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Enron accounting.....and how to prevent it

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The failure of the US energy company Enron in the early years of the century and the incestuous relationship between the company and its auditors Arthur Andersen gave a graphic public example of the dangers of relying on company accounts to provide a true picture of the financial state of a company. Enron went from being worth $80 billion to virtually nothing in a year, yet Arthur Andersen kept on giving them a clean bill of financial health right up to the end.

Since the Enron crash, a series of major private enterprise failures has occurred culminating in the catastrophic financial implosion of major banks and their ilk, most notably those in the USA and Britain. Much has been written about the failures of formal regulatory regime for banks and their ilk, but surprisingly little media and political attention has been given to the failure of the part played by the general regulatory rules for business – the audit of business account – in preventing the excesses of the banks: for example, how did the banks' auditors persistently accept the value placed on the exotic financial instruments which underpinned the sub-prime debt, or time and again fail to uncover fraudulent trading positions of dealers like Nick Leeson?

It is this aspect of failed regulation – the audit of companies – upon which I shall concentrate, an examination which will address the general problems of auditing rather than just those associated with banks.

What is the audit? Any limited liability company in Britain has by law to be inspected to some degree (the level of audit for very small companies is much less onerous than for the larger ones) once a year by a qualified accountant or firm of accountants. The auditors must either certify the annual accounts as a fair representation of the company's business or certify the accounts with reservations. Where the accounts are blatantly and seriously flawed, the auditors will refuse to sign the accounts and resign as auditors. Such events are very rare indeed in the case of the largest companies.

The audit regimes of different jurisdictions vary in detail: for example, British companies are required to divulge substantially more financial information than their US counterparts. Nonetheless, the audit regimes in any advanced country are similar enough for statements about auditing problems to be generally pertinent.

Why does the failure of large concerns matter?

Before I turn to the practical difficulties of producing honest and accurate audits, there is a prior question to answer: namely, why is the audit necessary? After all, private enterprises which do not take public money for government contract work are simply risking the money of their shareholders and those who extend credit to them. Pathological free marketeers would say that even a large business failure is merely the market at work and that all will come out in the competitive wash. Those not afflicted with this quasi-religious belief will see things rather differently. However, the free market case does need to be answered because of its present dominance in politics. So, why is the failure of a large company so important?

Obviously those who lose money or their jobs through the collapse of a large company suffer. But what about the general population? Why should they care? Indeed, many people shrug their shoulders when they hear of business failures, thinking, 'I own no shares, I have no pension with them. I do not work for them. I am not a creditor. It will not affect me.' In the special case of banks they may be concerned about money deposited; but that fear soon evaporates in a country such as Britain as they discover that the government underwrites either all or a large proportion of their deposits.

Those with this I'm-all-right-Jack mentality dwell in a fool's paradise. In aggregate, business failures of any size are important to an economy, but a large company going bust is particularly bad news, both immediately and in the longer term. To begin with there is a strong possibility that it will have most of its staff concentrated in a few areas or even in one area. If so, it will cause a local crisis. Structural unemployment on the heroic scale of the 1930s or even of the 1980s and early 90s, when British industries such as coal and steel were 'rationalised' almost out of existence, may be a thing of the past in Britain because the country has been cleansed of most of its great manpower demanding manufacturing and extractive industries. But a company can still employ sufficient people in an area to cause severe economic and social dislocation if it stops trading: for it puts out of work its own employees and the employees of firms dependent upon its orders and the local economy as a whole shrinks as purchasing power is reduced. Beyond the local economy, the taxpayer generally suffers because those now redundant pay no income tax and have to rely on taxpayer funded benefits, while the tax take generally in the area is reduced as demand shrinks.

Less tangibly, the failure of a company as large as Enron affects the general confidence of the population. They think, not unnaturally, that if a company that big can go down the pan, what company is safe? When people are unsure about the future they tend to reduce their spending. That deflates the economy. But not only do they fear for their immediate jobs. If they have a private or occupational pension, they begin to ask awkward questions such as ‘Is it safe?’ Those without pensions as yet ask, ‘What is the point of paying into a pension if it goes the way of Enron’s pension scheme?’

These are very pertinent questions to ask. Private and occupational pensions are heavily linked to the stock market because pension funds tend to hold much of their investment capital in shares. Any large pension fund will be likely to hold shares in many major companies. If a large company fails completely or even does very badly, non-state pensions will suffer. Even state pensions may indirectly feel the pinch because reduced tax revenues due to a slowing economy means that state funding cannot be so generous. Moreover, the failure of large companies has a depressive effect on the stock market generally, which again is to the general disadvantage of pension funds, which hold a large proportion of their funds in equities.

But the ripples spread even further. Companies rely directly and indirectly on the reliability of their audited accounts and the accounts of others. So do credit rating agencies and market analysts. Once confidence in audited accounts falls, then the cost of doing business rises as companies take steps to try to safeguard themselves against losses from honest business failures or outright fraud. They will become more cautious in their business dealings generally. They will attempt to insure against losses. The general cost of borrowing money will almost certainly rise as banks become more wary. New investment may become impossible. This is what caused the Asian Crash in the late nineties. Far Eastern companies looked a good bet from their accounts, but many were far from sound in reality. Once the accounts of a few big companies were exposed as works of fiction, a general collapse in confidence followed and even companies which on a trading level were perfectly sound found their supply of new capital drying up.

Finally, there is the loss of the capacity to provide of goods and services. A large company may fail through incompetence or fraud rather than a decline in demand for their products or competition from other at home and abroad. If that happens the country and its people lose the opportunity to purchase the goods and services. This may mean either no goods or more probably imported goods at a higher price. In the case of strategic industries, such as microchips or energy, it can also mean a dangerous dependence on foreign suppliers.

A single large failure will not capsize a first world economy on its own, although it can do a great deal of damage: Wall Street lost 2% of its value after Enron collapsed. But often one large failure will signal others. There is a good reason for this: such failures almost invariably occur in difficult economic times, either at the very end of overheated boom or on the downturn. In boom times, incompetence and even fraud can be hidden by a company because confidence is high, money is plentiful and cheap and customers easy to find; legal regulation becomes lax and self-regulation next to non-existent. Financial castles in the air can be and are happily and rapidly constructed. Come recession, the fruits of incompetence and fraud rapidly ripen to the point of collapse and exposure. If one large company has been caught by incompetence or fraud, you may bet the farm on a number of others having fallen into the same trap.

If audits are fair and accurate, the chances for reckless or criminal behaviour are greatly reduced. That is why they are essential to the efficient functioning of economies which are predominantly capitalist. The problem is that time and again audits fail to be either fair or accurate. To understand why this is so we need to understand the reasons and methods of those within companies who would act dishonestly or incompetently, the process of auditing and what practical steps can be taken to prevent abuses by both directors and auditors.

Why false accounting happens

False accounting occurs for two general reasons. The first is the 'honest' reason: accounts are falsified simply to keep a company afloat. This is very common. It may often have a moral slant to it as many employers who own the companies they run have a genuine sense of responsibility towards their staff as well as their own interests.

The other reason why accounts are falsified is fraud for the direct benefit of the individual. This has three basic forms. The first is when the directors of a company dishonestly influence the price of shares through the provision of false information to hide the poor performance of a company and persuade shareholders and suppliers that it is still a viable and attractive going concern. Higher share prices and misleadingly favourable accounts can also trigger very large bonuses and share options.

The second form of fraud is the direct attempt to steal the assets of a company. This often occurs in cases where directors are all in the know and have started off falsifying the accounts to keep a company afloat. They get to a stage where it is obvious the company is going under and the directors suddenly take what they can and run. However, it can also be fraud which consists simply of taking money or assets by one or more people – who need not be directors – without the directors as a whole knowing that fraud is being perpetrated.

The incestuous relationship between auditor and audited

The relationship between auditor and audited can be very close regardless of the size of a company (private limited companies with few shareholders are very prone to having a tame auditor, especially family-owned businesses). In the case of very large companies the relationship between company and auditor becomes very incestuous. Very few firms of accountants have the capacity to perform such audits: in Britain perhaps three or four could handle a company the size of Enron. This means that the same handful of accountancy firms carry on auditing the larger companies more or less regardless of their performance, simply because there is no one else to do it. For the same reason governments are reluctant to act against such audit firms no matter how they behave, because to do so could result in audits for the largest companies becoming a practical impossibility. There is probably not one large firm of auditors in Britain which has in the past 30 years not been involved in some serious failure to uncover financial wrongdoing.

The primary problem with the audit as a regulatory instrument is that the auditor has a vested interest in keeping the company audited sweet because there is money in 'them thar audits'. Auditors go from year to year or even decade to decade with the same companies, happily drawing their auditing fees, which can be very substantial in a large company: Enron paid Arthur Andersen $25 million for their last audit. The incentive not to kill the goose that lays the golden egg is obvious, and the auditor may be tempted to turn a blind eye to irregularities ranging from trading whilst insolvent to outright and wilful criminality.

Accountants will often tell you there is no money in auditing. Well, up to a point, Lord Copper. As auditing is a statutory requirement and qualified accountants have a monopoly of the work, there is little excuse for auditing not to be profitable. Indeed, at the smaller end of the trade, auditing is a staple of an accountant's practice. The larger the company, the more complicated matters become. Small companies frequently have their accounts audited by their accountant and little else done. Large companies commonly purchase a range of non-audit related services from their auditors, for example, management consultancy and sophisticated accounting and financial services software. (Enron paid more in consultancy fees – $27 million – to Arthur Andersen than they paid for their audit.) Auditors will drop the price of the audit to entice the customer to buy the non-audit services. The audit may even appear as a 'loss leader' in the audit house's ledgers. But of course it would not be offered at a 'loss leader' price if the other non-audit fees were not forthcoming. It does not require much imagination to see that such non-audit fees are going to end if the accounts being audited are not passed as satisfactory. It is worth adding that amounts paid by large companies to auditors for non-audit services are small compared to the value of the businesses they audit and the financial resources they command. What, after all, was $27 million Enron paid Arthur Andersen for consultancy work in their last trading year when compared to the billions Enron commanded?

Why is this laxness tolerated? Because the government cannot act, even in a purely legislative sense, too harshly against auditors for they know that if they make the rules for auditing too onerous, it may dissuade so many accountants from undertaking audits as to make the legal requirement to have accounts audited a practical impossibility. In the case of those accountants auditing the largest companies, there is a particular problem because none of the accountancy practices which have the capacity to undertake such audits has clean hands. If the largest audit firms were brought to book for their failures to audit meaningfully, the government might as well relieve the largest companies of their obligation to be audited for there would be no one left to do it.

The sad truth is that whatever regulatory legislation a government might pass to improve audits would be virtually a dead letter in practice if the audit profession does not wish to play ball. Government does not have the capacity to meaningfully police auditing and could not in practice acquire it. Because of the technical expertise required, the only people who could do it are accountants and they are never going to work as paid government employees in any numbers. That is so because accountants in private practice can both earn much more than public service could possibly offer and be their own masters. (This is a general problem for public service with jobs which require expertise with a high value in the private market.)

But even if sharp accountants could be persuaded to work for the government, their numbers would always be vastly less than the numbers needed to police audits meaningfully. In fact, the active policing of any law involving a fraud is always something of a confidence trick because the numbers of fraudsters are invariably vastly greater than the forces the state can muster against them.

How collusion may arise between auditor and client

The turning of a blind eye to irregularities may happen tacitly, that is both auditor and the company to be audited understand what the 'deal' is without anything being said: you get the fees, we get the clean bill of financial health. However, outright conspiracy between the auditor and the audited to suppress the true financial state of the company must happen reasonably frequently because apart from those instances which result in criminal charges, there are so many cases of publicly reported company failure which involve such dramatic failures of auditors to qualify accounts that it is difficult to imagine they are down to simple negligence or incompetence. In Britain think of the failure of auditors to unmask the corrupt behaviour of Robert Maxwell (Mirror Group), Asil Nadir (Polly Peck) and BCCI.

Such a conspiracy might include all the partners in a accountancy firm or just one. Where a large company is audited, the number of people required to carry out the audit is substantial. There is consequently a good chance that irregularities will be known to quite a number of people and a conspiracy might seem impossible to keep within the conspirators. However, most of the people who do the physical auditing are not partners or even qualified accountants, accountancy trainees being commonly used as the auditing footsoldiers. Such people have a vested interest – progressing their careers – in keeping quiet if they think the audit is being conducted dishonestly and also lack both the expertise to unravel fraud and the access to the overall audit data, which access often may be necessary to see a fraud.

Is it possible to audit companies meaningfully?

The problem for the auditor is how to balance the time available for the audit with the amount of data to be audited. As the data for a company of any size always vastly exceeds the time available all an auditor can do is sample the data. But that is only the start of his difficulties. Take the most basic act of auditing, comparing one document with another to verify that a transaction has taken place. The auditor checks one against another, say an electronic record against a paper invoice. One substantiates the other. What then? Does the auditor simply take the records at face value or does he institute further checks such as contacting a supplier of the audited company to see whether an invoice ostensibly from the supplier was actually issued by the supplier? The norm is that records which seemingly corroborate one another will be taken as genuine because the auditor simply does not have the time to check further all of the documents he inspects. The best that can be done is to investigate more fully a sample of the documents the auditor has chosen for inspection. But that means he is down to investigating a sample of a sample, and even if he does it rigourously, the chances of discovering that data has been falsified are pretty slight because most frauds will only affect a small part of a company's records. Interrogation software can be used to go 'data mining' on computerised records, but the best one can ever do with the manual data (which is probably the most easily identifiable source of irregularities) is sampling. Moreover, even where computer files can be interrogated efficiently – something dependent upon the IT skills of the user – that produces another sort of problem: the large volume of extracted data to be scrutinised. There is only so much time and effort that can be put into an audit.

If the directors are determined to obstruct an audit by supplying false or incomplete data, as Enron routinely did in the most complicated and opaque manner, I doubt whether it is possible to meaningfully audit a company of any real size, let alone one as enormous and as complicated as Enron. Their main accounting trick was the creation of fictitious revenue by setting up a complex chain of dummy companies, that is, companies owned and controlled surreptitiously by Enron, which pretended to trade with Enron as independent customers and the hiding of debt in those companies. A satirical e-mail which did the rounds at the time of the Enron collapse was perhaps not far short of the mark:

> Capitalism – You have two cows. You sell one and buy a bull. Your herd multiplies, and the economy grows. You sell them and retire on the income.
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> Enron Venture Capitalism – You have two cows. You sell three of them to your publicly listed company, using letters of credit opened by your brother-in-law at the bank, then execute a debt/equity swap with an associated general offer so that you get all four cows

> back, with a tax exemption for five cows. The milk rights of the six cows are transferred via an intermediary to a Cayman Island company secretly owned by the majority shareholder who sells the rights to all seven cows back to your listed company. The annual report says the company owns eight cows, with an option on one more.

But whatever the size of company, the auditor is always at the mercy of his client in the sense that he can only work from the data the client gives him. If a false set of plausible 'books' is presented there is not much an auditor can do in practice because of the constraints of time and money. And a false set of 'books' is all too possible these days because computers have made the business of falsifying records a doddle. Keeping two sets of books manually involves considerable effort; with computers all that needs to be done is keep two separate accounts programs running, one truthful, one bogus. Moreover, with computerised systems changes to hide fraud can be made without leaving the obvious telltale signs of alteration commonly found within manual systems such as rubbings out, pages torn from ledgers, obvious attempts to change data and other evidence of human interference.

Computers also affect the veracity of paper documents. As a reasonable stab at counterfeiting banknotes can be made using run of the mill IT equipment, it is not difficult to imagine how easy it is to forge other documents which have no security features built into them.

Suppose I want to forge an invoice from a regular supplier to account for money which in reality has been siphoned off illegally. I take an actual invoice from the company. I scan it in and then use a graphics package to remove the original sales data and to put in the false data. I then print out the forged invoice (using similar paper to the original) which for all the world looks like the other genuine invoices I have from the supplier.

There is also the problem of the auditor's ability as an investigator. Investigators like salesmen, are born not made. You can make a natural investigator better by training and giving him experience, but you can never make someone without the natural talent a good investigator. That is because an investigator must be someone with initiative, someone who does not require a textbook to tell them what to do. Many auditors frankly do not have that quality in any great degree and are literally incapable of conducting a serious investigation rather than a 'tick and turn' inspection, that is merely satisfying an audit by taking things at face value. Indeed, the type of personality which makes a good technical accountant – attention to detail, accuracy in small things etc – may mitigate against him being an efficient investigator. As already mentioned, it is also true that the least able and experienced members of an accountancy firm are put to audit work, while the more able and experienced do the consultancy work.

The scarcity of IT skills

Even after 20 years of computerised accounting systems being the norm, auditors all too often lack the computer skills needed to interrogate electronic data in a sufficiently sophisticated manner, something which is far from simple for even someone with good IT skills when they are dealing with an unfamiliar computerised records and accounting system. It could be argued that such skills should be made mandatory for auditors dealing with large companies with complex computerised accounting systems. That idea, like many a legislative wheeze, sounds attractive at first glance. The problem is that people with such skills are thin on the ground and very costly. If the employment of such people were made mandatory, large firms of auditors might well be unable to employ the staff they need. That in turn could lead to the auditing of all limited companies becoming impractical.

But let us assume for the sake of argument that there were sufficient people with IT skills and they could be enticed to work for auditing firms, what then? Very few of those IT competent people will also have the accountancy skills needed to properly perform an audit. Nor is it probable that sufficient people could be trained to have both at a high level because the dual training would simply take too long and be too costly. Consequently, auditors without high level IT skills would often have to work through IT specialists without accountancy skills. Apart from the immense cost implications of this, there is also the problem of meshing the IT specialist and the accountant together. As any systems analyst will tell you, the point in the creation of a new system where things are most likely to go wrong is the process of the computer illiterate customer telling the systems analyst what he wants of the system he is asking the systems analyst to design. Accountants without advanced IT knowledge are all too likely to ask for things which do not produce the data they want.

The responsibilities of directors

Directors, both executive and non-executive have legal obligations to take all reasonable steps to ensure that their company trades within the law. That obligation includes the presentation of an honest set of accounts.

Directors cannot be passive and automatically escape the consequences of any criminality or gross incompetence. Ignorance of wilful criminality or of gross incompetence in maintaining records adequate to show the true financial position of a company, does not excuse directors from their obligation, although it may be enough to save them from criminal charges.

Directors have limited liability in normal circumstances.

However, if it can be shown that the directors have not met their legal obligations as directors, for example criminality is proven or inaccurate records have resulted in a company making a loss, their limited liability can be removed. However that is extraordinarily rare which suggests that either the law is inadequate or there is a tacit understanding amongst those with the power to take action to remove their limited liability, especially the large pension and other managed funds, that pursuing individual directors would not be playing the game. As we shall see the law would appear to be adequate if it were only enforced.

Nowhere is this reluctance to act better seen than in the aftermath of the banking crisis which caused the present recession. Not one of the directors of the Royal Bank of Scotland or HBOS has been subject to criminal or civil action. Being a banker is a small-risk occupation for those at the top. As the Government almost invariably steps in when it is a bank going bust, being a banker is a one way bet: the bank makes money, you get the vast remuneration: the bank fails, the taxpayer steps in and you do not suffer any punishment such as summary dismissal, the removal of limited liability if you are a director or criminal proceedings, but instead leave with a massive payoff at worst

Section 174 of the 2006 Companies Act details the duties of the directors as follows :

(1) A director of a company must exercise reasonable care, skill and diligence.

(2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with —

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and

(b) the general knowledge, skill and experience that the director has.

How can the directors of RBS, HBOS, Lloyds TSB and Northern Rock be said to have met these requirements? Lloyds TSB have even admitted that inadequate due diligence was done before the take-over of HBOS. Yet there has been no suggestion of taking criminal or civil action against them.

There is also the question of general competence. The alarming truth is that the executive directors of the banks almost certainly did not understand the complex financial packages being devised by their investment arms which led to the crisis. On 10 February 2009 the recently removed executive directors of the RBS and the HBOS appeared before the Commons Treasury Select Committee: Sir Fred Goodwin (ex-RBS chief executive) and Sir Tom McKillop (ex-RBS chairman), Andy Hornby (ex-HBOS chief executive) and Lord Stevenson of Conandsham (ex-HBOS chairman).

During their examination by the committee, each of the four directors on show was asked to detail their formal banking qualifications. All four had to admit that they had none. I am generally an enemy of credentialitis, but in this case technical qualifications are necessary to ensure that the directors understand the very complex financial instruments being used and the exotic accounting practices employed by large corporations. If failure to understand such things does not amount to gross negligence what does?

The Companies Act allows shareholders, subject to the agreement of a court, to sue directors for negligence, default, breach of duty or breach of trust. No attempt has been made to removed their limited liability to allow this to happen. Nor, as far as I can discover, has any attempt has been made to get bank directors banned from holding directorships in the future. Why have the institutional shareholders not started such legal action to remove limited liability from directors so they can be sued? Why has no politician raised the possibility of banning ex-bank directors from being directors in the future? The only plausible reason is the tacit class interest encompassing politicians, bankers and large institutional investors, the last being the only non-governmental people generally with the financial muscle to fund actions to remove the limited liability of directors. There is a simple legal way to stop them enjoying the fruits of their ill-gotten gains: remove their limited liability and ban them from holding directorships for life.

As for criminal charges, I wonder if something could not be done under the laws relating to fraud. There must come a point where recklessness behaviour becomes fraud because the director knows they are taking chances which will most probably not come off. For the future we need a law of reckless endangerment which would make any director who endangered a bank or allied institution through their criminally reckless behaviour to be punished by the criminal law.

Far from being punished, bankers who have left the banks they have helped ruin have received gigantic payoffs to reward them for their incompetence. The case best known to the public is that of Sir Fred Goodwin of RBS who originally was to receive an immediately payable pension of more than £700,000 per annum (since reduced to a more modest £400,000 odd). But he does not stand alone. To take a couple of other examples, according to the *Telegraph* (27 February 2009) 'Eric Daniels, the chief executive of Lloyds Bank, which has accepted tens of billions of pounds from the Government, could receive almost £10 million in pay, perks and bonuses this year', while Adam Applegarth, the chief executive of Northern Rock when it failed, a bank so badly damaged that it is now wholly owned by the British taxpayer, reportedly trousered £760.000.[1]

When it comes to human behaviour, it is always risky to say that something has never happened, but I will stick my

1 Tony Undercastle, 'Northern Rock boss to get £760,000 payoff', *Daily Telegraph* 31 March 2008

neck out and say that there is no instance of a director of a large public company audited in Britain ever publicly blowing the whistle on criminality or recklessness verging on criminal irresponsibility and getting the backing of their board to publicly expose what was going on. I think one would even be hard pressed to find a director of such a company who has publicly exposed breaches of the law or recklessness on his own authority whilst still sitting on the board. In the case of Enron a so-called whistle-blower, Sherron Watkins, was not in fact a public whistleblower. She merely told senior Enron executives that massive debt was being hidden. When the senior executives did nothing, she followed their lead and kept quiet until after the company collapsed.

Non executive directors

The sinecure is alive and well in boardrooms. Non-executive directors are meant to bring some particular benefit, for example contacts or expertise, and a certain independence of mind to a board. In practice, and especially with large companies, non-execs have a pretty dismal record of bringing neither particular benefit nor independence of mind to their position. Where were Enron's non-execs when what appears to have been outright fraud was being practised? How did Robert Maxwell manage to perpetrate the frauds that he did within the context of public limited companies packed with non-execs? What were Marconi's non-execs doing as the management, through sheer recklessness, reduced a company worth £30 billion, with a cash balance of £3 billion, to one worth less than £1 billion with £4 billion of debt within 18 months in the 1990s? More dramatically why did the bank non-execs fail so spectacularly to raise concerns about the exotic financial instruments and other reckless behaviour which led to the banking collapse of 2008? They were at best simply drawing their salaries whilst doing as little as possible.

The truth is that non-execs in the vast majority of cases are no more than PR wallpaper. The case of the former Tory Minster, John Wakeham, is instructive. Wakeham is an accountant by training with considerable commercial experience before he went into politics. Not only did he accept a non-exec directorship with Enron, he also agreed to chair Enron's audit committee. In theory, Wakeham was the ideal non-exec. He had particular expertise (accountancy), contacts (politics) and was not dependent on Enron for his main remuneration. Apart from his position as Press Complaints Commission chairman (for which he received £150,000) Wakeham also held 16 other non-exec directorships. Yet it did not make a blind bit of difference. Enron and their auditors were able to do what they did without a peep from Wakeham.

Wakeham's situation when he was with Enron also raises a very interesting question: how it is possible for any person to head the PCC and hold as many directorships as he did (and Wakeham is far from being the champion in terms of numbers of directorships) and meaningfully satisfy his obligations as a director? Common sense says it is not possible, even for the most conscientious and able man.

But non-execs are all too often not conscientious or able. They sit on boards to lend their names (a title is always very useful on the letterhead) and to give the illusion that a company is being properly scrutinised by those not involved with its day-to-day management. The non-exec in return gets handsomely rewarded for doing very little and making even fewer waves.

How are non-execs appointed? The Old Pals Act is the answer often enough. In the case of very large public companies there is a 'magic circle' of non-execs who circulate around the companies.

What can be done to improve matters?

When one contemplates the practical difficulties involved in policing fraudulent or grossly incompetent behaviour by directors and auditors, the temptation is to throw up one's hands in despair. Yet something radical clearly needs to be done, for at present directors can act negligently or even fraudulently with near impunity. (If you want to be a fraudster with little chance of going to prison, go into business on your own account.) If you maintain at least the semblance of attempting to trade normally, generally you will be safe from criminal prosecution. If action is taken, the worst that can happen is normally a ban for a few years from being a director of a company, although in practice this is often a dead letter for very little check is made on their future employment. They may not formally be directors, but all too often they are to be found controlling companies through nominees (if the companies are small) or are employed as consultants.

How can matters be improved? Consider the practical restrictions within which any state-prescribed audit must exist. The state could never undertake the business of auditing itself because it would be impossible for the state to employ accountants in sufficient numbers to undertake the auditing. Nor, for the same reason, can the state police audit even to the degree that it can make checks on the deduction of VAT or income tax under PAYE. The best the state can do is investigate after the damage is done; and even then the lack of accountancy expertise directly employed by the state means that the state has to rely largely on accountants in private practice to undertake the work of investigation.

If a regulatory system is reliant on private individuals – the directors, auditors and suchlike – to behave honestly and competently but cannot make any meaningful general check on them, the only course left is to work on the minds of such people. The most potent way to do that is to make the penalties for fraud and incompetence by directors and auditors severe and their application exemplary, which means prison, heavyweight fines and banning them from any position of responsibility within a company for substantial periods, including life in the worst cases and any director who has liquidated three companies. The same willingness to prosecute should apply to any other person involved in a gross misrepresentation or outright fraud connected to a company: for example lawyers, credit agencies, financial journalists, and politicians. In addition, the state should provide the means to pursue civil actions for damages against those who defraud or act without due diligence. The strongest incentives they can have to behave properly are convincing threats of imprisonment and personal financial ruin.

If the removal of limited liability is to be effective, the ability to recover assets passed to family members and any other third party by a director must be greatly improved. At present all that can be done is to try to show that the assets passed to a third party were passed simply to keep the assets from the director's creditors, something which in practice is the devil's own job. What is required is a law that would allow assets to be seized if the third party could not show they had acquired them in a manner other than by receiving them from the director in question either directly or indirectly. (A frequent ploy by directors who own all or much of a business is to pay a third party, normally the wife, substantial remuneration for work they do not do.)

I would also advocate a new criminal offence to deal with situations where a prosecution is presently difficult or impossible because the directors are claiming gross incompetence to explain the collapse of a company or the unexplained disappearance of company assets. Directors should face criminal charges for such failures as inadequate or missing records as and the inability to account for missing company assets. These should be strict liability offences: that is offences where intent does not have to be proved merely the fact that something has or has not been done.

The position of non-executive directors needs to be tightened. As many of them do little more than lend their names (and sometimes their titles) in the manner described by Trollope in *The Way We Live Now*, the complete banning of non-execs would be no great loss. Any particular expertise a company needs can be brought in at non-directorial level. The same applies to people with contacts. The same applies to general independent advice on running the company.

The argument that non-execs provide oversight is unsustainable because they rarely if ever blow the whistle on corporate misbehaviour. Nor, as the example of British banks has recently shown, do they often have the expertise to understand the business they are supposedly overseeing. There might be a case of a small number of independent non-execs voted for by the smaller shareholders (to exclude the class interest between directors and the big managed funds), but the problem there would be whether sufficient people with the right expertise could be found to fill such roles.

It might seem logical for audit firms to be restricted to auditing work. That sounds fine in theory but it raises two severe practical problems. The first is obvious: what if insufficient accountants are willing to set up audit-only firms? Obviously the system of audit as we know it would collapse. That problem could conceivably be overcome by the government using taxpayers' money to pay audit-only firms a substantial retainer to add to their audit fees to make the work worthwhile. However, even if that did work, such a solution is unlikely to overcome the second problem, at least for the larger audit firms. Bright young would-be accountants, particularly with the larger accountancy practices, join because of the variety of work which is available. This provides them with not merely a good accountancy background but also valuable general management and business skills. An audit-only company would not provide such a background. It is also true that audit work is pretty dull.

What could be done instead of having audit-only firms? A halfway house is possible. Auditors could be forbidden by law to offer other services to a company they are auditing. That will mean they have to adjust their audit and non-audit fees, but is a practical suggestion. It would of course leave the problem that only a small group of audit firms can handle very large companies. That can to a degree be addressed by especially strict oversight of the auditors of such companies, but it will always be a problem. The application of penalties should be auspiciously rigourous where collusion or fraud occurs in such companies and audit firms.

Insolvency law needs to be enforced more strictly. However, that does present difficulties. In theory, a company unable to meet its debts is insolvent and should cease trading; but few if any companies have not been technically insolvent at some time, not least because trade is often strongly seasonal. But if that was the standard by which businesses operated the economy would collapse. What businesses do is trade while they have reasonable expectations that debts will be met in the course of normal trading fluctuations or they believe they have the ability to raise fresh capital through such devices as bond and rights issues. Of course, what constitutes a reasonable expectation is debatable and that gives great scope for interpretation by auditors as well as directors. The line between fraudulent trading and misjudgement of a company's circumstances is not always an easy one to discern. However, there are many blatant examples of companies going into administration or liquidation with debts which are simply so overwhelming that it stretches credulity well past breaking point to imagine that the directors had any reasonable belief that they could trade or borrow themselves out of an insolvent situation. (Think of Portsmouth FC.).

It is also important to realise that the audit at present is a narrow exercise designed to assess the past financial year.

It is not meant to judge the broader viability of a company such as its longer term potential to trade legally. There is a case for giving the auditor responsibility for making broader judgements, for example, whether a company's borrowing is such as to overwhelm it with a slight change in circumstances, for example, a hike in Bank Rate.

But no matter what steps are taken to enforce penalties against directors or to improve oversight, the policing of private business, like all other policing in any society with pretensions to be free, involves a large dollop of public consent. It relies on the honesty and good will of both those running a company and those with the duty to check the financial state of a company. Consequently, the general moral tenor of a society will to a considerable extent determine the volume of dishonesty in business.

The fact that at present directors rightly believe that they have little chance of being held responsible for their incompetence or criminality means, quite naturally, that they are more likely to behave in such ways. But their propensity for doing so is also bolstered by thirty years of laissez faire propaganda by businessmen, academics, politicians and much of the mainstream media which has promoted the idea that state regulation is an evil, that the 'free market' will police itself in a way ultimately benign to society as a whole and that Gordon Gecko's 'Greed is good' is by implication a worthy aspiration for everybody. That has created a moral vacuum which desperately needs to be filled. We need to get back to the idea that honesty is not merely a moral virtue but a necessity for a stable and prosperous society. Enforcing the law more assiduously and creating new laws where necessary, is one way to achieve that. Another is for politicians to stop their uncritical acceptance of so-called free markets (in reality, state controlled markets through anti-monopoly laws and privileges such as patents and limited liability) and start advocating a more pragmatic and broader approach to economic policy based on what actually happens rather than what an ideology tells them will happen.

Robert Henderson is a retired civil servant. His account of being harassed and smeared by the British state for the 'offence' of writing letters to Tony and Cherie Blair was in Lobster *45*.