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978-1-107-40653-7 - Corporate Reporting and Company Law
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Introduction

> Good company reporting is essential. It provides information to shareholders, as well as creditors, employees and others who may have an interest in companies and their activities. Equally, the need for information has to be balanced against the cost to the company of collecting and publishing that information, as well as the cost to the readers in finding the information they are seeking. More information is not necessarily better information; and the Government is firmly committed to improving the quality rather than the mere quantity of company reporting.[1]

Disclosure and information sharing represent a substantial portion of company law. The briefest of glances at the legislation and legal texts will highlight to the reader the importance of the so-called 'disclosure philosophy'. Disclosure requirements appear in statutes, in codes of practice and in rule books of various institutions with which many companies are connected, such as the Financial Services Authority. Information is delivered and shared in a variety of different forms and by using a broad range of media including written reports, newspaper reports, internet and advertising. There are many participants involved in the company's disclosure activities, especially for larger public listed companies.

Despite this emphasis on disclosure a considerable degree of scepticism also exists about the effectiveness of the disclosure system in the UK. The main criticisms focus on the complexity and cost burdens that pervade the disclosure system and the lack of clear measures used for assessing a company's performance, as well as the poor quality of the verification process, the failure of such disclosure to provide users with what they need and, finally, reactions to information that is produced. The fact that such criticisms exist leads naturally to the question of the role of disclosure and the appropriateness of the system currently in place. Before answering this question one needs to settle on the aims of company law and more particularly, the aims of disclosure.

[1] White Paper, *Modernising Company Law* (July 2002), Cm. 5553–I, para. 4.1, at p. 33.

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Is disclosure itself an appropriate system for achieving the objectives of company law generally? The answer to this question depends upon a clear understanding of the goals of companies and company law and the purpose of disclosure, a knowledge of the features of the disclosure regime and what disclosure requirements exist, as well as the practice of disclosure by companies and empirical evidence on communication processes.

The UK's disclosure regime is part of a legal framework that assumes a shareholder-centred model of the company. Mary Stokes, for example, describes the various phases of the legal model, highlighting first the traditional model, which 'originally treated the directors of the company as agents of the company', whose authority could 'at any moment be revoked by the shareholders' and the 'shareholders as the principal were entitled to issue specific instructions to the directors which as agents they were obliged to implement.' Then when the traditional model was abandoned and the board of directors 'came to be viewed as an organ of the company' with the shareholders no longer exercising the direct control of principals over the directors as their agents, nevertheless the model gave 'power to the shareholders to appoint and dismiss the directors and power to supervise them' and the fiduciary duties imposed upon directors meant that directors would be under a duty to act in the best interests of the shareholders. They cannot place their own interests above those of the shareholders.[2] Under this model, the primary interest attributed to shareholders is profit. Again, Mary Stokes asserts that the legal model adopts two mechanisms for ensuring that the directors of the company are subject to the control of the shareholders: by the structure of the internal division of power within the company so that shareholders can appoint and dismiss the directors and supervise them whilst in office and by the fiduciary duties that require them to act in the best interests of the shareholders. Stokes adds: 'the common aim of both legal mechanisms is to force managers to maximise profits for their company and prevent them from maximising their own utility'. Stokes says further, 'Corporate managers' discretion will be legitimated since their power will be severely limited by the requirement that all their decisions must aim simply at profit-maximization.'[3]

[2] See Mary Stokes, 'Company Law and Legal Theory' in W. Twining (ed.), *Legal Theory and Common Law* (Blackwell, Oxford, 1986) 155, esp. at pp. 160–1. See for a similar analysis of US corporate law developments, David Millon, 'Theories of the Corporation' (1990) 193 *Duke Law Journal* 201.

[3] Stokes, *ibid.*, at pp. 165–6.

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The potential benefits of disclosure make this generally an attractive form of regulation. In the context of the American health care system, Sage remarks that 'because disclosure laws influence private transactions without substituting direct government regulation, they illuminate all parts of the political spectrum, appealing equally to conservatives, who applaud "market facilitation" and "bootstrapping" and to liberals who favour "empowerment" and the "right to know"'.[4] This same observation could also be made of corporate disclosure laws. The Cadbury Committee, for example, advocated disclosure as a mechanism for accountability, emphasising the need to raise reporting standards in order to ward off the threat of regulation.[5] The Hampel Committee also regarded disclosure as 'the most important element' of accountability[6] and in introducing a new code and set of principles stated that their objective was 'not to prescribe corporate behaviour in detail but to secure sufficient disclosure so that investors and others can assess companies' performance and governance practice and respond in an informed way'.[7]

There also exist more positive reasons for a disclosure system than merely the avoidance of regulatory intervention. For example, disclosure could enable investors to make more accurate investment decisions and that disclosure could protect them and others from fraud by managers or directors. Additionally, some advocates suggest that a disclosure system could contribute to corporate democracy by enabling participants to make and influence decisions more effectively. Eccles and Mavrinac emphasise the interactive role of disclosure that brings about positive results for the firm since the intent of disclosure 'is to create shared perspectives and perceptions, build a context for constructive debate, and develop a supporting context to ensure effective capital allocation both inside and outside the firm'.[8] Disclosure of information

[4] William Sage, 'Regulating Through Information: Disclosure Laws and American Health Care' (1999) 99 *Columbia Law Review* 1701, at pp. 1825–6.

[5] Cadbury Committee, *Report on the Financial Aspects of Corporate Governance* (Gee, London, 1992), at para. 3.6. See also para. 1.10 at which the Committee stresses the advantages of a voluntary code and best practice over statutory regulation.

[6] Hampel Committee, *Final Report on Corporate Governance* (Gee, London, 1998), at para. 1.2.

[7] Hampel Committee Report, at para. 1.25. See also para. 1.9 at which the Hampel Committee observes that the primary aim of the Greenbury Committee, which reported on directors' remuneration, was full disclosure rather than control of board remuneration. See further, Greenbury Committee, *Report on Directors' Remuneration* (Gee, London, 1995).

[8] Robert G. Eccles and Sarah C. Mavrinac, 'Improving the Corporate Disclosure Process' (1995) *Sloan Management Review*, Summer Issue, 11, at p. 23.

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also provides participants with choice and the opportunity to make judgements.[9] Information connects choice and accountability and participation.[10] Choice provides participants with opportunities for exit from the organisation. In this way existing shareholders require information in order for them to give their consent to or to influence the way in which the managers perform their functions. Ultimately, as Sage remarks, 'lasting benefit from disclosure generally requires the availability of choice through entry and exit, ongoing control, political voice, or other forms of self-help through legal or extralegal mechanisms.'[11] It can be concluded then that disclosure has the potential to improve corporate behaviour and relationships and in doing so might also ward off more demanding forms of external regulation.

However, despite its appeal disclosure risks being an ineffective form of regulation if it is not designed appropriately to meet its objectives. For example, investors cannot make good investment decisions without relevant information. This might require predictions and details of future projections by directors and managers rather than just historical information. In addition, if attention is not paid to providing meaningful disclosure over time then this will result in 'boiler plates' that are of no real benefit to any of the participants.[12] Similarly, if information is provided in obscure or over-technical language or is not made widely available or not presented in good time then it could be ignored or missed despite its relevance to a decision. A poorly designed disclosure system could also lead to information overload by which the participants are unable to process the information effectively.[13] Ernst and Young made such an observation when the requirements introduced by the Greenbury Committee on disclosure of directors' remuneration had the effect of increasing the length of annual reports substantially, causing shareholders to discard or ignore the information because of the burden

[9] Patrick Birkinshaw, *Freedom of Information: The Law, the Practice and the Ideal* (2nd edn, Butterworths, London, 1996), at p. 14. According to Birkinshaw, 'information in the form of facts constitutes the basis of order in our lives, of community, regularity and knowledge'. *Ibid.*

[10] Lewis states that, 'as part of the argument surrounding accountability it is important to develop the innate relationship between choice and debate or discourse and freely available information'. See Norman D. Lewis, *Choice and the Legal Order:Rising Above Politics* (Butterworths, London, 1996) at p. 17.

[11] Sage, *op. cit.*, at pp. 1827–8.

[12] Boiler plates are rhetorical statements of policy or practice with stock phrases that fail to contain any meaning. Ernst & Young give the example of the phrase 'attract, retain and motivate' that is used in so many accounts that it has lost its meaning: *ibid.*, at p. 22. See also KPMG, *The Combined Code: A Practical Guide* (Gee, London, 1999), at p. 58.

[13] See, for example, R. Groves, 'Financial Disclosure: When More is Not Better' (May–June 1994) *Financial Executive* 11–4.

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it imposed on them.[14] In this way, Ernst & Young saw the 'sheer volume of information' as 'a barrier to effective communication'[15] and suspected that 'all but the most determined readers, when faced with a page or more of dense figurework simply skip to the next paragraph of narrative'.[16] These shortcomings in the disclosure system could result in poor decisions, causing loss to the participants or, perhaps in extreme cases, even failure of the company. In any event, if the disclosure system is not designed appropriately it is likely at best that the costs will exceed the benefits that might be gained.

The above paragraph makes it clear that simply to demand disclosure is not sufficient. Rather, some thought has to be given to the content and form of the required information. Such disclosure rules, if they are to be meaningful, should be cohesive and should address the specific objectives that they claim.[17] An example is provided by Lewis, who makes direct reference to information and its importance for consumer choice in the market place. He points out that to make free and effective choices price is not the only information needed. Rather, the seller as manufacturer or retailer must provide the purchaser with all the available information in his possession. Otherwise, according to Lewis, 'choices are partial, forced or even fake'.[18] Consequently, as Lewis asserts, this necessitates information of a constructive nature on safety, quality, durability, servicing, repair and replacement costs and the like.[19] Of course, the more purposes that are attributed to the system the more difficult it will be to design an appropriate system. This may be further complicated by the existence of a potentially wide range of interest groups seeking to participate in the disclosure and information-sharing process within the company. Thus the existence of different objectives as well as different interests gives rise to the need for a sophisticated disclosure system based on more than merely a principle of openness.

This book will show that the disclosure regime reflects a shareholder-centred structure, giving priority to shareholders over other constituents with regard to information entitlements and with an emphasis on their financial interests. A sophisticated and complex financial regulatory disclosure system has been developed over time, in which legislative

[14] Ernst & Greenbury Implementation (Ernst & Young, London, 1996) at para. 2.2, p. 6.
[15] *Ibid.*, para. 2.2., at p. 6.
[16] *Ibid.*, para. 2.2., at pp. 6–7.
[17] Sage, *op. cit.*, at p. 1827.
[18] Lewis, *Choice and the Legal Order*, at p. 18.
[19] Lewis, at p. 18.

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requirements are backed up by professional mandatory standards and are bolstered also by a developed verification process. The securities field is also heavily regulated with strong disclosure requirements designed to protect investors and to maintain creditable capital and financial markets.

The emphasis on equity capital and consequent focus on the interests of shareholders has resulted in a specific kind of accounting and disclosure system. The equity capital base of companies in the UK leads to a focus on shareholders. Coinciding with the existence of a common law jurisdiction, this lead to an accounting system that relies on private regulation to supplement basic statutory regulatory rules. By contrast, some other systems, in which companies rely more on loan capital, are characterised by the existence of more government-based rules and less developed private regulatory functions.

The complex and sophisticated financial reporting regulation may be contrasted with the disclosure requirements that would support a corporate social responsibility or social contract vision of the company. Social and environmental reporting requirements are indeed relatively underdeveloped, comprising mainly an array of voluntary guides and codes, which are left to the discretion of corporate managers to follow. Companies are encouraged to follow such codes as a way of improving the company's competitive position and helping it to improve its long-term profit opportunities. Thus even this aspect of disclosure has ultimately a shareholder interest objective.

The disclosure regime entails an expensive process of information gathering, reporting and analysis. Yet the evidence suggests that shareholders do not use such information to full advantage. They are inclined to use 'exit' strategies rather than seek to improve the company's long-term prospects. At the same time there are problems with the different types of information disclosed. Financial reports, for example, are typically complex and difficult to read. Social information, on the other hand, tends to lack comparability, which reduces its usefulness. As a corporate governance device disclosure is a questionable form of corporate control. Indeed, it could be accused of making matters worse. For example, disclosure rules relating to executive directors appear to have encouraged further increases in their pay levels rather than result in a ceiling over what they receive. Thus, in *The Guardian*'s recent executive pay survey, the Notebook article states,

> The remuneration consultants blame executive salary demands on the trend for greater disclosure. With full details of every pay deal now revealed in annual reports and newspapers, they say, directors are bound to compare their own pay with their peers

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and rivals. They then demand parity – or more – and average pay is remorselessly cranked up.[20]

Recent corporate disasters across Europe and the United States underline the problems with the disclosure regime. The Enron debacle, for example, highlighted the dangers of creative accounting and poor gatekeeping. Special purpose vehicles were used to hide financial discrepancies. The auditors were too close to the managers and were accused of shredding documents. One commentator described Enron's financial statements as 'impenetrable'.[21] Similar descriptions were made of MG Rover's accounts following the company's demise.[22] There are failures at different stages of the disclosure process: failures about what is disclosed; failures in the gatekeeping functions; failures with regard to the reaction to such information; failures in dialogue between the corporate constituents; and failures of enforcement of requirements.

The lack of a clear conceptual framework might be a root cause of its problems. This may be because accounting is an evolving process with objectives that 'will change over time as a result of changes in the economic, legal, political and social environment'.[23] Stamp was led by this fact to argue that the focus should not be so much on definitions and objectives but instead on the needs and priorities of the users, also noting that these may be varied and sometimes conflicting as the potential body of users and interests grows. The ASB also notes in its *Statement of Principles of Financial Reporting* that 'accounting thought is continually evolving and it is only to be expected that the statement will need to be revised from time to time to reflect such developments'.[24]

According to Litan et al, three challenges face the disclosure environment today: globalisation, technology and the internet, and the growing importance of intangible assets to the creation of shareholder wealth.[25]

[20] *The Guardian*, 27 August 2004, Notebook, 'Curbs have done little to shrink bosses' pay', p. 27.
[21] See e.g., Anthony H. Catanach and Shelley Rhoades-Catanach, 'ENRON: A Financial Reporting Failure?'(2003) 48 *Villanava Law Review* 1057; Macey, 'Efficient Capital Markets, Corporate Disclosure, and Enron' (2004) 89 *Cornell L Rev* 394.
[22] Ian Griffiths, 'Breaking Down the Mechanics of the Money', *The Guardian*, 15 April 2005; Ian Griffiths, 'Rover's £400m accounting puzzle', *The Guardian*, 15 April 2005.
[23] Financial Accounting Standards Board, Statement of Financial Accounting Concepts No 1, Stamford FASB. Discussed in M.R. Mathews and M.H.B. Perera, *Accounting Theory and Development* (3rd edn, Nelson, Melbourne, 1996), ch. 6. See also Edward Stamp, 'First steps towards a British conceptual framework' (1982) *Accountancy* 123.
[24] See *Statement of Principles of Financial Reporting,* (December 2000).
[25] Robert Litan and others, *Following the Money: The Enron Failure and the State of Corporate Disclosure* (Brookings, US, Mass., 2002).

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In their view, the best approach for dealing with globalisation is to inject competition at a low level and to ensure that capital flows can be maintained. They note that the internet provides many possibilities: interactive communication with investors, use of tags through XBRL (eXtensible Business Reporting Language) so that investors can look at information given from many different angles. In this way it becomes more difficult for the company to use presentational methods to hoodwink the investors and others. The increasing relevance of intangible assets means that financial reporting will not be sufficient on its own as it does not highlight sufficiently the contribution of intangibles to the performance of the business.

What has resulted is a disclosure system that is asymmetrical, being overly complex and multi-layered for financial reporting and underdeveloped for narrative, social reporting. In both broad areas international influences are important, more formally through international accounting standards and European Directives with regard to financial reporting requirements and more informally through the publication of voluntary codes of conduct and award schemes for social and environmental reporting and management.

A number of solutions are required. First it is important to address the different challenges, for example by including information relevant to the contribution of intangible assets or by making use of technological developments to improve the delivery and accessibility of information. More fundamentally, it is necessary to consider the different user needs and address them all by managing competing requirements appropriately. A system of communication needs to be more clearly developed that recognises the different users and leads to better rules and instruments and better presentation of information and that facilitates dialogue between the company and all parties affected by its activities. A new morality is required that reduces the profit motivation, that sorts out the problems involved with large institutions, that stops using non-shareholders instrumentally for profit and sees them in their own right.

This book explores the disclosure regime and suggests a number of possible solutions to the problems and limitations of the existing framework. Part one deals with the general aspects, including theoretical bases for the disclosure regime as it currently exists, an overview of the regulatory structure, and a discussion of the key players including those responsible for providing information and those who use the information produced. The official information requirements and the role of the companies registrar are also considered. Part two explores the financial reporting aspects of disclosure and covers the development of the UK's financial reporting rules and the contribution of international

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and European financial reporting requirements as well as the protections available within the securities markets. Part three is concerned with narrative reporting. In particular the Operating and Financial Review, social and environmental reporting and human capital management reporting are explored. Part four concludes with an overview of the current regime and concludes by offering specific solutions to some of the problems identified and suggestions on how the regime might be developed in the future.

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