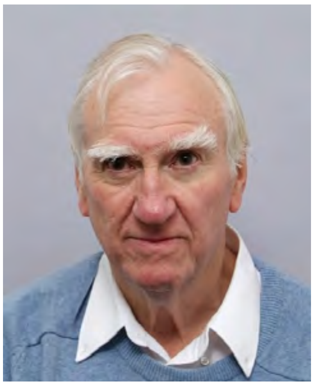
Template audits – the gravy train rolls on

by Malcolm Howard



On 14 March 2018, the accounts for Savills plc for the year ended 31 December 2017 were signed off by the directors. On this day the share price closed at 976p. At the year end the company had £99m net cash; in the year they had earnings of £81m and had generated cash of £112m through their operating activities. Even taking into account 'retirement benefit obligations' of £45m, they still had a surplus of £54m Hardly the financial structure of a company that is likely to go bust within a year!

Despite this financial strength, the auditors, PricewaterhouseCoopers, wrote in their audit report:

*As part of our audit we have concluded that the Directors' use of the going concern basis is appropriate. **However, as not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's and Company's ability to continue as a going*** **concern.**

On 17 May 2017, the accounts for Mothercare plc for the year ended 25 March 2017 were signed off by the directors. On this day the share price closed at 125p. At their year end the company had a net debt of £17m and a 'retirement benefits obligation' of £80m. Although in the year they had made of profit of £8m and generated £15m from operating activities, net debt had increased by £29m (they had £12m in cash at 26 March 2015). Clearly in terms of being a going concern, Mothercare is nowhere near as safe a Savills.

Mothercare's auditors, Deloitte, (Group materiality stated as £2.1 million) wrote:

*We agreed with the directors' adoption of the going concern basis of accounting and we did not identify any such material uncertainties. **However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's ability to continue as a going concern.***

What we have here is 'template' auditing. Exactly the same language is used despite the wide variation in the figures. The statements shown in bold above are absolutely meaningless. They merely state the obvious (that we cannot predict the future) and are there solely to protect the auditors.

We now know after investigation within the Houses of Parliament that there were serious misstatements in Carillion plc's published 2016 accounts and that the auditor, KPMG Birmingham, knew this was the case when they signed off the audit. Since then two of the company's Finance Directors have been sacked. The problem, though, is that Carillion plc is not the only company to suffer inadequate auditing in the hands of a big 4 auditor.

Luceco is a company making and selling light fittings which, since its IPO (initial public offering) at 130p per share, has been growing. The company's accounts for the year ended 31 December 2016 were signed off on 3 April 2017 and as the auditor, KPMG Birmingham, gave the company a clean bill of health the share price continued to rise, peaking at 265p in November 2017, more than double the IPO price.

For a company like Luceco, the value of inventory is a key issue. Now, when it comes to 'inventory' we cannot blame IFRS because stock is not valued at 'fair value', but at the lower of cost and net realisable value. 'Realisable value is defined as the selling price of the product, less the cost of getting it to the customer. In the usual 'template' style the auditor told us everything was in order. They met the internal audit team to discuss the provisions for obsolete and slow moving stock, who assured them that they discussed the issue with the product development and sales teams to ensure the level of provision was sufficient. The auditor then discussed the matter with the directors:

"We challenged the Directors by reference to available third-party market reference (such as reports on relevant regularity changes, market growth and the likely demand for products). We also assessed the historical accuracy of inventory provisions, with reference to the level of inventory write-offs during the year. We

considered sales post year end to see whether sales proceeds were sufficient to cover the net realisable value of the inventory at the year end. We considered the adequacy of the Group's disclosure in respect of the estimation risk in determining net realisable value of inventory. In our opinion, we have not identified material misstatement in these reports." Materiality was set by the auditor to be £714,000.

This sounds that the audit work has been comprehensive, but unfortunately any accountancy trainee who had passed his level one examination would know that the inventory figure had been materially overstated. The test for this is the calculation of 'inventory days' which is inventory divided by cost of sales x 365. Figures below are taken from the company's 2016 accounts:

	2016 (£'000)	2015 (£'000)
Inventory	38,462	26,195
Cost of sales	85,927	69,221
Inventory days	163	138

The clue is that inventory days are not only very high but are increasing. Even allowing for growth, inventory days are excessive.

On 15 December 2017 the company issued a statement:

We will now deliver a gross margin of 33% leading to a £3.5m reduction in profit after tax to £13.2m versus current market expectations of £16.7m. Regrettably the gross margin weakness was not identified sooner due to an incorrect assessment of the value of the Group's stock (inventory). The Financial Controller has resigned as a result of this error.

But it got worse! On 6 March 2018 the company issued another statement:

"Profit after tax is now expected to be £11.0m, as against the previous forecast of £13.2m. The Chief Financial Officer, David Main, steps down and is replaced by Matthew Webb, a Chartered Accountant who qualified with KPMG.

The shares collapsed to 51p, less than half their IPO price and less than a quarter of the price (215p) on the day the 2016 accounts were signed off.

Then we have Conviviality plc, a wholesaler and retailer of alcoholic drinks. Their accounts for the year ended 30 April 2017 were signed off on 17 July 2017. In their audit report, KPMG (Manchester) did not discuss whether the company could be considered a 'going concern' or not, but merely gave the opinion that 'the financial statements gave a true and fair view of the Group's and of the parent company's affairs as at 30 April 2017. There was no mention of risk, such as the company's increasing mountain of net debt standing at £98m at the 2017 year end. On the date the accounts were signed off the shares were trading at 333p.

On 29 January 2018 the company posted its half year results for the 26 weeks ended 29 October 2017. The profit for the six months was significantly lower than the previous six months due to having to spend £5.3m, being costs associated with the acquisition of Bibendum PLB Group. Despite making a profit of £6m in the six months, debt had increased to £134m from £98m and creditors had increased to £325m from £302m. Net equity amounted to £208m, but intangible assets were £289m, meaning that tangible assets were negative to the tune of (£81m). This could hardly be described as a healthy balance sheet.

However, there was a simple explanation for this, which was that the company was expanding rapidly. Between the year end at 30 April 2017 and the prior year revenue had increased by 85%. So, of course, working capital would be increasing. But was it under control?

	30 April 2017	1 May 2016
Inventory days	25	31
Receivables days	54	69
Payables days	(82)	(101)

Yes, clearly asset management was good.

By 29 March 2018, it was revealed that the company was in deep trouble and that it would need to raise £125m to survive. If it achieved this, net debt would fall to below £100m. *"The Board wish to thank its customers, suppliers and employees for their continued support during this difficult period for the Company."*

We can deduce from the statements made by the company that while they were trading within their banking covenants they could only do so by delaying payments to customers, even if this was not as bad as it had been. The £125m being raised would be spent: paying the £30m debt to HM Revenue & Customs, £35m to reduce debt and £60m to pay creditors to get back to paying within normal credit terms.

By the end of January 2018 the directors should have known they were in trouble because:

- They were up to their credit limit in terms of banking covenants and any softening of margins would automatically put them in breach.
- They could not pay their creditors within the agreed credit terms.

Given this state of affairs, the director's behaviour could only be described as bizarre:

- On 5 February 2018, Diana Hunter, CEO, bought 50,000 shares at 305p each
- On 5 February 2018, Martin Newman, Non-Exec Director, bought 3,330 shares at 300p each.
- On 5 February 2018, Steve Wilson, Non-Exec Director, bought 48,500 shares at 305p each.
- On 5 February 2018, David Adams, Chairman, bought 16,000 shares at 306p each.

On 8 March, the company announced that there had been a material error in their forecasts in that the company hadn't noticed that margins were softening and as a result EBITDA would be 20% below market expectations. The share price collapsed from 303p to 123p.

- On 9 March 2018, Diana Hunter, CEO, bought 44,176 shares at 114p each.
- On 9 March 2018, Mark Moran, CFO, bought 120,000 shares at 109p each.

On 13 March, the company confirms its forecast that EBITDA will be 20% below market expectations. The shares fall to 101p. Just one day later it announces that it has discovered that it has to pay £30m to HM Revenue & Customs and it hasn't got the cash to pay it. The shares were suspended.

The question is: why were the directors buying shares when they should have known how bad things were? Also, the auditors must have had some idea that things were bad at the time of the 2017 annual audit and while there was nothing wrong with the accounts investors should look for omission as well a possible error.

What happened here is classic, something accountants learn in the first year of training. It was simply a case of OVERTRADING. What this means is that if companies expand too quickly they run out of cash because working capital expands at the same rate as revenue. One way to alleviate this is to have an effective asset management programme, which the company did. But it wasn't good enough! This was an expanding and profitable company; why would the banks not lend them the £30m to pay HM Revenue & Customs? The answer was that the Finance Director could not have built in any contingency; if margins softened the company would be in breach of at least one of its banking covenants. Anyone reading the Annual Reports could not have known this.

Then we have Air Partner plc. On 3 April 2018 the company announced that it had identified an accounting error. It said, "The issue principally relates to the collection of receivables from customers and accounting for uncollected amounts since financial year 2010/11. Certain uncollected receivables were inappropriately offset against deferred income rather than being expensed to the income statement in the appropriate financial year. A figure of £3.3 million has currently been identified and a significant proportion of this relates back to 2011." Rumour had taken the share price down from 140p to 102p and when this announcement was made the price collapsed to 74p. The auditor, Deloitte, set materiality at £410,000.

On 11 April 2018 Air Partner plc put out a statement saying that the cumulative impact of the accounting error would not exceed £4 million and that when prior year statements are re-stated the company always had sufficient distributable reserves to legally pay the dividends it did. The share price recovered slightly to 95p.

On 13 April 2018, the Finance Director, Neil Morris, resigned.

In all these cases there is a pattern:

- Accounts are published and given a clean bill of health by the auditors.
- Company makes a statement that a material error has been found in the accounts.
- The company hires another big 4 audit firm to clean up the mess.
- The Finance Director resigns.

What appears to be missing is that there is no sanction against the erring auditor. In fact, for a big 4 Auditing Practice it is one big gravy train. If one auditor gets it wrong, another is appointed to sort it out. If it is so bad that the company goes bust, then another big 4 auditor is appointed as 'administrator' or 'adviser to the official receiver'.

The Financial Reporting Council (FRC) is responsible for auditing the auditors. Any complaint to them with regard to inappropriate accounting gets the response:

"We are aware of the situation but owing to confidentiality we cannot say anything at the moment."

If you ask them whether they are carrying out an investigation, they tell you they cannot do anything until any possible litigation has taken place. Of course, by the time we reach this point any evidence has long gone.

One MP described the FRC as 'useless and toothless'. It was reported in mid-April that a review of the workings of the FRC was to be led by John Kingman, the Legal and General Chairman, a former Treasury official. Prem Sikka, accounting professor at the University of Sheffield, was sceptical that a review would have any effect. He was reported to say, "The FRC is symptomatic of the poor regulatory architecture in the UK where captured and puny regulators are expected to shackle giant businesses whilst being colonised by the very interests that are to be regulated."

Sadly Prem Sikka is probably right. If history is anything to go by (previous official reviews), we can expect a thorough review by John Kingman, who will come up with justified sensible recommendations. These will duly be ignored by government. In my view, the solution is to stop the gravy train in its tracks. Where auditors have signed off accounts and it is subsequently proven that the accounts contained a **material** (significant) error, they should be **fined twice the fee they charged to do the audit.**

A significant problem for investors is that Annual Reports, including the Audit Report within them, are template affairs. We are in this sorry state because legally the auditors are responsible to the company and not to investors.

Investors should receive accurate accounts, published within an Annual Report, and should be given information which would allow them to make reasonable judgments. **For a start, given the Conviviality fiasco, the time has come for companies to publish their current banking covenants within each Annual Report.**