Corporate accountability and managerial change

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Finance is a science and follows rules just like any other discipline, however, it is not a science of black or white. There is a lot of room in finance to "maneuver". This discussion addresses an often marginalised, even ignored, factor of accumulated losses and bad debts in companies. It is important to understand the effect of accumulated losses and bad debts on issues such as managerial competence, corporate governance, and owner participation in their business, management and social responsibility.

One of the saddest features of our economy are the bad debts that exist in almost all institutions. It is not a question of whether they are there or not but rather, how they exist. Let us avoid classifications of which bad debt is from political pressures, which is from bad economics or which is simply from bad planning and analysis. The issue is the level and trend of bad debts in this country, which simply means financial anomalies do exist with roots that spread more into willful default and deceit rather than bad economics. Bad debts are written off eventually but they, at some point, do make up a portion of accumulated losses on the balance sheet of non-financial and financial institutions. Let us not get into whether provisioning is an antidote to loss. The question is not how to deal with issues like accumulated losses and bad debts but why they exist unchecked, unfettered in the first place.

The effect of accumulated losses and bad debts is long term and at times so slow that one fails to take heed in the short term. Accumulation of losses allow a deferring of the realisation of a loss. It is logical to believe that one should be allowed some time, some respite, in entirely absorbing the loss with future revenues. However, what is illogical is why companies / entities are allowed to pile up these losses over years and years (under the garb of "going concern and market stability")? Lets us pause here. What does a loss represent? It represents a lower revenue as opposed to a higher expense (for a given time period). If there is a loss why is it allowed to be carried forward to the next year, then the next, then the next, in an almost ludicrously indefinite manner? The rational is, if there is a loss the entity has to absorb it from its wealth (i.e. equity), and recognise it as an erosion of wealth. Giving an option to defer recognition of losses gives, perhaps, too much room for "maneuvering".

Equity not only represents ownership but also an "absorber" of risks, and losses; it is the health of an entity, and is also a reflection of managerial abilities and competence. The final resting place of a profit or loss is equity in that losses have to be absorbed in equity, and retained profits are added to equity. Barring misrepresentation from management, generally speaking an increase in equity represents a business better managed (given comparability with peer companies), whereas a decrease in equity represents the opposite. Yes, losses may occur due to an over all recession or depression however we speak of the average improvement / deterioration of equity over a time period. For the sake of analysis, one can very safely say that there is a "health of equity" in that there is strength or weakness of equity; the question differentiating both situations is, can the equity sustain the losses or not and is a true picture being presented? Is the health of the equity being honestly and diligently guarded by management?

As the entity participates in the market, public funds will inevitably be involved, which brings fiduciary duty into this discussion. Imagine a beast of burden that is weak in health; load the animal with stones, so much so that it manages to walk, but only barely. How long can one conceivably expect the animal to perform or even survive in a race; business is a race of the fittest, or rather, that is how it is meant to be. How can a loss accumulating, bad debt ridden entity, analogous of the beast of burden loaded with stones, be able to perform, fulfilling the rights, requirements and objectives of the shareholders? Is it not a logical conclusion that management that allows losses and bad debts to pile up needs to be removed?

Accumulated losses and bad debts are signs of bad economics, managerial incompetence and, possible willful anomalies; this may be analysed with the quantum and trend. If an entity has experienced a loss, it may be considered a part of business. What happens when there are continuous losses and bad debts over a period of time, resulting in a level of accumulated losses that may be a significant portion, equal to or higher than the entire equity of the same institution? Does that represent bad economics? Maybe, but for how long? It should, actually, also be interpreted as managerial incompetence, and willful. If the losses are absorbed in equity, the owners (equity holders) will realise and feel the quantum of the loss of their wealth at the hands of management. That will spur the owners to bring about change. Change is not bad. Lets remember whatever changes remain healthy (and alive!).

One has to analyse the effect of accumulated losses and bad debts, financially and time wise. Financially speaking if there is an accumulated loss and bad debt it should be adjusted with the equity; this will reveal the true worth of the entity. If there is an accumulated loss that started piling up just a while back, it has to be treated differently as compared with piling up of losses that have been occurring for years and years. At present there are many companies that have accumulated losses that are greater than the total value of their equity. The adjustment of accumulated losses will enforce corporate governance through proper and just managerial selection by the owners. With a greater number of companies going bust we can (hopefully!!!) expect more vigilance from the company, public, stakeholders and the regulators in the long run. However this act has to be enforced, for it to be effective. Let us take the example of western economies. Yes, they have cases like Enron that really raise eyebrows, but on the whole there is more accountability there than here; Enron did caught, didn't it? One should just look at their GDP and then ours, which represents less than 1 per cent of the American GDP. This means, managerially and economically they must be doing something right.

Where there is smoke there is fire and the fact that accumulated losses and bad debts are piling up means there is something wrong, somewhere. There is a limit to which bad economics can be blamed. There is a logical reason for allowing companies some sort of reprieve from immediately realising losses, however, there has to be a limit. Accumulated losses that come close to (e.g. 30 per cent) and exceed the value of equity need to be more strictly regulated, or simply in more draconian terms, disallowed. Realisation of accumulated losses in a timely and complete manner allows not only a fair and transparent picture to be presented to the investing public but also makes institutions healthier.