

**RESPONSE by Mr F.A.G. KAY (Retired
Company Secretary) to the Consultation Paper
issued by Derek Higgs in July, 2002, on the review
of the Role and Effectiveness of Non Executive
Directors**

1. What role should non-executive directors perform, and how does this compare to the present position?

Regulation 70 of the 1985 Table A states that the business of the company shall, unless the Articles specify to the contrary, be managed by the directors who may exercise all the powers of the company.

So the business of the company must be managed by the directors - not just the executive directors and not just the non executive directors - but by all the directors.

Therefore the non executive directors should have precisely the same role as executive directors. Because in law all directors are equal, each having the right to attend and speak at board meetings and, unless the Articles rule to the contrary, to vote for, against or abstain from voting on any issue put to the vote.

My experience of non executive directors is very limited but from what I have seen they attend board meetings for the free beer, utter a platitude or two, propose a Vote of Thanks to the Chairman at the conclusion of each board meeting, have a good lunch, collect their expenses and go off home. In voting they appear to take their cue from the Chairman.

I used to make a point when writing the minutes of ensuring that every director present got his name mentioned somewhere even if it was only "During general discussion, Mr X mentioned" even if he hadn't - and I never got any complaints.

The qualification for holding office as a non executive director often appears to be (1) the holding of other non executive directorships, or (2) being the representative of or the holder of a substantial shareholding.

How independent do non executive directors need to be for various roles? This implies it is an accepted fact that non executive directors are not always independent. If that is the case - and I agree if probably often is - of what real value are such people?

Not being independent means in effect they are Yes men who look to the hand that feeds them and act accordingly. If anyone is built that way they will never change.

What can be done to help non executive directors to be effective in relation to potential conflicts of interest within a company? The smart answer is to say issue each with a backbone - the realistic answer is that there is nothing that can be done which will be effective. You are not going to change a wimp into a tiger simply by introducing a few rules.

It is interesting that in private companies it is often the case that many companies do not even have non executive directors and if they do little or no distinction is made between executive and non executive directors.

The executive directors should have the day to day detail of running the business at their finger tips and they do not need any help from non executive directors on that score. But some companies have a need for extra help to expedite their business and so non executive directors are recruited, much on the same lines as a lobbyist is engaged to represent or push a particular interest.

But so much in the higher echelons of business is conducted on the Old Boy network where a professional lobbyist has much less influence than an old school chum. Consequently the Douglas Hurds of this world are recruited as non executive directors not because of their outstanding business ability but because of their contacts (which do tend to become a diminishing asset as the years go by and senior people retire).

I have heard the late Lord Boothby many times mention that he had the right of direct access to the Foreign Secretary - which was important to the company which was foreign controlled as the noble lord could help to speed up the granting of visas for visiting shareholder representatives. He also used to mention from time to time “As I said to Stalin...” or “as Churchill said to me ...” which implied he moved in the rarefied atmosphere of the highest level of politics with all that signified.

Some companies have a lawyer on the Board as a non executive director - other companies simply get the Company Secretary to take up any legal problem with the company’s solicitors. Other companies have a qualified tax accountant as a non executive director whilst others simply take any problem to their accountants for advice.

On reflection, it seems to me the role of non executive director could be dispensed with because all they contribute can be hired outside on a one off basis - except in the case of a large shareholding where a seat on the board seems to be obligatory and is little more than massaging an ego or where a person with a title is appointed to give the company a bit of status which is but a way of massaging the ego of the public..

As there are various reasons for the appointment of non executive directors - including providing a sinecure for relatives - it follows that there is no specific role for them to perform - it all depends on the circumstances.

What role should they perform? None. More often than not they are “grace and favour” appointments - if they had a real job to do they would be executive directors. All they do can be achieved by consultants -so why have them? If it is suggested they provide a brake on the extravagances of executive directors we can all immediately go outside and have a titter - any brake necessary can only be provided by severe legal penalties and equally severe enforcement.

The only justification I can think of for having non executive board members is because they may command a field of expertise needed by the company from time to time which none of the executive directors has. For example, extraordinary negotiating skills, particularly with shady customers.

The role of the chairman is the same for non executive directors as for executive directors. The chairman conducts board meetings and (hopefully) maintains order.

The ideal chairman is a someone who controls the discussion ensuring everyone has the opportunity to say his piece, and at the end of the discussion sums up the views expressed and states what the consensus of opinion has been. He then puts the resolution to the vote - usually in the form of “We are agreed then that we purchase an acre site of industrial land with planning permission and build a new factory - all in favour?” and declares the resolution “Carried” or “Not carried”.

From the point of view of someone who has to write up the minutes it is a blessing to have a chairman who determines quite clearly what has been agreed. So often chairman allow members to waffle on and when everyone has run out of steam simply say “Shall we pass on to the next item on the agenda.”

If non executive directors are to be given certain key roles then they automatically become executive directors under Regulation 84 of the 1985 Table A.

The whole object of a board of directors is for all the members to act as one - otherwise known as collective responsibility. If any member seriously disagrees with a course of action proposed he can resign - which in a listed company is a major, major event and certain to hit the headlines. It isn't all that frequent in private companies either.

If we are to go down the road of allocating non executive directors specific responsibilities it is likely that this will be copied in other areas such as trustees. Then you will have one trustee exclusively responsible for investment, another for grants, and so on. I boggle to think how this would work with the distribution of Lottery money or with the Princess Diana Trust which both seem to be in a big enough mess already without further help.

The number of non executive posts that an individual can take depends on how lucky that person is and how many non executive directorships he/she is offered. There are approximately 22 working days each month so realistically one board meeting a day would be quite realistic. But I have

known directors who have a 100 or more “other directorships” - and it is unlikely they could all be executive roles.

But where subsidiary companies are involved it would be quite possible to fit in half a dozen or more board meetings in a morning - it only take five or ten minutes to approve accounts and convene a general meeting.

To introduce a role for a “senior independent” non executive director would be the best way to create a second chairman and to cause a split if not a chasm down the middle of the board of directors between the executive and non executive directors. We are already a long way down the road to effectively having two boards of directors with all this emphasis of non executive versus executive directors. So is this in the interests of the shareholders - I think not.

I believe that the proposed statutory statement of directors’ duties is absolutely right not to distinguish between the duties of executive and non executive directors. The board of directors is nothing more than a talking shop where everyone is equal from which emerges policy decisions and all that is needed for this is a large table with sufficient comfortable chairs around with the carrot of a good lunch at the end of it all.

2. What knowledge, skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to non executive roles?

One could say experience, integrity, affability and a large circle of friends or acquaintances with influence at high level in various areas of politics, government, and the business world generally. But integrity is not such an important characteristic when large companies need to do business with foreign governments where “backhanders” are the norm.

So , again, the knowledge, skills etc required depend so much on the business activities of any particular company that there can be no hard and fast rule. There could be situations where a right scoundrel would be ideal whereas a person of the highest integrity would be useless.

As to how to attract, recruit and appoint the best people as non executive directors, the difficulty is always going to be how to assess who are the best people.

One area would be executive directors of other successful companies, but a company is hardly likely to want to recruit as a non executive director the chief executive of its biggest business rival.

Otherwise recruitment can only be from the pool of people who make a profession of being non executive directors and holding many directorships. But the majority of them do not and have not held executive posts so they have no proven record of ability and in the end it comes down to who you know and who can talk the best - we have all heard of the professional boxer who talks a good fight and in the event fails miserably and non executive directors often, I feel, fall into a similar category.

The answer to the question as to how easy it is to recruit non executive directors with the right skills and attributes is, I fear, the same as the one I gave to an American lady who took me to lunch to ask how she could recruit a team of top class tradesmen from the building industry - I explained it could be only with the of greatest luck! Money certainly is not the answer.

The main qualities required are integrity and loyalty. I have known a number of very senior R.A.F. officers who could only think of doing what was right; I have met even more of the other sort. Similar dedication to duty can I am sure be found in the Royal Navy and in the Army and Marines - but I would not expect these qualities to be too apparent in very senior Civil Servants or in Members of Parliament because "politics is the art of the possible". Retired senior members of any disciplined force would on the face of it have the necessary qualities of integrity and loyalty - but how many of them can read a balance sheet, or understand management accounts, cash forecasts, cash flows, budget statements and the rest of the paraphernalia of corporate management?

It is fairly well established that the appointment or resignation of a chairman or chief executive can make or break a company - how often does the appointment or resignation of a non executive director have a similar effect? And there lies the answer to the importance and effectiveness of non executive directors.

On one or two occasions I have heard discussions about inviting a person to join the board as a non executive director and what has mattered is not the ability of the individual but who he knows and how by his contacts he could help to overcome a problem.

A survey of the successful business men from Charles Clore in 1950 to date will I am sure reveal that not only were they able businessmen in their own right but they also had the gift of selecting the right subordinates to carry out the work for them.

The same applies in other fields. Brian Rix ran the Whitehall Theatre for years and years putting on farces always with the same bunch of actors. When they move clubs football managers take with them their coaching staff. Victoria Woods, the comedienne, has the same actors appear with her in her sketches and shows time and time again. It is noticeable that the same faces appear in films acted in and produced by Clint Eastwood.

Those who achieve success in this world do not break up a successful team - indeed they do all they can to hold it together. A company is much the same. It is not so much that a chairman or chief executive is brilliant and does it all himself - his biggest asset is his ability to gather together a team which is successful.

But it would be difficult if not impossible to gather together a team of non executive directors in a like manner. One reason is that the non executive director is on the board not for the general good of the company but to take care of the interest of, say, one large investor. If any quoted company were to vacate its listing on the Stock Exchange and re-register as a private company then any non executive directors would be off the board like a shot. But the company would probably perform better.

When 15 or so years ago Lord Alexander took over as Chairman of National Westminster Bank there were 30 board members. Assuming a three hour board meeting, this means that each director could, on average, speak for only six minutes out of those three hours - and had to sit and listen for two hours fifty four minutes.. And if some of them had nothing to say they could not be contributing - so why would they be there?

A company without non executive directors can survive and even thrive - but a company without executive directors cannot survive. This surely gives a message clear and loud. Non executive directors are non essential.

3. Do existing structures and procedures facilitate effective performance by non executive directors?

How can they when non executive directors do not perform but only attend, speak at and vote for, against or abstain from voting on any matter put to the vote at a board meeting.

Non executive directors are not there to perform - effectively or otherwise. They are but part of a committee known as the Board of Directors and the only performance they can give is to make dramatic gestures or even threaten to resign.

The question of risk or insurance provision for non executive directors is an interesting one and local government will have the same problem since the introduction of management by cabinet and executive councillors.

In most of the circumstances mentioned where a non executive director could play a greater role it seems that as soon as the greater role is taken on then that director becomes an executive director. There will already be provision made for insurance cover for executive directors but I doubt very much whether many companies will view non executive directors with a special role (such as a member of an audit committee) as executive directors and have updated their insurance policy accordingly.

Non executive directors are quite able successfully to challenge executive decisions and/or expose serious problems. All they have to do is raise such matters at board meetings and request they be minuted. In extreme cases they can tender their resignation and even make a report to the DTI.

It might be a good idea if a director who has resigned has the legal right to make a statement (not exceeding 15 minutes) to the members at the next general meeting - much on the lines of a Minister making a statement to the House of Commons following resignation.

Audit Committees

The Consultation Paper asks for comments on the composition and duties of Audit Committees and their effectiveness.

On the basis that if the company whose accounting records are being audited support them and the auditors auditing those records also strongly favour them, then I have a deep suspicion there must be something in it for both the company and for the auditors.

The guidelines for auditors have for years been that “Not only must auditors be independent, but they must be seen to be independent” and many years ago in furtherance of this policy auditors or any body controlled by the auditors were prohibited from holding office as Secretary of a client company being audited.

Yet it seems to me that getting together in an audit committee is as incestuous as being secretary of a company being audited - probably more so.

I do not like or see the need for audit committees because their very existence brings closer the relationship between the auditors and those being audited when the opposite is required if the auditors are to be truly independent.

The framework set up by the Companies Act, 1985, is that the directors will prepare the accounts (not anyone else) and present a signed balance sheet to the auditors for audit. The auditors then carry out their audit and report to the Members in their audit report, which may or may not contain qualifications about the correctness or exactness of the balance sheet and profit and loss account.

I recently submitted to the DTI my comments on the Intern Report of the Coordinating Group on Audit and Accounting issues set up by the DTI and the Exchequer which deals almost exclusively with audit committees, and enclose a copy as part of my comments on Derek Higgs’ consultation paper.

Do existing relationships with shareholders or others need to be strengthened?

To get to the true intent of this question I suspect the word “institutional” should be inserted immediately before “shareholder”.

The shareholders either appoint or acquiesce to the appointment of all directors. The purpose of appointing directors is for the directors to run the business on behalf of the shareholders. The law requires that the directors prepare accounts which they lay before the members in general meeting and it is at this time that the directors account to the shareholders on their stewardship.

I do not see any reason why a “relationship” between directors generally and shareholders should be fostered. Indeed, a relationship between directors and one particular shareholder could be detrimental to the interests of other shareholders.

Being rather old fashioned, I prefer to keep my distance from my superiors and call them “Mr X” or even “Sir” - although on occasion I have mentally spelt the latter as “Cur”. To maintain a distance from authority means all things are dealt with unemotionally in a business like manner.

I appreciate the modern way is for it to be christian names all round and for everyone to be ever so chummy. But my experience is that that eventually someone is going to get something dropped on his or her head from a great height - and it will be from a shitehawk rather than from a golden eagle.

6. How can non executive directors best be supported to perform their role?

What is the role of the non executive director (apart from being a member of the Board) - no one has yet defined what this role is supposed to be? There has been a lot of talk about the role of the non executive director but that is only because in recent years some circles have thought it appropriate to distinguish between executive and non executive directors.

When the chips are down, the role of the non executive director is precisely the same as that of an executive director - the only difference is that the executive director has employment on the side but this should have no bearing on his role as a director.

We put grown men on a board of directors because they have wisdom, business sense or whatever - and then suggest they need supporting. If they cannot do the job without support why are they there in the first place?

Non executive directors do not need support. If they disagree on a matter of principle with board policy or a particular board decision then they should resign. If they do not resign they have to live with the consequences.

It is indicative of the current bias towards the non executive director that the Consultation Paper does not contain the equally important question “How can executive directors best be supported to perform their role”? Didn’t someone, long ago, say “Equity prevails over the law”? - but not, it would seem, unless you are a non executive director.

7. In what way is the position different for smaller listed companies?

I do not see that there is much difference except size and that the number of directors - and particularly non executive directors - is likely to be proportionately less.

It has to be remembered that from small acorns big oak trees grow so the principles applied have to be applicable to the small company which can grow as well as to the large company which can shrink.

8. What can we learn from international experience?

If Enron and other major companies in the USA are anything to go by the lesson to be learnt is that auditors have to be a lot more aggressive in their approach and the “matey” relationship between all directors and auditors has somehow to be eliminated.

Otherwise our system and procedures appear to be more effective than those which were in operation in the USA. But the draconian measures recently introduced by The President of the USA on corporate governance has got all directors dead scared - including those of UK companies with company interests in the USA - which can only be a good thing.

General opinion appears to be that Mr Bush has gone a mite too far - but he has certainly made directors sit up and think and for once take real precautions to ensure that what they are putting forward to shareholders and the public is correct.

No longer is it a question of turning up at board meetings once a month, waffle on a bit for an hour or so, have an excellent lunch, and collect £30,000 a year for doing it. Now in the USA there is some real responsibility attached to the job - no wonder Mr Bush's measures have not found favour.

We could do worse in the UK than follow this example. To be effective, if a stick is going to be wielded it has to be a big stick. A twig is not sufficient.

AN ALTERNATIVE OPINION

My neighbour is a Chartered Accountant who spent his working life in the City of London with the same merchant bank, ending up as a main board director. I asked him his views on non executive directors and he expressed the following opinions:

He agreed that my view of non executive directors being nothing but "Yes" men is, unfortunately, correct in the majority of cases.

Nevertheless, he considers that it essential to have non executive directors; and thinks their role is to act as a whistle blower if things start to go wrong with a company.

He does not attach much importance to any specialist advisory role they make assume.

He feels that each individual should only hold two or three non executive directorships - maximum five or six.

He considers that non executive directors should be financially independent and takes the view that an effective non executive director can only be a person to whom director's remuneration is not important because in such circumstances a non executive director will have no qualms in resigning if the chairman and/or chief executive fail to heed warnings of the company's affairs going wrong.

He agrees that many non executive directors hold their position only because they are part of the Old Boy network.

He has no idea how desirable non executive directors can be found.

He considers that a board needs a strong but more cautious chairman who will temper the enthusiasm of any ambitious entrepreneurial chief executive.

He favours fostering the relationship between a company and its institutional shareholders. It is often the institutional shareholder who first spots that a company is going into a downward slide - they mentions this to the company's brokers who in turn mention it to one of the non executive directors - who raises it at board meetings.

He felt it was not detrimental to the interest of small shareholders for there to be a close relationship between a company and institutional shareholder because the institutional shareholder would speak up at the first sign of any trouble - and this protects the interest of the small shareholder. The alternative would be for the institutional shareholder to make a judgment, get out and leave the small shareholders with a company in a steep if not terminal decline.

COMMENTS by Mr. F.A.G. KAY (Retired Company Secretary) on the Interim Report dated July, 2002, to the Secretary of State for Trade and Industry and the Chancellor of the Exchequer by the Coordinating Group on Audit and Accounting Issues

The Interim Report

The report suggests a number of palliatives - but no cure. There is no defining of the problem, listing of the likely reasons for the problem, or any practical solution of the problem.

The Problem

The problem is that some companies have “cooked the books” to an unheard of extent with the object of conning investors into thinking the company was financially sound and profitable when it wasn’t - and the failure of the auditors to detect the defalcations and qualify the accounts as they should have done has simply compounded the deception.

The Reasons for the Problem

The basic reason is that some directors - and in particular some Chairmen, Chief Executives and Finance Directors - are without scruple if the situation so demands.

There are reasons why directors should have resorted to “cooking the books”. One is the pressure of the market on management to maintain high profits.

Another is the desire to show high profits in order to benefit from share option schemes which can provide a fortune for a participating director.

The Solutions Suggested

The main proposal in the Interim Report is for the establishment of Audit Committees consisting of “independent” directors who would provide “an independent element between the company management and the auditors”.

If anyone believes that non executive directors will be independent of the chairman, chief executive and finance director at crunch time they will believe that pigs can fly - in formation.

But why is an “independent element” between the company management and the auditors so necessary or even desirable? Audit committees are a comparatively recent management innovation - they did not feature in any significant way in the 1983 review of the Companies Act. So who is pushing for them? Boards of directors and auditors - so they must be beneficial to both parties although not necessarily the members.

But look at the simple, straightforward procedure laid down by the law. The directors prepare the accounts and the balance sheet of those accounts is signed by a director on behalf of the board. Under this system every director is, in theory, responsible under the doctrine of collective responsibility for the accuracy of those accounts.

The signed accounts are then passed to the auditors for audit. The auditors have no power or remit to recommend changes to the accounts already approved by the board - their task is simply to examine the signed accounts submitted to them for audit to such an extent that they can, if all is well, certify that in their opinion the accounts approved by the directors give a true and fair view of the financial state of the company as at the balance sheet date.

I was once present when a chairman of a small private company (a barrister) told an auditor in no uncertain terms that the accounts were his and they were not going to be altered - and if the auditor did not like it he could qualify his report.

If the auditors find there are aspects of the accounts with which they cannot agree their duty is to make audit observations. These are submitted to the company management for an explanation and it is only if the explanation given is incomplete or unsatisfactory to the auditor that such observations will be included in the auditor’s report to the members.

The reason some audit committees have been viewed with some dissatisfaction is because a nice and cosy relationship develops whereby the auditors prepare the accounts for the directors which are not approved by the

board until the audit has been completed. If the provisions of the Companies Act were complied with the auditors would be faced with a fait accompli in the form of a signed set of accounts to audit - and the opportunity for the auditors to suggest "adjustments" be made to the accounts would not exist.

One way to enforce the system laid down by the law would be for companies to have to file at Companies House a copy of the unaudited accounts approved by the board - and then later file a second copy bearing the auditor's certificate. If there was any difference between the figures in the unaudited accounts and the audited accounts the directors would have a few questions to answer.

Alternatively, the auditors could be required to include in the audit certificate a statement to the effect that the figures in the audited accounts agree exactly with those in the unaudited accounts approved by the board in the first place and submitted to the auditors for audit.

The proposal for the establishment of audit committees consisting only of "independent directors" will look good in the record and gives the impression that positive action has been taken to deal with the problem, but in practice the suggested solution presents more problems than it solves.

For example, if the proposal were to be introduced it would split down the middle the principle of collective responsibility because the members of the audit committee alone would be responsible for approving the provision of non audit services, monitoring the company's financial controls and policies, and reviewing the quality of audit process and audit judgment.

But all directors, including those serving on the audit committee, would be responsible for approving the accounts. So although all directors share collectively responsibility for the approved accounts only non executive directors would have collective responsibility for audit matters which would include financial controls and policies.

Another anomaly would be that as any committee is subordinate to the (main) board of directors the proceedings of audit committee meetings should be submitted to the full board of directors and be subject to over-ruling.

Yet another factor is that the definition of an executive director is any director who is an employee of the company or any director who provides services outside the scope of the ordinary duties of a director (1985 Table A, regulation 84). The duties of a member of the audit committee would be outside the scope of the ordinary duties of the directors because the executive directors would be barred from performing such duties. So under the proposal in the Interim Report a non-executive director appointed to serve on the Audit Committee would automatically become an executive director on appointment and so be disqualified from being a member of the Audit Committee.. A bit of a Catch 22 situation.

It is suggested the audit committee should be responsible for monitoring the company's financial controls and policies.

Financial controls should be the responsibility of the Finance Director. It would be ludicrous to have audit committee members not qualified in the accountancy profession placed in a position where they are basically in charge of and can dictate to the Finance Director.

Financial policies should be the responsibility of the board of directors as a whole. If the proposal for non executive director only audit committees is introduced it either means the tail will wag the dog with non specialists controlling a specialist function or else the audit committee will be packed with directors who are also experienced and qualified accountants which could make the office of Finance Director unnecessary.

Such a situation would bring about one of the worst management systems imaginable - split responsibility.

How are such deceptions achieved?

It might be thought that deceptions on the scale of the Enron affair could hardly be kept secret because the accounting staff would have to know what was going on and someone would blow the whistle.

But that appears not to be the case. Two senior accounting officers in the EC headquarters in Brussels have blown the whistle over extravagances and

mis-use of public funds - as a result of the action of the first whistle blower something like 20 of the 22 Commissioners were forced to resign. But the whistle blower also lost his job.

Mr Neil Kinnock, a former leader of the Labour Party in this country and one of two commissioners who escaped having to resign, was given the task of cleaning up and introducing new and effective systems, which the second whistle blower claims he has failed to do. She is still employed - but on other duties.

Staff are not - unless they have extremely high principles - going to take on the role of a whistle blower because at worst it means they are likely to be out of a job or at best be shunted into a corner counting paper clips.

Another reason why staff are unlikely to be in a position to know about any massaging of the accounts is the accounting system itself. The vast majority of accounting staff will be engaged in dealing with posting vouchers into the system - make a mistake of one figure in the coding on an invoice and what should appear against a contract in South Wales in fact appears against a contract in Northamptonshire - the possibilities are endless.

But the accounting staff generally will only be involved with balances up to trial balance - but it is after the trial balance stage that “adjustments” are made and this is the realm of the (imaginative) financial accountant.

To increase the profits of an organisation by a few million in the balance sheet is no simple matter - it calls for creative thinking and a degree of cunning. In the case of Enron it appears it was all too simple as purchases which should have been debited to profit and loss were simply capitalised. How this got by the auditors is a mystery.

But it is inevitable that a day of reckoning will come. One great boon of the double entry system is that once an item is in the accounts it cannot get lost and its trail is forever in the accounting records. In the case of Enron, one day someone - either a company accountant or an auditor - would have checked the capitalised assets existed - and then the cat would have been out of the bag.

Possible Solutions

One would be to set up a Government Auditing Agency to audit the accounts of all companies listed on a Stock Exchange and to prohibit such companies from having auditors other than the Government Agency.

If the audit of the 2,500 or so companies listed on a Stock Exchange no longer provided audit work for the Big Three or Four accountancy firms there would be a surplus of senior audit managers and other qualified and very experienced audit staff in these firms - which would provide a rich field of recruitment for a Government Audit Agency.

Inland Revenue and Customs & Excise use their own staff for audit and investigation so there would not be any breaking of new ground. An Audit Agency would need to be as aggressive as Inland Revenue and Customs & Excise but that is simply a matter of management policy, direction and control.

Another solution might be to authorise suitable firms to check, in detail, on an on-going basis, the audit work auditors had carried out on listed companies - much the same as some firms are presently authorised to approve ISO 9002 accreditation and to carry out the annual checks to ensure standards are maintained.

The best solution would be for the accountancy profession to put its own house in order - and to keep it that way.

The profession would need to identify those areas which could be used to distort the correct financial position. Enron has proved that all sums capitalised should be supported by a corresponding asset - so this is one area where a 100% audit check could be imposed. During the past 10 or 15 years the late Robert Maxwell managed to do wondrous things with the accounts of his companies and currently in the USA there are a number of other extremely large companies which have admitted their accounts have been little more than a fairy tale. The accounting profession can learn from these companies exactly where the danger zones are and adjust their auditing requirements accordingly. Such a task would not be rocket science - in fact the Highways

Department of any local authority would be able to show how it is done because they go out, spot holes in the road, and arrange for repair. No one is asking for anyone to forecast where the next hole will appear - although capitalisation of Research and Development and also Goodwill must be sensitive areas where the incorrect accounting treatment could cause major distortions in the accounting records.

We have a body of professional - presumably experienced and worldly wise - accountants and they should be able to identify all the known danger areas where it is possible to mis-represent the accounting situation. But the approach should be aggressive - to proceed on the basis that “we are all professionals together and wouldn’t be a party to any wrong doing” is just not good enough.

There would appear to be no problem if profits are under-stated because eventually such manipulations would come out in the wash. Why would directors wish to under-state profits? Because if a company had an incredibly good year followed by a disastrous year the directors might prefer to spread the combined profits over two years to avoid losing a record of steady profit.

The suggestion that the audit partner should be rotated every, say, seven years is but another sophism. The larger firms of accountants are divided into specialist department, e.g. audit, tax, VAT, Forensic, Insolvency, etc and one partner more equal than others heads up each department with a number of less senior partners working relatively independently but nevertheless under his (fairly loose) overall control. So when the time comes to rotate the audit partner and the senior audit partner steps down his No.2 or No.3 becomes the official audit partner for a company. Can anyone really believe that in these circumstances the Head of the Audit Department is going to sit back and wash his hands of how his No.2 or No.3 is going to conduct the audit? No way!

And if it is suggested the replacement auditor although of the same firm should not be someone working directly with or for the outgoing auditor, then it would be a simple matter three months before the change of auditor is due, nominally to move the selected replacement to another department and once he was in office to move him back again.

For years auditors have proclaimed “we are watch dogs - not bloodhounds”. If the professional accountant in public practice is going to retain any respect or credence in the future they have, after Enron, no alternative but to adopt the role of bloodhound and be more skeptical. And they are not going to achieve this through the medium of audit committees.

FAG Kay
19th August, 2002