BANK OF UGANDA

Remarks by

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CEO of Capital Markets Authority,
President of the Institute of Public Accountants of Uganda
All captains of industry, and sponsors of the FiRe Awards,
Ladies and Gentlemen

Good evening!

I would like to begin by thanking the CEO of the Institute of Certified Public Accountants in Uganda for inviting me to be chief guest at this wards dinner and to commend the Institute and the other organisers and sponsors – the Capital Markets Authority, the Uganda Securities Exchange and the New Vision – for this very commendable initiative.
I hope it will lead to a greater understanding among the business community in Uganda of the benefits which firms can derive by preparing financial accounts that comply with best practise and global reporting standards.

I want to reflect in these remarks on the contribution which financial reporting makes to a developing economy and in particular the growth of a modern business sector. The business sector in Uganda is dominated by small and medium scale enterprises (SMEs); the most recent comprehensive data which are available from the Census of Business Establishments indicates that the average number of employees of a registered business is only 2.3. As is the case elsewhere in Africa, SMEs in Uganda struggle to expand. The vast majority of them never expand enough to become large firms. Of the approximately 460,000 registered businesses in Uganda, less than 1,000 have more than 50 employees.

One of the reasons why SMEs struggle to expand is the nature of these firms. The majority are owned by a single proprietor or by a group of related family members. The proprietor of the firm is often the manager. The governance of these firms, including financial governance, tends to be informal, without transparent rules, records and procedures. This type of informal governance may be adequate for small companies but it is a major barrier to their growth and expansion.

Firms cannot expand without mobilising capital for investment. Beyond a relatively small size, the investment needs of a firm outstrip the financial resources of a sole proprietor or a single family. Hence finance must be mobilised from outside sources; i.e. from outside of the firm's immediate ownership. From a business perspective, the ideal form of finance for firm expansion is equity capital, because this is long term finance and its returns are linked to the performance of the firm. Equity capital from outside sources can be mobilised through private equity placements or by selling shares on the stock market.

But to mobilise equity capital from outside sources, the existing proprietor or proprietors must be prepared to share ownership of the firm with new, probably minority shareholders. For their part, new investors will only purchase equity in a firm if they are confident that they will, as non-controlling shareholders, be treated equitably by those who control the firm.

Some SMEs try to avoid bringing in outside shareholders to fund their expansion by relying on debt finance instead of equity. But this often leads to the failure of the firm. The maturity of debt finance is often much shorter than the payback period of capital investments. Thinly capitalised firms often have to devote a large share of their revenues to servicing their debt and so are very vulnerable to adverse shocks to their revenues or to the costs of debt servicing.

A second fundamental change which firms must make if they are to expand successfully is the separation of ownership and management. As a firm grows larger, its management becomes more complex and demanding of professional and technical expertise. As such, a professional manager or management team becomes essential. This means that the micro-management of the firm by a sole proprietor is no longer a tenable business practise. The proprietor or proprietors of the firm must be prepared to step back from its everyday management and instead focus on playing an oversight role as board directors of the firm.

These two types of changes which are essential for firm expansion – the diversification of share ownership and the separation of ownership and management – require fundamental changes in the governance of a firm. The type of informal, non-transparent governance which characterises small firms managed by a sole proprietor is no longer adequate for larger and more complex firms with multiple shareholders and professional managers. The governance structures of the latter must be much more formal and transparent, so that all of the different types of stakeholders in a firm can be confident that their own legitimate interests are properly taken into account in the management of the firm.

One of the reasons why formal and transparent corporate governance structures are necessary in larger firms is that complex organisations are often vulnerable to what economists call “principal agent problems”. An agent is someone endowed with executive authority by a principal to serve the interests of the latter. For example a chief executive officer is appointed by the shareholders of a firm to serve their interests; in this case the CEO is the agent and the shareholders the principals.

Principal agent problems usually arise when agents have incentives to act in ways which are not in the interests of their principals and when the latter lack the means to properly monitor and control the actions of the former. Three main types of principal agent problems can occur in the management of firms: between managers and owners, between controlling and non-controlling shareholders and between a firm and its creditors.

Proper corporate governance structures are a means to mitigate principal agent problems and thus ensure that a firm can be managed efficiently for the mutual benefit of all of its stakeholders. Because the operations of a large complex firm involve a host of non-controlling stakeholders, without effective corporate governance structures to mitigate principal agent problems, modern business would not be possible.

One of the most important components of effective corporate governance structures are accurate and reliable financial reports. Other key aspects are a clear legal framework which delineates the rights and obligations of all of the different stakeholders and which can be enforced effectively in the courts, and appropriate management and oversight structures within the firm, with clear responsibilities for the firm's board of directors. Financial reports provide a window into the operations of a firm which can give all of its stakeholders the information that they need to conduct transactions with confidence that they are not being taken advantage of in any way.

For example, without accurate financial reports, minority shareholders cannot be certain that the firm in which they have invested their wealth is being managed in the best interests of all shareholders and not just those who control the firm's management. Financial reports are essential to enable a firm's board of directors to evaluate the managers they have appointed. They are an essential tool for a firm's board of directors, which is why a firm's internal auditor usually reports directly to the board and not to the management, so that the board can be confident in the veracity of the financial reports.

The requirements of modern firms for credit cannot be accommodated satisfactorily by lenders unless the latter have confidence that a firm can service its debts from its future revenues as a going concern, but such confidence is only possible if lenders have access to reliable financial information with which to evaluate the firm's business prospects. For those firms seeking to mobilise capital by issuing equity or corporate bonds on the capital market, a history of financial reports is a prerequisite, because the institutional investors who are the main customers for corporate stocks and bonds rely heavily on financial reports to evaluate prospective investments.

To maximise the benefit of financial reports for all stakeholders, it is essential that they be prepared according to international best practise, such as the IFRS 9, which will become mandatory in Uganda, as in the rest of the world, from the beginning of 2018. A common set of internationally recognised standards for financial reports allows everyone to understand precisely what the information contained in them means. We also require high calibre professional accountants with the requisite expertise to prepare financial accounts to the highest standards. In this regard, I would like to commend the Institute of Certified Public Accountants of Uganda for their efforts to uphold the highest standards of accountancy and financial reporting in this country.

Finally, let me conclude by congratulating all the companies which have won Financial Reporting Awards this year.

Thank you for listening.