

THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND



The ICAS Annual Aileen Beattie Memorial Lecture

Towards an even Better Profession

– John Griffith-Jones

1 April 2008

*held by kind permission of the Secretary of State
for Scotland at The Scotland Office,
Dover House, Whitehall*

*sponsored by The Scottish Accountancy Trust
for Education and Research (SATER)
Registered Scottish Charity SC034836*

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The Scottish
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Aileen Beattie BCom CA

The Institute of Chartered Accountants of Scotland has established this annual lecture in memory of Aileen Beattie BCom CA (1957 – 2005). Aileen was Technical Director and then Executive Director, Technical Policy at the Institute over a period of almost twenty years. After a long battle with cancer, borne with characteristic bravery and good humour, Aileen died on 6 October 2005.

Over her time at ICAS, she co-ordinated and contributed to a number of major projects and publications, including the landmark publications *Making Corporate Reports Valuable and Auditing into the Twenty-First Century*, and the International Capital Markets Group publication *Who Holds The Reins?*, an international comparison of corporate governance. She was also heavily involved in the 2004 publication *Taking Ethics to Heart* and organised the IFAC 2000 conference in Edinburgh. Latterly, she initiated and co-ordinated the 2005 Principles not Rules project and, despite her illness, guided the Working Group with her customary enthusiasm and thoroughness.

Aileen was respected and liked by every person who was fortunate enough to know her. A tremendous professional – technically accomplished, underlined by steadfast ethics and integrity. She combined a strong sense of fairness with a wonderful light touch in her personal dealings.

The Annual Memorial Lecture is intended as a tribute to her qualities: to provide thought leadership and promote discussion of the major issues of the day, with integrity and in the public interest.

Welcome

Isobel Sharp, ICAS President 2007 – 2008

Good afternoon, ladies and gentlemen, and welcome to the 2008 ICAS Aileen Beattie Memorial Lecture.

Thank you to all at The Scotland Office for welcoming us here once again. Thanks are also due to The Scottish Accountancy Trust for Education and Research (SATER) for its support of this lecture, a feature which I feel is very appropriate as Aileen Beattie, to whom we pay tribute in this lecture, was of course partly responsible for the establishment of SATER.

For the few of you who did not know Aileen, and I suspect it is only a few, let me give you a brief background. Aileen was a personal friend. We met on her first full day of work as a CA student in 1978. She was assigned to the audit team that I was leading and so I explained the basics of auditing to her on that day, namely where the coffee machine, the photocopying room and the “food” machine were. Aileen subsequently claimed that on that first day I taught her one of the most valuable lessons she learnt in auditing – wear comfortable shoes.

Women were relatively scarce in accounting in those days (and looking round the room not much has changed) and we quickly became friends. Indeed, we used to play squash together for a number of years at Meadowbank in Edinburgh. Aileen was a superb tennis player and therefore not very good at squash. In fact, we never learnt the rules of squash. We played to a simple principle – try to hit the ball very hard. Clearly this evidenced our belief in principles, not rules.

I joined the Institute in late 1984 and Aileen started on 29 April 1985 (I still have my diary). Aileen took over as Director in 1989 and remained at ICAS until her untimely death in October 2005. Throughout that twenty year period, Aileen was simply at the heart of major accounting developments, such as the start of

audit regulation in the 1989 Companies Act; the establishment of the FRC in 1990, with its ASB and FRRP; the corporate governance movement in the early 1990s; and so on.

Over the years, we both have attended, with pride and recall of happy memories, the alumni events of our old firm, KPMG. So, it is a great pleasure that the senior partner of KPMG, John Griffith-Jones, has kindly agreed to give this lecture tonight.

John is of course a KPMG lifer. Schooled at Eton, followed by Trinity Hall, Cambridge, John joined KPMG in 1975, becoming a Corporate Finance Partner in the 1980s, and then Chief Executive in 2002. He is now Joint Chairman of KPMG Europe LLP following the merger of the German and UK firms on 1 October 2007.

For the historians among you, you will remember that speeches and articles from the senior partners of the major accounting firms used to be routine. Only a few years ago, I remember, in one of many office moves, having to archive leather bound volumes of senior partners' articles from 1945 to 1979.

John, I hope you are starting a trend again today and may I invite you to deliver your lecture, "Towards an even better profession".

Towards an even better profession

John Griffith-Jones, co-chairman of KPMG Europe LLP

It is a great honour to be asked by The Institute of Chartered Accountants of Scotland to give this, the second Aileen Beattie memorial lecture.

I do so fully aware that I am in prestigious company – Scotland produces a very high proportion of leaders in so many parts of UK society, from politics to business, the arts and the public sector. It is also home to many great accountants. Indeed, lurking beneath the anodyne title of my own firm KPMG, lie various great tartan dynasties, McLintock, Thompson, Marwick to name but a few.

In recent years some of the most innovative thinking in our profession has come from Scotland and Scottish accountants – not least the pioneering work done by Sir David Tweedie in leading the International Financial Reporting Standards project, to which – you will not be surprised to hear – I will refer some more this afternoon.

So, it is with more than a little trepidation that a “Welsh” Englishman steps on to this platform and prepares to give his opinions.

I know how fond you are of sending people like me home “to think again”.

I want to use my time to examine the challenges our profession will face in the next 10 years – and, specifically, to ask what the relationship between the auditor and society needs to become if our profession is to create for itself an even better and therefore more sustainable future?

A profession with good cause to be proud

Let me start by saying our profession in the UK has good cause to be proud of its recent achievements.

Look at the evidence. The UK accountancy profession is responsible for some £1 billion of exports a year, accounts for 1% of UK GDP and around 1% of UK employment.

Just under a quarter of FTSE-100 CEOs are accountants by training as are four out of five of the Finance Directors. More importantly, in the “Bean Counter or Business Leader” Survey carried out by ICAS, 76% of both the general public and investors felt that FDs should be qualified accountants.

And through our graduate trainee programmes, we – collectively – are doing more than our fair share of succession planning, by educating, training and developing the next generation of the UK’s business leaders.

So we are making a significant economic contribution.

And our professional record is in good shape too.

Year in, year out the UK firms audit some of the world’s greatest companies as well as its own national and middle market. It is to the UK professions’ credit that there has not been a FTSE-100 audit failure here for over 10 years. I say this, of course, touching a lot of wood and more than aware of the fact that it is the outgoing rather than the incoming tide that exposes the wrecks.

And right now, we are, of course, in very uncertain times. The credit crunch has severely tested the financial services sector and may well test the economy at large. Everyone – governments, regulators, auditors and management – has been under immense pressure. Mistakes have been made. Certainly I would hope, this time around as the dust settles that the audit profession will have been seen to have played a responsible role. So before anybody asks the question “Where were the auditors?”; the answer in the UK is unambiguously “hard at work to the best of their ability”.

Even if there were to be an incident in the next few months, unfortunate as that would surely be, the UK audit profession would still have good reason to be proud of its ethical record and its achievements.

How do we measure up to other parts of society? It depends, of course, who

you choose to compare us with. Perhaps, I could mention the accounts of the European Commission, which, last November, the European Court of Auditors refused to sign off for the 13th year in succession. Perhaps not!

Let's just stick with our own record. I think it's important to be up front about our achievements.

We have a strong profession in the UK.

Having said that, we cannot afford to rest on our laurels.

In my own firm we talk about "continually striving to be better". It may sound a little glib as a phrase – but it makes a point which is very important to us at KPMG and to the profession at large.

We work with a clear understanding that the respect we enjoy as a firm must continually be earned – it is not a lifetime achievement award. As British Airways know, the public isn't much interested in a 99% safety record.

The same applies to the profession, at large.

We work in a world where you are actually only as good as your next assignment, not the last one. We must recognise we are on a high plateau, but definitely not a summit. I, and I suggest the world at large, today believe that the audit is a valuable part of the regulatory framework of the capital markets. Valuable in the sense that things would not work so well without it. I also believe that at some point over the next ten years the question will be asked "Do we really still need audits in their current form?" Rather than wait for that moment when we have to defend our *raison d'être* – potentially from a point of weakness – I suggest we should try to improve further our contribution from our current position of strength.

As I look forward, I see many opportunities, ranging from carbon measurement and auditing to providing clients with even better insights about how to run their own businesses. Based on our profession's track record I see little danger of us not taking advantage of these. But I also foresee some challenges of a tougher nature that we will need to tackle together. These arise in the areas of

standard convergence, the changing shape of the economic world and the raised expectations by society of what an audit should be able to achieve. In these three areas we need to be planning now for the next 10 years rather than congratulating ourselves on how far we have come in the last 10.

One world – one set of standards

Let's start with converging standards. I've already paid tribute to David Tweedie. Thanks to him and his colleagues at the International Accounting Standards Board, we are well on the way to achieving, through IFRS, a consistent set of accounting standards which make sense for companies and investors working in today's global economy. Likewise we are making good progress with international auditing standards, which whilst less glamorous are every bit as important.

Not surprisingly, getting to the point where the large majority of countries in the world work to the same sets of standards has dominated the debate in recent years. As you are all well aware, this has been at times a pretty bumpy journey.

And it is not over yet. It will still take some more time before we fully synchronise the two dominant sets of accounting standards – IFRS and US GAAP. We may not yet achieve it, but the signs are increasingly good that we will.

But this is only Step 1.

In future we face an even greater challenge – achieving a consistency in the interpretation of these standards.

Ask yourselves – what is going to happen when something goes wrong with an audit or set of accounts prepared to “global” standards?

It will be national bodies – like the UK's FRRP, the SEC in the US and equivalent bodies in all other countries – who will interpret the rules and pass judgement

on the incidents. Already we are seeing some “interesting” interpretations, for example Soc Gen’s treatment of its rogue trader losses in its recent results. I will place a significant bet that one or more of the countries that operate a somewhat less capitalist system than ourselves may have something to say about the specific application in their countries of certain auditing or accounting standards as we move forward.

For example, given that China now is home to seven of the largest 20 listed companies in the world, it is only right that they have a powerful seat at the table. And given the credit crunch served up by the proponents of the Anglo Saxon way, it is no longer a foregone conclusion as to who will have the greater moral authority when it comes to future changes.

There could in theory be as many opinions as there are national bodies. And the danger is that the technocrats will be tempted to and try to drive out deviation by introducing more and more prescriptive rules, rather than having the courage to rely on a principles-based approach.

When that happens you are immediately into the tricky territory where the law of unintended consequences reigns supreme – where in the name of creating one simple set of standards, you find yourself creating an impossibly complex set of supplementary rules to support it.

It’s rather like religion. We can all see it would make logical sense for the world to have just one – but nobody can agree which one that should be. We should take heed – many wars have been fought in the name of rival religions.

All experience tells us that we will need time to accept fully the new regime. The worst of all courses right now would be for individual countries to gallop to interpretations that turn out to be mutually incompatible. The key challenge – to governments and the capital markets – over the next 10 years is the creation of a respected international and independent organisation with the delegated authority to set standards *and* interpret *and* enforce them. I expect this to be every bit as challenging as agreeing the standards in the first place, but ultimately just as necessary.

Technology

If standard setting is a job for regulators and governments, dealing with the pace of global change is largely up to the firms. This is an area where we do not have the luxury of waiting for evolution to take its course.

At one level there is the technology challenge.

Ever since I joined the profession people have talked about computers replacing the human auditor. There have been some moves in that direction. Artificial intelligence, XBRL, the next generation of accounting technology – these may just be ushering in a world where hands-free, continuous forensic auditing becomes a real possibility. Already we are writing and using programmes that can test every single book entry for certain characteristics – a far cry from random sample tables.

One only has to think how quickly key pieces of new technology have changed the operating environment in other sectors of the economy. Look at what the iPod has done to the music industry! Look what the iPlayer and other similar view-when-you-want systems are doing to television viewing habits and the traditional advertising business models of the broadcasters!

But technology does not always deliver on its promises. And in the short term, by far the largest component of an audit is still associated with human endeavour.

It's here that I foresee a potentially more difficult issue.

Even with technology already in use today, the world is becoming boundaryless – the phrase made famous in Thomas L Friedman's book, *The World Is Flat*.

In the UK we are (subject to the vagaries of the value of Sterling) the most expensive accountants in the world; which is good for us in the short term but leaves us very exposed to competitive threats. The iron laws of economics will challenge the cost differential. We should expect that challenge to come from the emerging countries – typically India – and to see much more outsourcing and off-shoring of audit work.

It may not be the whole audit that goes off-shore, but large and significant chunks of audit work may well be transferred to lower cost, but by no means lower quality professionals overseas.

This has tremendous implications for the shape of our profession in the UK. As structured at present, the staff pyramid of the Big firms provides the country's "Accounting Business School" alongside ICAS and the other professional bodies. Strip away the need for the lower end of the pyramid – and you strip away the supply source of the future.

Can I put a timescale on this?

In practice this issue is already in my in-tray. The pressure is only going to grow.

A modern view of the audit

It's a truism to say we live in complex times. The synchronisation of standards and the march of technology are just two reasons why life has become more complex for our profession.

But complex times often call for a redefinition of priorities and a simple restatement of purpose.

In my view it is time we did just that with the audit.

Audit is the staple produce of our profession. But more than that it is what our reputation for integrity, efficiency and competence rests most solidly upon.

I said earlier that the audit is regarded today as an essential, and therefore valuable part of our capital markets regulatory framework. But we must accept that a financial audit is a means to an end and not an end in itself. The end is a set of accurate and year on year consistent accounts prepared in accordance with a defined accounting convention – now IFRS. If the market or society at large can be satisfied that it can get the end without the means, the need for an audit evaporates.

If society believes that the means is not helping to achieve the end, the value of the audit evaporates. Either way we are in trouble!

The basic theory behind the audit is that an independent, robust and skilled professional testing and review of the company's activities and accounts, carried out with a dose of healthy scepticism will:

- spur the company to do an honest, thorough and responsible job in the first place – on the basis that someone is coming along behind them to check them out.
- reduce the chances that deliberate errors – fraud, or accidental errors – mistakes get into the final accounts because they have to pass through the audit sieve.

Simple really. And with audit methodology defined in audit standards and accounting treatment defined in IFRS we should be in a pretty good place.

So what is missing? Clarity on three points:

One: the process we have at the moment reduces, not eliminates errors.

Two: with existing technology perfection cannot be reached simply by the introduction of more rules or more work.

Three: there is a subjective judgement based element to the process, whose effectiveness is highly dependent on the quality of the people doing it. A “good” audit is *not* a commodity.

This lack of clarity gives rise to an expectation gap between the profession and the rest of the world which we need to close.

Much of the attempt to control or close the Expectation Gap has been reflected, almost by way of a “proxy battle” in the ever lengthening wording of the audit report. I dug out an audit report from 1968 which I can read out:

Auditors' Report

To the Members of Imperial Chemical Industries Limited.

We have examined the accounts set out on pages 26 to 33.

In our opinion the accounts comply with the Companies Acts, 1948 and 1967 and give a true and fair view of the state of affairs of the company and, so far as concerns the members, of the state of affairs and profit of the group.

I have a copy of the audit report on the same company for last year which I have no intention of reading out.

Every word and every paragraph added over the past forty years was agreed by very eminent people on very eminent committees in the sincere belief that each would add a new level of clarity to the world at large about what an audit was – and was not.

Yet we know that this has not been the case. I think we need a new approach.

If you buy a toy for your child, you look for a kitemark to “gain assurance” that it is “safe” for them to use. You do not expect to have to read a page of small print describing all the remoter possibilities of danger that the kitemark does not cover.

In my experience, not only for society at large but also for professional users of accounts such as analysts and fund managers, an audit report of whatever length is essentially a “kitemark” that says to them – these accounts are “about right”.

Corporate scandals of recent years have taught us that we miss the point in spending a lot of time debating what “about right” means. Because, in almost all the cases of major audit failure “about right” does not come into it. The accounts turn out, with hindsight, to be “spectacularly wrong”. No amount of words in the auditor’s opinion will change that fact. The means has failed to produce the end.

I fear the real *raison d'être* for those lengthy opinions is to offer the auditor some legal protection. It's not really been about providing society with a more reliable kitemark. It's as much about protecting people like me and my firm from being put out of business by a successful claim for negligence.

A new contract with society

This is not sensible. And it will, on a ten year view, as future incidents occur, threaten once more the stability of the relationship between our profession and society. Because I believe that society's confidence in our profession is paramount, I think the profession needs to try harder to move to a minimum "kitemark" standard. What is more I can see the opportunity to do so over the next five years.

Let me be clear – I am not about to argue for any reduction in the rigour with which an audit is carried out – I am not arguing for the commoditisation of an audit – and I am not proposing to take on liabilities I cannot meet.

I am making the case for acknowledgement of the reality.

And I believe the "kitemark" that the profession and society should agree to work towards could be summarised in vernacular as "these accounts are about right unless management have deliberately conspired to falsify them."

I am sure more eloquent words can be used – but not at the expense of clarity.

Society, for its part, would need to accept the standard of "about right" as value for money and that like it or not there is not, as of now, sufficiently reliable audit technology to make it possible to remove the fraud caveat.

Individual auditors and firms, for their part, would need to sign up to an increased level of responsibility for all material error elimination, absent fraud.

Why would this be better than what we have now assuming it could be achieved? Clearly the biggest immediate advantage would be the recognition

of the real *status quo* thereby removing the Expectation Gap, but there would be other very significant advantages over time.

A razor-sharp focus on *the* weak link in the chain – fraud – would be clearly established. This would encourage the profession and its regulators to prioritise their efforts to work collaboratively on technology and process in this area rather than others of lesser importance where my kitemark standard is already largely met.

Last, but by no means least, there would be a much clearer line of responsibility and therefore of blame where unfortunately things go wrong.

In our experience at KPMG, it takes roughly four weeks, maybe at most, four months for us to work out what happened when something goes wrong and why an audit did not get to the right result.

It then takes as much as seven years for the legal case and the disciplinary hearing to wind its way through various bodies in a truly Dickensian fashion. The legal and disciplinary procedures encourage – indeed require – adversarial defensiveness. The lessons – and there always are some – tend to get lost in the time elapsed and the layers of litigation rather than stand out to be acted upon quickly.

Is this the model for creating a better profession? I don't think so. I think this is a model for the past. With the lessons learned from Enron and Worldcom in the US, we have set up the AIU inspection regime in the UK. I believe that is one of the best things we have done to help move the profession forward. The AIU will never be able – it is not their job – to prevent any of us ever making an audit mistake – but they should be able to reassure society that there is no suggestion of systemic weakness in either an individual firm or the profession generally.

Armed with that reassurance, we have the opportunity to move from an adversarial to collaborative analysis of the difficult cases. The benefits of such an approach to the improvement of auditing over time would be huge. It is an opportunity there to grasp.

In the end it is about people

Throughout this talk I've tried to highlight the key issues we as a profession will need to address if we are to create a sustainable future for ourselves.

In the end the success of our profession depends on the people we employ. We are and we will always be a people business. Despite all the myriad changes our profession will experience in the next ten years or so, good audits will require good people to do them. I admire the FSA for their openness in their recent report on Northern Rock where they suggest that their own rules and processes were broadly there but not effectively applied by the people on this occasion. We need to adopt a similar attitude.

It's vital that we enthusiastically face up to the challenges I have outlined. If we don't we will find it harder and harder to attract and retain the talented people we need to maintain our record of achievement as a profession.

And if our goal is to become an "even better" profession, then we need to train people "even better" at their work.

If the people we want to attract to our profession perceive the job we do as being lacking in clear purpose or hidebound by excessively defensive rule making, they will simply look elsewhere for a place to build their careers.

Which is why I believe one of the most significant challenges we face is convincing bright, skilful young people that this is not only a profession with a great history, but one with a future of which they can be truly proud.

In the end it will be their generation's job to make sure we have an even better profession – as well as mine.

Today, it is our responsibility to provide them with the right opportunities and the right working environment to make sure that they can.

Conclusion

When I think back to the severe market downturn of 2001/2 and the state of crisis that gripped our profession in the aftermath of the Enron and WorldCom scandals, it is hard to believe the progress we have made.

These have not only been years of exceptional growth for the profession. They have also been years of clear-sighted soul-searching and positive action to restore confidence in our profession by the capital markets.

Because of the good work that has been done in recent years our profession has been able to stare the recent market turbulence, sparked by the sub prime mortgage crisis, in the face with far greater equanimity than might have been expected.

Shocks happen. They always have done and they always will. It takes courage to look beyond the immediate economic realities – however good or bad – and to plot a course to a longer-term, sustainable growth and development of the audit profession.

We must show that courage now.

Thank you for your attention.

John Griffith-Jones

John Griffith-Jones is Chairman and Senior Partner of KPMG UK.

He qualified as a chartered accountant in 1978 and worked for KPMG as an auditor until 1987 when he transferred to help set up their corporate finance practice. He ran that practice in the UK and Europe from 1998 until June 2002 when he was promoted to be KPMG's Chief Executive Officer in the UK.

In 2006, he became UK Chairman and Senior Partner and, later that year, agreed with his German counterpart to merge the UK and German KPMG firms, with a view to further European firms joining subsequently and to form an integrated KPMG Europe.

On 1 October 2007, he became Joint Chairman of KPMG Europe LLP.



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