Audit Committees for Retail Boards?

by John Gallacher

The question of appointing audit committees in public limited companies (plc's) refuses to go away even though the CBI did a hatchet job on a modest Bill brought to the Lords from the Commons where it had been introduced by a Conservative backbencher. That Bill empowered non-executive directors of a large plc to establish an audit committee with the approval of shareholders and suggested powers and obligations for such committee, including access to the auditors and a reporting duty to subsequent annual meetings of shareholders.

Audit Committees for PLC's?

In a sense the question of establishing audit committees is linked with that of whether or not to appoint non-executive directors in plc's as well as the role and function of such directors. This is, in turn, related to harmonisation of company law throughout the European Communities, leading to a single statute, which some see as essential to a policy for competition as well as helping the completion of the Internal Market of the EC. If there are non-executive directors and an audit committee, there may not be a need for the two-tier system for the control of companies as now in Holland and W. Germany. Under a two-tier regime, representatives of workers form part of the supervisory tier.

The British Government and the CBI are resolute in their opposition to any Community obligation to give a say to workers in their employing companies despite the growth of direct employee shareholding and indirect interest of workers in general through pension fund investment in plc's.

One expects the debate to continue despite ostrich-like postures by eminent giants of industry whose concern to avoid possible difficulty in their boardrooms is understandable if excessively cautious. In the end, however, they may have to settle for more than would currently satisfy workers and the European Commission. Britain has a capacity for getting itself the poorest deal possible in Europe. The CBI is an indifferent counsellor in such matters partly because, like the TUC, its financial position obliges it to pay excessive heed to certain large members whose chiefs still believe in their divine right.

Need to Assess Retail Boards

Where, if anywhere, does any or all of the above leave retail Co-operatives in

Britain? The Parliamentary Office of the Co-operative Union records in its Bulletin No. 9 that it "will be looking to see whether it can influence government thinking" on a consultative paper issued jointly by two Ministries on the principle of mandatory places for workers on boards. Unfortunately we are given no hint of the Movement's current thinking on the question.

British retail Co-operatives do not have executive directors. It follows that their boards must comprise non-executive directors only. Some of these may be employees although not elected as such. It is difficult to categorize a board of directors of a retail Co-operative. They are answerable to consumer members as shareholders for their conduct and results of the business as well as having collective responsibility for policies followed by the board. In what ways should the effectiveness of their stewardship be asessed?

Measuring Performance

If Co-operatives were public companies the price/earnings ratio of each society's shares would provide a rough guide to commercial success. Discontented shareholders could sell their holdings if they wished. The ratio of borrowing to equity would also provide a mirror as to how success, if any, was being achieved. Return on capital would enable shareholders to determine the course of their investment over the years or give the green light to predators willing to bid for control.

It is now fashionable to express company profits as a ratio of turnover. This is meaningful for businesses in the same class of trade, e.g. multiple food shops, as it provides a common yardstick. It says much less about different types of enterprise with greatly differing frequencies of stock turnover.

In the Past -

In bygone days retail Co-operatives compared rates of dividend on purchases with those of neighbouring societies or others of similar size. Returns on capital were not much computed. Share values then, as now, were constant and were only queried, if at all, on mergers between societies when sometimes opponents of merger would ask about the break-up value of shares. Reserve fund increases, like expansions of turnover, were part of valedictory speeches when a venerable chief official took leave of his charge. Beyond this little was assessed.

- And the Present

Nowadays a retail Co-operative returns little to members on their purchases. Reserve additions are as much compounded of profits on the disposal of depreciated assets as allocations of trading surpluses. The reward to share capital is modest by comparison with market rates. Borrowing is discreetly treated in the accounts and in notes thereto. Forecasting is minimal beyond the obligation to say something about future capital expenditure. Much reliance is placed on the true and fair view certificate of the auditor. No doubt directors would say that where solvency is not in question - reflected by growing reserves against declining shareholdings - more was not required of the board vis-á vis the members. Recent events have shown this to be a simplistic view.

Co-operative Union statisticians now postulate a target result for retail societies of 2.5 per cent net profit on turnover. It is not clear why this figure has been chosen or what it is supposed to represent beyond an attainable target based on that currently achieved. What does it mean in relation to capital employed (computed on historic or current cost) or results by comparable competitors? Does it allow for variations in patterns of a society's trade affecting low and high net surplus departments? Would it sustain more attractive rates of interest on share capital or is it high enough to self-finance development on a scale likely to win back market share? Is it intended to reward member loyalty and, if so, how?

A Role for Audit Committees

The postulation of questions in the preceding paragraph begins to indicate the scope for audit committees. Fifteen retail societies each with an annual turnover exceeding £100 millions now account for 75 per cent of our total trade. These are sizeable businesses, although the Bill to allow the establishment of audit committees in plc's had a turnover qualification of £200 millions annually and the employment of over 2,000 workers in any week. These figures obtain in six Co-operative retailers: including CRS and CWS.

It may be argued that audit committees in regional or national retail societies would duplicate the work of each society's auditor. Legal audits and performance assessments are grey areas in the world of accountancy. When retail societies were numerous and therefore smaller, auditors often acted like family doctors, guiding officials and boards of directors along prudential paths designed to keep societies healthy. Audit fees were modest so the financial risk of losing the appointment of auditor was bearable. Indeed in England and Wales an audit service was provided on a cost only basis by an independent department run by the CWS. In other lands auditing was sometimes the function of a non-trading Co-operative Union.

In to-day's climate the situation differs. Auditors are not necessarily in contact with boards of directors, let alone member-shareholders. If they assess performance, as distinct from legal requirements under the Industrial and Provident Societies Acts, the results of such assessments are little publicised. The Co-operative Union performs a service in looking at the figures of member societies based on returns made to the Union as well as published accounts. Useful as such reports are, their circulation is not wider than boards of directors and where assessments are critical these are more likely to be used for the promotion of mergers than for stimulating improvement in managerial performance.

It is interesting to peruse the occasional balance sheet which comes one's way nowadays. Regional societies give no more information than their lesser brethren. The form of accounts, with footnotes galore, seems as much designed to obscure as reveal. I doubt if many shareholders ask questions on the accounts at sparsely attended annual meetings. The need for a body to represent the shareholders in such circumstances must be apparent to all but the most sanguine. An audit committee seems the logical body. I leave its mode of appointment to others, but direct access to the auditor is essential.

Factors for Examination

Some of the factors which an audit committee might examine, apart from immediate operational results, are procurement policy, asset sales and use of profits arising and analysis of existing fixed assets, distinguishing between freeholds and leaseholds, including length of leases and rent reviews. Future capital expenditure, its financing and projected returns, needs querying. Current market share based on population served with a breakdown by areas to show where food and non-food sales are below the society's own and national averages could be reviewed. Anticipated trends of share and loan capital with the ratio of borrowing to shares, present and future, as well as the liquidity ratio now and projected would be a proper area for attention. Details of external pension fund investment to reveal how much, if any, of the fund is being invested by the trustees with companies in competition with the society and the CWS could be considered. The state of employee relations in the society as well as training and promotion policies might also be examined.

No doubt there are those who will see an audit committee empowered to examine matters listed above as intruding on the function of the board of directors. I do not share this view. If retail societies are regional and large they need closer scrutiny than is current. There are precedents for organs of the kind I am suggesting in retail Co-operatives in Western Europe. These reflect the tradition of indirect democracy which obtains generally in such countries.

A Form of Democracy

Britain prides itself on the decisiveness of direct control in most of its