valuation was wrong is provided by the bankruptcy of Long-Term Capital Management, the hedge fund which had the Nobel Prize winners Robert Merton and Myron Scholes as its investment advisors. The fund followed a revolutionary investment strategy which was designed to yield a high return in the long run. Unfortunately, the market values of the shares in which the fund invested failed to reflect their true value, and the fund collapsed. The Federal Reserve arranged for a number of investment banks to take over the fund's investments. In the end, the investment banks made a profit on these investments, which proves Keynes's remark '*markets can remain irrational for longer than you can stay solvent*'. See Kay (2015, p. 110).
- 30 Kay (2015, pp. 122–123).
- 31 See Taleb (2007, p. 43).
- 32 See Kay (2015, p. 127).
- 33 See Galbraith (1954).
- 34 Gambling (1974, pp. 155–162) extends the concept of the 'bezzle' to include accounting manipulations, such as secret reserves and insufficient provisions for bad debts. The common feature is that the accounts do not reflect reality.
- 35 Cooper (2015, p. 64).
- 36 Cited in Cooper (2015, p. 65).
- 37 Harvey (2010) cited by Cooper (2015, p. 72).
- 38 See 'The rotten heart of finance' *The Economist*, 7 July 2012.
- 39 The father of Charles Dickens, the famous English novelist, spent several months in Marshalsea prison for an unpaid debt, an experience which Dickens incorporated in his novel *Little Dorrit*.

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# 3 The Deplorable Current State of Accountancy Practice

The last chapter covered aspects of the principles and rules that govern the form and content of financial statements. The subject of this chapter is the people who apply these rules and help to set them—the accountants. Whereas the last chapter dealt with abstract ideas, this chapter deals with flesh-and-blood people. The way in which these people apply the principles that were set out in the last chapter has a determining influence on how well accountancy serves mankind. Accountants have existed since before the days of Pacioli, but have been organized in a profession only in the last two centuries. I start with an analysis of how the accountancy profession has developed over the last two centuries as a way of meeting the needs of capitalists, with particular reference to the situation in Britain.

## 1. The Function of the Accountancy Profession

### 1.1. *The Role of Accountants in Capitalism*

Accountants play a vital role in the functioning of the capitalist system. The basic idea is that, in a modern capitalist economy, the optimum result can be achieved only if the various parties are supplied with information that is correct, relevant and free from bias. In this way, resources are allocated, in the most efficient way, for the benefit of all members of society. The capitalist system depends on credit. Credit involves one person entrusting resources to a second person in the expectation of receiving a higher reward in the future. The essence of capitalism is that a person (the capitalist) entrusts resources (typically money) that are in excess of his consumption plans to a business firm to be employed in productive activities. The capitalist is prepared to forgo immediate consumption in return for a higher future reward. This arrangement reflects the technological characteristics of the modern economy, which requires substantial long-term investment in tangible assets, such as machines, and in intangible assets, such as complex information systems. Short-term credit is also important; almost all sales between firms (the great majority of transactions in the modern economy) are made on credit. The proper functioning of the credit system depends on trust—that

the credit-receiver will honour his promise to repay the credit-giver. This was made abundantly clear during the 2008 financial crisis when, at one point, the American economy was on the verge of collapse, since no one was prepared to trust anyone and therefore there was a general reluctance to offer credit. The credit system breaks down when trust disappears. For the system to function properly, both parties to a credit agreement must trust the other party to keep his promise and, in particular, to provide him with truthful information. The need to foster trust lies at the origins of the accountancy profession in nineteenth-century Britain.

### *1.2. The Rise of the Auditor*

In Britain in the early nineteenth century, most firms were small, with the finance provided by an owner-manager out of his own resources. Since the owner-manager combined the function of credit-giver and credit-receiver in one person, the problem of trust did not arise. But the situation changed when many owner-managers came to the conclusion that, to finance their firm's growth, they needed more capital than they could provide from their own resources. They turned to outside shareholders to provide the needed capital. With this development, the 'capitalist' was split into two parties: the capital provider and the capital user (the firm's manager), creating the division between ownership and control first analysed by Berle and Means.<sup>1</sup>

When more than a single person is involved in the financing and operation of the firm, it is essential that the different persons trust each other. The shareholders entrust their money to the firm's managers in the hope and expectation that the managers will use these resources to increase the firm's profits, which will be the source of future dividends. But the outside shareholder needs reassurance on this matter. In general, she has only very limited knowledge of what is happening inside the firm. It is very easy for the manager to defraud the shareholder. The simplest way is to pocket the shareholder's money and disappear. But there are more subtle and sophisticated ways in which the manager can enrich himself at the shareholder's expense. One widely used method is the 'Ponzi scheme'. The manager does not invest the shareholder's contribution in the firm, but instead pockets part of it. He does not report this to the shareholder, but instead reports, falsely, that the firm is earning high profits, out of which he pays a high dividend (paid out of the shareholder's initial contribution). On the basis of the (fictional) reported profits and the high dividend, he is able to issue further shares to finance further (fictional) investment, which provides the resources for further personal enrichment and dividends. This process can continue for many years, being a highly efficient way of transferring wealth from the gullible shareholder to the fraudulent manager. Ponzi schemes were very common in the early years of shareholder capitalism in the middle nineteenth century<sup>2</sup> and have retained their popularity among the

more numerate members of the criminal class. In 2009 Bernard Madoff was sentenced to 150 years' imprisonment for his role in a Ponzi scheme in which investors lost over \$60 billion. Apart from Ponzi schemes, there are many other ways in which the manager can operate the firm to benefit himself and not the shareholder: for example, by paying himself an excessive salary or granting himself extravagant benefits.

The first step that the manager can take to reassure the shareholder is to provide regular accounts of the firm's activities. These accounts perform the stewardship function, set out in the last chapter. But it is insufficient for the firm simply to provide accounts, for the shareholder needs reassurance on two points: that the accounts report on matters that are relevant to her interest in the company, and that the accounts tell a truthful story, that the profits and assets reported in the accounts actually exist and are not figments of the manager's imagination. Man is essentially selfish and cannot be relied upon to act honestly and truthfully in providing information that may be contrary to his interest. The shareholder cannot assure herself on this matter by visiting the firm and examining the books of account. She may not have the technical knowledge necessary for this task, and, even if she did, it would be costly in terms of time and effort. Where there are several shareholders, it would seem a duplication of resources for each individual shareholder to undertake the task separately, but, if the shareholders as a body delegated the task to one of their number, they would still have a problem: if they cannot trust the manager, why should they trust another shareholder?

The solution to this problem is to entrust the task of verifying the truth of the financial statements to a third person whom both sides trust. That person is the accountant: he<sup>3</sup> is an essential cog in the machinery of capitalism.

In my opinion, the crucial importance of credit in modern capitalism and the vital role of the accountant in assuring the smooth functioning of the credit system have the consequence that the provision of relevant truthful information to investors has become the fundamental economic function of the accountant in a capitalistic society. The two essential functions of the accountant are the preparation of financial statements (financial reporting) and their verification (auditing). All other functions (tax advice, consulting and so on) are secondary, in that they are not essential for the proper functioning of the capitalist system.

However, this justification for the function of the professional accountant contains a paradox. Accountants are necessary because men cannot be relied upon to tell the truth, but accountants are men who presumably are subject to the same failings as other men. For accountants to be capable of performing their essential economic function, they must, in some mysterious way, be exempt from the self-serving behaviour that blights all other men. This is achieved by requiring that the accountant be a member of a professional association.

### *1.3. The British Accountancy Profession*

In this section, I analyse the functioning of the accountancy profession in Britain, the country that I know best. In essence, the British accountancy profession was formed to provide a body of men capable of verifying accounts, who, in order to perform the job properly, had to have three attributes:

- (a) have the technical capability of auditing the accounts;
- (b) be independent of the management and of any individual shareholder;
- (c) be a member of a professional association which would guarantee his integrity, his technical knowledge and competence.

The accountancy profession was formed principally to meet attribute (c). It is no accident that the leading British professional accountancy bodies were formed in the second half of the nineteenth century to meet the need for independent audit of the accounts of the newly formed limited companies. The dates are significant: in 1844 and 1855, the British Parliament enacted laws that greatly facilitated the formation of limited liability companies, leading to widespread adoption of this corporate form; the 1853 formation of the Society of Accountants of Edinburgh, the fore-runner of the present-day Institute of Chartered Accountants of Scotland; the 1870 formation of the Institute of Chartered Accountants in England and Wales; and the 1888 formation of the Institute of Chartered Accountants in Ireland.<sup>4</sup> From these relatively humble origins, the British accountancy profession has grown into a major institution with over 497,000 members, of which 342,000 are resident in the British Isles—in Britain, approximately one person in 180 is a member of a professional accountancy association (see Table 3.1).

In the UK and Ireland, there are seven professional accountancy organizations that are recognised by the state. They are all listed in Table 3.1, which provides details of the number of their members and of the sectors in which the members work. The ACCA has the most members, but, of these, over half are resident abroad; the ICAEW has more members resident in the British Isles. In all the associations (except the CIPFA), the greater part of the membership works in industry and commerce. But public practice (providing accountancy, audit and tax services as an individual or, more frequently, as part of an independent firm) is also important, particularly for members of the ACCA and the ICAEW. The CIPFA is an exception: most of its members are employed in the government (central or local) service.

### *1.4. The Definition of a Profession*

Accountancy claims to be a profession. There has been much discussion as to the definition of the term ‘profession’—what are the features that justify a group of people to describe themselves as a ‘profession’?

Table 3.1 The British Accountancy Profession, 2016

	ICAEW	ICAS	CAI	ACCA	CIMA	CIPEA	AIA	Total
Members								
in UK & Ireland	123,541	17,852	21,699	86,828	78,402	12,957	1,489	342,768
abroad	22,205	2,857	2,797	96,558	24,540	683	5,266	154,906
Total	145,746	20,709	24,496	183,386	102,942	13,640	6,755	497,674
Sector (%)								
Practice	29.40%	24.83%	26.69%	24.20%	2.25%	3.17%	7.34%	20.53%
Industry	43.53%	46.30%	60.62%	57.67%	72.80%	9.80%	81.42%	55.34%
Retired	15.58%	18.24%	3.75%	4.35%	11.16%	25.65%	10.08%	10.26%
Other	11.49%	10.62%	8.94%	13.78%	13.79%	61.38%	1.15%	13.88%

Note:

ICAEW: Institute of Chartered Accountants in England and Wales

ICAS: Institute of Chartered Accountants of Scotland

CAI: Institute of Chartered Accountants in Ireland

ACCA: Association of Chartered Certified Accountants

CIMA: Chartered Institute of Management Accountants

CIPEA: Chartered Institute of Public Finance and Accountancy

AIA: Association of International Accountants

The Accountancy Foundation Review Board considered this question in its report '*Protecting the Public Interest*'<sup>5</sup> and identified three major characteristics:

*Knowledge and skills:* Practitioners apply specialised skills acquired by intellectual and practical training which enable them to offer a specialised service.

*Ethical values:* The service calls for a high degree of detachment and integrity on the part of practitioners in exercising their personal judgments on behalf of the client. The service involves direct, personal and fiduciary relations with the client. Practitioners collectively have a particular sense of responsibility for maintaining the competence and integrity of the occupation as a whole.

*Competence and conduct:* Practitioners are organized in bodies which are concerned to provide mechanisms for testing competence and regulating standards of competence and conduct.

It is a fundamental feature of a profession is that its members should be subject to the authority of a governing body, which, through disciplinary action, enforces minimum standards of competence and conduct on its members. A major factor is that the general public is often not able to judge the quality of the service provided by the accountant—for two reasons: firstly, the layman does not have the technical knowledge, and, secondly, the accountant's service often consists of 'credence goods', such as advice, the quality of which becomes apparent only after much delay if at all.<sup>6</sup> Hence, the function of the governing body is to ensure that the profession's members do not exploit their position so as to enrich themselves at their clients' expense, but instead put the interest of their clients before their own interest. The state, in the expectation that the profession's members will so act, reserves certain areas of work for the profession. In effect, the creation of a profession represents a grand bargain between society and a defined group of people, who are granted a monopoly in return for the promise to act in the public interest.

### *1.5. The Three Concepts of a Profession*

The definition of a profession that is presented in the previous section is known as the functionalist perspective. A profession is defined in terms of the function that it performs in society. It is assumed that this function is beneficial: that it advances the efficiency of the economy and the cohesion of society. The creation of the profession fulfils society's needs and is a rational response to these needs. An essential feature of the functionalist perspective is that the individual member of a profession should serve the public interest and hence should accept that the public interest has precedence over his personal welfare.

But there are two alternative concepts of the role that a profession plays in society: the interactionist perspective and the critical perspective. Both perspectives hold that men organize themselves in professions to enhance *their* collective welfare and not that of the public.

The *interactionist perspective* emphasises that the profession's members seek to distinguish their capabilities from those of other craftsmen and thus construct for themselves a unique occupational role. A particular profession is often formed in competition with other groups. The ultimate aim is to establish for the profession a monopoly in a specific field. One method of achieving this is to emphasise the extreme complexity and difficulty of the tasks performed by the profession's members—they are a 'mystery' that ordinary mortals cannot be expected to understand. In many ways, today's professions are the modern equivalent of the mediaeval guilds.

The *critical perspective* also maintains that professions seek to establish a privileged position in society, but, in contrast to the interactionist perspective, it emphasises the role that professions play in society, in particular, how professions use their political power and influence to secure advantages: for example, a legal monopoly in the supply of certain services.

Both these alternative perspectives are useful as a way of testing the accountancy profession's claims to serve the public interest.

### 1.6. *The ICAEW's Claim to Be a Profession*

The ICAEW endorse the functionalist concept of a profession, as evidenced by the following extract from its Royal Charter:

*'The Institute . . . has aimed at the elevation of the accountancy profession as a whole and the promotion of its efficiency and usefulness by compelling the observance of strict rules of conduct as a condition of membership and by setting up a high standard of professional and general education and knowledge and has thereby secured for the community the existence of a class of persons well qualified to be employed in the responsible and difficult duties devolving on professional accountants.'*<sup>7</sup>

'For the community' (the phrase used in the above quotation) and '*in the public interest*' are very similar concepts. In fact, the term 'the public interest' appears three times in the ICAEW's Royal Charter. The mission of acting in the public interest is central to the identity of a profession.

### 1.7. *Why, in Accountancy, Ethics Is Important—and Especially Difficult*

In section 1.2, I remarked that accountants, in order to fulfil their function of promoting trust between the parties to a credit transaction, must

be exceptionally honest and trustworthy—or at least have the reputation of having these qualities. Yet, there are particular circumstances regarding the accountancy profession which render unusually difficult the task of the individual accountant to act ethically. Cheffers and Pakaluk (2007) refer to four factors:

1. The accountancy profession is relatively young compared to the medical and legal professions. Hence, the individual accountant has no tradition of ethical behaviour to fall back on and few notable ‘heroes’ of the profession to inspire him.
2. The auditor of a company is in an awkward position. His fees are, in fact, paid for by the management, but the people to whom he renders a service are the shareholders. George Staubus (2005) comments: *‘In simple terms the management uses owners’ money to hire auditors to provide a stamp of approval on management’s reports on its own performance to owners. The auditor . . . makes his living by pleasing management but his societal justification requires serving investors and creditors’.*
3. The accountant must be truthful at all times, even when this is contrary to his immediate interests. Whereas the essence of a medical doctor is the ability to heal people and that of a lawyer to be knowledgeable and articulate in the law, the very essence of an accountant is to be truthful, in that the task of the accountant is to establish and communicate truthfully the facts relating to the enterprise for which he prepares or audits the accounts. Only by being ethical can the accountant fulfil his social function.
4. Accountants must serve that vague concept—the public interest. The US Supreme Court laid down this principle in the leading case of *USA v. Arthur Young* in the following terms: *‘In certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation’s creditors and shareholders, as well as to the investing public. This “public watchdog” function demands that the accountant maintains total independence from the client at all times and requires complete fidelity to the public trust’.* In some ways, the professional accountant is a public official (a public watchdog), but depends for his income on serving private individuals and firms. The British Accountancy Foundation Review Board refers to *the paradox that lies at the heart of the idea of a profession—that it is designed to be a way both of making a private living and of serving the public interest.*<sup>8</sup>

I next consider the ICAEW’s response to these difficulties.

### 1.8. *The ICAEW's Response*

The ICAEW seeks to resolve the problems identified in the previous section by requiring that future members undergo arduous on-the-job training supervised by an experienced member who (hopefully) possesses the necessary virtues and by requiring its members to respect many highly specific rules, such as forbidding a member to undertake the audit of a business in which she has a financial interest. If a member is found to be in breach of a rule, she may be subject to disciplinary action, which can range from a reprimand to being ejected from the Institute. It has also promulgated a code of ethics, which members are required to follow. In this way, its members are transformed from mere fallible men (and women) into paragons of virtue. The effectiveness of the ICAEW's training has been investigated by other authors (notably Power (1991)). In this chapter, I concentrate on the code of ethics.

### 1.9. *Codes of Ethics*

In order to ensure that their members act correctly, the professional accountancy associations issue codes of ethics. These codes are binding on their members and, in principle, a member who violates the code can be subject to disciplinary action: for example he may be reprimanded, fined or, as the ultimate sanction, expelled from the association. The codes of the individual accountancy associations are all based on the IESBA<sup>9</sup> Code of Ethics for professional accountants, issued by the IFAC, the body that represents the professional accountancy associations at the international level. The following extracts from this code's paragraphs provide an indication of the obligations imposed on professional accountants:

100.1 *A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest . . . In acting in the public interest, a professional accountant shall observe and comply with this Code.*

100.5 *A professional accountant shall comply with the following fundamental principles:*

- (a) *Integrity—to be straightforward and honest in all professional and business relationships.*
- (b) *Objectivity—to not allow bias, conflict of interest and undue influence of others to override professional or business judgments.*
- (c) *Professional competence and due care—to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.*

- (d) *Confidentiality*—to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not to disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor to use the information for the personal advantage of the professional accountant or third parties.
- (e) *Professional behaviour*—to comply with relevant law and regulations and avoid any actions that discredit the profession.

Of the fundamental principles listed in the above extract, only the first, 'integrity', would be recognized by a moral philosopher as an important principle of ethics. With respect to competence, normally, there is no moral obligation on the individual to act competently, as may be demonstrated with the following example. During a walk in the woods, I come across a badly injured man, who has apparently fallen from a tree. With a great effort, I carry him to a nearby house, but, in doing so, I aggravate his internal injuries, and he dies. I can certainly be criticised for acting imprudently but not for acting unethically, for my motivation throughout was to help my fellow man. With respect to confidentiality and compliance with laws, most moral philosophers would consider that, in certain circumstances, it would be ethical to act contrary to these principles; there is no moral obligation to obey an unjust law, or to remain silent, when, by speaking out, one can prevent a great evil.

But the inclusion of these principles in the IESBA's code is explained by the fact that the code applies to professional accountants and not to mankind in general. The code is, however, based on a general ethical principle—that a person should keep a promise. A professional accountant, in offering her services to her fellow men, is making an implied promise that she will act competently and respect confidentiality. If she fails to do so, she will have broken a promise and will, for this reason, have acted unethically. Hooker (2007, p. 110) summarises this point neatly with the aphorism: '*Professional ethics is not ethics. It is the identification of expectations that professions have created*'. On this view, the principal function of professional codes of ethics, such as the IESBA code, is to familiarise the profession's members and the public with these promises and expectations.

Some commentators dismiss ethical codes in general as being little more than a public relations exercise, whose function is to promote the entity (firm or association) through convincing others (customers, suppliers and so on) that they may deal with the entity's members with full confidence as to their integrity. There is some evidence to support this charge; thus, Enron had an excellent code of ethics.<sup>10</sup> The extent to which an entity (a firm or a professional institution) is serious about acting ethically may be judged by the steps that it takes to enforce the code. This issue is considered later in relation to the ICAEW's code.

**1.10. The Public Interest**

It is noteworthy that the IESBA's fundamental principles do not include a direct obligation to act in the public interest. This raises the question as to whether the accountancy profession is seriously committed to promoting the public interest. This question will be examined with respect to the ICAEW, whose code of ethics (ICAEW, 2011) is virtually identical to that of the IESBA.

The ICAEW's position in this matter is well expressed in the following extract from its code of ethics (Paragraph 100.1):

*A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest.*

*Acting in the public interest involves having regard to the legitimate interests of clients, government, financial institutions, employers, employees, investors, the business and financial community and others who rely upon the objectivity and integrity of the accounting profession to support the propriety and orderly functioning of commerce.*

The vital words are '*the propriety and orderly functioning of commerce*'. According to the ICAEW, the whole of society benefits when the capitalist economic system works smoothly, because business firms and investors can rely on the objectivity and integrity of accountants. The accountant serves the public interest by assisting in the efficient operation of markets through providing reliable objective information. This was the position of the late Professor Eddie Stamp, who wrote (Stamp, 1980, pp. 32–34):

*One end of corporate financial reporting is to assist in the efficient allocation of scarce resources by the provision of information useful to those responsible for making investment decisions . . . One of the prime objectives of published corporate financial reports is to provide an accounting by management to both equity and debt investors . . . of its success (or otherwise) in achieving the goal of producing a satisfactory economic performance . . . Reporting objectives of this kind assist investors (as well as potential investors) in making rational choices in allocating their necessarily limited resources . . . potential investors are plainly interested in the contents of published financial reports in making their investment decisions, and it is in the general economic interest that their needs should be properly looked after if the primary and secondary securities markets are to function effectively. The efficient operation of these markets is in the national interest since they are so important to the continuing health and strength of the operations of the private sector of the economy.*

In holding that the accountancy profession completely fulfils its responsibility to serve the public interest by providing the market with reliable objective

information, the ICAEW is adopting a very narrow interpretation of the words 'public' and 'interest'. It limits the 'public' to those who make use of accounts, and it limits 'interest' to the reliability of these accounts.

The fundamental question is whether the public is best served by the 'orderly functioning of commerce'. Willmott (1990) considers that this is the most central question of politics, asking: '*Do the objectives, procedures and policies embodied in the structure and regulation of social and economic relations benefit the "many", or do they, in the name of the public interest, disproportionately advantage a minority of unnecessarily privileged individuals, powerful interest groups or a dominant class?*'

Willmott is convinced that the accountancy profession, in equating the 'public interest' with the orderly functioning of markets '*has thereby contrived to fulfil its espoused commitment to the public interest by assuming and upholding the legitimacy of the private interests of investors and business*'. He adds that, since the efficient operations of free markets requires that no restrictions be imposed on market participants, '*the service of the public interest is equated with the development of a structure of relations that defends the right of the individual to pursue his or her material interest without unnecessary restriction*'.

The ICAEW discussed the freedom of the individual in a report entitled '*Acting in the public interest: a framework for analysis*'. The report was issued as a stimulus to debate and does not set out the ICAEW's formal policy, but it does provide an insight into the thinking of an influential element of the profession.

The report notes that, with respect to the professional accountant, the need to consider the public interest often arises in the following situation. An individual or, more frequently, an organization (such as the state, a profession or a firm) may seek to take some action which it justifies as being in the public interest. Typically, the action involves imposing some costs or constraints on others. One can think of numerous examples of actions justified on the grounds of the public interest: the state forbids people to smoke in restaurants or sanctions businesses that pollute the atmosphere, a professional institute requires its members to undertake regular training courses on the latest legislation and the firm demands that its employees treat customers with respect.

The ICAEW's report makes the basic presumption that '*people should be able to go about their own business in their own interests*'.<sup>11</sup> Hence, those who seek to limit other people's liberty, need to justify their actions. The report is very sceptical of the use of the 'public interest' as such a justification. It argues: '*invoking the public interest requires justification of an ability and right to decide what is for the greater good, in the face of a natural suspicion that those proposing an action in the public interest are actually acting in their own interests*',<sup>12</sup> adding, '*there is academic evidence to support a presumption that invoking the public interest is a smokescreen to disguise self-interested action*'.<sup>13</sup>

Given this approach, it comes as no surprise that the report places a number of hurdles that must be overcome before action is properly justified as being in the public interest. It sets out a lengthy and complicated process that should be followed by anyone who bases her action on such a justification. It seems clear that few proposals will survive such a process—many people would be put off at the start and would abandon the attempt.

The report is remarkable for its negative approach. Its objective seems to be to make it more difficult for someone to claim the public interest as a justification for a proposed action. There is not the slightest hint that a positive approach is possible—that individuals should be encouraged to pursue the general good and not solely their own selfish interests. In the conflict between the good of the individual and the good of society, the report comes down firmly on the side of the individual, quoting Margaret Thatcher's famous dictum, *'there is no such thing as society, there are individual men and women, and families'*.<sup>14</sup> A clue as to why the report takes this highly individualistic line is provided by the title of the section within the ICAEW that sponsored the report—Market Foundations. It would seem that some parts of the ICAEW adopt a free-market, neo-liberal approach to policy.

The above analysis makes clear that the ICAEW does not adopt a positive approach to the public interest, that it does not consider that its members have a duty to seek out and implement the public interest. It is true that the ICAEW has often cited the public interest as a ground for taking disciplinary action against a member. But this is always in combination with a more specific disciplinary offence, which is often a breach of its own by-laws but occasionally the vaguer charge of bringing discredit on the Institute or the profession of accountancy. I have not found a single example where the ICAEW has taken disciplinary action against a member solely on the grounds that she harmed the public interest. Hence, not only is there no requirement that professional accountants should positively seek out and implement the public interest, but also there is no sanction if they harm the public interest.

I will now examine how the obligation of the professional accountant to respect the public interest is reflected in the actual practice of accountancy with an analysis of a notorious scandal—the MG Rover affair.

## 2. The MG Rover Affair

The failure of the MG Rover car manufacturer in 2005 provoked much discussion as to whether a professional accountant has an obligation not to harm the public interest. This case provides an excellent demonstration of the problems in this area. The facts of this case are well known because it has been the subject of numerous enquiries whose reports are in the public domain. For a full analysis of the case, one should consult the official reports.<sup>15</sup> In the section, I concentrate on a single aspect of the highly complex affair (the so-called 'Project Platinum'), as it offers many insights into

the question of the professional accountant's responsibility to protect the public interest. But first, I give a brief outline of the whole affair.

### **2.1. Outline of the Affair**

At the start of the present century, the MG Rover Group was the last British volume car manufacturer. In the spring of 2000, BMW (which owned the group) announced its intention to sell its stake to a private equity partnership which had a reputation for asset-stripping. The news provoked a public campaign to thwart the sale and to maintain MG Rover as a major car manufacturer. This campaign culminated in a *March for Rover* in Birmingham on 1 April 2000. In response to the public concern, four local businessmen came forward with an alternative plan to buy the group from BMW. The four men, later to become known as the 'Phoenix Four', stressed that their principal motive was to preserve employment. They entered into negotiations with BMW, which, in May 2000, accepted their bid. The terms of the sale were remarkable. BMW sold its shares in the MG Rover Group to the Phoenix Four for £10. In addition, BMW lent the Phoenix Four £475 million; the loan was interest free and was not repayable until 2049. In reality the loan was a gift, as is clear from the nickname that it was given—the dowry. It would seem that BMW was prepared to pay a very considerable amount to rid itself of an embarrassing encumbrance in a way that would do least damage to its reputation. The Phoenix Four operated the MG Rover Group for some four years. At no time during this period did the group operate at a profit. Finally, the money (provided by the BMW dowry) ran out, and, in April 2005, the MG Rover Group ceased trading, with a loss of some 6,000 jobs in the Birmingham area.<sup>16</sup> The government appointed inspectors to investigate the company's collapse. The inspectors' report revealed that, over the four years, the Phoenix Four had extracted £41 million from the group for their personal benefit, which provoked considerable public outrage. But of more direct interest to the subject of this book was the finding that Deloitte, the group's auditors, had also benefited handsomely from its dealings with the group, receiving over £30 million. A large part of this money related to Deloitte's involvement in Project Platinum.

### **2.2. Project Platinum**

This project concerned the sale of a company, Rover Financial Services Ltd (RFS) from BMW to MG Rover. For the acquisition of RFS, the Phoenix Four set up a separate company, MGR Capital Ltd, which was essentially a joint venture between the Phoenix Four and a bank, HBOS, which provided the bulk of the £300 million required to purchase RFS. According to the government inspectors' report on the affair, the Phoenix Four decided that RFS should be purchased by a company which they (partially) owned and not by the MG Rover Group, because *'they wanted to secure the anticipated*

*profits for themselves*'.<sup>17</sup> The inspectors estimated that the Phoenix Four stood to gain around £14 million from their involvement in Project Platinum. From a moral point of view, any profits from the transaction should have accrued to the MG Rover Group (where it could have been used to pay the workers for a few more months) and not to the Phoenix Four, who were essentially using their management position to divert profits to themselves. Deloitte role in the purchase was that its partner, Magsoud Einollahi, negotiated the loan from HBOS, for which Deloitte received a fee of £7.5 million.

### 2.3. *The FRC's Disciplinary Action*

Following the inspectors' report, the Financial Reporting Council (FRC), the disciplinary body for the British accountancy profession, decided to charge Deloitte and its partner, Magsoud Einollahi, with misconduct. There were 13 separate charges, of which one specifically mentioned the public interest; Deloitte and Magsoud Einollahi were charged that *'they failed adequately to consider the public interest before accepting or continuing their engagement in relation to Project Platinum'*. The charges were the subject of a hearing before the FRC's Disciplinary Tribunal, which heard much evidence concerning whether or not a professional accountant was obliged to consider the public interest in her work. In the end, the Tribunal decided in the affirmative, stating:

*We do not accept that . . . the only duty that a member has is to his client provided that he is acting honestly and with integrity. It is this duty to consider the public interest that provides comfort to the client that matters are being dealt with properly and with integrity.*<sup>18</sup>

The Disciplinary Tribunal found Deloitte and Magsoud Einollahi guilty as charged. Deloitte was fined £14 million and received a severe reprimand; Magsoud Einollahi was fined £250,000 and excluded from the ICAEW for three years.<sup>19</sup>

Both Deloitte and Magsoud Einollahi appealed against the Disciplinary Tribunal's verdict. Their appeal was heard by the FRC's Appeal Tribunal, which was a completely different body from the Disciplinary Tribunal and came to a completely different decision. It held that a professional accountant was not obliged to consider the public interest. Its decision seems to have been based principally on the great difficulty for the accountant to determine the public interest. It wrote (in connection with the hypothetical case of an accountant advising on a take-over bid):

*We regard the suggestion, if it is made, that the accountants are not free to accept the engagement without considering the vague question of whether the takeover is in the public interest as absurd.*<sup>20</sup>

In using the term ‘*absurd*’, the Appeal Tribunal was ridiculing both the Disciplinary Tribunal’s decision and the ICAEW’s code of ethics, which provides that ‘*the public interest should be a factor which all members should bear in mind when accepting an assignment or appointment*’.<sup>21</sup>

The Appeal Tribunal allowed the appeals of Deloitte and Magsoud Einollahi in respect of the majority (eight out of 13) charges; it reduced the Deloitte’s fine from £14 million to £3 million (less than half the fee that Deloitte received for its work on Project Platinum) and reduced Magsoud Einollahi’s fine from £250,000 to £175,000 and quashed his exclusion from the ICAEW.

#### **2.4. Commentary on the MG Rover Affair**

I limit my comments to the question of the public interest in relation to Project Platinum. There were clearly fundamental differences between the Disciplinary Tribunal and the Appeal Tribunal. In this matter, I support the Disciplinary Tribunal for the following reasons:

1. It was certainly in the public interest that the profits from Project Platinum (estimated at around £14 million) should have accrued to the MG Rover Group (where it could have been used to maintain the employment of thousands of workers for many month) rather than to have been diverted into the pockets of the Phoenix Four.
2. Deloitte designed the convoluted scheme whereby RFS was acquired by a company separate from the MG Rover Group and was therefore closely implicated in an operation that was not in the public interest.
3. The Disciplinary Tribunal, in finding that a professional accountant has an obligation to consider the public interest in her work, created a great opportunity for the accountancy profession to reform itself so that it served the needs of the whole of society and not simply those of a narrow group of capitalists.
4. The reaction of the accountancy profession to the Disciplinary Tribunal’s verdict was one of sheer panic. It seemed to put an end to much of the profession’s most lucrative work, which consisted essentially of helping rich people to become even richer, contrary to the interest of the greater part of society. Hence, the Appeal Tribunal’s verdict was greeted with a huge, collective sigh of relief.
5. The principal reason why the two tribunals came to different conclusions was that the Disciplinary Tribunal took a common-sense approach in judging Deloitte’s actions and the Appeal Tribunal took a legalistic approach. The Appeal Tribunal’s chairman, a retired judge, treated the hearing as a criminal trial and put more emphasis on protecting the reputation of Deloitte and Magsoud Einollahi than on protecting the public.
6. The FRC’s Appeal Committee rejected the approach concerning the public interest of both the ICAEW and the FRC’s Disciplinary Tribunal.

But this cannot be the end of the affair. It is unacceptable that a group of three men (however distinguished) should decide such an important matter, particularly as their approach runs counter to that of many other distinguished people: not only the three men of the FRC's Disciplinary Committee, but also the drafters of the ICAEW's code of ethics. Furthermore, it is completely out of sympathy with the tenor of public opinion, which is very concerned that businesses should serve the public. Hence, I anticipate that the question of the accountancy profession's responsibility for the public interest will remain a topic of intense controversy and that, ultimately, common sense will prevail over legalism.

### 3. The Business of Accountancy

It can be argued that the behaviour of Deloitte in the MG Rover affair is an aberration and is in no way typical of the British accountancy profession as a whole. The truth is that we do not know whether such behaviour is widespread. The operations of accountancy firms are a 'black box'; the firms, mindful of their obligation to maintain confidentiality concerning their clients' affairs (one of the ethics code's fundamental principles), release virtually no information about their operations. A light is thrown on these operations only when a public scandal occurs and the government orders an investigation, as happened in the MG Rover affair. The public has no means of knowing how the accountancy firms have conducted themselves in the 99.9% of cases that are not the subject of an official investigation.

But I feel that the MG Rover affair provides evidence for the following thesis: the objectives of British accountancy firms are firstly to earn profits for themselves, secondly to assist their clients to earn profits and, a distant third, to serve the public interest. Evidence supporting this thesis can be found in the increasing commercialization of the accountancy profession.

#### 3.1. *The Commercialization of the Accountancy Profession*

Fifty years ago, the firms that carried out the audits of the larger British businesses described themselves as 'accountancy firms' or 'audit firms' and earned the greater part of their income from audits. That is no longer the case. These firms, notably the Big Four, which have a virtual monopoly of the audit of large enterprises,<sup>22</sup> now describe themselves as 'business service firms', or a similar title, and earn a relatively small proportion of their income from audits. This is demonstrated in Table 3.2, which presents a breakdown of the revenues of the Big Four for the most recent year. On average, only a fifth of their revenues come from auditing. Over two-thirds of their revenues come from non-audit clients.

An indication of the change in approach is given by the following statement on PwC's website: '*Our firm is a powerhouse of a commercial enterprise that does the right thing for our clients, our people and our communities*'.

Table 3.2 UK Income of the Big Four, 2016\*

	Deloitte		Ernst & Young		KPMG		PwC		Total	
	£m	%	£m	%	£m	%	£m	%	£m	%
Auditing	475	19.41%	370	18.41%	471	24.06%	604	21.89%	1,920	20.93%
Non-audit work to audit clients	173	7.07%	267	13.28%	281	14.35%	365	13.23%	1,086	11.84%
Non-audit clients	1,799	73.52%	1,373	68.31%	1,206	61.59%	1,790	64.88%	6,168	67.23%
Total	2,447	100.00%	2,010	100.00%	1,958	100.00%	2,759	100.00%	9,174	100.00%

Source: FRC: key facts and trends in the accountancy profession, June 2016

\* 2016 = year ending in 2016

Equally significant is this statement of the chairman of KPMG: ‘*Our industry is in the midst of historical change*’. The Big Four are no longer audit firms in a profession; they are ‘*commercial enterprises*’ in an ‘*industry*’.

Some years ago, the Big Four converted themselves from ordinary partnerships (in which each partner was personally liable for the firm’s debts) into corporations with limited liability. The corporate form chosen was the limited partnership, in which the partners share in the firm’s profits without being personally liable for the firm’s debts. I contend that, in such an organization, the partners are more concerned to increase their wealth than to serve the public interest. It is highly likely that the interest of the partners and that of the firm’s clients coincide, so that, in meeting the demands of clients, the partners maximize their own wealth—but frequently at the expense of harming the public interest. I argue that this is in fact what has happened in these two areas over the past 20 years: creative accounting and tax avoidance.

### 3.2. *Creative Accounting*

Creative accounting involves using loopholes in laws and regulations to prepare accounts that present a misleading picture of a business’s financial position and performance. In all cases, accountants are involved: both the business’s accountant and frequently also its auditor, who advises on how to present a misleading picture whilst staying within the law.

Michael Jones has defined creative accounting as,

*Using the flexibility in accounting within the regulatory framework to manage the measurement and presentation of the accounts that give primacy to the interests of the preparers and not the users.*<sup>23</sup>

The key word in this definition is ‘*flexibility*’. This refers to the fact that ‘*the regulatory framework*’ (the law and accounting standards) cannot specify in detail how every possible transaction should be dealt with in the accounts. British law deals with this problem by requiring that the accounts present ‘*a true and fair view*’. This phrase is vague and needs to be defined more precisely for it to influence the behaviour of accountants in preparing and auditing accounts. In very broad terms, the current position seems to be that ‘*a true and fair view*’ is what the IASB defines it to be—that, in applying the IASB’s standards in its accounts, a firm will automatically give ‘*a true and fair view*’.<sup>24</sup> But this does not solve the problem, for it is impossible for the IASB to specify in detail how every possible transaction should be dealt with in the accounts and, for this reason, some flexibility has to be left to the preparer. It is this flexibility that the preparer exploits to present accounts which comply with the law and the IASB’s standards and which therefore present ‘*a true and fair view*’ in the narrow legal sense explained above, but which do not present ‘*a true and fair view*’ as understood by most ordinary people.

Hence, creative accounting does not involve breaking the law. It may be contrasted with fraud which generally involves breaking the law, often by perpetuating falsehoods. The distinction between creative accounting and fraud may be illustrated by comparing two recent spectacular business failures: Parmalat and Enron. Both firms failed shortly after presenting accounts that showed a strong financial position. In fact, the balance sheets of both firms presented a misleading picture, but for different reasons. Parmalat reported a bank balance of €3.95 billion, which was completely fictitious—it was an invention of Parmalat’s management, who backed up their deception with forged documents.<sup>25</sup> This was clearly a criminal act; hence, Parmalat is an example of fraud. Enron’s balance sheet presented a misleading picture for a different reason. It understated the Enron group’s debt, because much of the debt was owed by special-purpose entities which Enron controlled but did not include in its group accounts. This treatment was permitted under US GAAP (of the time) and was therefore perfectly legal. Hence, Enron is an example of creative accounting.<sup>26</sup>

The distinction between fraud and creative accounting is important for the thesis that this chapter seeks to establish—that accountancy is committed to supporting and promoting capitalism. Accountants in general, as respectable members of society, are committed to upholding the law; they do not countenance committing a crime. But their underlying attitude towards capitalism may be determined by examining their actions within the law. When these actions reveal a tendency to favour the capitalist, even to the extent of presenting accounts that most people would consider to be misleading, then this is evidence to support my thesis.

I will not attempt to provide a detailed analysis of the practice of creative accounting. For that, I would recommend the reader to consult the many excellent books that have been written on the subject. One of the best is *Creative accounting, fraud and international accounting scandals* by Michael Jones. As its title indicates, this book covers not only Britain, but many other major developed countries. It analyses the techniques used by preparers to manipulate accounts and describes some of the most important recent scandals. Table 3.3 presents data about some of the more important cases of creative accounting presented in the book.

Table 3.3 Selected Examples of Creative Accounting

Country	Name of firm	Date of discovery	Size of manipulation
Britain	Polly Peck	1990	>£900 million
USA	Enron	2001	>\$1.5 billion
USA	WorldCom	2002	>\$4 billion
India	Satyam Computer Services	2009	Rs 78 billion (\$1.6 billion)
Japan	Nikko Cordial	2006	¥19 billion (\$155 million)
Netherlands	Royal Ahold	2003	>€ 400 million

The core of Jones's book is an analysis of a limited number of cases of creative accounting at the company level. He backs up this micro analysis with a survey of a number of statistical studies involving large number of companies, which demonstrate that creative accounting is widespread. Jones concludes: '*generally there is comprehensive evidence, both from the study of individual companies and also from the studies of companies in aggregate, of the existence of creative accounting*'.<sup>27</sup>

Based on Jones's analysis, I draw the following conclusions:

1. Creative accounting is an international phenomenon, affecting not only the countries that are the principal advocates of neo-liberalism (Britain and the USA), but other capitalist countries (such as Japan and the Netherlands). Even India and China have become infected by the disease, after they have embraced capitalism. The practice would seem to be a constant feature of capitalism.
2. Generally, the manipulation of accounts had the effect of presenting the business as being in a better position than in reality, with higher profits and/or more valuable assets.
3. The amounts involved in the manipulations are enormous. The figures in the last column of Table 3.3 are, in most cases, the amounts by which profits and/or assets were overstated.
4. Generally, the manipulation of the accounts only became evident when the firm collapsed. Only infrequently was it detected by internal or external control organs, such as the auditor. This raises the suspicion that there are many undiscovered cases of accounts manipulation among the firms that have not collapsed.
5. Most of the cases relate to the 1990s and early 2000s. The manipulation of accounts was rife in this period and, when the degree of manipulation became apparent (particularly with the Enron scandal), the public were outraged and demanded that something be done. The regulatory authorities (the state and the standard-setting bodies) reacted by enacting more restrictive laws and standards, which have undoubtedly had an impact in reducing the amount of (detected) creative accounting. But the businesses that seek to present an excessively favourable picture of their position make great efforts to find loopholes in these laws and standards. The result is a competition between the would-be manipulator and the regulator, in which the regulator is always two steps behind. When David Tweedie, the Chairman of the British standard-setter, was asked whether he would win the battle against the manipulators, he replied, '*We're like a cross-eyed javelin thrower competing at the Olympic Games; we may not win but we'll keep the crowd on the edge of its seats!*'<sup>28</sup> This suggests that he was not very confident of winning the battle, and he was correct in this surmise, as accounts manipulation is still a problem, as evidenced by two scandals that only became public after the publication of Jones's book: (i) *Olympus Corporation*. In October 2011, Michael

Woodford, the newly appointed CEO of the Japanese optical equipment manufacturer, announced that the firm had been overstating its profits using dubious accounting methods for many years. The amount of the overstatement was finally calculated to exceed ¥350 billion (around \$5 billion!). (ii) *Tesco*: In September 2014, the management of Tesco, the British supermarket chain, announced that previous years' profits had been overstated by around £260 million (peanuts compared to Olympus!) by the use of inappropriate accounting methods.

6. The accounts manipulation could not have occurred without the active cooperation of persons knowledgeable and skilled in accountancy, i.e., accountants. In all cases, the business's accountant (almost always a professional accountant) was involved. The most flagrant example of professional accountants being involved in creative accounting is the role that Arthur Andersen played in setting up the special-purpose entities that enabled Enron to keep much of its debt off the balance sheet. Arthur Andersen's role was to ensure that the special-purpose entities were so constructed that they fulfilled the conditions of US GAAP for non-consolidation.
7. In assisting businesses to present misleading accounts by the use of creative accounting, the accountancy profession is promoting the interests of a small segment of society: the capitalists. It is helping to portray capitalism as more successful than the reality. Cynics might suggest that accountancy, in pursuing its aim of supporting capitalism, is prepared to go to the extent of misleading the public as to the success of capitalist enterprises. The accountancy firms in devising schemes of creative accounting for their clients were in no way seeking to promote the public interest. It may be argued that, in many cases, they were responding to the clients' demands, but, in all case, there was a coincidence of the interests of the client and that of the accountancy firm, which was paid very well for its services.

### 3.3. *Tax Avoidance*

Tax avoidance is similar to creative accounting in three respects: that it generally involves the close collaboration of accountancy firms, that it is based on presenting a misleading picture of the income of an individual or business firm and that it is not illegal.

A distinction should be drawn between tax avoidance (the subject of this section) and tax evasion. These two concepts have the common feature that the taxpayer takes some action with the intention that, if successful, he would pay less tax than he would have paid if he had not taken the action. The principal difference between the two concepts is that tax evasion is a crime and tax avoidance is not.

The range of criminal actions that a taxpayer may take in order to reduce the amount of tax payable is very wide and limited only by the taxpayer's

imagination. They may range from the taxpayer blackmailing (or bribing) the local tax official to hacking into the tax authority's computer system in order to set his tax liability to zero. A very common form of tax evasion involves presenting a statement of the taxpayer's position that does not convey the truth, in that it contains significant misstatements or it omits material facts. Essentially, this involves lying or, at least, suppressing the truth. Such behaviour is dishonest and is generally condemned. Accountants, as respectable members of society, condemn tax evasion, but they are happy to assist their clients in practising tax avoidance.

In contrast to tax evasion, the tax savings that arise from tax avoidance do not generally depend on the taxpayer suppressing the truth. Normally, the taxpayer is prepared to reveal to the tax authorities all the facts relating to his actions, confident that, according to the letter of the law, he is entitled to the tax savings. In fact, if the taxpayer feels compelled to hide what he has done, that may be taken as a sure sign that he is engaging in tax evasion and not tax avoidance.

The essence of tax avoidance is that the taxpayer, often following the advice of expert lawyers and accountants, exploits loopholes or gaps in the law to pay less tax (or no tax at all) on his income than that paid by ordinary taxpayers, who are either more moral or who do not have the benefit of such advice. There is no generally accepted definition of the term 'tax avoidance'. Two widely accepted definitions place the emphasis on exploiting weaknesses in the law:

- Using tax law to gain a tax advantage not intended by Parliament;<sup>29</sup>
- The practice of seeking to not pay tax contrary to the spirit of the law.<sup>30</sup>

I feel that these definitions are incomplete, as they neglect the moral dimension. I consider that tax avoidance is unethical because the tax avoider is acting unfairly—he is shifting the tax burden (which morally he should accept as a member of society) onto his fellow taxpayers, who, because of his actions, have to pay more tax. This argument is based on the principle of fairness developed by the distinguished American philosopher, John Rawls. According to Rawls, citizens are obliged to obey the law, including the tax law; this obligation is founded on the principle of fairness which he defines in the following terms:

*This principle holds that a person is required to do his part as defined by the rules of an institution when two conditions are met: first, the institution is just (or fair). . . and second, one has voluntarily accepted the benefits of the arrangement or taken advantage of the opportunities it offers to further one's interests. The main idea is that when a number of people engage in a mutually advantageous cooperative venture according to rules, and thus restrict their liberty in ways necessary to yield advantages for all, those who have submitted to these restrictions have a*

right to a similar acquiescence on the part of those who have benefitted from their submission.<sup>31</sup>

I contend that the modern capitalist state is ‘a mutually advantageous cooperative venture’. Individuals benefit very substantially from the state’s actions in assuring law and order, providing public services and so on. They are partners in this cooperative venture, because they have voluntarily accepted the benefits that are produced by the state’s actions. All citizens benefit from the state’s existence and should play their part in ensuring that the state has the resources to continue to function effectively. As Rawls points out, this involves the acceptance by the partners in the cooperative venture of certain restrictions on their liberty, notably the obligation to pay some part of their income and wealth to the state in the form of taxes. Hence, those who have made their contribution to the state’s upkeep through their taxes have a right to demand that all should pay their fair share. Where some individuals succeed in avoiding paying their fair share, this is a breach of the rights of those who have paid their fair share.

Hence, accountants who assist individuals or business firms to avoid taxes are engaging in an activity that is unethical, although, of course, not illegal. Yet, for the Big Four accountancy firms, tax avoidance is big business. This became clear when the British Parliament’s Public Accounts Committee (PAC), concerned at the loss of revenue to the state from tax avoidance, investigated the Big Four’s activities in this field. The Committee uncovered some remarkable figures about the Big Four’s tax practice, which are summarised in Table 3.4.

Between 2011–2012, the Big Four’s fees from tax advice world-wide exceeded \$24 billion. In the UK, the fees totalled £1.8 billion. It is clear that the firms’ clients were not paying these astronomical fees simply to be informed on the amount of tax that they should pay according to the law. They paid because it was profitable, as the tax saved exceeded the costs incurred.

The nature of the advice that these firms were giving can be gauged from three examples where the details became public knowledge. In general, the techniques used by rich individuals to avoid tax remain hidden from the public gaze, but occasionally, they are revealed in their complexity and

Table 3.4 The Big Four’s Tax Practice, 2012

	<i>PwC</i>	<i>Deloitte</i>	<i>E&amp;Y</i>	<i>KPMG</i>	<i>Total</i>
Global revenue (tax)	\$7,944m	\$5,900m	\$6,011m	\$4,860m	\$24,715m
UK revenue (tax)	£659m	£453m	£431m	£310m	£1,853m
% UK turnover	25.0%	19.0%	26.0%	17.5%	22.0%
UK tax employees	3,005	2,141	2,081	1,670	8,897

Source: British Parliament’s Public Accounts Committee: PAC (2013)

deviousness, notably when they become the subject of a court case. Prem Sikka and Hugh Willmott, in a most useful article, provide an analysis of three of the most blatant:

*Phones 4u*: The directors of Phones 4u sought to avoid paying UK National Insurance Contributions on their bonuses by being remunerated in gold bars, fine wine and platinum sponge. When the law was amended to defeat this scheme, a second more complex arrangement was devised. With the aid of an accountancy firm, an employee benefit trust was set up in Jersey (a tax haven). Phones 4u paid the directors' bonuses into the trust, which then lent the money to the directors. It was claimed that no income tax was payable on the money received by the directors as it was a loan and not income. Some seven years after the scheme was devised, it was declared unlawful by the UK's highest court.<sup>32</sup>

*Schofield*: A business man sold his firm, making a profit of about £10 million. An accountancy firm devised a scheme whereby the businessman incurred a book loss of £11 million (but no overall cash loss) which would be set against the capital gain of £10 million. The scheme was very complex, involving circular interconnected transactions with options, derivatives, loans and investment in gilts. It was ultimately declared invalid by the British court, which declared '*Under the scheme as a whole, the options were created merely to be destroyed. They were self-cancelling. Thus, for capital gains purposes, there was no asset*'.<sup>33</sup>

*Dark Blue Investment*: This scheme was an attempt to avoid paying income tax and National Insurance Contributions on the bonuses of senior employees of the London office of Deutsche Bank. An investment company, Dark Blue Investment, was set up in the Cayman Islands, a tax haven. The bonuses were paid into the investment company and the employees were granted shares in the company of an equivalent value. It was argued that the employees were not subject to tax on the shares that they received, even when they sold them. The court rejected the scheme, declaring that '*the scheme as a whole, and each aspect of it, was created and coordinated purely for tax avoidance purposes*'.<sup>34</sup>

These three cases demonstrate that the larger accountancy firms are devoted to serving their clients (and simultaneously, themselves), even when it is abundantly clear that this results in harm to society,

The response of the accountancy profession to criticisms concerning tax avoidance has been to admit that, in the past, the behaviour of accountancy firms was less than perfect but that, in the future, it will be impeccable. Thus, in the proceedings before the PAC, the representatives of the Big Four insisted that they no longer marketed the aggressive tax avoidance schemes criticised in the PAC's report. For its part, the ICAEW proclaims that it has strengthened its code of conduct on tax by making clear that its members

should not promote tax planning arrangements that set out to achieve results contrary to the intention of Parliament.<sup>35</sup> But, I believe that these actions are a classical damage-limitation exercise by organizations responding to public criticism. Once the public furore has died down, they will revert to their former behaviour. In particular, I have no confidence that the ICAEW will use its disciplinary powers to sanction members engaging in tax avoidance. To the best of my knowledge, in the past, no accountancy firm has been disciplined for engaging in tax avoidance (certainly not in the three cases outlined above), and I very much doubt that the future will bring any change in the ICAEW's behaviour.

#### 4. Setting the Rules

The last two sections have demonstrated how the accountancy profession interprets the rules in a fashion that favours the capitalist. In this section, I seek to demonstrate that the accountancy profession seeks to influence the setting of the rules (laws and standards) so that they favour the capitalist. I start with rules that govern the subject matter of the last section—tax.

##### 4.1. *The Tax Rules*

The British Parliament's PAC, in its report referred in the last section, commented on the government's tax authority's practice of supplementing its limited staff numbers by employing experts from the Big Four seconded on a temporary basis. Many of these seconded experts are employed in drafting modifications to the tax laws and regulations. Clearly, this practice has certain advantages: the seconded experts have a good practical knowledge of how tax rules are applied in practice and can point out ambiguities and practical difficulties with proposed new rules. But there are obvious problems, particularly when the seconded experts return to their firms and start to advise clients not only on how to apply the new rules, but also (possibly) on how to circumvent them. The PAC was disturbed by the practice, commenting, '*we have seen what looks like cases of poacher, turned gamekeeper, turned poacher again, whereby individuals who advise governments go back to their firms and advise their clients on how they can use those laws to reduce the amount of tax they pay*'.<sup>36</sup> There is no evidence of wrong-doing on the part of any individual. But I feel that the advice that an expert from a Big Four firm would give on tax laws must be slanted in favour of promoting capitalism, given the commitment of these firms to this ideology.

##### 4.2. *Standard Setting*

The greater part of the rules that govern the form and content of financial statements are set by standard-setting bodies—in the case of the larger British companies, the IASB. In the previous chapter, I claimed that the IASB's

rules (both its conceptual framework and its standards) favoured the capitalist, for example, in permitting businesses to anticipate future profits. The accountancy profession is closely implicated in the setting of these rules. This is made clear in Table 3.5, which presents information about IASB's Board, the body that makes the final decision on standards.

Table 3.5 analyses the composition of the IASB's Board with respect to the members' career prior to joining the board. Eight of the 12 members were accountants; in fact, most still are accountants, as they are members of professional associations.<sup>37</sup> Four were previously associated with the major accountancy firms (Arthur Andersen, KPMG and PwC). The remaining members of the Board have a background as regulators or in banking. There are two university professors. Conspicuously absent from the Board are any

*Table 3.5 The Composition of the IASB's Board*

<i>Name</i>	<i>Country</i>	<i>A</i>	<i>P</i>	<i>R</i>	<i>U</i>	<i>Career</i>
Hoogervoost	NL			X		Former Minister of Finance; Chairman of Authority for Financial Markets (NL)
Cooper	UK	X	X			Managing Director, Equities Division, UBS Investment Bank
Danjou	F	X		X		Arthur Andersen; Director, Ordre des Experts Comptables; Director, Autorité des Marchés Financiers
Edelmann	D	X	X			KPMG; Head of Group Reporting, Deutsche Bank
Gomes	Brazil			X		Regulation Department of the Central Bank of Brazil
Kabureck	USA	X	X			PwC; CEO of Xerox Corporation
Lloyd	Australia		X			Investment banking; JP Morgan; Goldman Sachs
Ochi	Japan		X			Sumitono Corporation
Scott	S. Africa	X	X			CFO FirstRand Banking Group
Suh	Korea	X			X	PhD University of Illinois; Professor of Accounting Kookmin University, Seoul
Tokar	USA	X		X		KPMG; Securities and Exchange Commission
Zhang	China			X	X	Shanghai University of Finance and Economics; China Securities Regulatory Commission
Total		7	6	5	2	

Notes:

A = Qualified accountant

P = Preparer

R = Regulator

U = University professor

representatives of civil society, such as trade unions, consumer groups or NGOs (such as Greenpeace), that lobby for a change in corporate behaviour. This reflects the IASB's ideology that business firms have no responsibility to render account of their activities to the wider society. Their sole responsibility is to their capital providers. If there were representatives of civil society on the IASB's Board, then the IASB would be obliged to give serious consideration of the business firm's responsibility to society.

Richard (2015, p. 26) points out that, in France, the body that sets the standards for the individual accounts<sup>38</sup> refuses to allow fair-value accounting. Richard attributes this refusal to the fact that the standard-setting body includes representatives of stakeholders, such as trade-unionists. Hence, the rules in France reflect the interests of the whole of society, and not just those of the capitalists. But France is 'the exception that proves the rule'—the rule that, where the accountancy profession dominates the standard-setting process, the rules that are set favour the capitalist.

## 5. Summary and Conclusion

In this chapter, I seek to demonstrate that the accountancy profession, in preparing and auditing the financial statements of business firms, consistently favours the capitalist. I start by analysing the important role that the accountancy profession plays in the functioning of capitalism, notably by fostering the trust that is essential for the provision of credit. The origin of the British accountancy profession in the middle of the nineteenth century is traced to the need to provide audit services to the growing industrial and commercial enterprises of the period. The profession claims that its members, in addition to serving business firms by acting competently and honestly, are also obliged to consider the public interest. This claim was tested in two ways: firstly, in an analysis of its code of ethics, and secondly, in an examination of the actual behaviour of accountants in a specific case (the MG Rover affair) and, finally, in two general areas—creative accounting and tax avoidance. The conclusion is that the accountancy profession's claim to serve the public interest is a myth. In reality, accountancy firms are commercial enterprises functioning in a capitalist economy. In common with all capitalist firms, their primary aim is to maximize their own profits. Typically, they do this by assisting their clients to maximize *their* profits by providing accountancy and auditing services in a competent and honest way. There is little doubt that most business firms have benefited greatly from these services, in the form of increased profits. The relationship between the accountancy profession and business is a form of mutually beneficial symbiosis in which both sides benefit—but at the expense of society as a whole. Accountants also dominate the standard-setting bodies, which ensures that the standards that they set serve the interests of capitalists (capital providers), but neglect the responsibility of the business firm to render account to all stakeholders.

I charge the accountancy profession with aiding and abetting the spread of neo-liberal precepts throughout the economy. The first step was a change in the objective of the typical accountancy firm. Whereas 50 years ago, that objective was to render as good a service as possible to its clients, today it is unashamedly to maximize its own profit. Accountancy firms have discovered that typically, the most effective way of maximizing their own profits is to maximize those of their clients. Accountancy has internalized the doctrine of shareholder value that lies at the heart of neo-liberalism.

In the opening chapter, I listed the evils that currently afflict mankind as:

- The degradation of the environment and the consequent threat of global warming;
- Growing inequality, with a widening gap between an elite (who have benefited mightily from neo-liberal policies) and the mass of the population;
- Continued high unemployment and a general decline in the quality of work;
- An economic system that is unsustainable in the long run, thus putting in jeopardy the welfare of future generations;
- Financialization (the dominance of finance in the economy) which benefits the few at the expense of the many, and which was a major cause of the global financial crisis of 2007–8, which has brought misery to millions.

I contend that the accountancy profession has made no effort to rectify any of these ills. In fact, in aiding business firms to increase their profitability, it has aggravated many of them—notably the destruction of the environment, the increase in inequality and, above all, the growth of financialization.

Hence, as indicated in this chapter's title, I judge the current practice of the accountancy profession to be deplorable.

I am a Chartered Accountant, and, as such, I am acutely embarrassed that my profession actively supports and sustains neo-liberalism, an economic system that is destructive of society and of the environment. But, before considering how accountancy should be reformed, it is first appropriate to consider how the underlying economic system should be reformed.

## Notes

1 See Berle and Means (1932)

2 For example, see Flower (2002, p. 160).

3 In using 'he', I am not implying that all professional accountants are male. This was certainly the case in the nineteenth century, when most professional associations were founded. It was not until 1919 that the ICAEW admitted its first female member. However, times are changing, and in 1999, the ICAEW elected its first woman president. Currently, women make up about a third of the members of the British accountancy bodies listed in Table 3.1. My reason for using 'he', 'him' and 'his' to refer to professional accountants is simply that I dislike the

cumbersome ‘he/she’. To redress the balance, later in this chapter, I will use ‘she’ and ‘he’ indiscriminately.

- 4 For more information on the formation of the British accountancy profession, see Flower (2002, chapter 4).
- 5 AFRB (2002)
- 6 An example of a credence good: a doctor diagnoses that you have appendicitis and operates to remove your appendix. How will you ever know that his diagnosis was correct and not simply a way of earning money? For an analysis of credence goods, see Darby and Karni (1973).
- 7 Supplemental Royal Charter of 21 December 1948, available on the ICAEW’s web-site.
- 8 AFRB (2002, p. 46).
- 9 International Ethics Standards Board for Accountants
- 10 See Cowton (2009, p. 184).
- 11 ICAEW (2012, paragraph 1.2).
- 12 ICAEW (2012, paragraph 1.2).
- 13 ICAEW(2012, paragraph 1.4).
- 14 ICAEW (2012, paragraph 2.7).
- 15 There are three important reports: 1. The report of the government inspectors: BIS (2009). 2. The report of the FRC’s Disciplinary Tribunal; FRC (2013). 3. The report of the FRC Appeal Tribunal: FRC (2015).
- 16 See Bailey (2010). The figure of 6,000 includes jobs lost in suppliers.
- 17 BIS (2009, chapter 25, paragraph 37).
- 18 FRC (2013, paragraph 22).
- 19 The FRC’s sanctions related to the whole of Deloitte’s work with MG Rover, not solely to Project Platinum.
- 20 FRC (2015, paragraph 82).
- 21 ICAEW code of ethics, statement 1.201.
- 22 The Big Four audit 98% of the one hundred largest listed companies (FTSE100) and 96.8% of the largest 250 listed companies (FTSE250). Source *FRC Key Facts and Trends in the Accountancy Profession June 2016*.
- 23 Jones (2011, p. 6).
- 24 For a fuller discussion of the very complex topic of the definition of ‘*a true and fair view*’, see Flower (2002, pp. 106–108).
- 25 For a full description of the Parmalat case, see Jones (2011, pp. 259–273).
- 26 For a full analysis of the Enron case, see Flower (2004, pp. 193–225).
- 27 Jones (2011, p. 94).
- 28 Cited in Jones (2011, p. 78).
- 29 The British Parliament’s Public Accounts Committee, quoted in PAC (2013, summary).
- 30 Tax Glossary, available of the web-site of the Tax Justice Network. [www.taxjustice.net](http://www.taxjustice.net)
- 31 Rawls (1991, p. 96).
- 32 See Dextra Associates Ltd and Ors v. Inspector of Taxes [2002] UKSC SPC00331, quoted in Sikka and Willmott (2013, p. 422).
- 33 See Schofield v. Revenue & Customs (Rev 1) [2010] UKFTT 196, quoted in Sikka and Willmott (2013, p. 425).
- 34 See Deutsche Bank Group Services (UK) Ltd v. Revenue & Customs [2011] UKFTT 66 (TC) quoted in Sikka and Willmott (2013, p. 426).
- 35 See Biebuyck (2016, p. 76).
- 36 PAC (2013, summary).
- 37 It is not clear if Scott and Tokar are members of professional associations, but they were certainly accountants—Scott as Chief Financial Officer of the FirstRand Banking Group and Tokar with KPMG.
- 38 The rules for the consolidated accounts are set by the IASB.

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# 4 The Reform of Capitalism

## The Stakeholder Theory of the Firm

In the preceding three chapters, I have argued that the current economic system (based on neo-liberalism) is failing mankind and should be reformed. In this chapter, I consider how it should be reformed.

### 1. Central Planning: An Alternative to Capitalism?

What are the alternatives to neo-liberalism as a guiding principle for the economy? A principal criticism of neo-liberalism is that it insists on the right of the individual to act in the way that best serves his own selfish interests, with no consideration of the harm inflicted on others, on society and on the planet. Hence, it would be logical to replace neo-liberalism with a system that emphasised the welfare of society as a whole, as opposed to that of the individual. One possibility would be a centrally planned economy, where the government, acting on behalf of the entire population, would take all decisions concerning the production and distribution of goods and services. This was the system in the former Soviet Union, and that state's spectacular collapse implies that the system is faulty. Indeed, the former Soviet Union had many faults, but the one that led eventually to its demise was that its economy failed to provide the goods and services demanded by its people. It is abundantly clear that the economies of Western Europe and America, which relied largely on the market to guide decisions on the allocation of resources, were much more efficient in meeting their people's needs. There is an anecdote concerning the visit to America of a delegation of economists from the Soviet Union; one asked, 'Who is responsible for the supply of bread to New York City?' The answer was '*no-one!*' and one could, with great confidence, add '*that if one person were to be given this responsibility, the supply would certainly become much less efficient*'.

Central planning must be rejected as a possible alternative economic system, because, literally, it does not deliver the goods.

## 2. The Indispensability of Capitalism

The principal reasons why the market is more efficient than the central planner is that the latter does not have sufficient information on production possibilities and people's preferences to make proper resource allocation decisions, whereas the market distils the mass of information relating to thousands of producers and millions of consumers into a single statistic, the market price, which guides producers and consumers alike to the most efficient action—the market price is Adam Smith's 'invisible hand'. Hence, any alternative economic system must include a major role for the market in the allocation of resources. This implies that this feature of capitalism (at least) should be retained. In the words of Jonathon Porritt, an erst-while fierce critic of capitalism, *'Like it or not, capitalism is now the only economic game in town . . . The adaptability and inherent strengths of market-based, for-profit economic systems have proved themselves time after time'*.<sup>1</sup> Given that capitalism is *'the only economic game in town'*, the implication is that capitalism should not be replaced, but that it should be reformed.

## 3. Capitalism in the Service of Mankind

In what way should capitalism be reformed? The key to answering this question is to consider capitalism's faults. The analysis in chapter 1 demonstrates that neo-liberalism (the prevailing form of capitalism) has many faults, but I consider that its gravest fault is that the managers of business firms are obliged to give absolute priority to the interests of the capitalists who own the firm—the shareholders in the case of a company. In practice, they ignore the welfare of other people, of society and of the planet, except insofar as these outsiders can impact the firm's profits. Hence, at least, a reformed capitalism should provide that business firms be managed with a view to the welfare of all persons who are affected by the firm's activities and not just that of the capitalists who own the firm. That would be the first step in developing a reformed capitalist economic system whose defining characteristic would be that economic activity should not be guided exclusively by consideration for the welfare of the capitalist, but for the welfare of the whole of mankind.

## 4. Accountability

I propose that a reformed capitalism should provide that business firms be managed with a view to the welfare of all persons who are affected by the firm's activities and not just that of the capitalists who own the firm. I believe that, for accountancy to contribute towards the achievement of this aim, it is necessary to greatly develop the accountability of the business firm.

#### 4.1. *The Concept of Accountability*

The term 'accountability' refers to the relationship between a person who needs information and a person who can supply that information. The concept of accountability has been analysed by Yuji Ijiri (1983). Ijiri invented idiosyncratic terms for the people involved in the accountability process, which are italicised in the following outline of his schema:

- The *accountor* (a person or a group of persons, such as a firm) has an obligation or a responsibility to act in a certain way (or to refrain from acting) in respect of the *accountee* (another person or group of persons).
- The *accountee* needs to know that the *accountor* has fulfilled this responsibility towards him. Hence, the *accountee* has a right to demand information on this matter from the *accountor*. This right creates an additional obligation on the part of the *accountor*.
- The *accountor* fulfils his obligation to provide information by giving the *accountee* an account.
- The *accountant* is the person who assists the *accountor* in providing this information. According to Ijiri, the *accountant's* task is to provide '*a fair system of information flow between the accountor and the accountee*'.

The value of Ijiri's schema is that it places the emphasis on the obligations and rights of the people involved in an accountability relation. There are two possible sources of these rights and obligations: law and morality.

#### 4.2. *The Legal Basis of Accountability*

In this section, I consider the accountability of business firms, with particular reference to the legal position in Britain. The law in other countries in Europe and North America follows similar principles but is not identical. With respect to business firms, British law is most prescriptive in the case of corporations (limited companies, limited partnerships and so on). With respect to unincorporated businesses (such as general partnerships and sole traders), accountability is largely left to be decided by contract between the parties involved. With respect to limited companies, the directors are legally obliged to operate the business in the interests of the shareholders and to render account of their actions to the shareholders in the form of an annual report, which contains, inter alia, the financial statements. Hence, British law defines both the persons to whom the company (the directors) should render account and the contents of the account. These are minimum requirements; there is no prohibition against providing information to persons other than shareholders. But such persons have no legal right to demand information from the company. In the Caparo case,<sup>2</sup> the highest British court of law decided that a company's accounts were prepared for the benefit of the company's current shareholders, and no other party (for

example an employee, a supplier or even a potential future shareholder) had any legal rights in relation to them.

In 2006, some cosmetic changes were made to British law with the addition of a new section 172 to the Companies Act, which states that ‘it is the director’s duty to promote the success of the company for the benefit of its members (i.e. its shareholders). In doing so it should have regard to the interest of the company’s employees, the company’s relationships with its suppliers and customers, the impact of the company’s operations on the community and the environment and the desirability of the company maintaining a reputation of high standards’.<sup>3</sup> The directors have a *duty* to manage the company in the interests of the shareholders, but are only required to ‘*have regard to*’ the interests of people other than the shareholders. Colin Mayer summarises the law as: ‘*the fundamental duty of the company is to its shareholders and the interest of other parties derive from that primary duty*’.<sup>4</sup> Indeed, Colin Mayer argues that, if the directors ‘*have regard to*’ the interest of other parties ‘*to a degree that that was detrimental to the interests of their shareholders, then they would be acting beyond their authority*’.<sup>5</sup>

The position in other countries is broadly similar. In law, the company is accountable only to its shareholders, unless it enters into a contract with a third party to render accounts. That is the legal position. But the moral position is rather different.

#### 4.3. *The Moral Basis of Accountability*

As may be expected, there are many different viewpoints as to the moral obligation of the company to render account to third parties other than to shareholders. At one extreme are libertarian philosophers, who hold that an obligation to do something can only be imposed on a person (a company is a legal person) by law<sup>6</sup> or by a contract freely entered into.<sup>7</sup> But other philosophers argue that the firm has an obligation to render account to a wider group of people. A convincing argument for such an obligation is provided by the social contract theory of the firm.

#### 4.4. *The Social Contract Theory of the Firm*<sup>8</sup>

The social contract theory of the firm is explicitly derived from the social contract theory of the state, which was developed in the seventeenth and eighteenth centuries by Thomas Hobbes and Jean-Jacques Rousseau. These political philosophers asked what life would be like in the absence of the state (in the state of nature) and envisaged the conditions that the state would have to meet for individuals to agree to create the state. The state is thus founded on a contract between rational individuals. It is important to appreciate that neither philosopher believed that there was an historical contract, that at some time in the past, people came together to agree to form a state. The theory is based on a thought experiment, which provides insights

on the conditions the state must fulfil in order for it to be morally legitimate (that citizens are morally obliged to obey the state's laws). Hobbes and Rousseau came to different conclusions. For Hobbes, the state is legitimate if it protects its citizens from aggression; for Rousseau, the state is legitimate if its laws reflect the general will.

The social contract theory of the firm follows the same sequence of reasoning as the social contract theory of the state. In the beginning there were no firms (each man produced the goods that he needed without the cooperation of other men). Then, the members of society came to an agreement to allow firms to be formed; the ethical obligations of firms are derived from the terms of this agreement. The social contract theory posits an implicit contract between the members of society and firms in which society grants firms the right to exist and carry on their business, subject to certain restrictions and in return for providing society with certain benefits.<sup>9</sup> The right to exist covers such points as limited liability for corporations and the right to hire other members of society as employees (a practice which did not exist in the state of nature).<sup>10</sup> In return, society may reasonably demand that *'the benefits from authorizing the existence of productive organizations outweigh the detriments of doing so'*. Firms should be required *'to enhance the welfare of society . . . in a way that relies on exploiting corporations' special advantages and minimizing disadvantages'*.<sup>11</sup> Hasnas (1998) analyses the advantages of firms to society from the viewpoint of people as producers and as consumers. As producers (employees), they benefit from both an increased income and a more stable income. As consumers, they benefit from a greater and more stable supply of more varied goods (the result of increased specialisation). The disadvantages are that people, as employees, may suffer alienation and dehumanized working conditions and, as consumers, may be harmed by the pollution of the environment and the depletion of natural resources. According to Hasnas, the people who are most affected by the existence and operations of firms are the firms' employees and customers. However, certain aspects of the firm's operations may affect society as a whole: for example, there is the possibility that the people's liberty may be endangered if firms grow too big and too powerful.

The social contract theory provides a reasoned argument for the following precepts:

- The firm should act to enhance the welfare of its customers, for example, by supplying them with goods that provide the utility that they demand.
- The firm should act to enhance the welfare of its employees, for example, by providing them with a steady adequate income and with humane working conditions
- In respect of other stakeholders, the firm should act so as to ensure that that the welfare of society as a whole is not harmed, for example, by not polluting the environment.

It is important to understand that these obligations are imposed on the firm not through the laws of the state; they are moral obligations, which have their source in the social contract.

The social contract theory supplies the moral basis for the rights and duties of firms. Society demands that firms justify their existence and activities. These ideas were well expressed by the following authors.<sup>12</sup>

*Any social institution—and business is no exception—operates in society via a social contract, expressed or implied, whereby its survival and growth are based on: 1) The delivery of some socially desirable ends to society in general and 2) The distribution of economic, social or political benefits to groups from which it derives its power . . . An institution must constantly meet the twin tests of legitimacy and relevance by demonstrating that society requires its services and that the groups benefitting from its rewards have society's approval.*

(Shocker & Sethi, 1973)

*Every large corporation should be thought of as a social enterprise; that is an entity whose existence and decisions can be justified in so far as they serve public or social purposes.*

(Dahl, 1972)

The social contract theory has been criticised on two grounds:

There is no actual contract. However, this is a misunderstanding of the nature of the thought experiment used in developing the theory. The social contract theory specifies the moral obligations of firms: what society may reasonably demand of them. It does not specify what firms are contractually obliged to do.

Firms do not need the permission of society to exist and carry on their business. Again, it should be emphasised that the social contract theory sets out moral obligations and not legal obligations. But the state does place legal obligations on firms, especially on corporations, such as limited companies. In Britain, the approval of a government department (the Registrar of Companies) is necessary for the formation of a company, and the law (the Companies Act) specifies the company's rights and powers. The law grants the company very valuable privileges, of which the most important are limited liability and legal personality. In return for these privileges, the law places certain obligations on the company, for example, the requirement to publish accounts. In the USA, the Supreme Court has declared, '*The corporation is a creature of the state. It is presumed to be incorporated for the benefit of the public*'.<sup>13</sup> In both countries, it would seem that, at least with respect to corporations, the law is based on the concept of benefits in return for obligations, which is the fundamental concept of social contract theory. The argument against this theory may have some force in the

case of unincorporated businesses such as partnerships. However, since all except the smallest businesses are corporations, this point is of no practical significance.

The social contract theory provides a persuasive basis for the proposition that the firm is under a moral obligation to render account to all persons that are affected by its activities.

Dillard (2007) analyses the moral basis of the firm's accountability in terms of the social contract theory of the firm. He writes: '*Organizational management is specifically granted fiduciary responsibility over society's economic resources. By exercising these rights, an ethic of accountability is established whereby the actor agrees to being held accountable by those who grant these rights . . . An ethic of accountability requires a moral act to be preceded by a serious and conscious consideration of the physical and historical context within which an act is carried out. The actor acts within, and as a responsible member of, an ongoing community, accepting the right of the community to require an account of both process and outcome*'.<sup>14</sup> In effect, Dillard claims that the firm has a moral obligation to consider the impact of its activities on everyone so affected (employees, suppliers, customers and society in general); this applies both before the event (to consider the potential impact) and after the event (to measure the impact). Also, it must render account to these people both of the process (how the firm has been managed) and the outcome (the impact of the firm's activities).

#### 4.5. A Kantian Justification for Accountability

A rather different justification for the firm being under an obligation to render account to others is provided by the philosophy of Immanuel Kant. Kant held that all persons were under an absolute duty to obey certain categorical imperatives.<sup>15</sup> Two formulations of Kant's categorical imperative are relevant:

- Act in such a way that you always treat humanity, whether in your own person or in the person of any other, never simply as a means, but always at the same time as an end.
- Act only on that maxim through which you can at the same time will that it should become universal law.<sup>16</sup>

*Human beings as ends:* Kant states that I should treat other human beings as ends (as individuals with their own specific rights and duties) and not solely as a means (as a way of achieving my goals). Of course, it is inevitable that I use other human beings as means. For example, if I want to buy a loaf of bread, I am treating the shop assistant who serves me as a means to achieve my aim, but I must also treat her as an end—as a fellow human

being. For example, if in the course of my purchase, she suddenly has a fit, I am under a moral obligation to do everything in my power to help her. Evan and Freeman (1993) base their analysis of the obligations of the firm on Kant's categorical imperative in these terms: '*. . . we believe that each person has the right to be treated not as a means to some corporate end but as an end in itself . . . We maintain that persons (even legal persons) are responsible for the consequences of their actions . . . and must be able and willing to accept responsibility for them. Therefore any theory that seeks to justify the corporate form must be based on the idea that the corporation and its managers, as moral agents, can be the cause of and can be held accountable for their actions*'. The basic idea is that the Kantian categorical imperative confers a right on the persons who are, in any way, affected by the firm's actions—the right to be treated as an end. This right provides the basis for the accountability relation, as analysed by Ijiri (see section 4.1 above).

*The universal law:* This version of the categorical imperative is similar to the well-known principle that I should treat other people in the same way that I would like them to treat me. For example, the manager of a firm should treat his employees in exactly the same way as he would like to be treated if he were to become an employee.<sup>17</sup> Hence, the manager should respect the demands of the firm's employees to be provided with an account of the firm's actions that affect them. The American philosopher John Rawls uses a similar argument when he claims that the principles of justice should be set by people behind a 'veil of ignorance', where people do not know what position they will occupy in society—whether they will be the manager or the employee.

In my opinion, the social contract theory of the firm, backed up by the various formulations of the Kantian categorical imperative, provides a strong basis for the claim that the firm has a moral obligation to render account to all persons who are, in any way, affected by the firm's actions.

#### **4.6. Which Basis for Accountability: Law or Morality?**

It is very clear that the obligations placed on the firm through morality are much wider and more onerous than those placed by the law. A principal reason for this is that it is virtually impossible to devise a law that would cover all aspects of how the firm should be managed. In general, the law provides an insufficient guide as to what is ethically acceptable; the law has to be supplemented by morality. But what moral principles are appropriate? Libertarian philosophers, such as Hayek and Friedman, reject the social contract theory of the firm; they claim that the liberty of the individual is paramount and that obligations can be imposed on the individual only through law or contract. Personally, I reject libertarianism as destructive of society and prefer the social contract theory of the firm. I cannot prove

conclusively that my approach is correct. But I feel that there are strong arguments in favour of my position, and, at the very least, it is a valuable exercise to investigate the implications for accountancy if it turns out that I am right!

#### **4.7. *Why Accountability Is Important***

As analysed by Ijiri (1983), the accountee has a right to demand information from the accountant in order to assure himself that the accountant has properly fulfilled his obligations. If the accountant's report demonstrates that this is the case, the accountee need take no further action, except perhaps to communicate to the accountant that the report had fully met his information needs. But, if the report indicates that, in some respects, the accountant has not fulfilled his responsibilities towards the accountee, then the accountee should logically take some action to correct this failing. The nature of the action that the accountee may take varies with the circumstances: it can range from a simple note to the accountant reminding him of his responsibilities to much more consequential action, such as dismissing the accountant, as when a shareholder votes against the reappointment of a company director. The important point is that it makes no sense, from the viewpoint of society, that resources should be expended on producing an accountability report, unless there is at least the potentiality of action by the accountee on the basis of the information in the report.<sup>18</sup>

#### **4.8. *The Firm's Responsibility to Render Account***

I conclude that the business firm has a moral responsibility to render account to all those affected by its actions. The firm's responsibility is not limited to obeying the law and fulfilling its contracts. It has a further responsibility to render account. However, for this to be practicable, answers must be found to two fundamental questions:

- (i) Who, within the firm, is responsible for fulfilling the firm's duty of rendering account?
- (ii) In the case of the typical firm, the number of people whose welfare is affected by the firm's activities is enormous. The firm can hardly be expected to give equal consideration to the welfare of all these people. How is it to decide which group deserves the most consideration, and how is it to decide on priorities when the interests of one group conflict with those of another?

I believe that answers to these questions are provided by the stakeholder theory of the firm.

## 5. The Stakeholder Theory of the Firm<sup>19</sup>

The stakeholder theory of the firm is based on the concept of a stakeholder in a firm, which, in principle, is straightforward: a stakeholder is anyone who has a stake in the firm's success—who prospers when the firm does well and who suffers when the firm does badly. In practice, it appears that it is difficult to convert this concept into a precise definition, with various authors offering slightly different definitions. In this section, I set out my own version of stakeholder theory which I consider to be the most appropriate for analysing the firm's accountability and to be consistent with the other theories presented in the literature.<sup>20</sup>

Stakeholder theory is based on a concept of the firm that is fundamentally different from that of neo-liberalism. Neo-liberal economic theory considers the firm to be an independent entity which buys factors of production (labour, materials and so on) on the market and transforms them into other goods and services, which it sells on the market. If the value of its output is higher than the cost of its inputs, the firm makes a profit. At the same time, the firm has converted resources with a certain market value into goods and services that have a higher market value—it has increased the total market value of society's goods and services. For this reason, profit is a measure of the benefits that the firm has rendered society.

The stakeholder theory of the firm is based on a fundamentally different concept. It considers that the various parties with which the firm has dealings are not independent of the firm but are more or less closely associated with it. The firm is a nexus of relations between these parties who are given the generic title of stakeholders. For example, Evan and Freeman (1993), in presenting stakeholder theory, refer to the firm as '*a forum of stakeholder interaction*' and '*a vehicle for coordinating stakeholder interests*'. Clarkson (1995) defines the firm as '*a system of primary stakeholder groups*'. In essence, the firm may be considered to be a coalition of stakeholders.

The stakeholders of a firm may be divided into two groups:

Primary stakeholders: a narrowly defined group comprising all those who are vital to the firm's survival and/or success. The primary stakeholders are the members of the coalition that forms the firm.

Secondary shareholders: a wider group that comprises all those (other than primary stakeholders) who are affected by the firm's existence and activities.

### 5.1. Primary Stakeholders

Clarkson (1995) offers the following definition: '*A primary stakeholder group is one without whose continuing participation the corporation cannot survive*'.<sup>21</sup> The word 'group' is important. A firm can survive if it loses an

individual customer, but not if it loses the group of customers. The following are the principal primary stakeholders.

- i. Suppliers of capital (that is, shareholders and loan creditors), who provide the funds to finance the firm's assets.
- ii. Suppliers of labour services (that is employees), who operate the machines and other assets acquired with the capital.
- iii. Suppliers of raw materials and other inputs which go into the goods and services that are the firm's output.
- iv. Customers who buy the firm's output.
- vi. The state, which in many ways may be considered a partner in the firm, taking a percentage of the profits in the form of taxation. The state is vital for the firm's operations, as it both protects the firm from aggression and provides the legal framework which ensures that contracts are honoured.
- vii. The managers of the firm.

The relationship between the firm and these stakeholders is essentially one of mutually beneficial exchange. Suppliers of capital provide funds and receive dividends and interest; employees offer their skills, effort and time and receive wages; suppliers provide raw materials in exchange for cash; customers receive goods and services in exchange for cash. In many cases, the exchange relationship is the subject of an explicit contract that is legally enforceable. But, even when there is no explicit contract, there will generally be a quasi-contract that confers moral rights and duties. Furthermore, a narrowly framed explicit contract may be transformed into a wider quasi contract. For example, an employee who has worked for the firm for 30 years and who has become dependent on his continued employment for his livelihood may have a formal contract that permits the firm to dismiss him with one week's notice. However, the continued relationship has created a quasi-contract; it would be unjust for the firm to attempt to enforce its legal right of dismissal, as it would also be for the employee to exercise his right to leave (where the firm has become dependent on his services). Quasi-contracts are not only a moral concept. The courts of law in many countries have become increasingly prepared to recognise the legally binding character of quasi-contracts that have arisen from the behaviour of the contracting parties. Both the law and philosophy emphatically reject the economist's maxim 'bygones are forever bygones'. The 30 years' past service of the long-term employee may not be dismissed as irrelevant.

The shareholders are clearly important stakeholders. In most countries, the law grants shareholders a privileged position. Under the law, they appoint the managers who are required to manage the firm in their interests. According to neo-liberal economic theory, the firm should be managed so as to maximize profits, which, according to the law, belong to the shareholders.

The stakeholder theory of the firm treats shareholders in a fundamentally different way. The interests of *all* stakeholders should be taken into consideration, and shareholders should not be treated differently from other stakeholders. The principle is put very clearly by Donaldson and Preston (1995) as follows: *'Stakeholder analysts argue that all persons and groups with legitimate interests participating in an enterprise do so to obtain benefits and that there is no prima facie priority of one set of interests and benefits over another'*. There is no suggestion that shareholders have no rights or that all stakeholders should be treated equally, other than they all be treated with equal consideration.

Another important stakeholder group is the firm's management. The firm's managers are clearly primary stakeholders. Normally, a manager has a contract with the firm by which he is obliged to provide labour services in return for a salary. However, a manager is a very special type of stakeholder. In the words of Evan and Freeman (1993), *'management has a duty of safeguarding the welfare of that abstract entity that is the corporation . . . [It] must look after the health of the corporation and this involves balancing the multiple claims of conflicting stakeholders'*.

As pointed out in the above quotation, an important task of the firm's management is to balance the conflicting claims of stakeholders: employees want higher wages, shareholders want higher dividends, customers want a higher-quality product or a cheaper product or preferably both. It is the management's task to keep the relationships among stakeholders in balance. When these relationships become unbalanced, the survival of the firm is in jeopardy. As Clarkson (1995) points out: *'If any primary stakeholder group, such as customers or suppliers, becomes dissatisfied and withdraws from the corporate system, in whole or in part, the corporation will be seriously damaged or unable to continue as a going concern'*. Stakeholders have conflicting interests but also common interests. They all want the firm to survive and prosper. The most successful and longest-lasting firms are those where the management has ensured that the interests of one group of stakeholders have not prevailed over the interests of the firm as a whole.

When the other stakeholders have dealings with the firm, they invariably deal through the management. Essentially, from their point of view, the management *is* the firm. In the remainder of this book, whenever references are made to decisions or actions of the firm, they should be interpreted as decisions or actions of the firm's managers. The managers are the personification of the firm. This approach provides a neat solution to certain problems in stakeholder theory:

- (i) If the firm is defined as a coalition of stakeholders, the idea of a stakeholder (such as a supplier) having a relationship or a contract with the firm is problematic, since it suggests that a person can have a relationship with himself. But the idea of a contract between the supplier and the management is straightforward.

- (ii) It makes clear that decisions are made by people and not by an anonymous entity, the corporation. The statement ‘Mr. Smith, the CEO of the XYZ Corporation, has fired 1,000 workers’ reflects more accurately and truthfully reality than the anodyne statement, ‘The XYZ Corporation has downsized its workforce by 10%’.
- (iii) It makes operational the principle that the firm has a responsibility to render account. The firm’s management is clearly the element in the firm that is responsible for achieving this.

The idea that the management *is* the firm is a moral principle and not a legal principle. In law, a corporation is a separate entity from its managers. The firm’s assets are the legal property of the corporation and not of its managers. But how these assets are used is the moral responsibility of the managers who control them.

It is important to appreciate that primary stakeholders vary in their importance as members of the coalition that makes up the firm. An employee who has worked for the firm for 20 years in a vital position is clearly a much more important member of the coalition, compared with a secretary who joined last week. The same is true of a supplier who is the sole source of an essential component, compared with one that the firm deals with occasionally. The most successful firms have a core of primary stakeholders who have demonstrated commitment to the firm over time: thus a shareholder who has held her shares for many years, resisting an offer to sell in a take-over bid, is a more significant member of the coalition than a speculator on who holds his shares for a few days or even micro seconds.

### 5.2. Secondary Stakeholders

This wider group of stakeholders covers all those whose welfare is affected by the firm’s activities and who have a legitimate claim on the firm. They include all those who may experience actual benefit or harm (or may anticipate such benefit or harm) from the firm’s actions or inactions.<sup>22</sup> Examples of such stakeholders are:

- i. The local community in which the firm is located. Many members of the local community may be primary stakeholders, for example, employees and suppliers. The concept of secondary stakeholder applies to the other inhabitants whose welfare is often strongly affected by the firm’s activities. For example, local shopkeepers are secondary stakeholders because their business would be severely affected if the firm were to dismiss a large number of its employees.
- ii. Persons who are affected by pollution emanating from the firm. In the case of noise pollution, this will include the local community, but in the case of air and water pollution, it can include people on the other side of the globe.

- iii. Persons who have only indirect dealings with the firm. For example, a supplier of components is a primary stakeholder of the firm. The supplier of raw materials to the component manufacturer is a primary stakeholder of that firm and a secondary stakeholder of the firm to which the component manufacturer sells. If the firm were to collapse or drastically reduce its production, the welfare of this secondary stakeholder would be harmed.

There are a number of problems with the concept of secondary stakeholder. The term 'stakeholder' is not ideal; some secondary stakeholders have no stake in the firm, and the use of the term can lead to the secondary stakeholders being equated with the primary stakeholders, who clearly have a stake in the firm.<sup>23</sup> One problem is that, according to the definition, it would seem that competitors are stakeholders, since their welfare is clearly affected by the firm's activities, for example, in drawing away their customers. John Stuart Mill considered this question and concluded that the claim of a competitor that he should not be harmed is not legitimate, commenting, '*society admits no right, either legal or moral, in the disappointed competitors, to immunity from this kind of suffering*'.<sup>24</sup> The definition of secondary stakeholder given above includes the words '*and has a legitimate claim against the firm*'. This phrase was included principally to exclude competitors from the group of stakeholders.

Crane and Matten<sup>25</sup> (2007) argue that competitors should be considered to be secondary stakeholders because they have legitimate claims against the firm, for example, that their business should not be undermined by unethical behaviour on the part of the firm, such as bribing customers and deceptive advertising. But I feel that everyone has a right not to be misled or defrauded by the firm. Hence, to include competitors widens the concept of secondary stakeholders to an unreasonable extent so as to make it meaningless. Thus, on this point, I prefer John Stuart Mill to Crane and Matten.

Sternberg (1994), in a spirited attack on stakeholder theory, claims that among the groups that are considered to be stakeholders are terrorists, vegetation and generations unborn. The case for including terrorists was based on defining as stakeholders all those who can affect the firm, as proposed by certain authors.<sup>26</sup> The definition given above does not include that group—it includes only those who are affected by the firm (the passive verb). However, a terrorist might be considered to be a secondary stakeholder, if the reason why he attacked the firm was that he was adversely affected by the firm's activities: for example, he blew up a pipeline in protest at the pollution caused by an oil company. Perhaps he had a legitimate claim that he pursued by illegitimate means. I believe that it is appropriate to exclude from the concept of stakeholder, groups, such as terrorists, which can affect the firm but are not affected by the firm, when the objective is the assessment of those to whom the firm should render account. For other purposes (for example, in deciding how the firm should be managed

to assure its survival), it may well be appropriate to include such groups in the definition of stakeholder.

Sternberg's second category, vegetation, is clearly not a stakeholder. Only people can be stakeholders. However, if people value the natural world, then their demands are not illegitimate solely because they relate to non-humans.

Sternberg's third category (generations unborn) presents a problem for stakeholder theory. It seems to maintain that persons who do not yet exist are current stakeholders of the firm. A principal source of the problem is the term 'stakeholder', which, as already noted, is not ideal. When analysing the firm's accountability, it is necessary first to identify the people who are affected by the firm's activities, before deciding whether the firm has any responsibility towards them. If a person is unaffected by the firm's operations, then the firm has no responsibility towards that person. The purpose of specifying a group of secondary stakeholders is to identify the group towards which the firm may have a moral responsibility. There is certainly a case for arguing that the firm has a moral obligation to consider the welfare of future generations; for example, it would be wrong for the firm to use up all of a non-renewable resource and leave none for succeeding generations. Hence, future generations are stakeholders.

The secondary stakeholders will often not have a contract (either explicit or implicit) with the firm, and in some cases, their interest in the firm is adversarial (their principal interest is in the harm caused by the firm). This is in sharp contrast to the primary stakeholders, who are bound to the firm by contract (explicit or implicit) and by ties of mutual benefit (actual or potential).

### 5.3. Normative Versus Instrumental Stakeholder Theory

The version of stakeholder theory set out so far is termed normative stakeholders theory; there is an alternative version, known as instrumental stakeholder theory. The differences between the theories may be analysed as follows:<sup>27</sup>

*Normative stakeholder theory:* This theory is based on the categorical imperative of the German philosopher, Immanuel Kant, that one should never treat another human being solely as a means, but always as an end, as being valuable in his or her own right. Stakeholders should be treated as human beings and their rights respected.

*Instrumental stakeholder theory:* According to this theory, the firm is not defined as a coalition of stakeholders, but as an independent entity owned by capitalists in whose interests it should be managed. But the firm's managers can use parts of normative stakeholder theory to increase the firm's profits. Thus, the firm will do better if it takes proper account of the interests of its stakeholders. For example, Jones (1995) argues that firms who deal with their stakeholders on

the basis of mutual trust and cooperation will have a competitive advantage over those who do not. The firm's overriding interest in its dealings with stakeholders is the continued prosperity of the firm, as defined narrowly; the firm has no other interest in the welfare of its stakeholders. Essentially, this involves treating stakeholders solely as a means, in flat contradiction to Kant's categorical imperative. An alternative term for the same concept is managerial stakeholder theory, which emphasises the role of the firm's manager in organizing relations with stakeholders so as to achieve the best outcome for the firm.<sup>28</sup>

Instrumental stakeholder theory is completely consistent with the neo-liberal theory of the firm, in that it proposes a more realistic and effective way in which the firm can maximize shareholder value. Hence, only normative stakeholder theory offers a true alternative to the capitalistic theory of the firm.

#### 5.4. *Stakeholder Theory and Capitalism*

In section 3 above, it was suggested that a reformed capitalism should provide that business firms be managed with a view to the welfare of all persons who are affected by the firm's activities and not just that of the capitalists who own the firm. This proposition is fully compatible with normative stakeholder theory.

There is no contradiction between stakeholder theory and what I would propose to be the fundamental features of a reformed capitalism:

1. Firms should be managed independently of the state. The state creates a framework of laws, and the firms' managers are obliged to operate the firm within this framework. But this framework should give considerable latitude to the firm's managers in operating the firm.
2. The managers, in operating the firm, should take into account conditions in the market, notably market prices.
3. The managers should seek to assure to the providers of capital a just and reasonable return on their investment, consistent with treating all primary stakeholders fairly. This is the fundamental difference between stakeholder theory and neo-liberalism. In neo-liberalism, the shareholder is sovereign; in stakeholder theory, the shareholder is simply one stakeholder among many.
4. The managers should take into account the welfare of secondary stakeholders, notably the need not to inflict harm.
5. Compared with the neo-liberal theory of the firm (which emphasises the creation of value for the benefit of capital providers), the stakeholder theory of the firm holds that the firm is managed for the benefit of a far wider group of people—the firm's stakeholders and not simply its capital providers.

## 6. How to Change People's Behaviour

How can capitalism be reformed so that it is based on the stakeholder theory of the firm rather than the neo-liberal theory? Essentially, the aim is to bring about a change in the behaviour of people, notably the managers of firms, so that they manage the business in the interest of all the firm's stakeholders and not solely the shareholders. There are three forces that can contribute to such a change in behaviour: the state, philosophy and accountancy.

- (a) *The state*: The state has a whole range of measures that it can employ to induce a change in personal behaviour. At one extreme, the state can resort to coercion (for example, enacting a law that prohibits certain behaviour under threat of punishment); in a less coercive fashion, behaviour can be influenced through taxes and subsidies (for example, fossil fuels can be taxed and wind turbines subsidised). In an even less coercive manner, the state may influence behaviour through education and exhortation (for example, making ecology a compulsory subject in primary schools). Consider the measures that the government could take to reduce air pollution from cars: it could pass a law which prohibits the sale and registration of any car that emits more than (say) 100 grams of CO<sub>2</sub> per 100 kilometres; alternatively, it could use the taxation system to achieve this end, by placing a stiff tax on polluting cars; finally, it could resort to persuasion with an advertising campaign that highlighted the harm caused by air pollution. The state is the only body that has the right and the authority to dictate to people how that should behave, under the threat of punishment if they fail to heed the state's demands. Hence, the state will inevitably play a major role in any attempt to change people's behaviour. But it is obvious that, unless the state assumes totalitarian powers, its actions need to be backed up by the voluntary actions on the part of the other elements of society.
- (b) *Philosophy*: I use the term 'philosophy' to denote the underlying principles that a person follows in making decisions. Currently, too many businessmen follow the principles of neo-liberalism in deciding how to run their business. There is no inevitability about such behaviour. Currently, many CEOs consider it perfectly acceptable to 'downsize' their workforce (to fire workers) so as to increase both the shareholders' profits and the size of their bonus; 50 years ago, the great majority of businessmen would have considered such behaviour to be wrong, both morally wrong and contrary to what was considered to be socially acceptable. This change in behaviour was brought about partly by the very effective proselyting activities of philosophers and economists, such as Hayek and Friedman. The philosophers and economists who reject neo-liberalism should mount a counter-attack.
- (c) *Accountancy*: I expect that many readers will find ridiculous the idea that accountancy can have any influence in reforming people's behaviour—

that I, as an accountant, have quite unwarranted visions of glory for my profession. One is reminded of Rob Gray's aphorism, '*if one was looking to solve the problems of the world one would be unlikely to choose accounting as one's starting point*'.<sup>29</sup> But I do feel that accountancy can play a positive, if limited, role. I set out the case for accountancy by considering how best to tackle a current problem: the excessive remuneration of the senior management of large companies.

## 7. The Excessive Remuneration of Senior Management

Over the past 30 years, there has been an explosion in the level of remuneration of the senior management of large enterprises. Whereas a generation ago, the average CEO's pay was around 35 times that of the average worker, today, the ratio is 180! The average annual remuneration of the CEOs of the top 100 companies listed on the FTSE 100 now stands at £4.7 million.<sup>30</sup> Many people consider that this level of remuneration is morally and economically wrong and in no way reflects the contribution that these executives make to their companies' success. Society demands that something should be done.

Certainly the state could, in principle, pass a law to control payments to the senior management of companies, for example, to ban all remuneration in excess of £1 million per year to any company employee. In fact, in Britain, it has not done so—for a number of very good reasons: it would introduce an undesirable rigidity into the system, by prohibiting the payment of a large bonus to an exceptionally gifted CEO who actually merited it, it would be difficult to administer and possibly easy to evade and so on. But the principal reason is that it would be a violation of the basic principle of capitalism to bar an enterprising businessman from making a fortune from his bright ideas (as James Watt did with the steam engine in eighteenth-century England). A state which stopped an individual from enjoying (at least some of) the rewards of her efforts would no longer be a capitalist state.

Instead of banning over-large remuneration, the British state has adopted two measures that are intended to act as a brake on excessive remuneration: (i) companies are required to set up a remuneration committee composed of non-executive directors, which is charged with the task of setting directors' remuneration and (ii) companies are required to disclose in their accounts the total amount of each director's remuneration. The first measure concerns corporate governance (how companies are managed); the second measure is pure accountancy. I submit that the accountancy measure is an absolutely essential element of any policy that seeks to curb excessive executive remuneration, for two reasons:

- (i) Without the information provided by the accounts, the public would not be aware that a problem exists. If the executives' remuneration had

been hidden in the overall total of wages and salaries, then the user of the accounts would be blissfully unaware of the extent to which the top executives were exploiting their position to benefit themselves.

- (ii) Without this information, it would not be possible to discover whether the measures taken to tackle the problem have had the desired effect. Thus, if the accounts demonstrate that executive remuneration remains excessive, then one may reasonably conclude that the creation of a remuneration committee has failed to solve the problem and that further measures are necessary.

In fact, with respect to very many British companies, the accountant's report reveals that remuneration committees are failing to limit management compensation, in that total remuneration continues to rise, even when many other items of information suggest that the management has failed in its responsibility to operate the company efficiently and ethically, and that therefore, the managers' remuneration should be reduced and not increased. For example, the company's accounts may reveal that over the last year:

- The company's profits fell;
- The company's share price was in the doldrums;
- The company dismissed many employees and reduced the wages of the remainder;
- The company has been hit by many scandals that have severely damaged its reputation, such as customers falling ill after consuming the company's products, employees injured in industrial accidents, the company fined for polluting the local river and so on.

This list indicates that, for the accounts to play an effective role in limiting management remuneration, it is insufficient simply to provide information on remuneration; information on a host of other matters is also required.

## **8. The Power of Information**

This example demonstrates that information can play a key role in helping mankind to tackle its problems. The problem in question is how to induce the managers of firms to adopt stakeholder theory and operate the firm in the interests of all stakeholders and not simply the capital providers—to effect a change in managers' behaviour. The information that could contribute to such a change in behaviour relates to the impact of the firm's activities on its stakeholders. This information should be provided to people who have the potential to take action that can lead to a change in managers' behaviour, notably:

- The state, which has the power and authority to enact laws that are binding on managers;

- The firm's stakeholders, who can exert pressure on managers. Shareholders can vote, employees can go on strike, customers can organize boycotts.
- The managers themselves, who need to be made aware of the impact of their actions.

How the accounts may be reformed so as to provide the necessary information is the subject of the next chapter.

## 9. Summary and Conclusion

In this chapter, I analyse how capitalism should be reformed so that it served the whole of mankind and not simply the capitalists. Central planning is considered as an alternative to capitalism but is rejected, because it literally does not deliver the goods. I agree with Jonathon Porritt that '*capitalism is the only economic game in town*'. It is argued that the business firm has a moral responsibility to render account to all persons who are affected by its activities. This argument is based on the social contract theory of the firm and the philosophy of Immanuel Kant. The persons to whom the firm is accountable are the firm's stakeholders, as defined in the stakeholder theory of the firm. I consider the question of how to achieve a change in the behaviour of firms so that they are managed in accordance with the stakeholder theory, in the context of the problem of excessive management remuneration. I conclude that accountancy can make a significant contribution to making firms more accountable to stakeholders.

## Notes

- 1 Porritt (2005, p. xiv).
- 2 *Caparo Industries PLC v. Dickman and others*, 1990, 2 A.C. 605. This case concerned the liability of the auditor. It was decided that the auditor was not liable to any party other than the current shareholders, who are the only persons who have a legal right to rely on the company's audited accounts.
- 3 This summary of section 172 is taken from Mayer (2013, p. 30).
- 4 Mayer (2013, p. 31).
- 5 Mayer (2013, p. 31).
- 6 A libertarian may argue that the state has no moral right to impose such an obligation.
- 7 See Sternberg (1994, chapter 9).
- 8 This section draws heavily on chapter 3 of my book *Accounting and Distributive Justice*.
- 9 This is a paraphrase of Hasnas (1998, p. 29).
- 10 Rousseau held that human happiness came to an end when men started to employ other men in firms. As quoted in Ignatieff (1986), Rousseau wrote: 'as long as men undertook only what a single person could accomplish, and confined themselves to such arts as did not require the joint labour of several hands, they lived free, honest and simple lives . . . But, from the instant in which one man had occasion for the assistance of another, from the moment that he perceived that

it could be advantageous to a single person to have provisions for two, equality disappeared, property was introduced, labour became necessary’.

- 11 Donaldson (1982) quoted in Hasnas (1998).
- 12 Cited in Gray et al. (1996, p. 58).
- 13 Cited in Hessen (1979).
- 14 Dillard (2007, pp. 43–44).
- 15 The word ‘categorical’ refers to Kant’s claim that the obligation was derived from pure reason. The individual has no choice—he must obey the imperative. Kant contrasted the categorical imperative (which is binding in all circumstances) with the hypothetical imperative, which depends on what the person seeks to achieve. Thus, ‘never lie’ is an example of a categorical imperative, and ‘if you want to arrive by noon, catch the 9.15 train’ is a hypothetical imperative. (see Crisp, 2005)
- 16 Immanuel Kant *Grundlegung sur Metaphysik der Sitten*. The translations of Kant’s original German are by Blackburn (1996, p. 57).
- 17 This example is taken from Unerman et al. (2007, p. 95).
- 18 Ijiri (1983) argues that an accountability report can be useful even if no one reads it, as it serves to motivate the accountant to fulfil his obligations. But I consider that, if the accountant discovered that his report went unread, the report’s motivating effect would be seriously weakened.
- 19 This section draws heavily on chapter 3 of *Accounting and Distributive Justice*.
- 20 The concept of stakeholder theory that is presented here is a synthesis of the theories set out in Freeman (1984), Friedman and Miles(2002), Evan and Freeman (1993), Clarkson(1995) and Donaldson and Preston(1995).
- 21 Clarkson and most other writers on stakeholder theory refer to ‘corporations’. I prefer the economist’s term ‘firm’. The difference is not significant, as almost all firms (other than the very small) are corporations.
- 22 See Donaldson and Preston (1995, p. 85).
- 23 I have wracked my brain for an alternative term. The best that I have come up with is ‘beneficiary/victim’, which is less misleading than ‘stakeholder’ but most inelegant.
- 24 Mill (1991).
- 25 Crane and Matten (2007, pp. 359–361).
- 26 For example, Freeman and Reed (1983). The GRI’s Guidelines (see chapter 6) define stakeholders as those ‘whose actions can reasonably be expected to affect the ability of the organization to successfully implement its strategies and achieve its objectives’. This definition is so wide that it includes terrorists.
- 27 See Jones and Wicks (1999).
- 28 For an analysis of the different stakeholder theories, see Reed (1999).
- 29 Gray (2010, p. 49).
- 30 Jones (2015, p. 233).

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# 5 The Reform of Accountancy

## Stakeholder Reporting

### 1. Accountancy as a Man-Made Institution

In this chapter, I examine how accountancy may be reformed so as to better serve all stakeholders and not solely a limited group of capitalists. But before setting out my position on the reform of accountancy, I should make clear an important assumption or postulate<sup>1</sup> that forms the basis of my thinking:

*Accountancy is an institution created by mankind to serve its needs.*

This postulate has an important implication—accountancy is not immutable; it can be reformed. Some scholars hold that accounting is simply the objective presentation of facts about the firm, in the same way that a map is a representation of facts about the world. Hence, it is not possible to have more than one correct statement of an account—the one that truly reflects reality. I reject this claim—that, in principle, only one statement of account can be true. Any representation of reality (whether a map or an account) cannot cover the whole of reality. Both maps and accounts have the function of helping the user to make sense of reality; if they simply reproduced the whole of reality, they would be of no help to the user, who could simply refer to reality. Hence, in the map/account, some things have to be omitted and other things emphasised. The choices that the mapmaker/accountant makes in this matter influence the user's perception of reality. The mapmaker/accountant inevitably exercises judgement in making these choices. He can include a matter in his map/account and thus bring it to the attention of the map/account user. In this way, he can make that matter visible, to use the term employed by Hopwood (1996). Alternatively, he can omit something from the map/account and thus render it invisible (if the map/account is the user's sole source of information) or, at least, make a statement about its unimportance. The accountant can hide an item either by omitting it completely (as externalities are omitted in conventional accounting) or by aggregating it with other items (as the accountant of the Royal Mail Steamship Company did in presenting a single figure for profit, which aggregated a trading loss and a transfer from a secret reserve).<sup>2</sup>

The accountant has a further problem. In drawing up an account, he is obliged to reduce a mass of information about a specific item (say an asset) to a single monetary amount. But this is not a simple matter. One accountant may decide to report the asset at historical cost; a second accountant reports the asset at current value. Both accounts are correct; neither accountant can be accused of being untruthful.

In drawing up accounts, the accountant inevitably exercises his judgement. In doing so, he accepts a great responsibility, for accounts are an important factor in the distribution of power, wealth and income in society. Accounts cannot be neutral. In particular, they are used by the parties in the business firm as instruments in the struggle for power, wealth and income—not only between capitalists and workers, but among all stakeholders: customers, suppliers and the wider society.

My position is that mankind has created accountancy and, if it does not adequately meet its needs, mankind should change it. What mankind has created, mankind can change. The necessary change can be determined by an analysis of mankind's needs.

## 2. Reporting for Stakeholders

In the last chapter, I established two principles: that the business firm has a moral responsibility to render account to persons affected by its actions, and that a reform of capitalism should be based on the stakeholder theory of the firm. I now consider how accountancy should be reformed in the light of these principles. I start with the question of distribution. The term 'distribution' as used in this book refers to the sharing of income and wealth among members of society. Distribution is an important issue in the stakeholder theory of the firm, notably with reference to how the firm's income and wealth should be divided (distributed) among its stakeholders. I contend that conventional accountancy neglects distribution and gives too much importance to production. Before considering how accountancy should be reformed to remedy this fault, I first explain why distribution is more important than production.

## 3. Distribution Versus Production

In the field of economic affairs, mankind is faced with two fundamental problems:

- *The production problem*: what goods and services to produce, how much to produce and how to produce them most efficiently at the lowest cost.
- *The distribution problem*: who gets what is produced, how the output of goods and services is divided (distributed) among society's members and how the costs of producing this output are distributed.

I contend that, at present, capitalism (in the form of neo-liberalism) and its handmaiden, accountancy, concentrate almost exclusively on the production problem and neglect the distribution problem. But the proper solution of the distribution problem is the more important for the welfare of mankind for reasons related to both production and distribution. I deal first with production.

### 3.1. The Production Problem

#### 3.1.1. The Analysis of Mankind's Needs

Over 80 years ago, John Maynard Keynes predicted a world of plenty for his grandchildren:

*I draw the conclusion that, assuming no important wars and no important increase in population, the economic problem may be solved, or at least within sight of solution, within a hundred years.*<sup>4</sup>

What reasons did Keynes give for believing that mankind would soon solve the production problem? He divided human needs into two classes: absolute and relative. Absolute needs are those a person feels irrespective of the situation of others; relative needs are those whose satisfaction depends on superiority over others. Keynes felt that it was impossible through economic activity to satisfy all relative needs and hence regarded their satisfaction as not an economic problem.

A generation after Keynes, John Kenneth Galbraith argued persuasively that the USA in the 1950s had already solved the production problem.<sup>5</sup> Not only was output at a very high level, but it increasingly consisted of goods and services that served no real need. Since then, the GDP has continued to grow, and surely, Galbraith's conclusion is even more pertinent today.

My argument that mankind has already solved the production problem is based on two claims:

Man's relative needs cannot be satisfied by greater output, and hence, their non-satisfaction is not part of the production problem.

The world's output is already sufficient to meet the basic needs of all the world's inhabitants. This second claim will now be considered.

#### 3.1.2. The Current Level of Output

The validity of the second claim will be considered with reference to mankind's most basic need: food. The United Nation's Food and Agricultural Organization (FAO) admits that *'the world currently produces enough food for everybody, but many people do not have access to it'*.<sup>6</sup> This assertion may be validated using the FAO's own statistics. For the year 2011 (the latest for which statistics have been published), the world's supply of food

was sufficient to provide every man, woman and child with 2,870 kilocalories per day.<sup>7</sup> The FAO estimates that, as a minimum, a person requires around 1,800 kilocalories per day.<sup>8</sup> Hence, if the world's food were distributed equally among the world's population, it would provide everyone with a diet some 50% above the minimum. In fact, the FAO estimates that, in the period 2014–2016, there were approximately 800 million chronically hungry people whose food intake was below the minimum.<sup>9</sup> These statistics confirm the presumption that, with food, the problem is not production but distribution. In many developed countries, agricultural surpluses are a major problem, with governments taking measures to reduce production, and much of the population suffers not from malnutrition but from obesity. Gary Stix (2007) has estimated that, in the year 2007, the number of over-nourished (a euphemism for obese) people world-wide exceeded the under-nourished by several hundred million. The FAO estimates that, in the developed countries, over 40% of the population acquire more food than they need.<sup>10</sup> The position with regard to food almost certainly applies to mankind's other basic needs for clothing, shelter and so on. One may confidently conclude that the world's current output is sufficient to meet the basic needs of everyone.

### 3.1.3. *The Dangers of Economic Growth*

Moreover, further increases in output are not only unnecessary; they may be positively harmful. In chapter 1, I presented the arguments why this may be so. They may be summarised as follows.

More output now can lead to lower welfare in the longer run; hence, the maximization of output is the wrong goal for mankind. Throughout history, mankind has been able to achieve improvements in its standard of living by increasing the output of goods and services. However, in recent decades, increases in output have been running against constraints. There are two kinds of constraints:

- (i) The exhaustion of the world's resources;
- (ii) The degradation of the earth's environment caused by man's past actions.

It is unrealistic to expect that man can increase output indefinitely; production entails using up the earth's resources (such as oil), which are finite; at some point, these resources will be exhausted but, well before that point is reached, output will be constrained by shortages of raw materials. The aim of economic activity should not be to achieve the highest possible rate of economic growth, but instead to achieve a stable, sustainable level of output—that is, zero growth. It is significant the neo-liberal paradigm was developed at a time when the earth's resources seemed unlimited and the impact of economic activity on the environment was imperceptible, but that time is long past. Essentially, the neo-liberal paradigm is no longer relevant for today's world; in fact, the striving for ever greater output may lead mankind to disaster.

### 3.2. *The Distribution Problem*

The importance of distribution has already been demonstrated with the example of the world's output of food—currently, the world produces sufficient food to provide everyone a more than adequate diet, but some 800 million people suffer from malnutrition. With food, the problem would be solved with more efficient distribution. But critics of this solution point out that a change in the pattern of distribution almost inevitably means that some people are made worse off in order that other people are made better off.

It is true that, in certain cases, two persons can each be made better off by exchanging goods. After all, such exchanges have been completed, a pattern of distribution is established in which no one can be made better off without at least one person being made worse off. Such a position is known as a Pareto optimum. It is the basis of the first fundamental theorem of welfare economics, which states that an economy will automatically settle into a Pareto optimum by the process of exchanges between individuals, provided certain conditions are met, such as perfect information and no restrictions on exchanges. Creating a Pareto optimum is certainly desirable, as at least one person has been made better off and no one made worse off. But, in relation to any pattern of distribution, there are normally very many Pareto optima, and some would be considered less desirable than others. For example, consider the distribution of food among the world's population. One Pareto optimum would be for a single person to have all the food and everyone else nothing, for to share the food more equally would involve taking some from the single person, who would thus be made worse off.

If it is assumed that the present distribution of food in the world is reasonably close to a Pareto optimum, then allocating more food to the millions of under-nourished people would certainly cause some people to have less food. Can this be justified? I would argue in favour, using the law of diminishing marginal utility. This law states that the utility experienced by an individual from the consumption of a unit of a good (or service) grows smaller the more units that he consumes. Thus, if I give a loaf of bread to a hungry man, he experiences a certain benefit; if I then give him a second loaf, the benefit that he derives from the second loaf is less than that from the first loaf. This law seems a reasonable representation of human experience, but it assumes that the utility experienced by a human being can be measured objectively. For example, by observing an individual's behaviour, I can establish that he gains five 'utils'<sup>11</sup> from consuming one loaf and nine 'utils' from consuming two loaves (the marginal utility of the second loaf is less than that of the first). This assumption is highly controversial and rejected by most economists.

But to justify taking food from the over-nourished to give to the under-nourished requires a further assumption which is even more difficult to justify: that all the people involved have identical utility functions—that they all enjoy the same utility from the consumption of various units of the good. But, if you accept these assumptions, then it is easy to justify taking

food from the over-nourished and giving it to the under-nourished, for the loss of utility of the person who gave up some food is less than the gain in utility of the person who received the food. Thus, there has been an increase in the total utility experienced by society as a whole.

My position is that the assumptions set out above cannot be proved scientifically to be correct, but that they are reasonable assumptions that are consistent with my observations of human behaviour. Hence, the conclusions that are derived from applying them may be used in deciding the course of action that best serves the interest of society as a whole. In other words, the insight that a more equal distribution leads to a higher level of welfare for society as a whole is based on firm foundations. Social welfare can be increased, without any increase in output, by a more just distribution of the available goods.

### 3.3. *Cutting the Cake*

Everyone agrees that it is highly desirable that those millions of the world's population who suffer from malnutrition should be provided with more food. But there is considerable disagreement on how this is to be achieved. On one side are those who favour increasing the world's output of food; on the other side are those who favour changing the pattern of distribution. This dispute is often presented in terms of a cake that is to be divided among the world's peoples. One side advocates increasing the size of the cake, so that everyone can be given a bigger slice. The great advantage of this strategy is that everyone gains—no one has to suffer a reduction in the size of his slice. The other side advocates cutting the cake more fairly—increasing the size of the smaller slices and reducing the size of the larger slices. The great advantage of this strategy is that it avoids the costs of increased output.<sup>12</sup>

I am an advocate of cutting the cake more fairly. My principal reason is that attempting to increase the size of the cake will have serious negative consequences for mankind—as analysed above under the heading 'The Dangers of Economic Growth'. I acknowledge that a successful solution to the problem of world hunger would probably involve some increase in the world's food output, notably in ways that pose less strain on the world's resources, such as improved plant varieties. But I feel that the principal contribution must come from improved distribution.

### 3.4. *The Importance of Distribution*

The conclusion of the above analysis is that distribution is important. Mankind's overall welfare can be increased, without any increase in the output of goods and services, simply through a more appropriate distribution. The current emphasis on production is misplaced; the emphasis should be on distribution. The analysis was in terms of the world economy, but I consider

that the same conclusion applies to the operation of the business firm—that too much emphasis is placed on production and distribution is neglected.

#### 4. The Reporting of Distributions<sup>13</sup>

In this section, I consider how the firm should report distributions to its stakeholders. First, I consider further the nature of distributions in the stakeholder theory of the firm.

##### 4.1. *The Nature of a Distribution*

In the stakeholder theory of the firm, a major issue is the distribution between stakeholders of the costs and benefits arising from the firm's activity. Hence, an essential function of the financial statements is to report the amount of the costs borne and the benefits enjoyed by each category of stakeholder. The financial statements are denominated in terms of money—for example, euros. Hence, they can report only costs and benefits that can be expressed in money. Where a stakeholder receives a benefit, there has been a transfer of wealth from the firm (that is, the assets under the control of the firm's management) to the stakeholder. In this book, such a transfer of benefits is termed a 'distribution'. All of the following are distributions of the firm: a wage paid to an employee, tax paid to the state, a dividend paid to a shareholder. Where the stakeholder incurs a cost, the transfer of wealth is from the stakeholder to the firm and may be considered a negative distribution. In conventional accounting, according to the IASB's standards, only a dividend is considered to be a distribution. In this book, the term 'distribution' is given the wider meaning of the sharing out of the firm's revenue. With this definition of a distribution, it is not appropriate to define the firm as a coalition of stakeholders, for in that case, the cash that represents an employee's wages would not leave the 'firm' (as defined in this very wide sense). At most, there has been a transfer of wealth from one stakeholder to another. To avoid this anomaly, it is necessary to emphasise that the 'firm' is defined as the management. In the case of the employee's wage, there is a transfer of wealth from the management (the assets under its control have diminished), and hence (given the narrower definition of 'firm'), there has been a transfer of wealth from the firm.<sup>14</sup>

##### 4.2. *Information on Distributions in the Conventional Financial Statements*

The question of how the accounts may report distributions will now be considered, starting with the firm's standard financial statements. According to the IASB's standards, a firm should prepare a balance sheet, an income statement and a cash flow statement.<sup>15</sup> These statements are based on the IASB's concept of the entity, which reflects the neo-liberal theory

of the firm—the firm’s objective is to maximize shareholder value. The IASB’s concept of the entity is far narrower than the concept on which the stakeholder theory of the firm is based. Hence, for the IASB, the only outlay of the firm that qualifies as a distribution is a dividend to a shareholder. None of the IASB standard statements is specifically designed to provide information about the firm’s wider distributions. This is unsurprising, given that the term ‘distribution’ does not figure in the IASB’s stated objective of financial reporting.<sup>16</sup> However, the IASB’s statements do provide some information about the distributions made by the firm, as will now be demonstrated.

### 4.3. *The Income Statement*

The IASB’s IAS 1 recognizes two alternative formats for the income statement. They differ in the way in which the expenses are classified:

- i. A natural classification, in which expenses are classified by the nature of the expense: for example, depreciation, employees’ remuneration, consumption of raw materials, fuel etc.
- ii. A functional classification, in which expenses are classified according to their function: for example, cost of sales, administrative expenses, marketing costs etc.

Table 5.1 illustrates the alternative classifications using the income statement of a hypothetical corporation.

With the functional classification, payments to different stakeholders are often aggregated under one heading, masking the distributions to stakeholders. Thus, the cost of sales will be presented as a single figure which is made up of a number of different types of expenses, including:

- Wages to workers;
- Consumption of raw materials, which reflect (imperfectly) distributions to suppliers;
- Depreciation of machinery, which is not a distribution at all!

With the natural classification of expenses, these costs are reported separately. Hence, this format yields the more useful information about distributions. However, the income statement (even with the natural classification of expenses) is not particularly good at communicating distributions to stakeholders. One reason is that its principal function is to report the profit accruing to shareholders, who are but one category of stakeholder. However, the principal reason is that the figures for income and expense reported in the income statement are calculated using the accruals concept. With accruals, there is a time difference between the reporting of an expense in the income

Table 5.1 XYZ Corporation: Income Statements

<i>Natural classification of costs</i>		<i>Functional classification of costs</i>	
<i>Income statement for 2016</i>	€	<i>Income statement for 2016</i>	€
Sales	2,460	Sales	2,460
		Less cost of sales	1,444
Less		Gross profit	1,016
Materials	800	Less	
Wages	1,000	Distribution costs	290
Depreciation	125	Administration expenses	191
Other operating costs	150	Other operating costs	150
Interest	10	Interest	10
Total costs	2,085		641
Net profit before tax	375	Net profit before tax	375
Tax on profit	125	Tax on profit	125
Net profit after tax	250	Net profit after tax	250
Dividend	100	Dividend	100
Retained profits	150	Retained profits	150

statement and the transfer of wealth (the distribution) to a stakeholder. The reported expense precedes the transfer of wealth when the firm records a provision or a liability; the reported expense comes after the distribution when the firm records a prepayment. Hence, a reporting basis other than the accruals concept is called for.

#### 4.4. The Cash Flow Statement

Distributions are transfers of wealth from the firm to stakeholders. Hence, the cash flow statement, which aims to report the flows of cash into and out of the firm, may be considered to be a statement of distributions. The IASB's IAS7 prescribes two alternative formats for the cash flow statement: the direct method and the indirect method. The indirect method (which is preferred by most firms because it is easier to implement) does not present the figures for certain important distributions: for example, the figure for wages paid is not shown separately and cannot be derived from the disclosed information. Hence, the direct method is to be preferred. Table 5.2 presents the cash flow statement of the same hypothetical corporation, using the direct method in the format prescribed by IAS7, with separate subtotals for operating activities, investing activities and financing activities.

Table 5.2 XYZ Corporation: Cash Flow Statement for 2016

	€	€	€
Cash flow from operations			
Receipts from customers		2,400	
Payments to suppliers		-900	
Other payments			
Consultancy firm	-60		
Donation to charity	-40		
Compensation	-50	-150	
Wages		-850	
Interest		-10	
Dividend		-100	
			390
Cash flow from investing activities			
Purchase of plant			-250
Cash flow from financing activities			
Issue of bond		100	
Buy back of shares		-200	
			-100
Net cash flow			40

The operating activities section of the cash flow statement in Table 5.2 may be compared with the income statement of Table 5.1. There are striking differences between the two tables. Thus, in the income statement, wages are stated to be €1,000, compared with €850 in the cash flow statement. The difference represents unpaid wages. The difference with respect to tax is even more remarkable: €125 in Table 5.1 and nil in Table 5.2; this is caused by a provision for deferred tax being set up in 2016 but no tax actually being paid.

It is evident that a firm does not make a distribution to the state when it includes a provision for deferred tax in its accounts. This figure represents a potential distribution, which may never materialise. However, in respect of the unpaid wages, it can be argued that the firm made a distribution when it incurred a legal liability to pay the wages. From the employees' viewpoint, the firm's obligation represents an asset: their wealth has increased. However, if this line of argument is followed to its logical conclusion, the cash paid by a shareholder for her shares would not represent a (negative) distribution, as there has been no change in her wealth—she has exchanged one asset (cash) for another (shares). This seems unhelpful. Hence, distributions are best measured in terms of cash transfers.

#### 4.5. The Value-Added Statement

Although the value-added statement does not figure among the IASB's required statements, it is appropriate to consider it in conjunction with the standard statements, because it is derived from a standard statement: the income statement. A very few corporations include such a statement in their full set of accounts, although there is no obligation (either in the law or in the IASB's standards) to do so.

The basic idea behind the value-added statement is that a firm buys goods and services from other firms and converts them into other goods and services using its labour force and its capital. The surplus of the revenue from the sale of these goods and services over the cost of the goods and services acquired from other firms represents the value added by the firm. This surplus is divided between the parties that made it possible (the firm's capital providers and employees), with a share going to the state. That part of the surplus that is not distributed is retained by the firm. The 'firm' is considered to consist of the capital providers, the employees and the state.

Table 5.3 presents the value-added statement derived from the income statement of Table 5.1. The firm's value added is calculated as €1,385, being the difference between the sales to customers of €2,460 and the costs that are based on payments to other firms of €1,075. In the lower half of the statements, this surplus is divided between employees, capital providers

Table 5.3 XYZ Corporation: Value-Added Statement for 2016

	€	€
Sales to customers		2,460
Less transfers to other firms		
Suppliers	800	
Other firms	150	
Depreciation	125	
		1,075
Value added		1,385
Distribution of value added		
Employees	1,000	
Capital providers	110	
State	125	
		1,235
Retained in the firm		150

and the state, the balance of €150 being retained in the firm. Note that the value-added statement does not provide any information that is not already implicit in the income statement (with the natural classification of expenses)—it simply rearranges the figures and calculates certain subtotals.

There is no consensus as to the principal function of the value-added statement. Some consider it to be a statement of performance. They place the emphasis on the first half of the statement: the calculation of the value added. For example, according to Stoloway and Lebas (2002), *'value added is a measure of the economic performance of an economic entity, especially a measure of its contribution to creating a customer-oriented supply. Thus it is a form of "income" measure'*. Others consider it to be principally a statement of distributions; they place the emphasis on the second half of the statement. Janice Monti-Belkaoui (1996) writes that *'value added is the increase in wealth generated by the use of the firm's resources before its allocation among shareholders, bondholders, workers and government'*.

It can be argued that the principal function of the value-added statement is neither to measure performance nor to report distributions, but rather, to enable the firm (that is, the management) to signal that it considers employees to be on a par with shareholders, since the statement treats both equally.<sup>17</sup> It is clear that the value-added statement has often served a political purpose. This was especially the case in Britain the late 1970s, which witnessed a remarkable surge in interest in the value-added statement. As documented by Burchell et al. (1985, p. 396), of a sample of 300 British companies, the number that issued value-added statements increased from 14 in 1975–6 to 90 in 1979–80. The motives of the statements' advocates varied: to some, it was a means of fostering greater worker participation in the management of the firm; to others, it served to defend the payment of dividends by demonstrating what a small proportion of the firm's revenue went to shareholders. A contemporary source commented: *'most . . . seemed to be designed to show . . . how much of the value added goes to the employees . . . , how much the government receives and how little the shareholder receives'*.<sup>18</sup> In fact, the surge of interest in value-added statements subsided as quickly as it had arisen. Today they are issued by very few companies. They have become *'little more than a technical accounting possibility—to be mentioned in the footnotes of accounting texts'*.<sup>19</sup>

#### 4.6. *A Proper Statement of Distributions*

Of the standard statements, the value-added presents the best information on distributions, but it suffers from the following defects.

- (i) It based on the accruals concept, with the consequence that the reported figures do not generally represent transfers of wealth (which is a fundamental characteristic of a distribution).
- (ii) It covers only distributions relating to the income transactions and excludes those relating to capital transactions.

- (iii) It reports distributions to a limited group of primary stakeholders: providers of capital, employees and the state. Other primary stakeholders are ignored, as is the whole category of secondary stakeholders: the local community and the wider world.

What is required is a statement that reports all transfers of wealth to all stakeholders. The first fault can be rectified by basing the statement on cash flows rather than accruals. The second fault can be rectified by including cash flows relating to capital transactions. It is essential that such transactions be included in a statement of the overall distributions made to stakeholders. For example, the cash flow statement (Table 5.2) indicates that, during 2016,

Table 5.4 XYZ Corporation: Statement of Distributions for 2016

	€	€	€
Receipts from customers			-2,400
Distributions			
Primary stakeholders			
Employees		850	
Suppliers			
Materials	900		
Consultancy firm	60		
Plant	250		
		1,210	
Capital providers			
Shareholders			
Redemption of shares	200		
Dividend	100		
		300	
Bondholders			
Issue of bond	-100		
Interest	10		
		-90	
		210	
The state		0	
Total of primary stakeholders		2,270	
Secondary stakeholders			
Donation to charity	40		
Compensation	50		
		90	
Total distributions			2,360
Retained in the firm (increase in cash)			40

the firm, in addition to a dividend of €100, paid shareholders €200 to buy back some shares. The total distribution to shareholders made by the firm in 2016 was €300. The fact that some part of the cash payment was labelled ‘buy back’ and another part ‘dividend’ is irrelevant for the measurement of distributions. Similarly, in 2016, the firm paid an equipment supplier €250 for new plant. There is no essential difference between this payment and the payment of €900 to suppliers of raw materials. Both represent transfers of wealth from the firm to a stakeholder. Therefore, a complete statement of distributions should include both current and capital transactions.

As to the third fault, a proper statement of distributions should also cover secondary stakeholders. The cash flow statement (Table 5.2) reports two payments to secondary stakeholders (a donation to a charity and a compensation payment to persons harmed by pollution emanating from the firm).

Such a proper statement is presented in Table 5.4, which reports all cash flows between the firm and its stakeholders. The information content of this statement could be enhanced by providing a more detailed analysis of certain items. For example, to gain a full understanding of the distributions to employees, it would be necessary to have a detailed breakdown of this expense between different categories of employee (for example, analysed by gender, age, location and skill level).

## 5. The Principles That Govern Reporting to Stakeholders

The last section dealt with the form of the report to stakeholders and concluded that statement of distributions (Table 5.4) had significant advantages over the conventional reports: the income statement, the cash flow statement and the value-added statement. But, stakeholder reporting is not limited to reporting on distributions. In this section, I deal with reporting to stakeholders more generally by considering the principles that the firm should follow in reporting to stakeholders.

### 5.1. *The Philosophical Basis*

To develop these principles, I make use of the analytical technique employed by John Rawls (1999) in formulating his theory of distributive justice: the original position and the veil of ignorance.<sup>20</sup> Rawls’s theory of justice is a variant of the social contract theory which has already be presented in the last chapter. In the original position, people meet to set the principles of justice. They are behind a veil of ignorance. They know that they will become members of society, but they do not know in what capacity—whether rich or poor, healthy or handicapped, male or female, clever or retarded, black or white and so on. The people are rational and will seek to establish principles of justice which will best serve their own selfish interests as members of society. But, since they do not know their future role in society, they will be obliged to take into account the interests of all members of society.

It is straightforward to apply these general principles to the business firm. The basic idea is that the principles that should be followed by the firm in reporting to stakeholders should be decided by a group of persons behind a veil of ignorance—the persons know that they will be stakeholders in a firm, but they do not know in which category of stakeholder they will find themselves: as shareholder, employee, manager or any of the other categories of stakeholder. Hence, they are obliged to give serious consideration to the interests of *all* stakeholders. They would consider the interests both of the user of the financial statements and of the preparers, since the firm's manager is also a stakeholder. In the original position, all persons have equal bargaining power; this reflects the fundamental principle that all stakeholders are persons of equal moral worth.

### 5.2. *The Principles That Should Govern the Firm's Reporting*

Of the various categories of stakeholder, the management is clearly responsible for preparing the reports that fulfil the firm's responsibility to render account to its stakeholders. What are the principles that should govern the management's reporting? In my opinion, the stakeholders in the original position would agree on the following general principles:

- a. Stakeholders' right to information: Stakeholders have a right to demand and receive information from the firm.
- b. Dialogue: The content of the firm's reporting should be agreed in a dialogue involving all stakeholders.
- c. Scope of information: The information provided should not be limited to financial information; it should also include non-financial information.
- d. Truthfulness: The information provided by the firm should be truthful.
- e. Objectivity: The information provided by the firm should be objective.
- f. Equality: In the preparation of the financial statements, equal consideration should be given to the interests of every stakeholder.
- g. Just exchanges: Stakeholders should be provided with information that will enable them to make a contract with the firm that represents a just exchange.
- h. Prevention of harm: The information provided by the firm should not lead to a stakeholder suffering harm.
- i. Net benefit: The costs of financial reporting should not exceed its benefits.

### 5.3. *Stakeholders' Right to Information*

The right of a stakeholder to demand and receive information from the firm is based on two principles:

- That all stakeholders are to be given equal consideration (see point 5.8);
- That the firm has a duty to render account to all persons who are affected by its existence and actions (see section 4 of chapter 4).

Both principles are ultimately based on the Kantian categorical imperative that one should treat humanity as an end and not solely as a means. The firm (that is, the management) is under a moral obligation to render account to all people who are affected by its activities. These people have privileged knowledge of how they are so affected and, compared with the firm, are better able to assess what information they need on the matter. Hence, their view on what information should be provided should prevail over that of the management.

But this does not mean that the firm should be obliged to provide all the information demanded by its stakeholders. The firm (the management) may refuse to meet a stakeholder's demand for information, where the refusal is justified, with the onus of proof on the firm. Legitimate grounds for a refusal could be:

- The cost of providing the information would be excessive. This matter is discussed later under point 5.11. In principle, the information should not be provided if the costs exceed the benefits. But the benefits should be calculated from the viewpoint of the totality of the stakeholders, not solely from the viewpoint of the management. The calculation is complicated by the fact that many stakeholders may suffer a monetary loss when the firm spends resources on retrieving information, as this reduces the amount available for distribution to them.
- The release of the information would harm the firm. The fundamental point is that the firm as a whole (the totality of stakeholders) should (on balance) suffer harm. This point is considered in more detail in section 6.
- The release of the information would breach someone's fundamental rights, typically a right to privacy. An example would be information about a person's state of health. For example, assume that the firm's CEO is suffering from a degenerative disease that will soon lead to him being unable to perform his duties. A controlling shareholder would clearly like to be informed so that he can plan for the CEO's successor. Such planning would also be in the interest of the totality of stakeholders. Clearly, the CEO has a moral responsibility to inform the shareholder, but to release this information without his consent would be a breach of his right to privacy.

These considerations should be kept in mind in the process of deciding the content of the firm's reporting.

#### *5.4. Dialogue*

In this section, I consider the process by which the firm (the management) should determine the contents of its reporting. The principles that should govern this process are determined by what is considered to be the nature of the firm. I advocate the stakeholder theory of the firm and, given this theory,

the dialogue process that I set out in this section is the natural and logical way to establish the contents of the firm's reporting. But, of course, other theories of the firm are possible. For example, Eccles and Krzus (2015) advocate the 'shareholder value' theory of the firm; for them, the firm's objective is to create value for the benefit of capital providers.<sup>21</sup> This leads naturally to their conclusion that *'the corporation, as represented by its board of directors, will determine what is material for reporting purposes. In doing so, it chooses which stakeholders to address, how to obtain their input and the relative weightings to apply to issues'*.<sup>22</sup> Note that, in this quotation, the term 'material' refers to what should be included in the firm's report; if an item is not 'material', it is not included.

I regard the firm as a coalition of stakeholders and hold that all stakeholders should participate in determining the content of the firm's reporting. The contents should be set in a dialogue that involves all stakeholders. Each stakeholder has a privileged knowledge of her own very specific information needs and, given the stakeholder's right to information, her demands should be respected by the firm's management.

I do not hold that all stakeholders are equally important and that each stakeholder is entitled to expect that equal consideration should be given to her views. I feel that the weight to be given to each stakeholder's view should be proportionate to the contribution that the stakeholder makes to the firm's success. This contribution is closely related to the stakeholder's level of commitment to the firm. On this basis, the level of commitment of an employee should often be judged higher than that of a shareholder, on a number of grounds:<sup>23</sup>

- For the employee, her wage may be her sole source of income, whereas the shareholder may hold a portfolio of shares in many companies and thus not be committed in a serious way to any individual company.
- The employee may have demonstrated her commitment by staying with the firm for many years, whereas many shareholders hold their shares for much shorter periods—often for only days or even just milliseconds.
- The employee's contribution to the firm's success is often direct and obvious, particularly when the firm relies on the employee's skill and effort to maintain production.

The firm's management is clearly responsible for organizing the dialogue with stakeholders. The aim of the dialogue should be to achieve a consensus which takes into account the legitimate interests of all stakeholders. The management is an important stakeholder and its interests must be considered, but it should not seek to impose its views at the expense of other stakeholders, in sharp contrast to what Eccles and Krzus consider to be appropriate. The dialogue should be organized as a genuine attempt to reach a compromise acceptable to all stakeholders. In reaching the final compromise, it is appropriate to give greater weight to the views of the

more important stakeholders (as defined above), to views where there is a wide measure of agreement across stakeholder categories and to matters that some stakeholders hold to be vital.

What I am proposing here is a theoretical model of stakeholder consultation which is probably never achieved in practice. It reflects the 'ideal speech situation' of the German philosopher, Jürgen Habermas, who holds that a consensus that is acceptable to all concerned can be achieved, if people are rational, respect facts and seek truth. This may be an unachievable ideal, but it offers an ideal against actual modes of consultation may be evaluated.

### *5.5. Scope of Information*

The information that is provided by the firm should not be limited to financial information; it should also include non-financial information. This widening of the scope of information is justified by the understanding that many stakeholders would demand non-financial information: for example, employees need information on working conditions, and customers need information on product safety. But, even when the stakeholder is primarily interested in the firm's financial performance (for example, a shareholder who would like to forecast future dividends), she would require much non-financial information. This is because much non-financial information has a financial impact: for example, information on the amount of pollution created by the firm helps stakeholders to estimate the firm's future costs relating to such matters as the installation pollution control equipment.

This need for the firm to provide non-financial information presents a considerable challenge to the accountant. Traditionally, the focus of her work has been in drawing up the financial statements: the balance sheet, income statement and so on. All these statements are denominated in terms of money. Money is the accountant's particular field of expertise. Should the accountant seek to extend her expertise to an almost limitless range of non-financial measures, denominated in a host of different units, such as man-hours or tons of CO<sub>2</sub>?

There are valid reasons why accountants should take up this challenge. For historical reasons, the financial statements have become the principal means of communication between the firm and its stakeholders. Accountants have been happy to include non-financial information (such as the number of employees) in the notes to the accounts. Hence, it is natural that accountants should continue to play a leading role in providing non-financial information to stakeholders, for example, by coordinating the work of other experts.

### *5.6. Truthfulness*

It seems self-evident that no potential stakeholder behind the veil of ignorance would accept being provided with false information. This is the justification

for the principle that the information provided by the firm to stakeholders should be true. However, this principle is less straightforward than it might seem for three reasons: misleading information, valuation methods and the philosophical concept of truth.

### *5.6.1. Misleading Information*

It is comparatively rare for financial reports to contain information that is demonstrably false. For example, in the scandal involving Enron, the American energy company, there is no evidence that any information presented in the company's financial statements was actually untrue.<sup>24</sup> A rare recent example of a firm making of an untrue statement is provided by Parmalat, the Italian dairy concern, which reported a bank balance of €3.5 billion that did not exist.<sup>25</sup> More commonly, the financial statements give a false picture of the firm's situation in ways that do not actually involve making false statements. There are at least three ways in which this may be achieved:

- i. True information may be presented in a misleading manner.
- ii. The firm's transactions may be structured in a way that, when reported (truthfully) in accordance with GAAP, they misrepresent the firm's profitability. This is essentially what happened at Enron, which made much use of special-purpose entities.
- iii. Important information may be omitted from the financial statements (this subject is dealt with later under the heading 'Just Exchange').

The most famous example of misleading accounts is provided by the 1926 Profit and Loss Account of the Royal Mail Steamship Company, which was the subject of notorious court case in which a partner of a leading British accounting firm was accused of fraud.<sup>26</sup> In 1926, the company in fact made a trading loss of £331,000. But the management, not wishing to report such a negative picture, transferred £750,000 from a secret reserve, which converted the loss into a profit. Neither the secret reserve nor the transfer was reported in the accounts, which simply reported the profit of £419,000. The auditor insisted that the words 'including adjustment of taxation reserves' be added, and this action saved him from being found guilty of fraud, since he argued in his defence that these words were understood by knowledgeable people as indicating that the accounts had been manipulated. However, the general public was shocked that the accounting profession should connive at the issue of such misleading accounts, and, shortly afterwards, the law and accounting practice were reformed to outlaw secret reserves.

### *5.6.2. Valuation Methods*

In respect of most items that are reported in the financial statements, there can be reasonable differences of opinion as to their value. This is clearly

the case with real property or with a debt owed by a customer in financial difficulties. For example, a firm reports in its balance sheet the asset 'Land' valued at £100. In fact, the land is valued at its historical cost, and its current market value is £1,000,000. The financial statements cannot be criticised as being untrue. Even such a straightforward asset as a bank balance can cause problems, for to value this asset at the amount reported in the bank's statement is to assume that the probability of the bank becoming insolvent is zero, which is surely wrong. Firms often employ creative accounting techniques in preparing accounts that present a thoroughly misleading picture of its financial position and performance. But, as pointed out in a previous chapter, creative accounting is not illegal, and hence the accounts cannot be regarded as presenting a false picture.

### 5.6.3. *Philosophical Concepts of Truth*

The philosophical concept of truth is not straightforward. A widely held theory is that a statement is true if there is correspondence between the statement and external reality. This makes the application of the principle of truth to financial reporting highly problematic. Many figures reported in financial statements relate to things that do not exist in the 'real world'; an example is deferred income, which is essentially a construction of the accountant. Even the IASB admits this, stating that '*deferred charges and credits do not exist in the real world outside financial reporting*'<sup>27</sup>—that is, they exist only in the minds of the accountant and of the reader who shares the accountant's thought processes. The accountant's figures for profit and net worth (which include elements of such charges and credits) are subject to the same defect. Hence, they cannot be considered as 'true' according to philosophical principles that relate truth to external reality. Alexander and Archer (2003) argue that an alternative concept of truth (the coherence concept) and of reality (internal reality) should be applied to financial reporting. This view is not universally accepted, which indicates that the application of the principle of truth to financial reporting remains controversial and problematic.

The conclusion is that the principle of truth does not get us very far and that it needs to be supplemented by other principles.

### 5.7. *Objectivity*

The general principle that the information supplied by the firm should be objective is accepted by most accountants, practitioners and academics alike. The philosophical theory of objectivity contrasts a person's perceptions and beliefs with the real world outside that person. The statement that the height of the Eiffel Tower is 320 metres is objective, as it can be verified by measuring the object in question. The statement that Bloggs believes that the height of the Eiffel Tower is 320 metres is not objective (it

is subjective), as it cannot be independently verified; it refers to an internal state of Blogg's mind. Since, as argued in the previous section, many figures in the accounts refers to things that do not exist in the 'real world' outside the minds of accountants, this concept of objectivity cannot be applied to financial reporting.

Hence, accountants have had to develop an alternative theory of objectivity, based on the relationship between stakeholders and the information provided by the firm. Information is held to be objective if it is free from bias with respect to stakeholders—that it is not manipulated or presented in a way that benefits certain stakeholders and not others. I believe that persons behind the veil of ignorance would agree on this principle.

Although the basic concept of objectivity refers to the characteristics of information, the most practical way to achieve the desired result is by giving attention to how the information is prepared. Objectivity will be assured (or at least fostered) if the information is prepared in a certain way. Hence the definition proposed by Ijiri (1983) refers to the preparer: *'objectivity means the independence of the information content from the preparer of the information, that is, similar or identical information is produced regardless of who prepares it'*.

A characteristic of information that is closely related to objectivity is verifiability, which Ijiri (1983) defines as follows: *'verifiability means that the information can be verified at a later point in time, that is, that there are sufficient trails to enable anyone to reconstruct the information, should that become necessary'*. Verifiability is related to objectivity in that information that is verifiable is more likely to be objective, for two reasons. Firstly, the preparer will be more inclined to make sure that the information is not subjective, if he is aware that it will later be checked by a second person. The need to assure verifiability greatly circumscribes the preparer's discretion. Secondly, if a second person agrees with the preparer's treatment of the information, this is evidence of the quality of objectivity formulated by Ijiri—*'the same information is produced irrespective of who produced it'*. I am inclined to hold that verifiability is a necessary condition for objectivity, because a verification procedure that is always available is for a second person to attempt to reproduce the information. If this proves impossible, the information cannot be proved to be objective.

### ***5.8. All Stakeholders Are to Be Given Equal Consideration***

The firm should give equal consideration to the welfare of all stakeholders. This principle follows naturally from the principle that all persons are of equal moral worth. The equality principle demands that, in drawing up and disseminating the financial statements, the firm (that is the management) should give equal consideration to all stakeholders. But this does not imply that all stakeholders should receive the same information. As a general rule, a stakeholder should be provided with information that is relevant

to decisions that he may be expected to make in his capacity as stakeholder. Hence, for example:

- i. A person whose principal relationship with a firm is that he suffers from pollution created by the firm should be provided with data on such matters as the firm's production processes and the levels of emission of noxious substances. He has no need for information on cash flows, number of employees and so on.
- ii. A customer should be provided with information on the product's composition, on potential health and safety hazards associated with the product, on problems encountered by other customers that are known to the firm and so on.
- iii. Employees (and their representatives) should be provided with a substantial amount of information relating to the firm's present and projected future activities. This would cover not only specifically employment matters (such as number of employees), but also information that would enable employees to judge the firm's viability and profitability, in both the near and the more distant future. The very wide information needs of employees reflect the fact that, generally, their welfare is more closely dependent on the firm's activities than is the case with any other category of stakeholder.

Since different categories of stakeholder require information as input to different decisions, it is logical that these different categories should be provided with different types of information. However, a distinction should be drawn between disclosure and measurement:

- a. Disclosure  
The minimum amount of detailed information that the firm be required to disclose may reasonably vary between different stakeholder categories.
- b. Measurement  
It should not be permitted that the principles used by the firm to value assets and to calculate profit should vary according to stakeholder category; for example, the firm should not report one figure for profit to one group of stakeholders and a different figure to another group: for example, profit based on social costs (for stakeholders affected by pollution) and profit based on private costs (for shareholders). There are two reasons for this prohibition:
  - i. One of the functions of the financial statements is to aid in the division of the firm's wealth and income among its stakeholders. Such a division only makes sense if there is agreement among all stakeholders as to the value of what is being divided.
  - ii. If the firm were to report different figures for profit to different stakeholders, this would impair the credibility of the financial state-

ments and undermine the trust that stakeholders would have in their reliability.

I have argued that the firm should not report multiple figures for profit and for asset values. However, this does not prevent it providing further information, based on different measurement principles, in the notes to the accounts.

### 5.9. *Just Exchange*

The relationship between the firm and its primary stakeholders is essentially one of mutually beneficial exchange. Throughout the ages, philosophers have reflected on the nature of exchanges. The first philosopher to develop a comprehensive theory of exchange was Aristotle. Aristotle posited that no man is self-sufficient. He has wants that he is unable to satisfy with his own efforts and, in order to satisfy these wants, he has to seek the aid of other men. If he finds another man who is able to meet his wants, and if he is able to reciprocate by meeting that man's wants, then an exchange occurs. Such an exchange is fundamentally good, because it satisfies human needs. However, for Aristotle, the more important effect of exchange was that it created a community. He writes: *'It is proportional requital that holds the state together . . . if this is impossible, no exchange takes place . . . it is exchange that holds them [citizens] together'*.<sup>28</sup> Only in a community can a man exercise all the virtues of which man is capable. Daryl Koehn (1992) paraphrases Aristotle's position as follows: *'Exchange has the unique feature of binding people into a community in and through which all of the virtues come to be in a humanly complete form. Without exchange, we would not look upon nor share in any of those virtues which our community sees fit to extol as excellences . . . Exchange is itself an excellence or virtue because it is the active completion of the potential of human desire to become one with other human desire through a common act'*.

Aristotle held that man was a political animal. Only in the company of other men, that is, in society (the polis), could a man achieve his highest stature; only there could he exercise and display the highest human virtues, such as courage, generosity and love. However, the polis depended for its very existence on the labour of countless men and women, who were able to collaborate through exchanges that were generally mediated through money. Aristotle was no doubt fully aware that he was able to lead a life of philosophical investigation only because, in the polis, he could obtain the necessities of life by offering in exchange his own labour (in the form of teaching and advice). The highest form of human life, that of the philosopher, is only possible in a community built on exchange.

Aristotle held that the supreme value of exchanges was that they made possible the existence of the state. The relevance of this idea to the subject of this book is that exchanges make possible the existence of the firm;

the firm is fundamentally good (although of a lower order than the state) because it meets men's needs. Stakeholder theory is essentially the application of Aristotle's theory of the state to the business firm. However, for the outcome of an exchange to be good, it must be just: the costs and benefits of the exchange must be divided justly between the parties. There are generally considered to be two major conditions necessary for an exchange to be just:

- i. Neither party is forced to undertake the exchange;
- ii. Both parties should have information that is sufficient to enable them to judge whether the proposed exchange is in their interest.

The principle of no coercion raises very considerable problems in application, notably the extent to which the fact that the bargaining positions of the parties are unequal renders an exchange unfair. Fortunately, such problems are not in the domain of stakeholder reporting, which is more concerned with the second problem relating to sufficient information. The judgement as to whether information is sufficient has to be made from the viewpoint of the parties to the exchange. If either party to an exchange can subsequently claim truthfully that she would not have gone through with the exchange if she had been provided with information that the other party had available, then the exchange was not just. Neither party to an exchange should withhold information in her possession that is relevant to the other party's decision to go through with the exchange, either because the relevance of the information may be reasonably inferred or because she is aware of a particular interest of the other party. The withholding of relevant information makes the exchange unjust.

This principle would seem to imply that firms should include vast quantities of information in its financial statements so as to ensure that, subsequently, no stakeholder may reasonably claim that the firm withheld relevant information. This raises two issues:

- i. The cost to the firm of providing this information may be excessive. This matter is considered later under the heading of 'Net Benefit'.
- ii. More data may mean less information. The user may be unable to find the information that she needs in the vast amount of data supplied by the firm. A recent example in the field of financial reporting is provided by the financial statements of Northern Rock, the British bank that collapsed in August 2007. As reported by Towers (2008), its last annual report before its collapse covered 105 pages, but only three items (which were not given any prominence) were in any way relevant in predicting its collapse. Clearly, if one party deliberately seeks to hide relevant information in a mass of irrelevant information, such behaviour is unjust, but there is no evidence that this was the motivation of Northern Rock's management.

I am sure that stakeholders behind the veil of ignorance would agree on the principle that forbids the withholding of relevant information. Clearly, such a principle conflicts with the legal rule of ‘caveat emptor’ (let the buyer beware), which I suspect was developed by judges as a simple rule of thumb for deciding difficult cases and not as a manifestation of justice. Readers may feel that it is unreasonable to expect the parties to an exchange to volunteer information that is to their disadvantage. It may be human to behave in this way, but it most certainly is not just.

### *5.10. Prevention of Harm*

It is a fundamental principle that one person should not, without sufficient justification, harm another person. It is rare for a stakeholder to suffer harm as a direct result of information contained in a firm’s financial statements and, when this happens, it will generally be the case that the firm has violated some other principle. For example, the loss suffered by a person who invested in Parmalat on the strength of that firm’s financial statements can be attributed to the firm’s breach of the principle of truthfulness. Of greater significance for financial reporting is the derived principle that, when a person’s activities harm another person (or has the potential to harm), the first person has a duty to provide information that will enable the second person to limit the extent of the harm (or avoid it altogether).

Hence, when a particular stakeholder’s welfare is affected by a firm’s actions, the stakeholder rationally should take some action to defend her position. There are several possible types of action:

- She could cease to be a stakeholder by severing her relationship with the firm, as when, for example, a shareholder sells her shares;
- She could intervene directly with the firm’s management. Perhaps such intervention initially would consist of the presentation of rational arguments, but ultimately, it may consist of more forceful acts such as strikes by employees or boycotts by customers. If the management proves unresponsive, she may decide to appeal directly to the public by organizing a publicity campaign, such as that of Greenpeace directed against the Shell Oil Company.
- She could lobby the government to take action with regard to the firm, either by enforcing existing laws (where the information in the financial statements indicated that laws have been broken) or by creating new laws.<sup>29</sup> Where the stakeholder is the government, the financial statements provide the information that may trigger government action.

The stakeholder requires information in order to decide when she needs to take action and what action to take. The implication of this principle is that, when the firm’s activities harm other people or have the potential to harm

them, the firm is under a moral obligation to provide information on such activities.

### **5.11. *Net Benefit: The Costs of Financial Reporting Should Not Exceed the Benefits***

One of the principles of a just and fair financial reporting is that equal consideration should be given to the welfare of all stakeholders. The firm's managers are stakeholders, and their interests must be considered. This is of particular significance in relation to the costs of stakeholder reporting, which it is in the interest of the firms' managers to minimize.<sup>30</sup> This requires that the benefits of information to the user should be weighed against the costs to the preparer of providing the information. The user may not reasonably demand to be provided with information if the costs to the supplier exceed the benefits to the user. Ijiri (1983) considers that it is essential to maintain fairness between the supplier and the user and that (to quote) *'the objective of accounting is to provide a fair system of information flow between [supplier] and [user]'*. He acknowledges that the accountant's task in this situation is difficult and refers to *'the agony of finding a thin line of fairness between the conflicting interests of the two parties'*.

In my opinion, Ijiri is right in insisting that 'fairness' requires that the interests of the information supplier (the firm's management) should be taken into account in determining the information flow from the firm to stakeholders. The concept of fairness explains why it is reasonable to balance the costs that are incurred by one person against the benefits enjoyed by a quite different person.

I now consider the implications of these general principles.

## **6. Greater Transparency?**

The above analysis suggests that justice requires far greater transparency on the firm's part than is currently practised—that the firm should be required to release a considerable amount of information about its activities. The firms' management may be expected to argue that such transparency would have a negative impact on the firm's economic position, for example, in the following ways:

- i. Employees may use the extra information to force the firm to pay higher wages;
- ii. A supplier may refuse to supply goods on credit, when he learns that the firm is in danger of bankruptcy;
- iii. A supplier may demand higher prices when he learns how dependent the firm is on his continued supplies;
- iv. The government may use the information to punish the firm for breaches of the law—that is the firm is being compelled to testify against itself;

- v. A citizen of a remote foreign country may organize a consumer boycott of the firm's products, when she discovers the extent of the air pollution caused by the firm;
- vi. A competing firm may take action that is detrimental to the firm which it would not have taken in the absence of the information provided in the accounts.

An analysis of these examples gives an insight to the extent to which the arguments against greater transparency are justified. In my opinion, in examples i, ii, iv and v, the greater transparency leads to greater justice among stakeholders. It should be remembered that the shareholders are only one of many stakeholders. When the disclosure of more information leads to a transfer of wealth from one group of stakeholders to another (as happens in example i, where employees benefit at the expense of shareholders), this implies that the previous distribution of wealth depended on the relative ignorance of one of the parties, which cannot be justified on grounds either of economic efficiency or of justice.

Example iii is more problematic. In certain circumstances, the relationship between the firm and a particular supplier may be assimilated to a two-person game; in such a game, one party may gain a relative advantage over the other by withholding relevant information. In the section on 'just exchange' above, it was argued that such action would be unjust; justice requires that both the firm and the supplier be open. Furthermore, the firm's management would prefer that a major customer on whom the firm depends for a large proportion of its sales would be equally open. That is what it would decide behind the veil of ignorance, where it does not know whether it will be the supplier or the customer.

This example brings out very clearly the difference between the stakeholder theory of the firm and the neo-liberal theory. With the stakeholder theory, a supplier who provides components which are an essential element of the firm's product and are not available from other sources is part of the nexus of relationships that make up the firm. Both the firm (the management) and the supplier have an interest in the firm's continued existence and have a mutual obligation to provide information that ensures that their relationship is conducted in a just fashion. With the neo-liberal theory, the firm is independent of the supplier and should use every opportunity to increase its own profit at the supplier's expense, short of engaging in 'deception and fraud'.<sup>31</sup>

Finally, let us consider example vi, which is probably the most problematic. In the last chapter (section 8.2), it was argued that a competitor is not a stakeholder. But, given the very wide range of stakeholders, it will very likely gain access to any information that is made available to stakeholders. Furthermore, a competitor may be a stakeholder in another capacity, for example, by being affected by pollution emanating from the firm.

This example raises the question of whether the proper functioning of the economic system depends on certain categories of information being

kept secret. The answer must be ‘yes’. For example, innovation would be stifled if a firm were compelled to publish full details of all research and development work on which it was engaged. Competitors would be able to benefit from the firm’s efforts; they would be ‘free-riders’—reaping the benefits without sharing in the costs, which cannot be described as just. The firm would not be able to enjoy the full benefits of its efforts and hence would be less motivated to innovate. Hence, there is a good argument for firms withholding certain categories of information from stakeholders; the question is, which categories? I feel that there should be a presumption of great transparency and that exceptions to this principle should be justified using convincing arguments, such as that presented above in relation to research.

## 7. Summary and Conclusion

In this chapter, I seek to demonstrate how accountancy should be reformed so as to facilitate the adoption by businesses of the stakeholder theory of the firm. The fundamental feature of this reform is that the objective of the firm’s reporting is to serve the totality of stakeholders and not solely the capital providers. I argue that this revised objective implies that the firm’s reporting should give more weight to distributions to stakeholders, and I set out how the firm’s financial reporting could be adapted to achieve this aim. I analyse the principles that the firm’s management should follow in reporting to stakeholders, using the philosophical techniques of the original position and the veil of ignorance. I feel that these proposals go some way to setting the outlines of an accountancy that serves mankind.

In the opening chapter, I analysed the various crises that currently confront mankind. I believe that reporting to stakeholders would make a significant contribution by moderating the impact of those crises that have arisen as result of business firms adopting the philosophy of shareholder value—that the principal function of the firm is to maximize returns to shareholders. This behaviour by firms is the principal cause of the growth in inequality and the spread of financialization. Stakeholder reporting can help to tackle these developments by demonstrating the (often negative) impact of the firm’s activities on the wider group of stakeholders. This may lead to a change in management behaviour—for two reasons:

- Firstly, the management may learn for the first time of the true impact of its decisions on stakeholders and resolve to manage the firm in the interests of the wider group of stakeholders and not solely for the benefit of the shareholders.
- Secondly, the stakeholders may be motivated to apply pressure to the firm, once they become aware of the true situation. Other parties, such as the government, which have access to the information, may also take action.

Both instances are examples of the power of information. In very many cases, proper information is a necessary condition for remedial action, although rarely a sufficient condition.

But I feel that reporting for stakeholders is insufficient in that it does not deal adequately with certain problems that were identified in chapter 1, notably the impact of economic activity on:

- the environment, and
- future generations.

Both topics are treated in depth in the next chapter under the heading of sustainability.

## Notes

- 1 Chambers Dictionary defines '*postulate*' as '*a position assumed as self-evident*'. I make no attempt to prove my claim.
- 2 See the discussion of the Royal Mail case later in this chapter (in section 5.6).
- 3 This section draws substantially on chapter 1 of my book *Accounting and Distributive Justice*.
- 4 Keynes (1930).
- 5 Galbraith (1958).
- 6 Statement on the FAO's website: [www.fao.org/hunger/faqs-on-hunger/en/#c41481](http://www.fao.org/hunger/faqs-on-hunger/en/#c41481), accessed on 27 October 2009
- 7 See page 20 of 'Food & Nutrition in Numbers 2014', FAO (2014).
- 8 FAO (2004, table 8.1).
- 9 The precise estimate is 794.6 million, according to FAO (2015).
- 10 FAO (2014, p. 16). The FAO uses the term 'acquire' rather than 'consume', because much food that is acquired is thrown away.
- 11 It is assumed that utility can be measured, and therefore, it has to be measured in units that can be added, compared etc. I have called these units 'utils'. The idea of measuring utility in units on which arithmetic could be performed originates with the philosopher Jeremy Bentham (1748–1832), the founder of utilitarianism. For more information, see Harrison (1998).
- 12 It is true that changing the pattern of distribution may result in increased transport costs (to deliver the food to the countries where most of the under-nourished live). But these costs would have to be incurred if the alternative strategy (increasing the output of food) were to be followed. Hence, they are not an increased cost of the distribution strategy.
- 13 This section draws substantially from chapter 5 of my book *Accounting and Distributive Justice*.
- 14 The principle that, in stakeholder theory, the firm is identified with the manager, seems to lead to a paradox when the firm (that is, the manager) pays the manager a salary. How can a transfer from the manager to the manager be a distribution? The answer is that there has been a transfer from the manager in his capacity of manager of the firm's resources to the manager as a private person, separate from the firm.
- 15 IAS 1, paragraph 8.
- 16 See section 3 of chapter 2.
- 17 Presumably, as the state is treated in the same way as employees and shareholders, it is also a partner. Gray et al. (1996, p. 195) points out a complication

with the calculation of the state's share. The value-added statement reports the gross amount of employee's wages, out of which employees pay income tax to the state. The net benefit to employees is less than the amount reported, and the amount received by the state is understated. Furthermore, dividends are generally reported at the net amount (after the deduction of withholding tax). This means that the distributions to employees and to shareholders are not calculated on the same basis.

- 18 Cited in Burchell et al. (1985, p. 391).
- 19 Burchell et al. (1985, p. 306).
- 20 The first person to suggest that accounting principles should be set behind a veil of ignorance appears to be Gaa (1986).
- 21 The question of whether the firm's objective should be the creation of value for capital providers is discussed in chapter 7.
- 22 Eccles and Krzus (2015, p. 122).
- 23 For a more detailed analysis of the employee's commitment to the firm, see Flower (2010, p. 64).
- 24 See Flower (2004, chapter 9).
- 25 For a full account of the Parmalat affair, see Jones (2011, pp. 259–274).
- 26 A full account of this case is given in Jones (2011, pp. 124–125).
- 27 IASB (2006, paragraph QC18).
- 28 Aristotle (2004, p. 124).
- 29 Hill and Jones (1992) argue that '*much of the structure of law relating to business activity in society reflects critical points of conflict in stakeholder-agent relationships*'. The term stakeholder-agent relationship refers to the idea that the firm's managers are agents of the stakeholders.
- 30 It is also in the interests of other stakeholders, such as employees and shareholders, that the costs of financial reporting should be limited, as this increases the size of the surplus available for distribution.
- 31 Even Milton Friedman, the arch-advocate of the neo-liberal theory of the firm, accepts that the firm's managers should not engage in deception or fraud. See chapter 1, section 2.1, for the full quote from Friedman (1962).

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# 6 Sustainability Reporting

## The GRI Initiative

The subject of this chapter is sustainability, more particularly, the reporting of sustainability by business firms. Interest in sustainability originated in the 1980s with a wide-spread concern that the current modes of production and consumption were not sustainable in the longer run, given the exhaustion of the earth's natural resources (such as oil) and the harm being inflicted on the environment (leading to threats such as global warming). Sustainability reporting is clearly of central importance to the subject of this book—how accountancy may be reformed so as to better serve mankind. The contribution that accountancy can make to the achievement of sustainability is this chapter's principal topic. But first, it is necessary to define more precisely the concept of sustainability.

### 1. The Concept of Sustainability

There is no agreed definition of 'sustainability', but clearly it has a time dimension: what exists today should also exist tomorrow. The question is: *what* is to be sustained? In order to understand the meaning given to the term 'sustainability' in current discourse, it is necessary to go back to the 1980s to the origin of interest in the topic. This is generally traced to the publication of the report 'Our common future' by the UN's Commission on Environment and Development, known as the Brundtland Commission after its chairwoman, Gro Harlem Brundtland, the former Norwegian prime-minister. The Commission had been charged with the task of finding a way to resolve a clash of interests that had arisen between developed countries (such as Britain and the USA) and developing countries (such as the poorer countries of Africa and Asia).

The developed countries were concerned at the damage to the earth's environment that was being caused by rapid economic growth; they were suggesting that, in order for mankind to survive, certain limits should be placed on growth. This had been the message of the highly influential book *The limits to growth*<sup>1</sup> published some ten years earlier.

The developing countries were strongly opposed to this idea. They demanded that they should have the opportunity to develop their economies so as to raise their peoples out of poverty.

The Commission resolved this clash of interests by advocating ‘sustainable development’, which it defined as ‘*development that meets the needs of the present without compromising the ability of future generations to meet their own needs*’.<sup>2</sup> The Commission recognized the claims of the people in developing countries for a better life in the following terms: ‘*The essential needs of vast numbers of people in developing countries—for food, clothing, shelter, jobs—are not being met, and beyond their basic needs these people have legitimate aspirations for an improved quality of life*’. But, the Commission also recognized the need to protect the environment, stressing that ‘*at a minimum, sustainable development must not endanger the natural systems that support life on earth: the atmosphere, the waters, the soils, and the living beings*’. The term ‘sustainable development’ strikes one as an oxymoron, as a self-contradiction: ‘sustainable’ implies no change and ‘development’ implies change. Nevertheless, the concept of sustainability as defined by the UN’s Commission is now widely accepted.

Sustainability has both an economic dimension (the output of goods and services is to be maintained at a level to meet the needs of the current generation) and an environmental dimension (damage to the environment is to be limited to ensure that future generations are not disadvantaged). However, it is generally agreed that the concept of sustainability comprises a third dimension: a sustainable society—that only a society that is based on social justice is sustainable in the longer run. The first mention of this concept was in a report issued in 1974 by the World Council of Churches, which claimed that ‘*social stability cannot be assured without an equitable distribution of what is in short supply or without common opportunity to participate in social decisions. Second, a robust global society will not be sustainable unless the need for food is at any time well below the global capacity to supply it and the emission of pollutants is well below the capacity of the ecosystems to absorb them*’.<sup>3</sup>

The claim that ‘*social stability cannot be assured*’ is an empirical statement, the truth or falsity of which can be established by observing the real world. In my opinion, it is demonstratively false. In the past, many societies have survived for centuries despite being based on extreme injustice, for example, the Roman Empire, whose economy was based on slavery. More recently, British rule in India did not collapse when millions died in the Bengal famine of 1943. But despite the lack of a provable connection between sustainability and social justice, it is a fact that, in current usage in economics and accountancy, the term ‘sustainability’ has three dimensions: social as well as economic and environmental.

## 2. Sustainability Reporting: The Three Dimensions

I now turn to the principal subject of this chapter, which is how the business firm should report on sustainability. As the concept of sustainability has three dimensions, the firm’s report should cover all three dimensions. It should cover the impact of the firm’s activities on the economy, on society

and on the environment. Hence, a firm's sustainability report covers a significantly wider field than its report to stakeholders, which was covered in the last chapter. In particular, it covers three areas that are not covered adequately in the firm's stakeholder report:

- The firm's impact on secondary stakeholders,
- The firm's impact on the environment, and
- The firm's impact on future generations.

Consider the case set out in chapter 2 (section 1.3): a firm discharges a noxious chemical into a public lake, which becomes seriously polluted. Holidaymakers who previously enjoyed relaxing by the lake suffer a loss of amenity, and local fishermen suffer a fall in their income. These losses are not reported in the firm's conventional financial statements (which ignore externalities), but also, they are inadequately covered in the report to stakeholders presented in the last chapter. In principle, the report to stakeholders could be expanded to cover secondary stakeholders, such as the holidaymakers and the local fishermen. In reality, the group of secondary stakeholders is so wide and so diverse that this is impractical. In practice, the task of reporting the impact of the firm's activities on the wider world and on the environment has been assigned to sustainability reporting.

### 3. The Development of Sustainability Reporting

Interest in sustainability reporting can be dated from the 1980s with the increasing concern over the sustainability of the current modes of production and consumption. There was a widespread feeling that the conventional accounts failed to report adequately the impact of the business firm's activities on sustainability. All attempts to reform GAAP so as to correct its perceived deficiencies were met with a blank refusal by the standard-setters (the IASB and the FASB) to depart from their fundamental principles: that the final accounts presented the revenues and costs of the firm and not of that vague entity 'the environment', and that the accounts were prepared for the benefit of capital providers and were not intended to meet the information needs of other stakeholders. Given that companies were obliged by law to issue financial reports in conformity with (unreformed) GAAP, the firms that sought to report more widely were obliged to issue separate supplementary reports. Many of these reports were based on the principles of the 'Triple Bottom Line'.

### 4. The Triple Bottom Line

The term 'The Triple Bottom Line' (often abbreviated to TBL) was coined in 1994 by John Elkington in an article, whose title '*Towards the sustainable corporation: win-win-win business strategies for sustainable development*', clearly reflects his interest in sustainability.<sup>4</sup> He argued that firms should

report not only their financial performance (as calculated in the bottom line of its profit and loss account), but also their performance in two other dimensions: society and the environment. The three dimensions were often referred to as the three Ps: profit, people and planet. John Elkington's ideas seem to have struck a chord, and many firms began to issue so-called 'Triple Bottom Line' reports. To get an idea of the content of these reports, I set out, in annex 6.1, my analysis of the report of an actual firm, Cascade Engineering Inc. In the annex to this chapter, I criticise the report on a number of grounds:

- Much of the report consists of disparate information which is not coordinated to give a coherent picture of the company's performance. In fact, there is no 'bottom line' in any of the three dimensions. The significance of some of the given information is not clear as to its relevance for the environment or for society.
- The bulk of the report consists of narrative and pictures. There is a distinct lack of quantitative facts. For example, the only monetary figure given relates to a charitable donation of \$250,000. The word 'profit' is mentioned several times, but the actual amount of the profit is not given.
- The report paints a remarkably positive picture of the firm. The word 'picture' is entirely appropriate, as the report is full of pictures, all of which present the firm in a favourable light. The reports opening words sums up its message: *'Those of us at Cascade Engineering are proud of our commitment to the Triple Bottom Line—People, Planet, Profit—and this report details our achievements and current priorities in pursuit of these crucial objectives'*. After having read the entire report, I have come to the conclusion that the principal function of Cascade's report is to promote the firm and not to report objectively on the firm's impact on society and the environment.

Of course, one cannot draw general conclusions from a single report. But these comments are supported by much wider research reported by a number of authors, notably Gray and Milne (2004).

I believe that the weakness of TBL reporting can be attributed to the fact that John Elkington presented a vision of a wider, more socially responsible reporting, but did not define specifically what a TBL report should contain. Hence, it is left to the firm's managers to choose what to include in the report, and naturally, they choose to emphasise matters that present the firm in the most favourable light. I feel that, in this respect, GRI has done a far better job.

## 5. GRI: Overview

### 5.1. GRI's Origins

The acronym GRI stands for Global Reporting Initiative, an independent NGO which was founded in 1997 by CERES (an American NGO) in close

association with the United Nations Environment Programme. It became a fully independent body in 2001 and, one year later, moved its office to Amsterdam. Its principal function is the promotion of the reporting of sustainability. On its website ([www.globalreporting.org](http://www.globalreporting.org)), GRI defines its vision as ‘*a sustainable global economy where organizations manage their economic, environmental, social and governance performance and impacts, responsibly and report transparently*’ and defines its mission as ‘*to make sustainability reporting standard practice by providing guidance and support to organizations*’.

## 5.2. GRI’s Mission

GRI promotes sustainability by issuing standards for firms to follow in preparing a ‘sustainability report’. GRI has described the role of this report as follows: ‘*A sustainability report conveys disclosures on an organization’s impacts—be they positive or negative—on the environment, society and the economy. In doing so, sustainability reporting makes abstract issues tangible and concrete, thereby assisting in understanding and managing the effects of sustainability developments on the organization’s activities and strategy*’.<sup>5</sup> Prior to 2015, GRI issued its guidance in the form of guidelines, but, in that year, after a long period of consultation, it undertook a fundamental reorganization in setting up the Global Sustainability Standards Board, whose prescripts are given the grander title of ‘standards’.

## 6. The Global Sustainability Standards Board

The Global Sustainability Standards Board (GSSB) was set up by GRI in 2015. According to its terms of reference, it is ‘*an independent operating entity under the auspices of GRI and has sole responsibility for setting globally accepted standards for sustainability reporting, according to formally defined due process, exclusively in the public interest*’.<sup>6</sup> There are two interesting ideas in these terms of reference:

- The public interest, and
- Due process.

### 6.1. The Public Interest

The terms of reference define the public interest as:

1. In general, as those overarching interests of humanity held in common that include but exceed the partial interests of individuals and groups, and
2. In the context of sustainability reporting as:
  - Making well-informed decisions;

- Promoting positive (and discouraging negative) impacts on social, ecological, environmental and economic systems;
- Promoting transparency, fairness and integrity of processes that affect the public domain; and
- Ensuring that no person or community is either overlooked or marginalized—especially if relatively weak in comparison to others.

GRI is remarkable for having taken the initiative to define the public interest—something which the ICAEW has never done, notwithstanding the importance that this organization attaches to the concept. With respect to sustainability reporting, the emphases on transparency, fairness, integrity and the need to consider the interests of the relatively weak suggest that the GSSB should adopt the principle that the business firm should give full information about the impact of its activities on its primary and secondary stakeholders

### 6.2. *Due Process*

Throughout its history, GRI has placed great importance on consulting with stakeholders. This is a recurrent theme in the procedure that the GSSB should follow in developing its standards. This process is defined in the document ‘GSSB Due Process Protocol’,<sup>7</sup> which provides that, for the development of a proposed standard, the GSSB should set up a working group composed of representatives of the various stakeholder groups and that it should consult widely by issuing an exposure draft. But the most effective way in which the GSSB takes into account the interests of the diverse stakeholder groups is through the composition of its Board, the body that approves its standards.

### 6.3. *The Composition of the GSSB’s Board*

The composition of this body reflects the GSSB’s commitment to stakeholder participation. According to its terms of reference, its 15 members must include, in addition to the Chair and Vice-Chair, five members drawn from the ‘business enterprise constituency’, two members drawn from the ‘civil society constituency’, two members drawn from the ‘investment institutions constituency’, two members drawn from the ‘labour constituency’ and two members drawn from the ‘mediating institutions constituency’.<sup>8</sup>

Table 6.1 presents information about the Board members at the time of writing (December 2016). One point is clear: the GSSB, compared to the IASB, includes representatives from a far wider spectrum of society. Remarkably, there is only one qualified accountant, Michael Nugent. The GSSB includes two representatives of employees (the trade-unionists Jürgen Buxbaum and Dwight Justice) and at least two persons with a special interest in protecting the environment (Judy Kuszewski, who was formerly the Director of Corporate Programs at Ceres, one of GRI’s founders, back in

Table 6.1 Composition of the Global Sustainability Standards Board

<i>Name</i>	<i>Country*</i>	<i>Background</i>
Jürgen Buxbaum	Germany	International Trade Union Federation; Public Services International
Simeon Cheng	Hong-Kong	Senior manager CLP Holdings Limited (listed in Hong Kong)
Robin Edme	France	Advisor to the French Ministry of Ecology, Sustainable Development and Energy
Kirsten Hovi	Norway	Vice-president and Head of Extra-Financial Reporting, Norsk Hydro ASA
Dwight Justice	USA	Policy advisor International Trade Union Federation
Daniel Ingram	UK	Head of responsible investment, BT Pension Scheme; Analyst, Hermes Investment Management
Judy Kuszewski	USA	Director of Client Services, Sustainability; Director of Corporate Programs Ceres
David Russell	Ireland	Dow Chemical (25 years); Partner UetlibergerPartners, Switzerland
Vadakepath Nandkumar	India	Industrial engineer, Consultant to business; Trainer
Michael Nugent	Australia	Chartered Accountant; IFAC; IAASB; IIRC
Sulema de Budin Pioli	Brazil	Lawyer; CSR consultant; Human rights specialist
Jorge Taillant	USA	Director, Centre for human rights and environment
Hedemi Tomita	Japan	Senior principal, Lloyd's Register Quality Assurance
Stiaan Wandrag	South Africa	Veterinary surgeon; Dow Chemical (8 years)

\* Country of origin; in this age of globalization, many are now based in another country

1997, and Jorge Taillant). But I feel that these people are rather outnumbered by those whose background is either business or providing services for business, who make up a clear majority. Two constituencies seem not to be represented: consumers and radical environmental pressure groups, such as Greenpeace. I have the impression that the environmentalists on the Board prefer to work *with* business rather than *against* business, which is, of course, a very sensible choice for an organization that seeks to change business behaviour. The extent to which the GSSB has been 'captured' by the business constituency should be judged on the basis of the content of the standards that it issues, which will now be considered.

## 7. The Content of the GRI Standards

In the course of 2016, the GSSB, in a remarkable burst of activity, issued 36 standards. It was able to do so because the standards largely codified the GRI's existing practice and guidelines. They are all listed in Table 6.2. Although these standards are issued by the GSSB, which, in principle, is independent of the GRI, they are known universally as the GRI standards—the term used in this section.

Table 6.2 The GRI Standards

Universal standards	
GRI 101	Foundations
GRI 102	General disclosures
GRI 103	Management approach
Topic specific standards	
100 Economic standards	
GRI 201	Economic performance
GRI 202	Market presence
GRI 203	Indirect economic impact
GRI 204	Procurement practice
GRI 205	Anti-corruption
GRI 206	Anti-competitive behaviour
200 Environmental standards	
GR301	Materials
GRI 302	Energy
GRI 303	Water
GRI 304	Biodiversity
GRI 305	Emissions
GRI 306	Effluents and waste
GRI 307	Environmental compliance
GRI 308	Supplier environmental assessment
400 Social standards	
GRI 401	Employment
GRI 402	Labour management relations
GRI 403	Occupational health and safety
GRI 404	Training and education
GRI 405	Diversity and equal opportunity
GRI 406	Non-discrimination
GRI 407	Freedom of association
GRI 408	Child labour
GRI 409	Forced or compulsory labour
GRI 410	Security practices
GRI 411	Rights of indigenous peoples
GRI 412	Human rights assessment
GRI 413	Local communities
GRI 414	Supplier social assessment
GRI 415	Public policy
GRI 416	Customer health and safety
GRI 417	Marketing and labelling
GRI 418	Customer privacy
GRI 419	Socioeconomic compliance

### 7.1. *Level of Disclosure*

GRI is a private organization and has neither the power nor the authority to compel a business firm to apply its standards. The most that it can do is to demand that a business that applies the GRI standards in its sustainability report should acknowledge their use. This point is covered in the first standard: GRI 101 Foundation. The business should state that its sustainability report has been prepared *'in accordance with the GRI standards'*. GRI specifies two alternative levels of disclosure: comprehensive or core. A firm that chooses to report comprehensively must report on *all* the points specified in the standards that are *material* to the business. Alternatively, a firm may decide to report only a more limited set of core points. The concept of materiality is central in defining what the firm should report. This matter is discussed later in section 7.7.

### 7.2. *The Structure of the Standards*

The standards specify in remarkable detail the points on which the firm should give information in its sustainability report. In Table 6.2, the standards are classified into three universal standards and 33 topic specific standards, which are in turn divided into three categories: economic standards, environmental standards and social standards. It is apparent from their titles that the GRI standards are very different from other accounting standards, such as those of the IASB. Most of the GRI standards prescribe *what* the firm should report, whereas the IASB standards mostly prescribe *how* the firm should report the various categories of assets, liabilities and transactions. Given the large number of standards, it is impractical to analyse them all in detail. Instead, I propose to concentrate on the more interesting and important aspects, starting with the universal standards.

### 7.3. *The Universal Standards*

The universal standards apply to all firms that issue a sustainability report. They cover such matters as the firm's organization and the principles to be followed in preparing a sustainability report. Thus, GRI 101 Foundation has three sections:

1. Reporting principles;
2. Using the GRI standards for sustainability reporting; and
3. Making claims related to the use of the GRI standards.

The third point has already been mentioned in section 7.1 above. Under the first point, the standard lists ten reporting principles: stakeholder inclusiveness, sustainability content, materiality, completeness, accuracy, balance, clarity, comparability, reliability and timeliness. Of these ten principles, all except the first two are acknowledged by most authorities as being

fundamental principles for reporting by accountants. ‘Sustainability context’ is self-evident for a sustainability report, which leaves the first principle (stakeholder inclusiveness) to be explained.

GRI 101 explains stakeholder inclusiveness as: *‘the reporting organization shall identify its stakeholders and explain how it has responded to their reasonable expectations and interests’*. It further defines stakeholders as including: *‘employees and other workers, shareholders, suppliers, vulnerable groups, local communities, and NGOs or other civil society organizations, among others, and states that: when making decisions about the content of the report, the organization is to consider the reasonable expectations and interests of stakeholders’*.<sup>9</sup>

The information on stakeholders that should be included in the sustainability report is covered in the universal standard GRI 201: General disclosures, which lists no less than 56 different points that must be disclosed in the firm’s sustainability report. In the GRI standards, the term ‘disclosure’ is used to denote a subset of a standard which defines a specific point or range of points that should be included in the firm’s sustainability report. In GRI 102, they range from Disclosure 102–1, Name of organization, to Disclosure 102–56, External assurance. Stakeholders are covered in Disclosures 102–40 to 102–44, which are summarised in Table 6.3.

*Table 6.3* Disclosures Relating to Stakeholder Engagement in GRI 102

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Disclosure 102–40: List of stakeholder groups

The reporting organization shall report the following information:

- a. A list of stakeholder groups engaged by the organization

Disclosure 102–41: Collective bargaining agreements

The reporting organization shall report the following information:

- a. Percentage of total employees covered by collective bargaining agreements.

Disclosure 102–42 Identifying and selecting stakeholders

The reporting organization shall report the following information:

- a. The basis for identifying stakeholders with which to engage,

Disclosure 102–43: Approach to stakeholder engagement

The reporting organization shall report the following information:

- a. The organization’s approach to stakeholder engagement, including frequency of engagement by type and by stakeholder group, and an indication of whether any of the engagement was undertaken specifically as part of the report preparation process.

Disclosure 102–44: Key topics and concerns raised

The reporting organization shall report the following information:

- a. Key topics and concerns that have been raised through stakeholder engagement, including:
    - i. How the organization has responded to those key topics and concerns, including through its reporting;
    - ii. The stakeholder groups that raised each key topic and concern.
-

These disclosures demonstrate in a very clear fashion GRI's commitment to consultation with stakeholders. Not only does GRI practice this itself in the due process employed for developing its standards, but it encourages those business firms that use its standards to engage with their stakeholders. But, on a close reading of the GRI standards, there would appear to no formal obligation imposed on the business firm to engage with its stakeholders. GRI 101 only requires the business firm to *consider* the reasonable expectations and interests of stakeholders. It is apparently in order for the business firm to consider the matter and decide not to engage with its stakeholders and then report negatively under Disclosures 102–40 to 44 in its sustainability report.

The standard is based on the principle that the firm's management is responsible for the preparation of the sustainability report and has the last word as to its contents. The management should consult the firm's stakeholders but is not obliged to agree to all their demands. But it should include in the sustainability report information about the firm's stakeholder engagement process, including unmet demands for information. Of course, it could well be that the business firm would be reluctant to present such a negative picture, and hence the need to report would be a factor in motivating the firm to engage with its stakeholders.

Overall, it is clear that GRI strongly supports engagement with stakeholders. It would not be an exaggeration to claim that the GRI's interpretation of sustainability calls for the implementation of the stakeholder theory of the firm.

#### 7.4. *The Economic Standards*

Table 6.2 lists six economic standards. In common with all the other topic specific standards, they specify what should be disclosed in the firm's sustainability report. Table 6.4 presents a summary of one of the most interesting standards: GRI 201: Economic performance.

Standard GRI 201 calls for four separate disclosures, and each disclosure prescribes a number of points to be included in the sustainability report. This is the general pattern with the topic specific standards. Hence, the total number of points to be included in the sustainability report in respect of the 33 topic specific disclosures must total several hundred (I gave up counting them).

The full text of one of these four (Disclosure 201–1) is presented in Table 6.4. The most interesting feature of this disclosure is that it asks for the type of information that I advocated in the previous chapter under the heading of a proper statement of distributions (section 4.6)—the distribution of the value created by the firm between its various stakeholders: employees, capital providers, suppliers, government and the local community. This is a clear example of the superiority of the GRI standards over the IASB's standards, which ignore most distributions.

Table 6.4 GRI 201: Economic Performance

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Under this standard, the firm should make four specific disclosures:

Disclosure 201–1 Direct economic value generated and distributed

Disclosure 201–2 Financial implications and other risks and opportunities due to climate change

Disclosure 201–3 Defined benefit plan obligations and other retirement plans

Disclosure 201–4 Financial assistance received from government

The text of the first disclosure runs as follows:

Disclosure 201–1 Direct economic value generated and distributed

The reporting organization shall report the following information:

(.a.) Direct economic value generated and distributed (EVG&D) on an accruals basis including the basic components for the organization's global operations as listed below. If data is presented on a cash basis, report the justification for this decision in addition to reporting the following basic components:

- Direct economic value generated—revenues
- Economic value distributed: operating costs; employee wages and benefits; payments to providers of capital; payments to government by country; community investments
- Economic value retained: 'direct economic value generated' less 'economic value distributed'

(.b.) Where significant, report EVG&D separately at country, regional or market levels where significant and the criteria used for defining significance.

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### 7.5. *The Environmental Standards*

Table 6.2 presents eight environmental standards. They cover all the important aspects of the environmental crisis described in the opening chapter: use of non-renewable and renewable materials, energy, water, biodiversity and so on. An important standard is GRI 305 Emissions, a summary of which is presented in Table 6.5. A significant feature of this standard is the amount of detail required of the business firm: seven disclosures, of which the text of only one (Disclosure 305–1) is given in Table 6.5.

Table 6.5 GRI 305: Emissions

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This standard prescribes seven specific disclosures:

Disclosure 305–1 Direct (scope 1) GHG emissions

Disclosure 305–2 Energy indirect (scope 2) GHG emissions

Disclosure 305–3 Other indirect (scope 3) GHG emissions

Disclosure 305–4 GHG emissions density

Disclosure 305–5 Reduction of GHG emissions

Disclosure 305–6 Emissions of Ozone-depleting substances (ODS)

Disclosure 305–7 Nitrogen oxides (NO<sub>x</sub>), sulfur oxides (SO<sub>x</sub>) and other significant air emissions

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(Continued)

Table 6.5 (Continued)

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The text of the first disclosure runs as follows:

Disclosure 305–1: Direct (Scope 1) GHG emissions

The reporting organization shall report the following information:

- (.a.) Gross direct (Scope 1) GHG emissions in metric tons of CO<sub>2</sub> equivalent..
  - (.b.) Gases included in the calculation; whether CO<sub>2</sub>, CH<sub>4</sub>, N<sub>2</sub> O, HFCs, PFCs, SF<sub>6</sub>, NF<sub>3</sub>, or all.
  - (.c.) Biogenic CO<sub>2</sub> emissions in metric tons of CO<sub>2</sub> equivalent.
  - (.d.) Base year for the calculation, if applicable, including:
    - (i) the rationale for choosing it;
    - (ii) emissions in the base year;
    - (iii) the context for any significant changes in emissions that triggered recalculations of base year emissions.
  - (.e.) Source of the emission factors used and the global warming potential (GWP) rates used or a reference to the GWP source.
  - (.f.) Consolidation approach for emissions; whether equity share, financial control, operational control.
  - (.g.) Standards, methodologies, assumptions, and/or calculation tools used.
- 

The most noteworthy feature of Disclosure 305–1 is the degree of detail required of the business firm. The demand is for precise information (metric tons of CO<sub>2</sub> equivalent), tempered with the appreciation that, in this field, inevitably recourse must be made to estimates and assumptions, which should be fully documented.

### 7.6. *The Social Standards*

Table 6.2 lists no less than 19 social standards. They cover a very wide field, referring to all the important stakeholders: employees, suppliers, customers, local communities and indigenous peoples. About half the social standards concern workers, possibly reflecting the influence of the trade-unionists on the GSSB's board. The text of one particularly revealing standard (GRI 418) is presented in Table 6.6.

Table 6.6 GRI 418: Customer Privacy

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This standard has a single disclosure

Disclosure 418–1: Substantiated complaints regarding breaches of customer privacy and losses of customer data

The reporting organization shall report the following information:

- (.a.) Total number of substantiated complaints received concerning breaches of customer privacy categorized by:
    - Complaints received from outside parties and substantiated by the organization
    - Complaints from regulatory bodies
  - (.b.) Total number of identified leaks, thefts, or losses of customer data.
  - (.c.) If the organization has not identified any substantial complaints, a brief statement of this fact is sufficient.
-

This standard requires the business firm to provide information on complaints concerning breaches of customer privacy. This demand reveals much about the GRI's interpretation of the concept of sustainability. It is evident that GRI applies a concept of sustainability that is very different from that defined in the Brundtland report, which has at its heart the need to protect the welfare of future generations. One may legitimately ask the question 'What has customer privacy to do with sustainability?' It would seem that GRI has expanded the concept so that it covers almost everything!

Table 6.2 gives the impression that business firm has to cram an extraordinary amount of information into its sustainability report. But before reaching a judgement on this matter, the question of materiality must be considered.

### 7.7. GRI's Concept of Materiality

A firm is not required to report under a particular standard if the information is not material. Hence, questions of materiality determine the content of the firm's sustainability report. The basic justification for this principle is to prevent the sustainability report becoming unwieldy, leading to the important information being lost in a mass of irrelevant detail. In standard GRI 101, GRI defines its concept of materiality in the following terms:

- Materiality has two dimensions. A matter is material if either (a) it can significantly influence stakeholders' decisions and assessments or (b) it has a significant impact on the economy, the environment or society.
- The first criterion (stakeholders' decisions) is the equivalent in sustainability reporting of the well-known principle in financial reporting that a matter is material if it can influence a decision of a user of the financial statements.
- The second criterion requires that the firm should assess the potential impact of its activities on the economy, the environment and society using objective measures, such as the opinions of experts, and established techniques, such as impact assessment methodology.

The GRI's concept of materiality is very similar to that advocated by Eccles and Krzus (2015, pp. 147–171), who describe materiality (which they define as the quality that qualifies a matter for inclusion in a sustainability report) along two very similar dimensions: the stakeholders' perception of materiality and the management's perception.

### 7.8. Evaluation of the Standards

In my opinion, three aspects of the GRI standards should have a favourable impact on the quality of a firm's sustainability report:

- Procedure: The standards cover the process that the firm should follow in preparing the report, which, if followed, should greatly enhance the report's value.

- **Completeness:** The standards cover many matters that are relevant for assessing sustainability, notably the three elements of the TBL.
- **Detail:** The standards define what the firm should report on particular points in such detail that, if followed, the firm would provide a balanced report, covering both positive and negative matters, thus preventing the problem that was identified with TBL reports: that the firm's management reports only on matters favourable to the firm.

But I have two major criticisms: incoherence and lack of assurance:

### *Incoherence*

The standards call for a mass of detail on a great number of specific points. The degree of detail demanded can be judged from the text of the standards presented in Tables 6.3 to 6.6. These tables covered only certain disclosures in only four standards. Hence, to get a better impression of what is demanded, the information in these tables should be multiplied many times! The points on which information is demanded seem to have been chosen in a haphazard fashion. Some are certainly highly relevant for an assessment of the firm's impact on sustainability—for example, Disclosure 201–1 on greenhouse gas emissions. Others, on the other hand seem trivial—for example, Disclosure 418–1 on customer privacy. The relationship between customer privacy and sustainability is surely tenuous.

The reader of a sustainability report that is drawn up faithfully in accordance with the Guidelines (comprehensive option) would be confronted with a mass of disparate uncoordinated material, some highly relevant for an assessment of the firm's contribution to sustainability, much far less so. Above all, the reader would not find an overall evaluation of the impact on sustainability of the firm's activities.

### *Lack of Assurance*

For a business firm to issue a report that provides information on the firm's impact on the economy, the environment and society in a truthful and comprehensive fashion, and which contains information that is comparable and consistent with that in the reports of other firms, two conditions must be met:

- A body, such as GRI, should publish standards which, if followed, will result in a proper sustainability report, and
- Business firms must apply these standards faithfully and comprehensively in preparing their reports.

In my opinion, the GRI standards go some way to fulfilling the first condition. But the second condition must also be fulfilled. In my opinion, GRI

pays insufficient attention to whether business firms faithfully implement its standards in preparing their sustainability reports. I will discuss this vital issue after considering the extent to which the GRI standards are applied by firms.

## 8. The Global Spread of Sustainability Reporting

The GRI has been remarkably successful in persuading companies to issue sustainability reports based on its precepts. This is apparent from the report of a survey undertaken by KPMG. The report's title is '*The KPMG survey of corporate responsibility reporting 2013*', but it is clear from its contents that, for KPMG, corporate responsibility reporting and sustainability reporting are virtually identical. KPMG surveyed 4,100 companies in 41 countries, being the top 100 companies in each country. Of these companies, 2,911 (71%) issued CR (corporate responsibility) reports in the year 2013, and of these 2,911 companies, the great majority (78%) used the GRI Guidelines. At the time of the survey, the GRI's prescripts were termed Guidelines: they were virtually identical to the Standards which were issued in 2016. Given that 78% of 71% is 55%, well over half of the surveyed companies issued sustainability reports based on the GRI Guidelines. The 41 countries surveyed included all the major countries (the USA, China, Germany, France, Britain, Russia, India, Brazil, Australia, South Africa and Indonesia) with a preponderance of European countries (19 of the 41 were from this continent). Truly by 2013 sustainability reporting, based on the GRI's Guidelines, had become a global practice, at least for the larger companies in the developed countries.

## 9. The Accuracy of Firms' Sustainability Reports<sup>10</sup>

The last section demonstrated that very many business firms issue sustainability reports which they claim follow the GRI Guidelines. But do they in fact faithfully apply these Guidelines? This question was investigated by Olivier Boiral, using the research technique of counter accounting, which, drawing on the previous work of Adams (2004), O'Dwyer (2005) and Gallhofer and Haslam (2006), he defined as follows: '*Counter accounting in the area of sustainability reporting can be defined as the process of identifying and reporting information on organizations' significant economic, environmental and social issues that comes from external or unofficial sources (expert reports, research papers, online journals, studies from NGOs, government publications, legal proceedings, etc.) in view of verifying, complementing or countering organizations' official reports on their performance and achievements*' (Boiral, 2013, p. 1037). The significant word in the above quotation is 'external'. An organization's report is to be judged as to its conformity to the GRI Guidelines with reference to information external to the firm.

Boiral selected the sustainability reports for the year 2007 of 23 firms for detailed investigation. All the reports were graded 'A', indicating that they fulfilled all the requirements of the GRI Guidelines and, in addition, all but four were graded A+, indicating that they had been externally verified. All the firms were large multinational enterprises (MNEs) and included several well-known companies, such as BP, Shell, Repsol and BHP Billiton.

Boiral and his team then searched the external sources mentioned in the above quotation for news items about the 23 MNEs, which were relevant to their sustainability performance. These items often related to events, such as an oil spill, a fine levied by a government, a conflict with local residents or legal cases involving the firm. In order to ensure a certain degree of objectivity, each event had to be mentioned in two different independent sources and be evaluated as relevant by two researchers, acting independently.

The researchers identified 116 events, relating to the 23 MNEs which they considered to be of such significance that, according to the GRI Guidelines, they should have been mentioned in the firms' sustainability reports. They then examined these reports to ascertain how they had been reported. The results are presented in Table 6.7.

Personally, I am shocked by the figures presented in Table 6.7. In only 10% of the cases were the events reported in a way that the researchers judged to be adequate, although often not ideal. An example is the following extract from BP's Sustainability Report: *'In relation to Alaska, we have paid a \$12 million fine and are subject to one to three years' probation. We also paid \$4 million restitution to the State of Alaska and an additional \$4 million to support Artic environmental research'*.<sup>11</sup> The researchers classified this extract as 'rather clearly reported' despite the complete absence of any information about the company's actions that led to these payments, commenting, *'disclosure of this type of information allows the reader to recognize that a problem or negative impact exists; however, given the length of the report (46 pages) it is easy to overlook very short passages concerning adverse events'*. Personally, I consider that the researchers were rather generous in their judgement, as I feel that BP's report fails to satisfy GRI's principle of completeness. Certainly, the researchers cannot be accused as being excessively critical of the firms.

Table 6.7 Results of Olivier Boiral's Research

	<i>Number of reports</i>	<i>%</i>
Rather clearly reported	12	10%
Partially or poorly reported	42	36%
Not reported	62	54%
Total	116	100%

In a further 36% of cases, the event was judged to be ‘partially or poorly reported’. Boiral gives the following example from the report of RWE, the German energy supplier:

*In Germany, where RWE owns transportation and transmission networks, unrestricted access to these networks has a key role to play in promoting genuine competition. We therefore guarantee every power generator unrestricted, discrimination free access to our transportation and distribution network subject to fair terms and conditions, and will continue to do so in the future, too. The European Commission is nevertheless demanding that these distribution networks be run by independent companies.*

(RWE’s 2007 report, quoted in Boiral, 2013, p. 1053)

The European Commission’s website (the researchers’ principal source of information) gives a rather different picture of the event:

*The European Commission has decided to open antitrust proceedings against the German energy company RWE . . . The Commission proceedings focus on possible exclusion of potential competitors from the market by RWE Group through the putting in place of artificial obstacles to access by other companies to its gas transport network in its core area, North Rhine-Westphalia.<sup>12</sup>*

There are clearly two sides to the dispute between the European Commission and RWE. The European Commission considers that RWE is restricting competition, whereas RWE claims that it is promoting competition. It is not impossible that what RWE wrote was roughly correct, given that, at the time that RWE’s report was written, the issue had not been resolved. But I feel that it is thoroughly misleading for RWE to refer to the Commission opening antitrust proceedings (the first step in a legal process that often leads to very large fines) as the Commission ‘demanding’. Furthermore, RWE’s report clearly lacks balance (one of the GRI’s fundamental principles), which requires that *‘the report should reflect positive and negative aspects of the organization’s performance’*.

Boiral gives other examples of MNEs’ sustainability reports that give a thoroughly biased and one-sided account of an event or dispute. In most cases, the principal criticism of a firm’s report is not that it commits an outright falsehood, but that it fails to present fully all the aspects of the event or dispute, notably those that reflect negatively on the firm.

But the most shocking figure in Table 6.7 is that 54% of the events were not mentioned in the firms’ reports. According to the researchers’ judgement, all these events satisfied the GRI principle of materiality, which states that *‘the report should cover aspects that reflect the organization’s economic, environmental and social impacts; or substantively influence the*

*assessments and decisions of stakeholders*'. Boiral gives the example of three such significant events concerning Shell in 2007 which were not mentioned in that firm's report (Boiral, 2013, p. 1054).

- Shell was accused by the French competition authorities of colluding with other oil companies in pricing kerosene on Réunion Island;
- Shell was being sued by some of its Ethiopian and Malaysian employees for discriminatory hiring practices;
- The British Advertising Standards Authority accused Shell of improperly using the term 'sustainable development' in connection with its exploitation of the Athabasca oil sands.

In each case, the event was covered by a specific GRI Guideline which required that it be reported.

Sixteen of the 23 companies failed to report at least one material event that the researchers had identified. Boiral commented: *'This lack of reporting through omission involved all of the sustainable development issues covered by GRI—issues which could also potentially damage the firm's image—including illegal pricing cartels, discrimination, forced labor, spills that were the subject of legal action, relocation of populations, corruption, worker deaths implicating inadequate health and safety measures, and violation of the rights of indigenous peoples. The number and severity of these events, and their relationship to specific GRI indicators, makes it implausible that these omissions were the result of errors or oversights'* (Boiral, 2013, footnote 19, p. 1066).

It is obvious that many of the sustainability reports were seriously defective. This raises grave doubts about the effectiveness of the assurance process, for all but four of the reports had been reviewed by an external independent assurance provider.<sup>13</sup> Possible reasons for the failure of the assurance providers to spot the deficiencies in the reports are:

- The most serious cases noted by Boiral related to omissions. It is more difficult for the reviewer of a report to identify a matter that has been omitted than it is to comment on the truth of an item that has been included.
- With respect to some Guidelines, judgement is required in deciding whether or not the Guideline has been breached. An example is Guideline G4-HR3 (now standard GRI 406), which requires the firm to *'report the total number of incidents of discrimination during the reporting period'*. It clearly requires judgement to decide whether a particular incident is 'discrimination' rather than some less serious offence. Boiral wrote that *'Shell [was] being sued by some of its Ethiopian and Malaysian employees for discriminatory hiring practices'* and classified that as *'an incident of discrimination'*. Shell judged otherwise, possibly on the grounds that, until the case was settled, 'discrimination' was

not proved. This case illustrates the difficult task of the reviewer of the report. Where the management has to exercise judgement on what to disclose, the reviewer also has to exercise her judgement. In my opinion, one of the reviewer's principal tasks is to counter the excessive optimism of management. Hence, in this case, the reviewer should err in favour of greater disclosure of events that reflect badly on the management.

My conclusion is that Boiral's research has revealed serious deficiencies in the assurance process. It can be argued that it is not possible to draw scientifically valid conclusions from such a small sample. But, at the very least, Boiral's research has revealed a thoroughly unsatisfactory state of affairs, given that his sample included many prestigious firms—firms who may be expected to set the tone for business as a whole, such as Shell, BP, Petrobas, RWE, Repsol, Anglo-American, BHP Billiton, Teck Cominco and Rio Tinto. One may reasonably conclude that, at least in 2007, it was very common for a sustainability report not to present a true and fair view of a firm's performance.

Does this conclusion mean that the efforts of a body such as GRI in issuing general guidance are a waste of time? The answer is an emphatic 'No'. As explained previously, for firms to publish complete, correct and comparable information on their performance relating to sustainability, two conditions must be met:

- (a) A body (such as GRI) should issue reporting standards that, if applied by firms, would lead to comprehensive reporting of sustainability that would be consistent and comparable with that reported by other firms.
- (b) Firms, in preparing their reports, should apply these standards correctly and consistently.

GRI has gone some way fulfilled its responsibilities in respect of condition (a), but I feel has rather neglected them in respect of condition (b).

## **10. The Importance of Assurance**

The lesson to be learned from Boiral's research is not so much that the management of firms are motivated to present their results in the best possible light (for it is unrealistic to expect managers to report truthfully and comprehensively on their failures), but that the process of providing independent assurance of the accuracy of the reports failed so miserably. The reports examined by Boiral were prepared using the GRI's G3 guidelines, which included provisions as to assurance. A report that had been verified by an external body was given a grade of A+, as was the case with 19 of the 23 reports examined by Boiral. In its latest standards, GRI largely ignores the subject of assurance, no doubt disheartened by its experience with the G3 guidelines. The matter is covered in Disclosure 102–56, which requires

the business firm to report on the firm's policy regarding external assurance, adding, *'the use of external assurance for sustainability reports is advised . . . but is not required'*. Hence, it is perfectly in order for the firm to report that it has no policy regarding assurance. I feel that this is a serious abdication of responsibility on the GRI's part. It is insufficient to issue standards on how a firm should report without giving consideration to how the public may be assured that the firm has faithfully applied the standards.

GRI's failure to prescribe assurance has to a limited extent been remedied by the action of certain organizations in publishing standards on the task of the assurance provider—notably AccountAbility, with standard AA1000AS, and the International Auditing and Assurance Standards Board with ISAE 3000. These standards largely set out common-sense rules for assurance engagements in general and do not deal specifically with the review of sustainability reports.

Many sustainability reports are not subjected to verification by a qualified external reviewer; for these reports, the user has no means, other than relying on the firm's honesty, of assuring herself that the report presents a faithful picture of the firm's impact on sustainability. But some sustainability reports have been subjected to external review; these reports include a statement from the external reviewer which presents his conclusions. I set out below extracts from the external reviewer's statement for two firms:

#### **ABB Ltd**

Extracts from the statement of DNV GL on its review of the 'Sustainability Performance Report 2015'

*DNV GL's assurance engagements are based on the assumption that the data and information provided by the client to us as part of our review have been provided in good faith.*

*On the basis of the work undertaken [which is described in some detail in the statement], nothing came to our attention to suggest that the Report does not properly describe ABB's adherence to the Principles.<sup>14</sup>*

#### **Total**

Extract from the statement of Ernst & Young on the CSR information contained in the registration document.<sup>15</sup>

*. . . based on our work, we have not identified any significant misstatement that causes us to believe that the CSR information, taken together, has not been presented in accordance with the Criteria.<sup>16</sup>*

In my opinion, the above statements of the assurance providers do little to increase the confidence of the reader that the sustainability report provides comprehensive truthful information on the firm's sustainability. Statements such as *'nothing came to our attention'* and *'we have not identified'* are not helpful. Their function seems principally to limit the reviewer's legal liability

rather than to convey information. What is required is a positive statement. With respect to the firm's *financial* statements, the auditor is required to report that they give a true and fair view of the firm's financial position and performance. It would greatly help the public if the assurance provider were to make a similar positive statement concerning the sustainability report, perhaps on the lines: 'In our opinion, the sustainability report presents a true and fair view of X's contribution to sustainability during the year 2016'.

## 11. Summary and Conclusion

In this chapter, I consider the contribution that accountancy can make to sustainability. I define the concept of sustainability, drawing on the Brundtland Commission's definition of sustainable development as '*development that meets the needs of the present without compromising the ability of future generations to meet their own needs*'. I show that sustainability covers both the present generation and future generations and has three dimensions: a sustainable economy, a sustainable society and a sustainable environment—the three P's, profit, people and planet. The first attempt to develop sustainability reporting by business firms was based on John Elkington's TBL, of which a typical report is presented in the annex. I criticised this report as consisting of an uncoordinated mass of diverse information which painted a uniformly positive picture of the company. I attributed these deficiencies to the lack of generally agreed standards for a sustainability report.

The bulk of this chapter is given over to an analysis of the GRI standards, which are intended to rectify the faults of the TBL reports. I conclude that the GRI standards, which specify the content of a firm's sustainability report in considerable detail, should, in principle, prevent firms from issuing unbalanced reports that emphasise items favourable to the firm and omit negative points. But I conclude that the GRI standards provide an inadequate basis for the sustainability report for two reasons:

- The standards ignore the important matter of how the public can be assured that the information in the firm's sustainability report is correct, complete and comprehensive. The research by Oliver Boiral has demonstrated that businesses often fail to report on negative matters, even when an independent reviewer has certified that the sustainability report was prepared in accordance with GRI's prescripts. It is evident that, because of lack of effective assurance, the public cannot have confidence in the integrity of much sustainability reporting.
- The standards prescribe the disclosure of a great amount of information covering sustainability's three dimensions but may be criticised on two grounds. (i) The connections between the different items of information are not made clear. In particular, the contribution that each item makes to sustainability is not explained. Some items seem to have only the most tenuous connection with sustainability. (ii) There is no overall

assessment of the firm's contribution (positive or negative) to the sustainability of the economy, of society and of the environment.

The next chapter presents a recent initiative that sought to rectify these deficiencies.

### **Annex 6.1 An Example of a TBL Report**

A good example of a TBL report is that of the firm Cascade Engineering Inc, mentioned in the article 'The Triple Bottom Line: What is it and how it works?' by Slaper and Hall (2011). Presumably, this report was picked out for special mention as being a particularly good example.<sup>17</sup>

The report is entitled 'Triple Bottom Line Report 2012: Defining Purpose'. It has three principal sections, headed, respectively, 'Social purpose', 'Environmental purpose' and 'Financial purpose'. Each section is comparatively short: six pages, consistently of about half narrative and half pictures. There are virtually no quantitative facts in these sections. Quantitative information is given in a one page 'Annual Scorecard', which presents graphs of the following nine variables for the years 2003 to 2012:

- Sales (in \$)
- Energy consumption (Sales dollars per Kwh)
- Greenhouse gas emissions (tons of CO<sub>2</sub> equivalent)
- Use of recycled materials (weight)
- Landfill costs (as percentage of sales)
- Employee training (hours per employee)
- Incident rate (per 200,000 hours worked)
- Lost/restricted workday rate (per 200,000 hours worked)
- Welfare to career retention rate (percentage)

The first six statistics are self-explanatory, but I have no clear idea as to the meaning of the last three measures, and no explanation is given in the report. What is most striking about these statistics is they cover a very wide, diverse field, but there is no attempt to summarise or to present an overall conclusion: i.e., to set out 'the bottom line'. This is true even for the financial bottom line. Although the word 'profit' is mentioned several times in the report, the actual amount is not given. There is a very obvious reason. Cascade Engineering Inc is a private company which is not obliged to file its accounts, and the management prefers to keep details of its profits secret.

The report is remarkable for the very positive picture that it paints of the firm. The word ‘picture’ is entirely appropriate as the report is full of pictures, all of which present the company in a very favourable light. The report’s opening words give a good impression of its contents: *‘Those of us at Cascade Engineering are proud of our commitment to the Triple Bottom Line—People, Planet, Profit—and this report details our achievements and current priorities in pursuit of these crucial objectives’*. The report claims that TBL is *‘the world’s greatest money-maker . . . we would be remiss to show our social and environmental efforts without giving equal credence to our economic picture. We are, after all, a for-profit company. And, just as we hold fast to our social and environmental values, we focus on creating profits’*.

I have two principal criticisms of Cascade Engineering’s TBL report: There is no attempt to present a ‘bottom line’: a single number that encapsulates the firm’s performance in relation to society and the environment. The quantitative information on these matters consists of a series of disparate unconnected statistics. It would seem that the term ‘Triple Bottom Line’ is a misnomer. The function of the report seems to be to help the management to run the company successfully. I base this judgement on two observations. Firstly, the TBL report is publicly available on the firm’s website, but the firm’s financial statements are not. Secondly, the report paints a uniformly favourable picture of the firm. These points suggest to me that the management is willing to be open only if it is in the firm’s interest. The TBL report seems to be addressed to three principal audiences: firstly, to a very wide audience, including customers, suppliers and the local community, to convince them that, with respect to the environment, the firm is acting responsibly; secondly, to the firm’s employees to assure them that the management has their interests at heart; and, thirdly, to the firm’s shareholders to reassure them that the management will not let its attention to social and environmental matters distract it from the pursuit of profit. I have the impression that, from the management’s viewpoint, the report’s principal function is to promote the firm.

This criticism is based on analysis of the firm’s TBL report for 2012. The latest report for the year 2015 is available on the firm’s website: [www.cascadeng.com](http://www.cascadeng.com). The 2015 report has a similar format to the 2012 report. The greater part of the report is given over to narrative and pictures, with a distinct lack of quantitative facts. The only hard information is given in two pages of graphs. These present the same variables that were shown in the 2012 report, with one change. In the 2015 report, a graph for ‘Social Contributions—dollars’ replaces that those for training and loss/restricted workday rate. ‘Social contributions’ would seem to be donations to local communities; in 2015; they totalled \$293,000 compared with \$205,000 in 2012, an increase of

over 40%. One wonders whether this was the principal reason for including this figure in the report. All of the graphs show an improvement in 2015 compared with 2014. As was the case in 2012, the word ‘profit’ is mentioned several times, but the actual figure is not given.

The criticisms that I made of the 2012 report apply with equal force to the 2015 report. There is no attempt to present a ‘bottom line’ in any of the three dimensions—not even for profit. The hard information consists of a series of disparate unconnected statistics. And, as in 2012, the report paints a uniformly positive picture of the firm. One conclusion relating to the 2012 report seems to apply with even greater force to the 2015 report: that a principal function of the TBL report is to assure shareholders that the firm, in pursuing social and environmental objectives, is not neglecting its responsibility to maximize profits. This is made clear in the Chairman’s introduction when he writes: *‘We define our purpose as follows: “To make a positive impact on society and the environment and to be financially successful”. To many organizations this may sound like a zero sum game since making an impact can be perceived as taking away from profitability. We believe something quite different. We believe that if we treat people well, design our systems and culture to help people thrive, both personally and professionally, that the business will quite naturally thrive as well’.*\*

## Notes

- 1 Meadows et al. (1972).
- 2 World Commission (1987, p. 43).
- 3 Report of the World Council of Churches, cited in Dresner(2002, p. 29).
- 4 Elkington (1994).
- 5 Preface to the G4 Guidelines, available on GRI’s website: [www.globalreporting.org](http://www.globalreporting.org)
- 6 See ‘Terms of reference’ available on GRI’s website.
- 7 Available on GRI’s website.
- 8 The GRI website does not define the term ‘mediating institutions’. I believe that it refers to bodies that provide services to business, such as consultants, because an employee of Deloitte is listed as a representative of a ‘mediating institution’.
- 9 All citations in this paragraph are from GRI 201, page 8.
- 10 This section draws substantially on Flower (2015).
- 11 BP’s Sustainability Report 2007, quoted in Boiral (2013, p. 1051).
- 12 Quote from the European Commission’s press release of 11 May 2007, accessed on [europa.eu/rapid/press-release\\_MEMO-07-186\\_en.htm](http://europa.eu/rapid/press-release_MEMO-07-186_en.htm) on 17 January 2014
- 13 Of the 62 material events that were not reported, 60 related to reports that had received the A+ grade.
- 14 The term ‘the Principles’ refers to set of assurance principles developed by DNV-GL based on the AA1000 Assurance Standard and the International Standard on Assurance Engagements 3000.

- 15 Large French enterprises are required to lodge a ‘registration document’ with the authorities, which contains a mass of information, including the conventional financial statements and CSR (Corporate Social Responsibility) information.
  - 16 The term ‘the Criteria’ refers to a set of protocols established by Total for the preparation of the CSR information required by law.
  - 17 The report may be viewed on the company’s website: [www.cascadeng.com](http://www.cascadeng.com). The references here are to the report accessed on 24 January 2015.
- \* Part of the text in this chapter has been reprinted from the G4 Sustainability Reporting Guidelines (August 2015) with written permission from the GRI. GRI does not endorse any of the views in this publication.

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# 7 Integrated Reporting

## A Disappointing Failure

This chapter tells the story of an important recent initiative which at first promised to revolutionize the practice of both financial reporting and sustainability reporting—the project to develop a new form of corporate reporting (integrated reporting) by the International Integrated Reporting Council (IIRC). The project’s objective was very ambitious—essentially, to rectify the faults in conventional accountancy that have been identified in this book, including the deficiencies in the GRI model noted in the last chapter. As indicted in the chapter title, I believe that the IIRC has failed to achieve its objective. But the analysis of this failure is very revealing of the nature of the problems faced by accountants and of the difficulties that they encounter in seeking to solve them.

### 1. The IIRC’s Creation

The IIRC was created in 2010 at the initiative of GRI and A4S,<sup>1</sup> two bodies which had, over many years, worked hard to promote sustainability reporting. They set out the rationale for the creation of the IIRC in the following terms:

*The world has never faced greater challenges: over-consumption of finite natural resources, climate change, and the need to provide clean water, food and a better standard of living for a growing global population. Decisions taken in tackling these issues need to be based on clear and comprehensive information; but, as the Prince of Wales has said, we are at present “battling to meet 21st century challenges with, at best, 20th century decision making and reporting systems”. The IIRC’s remit is to create a globally accepted framework for accounting for sustainability . . . The intention is to help with the development of more comprehensive and comprehensible information about an organization’s total performance, prospective as well as retrospective, to meet the needs of the emerging, more sustainable, global economic model.<sup>2</sup>*

This statement bears unmistakable signs of the Prince’s idealism: accounting is to be given the task of saving the planet! It is abundantly clear that,

according to its founders, the principal task of the new organization was to create a framework for accounting for sustainability that would be globally accepted.

## 2. Why 'Integrated'?

The title of the body created by A4S and GRI was the IIRC (International Integrated Reporting Council) and not the ISRC (International Sustainability Reporting Council), as might have been expected, given these bodies' commitment to sustainability. The choice of title can be explained by the way in which social and environmental reporting had evolved in the decades prior to the IIRC's formation in 2010. These decades had witnessed a great expansion in the number and variety of reports on social and environmental matters issued by business firms: reports on such matters as the TBL and the balanced scorecard. Of particular importance were the sustainability reports based on the GRI guidelines.

The IIRC analysed the situation in the following terms: *'As business has become more complex and gaps in traditional reporting have become prominent, new reporting requirements have been added through a patchwork of laws, regulations, standards, codes, guidance and stock exchange listing requirements . . . These developments, led by policy makers, companies and other reporting organizations, investors and civil society, are welcome reactions designed to elicit the information needed in a changing world. However . . . many currently perceive a reporting landscape of confusion, clutter and fragmentation'*.<sup>3</sup>

There was widespread agreement of the need to bring some order into corporate reporting and in particular to bring out more clearly the connections between the different reports. The IIRC's solution was for business firms to issue an integrated report, a single report that would incorporate in one document all the information contained in the profusion of separate reports currently issued by firms. The IIRC set out its aim in the following terms: *'a single report that the IIRC anticipates will become an organization's primary report, replacing rather than adding to existing requirements'*.<sup>4</sup>

Why did the GRI and A4S accept the principle of integrated reporting? It seems highly unlikely that they originated the idea; the most likely source was Robert Eccles, the Harvard Business School professor, who was a member of the IIRC's original governing body and who had written one of the first books on integrated reporting.<sup>5</sup>

For A4S and the GRI, the fact that business firms typically issued conventional financial statements (balance sheet etc.) and a separate sustainability report had two major negative consequences:

- (i) The capital market considered the conventional financial statements to be the more important and more reliable measure of the firm's performance and position. It tended to ignore the other reports as being

informal and lacking in authority. Hence, the firm's management, whose position depended on their retaining the confidence of shareholders, generally based their decisions in managing the firm on the impact that these would have on the firm's profit as reported in their conventional financial statements and ignored questions of sustainability.

- (ii) Hence, the other reports, notably the sustainability report, had little impact on the way that firms were managed. There was a strong feeling that, from the firm's viewpoint, their main function was to present the firm in the best possible light: in other words, they were little more than a public relations tool.

It was felt that both problems would be solved if businesses were obliged to present only one report that would combine information on both financial performance and sustainability. In this way, the firm's management in making decisions would be forced to consider the question of sustainability. The Prince of Wales, in particular, is insistent that businesses should not only report on their sustainability but also act sustainably—that, to use the Prince's favourite metaphor, sustainability should be imbedded in the organization's DNA. This would only come about if the organization's primary report (and ultimately its sole report) incorporated information on sustainability.

Integrated reporting also offered a solution to a problem that was identified in the last chapter—that a GRI sustainability report consisted of a mass of diverse uncoordinated information, with no indication of the relationships between the individual items and with no overall measure of the firm's impact on sustainability

### 3. The IIRC's Framework

Over the three years following its creation, the IIRC issued a number of documents in which it set out its ideas for the reform of corporate reporting: in 2011, a Discussion Paper;<sup>6</sup> in April 2013, a Consultation Draft of a Framework;<sup>7</sup> and finally, in December 2013, after a period of extensive consultation, the definitive text of its Framework, which sets out the fundamentals of the firm's integrated report.<sup>8</sup> All of these documents are of interest, notably because, in my opinion, they reveal a gradual but significant transformation of the IIRC's thinking. But, in this section, I concentrate on the Framework, which presents the IIRC's current position.

#### 3.1. *The Integrated Report*

In its Discussion Paper, the IIRC proposed that the integrated report would be an organization's primary report, replacing rather than adding to existing requirements. In the Framework, this proposal is dropped; there is no obligation to present a single integrated report. This represents a highly significant retreat on the IIRC's part. The integrated report loses its status as the organization's primary report; it becomes simply another report, adding

to the clutter of reports which the IIRC so graphically condemned in its Discussion Paper.

The significance of this retreat is that the IIRC accepts that firms may issue separate reports on such matters as social and environmental accounting, and sustainability. Hence, the need for a firm's integrated report to cover these matters is greatly reduced, with far-reaching consequences for the integrated report, as becomes clear when the content of this report is analysed later in this chapter.

The Framework defines an integrated report as follows:

*An integrated report is a concise communication about how an organization's strategy, governance, performance and prospects, in the context of the external environment, lead to the creation of value over the short, medium and long term.*<sup>9</sup>

There are many interesting ideas in this paragraph, but here I will concentrate on the term which, in my opinion, is the Framework's central motif: *'the creation of value'*.

### 3.2. Value Creation

Value creation, or a variant, is mentioned over 50 times in the Framework's text. Value creation would seem to be the Framework's theme, and not sustainability, which is mentioned just twice. There seems to be an (unstated) assumption that the organization's objective should be the creation of value.

The Framework's paragraph 2.4 explains how the organization creates value:

*Value created by an organization over time manifests itself in increases, decreases or transformations of the capitals caused, by the organization's business activities and outputs.*

The IIRC adopts a balance sheet approach to the measurement of performance. An organization has done well when the value of its capitals has increased (the organization has created value) and has done badly when their value has declined. But the IIRC's balance sheet approach is based on an idiosyncratic concept of 'capital', which needs to be explained.

### 3.3. The IIRC's Concept of Capital

In its Framework, the IIRC adopts an idiosyncratic concept of 'capital', which it explained as follows:

*All organizations depend on a variety of resources and relationships for their success. The extent to which organizations are running them down or building them up has an important impact on the availability of the resources and the strength of the relationships that support the long-*

*term viability of those organizations. These resources and relationships can be conceived as different forms of “capital”.*<sup>10</sup>

The Framework lists six different categories of ‘capital’: financial capital, manufactured capital, human capital, intellectual capital, natural capital and social and relationship capital. I set out my interpretation of the IIRC’s concept of capitals in Table 7.1, in which I have classified these capitals as being either internal or external to the firm, with further a subdivision of internal capital between capitals owned by the legal entity and capital not so owned. In assuming that the firm and the legal entity are not identical, I am adopting a specific theory of the firm—the stakeholder theory. The IASB adopts a narrower view of the firm as being the legal entity; hence the conventional accounts, drawn up in conformity with its standards, report only on the assets listed under the first column. The cells in the table present examples of the various forms of capital; these examples are in no way exhaustive.

The concepts on which most of the categories of capital are based are reasonably clear; thus, natural capital is nature (flora and fauna), and manufactured capital comprises material objects created by man. A tricky category is social and relationship capital; this is based on the idea that the viability of the firm (and the welfare of mankind) depends, in part, on well-functioning relationships between people, as demonstrated, for example, in the existence of an effective government that maintains law and order. Financial capital is rather different from the other five, as is explained later.

*Table 7.1* The IIRC’s Categories of Capital

Type of capital	<i>Internal to the firm</i>		<i>External to the firm</i>	
	Owned by the legal entity	Not owned by the legal entity	Renewable	Not renewable
Financial	Cash, debts			
Manufactured	Factories, machines		Public roads, schools	
Human	Slaves	The firm’s work force		
Intellectual	Patents, management systems	The knowledge of its workers		
Natural	Cows on a farm, stocks of cotton and oil		Agricultural crops, flora and fauna	Air, water, land, fossil fuels
Social and Relationship	Brands	Reputation with customers	A cohesive society and an effective government	

The boundaries between the various categories are often fuzzy; the knowledge of the firm's work force may reasonably be classified as either human capital or intellectual capital.

The basic idea is that a firm's integrated report should indicate how the firm, through its activities, has created value, as measured by the increase less the decrease in the value of the assets represented by these capitals, but with a far wider definition of 'asset' than that used in the conventional balance sheet, in that it covers all the resources that the firm uses or affects in its activities. Thus, the IIRC's concept of 'capitals' covers not only the firm's capital in the conventional sense, but also the capital of society, for example, the environment. Hence, many of the capitals included in the integrated report are not owned by the firm.

#### **4. The IIRC's Betrayal of Sustainability Reporting**

There can be no doubt that the objective of the GRI and A4S in founding the IIRC in 2010 was to promote sustainability reporting. This is abundantly clear from the wording of their statement (referred to in section 1), which mentions 'sustainability' or a variant no less than 13 times in its three pages. But in the IIRC's Framework, issued some four years later in 2013, there are only two references to sustainability, each time to a separate sustainability report.<sup>11</sup> In my opinion, the IIRC has abandoned sustainability reporting, an action which I characterise as a betrayal.

The IIRC, in its defence, can claim that its concept of value creation (being defined as the increase in the value of the firm's capitals) is closely related to the concept of sustainability. For, if the firm has maintained the value of its capitals, then it may reasonably claim that it has operated sustainably. For example, if the value of natural capital has been maintained, the firm's activities have not resulted in damage to the environment. Hence, although sustainability is not the Framework's central theme, it can be argued that the IIRC's proposals may cover sustainability without actually using the term. But, for this to be the case, three conditions have to be met:

- The term 'value' should be interpreted very widely, for example, as 'value to society'.
- The firm should report comprehensively on all the categories of capital listed in Table 7.1. If all six capitals (valued appropriately) show no decrease resulting from the firm's activities, then one may confidently affirm that sustainability has been achieved.
- But, if one or more capitals shows a decrease, then overall sustainability is only achieved if this decrease in value may be compensated by the increase in the value of other capitals; hence, trade-offs between capitals should be meaningful.

These conditions are now considered.

#### 4.1. *Value for Whom?*

The Framework emphasises that the principal function of integrated reporting is the reporting of ‘value’. Paragraph 1.7 states, ‘*The primary purpose of an integrated report to explain to providers of financial capital how an organization creates value over time*’.

The crucial point is the meaning given to the word ‘value’; possible alternative interpretations are ‘value for society’ (which is consistent with social and environmental accounting), ‘value for stakeholders’ (which is consistent with the stakeholder theory of the firm) and ‘value for both present and future generations’ (which is consistent with sustainability). The words ‘providers of financial capital’ in paragraph 1.7 suggest that the IIRC’s focus is ‘value for investors’. But the Framework recognizes alternative concepts of value, notably in the following two paragraphs, which, in view of their importance, are quoted in full:

*2.4 Value created by an organization over time manifests itself in increases, decreases or transformations of the capitals caused by the organization’s business activities and outputs. That value has two aspects—value created for:*

- *The organization itself, which enables financial returns to the providers of financial capital*
- *Others (i.e. stakeholders and society at large).*

*2.5 Providers of financial capital are interested in the value an organization creates for itself. They are also interested in the value an organization creates for others when it affects the ability of the organization to create value for itself, or relates to a stated objective of the organization (e.g. an explicit social purpose) that affects their assessments.*

The reference to ‘others’ in paragraph 2.4 seems to imply that a very wide interpretation is to be given to the word ‘value’. However, paragraph 2.5 has the effect of severely limiting ‘value for others’ as a component of value created by the firm. The primary purpose of an integrated report is to explain the firm’s value creation to providers of financial capital, and hence, ‘value’ has to be interpreted according to their interests. Paragraph 2.5 makes clear that the providers of financial capital are primarily interested in the value that an organization creates for itself. They are interested in the value that an organization creates for others in only two circumstances:

- (a) when this affects the ability of the organization to create value for itself;
- (b) when the creation of value for others is a stated objective of the organization.

Condition (a) is further expounded in the Framework’s paragraphs 2.6 to 2.8, which state:

*The ability of an organization to create value for itself is linked to the value that it creates for others . . . this happens through a wide range of activities, interactions and relationships . . . for example, the effects of the organization's business activities on customer satisfaction, suppliers' willingness to trade with the organization . . . When these interactions, activities and relationships are material to the organization's ability to create value for itself, they are included in the integrated report.*

These paragraphs make clear that the IIRC considers that the integrated report should cover 'value for others' only to the extent that this is '*material to the organization's ability to create value for itself*'. Moreover, the reference to the information needs of providers of financial capital reinforces the suspicion that 'value for itself' should be interpreted as 'value for investors'.

Since condition 2(b) above applies to few organizations other than charities, one may confidently conclude that, when the Framework refers to 'value', this should be interpreted as 'value for the firm' and, more precisely, as 'value for investors', given that the primary purpose of the integrated report is to explain value creation to the providers of financial capital. The Framework accepts that providers of capital are principally interested in the monetary benefits that they can expect from the firm (in the form of dividends and other returns on capital), referring in paragraph 2.4 specifically to '*financial returns to the providers of financial capital*'. Hence, it is reasonable to presume that the investors' principal interest in other capitals is in enabling them to make a better estimate of future cash flows, 'better' in the sense that it is likely to be more accurate in that it takes into account such factors as the quality of the workforce, possible future material shortages and customer relations. Essentially, the values of other capitals are assessed solely on their contribution to the firm's profit-making activities. From the firm's viewpoint, other capitals have value only insofar as they contribute to the firm's value.

#### **4.2. Investors Versus Stakeholders**

When there is a conflict between meeting the information needs of investors and those of other stakeholders, the IIRC comes down unequivocally in favour of reporting for investors. This is abundantly clear from the Framework's most important paragraph:

*1.7 The primary purpose of an integrated report is to explain to providers of financial capital how an organization creates value over time.*

I consider that the Framework adopts an instrumental view of stakeholders other than investors—it may be rational to treat them fairly, as this will lead to higher profits in the longer run.<sup>12</sup> Bearing in mind that the IIRC's

concept of ‘value’ is ‘value for investors’, the instrumental view is the rationale behind the following extract from paragraph 3.11:

[The Framework] *reflects the importance of the relationship with key stakeholders because . . . value is not created by or within an organization alone, but is created through relationships with others.*

Initially, the IIRC gave the impression that it favoured a normative approach to reporting on stakeholders. The Discussion Paper includes, as a guiding principle, ‘*Responsiveness and stakeholder inclusiveness*’. The word ‘*inclusiveness*’ suggests that the IIRC accepted the principle that stakeholders were part of the coalition that made up the firm—an essential feature of normative stakeholder theory. However, two years later, in the Consultation Draft, the principle had become ‘*Stakeholder responsiveness*’, and finally, in the Framework, ‘*Stakeholder relationships*’, a neutral term which is fully consistent with instrumental stakeholder theory.

In the Framework, the IIRC recognizes the existence of stakeholders other than investors and seeks to give the impression that it takes into account their needs. But it is abundantly clear that the IIRC takes an instrumental view of stakeholders—that, for investors, the relevance of other stakeholders is that the firm’s prosperity depends, in part, on their continued cooperation; hence, it is important that the firm should treat stakeholders properly because this will result in higher profits for investors. Thus, the IIRC states: ‘*value is not created by or within an organization alone, but is created through relationships with others*’.<sup>13</sup> As already noted, in determining the content of the integrated report, priority is given to serving the information needs of capital providers. The IIRC claims that the information will be of benefit to other stakeholders, as they, in common with capital providers, are interested in the organization’s ability to create value.<sup>14</sup> But there is no obligation on firms to consult with stakeholders on the content of the integrated report (as the GRI requires with respect to its report). The Framework’s principal references to stakeholders are in the following texts: ‘*an integrated report contains qualitative and quantitative information that may [emphasis added] include matters such as . . . the state of key stakeholder relationships and how the organization has responded to key stakeholders’ legitimate needs and interests*’<sup>15</sup> but ‘*it does not mean that an integrated report should attempt to satisfy the information needs of all stakeholders*’.<sup>16</sup> The reader is left with the strong impression that the IIRC pays lip service to the need to consider the interests of other stakeholders but its primary interest is the needs of investors. This impression is confirmed by the results of an investigation by two New Zealand researchers who examined the integrated reports issued in 2011 and 2012 by a small sample (58) of companies. Presumably, the reports were based on the IIRC’s 2011 Discussion Paper. They found that only a third of the companies reported on relationships with stakeholders and commented on ‘*the generally low level of responsiveness to stakeholder*

*inclusiveness, suggesting that the reports (and indeed business operations) are still only focused primarily on the shareholder group's needs*'.<sup>17</sup>

The Framework is fundamentally investor oriented; it unashamedly accepts the creed of 'shareholder value'.

#### 4.3. Comprehensive Reporting of Capitals

The IIRC's concept of different capitals, if applied appropriately, would certainly facilitate the reporting of the firm's impact on society and the environment and hence on sustainability. This seems to have been the IIRC's original intention, as set out in its 2011 Discussion Paper, which states that *'The IIRC seeks . . . to achieve a reporting framework that . . . reflects the use of and effect on all the resources and relationships or "capitals" . . . on which the organization and society depend for prosperity . . . and reflects and communicates the interdependencies between the success of the organization and the value it creates for investors, employees, customers, and, more broadly society*'.<sup>18</sup> (emphasis added). However, for the integrated report to cover sustainability, it is essential that the firm should report on **all** the capitals that are affected by its activities, including the capital of society. The Framework's provisions in respect of certain specific categories of capital are now considered.

*Manufactured capital:* The Framework describes manufactured capital as *'manufactured physical objects . . . that are available to an organization for use in the production of goods or the provision of services, including buildings, equipment, infrastructure (such as roads, ports, bridges, and waste and water treatment plants)*'.<sup>19</sup>

It is clear that manufactured capital includes objects that are not owned by the firm (such as public roads), but only to the extent that they are inputs to the firm's production process. Objects that are not inputs to the firm's production process are excluded; examples of such objects are hospitals and schools. Thus, when these objects are damaged as a result of the firm's operations (say, from pollution emanating from the firm), such damage is not reported in the firm's integrated report. Essentially, external objects are only reported on if they provide value to the firm.

*Human capital:* The Framework describes human capital as *'people's competencies, capabilities and experience, and their motivation to innovate including their alignment and support for an organization's governance framework, risk management approach, and ethical values, ability to understand and implement an organization's strategy, loyalties and motivations for improving processes, goods and services*'.<sup>20</sup>

As with manufactured capital, human capital is viewed exclusively from the firm's viewpoint. From the firm's viewpoint, they have no intrinsic value:

their value depends exclusively on the contribution that they make to the firm's success. This is a very narrow definition of human capital. It excludes persons who are not inputs to the firm's business model. Consider the example of people living in the local community who are killed by poisonous gases released by the firm. This is a clear example of a decrease in human capital. But, according to the IIRC, this decrease would be reported by the firm only if it had an impact on its future profitability: for example, if the people killed were its own employees, if the firm suffered such damage to its reputation that future sales were affected or if the firm incurred costs in paying compensation or fines. Of course, most firms would feel obliged to cover such a grave event in their reports because of their need to limit and manage the reputational damage that they would undoubtedly suffer. But this would be reporting for the wrong reason—to limit the damage to future profitability and not because the planet has suffered a loss of human capital. If it proved possible to suppress knowledge of the loss of life or of the firm's culpability, then, according to the IIRC's Framework, there would be no obligation for the firm to report the event.

*Natural capital:* The Framework describes natural capital as '*all renewable and non-renewable environmental resources and processes that provide goods or services that support the past, current or future prosperity of an organization. It includes air, water, land, minerals and forests, bio-diversity and eco-system health*'.<sup>21</sup> The important phrase in this description is '*prosperity of an organization*'; there is no reference to the prosperity of society as originally envisaged by the IIRC in its 2011 Discussion Paper.

The Integrated Report covers natural capital only to the extent that it is an input to the firm's production process. It does not cover the firm's impact on the broader environment. For example, a firm emits large quantities of greenhouse gases which lead to climate change with a catastrophic impact on the environment, such as the rise in the sea level that inundates many islands. The disappearance of these islands is clearly a loss of natural capital, but the IIRC does not require that it be reported. It would only be reported if the firm depended on these islands, say, for the supply of raw materials.

The fundamental point is that IIRC accepts that the Integrated Report should cover the impact of other capitals on the firm but ignores the firm's impact on these capitals, except to the extent that this impact rebounds on the firm—for example, when the people killed by the firm's release of poisonous gases include the firm's employees.

The IIRC does accept that a firm may have a wider stewardship responsibility in relation to those elements of capitals that are not inputs to its productive processes. Where such a responsibility is imposed by law, then clearly, the firm should report. The Framework states that '*when there is no legal stewardship responsibility, the organization may have an ethical*

*responsibility to accept or choose to accept stewardship responsibilities*<sup>22</sup> (emphasis added). The significant word is ‘may’; there is no obligation to report.

In my opinion, the above analysis makes it abundantly clear that the IIRC requires a firm to report on the effect on its activities on society and on the environment *only* to the extent that there is a material impact on its own operations.

In fact, the Framework acknowledges that there is no requirement for a firm to report comprehensively on its capitals. It states: ‘*This Framework does not requires an integrated report to provide an exhaustive account of all the complex interdependencies between the capitals such that an organization’s net impact on the global stock of capitals could be tallied*’.<sup>23</sup>

However, the IIRC is aware of the importance of firms adopting a wider concept of capital than has conventionally been the case. It considers that a firm should report on capitals that it uses even if they are not owned or controlled by the firm—in flat contradiction of the IASB’s definition of an asset. In general, the firm is obliged to report on capitals that are inputs to its production process (such as public roads), since the firm’s profitability will generally be affected by the condition of these capitals. But it will often be the case that a firm’s activities have a negative impact on other capitals but no significant impact on the firm’s long-term profitability. In such a case, according to the Framework, there is no requirement to report this negative impact. This conclusion is based on the interpretation of ‘value’ as ‘value for investors’; if the IIRC had adopted a wider concept of value, such as ‘value for society’, then it would have been necessary for the firm to report on its impact of its activities on all capitals, irrespective of the impact on its profitability.

#### 4.4. Trade-Offs Between Capitals

IIRC accepts that it is appropriate to trade-off a decrease in the value of one category of capital against an increase in another category. For example, the Framework states that ‘*an integrated report . . . may also include a discussion of the nature and magnitude of the significant trade-offs that influence the selection of inputs*’.<sup>24</sup> All trade-offs are problematic in view of the difficulty of measuring the different capitals in consistent and comparable ways. But trade-offs involving natural capital are surely highly unlikely to be in the interests of society as a whole.

The question of whether an increase in one form of capital may compensate for a decline in another form is one of the most hotly disputed topics in the theory of sustainability. This is dealt with later in this chapter in the section 5.2 headed ‘*Weak sustainability versus Strong Sustainability*’. The Framework ignores the debate between the advocates of the different degrees of sustainability. It simply accepts that firms will make trade-offs. The Framework states that integrated report should disclose

*‘the important trade-offs that influence value creation’, giving as an example ‘creating employment through an activity that negatively affects the environment’.*<sup>25</sup>

I feel that this quotation gives the game away. The IIRC has developed the concept of different capitals as a means of enabling firms to justify damaging the environment. Such damage may be justified by an increase in another category of capital, including financial capital.

#### **4.5. *The Abandoning of Sustainability***

The previous four sections have clearly demonstrated that the three conditions for the IIRC’s reporting of capitals to lead to the reporting of sustainability have not been met. In particular, the IIRC does not require that firms report on the full impact of their activities on society and the environment. It is evident that the IIRC has abandoned the goal of comprehensive sustainability reporting. The Framework’s references to a separate sustainability report suggest that it has assigned this task to other organizations, such as GRI.

#### **4.6. *The Paradox of the IIRC’s Failure and Its Simultaneous Success***

In my opinion, the IIRC has failed to achieve the objectives that its founders, the GRI and A4S, set for it. In particular, it has failed comprehensively in respect of two objectives: the realization of the single report and the development of an effective model of sustainability reporting.

Yet, paradoxically, the IIRC has had considerable success, for, as demonstrated in the next section, very many enterprises around the world currently issue so-called ‘integrated reports’ based on the IIRC’s Framework.

### **5. The Current (Lamentable) State of Sustainability Reporting**

Throughout the world, large MNEs issue conventional financial statements based on the IASB’s standards. But they also supplement these accounts with reports providing information on social and environmental matters. The IIRC’s Framework (often in combination with the GRI Guidelines and Standards) has become the dominant model for these supplementary reports. This is clear from the IIRC’s website, which lists hundreds of companies from around the world that issue integrated reports based on its Framework, including such well-known names as (in alphabetical order) Asahi Group, Astra Zeneca, BHP Billiton, BP, Coca Cola, Diageo, Eni, General Electric, Hyundai, ING, Lloyds Bank, Marks & Spencer, Nestlé, Novo Nordisk, Omron Corporation, Rio Tinto, SAP, Tata Steel, Unilever, Vodafone and the World Bank.

The principal exception to this general practice is the USA, where the conventional financial statements are based on the US GAAP, and the supplementary reports are based on the standards of the SASB (Sustainability Accounting Standards Board). But the SASB does not represent a rival to the IIRC for two reasons: its standards are directed solely at companies listed on an American stock exchange, and its approach is essentially similar to the IIRC's.

Personally, I do not celebrate this wide adoption of integrated reporting, for I consider that the integrated reports, as defined in the IIRC's Framework, suffer from a number of deficiencies that are so serious as to render them a thoroughly inadequate account of sustainability.

### *5.1. Inadequate Reporting of Damage to the Environment and to Society*

The gravest deficiency in the IIRC's integrated report is its failure to report comprehensively on the damage that the firm's activities have inflicted on the environment and on society. This failure has been comprehensively analysed in previous sections. It is abundantly clear that the integrated report covers only half of the relationship between the firm and the context in which it operates: both the natural environment and the wider society. It covers the impact of these factors on the firm but not the impact of the firm on these factors—the integrated report tells only half of the story and, regrettably, the less important half.

### *5.2. Weak Sustainability versus Strong Sustainability*

The IIRC Framework makes no reference to the ongoing controversy over the nature of sustainability, notably in respect of two aspects:

- The importance of preserving the natural world (animals and vegetation, mineral deposits and so on), and
- The extent to which man-made capital (such as the IIRC's manufactured capital) is an acceptable substitute for natural capital.

The two aspects are closely related. A person who places great value on nature is unlikely to regard a plastic tree as an acceptable substitute for the real thing. One can conceive of different degrees of sustainability depending on the weight placed on these two matters.

*Very strong sustainability:* The proponents of very strong sustainability hold that no substitution of man-made capital for natural capital should be permitted. Sustainability has been achieved only if the natural world is handed over to the next generation in exactly its present state. For example, there should be no reduction in the quantities

of natural resources, such as reserves of fossil fuels. It is generally accepted that very strong sustainability is incompatible with the maintenance of human life on earth—at least, as presently practised—for example, no extraction or consumption of raw materials, such as fossil fuels, would be permitted. The fundamental principle of very strong sustainability is that the preservation of nature should have precedence over the welfare of mankind. For this reason, it was castigated by the Oxford economist Wilfred Beckerman as ‘morally repugnant’.<sup>26</sup>

Also, the whole concept seems incoherent. Over the history of this planet, there have been continuous changes in the patterns of nature without any interference from man: species of animals have become extinct, forests and deserts have expanded or contracted, glaciers advanced and retreated. Therefore, it would seem to be impossible to hand over to the next generation the earth in *exactly* the same state as this generation received it. Hence, very strong sustainability is little more than a theoretical curiosity of no practical relevance.

*Strong sustainability:* Strong sustainability is favoured by those who give precedence to mankind’s welfare over nature, but who also seek to preserve the natural world to the greatest extent that is practically possible.<sup>27</sup> It allows a certain degree of substitution. In particular, reserves of natural resources, such as oil, may be consumed, provided that they are replaced by man-made capital that provides the same level of service to the next generation. Assume that the next generation is principally interested in the benefit provided by the oil, say, the generation of electricity. The next generation can be compensated for the loss of the oil used by the current generation by being provided with wind turbines that generate the same amount of electricity. This is a substitution of man-made capital for natural capital that, theoretically at least, seems to not disadvantage future generations. Personally, I am not convinced. How do we know that future generations are more interested in having electricity on tap than in having a landscape that is not disfigured by wind turbines? This question illustrates the problems involved in deciding what should be preserved for future generations. I feel that the only practical solution is to assume that future generations have the same preferences as the present generation. But strong sustainability, although perhaps difficult to realise, is a straightforward concept—the emphasis is placed not on the inviolability of nature (which underlies very strong sustainability), but on the need not to disadvantage future generations.

*Weak sustainability:* As the term implies, weak sustainability does not require that nature be preserved. The emphasis is put on assuring the welfare of mankind (both the present and future generations). There is an assumption of considerable substitutability between man-made

capital and natural capital. Over the centuries, the quality of life of the human race has been enhanced by the growth of man-made capital (from ploughs to computers), and there is no reason to doubt that this trend will continue into the future. But, it is widely accepted that certain elements of natural capital cannot be replaced by man-made capital. Andrew Dobson refers to ‘critical natural capital’ where ‘critical is to be understood primarily in terms of critical to the maintenance and reproduction of human life’.<sup>28</sup> Here the emphasis is on the survival of the human race: sustainability measured in terms of survivability. Survivability is the weakest variant of sustainability—it places only weak restrictions on the behaviour of the present generation. But the threat posed by global warming to the human race’s survival suggests that currently even survivability is not being assured. Weaker interpretations of the word ‘critical’ are possible: for example, critical for ensuring that future generations enjoy the same quality of life as the present generation.

Hence, ‘weak sustainability’ can refer to a wide spectrum of possible outcomes. This is true of the whole spectrum from very strong sustainability at one extreme to survivability at the other. The IIRC, in developing its Framework, seems to have been completely unaware of the controversy about whether man-made capital is an acceptable substitute for natural capital. It simply accepts that trade-offs between capitals will occur and that they should be reported. It therefore offers tacit support to the premise that man-made capital is an acceptable substitute for natural capital.

### 5.3. *The Sustainability of the Firm versus the Sustainability of the Planet*

In much of current sustainability reporting by business firms, there is confusion about *what* is being sustained. Two very different interpretations of the term ‘sustainability’ are possible: sustainability of the business (the business will continue to exist and flourish in the future) and sustainability of life on the planet. There is much evidence that many firms interpret ‘sustainability’ as ‘sustainability of the business’. For example, Vodafone’s 2012 integrated report states: ‘*Building trust, respect and credibility among our stakeholders, and including them in how we manage our business, is vital to our sustainability*’. The vital word is ‘our’. Vodafone is only interested in whether it survives. This seems to be the IIRC’s position. Mervyn King, at one time the IIRC’s chairman, has claimed of integrated reporting that it ‘*equips companies to . . . be better prepared to manage any risks that may compromise the long-term sustainability of the business*’.<sup>29</sup> The IIRC’s emphasis on the sustainability of the business is confirmed by the stress that it places on ‘value for the investor’, as demonstrated in section 4.1 above.

The IIRC would probably claim that its proposals will lead to firms giving more attention to questions of sustainability than is presently the case. For example, according to the IIRC, firms should consider the impact of its activities on the stocks of natural capital that are inputs to its operations, particularly in the longer run. In doing so, firms may come to appreciate better the danger of future shortages of raw materials and hence adopt a more sustainable method of operating. Firms, in acting so as to assure their own sustainability, are making some contribution to overall sustainability.

But the sustainability of the firm and the sustainability of society and of the planet are not identical, and, in assuring the former, there is no guarantee of achieving the latter. This occurs because of the discrepancy between private costs and social costs, which can lead the firm, in pursuit of profit, to act in ways that are damaging to both the environment and society,

#### *5.4. Private Costs Versus Social Costs*

The private costs of the business firm are the costs that are reflected in falls in the value of its assets or increases in the value of its liabilities. An example of a private cost is a wage paid to an employee, which causes a fall in the firm's asset, cash. But the firm, through its activities, also causes social costs, which are losses borne by people outside the firm but which are not reflected in a fall in value of the firm's net assets. Examples would be damage to other people's property from smoke emitted from the firm's plant or harm suffered by an individual from consuming the firm's products. The damage and harm are the private costs of the individuals concerned but not of the firm that caused them. From the viewpoint of society as a whole (the combination of the firm and the individuals) a cost has occurred—hence the term 'social cost'.

An alternative term for social costs is 'externalities'—they are costs external to the firm. They are a major problem in economic theory, as they seem to represent a challenge to the theory that capitalism leads to the optimal allocation of resources. Ronald Coase proved that the optimal allocation of resources would be achieved by means of private contracts between the parties involved.<sup>30</sup> But, for private contracts to be an effective solution to the problem of social costs requires that: firstly, the number of parties is limited, secondly, all parties have perfect information, thirdly, all parties are rational and fourthly, there are no transaction costs. The sheer impracticality of fulfilling all these conditions makes Coase's solution of only academic interest, albeit sufficient to earn him a Nobel Prize. Thus, other solutions must be found to the problem of social cost.

The IASB recognizes only private costs;<sup>31</sup> hence, the conventional financial statements fail to give an accurate picture of the impact of the firm's activities on the wider world. This deficiency in conventional accountancy is widely recognized, and the need to tackle it was a major factor in the creation

of the IIRC. But the IIRC has failed completely in finding a solution. Its Framework mentions externalities in the following terms:

*Externalities may ultimately increase or decrease value created for the organization; therefore providers of financial capital need information about material externalities to assess their effects and allocate resources accordingly.*

(paragraph 2.8, emphasis added)

I have emphasised two points in this extract. Firstly, the IIRC's integrated report is concerned with externalities only to the extent that they affect value for the firm—that, in the longer run, they become private costs. Secondly, information on externalities is provided solely for the benefit of providers of financial capital—only the impact of the firm's activities on the capitalists' wealth is relevant, not the harm suffered by others. The reporting of externalities in the IIRC's integrated report is essentially non-existent.

### 5.5. Neglect of Stakeholders

As already explained in section 4.2, the IIRC takes an instrumental view of relations with stakeholders. Relations with stakeholders should be managed so as to maximize the firm's value. The IIRC is interested only in the firm's primary stakeholders—those with whom the firm's management has dealings and who can directly influence the level of the firm's profit (or, to use the IIRC's term, the value created for the organization). It completely ignores secondary stakeholders. As explained in chapter 4, this wider group of stakeholders covers all those whose welfare is affected by the firm's activities and who have a legitimate claim on the firm. They include all those who may experience actual benefit or harm (or may anticipate such benefit or harm) from the firm's actions or inactions.<sup>32</sup> Examples of such stakeholders are:

- i. The local community in which the firm is located. The welfare of many local inhabitants is strongly dependent on the firm's actions: for example, local shopkeepers are secondary stakeholders because their business would be severely affected if the firm were to dismiss a large number of its employees.
- ii. Persons who are affected by pollution emanating from the firm. In the case of noise pollution, this will include the local community, but in the case of air and water pollution, it can include people on the other side of the globe.
- iii. Persons who have only indirect dealings with the firm. For example, a supplier of components is a primary stakeholder of the firm. The supplier of raw materials to the component manufacturer is a primary stakeholder of that firm and a secondary stakeholder of the firm to which the component manufacturer sells. If the firm were to collapse

or drastically reduce its production, the welfare of this secondary stakeholder would be harmed.

It is evident from this analysis that the welfare of secondary stakeholders may be strongly affected by the firm's operations—generally to their disadvantage. It is greatly to be regretted that the IIRC ignores them. This reflects the emphasis that the IIRC places on reporting for the benefit of capitalists (capital providers).

### 5.6. *Regulatory Capture*

In my opinion, the IIRC's Framework does not require business firms to provide a full account of their (often negative) impacts on the environment and on society. In fact, the Framework places very few onerous reporting requirements on the business firm.<sup>33</sup> I believe that the reason for this very accommodating attitude is that the IIRC has been captured by business interests.

As shown in Table 7.2, ten of the 12 members of the IIRC's Board have a background in business management, accountancy or securities regulation.

*Table 7.2* Composition of the IIRC Board

<i>Name</i>	<i>Position</i>	<i>Country</i>	<i>Background</i>
Barry Melancon	Chairman	USA	President and CEO, AICPA
Peter Bakker	Deputy Chair	NL	Former CEO of TNT
Jane Diplock	Deputy Chair	Australia	Director, Singapore Exchange; former Chair IOSCO
Richard Howitt	CEO IIRC	UK	Labour politician; former Member of the European Parliament
Helen Brand		UK	Chief executive ACCA
A. Broedel-Lopes		Brazil	Finance Director, Itaú Unibanco; former Commissioner of the Brazilian SEC
Louise Davidson		Australia	CEO, Australian Council of Superannuation Investors
Timothy Flynn		USA	Director JPMorgan; Chase; & Walmart; former Chair of KPMG
Reuel Khoza		South Africa	President of the Institute of Directors in Southern Africa; Chair of Aka Capital
Izumi Kobayashi		Japan	Vice-Chair, Japan Association of Corporate Executives
David Nussbaum		UK	Former Chief Executive, WWF-UK; Chartered Accountant
U.K. Sinha		India	Chair, Securities & Exchange Board of India

There are no representatives of employees or consumers. Conspicuously absent are NGOs that actively seek to protect the environment, such as Greenpeace, or academics who have adopted a critical attitude towards the destruction of the environment by business, such as Rob Gray of CSEAR (the Centre for Social and Environmental Accounting Research). Rob Gray knows more about accounting for the environment than anyone else on the planet. Why is he not on the IIRC's Board? The answer is obvious. He would articulate the case for the protection of the environment in a way that would embarrass businessmen. The sole member of the Board with a background in the environmental movement is David Nussbaum. He has had a very varied career. He qualified as a Chartered Accountant and worked for 15 years in business before becoming the Finance Director of Oxfam in 1997. Since then, he has worked for a number of charities including Transparency International and WWF-UK. I feel (perhaps unfairly) that David Nussbaum, given his background in business, is likely to take a business-friendly approach to the obligations to be required of firms, and, even if I am wrong in this supposition, he would be outnumbered ten to one by the other members of the Board.<sup>34</sup>

### 5.7. *The Anomalous Concept of Financial Capital*

Further proof that the IIRC adopts an accommodating attitude towards business is provided by its action in including financial capital as one of its six capitals—in my opinion, wrongly. As Chris Nobes<sup>35</sup> has pointed out, the concept of 'capital' is ambiguous: sometimes it refers to an asset, as in 'capital gains tax', where the word 'capital' refers to an asset that has increased in value, and sometimes it refers to the opposite of an asset—a source of funds, as in 'share capital'. Nobes considers that, because of this ambiguity, the term 'financial capital' in the IIRC's Framework is incoherent. It can be interpreted as referring to three quite different concepts:

- The total capital provided by equity holders;
- The firm's total assets;
- The firm's financial assets (cash, debtors etc.) which are not reported under any other category of capital (manufactured capital etc.)

The first concept can be ruled out as it would make 'financial capital' the opposite of the other five capitals, which are all assets.

The second concept can be ruled out, because it would involve double counting of the assets reported under manufactured capital, intellectual capital and so on.

The third concept can be ruled out because it would be in contradiction with the rest of the Framework—for example, it would be nonsense to hold that the 'providers of financial capital' mentioned in paragraph 1.7 provide only the funds for financial assets and not for machines and other

non-financial assets. Furthermore, a firm's financial assets are not a component of global capital. All financial assets are claims against other persons and firms,<sup>36</sup> with the consequence that, from the viewpoint of society, their net value is nil.

According to this analysis, the IIRC has included in the Framework a category of capital that is incoherent. Why did the IIRC do this? I feel that the IIRC's action can be attributed to the importance that the IIRC attached to the need that its proposals should be accepted and implemented by business firms. This is very clear from a note by Paul Druckman, the IIRC's then Chief Executive, posted on the IIRC's website.<sup>37</sup> The following extracts from the note give a good impression of its overall message:

*A key aspect of our culture is that we have always been market-led. So as we created the Framework it was the 100+ businesses and 30 institutional investors who provided detailed input, rigour and critique to the whole process. As a result of the experimentation and innovation of our pioneers—businesses like Tata, Unilever and Nestlé—we created the conditions for market acceptance. I wanted to apply the same market-led rigour to the IIRC as a team. It surprised some of those I brought into the IIRC when I told them that we were creating an organization that could easily be dismantled if there was an allergic reaction in the market to what we were offering . . . If the market did not want Integrated Reporting, we would not have pursued our mission.*

The above extract makes abundantly clear that the IIRC's Framework was deliberately designed to appeal to the 'market'. For Paul Druckman, the 'market' was 100+ businesses and 30 institutional investors. At that time (as is still the case today), the management of business firms were obsessed with the need to deliver 'shareholder value'—to maximize (or at least to give the impression of maximizing) the return to shareholders. That would be the preoccupation of the management of the '100+ businesses' who contributed to the development of the Framework's text. It would also be the principal concern of the '30 institutional investors'. The overriding influence of these parties is clear in the wording of what is arguably the Framework's most important paragraph:

*Paragraph 1.7: The primary purpose of an integrated report is to explain to providers of financial capital how an organization creates value over time.*

The providers of financial capital had to be assured that, in the Framework, their interests were taken fully into account. This was achieved by including financial capital alongside the other five capitals as an element that should

be considered in assessing the firm's position and performance. The implicit message is: integrated reporting is completely consistent with the need for the firm's management to maximize the return to providers of financial capital. I contend that this was achieved at the expense of the making the Framework's text incoherent.

### 5.8. *The Business Case*

The IIRC advocates the 'business case' for sustainability reporting. The essence of the business case is that sustainability reporting helps the firm to earn higher profits in the long run. It is in the firm's long-term interest that it consider such matters as the morale of its workforce, possible future shortages of raw materials and its reputation with its customers—all matters largely ignored by conventional financial reporting. Strong evidence of the IIRC's attachment to the business case is provided by the wording of a press release that the IIRC issued on the publication of its Framework.<sup>38</sup> The emphasis in the press release is on the needs of investors. It claims that integrated reporting '*improves the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital*'. It mentions a host of multinational enterprises that already apply integrated reporting and states, '*[W]e will use the Framework, together with evidence of the business and investor case, to reach out to a wider pool of businesses*'. The whole tone of the press release is that the IIRC is business and investor friendly and is not proposing anything that these parties would find unacceptable. The IIRC's approach may be neatly summarised in the following quotation from the IIRC's 2011 Discussion Paper: '*Integrated reporting has brought with it a broad range of business benefits, ranging from richer access to capital markets and identification of cost savings to an increase in employee engagement*'.<sup>39</sup>

An eloquent advocate of the business case is Michael Porter, the Harvard Business School professor. In an influential article,<sup>40</sup> he argues the case for 'shared value'—that the firm should create value for society at the same time as it creates value for itself. He cites numerous examples of firms that have achieved this: Johnson & Johnson saved \$250 million by investing in employee wellness programmes that led to improved employee health and productivity, and reduced employee absenteeism; Yara, the world's largest mineral fertiliser company, spent \$60 million on improving public roads and ports in East Africa, which helped grow Yara's business but also greatly helped the local economy; Walmart saved \$200 million by economising on packaging and cutting 100 million miles from its delivery routes. Undoubtedly, Porter has a case that, for the socially and environmentally conscious firm, there are numerous opportunities to combine value for itself with value for society.

But I contend that there are also many occasions in which the two values are in conflict. There are two principal defects of the IIRC's approach:

- It provides that the business firm should report on the impact of the environment on the firm but ignores the impact of the firm on the environment. In effect, the IIRC covers only half of environmental reporting, and the less important half.
- It treats stakeholders (other than providers of capital) as merely instruments to be manipulated in the search for the highest profit. The IIRC hopes that in general, higher profits are achieved by treating stakeholders fairly, but there is no guarantee of this happening.

Robert Eccles, a member of the IIRC's Council, presents an interesting defence of the business case.<sup>41</sup> He points out that business reporting practice develops as a result of two forces acting on the firm: the market and the state (through regulation). In the case of financial reporting, initially, the market was the predominant force. In 1926, over 90% of companies listed on the New York Stock Exchange issued audited financial statements despite the absence of a law requiring them to do so. Initially, the state was reluctant to compel companies to act, one reason being that firms naturally opposed regulations that imposed additional burdens on them. But, after the practice of financial reporting had become widely established, the state did finally intervene to regulate it—through the Securities and Exchange Act of 1934. There would appear to be two reasons why this happened: firstly, it is easier for the state to regulate a practice that already exists—it is far more difficult for the state to create a practice from scratch; secondly, with an established practice, the faults and deficiencies finally become evident, as happened with financial reporting in the crash of 1929.

Applying this reasoning to sustainability reporting, it is extremely unlikely that the state would impose detailed reporting obligations on business in the face of opposition from business and the lack of accepted practice. But, in the absence of state regulation, practice can only develop through the voluntary actions of firms. Hence, the need to persuade firms that sustainability reporting is in their own interest. Eccles's argument is persuasive. Hence, one can expect effective state regulation to occur only when the deficiencies of the IIRC's model become obvious to everyone. One can only hope, for the sake of future generations, that this is sooner rather than later.

### *5.9. My Judgement*

I judge that the IIRC has been captured by business interests. In the Framework (as opposed to earlier documents) it has not proposed anything that would embarrass business firms, for example, requiring them to report fully on the damage that they are inflicting on the environment. In my opinion, the reason why so many business firms issue sustainability reports based

on the IIRC's Framework is that it offers them the opportunity of giving the impression that they are serious about sustainability, without revealing anything about the true impact of their activities on sustainability. This enables business firms to continue to harm the environment whilst giving the impression that they are sustainable. This contradiction is possible because the IIRC's concept of sustainability is the sustainability of the firm and not the sustainability of the planet. There is no doubt that it is in the interests of the individual firm to take into account many matters external to the firm, notably in relation to the state of the environment and society—such as the reliability of future supplies of raw materials, the need to anticipate future threats arising from climate change, the desirability of having good relations with the local community and so on. In stimulating business firms to consider such matters, the IIRC has made a significant contribution to the continued survival of the individual capitalist firm and hence to the survival of capitalism. I consider the IIRC's proposals to be an extremely clever way of enabling capitalist firms to carry on 'business as usual'—that is, to continue their present operations with only minimal changes in their mode of operations—essentially, only changes that are in their own individual long term interests. But this does not alter the incontrovertible fact that the present mode of operation of the global capitalist economic system is unsustainable. In the longer run, the system will collapse under the combined impact of the unsustainable operations of the totality of capitalist firms, which, in their sustainability reports, have been deceiving both themselves and the general public into believing that they have been operated in a sustainable fashion.

## 6. Conclusion

In the last two chapters I have analysed two initiatives (GRI and the IIRC) that have sought to reform accountancy so that it can better serve the welfare of mankind. I judge that both have failed to achieve this objective, with the IIRC's failure more egregious than that of GRI. Where does this leave the project of reforming accountancy so that it genuinely serves mankind and not just an elite group of capitalists? That is the subject of the next (final) chapter.

## Notes

- 1 A4S stands for 'Accounting for Sustainability', a body set up by the Prince of Wales to promote sustainability reporting.
- 2 See the press release 'Formation of the International Integrated Accounting Committee' available on the IIRC's website at [www.theiirc.org/22010/08/02](http://www.theiirc.org/22010/08/02).
- 3 IIRC (2011, p. 4).
- 4 IIRC (2011, p. 6).
- 5 See Eccles and Krzus (2010).
- 6 IIRC (2011).

- 7 IIRC (2013a).  
 8 IIRC (2013b).  
 9 Framework, paragraph 1.1  
 10 IIRC (2011, p. 11).  
 11 Framework, paragraphs 1.13 and 4.48  
 12 For a discussion of instrumental stakeholder theory versus normative stakeholder theory, see chapter 4, section 5.3.  
 13 Framework, paragraph 3.11.  
 14 Framework, paragraph 1.8.  
 15 Framework, paragraph 4.31.  
 16 Framework, paragraph 3.11.  
 17 Wild and van Staden (2013).  
 18 Discussion Paper, page 5.  
 19 Framework, paragraph 2.15.  
 20 Framework, paragraph 2.15.  
 21 Framework, paragraph 2.15.  
 22 Framework, paragraph 3.16.  
 23 Framework, paragraph 4.56.  
 24 Framework, paragraph 4.16.  
 25 Framework, paragraph 4.56.  
 26 Beckerman (1994).  
 27 The concept of strong sustainability that is presented here is that advocated by Herman Daly (1995).  
 28 Dobson (1998, p. 45).  
 29 2010 press release, see endnote 2.  
 30 See Coase (1960).  
 31 See chapter 2, section 3.3.  
 32 See Donaldson and Preston (1995, p. 85).  
 33 For an analysis of the Framework's failure to require business firms to report what they do not want to report, see Flower (2015, section 4.3).  
 34 During his tenure as Chief Executive of WWF-UK, David Nussbaum acted more like the head of a large business than a militant protector of the environment. During his last year as Chief Executive, he received a salary of £140,000 for managing a business with income of £71 million, assets of £32 million and a staff of 332. Source: the annual report of WWF-UK available on its website.  
 35 Nobes (2015).  
 36 Cash (notes and coins) may be considered to a claim against the Bank of England and hence is a claim against 'other persons or firms'.  
 37 'From narrow choices to balanced decisions' available on <http://integratedreporting.org>.  
 38 See the press release available on the IIRC's website: [www.theiirc.org/2013/04/16](http://www.theiirc.org/2013/04/16).  
 39 IIRC(2011, p. 20).  
 40 See Porter and Kramer (2011).  
 41 See Eccles and Krzus (2014, pp. 286–287).

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# 8 Conclusions

## 1. The Argument So Far

In chapter 1, I analyse the crises that currently confront mankind. These may be classified under three headings:

- The harm inflicted on the environment;
- The potential harm inflicted on future generations;
- The harm inflicted on the current generation, of which two aspects are emphasised: the corrosive impact of inequality and the ill effects of financialization.

The principal cause of these crises is held to be the widespread adoption in Britain and other countries of neo-liberal policies, both by the state and by the management of business firms.

In chapters 2 and 3, I demonstrate that accountancy, as currently practised, facilitates and supports neo-liberalism—it is capitalism’s ‘handmaiden’, as demonstrated by the IASB’s standards and by the practice of the accountancy profession.

In chapter 4, I concede that capitalism is ‘*the only game in town*’ and that capitalism should not be replaced by a radically alternative economic system (such as central planning) but should be reformed. I propose the stakeholder theory of the firm as the basis of such a reform.

In chapter 5, I discuss the implications for accountancy of adopting the stakeholder theory of the firm—that the firm should change its objective from reporting to a limited group of capitalists to reporting to the wider group of stakeholders. The business firm has a moral obligation (founded on social contract theory) to render account to all affected by its activities. I conclude that stakeholder reporting would make a significant contribution towards tackling certain of the ills suffered by the current generation, notably those stemming from the adoption by business firms of the shareholder value imperative, which leads to inequality and financialization. This is because ‘information is power’. When the business firm reports comprehensively the extent to which the rewards from its activities are appropriated

by a limited group of capitalists, then the rest of society (both stakeholders and the state) will exert pressure on the firm to change its behaviour. But, this reform of accountancy makes only a limited contribution towards tackling the other two crises identified in chapter 1: the harm inflicted on the environment and the potential harm to future generations.

These two issues are covered in chapter 6, which deals with sustainability. I analyse the GRI Standards for the reporting on sustainability, which aim to rectify the deficiencies of conventional accounting. I conclude that the GRI Standards go a long way to rectifying these deficiencies, but nevertheless suffer from certain weaknesses, notably in relation to two matters:

- Assurance—how is the public to be assured that a business firm, in its sustainability report, has faithfully applied the GRI Standards? Research by Oliver Boiral has demonstrated alarming deficiencies in these reports.
- Connectivity—the GRI Standards ask for the disclosure of a vast amount of diverse information, but the relationship between the individual items and the firm's overall impact on sustainability is not made clear.

Hence, the present position in relation to sustainability reporting is not yet fully satisfactory.

In chapter 7, I consider the proposals of the IIRC to develop a radically new form of reporting (integrated reporting) which is intended to address the deficiencies of conventional accountancy. I conclude that these proposals are seriously deficient and, in fact, offer little more than a cover for business firms to carry on 'business as usual'.

The aim of this book is to analyse how accountancy may contribute to the resolution of the crises identified in the first chapter. How far has this aim been achieved? I feel that, at this stage in the analysis, the following points have been established:

1. The present state of accountancy is deplorable. Accountancy facilitates and supports the implementation of neo-liberal policies by business firms, which are destructive of society and of the environment.
2. In relation to the problem areas of inequality, financialization and the welfare of the current generation, the adoption by accountants and business firms of stakeholder reporting (as set out in chapter 5) would make a significant contribution to the resolution of these problems. But this leaves unresolved the question of how accountants and the managers of business firms are to be persuaded to adopt this mode of reporting.
3. In respect of the crises concerning the environment and the welfare of future generations, the adoption of a comprehensive model of sustainability reporting would represent a significant contribution on the part of accountancy towards the resolution of these problems. The GRI Standards go some way to defining such a model but are considered to be

inadequate, both in being insufficiently comprehensive and in failing to tackle the question of how to ensure that business firms faithfully apply the Standards.

The issue raised in the second point (how to persuade accountants and the managers of business firms to adopt stakeholder reporting) is discussed later in this chapter. The third point (the weaknesses of present proposals for sustainability reporting) is the subject of the next section.

## 2. Sustainability Reporting

Based on my analysis in chapter 6, I accept that the GRI Standards go a long way towards providing a suitable basis for the reporting on sustainability, but I consider that they suffer from two deficiencies:

- They ignore the vital issue of assurance;
- They are insufficiently comprehensive.

I deal with the first issue (assurance) later, after I have considered how the sustainability report may be reformed so as to provide a more complete picture of the firm's contribution to sustainability. But first, I have to consider the question of whether this objective is realistic.

### 2.1. *Is Sustainability Reporting Possible?*

Is sustainability reporting even possible? Some six years ago, Rob Gray posed this question in a paper with the provocative title '*Is accounting for sustainability actually accounting for sustainability . . . and how would we know?*'<sup>1</sup> Rob Gray discusses the paradox that the present economic system is causing immense damage to the environment (to the extent that, with global warming, even the survival of the human race is threatened), yet countless MNEs are issuing reports which claim that their operations are sustainable.<sup>2</sup>

Rob Gray characterises the current mode and level of economic production as unsustainable, both in its use of scarce resources and in its production of noxious waste. But the judgement of unsustainability applies at the level of the planet, not at the level of the individual firm. He points out that an individual firm may have a method of production that is unsustainable (for example, it is extracting a finite mineral resource), but, at the level of the planet, it is possible that the firm is operating within a wider system which compensates for the extraction of the mineral in a sustainable way. For example, the corporation extracts iron ore, which is used in the construction of wind turbines. The opposite is also possible: the corporation seems to be operated in a sustainable fashion, but, when the wider impact of all its activities is considered, the net effect is to increase global unsustainability. Clearly, measuring the overall impact of the individual firm on the planet is

extremely difficult. A few brave academics have attempted to measure the costs, in money terms, to an individual corporation of maintaining capital intact, when capital is defined to include not only the firm's own capital, but also social capital and the natural world. In principle, the cost to the individual firm of sustainability should be estimated as the amount that it would have had to spend if it had been operated sustainably in this wider sense. This is clearly a highly hypothetical figure. The figures that result from this exercise are generally immense and prove conclusively that the firm is being operated in an unsustainable manner.<sup>3</sup> Rob Gray sees two problems with this approach: firstly, the business firm is generally unwilling to accept what it considers to be a 'wrong answer' and secondly (and more fundamentally), the lack of sustainable options within current markets means that the amount that the individual firm would have to spend is unknowable in any realistic sense, but is clearly very large.

Hence, Rob Gray is very sceptical of the feasibility of measuring sustainability at the level of the corporation. He writes:

*Any assessment of the relationship between a single organisation and planetary sustainability is virtually impossible. The relationships and interrelationships are simply too complex. Furthermore, to assume that the notion of 'sustainability' has tangible meaning at the level of organisations is to ignore all we know about sustainability. Sustainability is a systems-based concept and, environmentally at least, only begins to make any sense at the level of eco-systems and is probably difficult to conceptualise at anything below planetary and species levels. So whatever else organisational 'accounts of sustainability' are, they are not accounts of sustainability.<sup>4</sup>*

A demonstration of Rob Gray's thesis is provided by a recent court case in Germany. A farmer from Peru, Saül Luciano Liluya, sued the German energy company, RWE, for damages. He claimed that the CO<sub>2</sub> produced by RWE in generating electricity caused the global warming which was leading to the melting of a local glacier which threatened his hometown. He claimed that RWE was responsible for 0.4% of global emissions of CO<sub>2</sub> and was therefore responsible for 0.4% of the harm he suffered. The court decided that RWE was not legally liable.<sup>5</sup>

Rob Gray's argument seems to me to be incontrovertible; the individual firm's 'sustainability report' cannot be a comprehensive account of the firm's impact on planetary sustainability. This would seem to leave two possible functions for the firm's sustainability report:

- To report on the sustainability of the firm and not of the planet.
- To make as comprehensive an account as possible of the impact of the firm's activities on planetary sustainability, despite acknowledging that a complete account is not possible in the present state of human knowledge.

## 2.2. *The Sustainability of the Firm Versus the Sustainability of the Planet*

The distinction between the sustainability of the individual business and the sustainability of the planet lies at the heart of my criticism of the IIRC's proposals for integrated reporting. Clearly, the sustainability of the firm is a coherent concept—the idea that the individual firm will survive and even prosper for the foreseeable future—at least until the global economy collapses under the combined unsustainable activities of the totality of business firms. Moreover, the sustainability of the individual firm is of considerable interest to the firm's primary stakeholders, particularly the providers of financial capital. But clearly, the sustainability of the firm is subsidiary to the sustainability of the planet. If the global economy is not sustainable, the individual firm cannot survive. The overwhelming interest of the mass of the population is in the sustainability of the planet. What can the firm's report contribute in this matter?

## 2.3. *The Accountant's Contribution to Sustainability Reporting*

Does the analysis so far mean that sustainability reporting is a waste of time and that accountancy has no meaningful contribution to make in this matter? I would reject such a defeatist approach and argue that accountancy has a positive contribution to make to improve the situation relating to sustainability reporting. A definitive solution to the problem (how to measure the impact of the individual firm on planetary sustainability) is not possible in the present state of mankind's knowledge. But this does not mean that progress cannot be made. I consider that the present situation is grim and potentially of great danger to the future of mankind, and for accountancy to abandon efforts to improve the situation would be an abdication of its moral responsibility. What do I mean when I claim that the present situation is grim? I base this claim on the following propositions:

- The present mode of economic activity is causing great damage to the environment, notably in the pollution of the atmosphere, which will lead to an increase in temperature, causing great suffering to billions of people. But global warming is not the only negative consequence of current economic activity; future generations will also suffer from the pollution of the oceans (which will greatly reduce their value as a source of food) and from shortages of non-renewable raw materials which are currently being used up at a profligate rate.
- The large MNEs are the major players in the present global economy. They produce much of the pollution, consume an exorbitant amount of scarce materials and, in general, provide the model for smaller businesses to follow.
- Yet many of these MNEs, making use of the latitude offered by the IIRC's Framework, are issuing 'sustainability reports' which claim to demonstrate that they are being managed in a sustainable fashion.

The concentration of CO<sub>2</sub> in the atmosphere increases year in and year out, yet the world's largest companies insist that it has nothing to do with them, as they are being managed sustainably. It is essential that the truth be made known about the un-sustainability of the operations of the great majority of world's large enterprises. The truth should be spoken to two constituencies: the MNEs' management, who are, at present, deceiving themselves that their firms are sustainable, and to the world's peoples, so that they can bring pressure to bear on the MNEs to change their ways.

What can accountancy contribute? I accept that a proper sustainability report, which measures the full impact of the individual firm's impact on planetary sustainability, is not feasible. Hence, the initial aim of the IIRC's founders (a comprehensive report on the firm's sustainability) is not achievable. This is amply demonstrated by the analysis in the last chapter of the IIRC's Framework. In my opinion, the Framework is an extremely clever and sophisticated attempt to ensure the sustainability of capitalism, and it will probably achieve this aim—that is, until capitalism fails with the collapse of planetary systems under the weight of capitalist firms' abuse of the environment.

Since a proper sustainability report is impossible, accountancy must set its sights much lower. I feel that the best it can achieve in the present state of knowledge is to report facts about the firm that will enable the reader to make her own assessment of the firm's impact on global sustainability. This would promote the cause of sustainability in two ways: the reader would be motivated to apply pressure both on the firm and on regulatory authorities to force the firm's management to change its ways, and the firm's management might be so shocked by the reported facts that it institutes reforms. This is essentially the task currently undertaken by the GRI. In comparison with the IIRC, the GRI has the important advantage that it has not been captured by business interests.

I conclude that the GRI Standards provide the best current basis for sustainability reporting by the business firm. Over the some 20 years of the GRI's existence, its guidelines have been modified several times and, as each modification represents the outcome of very wide consultation involving all stakeholders and not simply business interests, each successive update of the guidelines marks a further step towards the ultimate goal of a fully comprehensive report on sustainability. Hence, I would urge GRI to carry on with its good work.

#### 2.4. *The Role of Accounting Academics*

I would also urge my colleagues in academia to play a more active role in this matter. Too much of the current research output of accounting academics concentrates on technical issues of little interest to anyone other than fellow academics. Anthony Hopwood (2007, pp. 1370–1371) characterised the state of accounting research *'as an increasing autonomous one*

*with the primary conversations being internal to the community . . . almost the only consumers of accounting research are fellow accounting researchers*'. Accounting research seems to be excessively concerned with its own narrowly defined field, with accounting academics devoting their energies to analysing and criticising the work of other accounting academics, rather like a dog chasing its own tail. A fundamental task of the university is to serve the whole of society by subjecting current practice to searching criticism and by developing novel practices that better serve society's needs. The great challenges that mankind currently faces are the crises identified in the opening chapter. They are almost completely ignored by most contemporary accounting researchers. I would characterise their behaviour as 'rearranging the deck-chairs on the Titanic'. Whilst mankind is confronted with existential threats, they busy themselves with issues that, in comparison, are ridiculously trivial and are irrelevant to the real problems.

### 2.5. *The Difficulty of Assessing Sustainability*

So far, I have established that a comprehensive assessment of the individual business firm's impact on (planetary) sustainability is impossible with the present state of human knowledge. Moreover, the GRI, despite having laboured for some 20 years, has yet to develop standards that, in my opinion, provide for a fully satisfactory report on sustainability. Some ten years ago, as part of the research that went into the writing of my last book *Accounting and Distributive Justice*, I subjected the sustainability report of a specific business firm to a thorough examination. The report that I chose was the '2007 Sustainability Report of the Cooperative Group', a British retail cooperative, known universally as the Co-op. The report is certainly very long (135 pages) and very detailed (covering over 20 different topics). After having read all 135 pages, I came to two conclusions which, although they relate specifically to the reporting of justice, are equally valid for the reporting of sustainability, a very similar concept.<sup>6</sup>

- The report uses a 'scatter gun' approach to the reporting of sustainability and justice. I wrote: '*It reports on a large number of different topics in the hope that, among these topics, the reader will find the information that she needs. This is certainly one way in which a firm can provide the reader with (some of) the information that she needs to judge the sustainability and justice of the firm's activities*'.<sup>7</sup>
- The reporting of justice is extremely complex. I wrote that '*the analysis of both the GRI guidelines and the Co-op's report has confirmed my initial suspicion that justice is such a complicated and multi-faceted subject that, to provide the reader with all the information that she needs for its assessment requires a report of extraordinary length and complexity*'.<sup>8</sup>

In relation to the reporting of sustainability, the current situation is essentially similar to that relating to justice, in two respects:

- There is no consensus on how to assess the contribution of the business firm to the achievement of the stated objective: planetary sustainability. The various interested parties (the firm's management, the government, stakeholders, NGOs, civil society, scientists and so on) have different opinions on this matter.
- The most realistic way of dealing with this lack of consensus is for the firm's report to provide a mass of information so as to ensure that each interested party can have access to the specific information that it considers to be important.

The implication of this analysis is that the business firm should err in the direction of providing too much rather than too little information. Does this mean that the principle of materiality should be scrapped? This principle is included in the GRI Standards as a means of ensuring that the sustainability report does not become unwieldy, where the truly significant information is lost in a mass of irrelevant facts. This is a worthy objective, but perhaps it should be put to one side until agreement is reached on what is really important. I feel that the best solution would be to widen the principle of materiality so that it covers everything that any interested party considers to be material. Since, with certain data, such as CO<sub>2</sub> emissions, which cause global warming, every world citizen has a legitimate interest in what is reported, and this would imply a very wide interpretation of what is material.

The conclusion of this analysis is that there is still much progress to be made in the matter of defining the form and content of the business firm's sustainability report. The current GRI Standards are a good start but are insufficiently comprehensive. But I feel that this is not the most serious challenge in the field of sustainability reporting—which is how to assure the report reader that the business firm, in preparing its sustainability report, has faithfully followed the Standards. This is the subject of the next section.

### 3. The Problem of Assurance

It is common for a business firm to employ an assurance provider to review its sustainability report and give an opinion on its veracity. The function of the assurance provider is to add credibility to the sustainability report, which is prepared by the management of the business firm. The reader of the report needs to be assured that the report does not present a misleading picture of the firm's impact on sustainability. The reader is naturally suspicious that the management is likely to seek to present an unduly favourable picture of the firm's activities. It seems rather improbable that the management would be prepared to report truthfully and comprehensively of the firm's failures to achieve sustainability. The report's user has two concerns:

firstly, that the report deals only with matters that reflect favourably on the firm ('good news') and omits any mention of the firm's failures ('bad news') and secondly, that the information on a specific topic may have been 'massaged' or even falsified. A report over which the user has doubts is not performing its allotted function of communicating the business firm's impact on sustainability to the wider world. This is true even if the firm's managers are highly moral people who make a genuine effort to be truthful and comprehensive, for how is the user to be aware of this (rather improbable) fact? To add to the credibility (and information value) of their sustainability reports, many business firms employ an independent expert to undertake a review of the sustainability report and to issue her own independent opinion on the report's accuracy. In principle, the outcome of the expert's work should be to convert a sustainability report, which most users dismiss as a self-serving PR exercise, into a valuable and respected source of information. In this section, I seek firstly to assess the extent to which the assurance process achieves this aim and secondly to consider ways in which its performance may be improved.

The research of Oliver Boiral (presented in section 9 of chapter 6) revealed a deplorable state of affairs relating to the assurance process for sustainability reports. Boiral conducted his research on the sustainability reports of 23 MNEs for the year 2007. Clearly, it would be highly desirable that this research should be updated, as a means of checking whether the current state of affairs is equally bad. Unfortunately, I have been unable to find any reference to similar research covering more recent sustainability reports. Hence, we simply do not know if the effectiveness of assurance provision has improved in the interim. But I feel that factors which contributed to the failure of assurance in 2007 are still relevant today, of which two are especially pertinent: the technical difficulty of the assurance process and the anomalous position of the assurance provider.

### *3.1. Technical Difficulties*

There is no doubt that the task of verifying the completeness and accuracy of a sustainability report presents the assurance provider with many problems of a technical nature. Boiral's research highlighted one difficulty—how to ensure that the report covers all relevant matters. It is relative easy to verify an item included in the report: the reviewer simply goes through the report item by item. It is much more difficult to verify an item that is not there but should be there. The reviewer does not fulfil her responsibility towards the report user by including in her opinion phrases such as 'nothing came to our attention'.<sup>9</sup> She should be much more active in ensuring that important matters came to her attention. If Boiral sitting in his office in Québec could detect serious omissions in a sustainability report, so should the reviewer, who has far greater resources at her disposal.

But the detection of missing items is not the reviewer's only problem. A pervasive difficulty stems from the great variety of data that she must report on: tonnes of CO<sub>2</sub> emitted, man-hours lost through accidents, the chemical composition of toxic waste and so on. Clearly the reviewer cannot be an expert in all these fields, but she must develop techniques for communicating with the experts so that she can be sure that she can rely on their data.

I have no experience in reviewing a sustainability report. It strikes me as an incredibly complex task. My background is in financial auditing, and I feel that the history of financial auditing offers some justification for hoping for an improvement in the situation relating to sustainability reports. The accountancy profession has been auditing financial statements for over 150 years. During that time, there has been a continuous improvement in auditing techniques. The activity of providing assurance on sustainability reports has been carried on for less than 20 years. It is obvious that, as greater experience is accumulated (particularly learning from mistakes made), the efficiency of the assurance process will gradually improve.

Many readers will doubt that I am correct in asserting that the efficiency of financial auditing has improved over time, pointing to recent audit failures, such as those at Enron and WorldCom.<sup>10</sup> My response is that these audit failures are the exceptions that prove the rule—in the sense that they test the rule and find it to be valid. These audit failures arose not from a lack of technical competence on the part of the auditor, but from the auditor's moral failings. In both cases, the auditors were aware of the issues but chose to ignore them, because of their close relationship with the business firm's management. This aspect of the auditor's role is the subject of the next section.

### 3.2. *The Anomalous Position of the Assurance Provider*

The assurance provider of a sustainability report is in a very similar position to the auditor of financial statements. The anomalous position of the auditor has already been evoked in chapter 3. In essence the auditor of a firm's financial statements serves two masters whose interests are in no way identical: the shareholders who need assurance on the financial statements' accuracy and the firm's management who (in practice) appoints and pays the auditor. George Staubus summarised the auditor's dilemma as follows:

*In simple terms the management uses owners' money to hire auditors to provide a stamp of approval on management's reports on its own performance to owners. The auditor . . . makes his living by pleasing management but his societal justification requires serving investors and creditors.*<sup>11</sup>

I feel that these remarks are equally applicable to the assurance provider of the sustainability report—to adapt George Staubus's words:

the assurance provider makes his living by pleasing management, but his societal justification requires serving all those concerned about protecting the environment and the well-being of future generations. In my opinion, the present position is thoroughly unsatisfactory. I justify this claim principally on the weakness of the assurance providers' opinions that were analysed in chapter 6, but I feel that reforming the way in which the assurance provider is appointed and remunerated would be an absolutely essential step towards improving the whole field of assurance. I can envisage very many different ways in which the provision of assurance may be organized. The ways differ according to the answers given to the following questions:

1. Who decides that the firm's sustainability report should be subjected to independent assurance?
2. Who appoints the assurance provider?
3. Who pays the assurance provider?
4. Who decides on the scope of the assurance provider's work and the form of her opinion?

The answers to all four questions consist of some combination of the following three parties:

- the firm's management,
- the firm's stakeholders (including its shareholders), and
- the state.

The present position is that all four functions referred to in these questions are performed by the firm's management. Assigning these functions to the firm's stakeholders would clearly go some way to resolving the problems arising from the assurance provider's anomalous position outlined above. But it is not obvious how passing the responsibility to the stakeholders could be achieved in practice. One possibility could be a gradual process involving GRI. For example, the GRI Standards could be revised to include a requirement to report on how the assurance provider is chosen and what role the firm's stakeholders play in the process. GRI could impose progressively more stringent conditions for reporting 'in accordance with' its standards—for example, making independent assurance a condition and insisting on stakeholder participation in the appointment process. The GRI already plays a leading role in defining the content of the sustainability report, and it is logical that it should expand its mission to cover the content of the assurance provider's work and report.

The third possible party is the state. In my last book, *Accounting and Distributive Justice*, I suggested that the state could play a more interventionist role in the audit of business firms, calling for the creation of 'a corps of accountants, not employed by or paid by any stakeholder, who would

*prepare and certify the financial statements of firms; the accountants would be employed and remunerated by the state, which would finance their activities out of a levy on the body of stakeholders*'.<sup>12</sup> In this vein, in relation to sustainability reporting, the government could pass a law that regulated in detail the whole process, covering the obligation of the business firm to issue a sustainability report, its form and content and including a requirement for assurance, even providing for the creation of a corps of assurance providers employed by the state.

But I feel that, in the present circumstances, such a degree of state intervention in sustainability reporting is highly unlikely. I am persuaded by the arguments of Robert Eccles<sup>13</sup> that I have already evoked in section 5.8 of chapter 7. The state will only intervene to regulate a process after it has been developed in the private sector of the economy and faults become apparent in its operations which are so fundamental that they can only be resolved by state intervention.

I judge that, at present, the position with regard to sustainability reporting is not satisfactory, especially in relation to assurance. But it is unrealistic to expect the state to intervene to improve matters. The necessary reforms will have to be achieved through the actions of people in their private capacity, people such as the firm's managers, its stakeholders and, of course, accountants. How are these people to be motivated and stimulated to undertake the necessary action? This is essentially the same problem that was encountered with reporting to stakeholders—we know what needs to be reported but still need to persuade those involved in the reporting process to adopt the necessary reforms.

#### 4. The Need to Persuade People

The conclusion of the analysis so far is that there has to be a change in people's behaviour if society is to resolve the existential crises that are identified in the opening chapter. In respect of accountancy (the focus of this book), this entails that business firms adopt the practice of stakeholder reporting and sustainability reporting as outlined in chapters 5 and 6. I do not claim that such a change in accountancy practice will, on its own, resolve these crises, but I assert that accountancy can make a significant positive contribution. Above all, accountancy will be transformed from a force for destruction (of society and the environment) into a force for good. How can such a change in behaviour be brought about?

In chapter 4 (section 6), I identify three forces that can influence people's behaviour: the state, philosophy and accountancy. I have already decided that it is not realistic to expect the government to enact laws that oblige business firms to adopt stakeholder and sustainability reporting—at least, not in the near future. And the current situation is so grave that action must be taken now. Hence, recourse must be made to the other two forces: philosophy and accountancy.

I use the term ‘philosophy’ to denote the underlying principles that a person follows in making decisions. At present, for far too many people in accountancy and business, these are the principles of neo-liberalism. Since I believe that neo-liberalism is destructive of society and the environment, people must be persuaded to adopt a different philosophy.

The third force is accountancy. In chapter 4 I analyse the positive, albeit limited, contribution that accountancy can make to changing people’s behaviour, using as an example the case of excessive management remuneration. I believe that the accountant’s contribution is not limited to this one area but can be extended to cover a wider area of management behaviour. I envisage the process by which accountancy can contribute to the reform of business behaviour as consisting of three stages:

1. Accountants (the accountancy profession) adopt a different underlying philosophy supplanting the current dominant philosophy of neo-liberalism.
2. Accountants, in consequence, change their behaviour. They modify the principles that they follow for the preparation of the business firm’s reports.
3. The managers of business firms change their behaviour in the light of the information presented in these revised reports. This change may be voluntary (the managers are shocked by the information) but is more likely to occur in response to pressure brought by stakeholders (including the state).

This process is initiated by the accountancy profession, which must be transformed. I now consider how this transformation may be achieved.

## **5. A Vision of a New Accountancy**

In this final section, I set out my proposals for a new breed of accountant and a transformed accountancy profession. But first, I summarise what is wrong with current practice.

### *5.1. The Present Practice of Accountants*

At present, most accountants are motivated by the standard capitalistic imperative to maximize their income. This is particularly the case with the larger accountancy firms (the Big Four). Their priorities are: firstly, maximize their own profits and secondly, maximize the profits of their clients. Since a satisfied client is happy to pay the accountant’s fees, there is a coincidence of the interests of the accountancy firm and of its clients. The reality of the situation is that the major accountancy firms are capitalistic enterprises which are motivated by the imperative of all such firms to maximize their profits. Of course, the accountancy firms deny that this is the case. But for such a

denial to be creditable, they must be able to identify some way in which they differ from other capitalistic firms. They point to their obligations as members of the accountancy profession to serve the public interest. But, as I analysed in chapter 6, the accountancy profession's claim to serve the public interest is a myth, as evidenced by the behaviour of one accountancy firm in the MG Rover affair and of accountancy firms in general in relation to tax avoidance and creative accounting. Also the professional institutions make no effort to discipline their members for failing to serve the public interest. I hold that accountants need to replace their present philosophy of profit maximization with one of service to the public. But the only institution that can bring about such a change is the accountancy profession.

### *5.2. The Present Role of the Accountancy Profession*

The fundamental problem is to transform the accountancy profession's claim that it serves the public interest from myth into reality. The accountancy profession claims that it serves the public interest by assuring the orderly functioning of markets. This is essentially a consequentialist argument: everyone benefits from a well-functioning market. The force of such an argument depends critically on whether the alleged consequences exist in reality. I hold that the claim that everyone benefits from a well-functioning market is false.

In recent decades (following the adoption by the state and business of the principles of neo-liberalism), the greater part of society in Britain has not benefited from the operations of the market economy, as evidenced by the stagnating income of all except the top 10%, the extraordinary increase in the incomes of a tiny elite and the consequent growth in inequality.

The accountancy profession is closely implicated in the growth of financialization, which is essentially a zero-sum game which benefits the few at the expense of the many. Without the accountancy profession to measure and certify the profits of financial institutions, financialization could not take off. But the accountancy profession has not only done nothing to curb the excesses of financialization but, through its influence on standard-setting bodies, has even promoted it.

The effects of unfettered market operations are destructive of the environment and put in jeopardy the well-being of future generations. The accountancy profession has completely neglected its responsibility to reform accountancy practice so as to rectify these defects of the market. It has not championed the cause of stakeholder reporting or sustainability reporting. The profession's principal contribution in this area has been to support the work of the IIRC, which I charge to have betrayed the cause of sustainability reporting.

In the current situation, it is insufficient for the accountancy profession to require that its members act with competence and integrity in dealing with their clients. It seems probable that such limited obligations were sufficient when the British accountancy was formed in the middle of the nineteenth

century. At that time, most of society did benefit from the economic growth generated by successful capitalism, and the damage to the environment caused by economic activity was not such as to put in jeopardy mankind's future. But that time is long past. The British accountancy profession must adapt itself to the changed environment.

How can the British accountancy profession reform itself? A major difficulty is that the profession is an independent, self-governing organization. The people who run the organization are elected by its members, and they consider that their principal responsibility is to serve their members. Cowton (2009, p. 185) identifies three ideal types of professional bodies:

1. The qualification professional body: The professional institution performs the function of certifying the technical competence and integrity of its members by organizing an examination for entry into the profession and subsequently monitoring their behaviour. To be a member is to be little more than someone who holds a qualification.
2. The customer-focused professional body: The professional institute, in addition to the functions performed in 1, provides services for its members. The relationship of the individual member to the professional body is essentially the same as that to any entity that provides services, be it a golf club or a supermarket. Cowton (2009, p. 186) writes: *'many members no doubt wonder about whether the annual subscription is worth it, and professional body staff worry about whether enough is provided to such members to coax them to part with their money'*.
3. The 'membered' professional body: The unusual word 'membered' reflects Cowton's emphasis on the active role that the members should play in the body's activities. This ideal type is Cowton's preference. He would like the members to see themselves as members of a moral community united in pursuing a common aim. That aim should not be limited to the material success of the individual member; it must have a wider dimension, expressed in the profession's stated aim to serve the public interest.

I have no doubt which of the above ideal types most closely describes the present state of the ICAEW, the professional body to which I belong. A visit to the ICAEW's website ([www.icaew.com](http://www.icaew.com)) is a most revealing experience. One is struck with two dominant impressions:

- The website is very well designed and offers the user a vast amount of information. The ICAEW gives the impression of being a highly efficient organization, at home with the very latest developments in information technology.
- The ICAEW is dedicated to serving its members. Virtually all the information offered on the site is designed to help members perform their functions more efficiently.

If one searches carefully, one can find a reference to the public interest. There is a section headed ‘Acting in the public interest’, of which the principal feature is the following text:

*As a professional membership organisation we believe in acting responsibly in the best interests of our members and the general public. We are responsible for protecting the public by ensuring that members maintain the highest standards of professional conduct and competence.*

There are two significant points in the above statement, one much as expected and one rather surprising. The expected point is the emphasis on the highest standards of professional conduct and competence. The surprising point is that the ICAEW considers that the interests of its members and the interest of the general public are of equal importance. Earlier in this book, I argued that the obligation to serve the public interest required that the individual accountant should place the welfare of the public before his own interests. Clearly, the ICAEW does not agree with me.

In addition to the above statement, there are short references to three subsidiary matters which presumably the ICAEW considers to be relevant to the issue of the public interest:

- The ICAEW’s advice to policy makers;
- How to make a complaint;
- The ICAEW as regulator.

In all, I estimate that material relating to the public interest makes up less than 1% of the website’s total content. I feel that this is a telling indication of the importance that the ICAEW attaches to serving the public interest as opposed to serving its members.

### ***5.3. The Accountant’s Mission: Speak Truth to Power***

At present, the accountancy profession is failing to serve the community. The ICAEW is failing to live up to the promise that it made in its Royal Charter to secure ‘*for the community the existence of a class of persons well qualified to be employed in the responsible and difficult duties devolving on professional accountants*’. In my opinion, the principal function, which far too many contemporary accountants are ‘*well qualified*’ to perform, is the maximization of their income. They completely neglect their ‘*responsible and difficult duties*’.

What are these duties? What is the fundamental social function of the accountancy profession? In my view, it is to inform the community about the reality of the economic and financial activities of business firms and other entities. The accountant’s ultimate client is the community and not the entity on which she reports. The accountant’s fundamental duty is to reveal the

truth. I would suggest a new motto for the ICAEW: ‘speak truth to power’. The two words ‘truth’ and ‘power’ need to be explained.

### 5.3.1 *What Is Truth?*

I contend that conventional accounts do not tell the truth about the typical business firm. Accounts which ignore the impact of the firm’s activities on stakeholders, on the environment and on future generations are not just inadequate—they are seriously misleading; they are deceiving society as to the truth about the business firm. What is required is an active approach to the reporting of truth. The accountant should seek out the truth and report it comprehensively. She should not be satisfied with the anaemic version of the truth presented by conventional accounts.

In chapter 5, section 5.6, I discuss the concept of truth as applied to accounts and conclude that it is not straightforward. Thus, it is possible to have two quite different accounts of a specific item (say an asset), both of which are truthful—for example, in one account, the asset is valued at historical cost and in the other at current value. Such differences are inevitable in the calculation of accounting items such as profit; profit does not exist in the real world—it is an artefact created by the accountant. In such a perplexing situation, I propose three guidelines for the accountant to follow:

- Do not mislead. It is a breach of the accountant’s obligation to inform the public if she presents information in such a way that the user gains a misleading impression. Creative accounting is clearly a breach of this obligation. The conscientious accountant must always put herself in the position of the account user and ask herself what conclusions the typical user would draw from the accounts.
- Be transparent. Be diligent in including in the accounts, information on all matters of relevance to the typical user. Above all, give full information on matters on which the accountant has exercised judgement, such as valuation methods.
- Use common sense. Be guided by the wisdom of the common man (and woman) and not by the sophistry of clever experts. Sir David Tweedie, the IASB’s first chairman, claimed that, in setting standards, he was guided by the following principle: ‘*If it swims like a duck, walks like a duck, and quacks like a duck, it is a duck*’. For example, if the common man considers that the debts owed by an entity controlled by a firm, is a debt of the firm, then the accountant should respect the common man’s judgement.

It is clear that reporting the truth is not a simple matter. It requires the exercise of judgement on the part of the accountant. But above all, it requires integrity. The accountant must never exploit the lack of knowledge of the general public as a means of distorting the truth.

### 5.3.2 Whose Power?

There are two important powers that the accountant, in performing her social function, should stand up to, should speak the truth to: the MNEs and the state.

#### 5.3.2.1 THE MULTINATIONAL ENTERPRISES

Over recent decades, the major MNEs have become so large that there is a real danger that they may come to replace the state as the ultimate source of power and authority, as forecast in David Korten's 1995 classic *When corporations rule the world*.<sup>14</sup> Some MNEs are now larger than many states. They use their power to undermine the democratic processes of these states. For example, in the negotiations on the Transatlantic Trade and Investment Partnership (a trade agreement between the USA and the European Union), the MNEs secured the provision that any dispute between an MNE and an EU Member State would be judged not by the state's courts of law, but by an arbitration tribunal—a clear surrender of sovereignty by the state. It is essential that these powerful corporations be held accountable for their actions. This is a task that devolves on the accountant—a task far more vital for the preservation of democracy compared with the orderly functioning of markets.

#### 5.3.2.2 THE STATE

The state is the second power that the accountant should speak truth to. In this book, I have concentrated on the accounts of the business firm and largely ignored the state. Yet, often governments seek to deceive their citizens and the rest of the world about the true financial position, as demonstrated by two recent examples: Greece and the Private Finance Initiative.

*Greece:* In 2001, the Greek government hired the American investment bank Goldman Sachs to help it disguise the true scale of the country's debt. As reported in the British newspaper *The Guardian* (26 February 2010), Goldman Sachs devised complex derivatives which enabled the Greek government to 'borrow' billions of dollars in exchange rate swaps which did not officially count as debt under Eurozone rules. The Greek government, with the aid of Goldman Sachs, was deliberately misleading the world as to the level of its debts. No doubt Goldman Sachs's accountants played a role in devising this piece of 'creative accounting'.

*The Private Finance Initiative (PFI):* The PFI was developed by the British government in the 1990s as an alternative way of administering investment in infrastructure, such as hospitals, schools and transportation systems. The basic concept is that a private body (often a consortium

of a construction company and a bank) contracts with the government to build the asset and in return receives from the government an annual fee that covers both annual maintenance costs and capital costs (finance and depreciation). The PFI has always been controversial. *The Economist* analysed the position in the following terms: ‘*There is a good reason for the PFI, but also a bad one. The good reason is value for money . . . The bad reason is that the PFI is a way of massaging public debt figures*’.<sup>15</sup> The accounting treatment of PFI contracts has been the source of a dispute between the government and the accountancy profession. The government argued that a PFI contract was for the provision of future services and did not involve the state either acquiring an asset or incurring any debt. The British accountancy profession (through the standard-setting body, the Accounting Standards Board) disagreed, arguing that, in most cases, the PFI contract created a finance lease, under which the lessee acquired both an asset and a debt. The stand-off between the government and the ASB is analysed by Broadbent and Laughlin (2005). By all accounts, the result was a draw. Opinions differ on the merits of the PFI, but personally, I have no doubt that it included an element of the government seeking to mislead the public as to the level of its debt and that, in this case, the accountancy profession did speak truth to power.

This section has demonstrated the importance of the accountant’s social function. But I hold that at present, far too many accountants are motivated by a philosophy of personal gain; how can this be changed to a philosophy of service to the public?

#### *5.4. The Accountancy Profession’s Mission*

I believe that the only bodies that have the capability to bring about a change in the fundamental philosophy of accountants are the professional accountancy associations, such as the ICAEW. I do not believe that the ICAEW’s 145,000 members are going to change their fundamental philosophy without some person or group of persons providing the necessary impulse through inspiring leadership. This could be from outside the profession, for example, through a religious-style revival. But the professional body is clearly the best placed to provide the necessary leadership. How can the ICAEW be transformed from one which considers that its principal function is to serve its members to one that sincerely believes that its principal function (and that of its members) is to serve the public interest? I have already mentioned a major difficulty. The ICAEW is a self-governing body. The majority of the members of its governing body, the ICAEW’s Council, are elected by the ICAEW’s members—chartered accountants. Naturally and properly, the Council members consider that, in reaching decisions, they have a democratic obligation to consider the views of the ICAEW’s members. But I consider that

they also have a moral obligation to consider the public interest. I base my argument on their personal moral obligations as human beings, coupled with the special obligations of a profession.

Every human has a moral obligation to consider the impact on her action on other people. An action that harms another person can be justified only if it can be shown that there are countervailing benefits. But it is not obvious that a person has a moral obligation to go out of her way to benefit other people even at a cost to herself, as would be the case if the individual accountant were to take an action that is in the public interest but costs her a loss in income. One cannot expect such behaviour from the individual chartered accountant, but I hold that it can and should be expected of the members of the ICAEW Council. I base my argument on the writings of Francis Bradley, the nineteenth-century British moral philosopher. In 'My station and its duties',<sup>16</sup> Bradley argues that ordinarily the moral obligations of the individual are rather limited, but, once the individual occupies a specific station in society, then she takes on the moral obligations attached to that station. These extra moral obligations are defined by the community. For Bradley, the community is more fundamental than the individual, for he believes that, to separate an individual from the community of which she is a member is to strip her of her essential humanity. In my view, the members of the ICAEW Council have deliberately chosen a particular station in the community of professional accountants and have thereby accepted the moral obligations attached to that station. The fundamental moral obligation is to serve the community. The individual ICAEW Council member should do everything in her power to transform the body of ICAEW members into a moral community dedicated to serving the public interest.

### 5.5. *A Transformed Profession*

An accountancy profession that is truly dedicated to serving the public interest would be very different from the current profession. The fundamental difference would be in the functions that it performed. Currently, the profession considers that an important function (for some, the most important function) is to aid business firms to improve their profitability. I believe that this is a serious mistake, as it distracts the profession from its fundamental social function, which is to establish and report the truth about the activities of business firms and other entities. Hence, the professional accountant should be forbidden to undertake any work that undermines her ability to report independently and fearlessly the truth about the entity. This truth would be much wider than presented in conventional financial statements: it should cover the impact of the entity's activities on stakeholders, the environment and future generations, as outlined in this book.

The provisions of consultancy services and any involvement in the management of the business should be forbidden, as it detracts from the accountant's fundamental social function. The fate of the accountancy firm,

Andersen, in the Enron affair is a clear demonstration of the dangers of the auditor becoming too closely involved in the management of the business that he audits. The lesson is not that Andersen collapsed, but rather that Andersen failed in its social duty to report the truth about Enron.<sup>17</sup> For similar reasons, the provision of tax advice by the professional accountant should be prohibited. Not only does it compromise the auditor's ability to report objectively on the business firm's tax liability, but, as currently practised, it is clearly not in the public interest.

The profession's role should be limited to the following four functions:

- To contribute to the development of the craft of accountancy by promoting research of both a basic and an applied nature.
- To contribute to the provision of the continued supply of a corps of competent and trustworthy accountants (to be employed both in accountancy firms and elsewhere in the economy) by organizing and supporting the training of accountants (both in academia and on the job).
- To contribute, in cooperation with other parties, to the development of the principles that govern the form and content of accounts, for example, by collaborating in the work of standard-setting bodies. As proposed in this book, the scope of these accounts should be greatly expanded to cover the impact of the firm's activities on all stakeholders on the environment and on future generations.
- To report on the truthfulness of the accounts issued by business firms and other entities. This is the classical audit function, but applied to accounts with a greatly expanded content.

At present, only a minority (much less than 10%) of the ICAEW's members are engaged in these functions.<sup>18</sup> The great majority are employed in activities which (I argue) are not appropriate for professional accountants and should be forbidden to them, notably the preparation of accounts and other management functions within business firms and the provision of tax and consultancy services by accountancy firms. I do not suggest that these activities have no social value—only that they are incompatible with the practice of the accountancy profession. Hence, a trained accountant who wished to undertake a prohibited activity would be obliged to leave the profession—perhaps temporarily. What I propose is a much smaller, leaner profession composed of an elite dedicated to performing accountancy's essential social functions. The major accountancy firms, the Big Four, would also become much smaller, probably dividing into a small audit firm staffed by professional accountants and a much larger consultancy firm.

I am not confident that such a transformation of the accountancy profession will occur soon or even in my lifetime—hence the title of this section, 'A Vision of a New Accountancy'. But such a transformation is absolutely essential if accountancy is to fully fulfil its social function.

## Notes

- 1 Gray (2010).
- 2 Evidence that the present mode of operation of the world economy is unsustainable is provided by the figures for the concentration of CO<sub>2</sub> in the atmosphere provided by the Scripps Institution of Oceanography. Over the last ten years (2006–2016), the concentration of CO<sub>2</sub> increased at a faster rate than in any previous decade, and the increase in the last year (2016) was at 0.876% the highest in any year since measurements started in 1957. Source Scrips Institution of Oceanography (2016).
- 3 For more details of attempts to measure the sustainability cost of the individual firm, see Bebbington et al. (2001) and Herbohn (2005).
- 4 Gray (2010, p. 48).
- 5 See 'Bauer aus Peru verklagt RWE' on the website [www.heute.de](http://www.heute.de) for 24.11.2016.
- 6 I discuss the relationship between sustainability and distributive justice on pages 94–5 of *Accounting and Distributive Justice*.
- 7 Flower (2010, p. 108).
- 8 Flower (2010, p. 110).
- 9 A phrase from the opinion of the reviewer of the sustainability report of ABB Ltd, which I castigated in chapter 6.
- 10 For a detailed analysis of the scandals at Enron and WorldCom, see Flower (2004, chapter 9). In both cases, the auditor's technical staff discovered the irregularities.
- 11 Staubus (2005, p. 5).
- 12 Flower (2010, p. 174).
- 13 See Eccles & Krzus, pp. 286–287.
- 14 See Korten (1995).
- 15 'The art of concealment', *The Economist*, 20 March 2010.
- 16 See Bradley (1951).
- 17 For a full analysis of Andersen's role in the Enron affair and other audit failures, see Flower (2004, chapter 9).
- 18 I estimate that only about 6% of the ICAEW's members are engaged in these functions. Only about 30% of the members are engaged in accountancy practice (see Table 3.1) and, of these, only about 20% are engaged in audit (Table 3.2).

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