The law must change – auditors must be responsible to the company's shareholders and not the company.

by Malcolm Howard

Investors believe that audited accounts give them assurance that the company's accounts have been audited (checked/reviewed) and must therefore be accurate. After all, the auditors do state "In our opinion the group's financial statements give a true and fair view of the state of the group's affairs at the year end stated and of its profit for the year then ended." The reality is often not the case and the sad story of *Stanley Gibbons Group plc* emphasises that the law needs to be changed.

In their audit report for the company for the accounts for the year ended 31 March 2015, *Nexia Smith & Williamson,* Chartered Accountants, stated: "This report is made solely for the company's members, as a body, in accordance with Article 113A of the Companies (Jersey) Law 1991. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed."

The law in the UK in this respect is exactly the same as that in Jersey; auditors have no responsibility at all in relation to individual shareholders of the company, whether existing or proposed. What this means is that shareholders cannot sue auditors when they have signed off fraudulent accounts.

There are two ways that directors/senior managers can 'bend' the accounts; they are taking sales too early and/or valuing inventory that should be written off. The reason they do this is usually they are being pressurised to perform either by 'the market' or by directors of their parent company. The problem for investors is that the law is framed in such a way as to encourage such fraudulent accounting to be concealed. To give an example, the company's auditors discover that sales are being taken early and they point this out to management. Those responsible for the fraud promise that in return for the auditors staying quiet they will promise to fully rectify the situation by the following year end. This puts the auditors in a dilemma; if they report the fraud and the company is harmed as a result they could find themselves being sued by the company if the subsequent statement made by them is not wholly accurate. If they do nothing, the auditors face no risk; it is the employees not them who have committed the fraud. This is why, many fraudulent accounts go undetected.

There is a simple way to find out if some fraudulent activity might be taking place. I call it my 'prime test'. I simply compare 'cash inflow from operating activities' in the Cash Flow Statement with 'net profit' from the Income Statement. With the exception of a few type of companies (for example house builders who show land as a current asset, rather than a fixed asset) cash generated must always be higher than profit as profit is calculated after taking into account non-cash items such as depreciation, amortisation and share based payments. In well run companies cash generated will be 120% to 125% of net profit. I have researched this over several years and the conclusion is that where cash generated is lower than net income for three consecutive accounting periods there is a 50% probability that the company will go effectively bust. Where this happens it will indicate there is a problem with inventories, debtors, the pension scheme or a combination of all three. The word 'might' is used because the test failure might be the result of incompetent managers, rather than fraud.

The 'prime test' for Stanley Gibbons plc clearly indicated that there were significant problems.

	Cash generated/(expended)	**Net profit/(loss)**	**Difference**
	£'000	**£'000**	**£'000**
Year to 31 Dec 2012	**414**	**4,667**	**(4,253)**
Six months to 30 June 2013	**2,066**	**1,030**	**1,036**
Six months to 31 Dec 2013	**(1,289)**	**2,428**	**(3,717)**
3 months to 31 March 2014	**(5,118)**	**(1,075)**	**(4,043)**
Six months to 30 Sept 2014	**(8,429)**	**3,221**	**(11,650)**
Six months to 31 Mar. 2015	**404**	**(2,440)**	**2,844**
Six months to 30 Sept 2015	**(4,170)**	**200**	**(4,370)**

Out of seven accounting periods the prime test had failed five times and there were three consecutive failures. By the end of 2014 when the six months accounts to 30 September 2014 were out, alarms bells should have sounded. There were none and the shares traded at around 300p.

An analysis of the company's full year accounts is illuminating.

	Year to 31/3/15	**15 months to 31/3/14**	**Year to 31/12/12**
	£'000	**£'000**	**£'000**
Revenue	**56,865**	**51,772**	**35,599**
Cost of sales	**24,600**	**28,937**	**20,031**
Distribution & Admin	**28,693**	**20,481**	**10,205**
Interest	**424**	**141**	**208**
Tax & other	**2,367**	**(170)**	**488**
Net profit	**781**	**2,383**	**4,667**
Inventories	**53,822**	**42,118**	**20,728**

Receivables	**19,604**	**14,144**	**11,897**
Fixed assets	**46,174**	**38,865**	**3,868**
Creditors	**(26,865)**	**(21,350)**	**(11,367)**
Cash/debt	**(10,331)**	**10,168**	**6,578**
Total	**82,404**	**83,945**	**31,704**
Share capital	**64,153**	**63,031**	**11,421**
Other	**18,251**	**20,914**	**20,283**
Total	**82,404**	**83,945**	**31,704**

Given the prime test failure, we need to calculate inventory days and debtor days.

	Year to 31/3/15	**15 months to 31/3/14**	**Year to 31/12/12**
Inventory days	**799**	**531**	**378**
Debtor days	**126**	**100**	**122**

We can now see at a glance the major cause of prime test failure. It was bad enough at December 2012 with over a year's worth of stock, but in just 27 months stock had more than doubled to well over two year's stock. (Inventory days are calculated by dividing inventory by cost of sales and multiplying by 365, so at 31/3/15 the calculation is: 53,822/24,600 x 365 = 799 days.)

Why were the auditors not asking some serious questions?

At the end of December 2012 the company was in a relatively strong position, because although inventories were high they had plenty of cash. Then on 21 November 2013 they acquired Noble Investments and on 31 January 2014 they acquired Murray Payne. These transactions resulted in taking in additional inventories of £11,110k and intangible assets in the form of goodwill increased £23,894k. These purchases totalled £47,394k with £35,274k paid in cash and the balance of £12,120k in shares. The company issued more shares to pay for these transactions, so by 31 March 2014 everything seemed OK. But the directors in working to integrate these acquired businesses took their eye off the ball and inventories went through the roof. If alarm bells hadn't rung when the half-year accounts to September 2014 came out, they should have been sounding loud and clear six months later as in a year over £10 million in cash had become over £10 million in debt.

In 2015 the company appointed new auditors who concluded that the previous auditors had failed to meet the appropriate accounting standards. As a result, in the year to 31 March 2016 the company's assets were substantially written down and methods of accounting treatment were significantly altered. Despite this, the new auditors still 'qualified' the accounts illustrating where they were unable to verify certain figures.

It is sad that an iconic company famous for postage stamps, coins and medals and established for decades has been effectively ruined. At the time of writing the shares stood at a mere 8.62p having been nearly 400p three years earlier. But any qualified accountant could have worked out what lay ahead when the shares were trading at 300p. So why were investors not warned? The answer is straightforward; the law is not designed to do this. It has to change; auditors must be accountable to the company's shareholders, not the company.

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