# What the City expects from the accounting profession

*The **Deputy Governor** discusses[1] the role of the accountancy profession as seen from the City, considering in turn the different roles that accountants fill. He remarks that the City expects the continued maintenance of the high standards of technical competence, integrity and independence which have distinguished the profession hitherto. And he concludes by mentioning areas to which the profession will need to give further attention in order to achieve this.*

My subject today is 'What the City expects from the accounting profession'. In thinking about what I should say to you on this subject, I was led first to the broader question: what are any of us, as non-accountants, entitled to expect from your profession? I suggest that in simple terms there are three things: integrity, information and judgement.

Integrity, of course, is an essential quality in its own right. But it has the further significance that if we cannot take your integrity for granted we cannot rely on what you tell us. Obviously, the information you provide for us must be accurate and, within the context, complete. But even more important—though much more difficult and often controversial—we must be able to rely on the judgement with which you select, present and assess the information you give us and on the basis of which we must make our decisions. In my remarks today I shall try, as a layman, to indicate and celebrate some of the ways in which, essentially through these three qualities, the accounting profession serves the City. But I shall also—perhaps with greater boldness than wisdom—suggest some areas in which we might wish to see change or to encourage developments already afoot but which could be taken further.

First some general considerations. Properly presented information on the history and prospects of the enterprise to be financed is indispensible to investors and lenders alike. It is equally important that users of information should, where appropriate, have an assurance that it has been prepared and independently verified in accordance with professional standards.

The accountancy profession has come to fulfil an important role in providing financial advisory and verification services to industry; and, through the medium of City institutions or directly, to the investing public. This is a measure of the skill and independence applied by the profession. The City relies on the profession for the production of necessary information and for an objective assessment of a company—either by reporting on a company's prospectus or acting as auditors expressing an opinion on a company's accounts.

The accountant is involved in all stages of a company's existence from the birth of a new enterprise, through its growth and possible public flotation, its merger or absorption into another enterprise, and in some cases, either its rescue from financial difficulties or unhappily its eventual demise. The accountant is involved not only in the regular monitoring of financial performance through all these stages but also in providing advice on financial matters. Ultimately, he will always be reporting to non-accountants, whether to management, to members of other professions or to the investing public; and it is essential that his advice should be relevant, unambiguous and understandable to the intelligent layman. The accountant must distil from the mass of technical detail and accounting jargon—necessary perhaps as a tool of his trade—a concise and clear presentation of an enterprise's financial position and performance.

There are, of course, many types of accountant, all doubtless represented here today. There are those employed in industry and commerce, those working in the financial sector, and those in practice large or small.

It is the fact that accountants work in both industry and the City, as well as on their own account, that makes them a unique link between the providers and recipients of corporate finance, with accountants—whether in practice or employed—offering their advice on both sides of a transaction. For this link to continue to function, communication not merely between accountants and non-accountants, but between these different groups of accountants themselves, is vital. Without good communication between accountants, the effectiveness of the profession and its standing may suffer.

I should now like to address the various groups of accountants in turn, starting with those working in industry.

## Accountants in industry and commerce

A company's accountants frequently become a crucial point of contact between the company and the City. Their main responsibilities are naturally orientated towards the needs of management and they are accordingly expected to contribute prominently to both the efficiency and financial control of the company. Theirs is the responsibility for introducing adequate systems of internal control and for

(1) In a speech to the summer conference of the Institute of Chartered Accountants in England and Wales, on 15 July.

producing accurate—and timely—information, so that management can plan, take operational decisions and monitor its financial performance. This requires the accountant in industry to exercise his professional judgement with integrity. An assessment of the quality of financial management will play a large part in the formation of an opinion on the soundness of an existing or proposed investment in a company.

In the Bank's experience of industrial finance, a very common feature of companies in difficulties is that their financial systems have failed to give them an adequate understanding of the real profitability of their operations. We take it for granted that a company will have a financial system which will enable it to assess its direct costs and its requirements for fixed and working capital, and to determine its pricing and commercial strategy accordingly. Unfortunately that job has been made far more difficult by inflation.

I am very conscious that when I touch the subject of accounting for inflation I step on a battlefield littered with unexploded ammunition and dead heroes from past engagements. I know that I risk not only explosions of controversy but—even worse—the stillness of an apathy bred of exhaustion. But even so I am going to say something.

I am not going to offer views on how the various issues involved should be resolved: you are the professionals and it is on you that the responsibility to find solutions lies. I do, however, want to underline the great importance of the further decisions about the nature of accounting for inflation which lie ahead for your profession.

It is clear from our viewpoint in the Bank of England that failure to have an adequate understanding of what is really profitable; of which activities are really eroding capital; of what level of expenditure on research and development and on new plant and machinery is necessary to sustain a long-term competitive position in the market place—all these are common features in industrial failures. And more often than not, it is in failure of the management information systems to take due account of inflation that they have come to grief. It seems to me that it is as important that these tools of management, on which day-to-day decisions are based, should take proper account of the effects of inflation, as it is that the profit and loss account at the year-end should do so.

Disagreements about the means of adjusting for inflation must not lead to the basic issue being lost to sight—that historic cost accounts can be seriously misleading in the face of general inflation, or of relative price changes. This is the fundamental fact which has inspired the long debate, which remains true, and for which a remedy must be found. Even if, as we all hope, we can look forward to much lower rates of inflation in the future than have characterised the past, the need for appropriate adjustments will still be great so long as corporate balance sheets include substantial assets bought in the inflationary era. Experience has shown that the problem is even more difficult than it once appeared. But the fact that a problem is difficult does not mean it is any less important to solve.

Adequate treatment of inflation will not of itself improve financial performance in the short term, but it will bring an understanding of where a business is going. It will prevent self-deception on the part of managers, and on the part of boards in their reports to shareholders.

That self-deception is enshrined in our system is something we must recognise. I will take a simple illustration. The distinction between revenue and capital is fundamental both to accounting but also to company law. In company law the distinction is designed to prevent companies from making distributions unless their original share capital is intact. That principle is broadly non-controversial. Yet the law, as it stands, allows a distribution which erodes the real value of the original share capital. It is thus possible for a company which has been making losses in inflation-adjusted terms to record historic cost profits and make distributions which erode the real equity base of the company. Turning from law to practice, a survey of the latest published annual reports of some 300 of the largest listed industrial and commercial companies indicates that as many as 40 per cent of these paid dividends that were not fully covered by current cost earnings.[1]

Without claiming that current cost accounting as embodied in SSAP 16 provides a perfect measure of the effects of inflation on every business, I think that the statistic I have quoted indicates the serious extent to which large companies have recently been paying dividends out of capital. The fact that a consensus has yet to be reached on the treatment of inflation in company accounts has made it easier for both boards and shareholders not to understand what they are doing. It is clear to me that if the profession is to give the business community the lead that it needs, and to maintain its overall credibility in setting accounting standards, the question of accounting for inflation will need to be gripped resolutely.

## Accountants in large practices

I turn now to the responsibilities of accountants in practice. It is here perhaps useful to distinguish between those larger firms dealing to a great extent with the affairs of the public listed company and the smaller practitioners whose portfolio of clients will usually consist of the smaller company and unincorporated business. I will take first the accountants in large practices. One of their principal roles is to act as watchdogs for the investing public. As auditors of public companies they give comfort on the reported stewardship of management to investors and lenders alike. The auditor's primary duty is to report to the shareholders, but he must be aware that the accounts on which he reports will be read and acted upon by others. Creditors and

(1) See the article 'Current cost accounting' in the September 1982 *Bulletin*, pages 376–81.

depositors, customers and suppliers, and also employees, all have a direct interest in the financial health of a company.

In the Bank of England's work as supervisors of the banking community, we rely heavily on the work carried out by auditors because we do not normally carry out an inspection as part of our supervisory process. The auditors' verification of asset valuations, liabilities and reserves, and their assessment of the adequacy of the systems of internal control, provides us with a substantial degree of comfort about the information provided by a bank. Auditing standards in this country being very high, we are happy to rely on the auditors in this way—though unfortunately isolated cases do occur where auditors of supervised and other institutions appear to have allowed themselves to be misled, and where reliance on audited accounts has therefore been misplaced. Such instances are rare; but they highlight the importance of the auditing function, not only in an industrial or commercial company, but also—perhaps even more—in those institutions which accept deposits from the public.

The auditor to a medium or large company is, of all the outsiders who deal with the firm, in the best position to get a feel for the business and in particular the effectiveness of its management and financial controls. Inadequate financial controls are almost invariably symptomatic of a deeper malaise within a company.

The ultimate sanction of the auditor is to qualify his audit report to the shareholders, to whom his primary responsibility lies. This is a drastic step, as certain types of qualification signal clearly a lack of confidence in management. At one extreme, it could precipitate the collapse of the company. The increasing complexity of the framework, both statutory and self-regulatory (in the form of accounting standards), under which companies draw up their published financial statements has led over the last few years to an increasing number of audit report qualifications on more or less technical grounds. There is a danger, I think, that the proliferation of such qualifications may tend to diminish the impact of those relatively few cases where the auditor's remarks are a matter of serious concern for members of the company. Is it worth asking whether current presentation here is as helpful as it could be? Should there perhaps be a more obvious distinction between the types of comment and qualification, so as to assist shareholders and analysts to weigh the importance to be attached to these statements?

Where the auditor has grounds for criticism of any aspect of the financial management, there is, of course, much that he can do, short of the drastic step of qualification or resignation, by working through the management and the board of the company. Where the client's board and management structure is adequate and the auditor's comments are not of a serious nature, the most usual and effective channel of communication will, I suppose, be the management letter. This will draw the attention of top management to any shortcomings the auditor has noted, and will make specific recommendations for remedial action. If the auditor's advice is taken by management and the weaknesses rectified by the time of the next audit, that should normally be an end to the matter.

But whether or not a qualification is needed in the audit report, the auditor must see that any serious misgivings he may have are communicated to the board. For this communication to be effective it is important that the structure of the board is right with an adequate representation of good independent-minded non-executive directors.

Ideally, such directors can ensure that management takes speedy action to rectify major shortcomings in personnel or control systems which are brought to their attention. It has been said that non-executive directors are like frogs, who apparently have the unenviable capacity to sit quietly in water which is progressively heated to boiling point, without sensing their own destruction. I would hope rather that they were like geese, who you will remember were kept in the Roman capital because they would honk loudly when disaster threatened.

The importance attached in the City to appropriately structured boards is evident from the formation early in 1982 by the Bank, the CBI and banking and institutional sponsors of Promotion of Non-Executive Directors (PRO NED). As doubtless you are aware, PRO NED's function is to maintain a register of suitable appointees for non-executive director positions and to promote among companies the need for a well-balanced board structure. It aims to foster and stimulate both the supply of non-executive directors and the demand for them. PRO NED has made good progress; it has so far been consulted by some 120 companies, and 25 appointments have been made to boards as a result of its introductions. But responsibility for the structure of boards must, of course, remain primarily with company chairmen and I should add also with the shareholders, particularly the large financial institutions.

The auditor should, at a minimum, I believe, meet the directors collectively once a year at the conclusion of the audit to discuss the accounts and to explain any major points arising from the examination including significant weaknesses in financial control. Although nothing can derogate from the collective responsibility of a board for financial matters, it is increasingly found convenient for contact with the auditors, and for oversight of accounting and financial control, to be delegated to an audit committee, consisting mainly of non-executive directors. Properly constituted audit committees, at which the auditors may themselves raise matters which they feel should be considered, especially by non-executive directors, can often be a more effective channel of communication than the attendance of auditors periodically at full board meetings; and they can help companies to get the maximum benefit from costly audit work.

There will be occasions where justified advice and warnings from an auditor go unheeded by a lazy or inadequate board.

Unless the matter is one which calls for qualification, the auditor will then be placed in a real difficulty. Given his duty of confidentiality in relation to the client's affairs, there is no way other than by resignation whereby his anxieties can be communicated to those in a position to do anything about the problem. It may, I suggest, be worth further consideration whether the absolute need to respect client confidentiality in such cases can operate against the interests of investors and creditors—whose interest in the company and the company's well-being may be at least as great as that of the board. If it were agreed that this can be the case, there is the difficult question of what should be done about it.

Apart from his role as watchdog, but arising out of the expertise gained from this, the accountant in a large practice has come to be relied upon as a financial adviser in a number of other circumstances. Thus the accountant is frequently asked to investigate a company, to report his findings to banks or investing institutions, and report on profit forecasts in takeover documents. The reports prepared by reporting accountants have become key documents in the raising of new capital, crucial both to the merchant bank promoting a public issue and to the investor. What distinguishes the advice provided by the reporting accountant is his objective assessment, backed up by the integrity and independence of his profession. I am sure the investing institutions will continue to use the profession in this capacity.

It is not necessarily the company's auditors who are chosen to fill this role, indeed it may often be desirable to engage an independent firm which makes this sort of work a speciality. This is a prime example of an area where the accountant has to look beyond the pure figures he is studying in order to gain a proper understanding of the business and economic climate peculiar to a company. It moves him further into the role of judge, and may introduce a new area of tension in his relation with his clients. But it is a role into which his own qualities have thrust him, and a role which the City looks to the accountant to perform; this role needs a pertinent understanding of the needs of those who have commissioned a report in order to ensure that the information provided is presented in a form easily assimilated by the City. The reporting accountant should often be in a good position to do this, and provide a bridge between the company and the investor and be able to understand and, if necessary, interpret the requirements of both.

For similar reasons, the accountant is frequently approached to investigate and monitor businesses which have got into financial difficulties; or, sometimes, to act as a receiver and manager or liquidator. In this capacity he may be able to salvage viable businesses from companies which have stepped over the precipice into insolvency. When acting as receiver, the insolvency practitioner's primary duty is to the creditor under whose debenture he was appointed. But I know that many qualified accountants who undertake this work also take into account—as now do directors—the wider interests of the employees, and indeed the interests of unsecured creditors as well.

## Small practitioners

I turn now to the accountant in the smaller professional practice who finds himself in a somewhat different position. Most of his clients will be private companies or unincorporated businesses where management and the proprietors are often the same. For many such companies, the product of the audit, the annual accounts, will be of greater interest to trade creditors and any minority shareholders than to the proprietor. The most important service provided by the accountants to the proprietors of small firms may be taxation advice, help in the preparation of tax returns and more generally, the provision of financial advice and assistance in those areas where the client lacks the requisite knowledge and expertise.

If he is to offer a full service, the small practitioner must keep abreast of current developments on the considerable range of sources of finance available from the City or government, and on the wide range of specialist services offered by the financial sector. The number of regional and industry-related assistance schemes offered by government departments have multiplied in recent years; but many enterprises eligible to claim fail to do so. The fault for this must lie to some extent with a company's financial advisers—including the auditor, who enjoys a unique position with a close understanding of the client's business and may often be in the best position to offer independent and objective advice.

The accountant in a small practice may also often be able to provide invaluable guidance to small and medium-sized enterprises in presenting their case to the providers of finance. Such presentations are frequently put together by businessmen with no particular expertise in accounting and financial matters. The small practitioner should ensure that a presentation contains all relevant information necessary for a proper understanding and appraisal of the investment proposal.

The small practitioner may do this, but there is some question as to how widely in fact he does so. The recent report into the operation of the loan guarantee scheme suggests that the reliance placed by banks on accountants is often misplaced. In the words of the authors 'the accountant's role appears in most cases to be no more than that of a programmed abacus'. There appears to exist, in relation to small businesses, a gap between the service at present provided by accountants to their clients and that required by the financial community.

The accounting and banking professions need to work together to improve the financial advisory service offered to these businesses, utilising the recent developments in corporate finance which are geared to helping the smaller business. It is particularly important at a time when it is recognised that the future prosperity of this country will depend partly on the health and success of its smaller businesses, that a viable opportunity is not missed merely for lack of a sufficiently well thought out presentation to prospective investors.

## Attributes of the profession

If you will allow me to do so, I should like to offer some comments on the attributes of the accountancy profession which cause its members to be called upon to perform these important roles. As I indicated at the beginning, paramount among these are the integrity and independence which have come to be seen and expected and so highly prized by the discerning public.

Independence, however, may not always be wholly attainable. The accountant in practice may have a small number of large clients, the loss of any one of which would affect him financially. Your Institute has, I know, already taken significant steps in drawing up ethical guidelines designed to preserve the professional independence of its members. It is now accepted by all that an auditor should not have a financial interest in a client company beyond his proper fee. It is also accepted that a receiver should be disqualified from being appointed as liquidator of the same company, or an auditor as receiver, because of possible conflicts of interest. These are obviously welcome developments.

There are many other situations where the accountant's independence may be, or risk appearing to be, impaired. Many firms of accountants will have their own internal rules which will exceed the Institute's requirements. But the Institute has taken the lead in many of these matters—for instance, in anticipating statutory control over insider dealing—and is still an example to others of the standard of behaviour expected of a profession. Nevertheless, the subject must be kept constantly under review to ensure that the independence of the profession is preserved, and is seen to be preserved.

The great majority of accountants are in full-time employment. Such accountants will have one client only, the employer, and will inevitably be influenced by loyalty to the organisation in which they serve. While rightly expected to be sensitive to their employer's interests, they must maintain the same standards of professional competence, conduct and integrity as their colleagues in practice; and there will be occasions when it will be difficult to reconcile these.

In that context I welcome the Institute's initiative in setting up the Industrial Members' Advisory Service on Ethics. This is intended to allow an accountant, while preserving the utmost confidentiality, to discuss any problems with an appropriate adviser. Provided that he recognises a potential conflict when it arises and is ready to talk about it to someone whose confidence he can respect, the accountant in industry should be able to benefit by making use of this service.

The reputation of the profession for integrity and competence has been reinforced by self-imposed disciplinary procedures. It is essential that the standards of conduct and practice required of members should continue to exceed the minimum set down by the law, and that those who fall short of these standards should be brought before their peers and called to account. The proceedings of the Joint Disciplinary Committee of the accountants' institutes are clear and well-documented evidence of self-regulation at work; and show that even the larger firms of accountants do not escape censure on those few occasions when their work has fallen below standard. Indeed, I believe the existence of the Disciplinary Committee sets an excellent example to the other professions.

Unlike his counterpart in some other countries, the accountant—especially the member of the chartered institutes—is afforded a high standing in the United Kingdom. This is not merely because of standards of independence and integrity, but because of the skill and experience acquired through training and work. Moreover, and particularly important in my view, the accountant in this country is required to exercise his judgement and not simply to follow prescriptive accounting rules and regulations as in some other countries. UK accounting standards, unlike the lengthier requirements for example in the United States, require compliance with the spirit of their underlying principles rather than strict adherence to detailed rules.

These attributes have produced accountants of great stature, both in the City and in industry, whose voices are heeded well beyond the confines of their profession. It is no accident that the City has often turned to accountants to help reorganise those City institutions which have failed to match up to the high standards expected of any profession. You will, no doubt, continue to be called upon to contribute to the evolution of control and regulation of the City.

## Areas of improvement

I should like to conclude my talk with some comments on areas where you in the accountancy profession may see the need for improvement or reform to maintain your present pivotal position. Some of these I have already mentioned. At least until such time as inflation stabilises at a negligible level, failure properly and consistently to account for the effects of inflation will continue to mislead investors, lenders and, quite possibly, management, about the real performance and future viability of a business. The decisions which still lie before the profession on this topic are of greatest importance to the City, to the community, and to the profession.

The establishment of clearer accounting standards in other areas is also important. After protracted gestation, a standard on foreign currency translation has now been established. But in other areas, there has so far been little progress. An accounting standard on leasing has not yet been published, despite the rapid growth of this form of finance over the last five to ten years; nor is there an agreed form of accounting for goodwill and mergers. I understand that the United States has had accounting standards on these subjects for some time.

I understand that the profession is now grappling with the question of recording pension costs and obligations in company financial statements. This is a peculiarly difficult question which necessarily involves judgements about events and conditions many years ahead on some aspects of which actuarial advice is essential. Because of the large, and in some cases open-ended, nature of companies' pension obligations, investors need assurance that provision is being made year by year on a sensible and consistent basis in accordance with well understood conventions. The development of adequate standards in this area is a challenge to both the accountancy and the actuarial professions.

Delay in issuing accounting standards has come from the difficulty both in reaching a consensus within the profession and in gaining the acceptance, and even the interest, of preparers and users of accounts. The different parties—preparers, auditors and users of accounts—often have conflicting interests; and the application of a standard in particular circumstances may be considered by some to be inappropriate.

There is already a large volume of company law which, partly in the interests of harmonisation of the law within the European Community, pronounces on various accounting and disclosure requirements. To a large extent, the statutes codify the practices observed voluntarily for many years. Under the Companies Acts departure from specific statutory requirements is permitted in the overriding interests of true and fair accounts. The accounting profession is bound to have considerable responsibility for advising when the specific requirements are not appropriate; accountants should not abuse this trust.

It is generally accepted, I think, that the increasing breadth and depth of knowledge required by accountants point to the need both for continued education and training and for more specialisation. There will always be a place for the generalist, but he will need to be able to turn to others who have specialised in a particular branch of the accounting profession. This process has already begun in the larger practices, where, after a broad grounding and early experience in general accountancy work, many accountants now further their careers within specialised departments. Taxation and insolvency work are two examples where the degree of specialised knowledge required may be too great for the generalist to give good service; but there are many other areas. The smaller practice may need to assess whether it has the resources and expertise to offer a service in all areas and, if not, to decide in which it will specialise.

Your profession, like others, has the problem that while the average quality of work done is high the same standard fails to be achieved by all firms. This has been recognised by the Audit Commission in drawing up a list of firms eligible to undertake local government audits. There may be merit in the argument that auditors of building societies, licensed deposit-takers, insurance companies and other similar institutions should also be selected from approved lists of firms recognised as having the requisite expertise and competence.

There is another problem which is going to grow steadily in importance for both auditors, and those in government and in the central bank who act as supervisors of the financial sector. Traditional distinctions between suppliers of different financial services—banker, building society, insurance company, unit trust manager—are breaking down. There is every reason to expect this trend to go further, and also to expect the financial services industry to become still more international. At present the auditing and supervision of each type of specialist financial institution tends to be carried out by separate groups of specialists. In years ahead we are likely to find it increasingly necessary to be able to understand, to audit and to supervise financial services companies covering a whole range of these functions across many financial centres. For you as auditors, and for us among other supervisory authorities, that is going to call for a broadening of expertise, skills and understanding.

Another aspect of training, which I know was already much in David Cormie's mind, is the possibility of creating the right conditions to allow accountancy students to train in industry. There is no doubt that a professional practice offers the young accountant a valuable and extensive range of experience. But one of the criticisms sometimes made of the profession is that the large accounting firms, which now undertake a large share of training tomorrow's accountants, fail to impart sufficient understanding of industry's methods and needs. It may be that some middle ground can be found, with the advantages of both, by allowing student accountants to spend part of their training contracts working within industry.

Changes may also be required in one or two other specific areas. In the field of insolvency work, for example, there is much public dissatisfaction with the work of receivers and liquidators. Some of this is unjustified and the reputable practitioners may need to make more widely known the many constructive aspects of receivership. Within the profession clear guidelines as to the duties and responsibilities of receivers and liquidators need to be established, which will reflect the best practice already observed by all reputable practitioners. More than that seems to be needed, however. Receivers and liquidators do not necessarily come from within the profession, and action of a wider character is also required to ensure that the unscrupulous cannot take on the role and abuse it.

The City can make no claim to a monopoly of new ideas for developing the methods of financing companies. It must indeed be admitted to have its own problems of communication and understanding; and it must be one of the tasks of the Bank to seek to ease such problems. I would like to thank the officers of the Institute for the positive and constructive approach which they always show in discussions we have with them. Should you conclude that the City is failing to respond properly to your needs or to the needs of industry, I hope you will take steps to bring it to the attention of the relevant body or institution.

## Conclusion

It is time for me to conclude. In doing so I return to my opening theme, which I hope I have illustrated in the course of my remarks. What the City expects from the accountancy profession is the continued maintenance of the high standards of technical competence, integrity and independence which have distinguished it hitherto. Beyond this, I am sure that you will be increasingly expected to be ready to offer opinion and guidance on the basis of information that you process and supply. I hope that you will be ready to respond to this challenge for, while I do not belittle the difficulties and sensitivities, nor should you underestimate the potential value of advice that, by virtue of your familiarity with the financial position of a company, you will often be uniquely equipped to tender.