Accountants are Helping to Destroy the World, but They Could Help to Save it.

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This draft paper accompanies a seminar given by Dr Todd Sayre on 8 July 2021 for Accounting Cafe (accountingcafe.org). Dr Sayre welcomes comments, suggestions and questions.

A recording of the seminar is available on the Accounting Cafe website. Timings within the recording are provided in square brackets below.

https://accountingcafe.org/2021/06/10/changetheworld/

The scope is limited to general purpose financial reporting of large going-concern corporations with diverse share ownership.

The paper is in three sections.

Part One: How Does Reporting Help to Destroy the World? *[07:20]*

- Financial reports incorrectly portray shareholders as owners.
- This portrayal leads corporations to maximizing shareholder value.
- This contributes to destroying the world.

Part Two: How Can Accountants Help to Save the World? *[11:57]*

- Question 1: Is the corporation an association of shareholders, who privately contracted the corporation into existence and delegated their authority to govern to the board? *[12:10]*
- Question 2: Do shareholders have rights to the residual (i.e., accumulated profits)? *[18:22]*
- Question 3: Do shareholders collectively control management? *[24:46]*
- Question 4: How should reports portray shareholders? *[32:44]*

Part Three: A Historical Perspective of the Causes of Confusion in How Shareholders are Conceived. *[35:39]*

Part One: How Does Reporting Help to Destroy the World? [07:20]

Accountants are helping to destroy the world by portraying shareholders as private owners of the corporation, making pollution and exploitation more defensible in the public's eyes.

Reports portray shareholders as owners.

1. Retained earnings are reported as a subset of Shareholders' Equity, implying that shareholders own the residual (i.e., accumulated profits), and
2. dividends are treated like withdrawals by a sole proprietor rather than expensed as a cost of capital.

This portrayal of shareholders as owners leads the public to believe corporate management must maximize shareholder value.

What is the result of maximizing shareholder value?

1. To maximize profits, you maximize revenues and minimize expenses.
2. Maximizing revenues in a finite world ultimately destroys the earth.
3. Minimizing expenses acts to externalize pollution costs and minimize labor cost.
4. The result is the world we live in—climate change craziness, massive extinction of species.
5. Most people are struggling because of debt, low pay, etc. The rich benefit from destruction with higher asset values and live above it all with anti-depressants and other things. Of course, everyone is on Soma.

Why is this a problem?

Accountants in the first half of the 20th century justified portraying shareholders as owners as follows:

Shareholders own the corporation because the corporation is

1. An **association** of shareholders, who…
2. …privately **contracted** the corporation into existence and…
3. …delegated their authority to govern to the board.
4. Shareholders have **rights** to the residual (i.e., profits), and…
5. …shareholders collectively **control** management

This paper argues that these pioneers in the proprietary theory of accounting were wrong on all counts.

Part Two: How Can Accountants Help to Save the World? [11:57]

Accountants can challenge and question the reports that portray shareholders as owners, and press regulators for changes to financial reporting.

Accountants justify portraying shareholders as the owners as follows:

1. The corporation is an ***association*** of shareholders, who privately ***contracted*** the corporation into existence and delegated their authority to govern to the board.
2. Shareholders have ***rights*** to the residual (i.e., profits), and;
3. Shareholders collectively ***control*** management.

Question 1: Is the corporation an association of shareholders, who privately contracted the corporation into existence and delegated their authority to govern to the board?

Answer 1: *Shareholders do not privately contract the corporation into existence, and it is the state who delegates to the board its authority to govern.*

Opposing Facts:

1. The corporation must own property to exist as a long-term contracting entity. Private contracting does not require statutes,
2. **Statutes are required** to shield the entity's property from capital providers and the creditors of those capital providers. In a business corporation that includes the shareholders and shareholders' creditors.
3. **Private contracting cannot shield shareholders' creditors from the assets.** (Hansmann et al. 2006) [It's certainly hard to get all jurisdictions to agree on the contractual shielding mechanisms. The trust, made legal in the 17th century courts, worked in England until mid-19th century and did not work well across states in the USA].

Evidence Supporting the Assertion that Statutes are Required

1. For business corporations, de-privatizing property enables the existence of a stock market for freely tradable shares.
2. We do not see stock markets for freely tradable shares until 1602 when the Dutch States-General de-privatized investment capital, which was contracted for 10 years, then made permanent property of the Dutch East India Company (VOC) in 1612.

Question 2: Do shareholders have rights to the residual (i.e., accumulated profits)?

Shareholders do not own the assets related to the residual.

For shareholders to own the assets related to the retained earnings, they need the legal rights and duties of ownership, including:

(1) the *liability* to execution for personal debts (i.e., personal creditors may seize the thing in question.

(2) *duty* to prohibit harmful use;

(3) the *rights* to possess, use, sell, and manage.

1. Shareholders have no liability of execution because statutes shield corporate assets from shareholders' creditors.
2. Shareholders have no *duty of responsibility* because they have no liability for corporate debts or torts. (The term 'limited liability' originates from a shareholder's liability being limited by the unpaid capital still owed on the shares. See Ireland 2006.)
3. Shareholders have no right to use, sell, or manage the assets related to retained earnings. To have such a right all others must have a duty to exclude themselves, which they don't have. In fact, historically, employees and shareholders have fought over the distribution of retained earnings.

Corporate boards have a fiduciary responsibility to the corporation (and its shareholders). Their decisions are protected by the business judgment rule, and they can distribute the residual as they with, within reason.

Legal experts agree that "…shareholders do not own corporations; nor do they own the assets of corporations. Shareholders only own shares…"[1] (Also see Stout 2012)

[1] For the quote and signatories, see https://themoderncorporation.wordpress.com/company-law-memo/

Question 3: Do shareholders collectively control management?

Answer: They do not have direct or unilateral control, but they have some political influence, similar to that of a voter.

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1. Shareholders have no unified voice as their preferences differ among mutual funds, pension funds, sovereign funds, hedge funds, CSR funds, etc. The preferences of long-term shareholders are likely more like long-term employees than hedge funds.
2. Labor also has influence over the board.
3. Management fights against shareholder influence. (e.g., Business Roundtable against takeovers with state statutes and Business Roundtable against SEC shareholder proxy access).

The right to vote has not conveyed ownership anywhere, anytime, over anything, except shareholder ownership of the corporate residual. Consider the following:

1. If only property owners vote in city elections, they stand to benefit, but they are not called owners.
2. Beneficiaries of trusts have no control but are considered beneficial owners as the have a right to the trust's benefits. The trustees vote and are not owners.
3. In reporting, common no-vote shares and preferred shares are portrayed like common shares with a vote.
4. In Sweden and Germany, employees one-half the operating board but are not considered owners.

Shareholders may have "rights to the residual" but they do not have a "legal right to the residual," whereby others are legally obligated to exclude themselves. On the contrary, others (e.g., labor) also have "rights to the residual" and can also influence management.

Question 4: How should reports portray shareholders?

1. The corporation is an entity, not an association.
2. Reporting on an entity, suggests Assts = Equity (Paton 1922) or Assets = Liabilities (Davis 1908), where all items are listed as credits and dividends and interest are treated the same, as expenses.
3. Entity reporting is consistent with tax policy.

Accountants can save the world by not portraying shareholders as owners; not presenting to the public that shareholder value maximization is the purpose of corporations.

Part Three: A Historical Perspective of the Causes of Confusion in How Shareholders are Conceived. [35:39]

Misunderstanding started with the East India Company, etc. Unfortunately, the misunderstandings continue today in the courts, the media, universities, etc. We accountants contribute to the misunderstanding through our reports that portray shareholders as owners.

The confusion is still present:

In Citizens United, Scalia arguing that "[t]he authorized spokesman of a corporation is a human being, who speaks on behalf of the human beings who have formed that **association**..."

What causes the confusion?

1. The Dutch East India Company (VOC) began as a limited partnership and therefore never gave a vote to shareholders.
2. The Dutch States General created the stock market to incentivize wide capital investment not to provide shareholders with control.
3. The British East India Company (EIC) began as a member corporation and carried over "one-person-one-vote" to the business corporation.
4. To entice capital investment, the EIC gave more votes for holding more shares.
5. Without a stock market until the 19th century, EIC shareholders looked like partners with property rights in the corporate assets—they looked like an **association**.
6. In the UK, the Limited Liability Act 1855 called the corporation an association and the 1860 Act called it an entity. (Ireland)
7. Berle & Means viewed the corporation as an entity, unowned with the purpose of benefitting society (although shareholders needed protections).
8. Berle & Dodd agreed that corporations were being run for society not shareholders starting in the 1930s. This type of corporate governance was called 'managerialism.'
9. Shareholders were portrayed and treated as capital providers and speculators; however, in the latter part of the 20th century the SEC, FASB, and academics, fighting against a totalitarian state, argued that shareholders were owners.
10. Friedman (1970) argued *against* the status quo and *for* maximizing shareholder value because, he argued, shareholders owned the corporation.
11. In 1975, wages stopped rising with productivity.
12. Manne in the 1960s and Jensen and Meckling 1976, et al. argued first for takeovers, which the Business Roundtable fought against and won.

13. Jensen & Murphy 1990ab published in *Journal of Political Economy* and the same paper the Harvard Business Review said that executive pay should be tied to stock price.
14. In 1993, Congress passed a law making it illegal to pay executives over $1 million unless it was performance-based.
15. Jensen et al. argued in congressional hearings that stock price was performance based.
16. In 1994, executive pay increased, and we have had scandals in 2000 and 2008 because of it.
17. Buybacks have hurt the corporation itself (Lazonik 2014) and the government has stepped in to save them.
18. Retirement accounts.

Conclusion

Maximising shareholder value is justified by financial reports that portray shareholders as the private owners of the corporation. Accountants should question rule-making authorities as to why shareholders are portrayed as owners when legal scholars agree they are not.

A more faithful representation in reports would portray the corporation as an entity. This would help the public better understand its role in society.

Selected references

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