How hollowed-out firms manufacture their distributable profits

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1. Introduction

The 'hollowed-out firm' has been identified as a significant social and economic problem (Baker et al 2020). Hollow firms[1] have a number of common characteristics, of which three, are key: high levels of dividends and buybacks which, in many cases exceed earnings, the growth of to write downs that could push firms into negative shareholder equity. Many firms now face a perfect storm: the prospect of realising fair value impairments on top of their operating losses whilst also trying to find liquidity from the capital markets just as company credit ratings fall and equity markets dry up.

Hollowed-out firms highlight the extraordinary disregard of the basic principles of financial resilience that emerged as the 2010s progressed. This is of real concern since many such entities are what are now commonly called Public Interest Entities (PIE)

[2] – i.e. companies with shares quoted on stock exchanges, or that engage in banking, credit and insurance activities, plus those additional entities deemed to be PIEs by government because of their public significance. As a result, many hollowed-out forms are now integral to the management of national economies.

The processes by which firms are hollowed out are usually to be located in the arcana of creative accounting. This may involve the exploitation of the rules on what might represent distributable profits (Leaver and Murphy 2021), or the exploitation of revenue recognition and fair value rules

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[1] In this note the term 'firm' refers to commercial activities undertaken in pursuit of profit in the course of a trade, whatever that trade might be. In general, the term is used to refer to the activities of a group as a whole i.e. the firm is considered to be the sum total of the activities undertaken by all the entities making up a group as represented in the consolidated financial statements that it produces annually for the benefit of its shareholders and published on public record. In contrast the term company is used to refer to a particular legal entity within that group, whether or not its activities contribute to the overall result of the firm as a whole, or not. This differentiation is of particular significance in the case of the group parent company i.e. that legal entity that acts as the legal owner, whether directly or indirectly, of all those other entities that are together grouped together to undertake the trading activities of the firm. This particular company is possessed of a dual personality: it is both a constituent member of the firm, where its trading activities might, in practice, be insignificant, but it is also a legal company undertaking activity in its own right quite distinct from the firm as a whole, and therefore capable of recording a profit or loss independent of that which the firm might recognise, largely as a consequence of the income that it does, or does not (at the discretion of the firm's directors) enjoy as a consequence of the distribution of profits to it by the subsidiary entities that it controls.

[2] PIEs are defined in EU law,

(Baker et al 2020). In Baker et al (2020) we raised the idea that some of the accounting techniques conventionally understood as tax planning practices may – in fact – be used to maximise

can do this because the dividend received from B Limited will then constitute its sole distributable reserves in its capacity as a parent company, and not as a group entity.

As a consequence, B Limited and A plc (as a parent company) have no reserves, and the group has negative reserves of £20 billion, as does C limited. Yet dividends have been paid legally even though they are in excess of real profits arising because the reserves in A plc, acting as a parent company, are recognised as realised and distributable despite the fact that most of the8 (b)-0.f-4.7 (d)TJ94uhe8n i d r p dluta rw

purposes of corporate profit reporting. A tax adjustment need not be reflected in an accounting adjustment[4]. Directors of companies, including those that are part of larger firms, can make 'bad bargains' that result in losses, and so long as their accounts properly reflect the bad bargains they have made, their accounts are true and fair under current law. The consequence is that the realised profits of the parent company may exceed that of the consolidated group as a result of transfer mispricing and that outcome would be entirely legal under existing rules.

4. Transparency and disclosure

Another issue of concern when considering this issue is that subsidiary entities used for this purpose often have their accounts prepared under differing generally accepted accounting principles from those used for the parent entity of the group. Hence, much of what we describe above is largely hidden from view in the accounts of the subsidiaries involved. For example, the UK's Financial Reporting Standard 102, which is the alternative generally accepted accounting principle most likely to apply in this situation to a UK subsidiary company of a parent entity that for group accounting purposes uses International Financial Reporting Standards merely requires[5] that the subsidiary provide 'a reconciliation between (i) the tax expense (income) included in profit or loss; and (ii) the profit or loss on ordinary activities before tax multiplied by the applicable tax rate.' This reconciliation need not be provided in detail and the language used is often vague, and non-descriptive, with the term 'other items' or 'other adjustments' frequently appearing, meaning that no effective disclosure is made. In that case transfer pricing adjustments for tax purposes that might disclose that activity of the sort described is taking place can very often be hidden from view within accounting disclosures made.

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purpose: it incentivises what Jim Chanos has called 'legal fraud'[6]. And when management are remunerated in stock options on the basis of their ability to create shareholder value, they have

Third, there is a pressing need for information that would allow all stakeholder groups to appraise whether the decisions of directors prejudice the capital base of the firm which ultimately sustains all stakeholder claims, both present and future. In that case the entire conceptual framework of the

Leaver, A. and Murphy, R. 2021. *Creative accounting and shareholder value: why the accounting rules on distributable reserves must change.* . Sheffield: Centre for Research into Accounting and Finance in Context (CRAFiC), University of Sheffield, forthcoming.

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