Watchdog warns that corporations' financial viability is at risk

Jean Shaoul
2 January 2008

The world's press has been focused on the financial fallout for the banks from the credit squeeze and the crisis of liquidity following the collapse of the sub-prime mortgage market in the US. This has seen the world's largest banks write off billions of dollars of assets and seek extra funding to balance their books.

Less has been said about how all this will affect other corporations, their workers and the economy as a whole.

A short but unprecedented press release from the Financial Reporting Council (FRC), the UK corporate reporting regulator, demonstrates just how closely the financial sector and the "real economy" are connected and the devastating impact the turmoil in the world's financial markets will have on major corporations in Britain and around the world.

Paul Boyle, the FRC's chief executive, addressed himself to big business and the audit industry, which scrutinises the corporations' annual accounts before giving them a clean bill of health. He couched his words in technical terms but could not disguise the scale of the crisis as corporations approach their financial year-end and prepare their annual report and accounts. His denial that there was any reason to panic only served to underline the alarm now permeating the more perceptive layers within the City.

Boyle said that the recent credit crunch and the fall in the value of sophisticated debt instruments, shares and other financial assets "mean that the risks to confidence in corporate reporting and governance are higher than they have been for some years."

These increased risks "require additional diligence on the part of preparers of accounts, members of audit committees and auditors this year," he continued. "If all players in the reporting chain do their jobs properly and are diligent about judgements, there is no reason to believe things won't go well, but clearly risks are higher than normal this year, though we are not suggesting any cause for panic."

Boyle warned that companies reliant on short-term credit for long-term debt would find it harder to obtain credit in the coming period. With levels of corporate debt running at unprecedented levels in order to finance not investment in new productive capacity but entirely parasitic activities such as mergers and takeovers of other companies at grossly inflated prices, many companies are likely to run into difficulty.

Corporations will be forced to write down the value of their assets, which include not just bricks-and-mortar assets such as property, and real estate, whose prices are expected to fall, but also financial assets whose value has already fallen sharply. This will affect not just the financial services sector—the largest sector in Britain—but also property companies, and the big high street chains whose credit card subsidiaries have been in some cases, at least, the most profitable part of the business.

Many companies now value their assets at "fair" or market value, rather than the more traditional historic cost, the price they originally paid. But with many financial markets drying up, "market" prices are now more difficult to determine.

When asset values were rising, the corporations could use them as collateral to borrow ever more loans. Now as their asset values plummet, borrowing will become ever more difficult. The write down in assets will be a charge against profits.

Some of the most highly indebted companies in Britain today are the former state-owned enterprises: the infrastructure industries, transport and utilities. Their essential nature means that they cannot be allowed to fall prey to the ultimate sanction of the market—bankruptcy—meaning that either the state must step in or the economic regulator, where there is one, must allow prices to rise sharply. Either way, the public will bear the cost.

The FRC called for "detailed consideration" of potential impairments to assets as the main accounting issue, as well as "due care and diligence" of the valuation based on market prices.

"The financial sector has got a great deal of attention, but the way this is playing out means that companies outside the sector could be affected in ways that are not immediately obvious. We want to encourage them to think through the implications," Boyle said.

He added that the accounting standards used to prepare the annual accounts leave plenty of room for "judgement," which could lead to serious mistakes. "That's the sort of thing that really gives corporate reporting a bad name and what we want to try to avoid," he added.

"Corporate reporting always involves the use of estimates and the exercise of judgement and those estimates and judgements are likely to be particularly challenging this year," he warned.

Boyle also warned about the business review, the section in the annual report where executives discuss the outlook for the coming year and the main uncertainties and risks confronting the business. "It won't be too convincing, if there are difficulties in 2008, for companies to say 'when we signed off we didn't think about that,' " Boyle said.

A recent survey by the accountancy firm BDO Stoy Hayward confirmed that the credit crunch is being felt in several business sectors and by both large and small companies. A large minority of finance directors believed that their companies do not have sufficient access to finance. But a staggering 30 percent of finance directors said that they never assess the impact of the current economic conditions on their business. More than a third had failed to carry out a thorough analysis of the financial health of their business in the previous six months.

Mike Prangley, the business restructuring partner at BDO Stoy Hayward, told the *Guardian,* "Some corporates are showing signs of reluctance to accept there are problems. This is definitely a cause for concern and suggests some management teams have their heads in the sand, especially with uncertain times ahead."

At the heart of the FRC's concerns lay the fear that many companies would not receive the "going concern" assurance—based upon the Board of Directors' and the auditors' judgement that the business is sound and has sufficient financing in place for 12 months from the date that the accounts are signed off. Auditors cannot issue a clean bill of health on a company's accounts without certifying that it is a "going concern."

Many companies will be forced to find additional sources of finance under conditions where everyone else is doing the same. That is why the central banks took such unprecedented steps to inject liquidity into the financial markets. It is not just the banks' financial position that is at stake but that of the corporate sector as well.

Mindful of previous accounting scandals whose origins lay in an attempt to disguise the true state of affairs, the FRC's statement was a not too subtle warning to top management and their auditors not to cook the books as others had done when boom turned to bust. Any attempt to conceal the worst effects of the credit crunch would soon unravel, giving rise to an accounting scandal. That, in today's circumstances, would further undermine the credibility of corporate profits, the corporate reporting regulator, and thus the position of London as a leading international financial centre, already under threat after the collapse of Northern Rock.

While the FRC speaks on behalf of the financial elite whose concern is with their own profits, it nevertheless makes clear just how parasitic British corporations have become—dependent on financial engineering and creative accounting rather than the production of goods and services for their profits—and how closely entangled they are with the financial sector. It also points to the devastating impact the credit crunch will have on the livelihoods of ordinary people as major corporations collapse, jobs go, mortgage costs and debt servicing rise, and homes are repossessed.

Above all, the FRC fears the political backlash that will follow a wider economic meltdown from working people against the neo-liberal economic agenda that has dominated politics for nearly three decades. As long as finance capitalism was able to deliver jobs, however insecure and poorly paid, and provide a means of accessing cheap credit to purchase life's necessities, then it faced little political challenge. Now, the chain of events set in motion by the US sub-prime mortgage crisis threatens to topple the economic conditions that sustained the political dominance of the financial and corporate elite.