

As you say strong stocks
 Care & trouble taken to present in case study. It brings out
 which lie behind the valuation of

The hazards of valuing stocks & debitors and the need to get

Most of us have had ^{many} ~~some~~ surprises in the field of not to the extent
 of that occur degree which occ. in co. to which you refer.

While yr. proposals fall o/s. remit this office they will

be put before the appropriate a/cg bodies and other members felt

that a case study based on episode described would

provide an imp't. input to the trig. causes for dis. & a/cg.

CFACG(94)10

**COMMITTEE ON THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE**

Letter from Mr J R Gillum

Note by the Secretary

1. You will find attached a copy of a letter and enclosures which the Secretary has received from Mr J R Gillum, concerning the flow of information to non-executive directors, and specifically the role of audit committees.
2. This case is being drawn to your attention, not only in view of the actual circumstances surrounding the listed company which is the subject of Mr Gillum's case history, but also to keep you aware of the fact that the Committee is seen as the correct authority to whose attention these cases should be drawn.
3. I do not believe that the Committee should take any action other than note Mr Gillum's proposals. To suggest adopting them as part of a revised Code could be seen as being overly prescriptive.

Gina Cole
29 November 1994

Holwell Manor
HATFIELD
Herts. AL9 5RG

Tel: 0707 261232
0707 272971

(Business with Answerphone)

Fax: 0707 272957

J. R. GILLUM

19th October 1994

Mrs Gina Coles,
The Cadbury Committee,
c/o The London Stock Exchange,
London EC2N 1HP.

Dear Mrs Coles,

I refer to our telephone conversation yesterday, and now enclose a paper for consideration as part of the review of Cadbury procedures, which I understand is currently in progress.

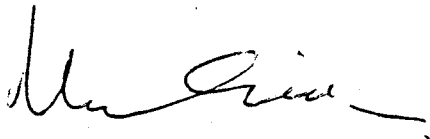
In case my own background may be of interest, I was a merchant banker for 32 years until my retirement at the age of 60 in 1988. Since then I have had a number of non-executive directorial positions, although, understandably, they have reduced during the more recent past. I am not a Chartered Accountant - although I have for many years been a Lay Member of the Disciplinary Committee of the Institute.

You will note that I have omitted the names of the company concerned, of the auditors and of the merchant bank in the case history in the attached paper. I did this on advice, since it was felt that inclusion of the names - particularly as both the auditors and the merchant bank are very well known - might prove a distraction. That said, if you wanted these identities at any time, please let me know.

Finally, it will not surprise you to be told that I was one of the non-executive directors on the Board - and indeed was the one who became Chairman. You will understand, therefore, that I have a particular mission to see that procedures are improved, so that the experience I suffered will not have been in vain.

I will await to hear from you in due course.

Yours sincerely



SUBMISSION
to the
Committee of Financial Aspects of Corporate Governance

1. CASE HISTORY

In the spring of 1990 a hostile takeover bid was made for a public listed company, which was resisted and in response to which a profit forecast for the year ending 30th March 1990 was produced. This forecast (of profits before tax of £6m) was significantly less than the previous year's reported profits, as well as being below market expectations, and the bidder withdrew.

Thereupon, under pressure from the Company's two non-executive directors, the then Chairman and Chief Executive resigned, to be replaced as Chairman by one of the non-executive directors. As it happened, this coincided with a second bid - from another party and at a lower price than the first bid. This was also resisted and, as part of the defence, the forecast was repeated (this being in the second half of March with only a few days of the Company's year remaining), whilst new executive management was introduced. The second bid in due course lapsed.

The profit forecast was, needless to say, reported upon by the Company's auditors and merchant bankers, both household names in the City.

As part of the audit procedures in respect of the year ended 30th March 1990, the new executive management reported that they were unhappy with the carrying values of fixed assets, stocks and debtors, where they felt that the then existing approach was unduly optimistic. Independent accountants (again, a well known name) were appointed to review these matters.

In the event the £6m profit turned into a £2m loss, the bulk of the £8m swing being:

Reassessment of bad and doubtful debts	£3.3m
Reassessment of stock provisions	2.8
Write-off of fixed assets	<u>0.8</u>
	<u>£6.9m</u>

Remembering the timing of the forecast (i.e. very nearly at the Company's year end), it seemed surprising that the auditors were prepared to sign off the accounts, as indeed they did, when effectively the very same items which had gone into the £6m forecast appeared in the audited accounts at £6.9m less! The description was, officially, "Effect of more prudent accounting judgment", or, more colloquially, "Change of management perception".

The "change of management perception" set off a chain reaction. The consequential reduction in net assets meant that there was no

longer the minimum capital cover required by the Company's banking arrangements and, to remedy the breach, a rescue rights issue was made. Not surprisingly; the Company's credibility suffered a very severe blow and the two non-executive directors (one of whom, as mentioned above, was the new non-executive Chairman) felt obliged to resign. The auditors, let it be said, were replaced at the year's Annual General Meeting.

2. GENERAL OBSERVATIONS

The story is a shocking one, and the experience was particularly unpleasant for the non-executive directors. Regardless of the popular external perception ("What were the non-executives doing?"), the fact is that non-executive directors are in no position to form any direct opinion as to whether or not stocks and debtors are carried at a fair value in a company's balance sheet. They are reliant on the competence and integrity of the executive management and of the company's auditors. And, of course, it should not be forgotten that the subject can be highly sensitive, with aggressive "earnings per share worship", encouraged in many cases by incentive plans being earnings per share based.

Corporate governance has, of course, developed significantly over the four years since the episode described above and, in particular, the principle of audit committees is now well established with their functions increasingly formalised.

Nevertheless, no special measures appear to have been adopted to make a recurrence of the above episode either impossible or, at the very least, highly unlikely.

It is certainly the experience of the writer that the subject of fixed asset valuation is visited - and revisited - adequately under present procedures. It is, therefore, the procedures regarding the valuation of stocks and debtors which call for review. In any event, they were the serious culprits in the case history, fixed asset valuation playing a relatively minor part.

3. PROPOSALS

For the purposes of audit committee meetings dealing with annual accounts, the "pack" provided by management and the auditors should include sections on stocks and debtors, as follows:


- (a) As regards stocks, indicating amount of 'slow moving' items, and indicating the carrying value of the relevant such items in the previous balance sheet;
- (b) As regards debtors, tabulated information on overdue debtors, annotated to show specific provisions, where applicable.

In both cases, the interface with general provisions should, if applicable, be indicated.

The above, let it be said, is intended to be a broad brush approach. Clearly, if the general idea finds favour, it would be for the accountancy profession to design properly detailed guide lines.

4. COMMENTS

Arguably, there might be a case for reviewing the accountancy standards covering stocks and debtors. However, recognising the subjective nature of valuation, the approach suggested above may be preferred. Designed, as it is, to provide audit committees with a sufficient degree of detail, it would enable such committees to question management and auditors - and particularly on cases where slow moving stocks or long overdue debtors were NOT being provided against. In other words, management and auditors would have to be prepared to justify their approach in such cases.


J-R Gillum
October 1994

Holwell Manor
HATFIELD
Herts. AL9 5RG
Tel: 0707 261232
0707 272971

(Business with Answerphone)

Fax: 0707 272957

J. R. GILLUM

19th October 1994

Mrs Gina Coles,
The Cadbury Committee,
c/o The London Stock Exchange,
London EC2N 1HP.

Dear Mrs Coles,

I refer to our telephone conversation yesterday, and now enclose a paper for consideration as part of the review of Cadbury procedures, which I understand is currently in progress.

In case my own background may be of interest, I was a merchant banker for 32 years until my retirement at the age of 60 in 1988. Since then I have had a number of non-executive directorial positions, although, understandably, they have reduced during the more recent past. I am not a Chartered Accountant - although I have for many years been a Lay Member of the Disciplinary Committee of the Institute.

You will note that I have omitted the names of the company concerned, of the auditors and of the merchant bank in the case history in the attached paper. I did this on advice, since it was felt that inclusion of the names - particularly as both the auditors and the merchant bank are very well known - might prove a distraction. That said, if you wanted these identities at any time, please let me know.

Finally, it will not surprise you to be told that I was one of the non-executive directors on the Board - and indeed was the one who became Chairman. You will understand, therefore, that I have a particular mission to see that procedures are improved, so that the experience I suffered will not have been in vain.

I will await to hear from you in due course.

Yours sincerely



SUBMISSION
to the
Committee of Financial Aspects of Corporate Governance

1. CASE HISTORY

In the spring of 1990 a hostile takeover bid was made for a public listed company, which was resisted and in response to which a profit forecast for the year ending 30th March 1990 was produced. This forecast (of profits before tax of £6m) was significantly less than the previous year's reported profits, as well as being below market expectations, and the bidder withdrew.

Thereupon, under pressure from the Company's two non-executive directors, the then Chairman and Chief Executive resigned, to be replaced as Chairman by one of the non-executive directors. As it happened, this coincided with a second bid - from another party and at a lower price than the first bid. This was also resisted and, as part of the defence, the forecast was repeated (this being in the second half of March with only a few days of the Company's year remaining), whilst new executive management was introduced. The second bid in due course lapsed.

The profit forecast was, needless to say, reported upon by the Company's auditors and merchant bankers, both household names in the City.

As part of the audit procedures in respect of the year ended 30th March 1990, the new executive management reported that they were unhappy with the carrying values of fixed assets, stocks and debtors, where they felt that the then existing approach was unduly optimistic. Independent accountants (again, a well known name) were appointed to review these matters.

In the event the £6m profit turned into a £2m loss, the bulk of the £8m swing being:

Reassessment of bad and doubtful debts	£3.3m
Reassessment of stock provisions	2.8
Write-off of fixed assets	<u>0.8</u>
	<u>£6.9m</u>

Remembering the timing of the forecast (i.e. very nearly at the Company's year end), it seemed surprising that the auditors were prepared to sign off the accounts, as indeed they did, when effectively the very same items which had gone into the £6m forecast appeared in the audited accounts at £6.9m less! The description was, officially, "Effect of more prudent accounting judgment", or, more colloquially, "Change of management perception".

The "change of management perception" set off a chain reaction. The consequential reduction in net assets meant that there was no

longer the minimum capital cover required by the Company's banking arrangements and, to remedy the breach, a rescue rights issue was made. Not surprisingly, the Company's credibility suffered a very severe blow and the two non-executive directors (one of whom, as mentioned above, was the new non-executive Chairman) felt obliged to resign. The auditors, let it be said, were replaced at the year's Annual General Meeting.

2. GENERAL OBSERVATIONS

The story is a shocking one, and the experience was particularly unpleasant for the non-executive directors. Regardless of the popular external perception ("What were the non-executives doing?"), the fact is that non-executive directors are in no position to form any direct opinion as to whether or not stocks and debtors are carried at a fair value in a company's balance sheet. They are reliant on the competence and integrity of the executive management and of the company's auditors. And, of course, it should not be forgotten that the subject can be highly sensitive, with aggressive "earnings per share worship", encouraged in many cases by incentive plans being earnings per share based.

Corporate governance has, of course, developed significantly over the four years since the episode described above and, in particular, the principle of audit committees is now well established with their functions increasingly formalised.

Nevertheless, no special measures appear to have been adopted to make a recurrence of the above episode either impossible or, at the very least, highly unlikely.

It is certainly the experience of the writer that the subject of fixed asset valuation is visited - and revisited - adequately under present procedures. It is, therefore, the procedures regarding the valuation of stocks and debtors which call for review. In any event, they were the serious culprits in the case history, fixed asset valuation playing a relatively minor part.

3. PROPOSALS

For the purposes of audit committee meetings dealing with annual accounts, the "pack" provided by management and the auditors should include sections on stocks and debtors, as follows:

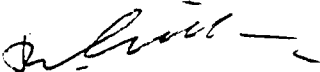
- (a) As regards stocks, indicating amount of 'slow moving' items, and indicating the carrying value of the relevant such items in the previous balance sheet;
- (b) As regards debtors, tabulated information on overdue debtors, annotated to show specific provisions, where applicable.

In both cases, the interface with general provisions should, if applicable, be indicated.

The above, let it be said, is intended to be a broad brush approach. Clearly, if the general idea finds favour, it would be for the accountancy profession to design properly detailed guide lines.

4. COMMENTS

Arguably, there might be a case for reviewing the accountancy standards covering stocks and debtors. However, recognising the subjective nature of valuation, the approach suggested above may be preferred. Designed, as it is, to provide audit committees with a sufficient degree of detail, it would enable such committees to question management and auditors - and particularly on cases where slow moving stocks or long overdue debtors were NOT being provided against. In other words, management and auditors would have to be prepared to justify their approach in such cases.


J-R Gillum
October 1994