Anthony Hilton: Watchdog has to restore trust in auditors

- Anthony Hilton The Evening Standard 25 October 2017

Tesco: The FRC gave an upbeat view of accounting despite the ongoing Tesco trial

The Financial Reporting Council (FRC) published an upbeat review of the quality of UK company accounts this week, just as three former senior executives of Tesco entered the second month of their trial for fraud and false accounting at Southwark Crown Court — a case that followed the discovery that Tesco's reported profit was inflated by £326 million in 2014.

This is not the time or the place to comment on that case, given it is one of the highest-profile prosecutions ever brought by the Serious Fraud Office, and it is important that justice is allowed to run its course.

It has not gone unnoticed, however, that these three are alone in the dock although the crime of which they stand accused would require the co-operation of people in other companies to succeed.

This is because it allegedly involved the early recognition of payments for promotions and such like between Tesco and some of its suppliers.

So if Tesco's accounts were overstated there ought to be a matching understatement somewhere among its suppliers.

For every false accounting entry at Tesco, there must be a corresponding false entry at a supplier.

One might have expected therefore that, in addition to the charges faced by the executives, that there would have been false accounting charges levelled at some people in positions of authority within the suppliers, or even a possible conspiracy charge covering the whole lot of them.

But that is not how things have turned out.

This brings us back to the FRC.

Its report talks eloquently of what makes good reporting — having a single story, explaining clearly how the firm makes its money, spelling out what risks worry the board, keeping the whole thing as clear, consistent and uncluttered as possible, and being open and upfront about any changes in accounting treatment from previous years.

All these things do indeed mark a qualitative improvement in reporting and are nice to have from the users' perspective.

But they lose their gloss if the underlying numbers are wrong in the first place, or if a petty substantial fraud has taken place under the noses of auditors without their having noticed.

This rosy review also jars just a little with the FRC's work in 2014 when it looked at the reporting of small-to-medium-sized listed companies and was deeply unhappy with what it found — so much so that it said that at least a third of the accounts had to improve significantly.

Perhaps there has been a miraculous turnaround which we have missed, or perhaps its strictures are just gathering dust.

Auditors will say, as they always have done, that it is not their responsibility to uncover fraud, and that what goes into the accounts is the responsibility of the board of directors, not them. But while this is a position they have held for years, what it fails to recognise is how much public perceptions have moved on.

There is an uncomfortable gulf between what the users of accounts think they should have and the assurance the auditor is willing to give. And as long as this persists, talk of the improving quality of accounts will have a hollow ring.

Nor does it fit the FRC's upbeat perception of events when Hans Hoogervorst, the chairman of the International Accounting Standards Board, says that having corporate governance codes a foot high and enough accounting and auditing standards to fill a small library, does not seem to stop companies seeking to mislead about how well they are doing.

ONE of his favourite rants is that four out of five companies hype up figures, and lay claim to profits which are around 30% higher than they ought to be.

Similarly, Guy Jubb, who for many years at Standard Life was one of the UK's most influential corporate governance specialists, expressed grave reservations about the quality of corporate reporting only a few weeks ago, in a paper published by the Institute of Business Ethics.

Much of what he wrote was a wake-up call to non-executive directors he thought could do much more to rein in the excessive optimism of their managerial colleagues to ensure that accounts were accurate and fair. Financial reporting has also to respond to the obvious fact that the era of unquestioned shareholder supremacy is coming to an end and companies are increasingly expected to be servants of wider society and held to account on that basis. In Jubb's view, widespread failure on both these fronts meant that today's corporate reporting was a long way short of the ideal.

A few weeks ago, the FRC decided auditors KPMG could not reasonably have foreseen the collapse of HBOS even as the financial crisis was picking up pace, and that the auditors of RBS should be allowed to pocket, with a clear conscience, their multi-million-pound fees for the audit work they did at that bank before it collapsed.

These findings prompted deep-seated relief in the accounting firms and provoked widespread public unease.

That is the challenge the FRC has to face.

By its own measures it is most certainly right that corporate reporting has improved, but the question it needs urgently to ask is whether these are the right measures.

If its objective is to restore trust in the system, but the public do not think it is measuring what is important, it is going to spend a lot of money making very little progress.