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Auditors and the Supervision of Retail Finance:
Evidence from Two Small-Sized Building Societies, 1976-1978

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Abstract
This study adds to the accounting history literature by looking at features common to major defalcations in two small-sized building societies (namely the Wakefield and the Grays). These features were the dominance of an individual over a building society’s systems, and poor systems of internal control and supervision. Because they failed to recognise the significance of these factors sufficiently, auditors of both societies were criticised for failing to discharge their duties as expected under the Building Societies Act 1960 (BSA60) (which had introduced a new auditing regime by requiring the auditors to examine whether the directors of a society complied with its requirement to establish and maintain a system of internal control and, if not, to report thereon). The cases of the Wakefield and the Grays were a turning point in the supervision of retail financial intermediaries. Prior to them the Chief Registrar of Friendly Societies (CRFS) had adopted a reactive approach to supervision, which effectively delegated the monitoring of the societies to external auditors. After the defalcations were uncovered, they showed there was a lack of productive communication between the Registry and external auditors. As a result, it was felt there was a need to reform and adopt a proactive approach to supervision of the societies under which the CRFS was to directly examine the quality of the auditor’s work. The professional accountants, as represented by the Institute of Chartered Accountants of England and Wales, initially resisted such reform. But ultimately, accountants could not help but to accept it.

Keywords: corporate governance (the system of internal control); BSA60; the Chief Registrar of Friendly Societies (CRFS); the Treasury; building societies; supervision of retail financial intermediaries; delegated monitoring; UK

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Introduction
The aftermath of the recent financial crisis included a strong perception that the corporate governance of financial intermediaries needs reinforcement to give more say to shareholders, capital markets, regulators and clients. An element of these calls is a revision of the links between financial intermediaries and their auditors (e.g. Prechel and Zheng, 2011; Guénin-Paracini et al., 2011). In this regard, the recommendations of the House of Lords were successful in having the Office of Fair Trading announcing a formal investigation in May 2011, looking at whether there was a ‘dereliction of duty’ by auditors of banks during the crisis (The Economist, Britain’s Auditing Oligopoly).

Corporate governance involves greater accountability as well as appropriate control and transparency. There is substantial empirical evidence and a vast conceptual foundation to support the view that financial intermediaries play a key role in enhancing the transparency of companies’ business operations. Many of these conceptual arguments are based on the seminal contributions by Benson and Smith (1976), Diamond (1984) and Berger and Udell (1998 and 2006). Specifically, the concept of delegated monitoring is well established within these frameworks. It was originally introduced by Diamond (1984), who proposes that using an intermediary (such as a bank) is more cost effective than lenders directly overseeing the selection and performance of borrowers. In other words, in this framework financial intermediaries chiefly exist to solve informational asymmetries between borrowers and lenders. Cost advantages emerge from both of scale economies and economies of scope that the intermediary can achieve through diversification and scale of operation (for a detail review see Swank, 1996; as applied to mutual deposit accepting financial institutions see further Hollis and Sweetman, 2007; Wadhani, forthcoming).

The intermediaries themselves, however, are open to moral hazard problems. Hence they need to be regulated and their operations supervised by state authorities through, for example, the introduction of statutory minimum capital requirements and/or deposit insurance schemes (e.g. Diamond and Dybvig, 1983; Townsen, 1979). It is beyond the scope of this study to provide a full and detailed review to broad literatures of the economics of information, corporate governance and regulation of financial intermediaries (see further Koppell, 2011; Vives, 2010). Instead, it is our purpose to bring history back to the concepts using as evidence historical case studies where the
role of external auditors is to support the state in the supervision of retail financial intermediaries. In this view, the examination by auditors of the system of internal control and of internal accounting information is another form of delegated monitoring.

Auditors become agents of the state in supervising financial institutions in the process of examining annual accounts because the state relies on the auditors to overcome, firstly, a lack of scale necessary for observation. Directly screening a large numbers of financial intermediaries is costly as it requires vast amount of staff, resources and procedures. Second and more important, the state relies on auditors' skills and professional knowledge to overcome information asymmetries and idiosyncrasies associated with the assessment of individual systems of control and the generation of financial information. The state reduces its cost of monitoring by introducing auditors as its agent. Auditors are then commissioned to examine not only the adequateness of financial reporting but also the suitability of systems of internal control and to report thereon. This allows the state to limits its function of supervision to focus on adverse behaviour when the operation of an individual financial institution departs from appropriate norms (or those established through comprehensively collected financial data from the entire industry).

This approach to supervision suggests a multi tiered agency structure (see further Laffont and Tirole, 1991), In the first tier, financial intermediaries are agents of retail depositors and investors. But the potential of moral hazard introduces a second tier. In it, the investing public, through Parliament and subsequently the Treasury, is the principal. Here the agent is the supervisory body of building societies, namely the Registry of Friendly Societies (RFS). In a third tier, the supervisory body becomes the principal while external auditors and the regulated firms become the agents. More succinctly, a multi tired agency structure to supervision purports the notion that shortcomings in the institutional context open opportunities for corporate malfeasance. This idea has found some empirical support in both mutual and public traded companies (e.g. Gabbioneta et al., 2011; Guinnane, 2002 and 2003; Slovin et al., 1990).

In this study the idea of external auditors as delegated monitors is explored through an examination of two historical cases of defalcation that occurred at building societies, namely misappropriations at the Wakefield and the Grays. As noted above, our aim is not providing an explanatory hypothesis to a problem. Rather we aim to show how and why this practice emerged in a particular context and explain its outcome in light of conceptual tools.

Misappropriation of funds at building societies could range from relatively small
transactions that were dealt internally or with the local police; to large deceptions, which resulted in the end of the society as a going concern. Between 1976 and 1978, fraudulent activities were found in at least four societies, of which two were considered minor or ‘ordinary’ cases of defalcation where amounts in question were rather insignificant and dealt internally (Provincial in 1976 and Chorley Permanent Benefit in 1978).\(^1\) The monies defalcated at the other two cases impaired the continuity of the societies as free standing organisations, required action by the RFS and resulted in the amalgamation of the troubled societies with larger more liquid societies (namely Wakefield with the Halifax in 1976 and Grays with the Woolwich in 1978).

The societies in trouble were a tiny fraction of the 343 societies in existence in 1977 (with a sum of total assets equal to £2,407,956,000).\(^2\) This suggests that, on balance, directors and external auditors were good monitors of managers and staff.\(^3\) Indeed, the stories documented in our study were the first and only cases of major misappropriation in the building societies sector during the twenty years that followed the passing of the Building Societies Act 1960 (BSA60).\(^4\) The cases of the Wakefield and the Grays are thus interesting events in themselves for an industry where fraud and the manipulation of financial statements were rare occurrences, though the influence of such events was extensive when in fact happened (see further Bátiz-Lazo, 2006; Bátiz-Lazo and Billings, forthcoming; Davison and Stuart-Smith, 1979: 75).

The discovery of fraud in the Wakefield and the Grays societies took place within a relatively short space of time of each other and misappropriations became evident only after the appointment of new auditors replaced others who had been in office for decades.\(^5\) The root of the material accounting misstatements in both cases was a

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\(^1\) A senior manager of the Cheltenham branch misappropriated £72,000 in the course of five years of a society with assets exceeding £1,300m and reserves of £30m. The event grabbed the attention of the media, the CRFS and the Treasury as it took place close after the events surrounding the Wakefield (T386/308, ‘Provincial Building Society’, 6 September 1976). The case of the Chorley (which dropped the ‘Permanent Benefit’ in 1943) received little attention, perhaps as it was quite small (with total assets of £1 million) or perhaps because the Registrar was successful in keeping it outside the public domain. With notable resemblance to the case of the Grays, the Chorley’s Secretary and Chief Executive died of natural causes. He was the only full time employee of the society and had been in office for very many years. It was then discovered that he committed a number of accounting irregularities (particularly around

\(^2\) Of the 343 societies (including four in Northern Ireland), 209 (three in Northern Ireland) had less than 5,000 shareholders and depositors in 1977 (T386/308, ‘Background Note’, circa 25 May 1978).

\(^3\) Anecdotal evidence would suggest that malfeasance at building societies was lower to that observed in other not for profit financial institutions during the second half of the 19\(^{th}\) century when there were numerous cases of defalcations and embezzlement in other intermediaries working in UK finance (see further McLaughlin, 2011).

\(^4\) Reference to BSA60 is often substituted for the reference to the Building Societies Act 1962 (BSA62) because BSA60 experienced minor revisions and was reintroduced in 1962 as BSA62.

\(^5\) Surprisingly, the risks of auditors staying office for long periods of time are still downplayed by large public quoted companies even at present. Evidence to this effect emerges from the Financial Reporting
dominant senior manager who took advantage of poor systems of internal control and weak supervision (see further Lee et al., 2008; Vinten and Greening, 2001). External auditors were criticised for failing to use their influence far more effectively to set up more robust internal control systems and also prevent individuals overriding these controls (Davison and Stuart-Smith, 1979; Vinten and Greening, 2001). The cases of the Wakefield and the Grays were of special concern to the state authorities, namely the RFS and the Treasury, because they highlighted important limitations to the powers recognised to the RFS in BSA60, particularly the lack of resources and skills available to the RFS to implement its duties, as well as the issue of how to make necessary arrangements in which building society auditors acted as their agents. All these are themes that echo issues in contemporary banking and financial industries, from the abuses at savings and loans in the USA (e.g. Black, 2005; Mason, 2004) to the demise of Northern Rock in the UK (e.g. Congdon et al., 2009; Shin, 2009).

This study is based on the examination of surviving records, including minutes, correspondence and other historical records of individual building societies, the Treasury, the Chief Registrar of Friendly Societies (CRFS), the Building Societies Association (hereafter ‘the Association’) and the Institute of Chartered Accountants of England and Wales (ICAEW), which allows us to use the history of fraud at the Wakefield and the Grays to inform the current debate on the regulation of retail financial institutions by enriching our understanding of the financial auditing and the systems of internal control of building societies. Other useful source materials were found in the Building Societies Gazette, The Times and the Financial Times. To assess the validity and reliability of the source materials, a heuristic method of qualitative research, i.e., data triangulation (the use of a variety of data sources for studying the same phenomenon) is adopted to minimise the bias introduced by a single source.

The remainder of the article proceeds as follows: the next section contextualises this study. Greater detail on the idea of delegated monitoring intertwines with a brief history of building societies. This story includes a review of the background of the establishment of BSA60 and the introduction of legal requirements by which external auditors reported on and directors established systems of internal control. The subsequent two sections examine the shortcomings in the systems of internal control

Council, Britain’s accounting watchdog, which reported that as late as 2010 the fidelity of British firms to their auditors was 48 years on average while the ‘Big Four’ accounting firms serviced 99 of the 100 largest firms (as measured by market capitalization) (The Economist, Britain’s Auditing Oligopoly). The four firms were: PwC, Deloitte, KPMG and Ernst & Young. The ratio of fidelity remained the same in a larger sample as 240 of the FTSE250 companies were serviced by these four accounting firms (The Economist, Britain’s Auditing Oligopoly).
that lead to defalcations at the Wakefield and the Grays building societies. These sections also consider the repercussions that these two cases had on the regulation of building societies and their auditors. The final section offers concluding remarks.

**Delegated Monitoring in the Building Societies Sector**

As noted above, the framework of financial intermediation based on Diamond (1984) considers that the intermediary exists because it is more efficient for depositors (the principal) to lend their money to an intermediary (the agent) who can invest it and monitor its use on their behalf. This implies there are at least two information and incentive problems. One, as already noted, is the reason for the monitor’s existence. The second relates to the monitor (in this case, the manager of the financial intermediary) to have more and better information on investment projects than do their principals (i.e. the depositors). This second issue has lead to a distinctive literature asking why the monitors are thought to act opportunistically. One approach argues that the introduction of certain mechanism aligns incentives (e.g. Lamoreaux, 1996). Other proposes that depositors should be protected in the case of failure (e.g. Calomaris and Kahn, 1991).

British building societies faced both of the problems at the heart of the framework proposed by Diamond (1984) and also, a more general problem that has in some ways disappeared from the literature (Guinnane, 2002). First, consider that building societies are mutual financial organisations owned by long-term depositors and mortgage borrowers while specialising in liquidity creation by turning retail deposits into mortgage loans. Regulation eventually forebode them from issuing debentures while any residual income was distributed in the form of higher interest (than that paid by alternative investments) to long term depositors (called ‘shareholders’) and, allegedly, lower interest to mortgagors than the market clearing rate.

The first society was formed in Birmingham in 1774, and they soon began to spread out across the Midlands and the North of England in the second half of the 18th century, as essentially investment clubs, to enable working and lower-middle class people to purchase or build their own homes. By 1825 there were at least 69 societies (Jeremy, 1998: 299). Their growth accelerated from the mid-19th century, following their transition from ‘terminating societies’ (that were disbanded after their original members had all made house purchases, the last of which was wound up in 1980) to permanent societies. By 1895 the number had grown to 3,642 (Jeremy, 1998: 299), but soon started
to decline and this trend continued throughout the 20th century. By 2011, only just 48 remained.\(^6\)

In spite of the reduction in number, the size of their assets and number of retail branches grew substantially. This was particularly the case during the interwar period (see further Humphries, 1987; Scott, 2008; Scott and Newton, forthcoming). The share of building society advances grew from 27 percent of total mortgage transactions in 1920, to 38 percent in 1936, and to 50 percent in 1958 (Cleary, 1965: 282). But the growth within the individual business portfolio was unevenly distributed. For instance, by 1958 there were 755 societies with a sum of total assets of £2,407,956,000.\(^7\) The top five societies (0.66 percent of the total number of societies) held £1,029,108,000 in assets altogether, or 43 percent of the overall total for all societies.\(^8\) Although most building societies remained small, provincial and deeply embedded in their local community during the 20th century, some became large and national, as represented by the formation of the Halifax in 1937, Abbey National and the Woolwich in 1948 and the Co-operative Permanent Building Society in 1952 (Davies, 1981: 87-8).

As was the case for many other not-for-profit retail financial intermediaries (such as savings banks and co-operatives), building societies faced the problem that their managers or directors made mistakes that do not happen in the Diamond’s framework (Guinnane, 2002). In the Diamond framework the manager/director knows what he/she is doing. It is assumed to have appropriate skills and technical expertise, that is, Diamond assumes agents are competent (as opposed to fully informed). This was not always the case for not-for-profit retail financial intermediaries. Board members of British savings banks, for instance, were persons of repute in the local community who seldom had any banking or financial background. The problem posed by Diamond can then be re-read as one of confidence (‘as a depositor, how do I know the manager will not abuse my interests?’, Guinnane, 2002:75) where confidence is as much an issue of trusting them not to misbehave deliberately as much as how good is the expertise and skill set.

As noted above, building societies were very simple financial intermediaries. Cash came in the form of retail deposits and was distributed in the form of long-term loans and payments to long-term individual investors (i.e. ‘shareholders’). When a building society had excess cash it would stop taking investments and/or deposits. When there


\(^7\) Building Societies Association Circular 664, page 4, table II.

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was insufficient, then it would try to attract more investors. If that failed to cover withdrawal requirements, then it would most likely transfer engagements rather than dissolve. Indeed in order to safeguard depositors and assure the stability of the sector, societies in distressed were typically required to amalgamate with other financially sound societies either at the initiative of the larger societies, the CRFS or the Association. The management of the societies was thus inherently risk averse and conservative. Success was measured by growth in total assets rather than profitability or operational efficiency.

Systems of internal control for the management of building societies had to satisfy at least three problems (Guinnane, 2001),

a) Fraud – In any organization dealing with cash there will be opportunities for unauthorised withdrawals or falsifying records.

b) Record keeping – Accounting for all inflows and outflows of funds as well as ensuring all legal documents recording outstanding loans were in order. The societies also had to maintain minutes of meetings of directors, lists of staff, members and other information required by relevant regulation.

c) Mistakes – A final and important class of problems arose from decisions that were not conscious attempts to take advantage of the society, circumvent established systems or procedures or falsify record keeping. Honest mistakes do happen. But they can result from poor management or director’s imperfect grasp of the problems their organisation can and might face.

Failure of the system of internal control resulted in notorious episodes of fraud and scandal. Indeed, important regulatory innovations (including those dealing with financial disclosure) were introduced following the demise of a building society (Drake, 1989: 90). For instance, the 1894 Act followed the collapse of the Liberator Building Society in 1892, whereas the 1939 Act emerged from the publicity given to the ‘Borders case’. There was thus a long held view that the building society ‘industry’ was largely managed reactively rather than pro-actively.

There were, of course, disclosure requirements for building societies aiming to prevent the occurrence of such frauds and scandals. The origin of these regulations date back to the Building Societies Act 1874, which required individual societies to specify the appointment of auditors and to make audited financial statements available to members.

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9 Note there is no systematic and detailed record of the ‘population ecology’ of building societies.
The Building Society Act 1894 further required professional audits by demanding that ‘one at least of the auditors of the society shall be a person who publicly carries on the business of an accountant’ (Edwards et al. 1999: 193). There were some amendments in subsequent legislation (for example in the Building Societies Act 1940), but the 1894 Act remained the main statute regulating disclosure until changes were introduced through BSA60 (see also Drury 1994; Perks 1977; Phillips 1983).

In other words, before the passing of BSA60 accounting and auditing requirements for building societies remained under the influence of nineteenth-century legislation. This effectively meant that the auditors, rather than the directors, were required to certify that they ‘actually inspected the mortgage deeds and other securities belonging to the society’ and to state ‘the number of properties with respect to which deeds have been produced and actually inspected’ for the purpose of safeguarding the societies’ financial assets. Physical inspection of each and every certificate of financial assets might be a possible approach to the audit of financial intermediaries when the original 1874 Act was enacted at the end of the nineteenth century, but it was quite doubtful whether a detailed review of all certificates was actually put into practice in every case.

In June 1959, another building society, the State, collapsed as a result of its directors making mortgage advances, without proper security, for bridging finance in take-over bids to a company in which the same directors also held board positions. This episode became known as the ‘Jasper affair’ and led to the expansion of the societies’ disclosure requirements in BSA60. The need for a response following the demise of the State Building Society reached the top echelons of British government, as revealed in the following report in The Times (28 September 1959: 14):

> The Prime Minister has confirmed the appointment of a committee to review the Companies Act and the Chancellor of the Exchequer has said that good progress has been made in preparing new building society legislation. The Jasper affair has certainly underlined the importance of both moves.

The demise of the State Building Society became an opportunity to bring building societies legislation ‘up-to-date’ while adopting similar lines to improvements made in company law (see further Noguchi and Bátiz-lazo, 2010). Innovations stressed the

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12 Representing the views of building societies, R. Cowling, Director and Deputy General Manager of Leeds Permanent Society, a member of the Association’s Council, and Chairman of the Yorkshire County Association of Building Societies, stated that ‘[t]he draftsmen of the Bill, no doubt receiving their brief from Government’s advisors, seem to have been determined that as far as possible the provisions of the Companies Acts should apply to building societies’’. He added that ‘It was not easy to convince the negotiations, or Parliament, that the operations of a building society were in many respects far removed
need for ‘adequate disclosure of the use made of [individual society’s] funds and the state of its affairs’. As a result, the auditors’ report of individual societies was required to contain statement as to whether, in the auditors’ opinion, the annual accounts of the society gave the true and fair view required by the Act.

In a parallel development, the ICAEW attempted to modernise the societies’ audit procedure by emphasising that ‘[directors] should be required by statute to keep proper books of account…including the need to maintain proper records of and control over the mortgage deeds and other assets’. In particular, they regarded the original requirement in the 1894 Act for annual inspection of each and every mortgage deed by the auditors, rather than directors, as ‘totally out of accord with modern methods of auditing’ and ‘not in fact properly carried out at present’ (T233/1652). For them, ‘the correct method was for the Directors to be required to establish a proper system of control over the mortgage deeds, and for the auditors to have to examine that control to see that it was effective and to carry out sample checks’ (T233/1652, emphasis added).

The state authorities, represented by the Treasury and the RFS, were on the other hand keen to maintain the status quo and attached a greater importance to the auditors’ ‘paternalistic’ duty to safeguard the financial assets of building societies on behalf of depositors and savers. Although they, though reluctantly, conceded to the accountants’ position, it was in fact a mutual concession: in exchange for abandoning the requirement to inspect each and every mortgage deed by the auditors, the state authorities insisted that the auditors should perform the alternative duty of reporting on the nature and quality of internal control of building societies.

Auditor’s duty to examine whether the directors of a society complied with BSA60’s specific requirement to establish and maintain a system of internal control (and if not, to report thereon) was enacted through Sections 38 and 45 of BSA60 (Sections 76 and

from those of a limited liability company’ (Building Societies Gazette, December 1960: 996).

13 P&L Committee Minutes Book: I: 25.
14 P&L Committee Minutes Book: I: 27.
15 The importance of testing the effectiveness of internal control in conducting audit of accounts had been recognised in the early 20th century, as demonstrated in the preface to the first edition of Spicer and Pegler’s Audit Programmes (1908: 4). Concerning the widespread adoption after World War II of the systems-based approach in auditing, the ICAS (1954: 72) stated that “[t]here is little doubt that these demands [on manpower during World War II] resulted in some relaxation of standards of auditing work, but in so far as this merely eliminated repetitive checks and led to a greater reliance on proper sampling and to emphasis on the importance of adequate internal control, the changes may well have been beneficial.”
16 The ICAEW commented on BSA60 that: ‘Subsection (4) of Section 45 places a positive duty on the auditors to carry out such investigations as will enable them to form an opinion on certain matters which they are not required to refer to in their report unless they form an adverse opinion. The absence of any comment in their report is therefore equivalent to a positive statement by the auditors that they have
87 of BSA62). The regulation was succeeded to Sections 71 and 79 of the Building Societies Act 1986\(^{17}\) and the basic structure is maintained even at present, though amended in subsequent reforms.

Other important novelties introduced by BSA60 were Sections 6 and 7 (later sections 48 and 51 of the Building Societies Act 1962), which provided the CRFS new powers. As already documented in prior research (see Bátiz-Lazo and Noguchi, 2011a, b), the new powers granted to the RFS played an important role in supervising the societies’ operation. Specifically they gave the RFS the possibility to intervene in the operation of individual societies by limiting the marketing and/or acceptance of any new deposits as well as advancing any new mortgage loans. The cases of the Wakefield and Grays below document how these new powers were also key when the RFS moved to intervene and expose evidence of corporate malfeasance.

But before proceeding, note that a move to intervene an individual society by the RFS was based on limited information and doubts about the adequacy of internal controls. These doubts emerged as a society was seen to be having financial difficulties. In providing to the RFS the necessary information to detect irregularities, the annual accounts submitted in the form of annual return by the building societies to the RFS became indispensable tools for the supervision of the societies. In this process, the duties of the auditors of building societies to report not only on the reliability of annual accounts but also on the quality of the internal control systems comprised essential elements for the RFS to exercise its powers and discharge its duty to supervise the societies adequately.

**Wakefield Building Society**

*Unravelling the defalcation*

The Wakefield was established as a terminating society in July 1846 and transformed into a permanent society in March 1850. Events that led to its end started to unfold in January 1975, when Thomas W. (Tom) Taylor joined from the Furness as Deputy General Manager and heir apparent in light of the long service and growing age of William Robinson, the 70-year old General Manager (Taylor, 1977: 2). Robinson took office in 1949 and had been described as a ‘pillar of the [local] church’ (Stone, 1976: 1). Evidence supporting the ‘senior dominant manager’ was found in how Robison,

\(^{17}\) Section 71 of the 1986 Act requires every society to make an annual report on its systems of control of its business and records and of inspection and report, whereas Section 79 provides that the auditors shall report on each matter required under Section 71.
following practices introduced by the previous general manager, G. E. Jackson (deceased), controlled personally (and singularly) the management of the society and the preparation of the annual accounts in addition to maintaining a position of sole link between the Board and staff (RFS, 1976: 20). He kept everything ‘close to his chest’ and staff could only approach him ‘by appointment’ (Taylor, 1977: 7, 23). Further evidence of a dominant senior manager was found in Robison’s ‘autocratic’ management style. It ‘kept his assistance at arm’s length’ thanks to the Board’s neglect to supervise him’. Robinson could then design systems and procedures to fit his purposes. This was facilitated by staff ignorant of alternative systems and procedures because, with the exception of Taylor, all staff had basic qualifications and work experience solely at the Wakefield.

As Taylor became more familiar with the operations and systems of the Wakefield, the deficiencies in the management of the society became more apparent and the relationship with Robinson strained (Taylor, 1977: 23-4). The society’s internal control system was a source of serious friction between the two. The bookkeeping function was divided into sections, aided by a NCR 500 (to collate and maintain personal ledgers), and chief clerks were supervised only by Robinson.

There were a number of doubtful and obscure accounting procedures, which drove the work of the clerks, made their work cumbersome to the extreme and made gathering information to produce annual accounts difficult. For instance, it mixed up different types of income and expenditures in recording entries, such as deposit receipts and withdrawals with payments for insurance premium and survey fees. The control of management expenses was loose as demonstrated by the maintenance of a so called ‘Green Ledger’ which recorded cash transactions and mortgage loans solely at the discretion of Robinson (and, of course, unauthorised by the other directors), with the result that the Wakefield had a higher expense ratio than societies of similar size (Taylor, 1977: 26-8, 121).

F. W. T. Mills and R. R. Breckin were the long-standing individual auditors of the Wakefield (Stone, 1976: 1). The two auditors were in their seventies and had been ‘unchanged for 20 years’. On the morning of 30 June 1976, representatives of the

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18 Direct quotes from T386/308, ‘Private Secretary to Minister of State’, 7 July 1976: 2
19 This small, transistor-based, programmable, punched paper tape computer was introduced in the early 1960s as an alternative to the larger NCR 315. Hence, the working of Wakefield accounting function as described by Taylor was reliant on technology that was at least 10 years old. Taylor’s proposal to upgrade the computer system while streamlining the accounting function was torpedoed by Robinson (Taylor, 1977: 25-6).
20 T386/308, ‘Private Secretary to Minister of State’, 7 July 1976: 2
Wakefield reported to Keith Brading, CRFS, that following the appointment of Wheawill & Sudworth as new auditors, it had been discovered that Robinson had misappropriated an estimated £600,000 over a period of 20 years.\textsuperscript{21} Robison was immediately suspended and replaced by Taylor.\textsuperscript{22} A note by K. J. Jordan, private secretary, to Denzil Davies M.P. (Llanelli, Labour), Minister for Treasury, commented on the system Robinson used to defalcate funds, which stated that

\textellipsis this [defalcation] was made possible by the combination of a ruthlessly crooked man in a position of trust, a laxity in the degree of supervision of the General Manager by the Board and less than adequate performance of auditors – who in later years of their long tenure and more or less retired from active auditing but who simply continued in this, as they thought, routine job.\textsuperscript{23}

The auditors were criticised because they had not reported on the Wakefield’s poor systems of internal control in spite of their prescribed duty to report thereon (Taylor 1977: 121). In Taylor’s view, ‘[a]t no time do the auditors appear to have been concerned with ensuring that all advances made were authorised in the minutes of the Society’ (Taylor, 1977: 121). ‘Clearly the inaccuracies in the return prevented the Registrar discovering malpractices which would have been clearly evident from a properly completed return’ (Taylor, 1977: 122).

The auditors were ignorant that the systems of internal control at the Wakefield had failed to detect advances recorded in the ‘Green Ledger’ (Taylor, 1977: 121). The auditors also failed to identify a number of misstatements relating to special advances (Taylor, 1977: 122). Moreover, they allowed for these to be recorded as such in the annual return by stating in their report that ‘the return “is in agreement with the books of account and records of the Society”’ (Taylor, 1977: 122). The failure to report on the effectiveness of control for advances, raised the issue of whether the auditors’ duty to report on the annual accounts of the society was properly discharged or not. The auditors were criticised as ‘negligent in fulfilling this duty’ (Taylor, 1977: 122).

In spite of the loss caused by the defalcation by Robinson, the 130-year old society, with assets of £24m and branches in Doncaster, London, Manchester and Mansfield, was still in a secure financial position (see further Appendix). Its reserves of £1.3m could assimilate the misappropriation while keeping its reserve ratio at 3 percent, well above the 2.5 percent required for the society to maintain its trustee status.\textsuperscript{24} Based on

\textsuperscript{23} T386/308, ‘Private Secretary to Minister of State’, 7 July 1976: 1.
\textsuperscript{24} Following the enactment of the Housing and House Purchase Act 1959, societies gained two forms of government recognition: their deposits became authorized ‘trustee investments’ and building societies became entitled, for the first time in their long history, to borrow from H. M. Government. ‘Trustee investment status’ was first sought by societies for investments in their ‘shares’ and deposits in the
that relative strength of the Wakefield’s financial position, its directors and the Association were of the view that the society should be ‘allowed to weather the consequences of the storm with such temporary cash assistance as a consortium of other societies might have provided’. However, Brading considered that the possibility of the losses exhausting the reserves could not be excluded and that there was real risk of a serious loss of confidence in the society and its directors when the losses were publicly announced. The Chief Registrar intimated that an order under BSA62 should be issued to stop the society taking further investments ‘unless it was able and willing to merge with another society of considerable size’. During consultations, representatives of the Association changed their mind and advised the Wakefield to amalgamate (Stone, 1976: 1).

The Wakefield’s directors decided against soldering on alone and started discussions with the Halifax, another Yorkshire-based society and the largest in the world with assets of £4,576m. In fact the Halifax’s general manager, Raymond Potter, was also chairman of the Association and had been intimately involved in the rescue operation. Agreement in principle between the two Boards was swift and a proposal to that effect was put forward to Wakefield’s members on 13 July 1976.

The aftermath

Disregarding minor defalcations, the case of the Wakefield was the ‘first major scandal’ since the ‘Jasper affair’ and the collapse of the State Building Society in 1959 (Stone, 1976:18). But, much to their credit, the Chief Registrar, the Association and the individual societies endeavoured to settle the case as much detail as possible before the affair became public, thus minimising potential repercussions and assuring the stability of the sector (see further Cassell, 1976). Nevertheless and even before the ‘dust had settled’, staff at the Treasury started thinking of enlarging the powers of the RFS by exploring:

(i) the possibility of applying the ‘four eyes principle’.

mid-1920s (Humphries, 1987: 335). Without it, trustees, including executors of estates of the deceased, were unable to invest in building societies in the absence of specific directions. Societies believed that this status would give them a competitive advantage and increase their loanable resources but it rapidly turned into ‘a seal of respectability’ (Boléat, 1981: 32). See further Bátiz-Lazo (2006) and Bátiz-Lazo and Billings (forthcoming).

28 T386/308, ‘Confidential: Wakefield Building Society - Draft’, 5 July 1976; Stone (1976:1). In a public communiqué it was clarified the merger would require 120 days if the Wakefield members gave their consent (13 July 1976).
(ii) a power for the Registrar to approve the selection of auditors;
(iii) a restriction on the use of de facto retired auditors;
(iv) a statutory requirement for the auditors of a building society to be changed after a certain period of years; and
(v) the ability of the Registrar to put in auditors to make spot changes of societies’ books.

It is noticeable that item (v) above acknowledged the rather limited (human) resources made available at the RFS to discharge its duties. At the time, there were only four full time members of staff available to supervise over 700 societies. To make up for the lack of man-power the CRFS had to rely on effective auditing of professional accountants, on the corporate governance of societies themselves and even on the internal accountants and staff at large building societies.

On 20 August 1976 a meeting took place between Treasury officials and staff at the RFS to discuss enlarging the powers of the latter along the five points proposed above. J. Walters at the RFS saw difficulties in the practicalities of carrying out the proposed duties. In particular, the Friendly Societies and Industrial and Provident Societies Act 1968 had removed the approved list of auditors and it was hard for the Registry ‘to know the quality of small auditors’. Walters rather supported the limit of up to five years for the appointment of auditors but, at the same time, he ‘doubted whether auditors would be interested in…[auditing] the accounts of a small building society if they knew they would have the account for only five years’.

Interestingly, the Chief Registrar was also ‘unhappy’ with the ‘general attitude’ of the Halifax and the Association during the rescue operation. In his view, it needed to change to assure a ‘speedier resolution’ in the future. But the hope that the Wakefield’s case was an isolated occurrence somewhat dissipated when the defalcation over a period of five years at the Cheltenham branch of the Provincial became public. In light of this, Brading intimated his concerns on the adequacy of the systems of internal control of building societies to Jordan by stating that

...informal talks with Potter and a number of others prominent in the Movement have left me with the impression that directors, even if they are conscious of their duties under [BSA]

or ‘four eyes principle’ roots to German law. It aims for at least two persons effectively managing the financial intermediary as much for purposes of keeping it running during holidays as to prevent fraud.

Note Jordan at the Treasury considered that it was ‘common practice’ to change the auditors of nationalised industries ‘every few years’ (T386/308, ‘Auditors of Building Societies’, 17 August 1976: 1). But it is not clear whether this was indeed widespread as this provision only appeared in the Gas Act (1972) and Water Act (1973). These Acts gave the Secretary of State the power to appoint auditors at the end of each financial year (T386/308, ‘Auditors of Building Societies: Reply from T. A. M. Pollock’, 19 August 1976).

T386/308, ‘Private Secretary to Minister of State’, 7 July 1976: 2.
s.76(1)(b), tend to rely too much on auditors and take too little personal responsibility for ensuring that an effective system of internal security is in operation.\textsuperscript{35}

In sharing his views with the Treasury, Brading now acknowledged that the time to introduce legislation would result in a loss of immediacy to deal with the issue of the auditors of building societies. But, at the same time, he considered that while auditors ‘had an essential function in...building society affairs, [they] do not have the primary responsibility for preventing or uncovering fraud. In his view, ‘[t]hat responsibility lies and…must continue to lie with directors’.\textsuperscript{36}

These concerns were not to remain private. On 16 September 1976, the CRFS wrote to the chairmen of all societies to remind them of their responsibility and that of auditors (RFS, 1976: 21). In the letter he pointed to Sections 76(1)(b) and 76(5) of BSA62 to highlight that internal security was responsibility of the directors, as under these sections it was their duty to establish and maintain a system of internal control of the society’s books of account and cash holdings.\textsuperscript{37} He also remind them that under Section 87(4) of BSA62 the auditors had to consider, amongst other things, whether a society had maintained a satisfactory system of control so as to comply with the above named sections. In this connection, Brading added that:

…directors should not consider that s.76(1)(b) has been complied with because the auditors have not reported to the contrary. It is the director’s responsibility and not the auditor’s to ensure that compliance is effective.\textsuperscript{38}

Brading recognised that there were no full proof systems and the establishment of internal control depended on the society’s asset size and number of staff. But should misappropriation occur, then appropriate systems would bring ‘it to light within a short time....No one handling books or cash should escape this system, however senior or trusted he (sic) may be’.\textsuperscript{39} The CRFS was thus considering that immediate action to reduce the possibility of fraud could be taken if directors discharged their responsibilities as envisioned by BSA62.

The Treasury welcomed Brading’s letter as a ‘first step’ but were sceptical that it would result in directors excising the necessary vigilance to ensure that individual societies established and ‘maintained the system of control and inspection of [their] accounts unless [directors were] concerned that their auditors [were] likely to comment...under Section 87(4)’.\textsuperscript{40} The skepticism of senior civil servants was even more evident later on

\textsuperscript{35} T386/308, Memo from Brading to Jordan, 15 September 1976.
\textsuperscript{36} T386/308, Memo from Brading to Jordan, 15 September 1976.
\textsuperscript{37} T386/308, Letter from CRFS to all building societies, 16 September 1976.
\textsuperscript{38} T386/308, Letter from CRFS to all building societies, 16 September 1976.
\textsuperscript{39} T386/308, Letter from CRFS to all building societies, 16 September 1976.
\textsuperscript{40} T386/308, ‘Audit of Building Societies’, 5 October 1976. Underlined in the original.
in the same communication as it ended as follows: ‘it would be interesting to know if auditors have ever commented unfavourably on societies’ internal control systems’.\textsuperscript{41}

This concern was understandable because, as demonstrated in the case of the Wakefield, auditors of building societies rarely made any qualification in their report to any society (see further Bátiz-Lazo, 2006; Bátiz-Lazo and Billings, 2009).

A meeting then took place on 6 October 1976 between A. T. Baker and Jordan from the Treasury and Brading, A. Vollmar and Walters from the RFS with the aim of discussing how the societies could employ competent auditors ‘and...[how] these [were] not shackled’.\textsuperscript{42} During this meeting Brading informed the Treasury officials that in order to ‘assess...the risk that other societies [were] in a similar position as the Wakefield’,\textsuperscript{43} the CRFS intended to look into the affairs of all small societies whose general manager was of advanced age. This investigation was based on Brading’s desire to improve the RFS’s ability to suggest and criticise internal security systems (not least in the variety and size of societies)...apart from very few ad hoc investigations of specific defalcations, very little attention has been given to [the Registrar’s responsibility over the supervision of the operations of building societies] in the past. You will appreciate therefore that, although I accept the need for a more positive approach, the extent to which I can step up our supervision in this field is currently severely limited by staff availability.\textsuperscript{44}

Registry officials also informed that they had communicated with the accountancy bodies of their concerns regarding the quality of the audit of building societies, and that it was expected that these bodies circulated the communication among their own members. This communication eventually took place as demonstrated by the following editorial in \textit{The Times} (12 October, 1978: 27), entitled ‘Stricter checks pose audit problems for small building societies’:

\begin{quote}
An extended search of public sources resulted in no record of a major threat for building societies accounts’ being qualified before October 1978. On the face of it, then, the framework for disclosure and internal control emanating from the early 1960s not only brought societies under the same regime as other corporate bodies but seemed fit for purpose. However, the failure of the otherwise small Grays Building Society questioned the established wisdom. In this context Mr Keith Brading, Chief Registrar, and Mr Eric Sayers, President of the ‘English Institute’, wrote a joint letter to all societies and their auditors warning them of the lax application of the 1962 Act while reminding them of Section 38(2), which made specific provision for individual societies to keep (and auditor’s to examine) a system of control, inspection and supervision. Both Mr Brading and Mr Sayers were of the view that there was an impending need to reappraise those systems – particularly at small societies.
\end{quote}

However, the above quote of \textit{The Times} (12 October 1978: 27), took place only after

\textsuperscript{42} T386/308, ‘Note for the Record [probably by A. T. Baker]’, circa 6 October 1976.
\textsuperscript{43} T386/308, ‘Private Secretary to Minister of State’, 7 July 1976: 3.
\textsuperscript{44} T386/308, Memo from Brading to Jordan, 15 September 1976.
another more serious case of defalcation was discovered in 1978.

**Grays Building Society**

*The Crime*

In March 1977, when the financial statements for the year ending 31 December 1976, were presented to the membership, the auditors of the Grays Building Society, Appleby English & Partner, reported that the ‘Balance Sheet, Revenue and Appropriation Account and Notes thereon, [were] properly drawn and in accordance with the [BSA62]....and in [their] opinion they gave a true and fair view of the state of the societies affairs…’\(^45\) (see further Appendix). But shortly after, when the society should have opened its doors after the Easter break, the 7,000 members of a society with £10m in total assets were to find out that Harold Jaggard, 79 years old, Secretary and Chairman, had not only committed suicide but was responsible for deficiencies in the accounts of £7.1m (Cassell, 1978; Churchill, 1978). Jaggard died on Friday 17 March 1977, a few hours after audit queries had been raised with him.\(^46\) The bulk of the misappropriation was composed of interests lost on some £2m of fraudulent loans over 40 years but it was still a blow as ‘the vast majority of depositors [were] local people’ (*Evening Standard*, 29 March 1978). Moreover, depositors were unable to withdraw money before July after members approved a transfer of engagements to the Woolwich Equitable at the end of June (Cassell, 1978).

The society was established in 1880 in the small town of Essex with the same name, north east of London. Jaggard joined as Assistant Secretary in 1923, became Secretary in 1927 (after the previous post holder, resigned having been found to have embezzled nearly £1,000) and Chairman in 1963. Until the mid 1940s the society employed a staff of three or four; by the 1970s there were eleven full-time employees, supplemented by a part-time assistant at year end (Davison and Stuart-Smith, 1979: 19). Staff later on admitted to have observed that Jaggard committed many procedural irregularities but said to be unaware of the dangers involved (Davison and Stuart-Smith, 1979: 21).

For a number of years Jaggard consistently stole cash from the society at an estimated average of £1,250 a week (£65,000 p.a.) to finance a lavish lifestyle that included large bets in horse racing, two families and a mistress, purchases at Harrods and Fortune &

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\(^{45}\) Grays Building Society, 95\(^{th}\) Annual Report and Statement of Accounts for the year ended 31 December 1975: 5.

\(^{46}\) Speech by Keith Brading to the Metropolitan Association of Building Societies, 20 April 1978 (HLG 118/3241 and T386/308): 1.
Mason, suits from Saville Road, children at private schools, continental holidays, etc. (Taylor, 1979). He covered the theft by delaying the banking of cheques received in a subsequent accounting period and later falsifying the records – a practice known by accountants at the time as ‘teeming and lading’ (Accountant, 24 May 1979: 646; Davison and Stuart-Smith, 1979: 22-7). He also set up a special ‘share’ (i.e. long-term investment) accounts from where he misappropriated funds. To aid his deception Jaggard insisted in keeping records in pencil or fountain pens using only Stephens blue ink. This made it easier for him to falsify records and resulted in a system described as ‘swift, effective and simple’ (Taylor, 1979).

The Grays did not make proper use of the double entry bookkeeping and hence, did not operate a proper system of control which would have made possible to check that the books were in balance at intervals during the year (Davison and Stuart-Smith, 1979: 31). The only way to balance the books was to extract and summarise all the transactions of the year on to summary sheets. Staff was obliged to undertake a vast manual exercise of scheduling and adding up transactions, as Jaggard destroyed the summary sheets after doctoring the books. The fraud came to light only after the long term auditors, English and Partner, merged with Appleby and Woods in March 1976. The new auditors, Appleby English & Partner spotted material differences in the accounts on the first day of preparations of the annual audit.

Events leading to the discovery of defalcation and its aftermath

Jaggard’s frequent visits to race meetings sparked a special enquiry by the Gray’s Board in 1952. At the time, this involved a week long investigation by two members of the Audit Department of the Co-operative Wholesale Society (CWS), the then auditors of the Grays. But nothing else came out from this incident (Davison and Stuart-Smith, 1979: 9-10). It was until 1974 when the RFS first enquired into the Grays, prompted by the advanced age of the directors (averaging 74 years).48 Correspondence then ensued. Around this time, the Chief Registrar also required ‘all active societies to submit monthly financial statements which, in particular, enable cash flow and liquidity to be monitored on a systematic and continuing basis’. He added that ‘[t]hese statements [should be] provided on a non-statutory basis’.49

47 His final annual salary was £5,275 in 1977 and he left only £1,500 in his savings account before committing suicide.
48 In 1972 the RFS introduced changes to the main financial disclosure document of building societies (namely the A.R. 11, which included the annual set of accounts) for directors to disclose their age.
49 ‘Grays Building Society: Supervision of Building Societies’ (Note by I. L. Smith for Minister of State to questions by Dr Oonagh McDonald, Thurrock; Labour) 7 June 1978 (T386/308).
At the end of June 1976, Jaggard, as chairman of the Grays, informed his Board, that he as Secretary had received of a new letter from the CRFS. In this letter the Registrar not only continued to request a reduction in the overall age limit of the directors but also questioned the mode of dealing with applications of new advances, bookkeeping methods and the level of liquidity (which the CRFS thought it too low). The Secretary’s retort to the CRFS is telling of the state of affairs at the Grays, as he is recorded as responding:

…to the Registrar to the effect that in 1974 he mentioned a figure of 12% as far as liquidity was concerned and the Society had at the end of 1975 over 15%...and the only way to get a high liquidity to compare with some other societies was either to stop or curtail advances...that efforts were being made to reduce the overall age...that the method adopted as far as advances were concerned was to borrowers advantage...and in special cases the Directors always agreed for the Secretary to use his discretion. With regard to the Book Keeping the Secretary pointed out to the Registrar that he himself had stated what was being done was accurate and whilst it was agreed that some methods were old fashioned there was ample evidence that the Society’s members were quite satisfied with the information they could always receive from this Secretary for their accounts, at one minute’s notice...The Secretary stated that he was not exactly worried but he did not like having to get this kind of reminder every so often from the Registrar.

Nevertheless, the Registrar wrote two more letters. That of 29 June 1976 asked not only for two much younger persons to be appointed to fill the current vacancies and reduce the average age of the Board, but also for all of the directors to meet the Registrar in person. The meeting between the Registrar and the Gray’s Board in full never took place. But two actions did follow as a response. First, Keith Jordan (who had been previously at the Board of the Essex & Kent society) and J. Sanders were appointed to the Gray’s Board on 19 August 1976. These appointments brought to nine persons the number of Board members. Second, a quota of advances was introduced and set at £30,000 maximum per Board meeting in order to increase the liquidity ratio.

In a parallel development, the CRFS sent a circular letter to all societies in which Brading stated he was planning to make enquiries into particular societies’ bookkeeping methods and system of internal control. The Gray’s minute book recorded Jaggard’s response to this letter as follows: ‘[t]he Secretary gave particulars as to how the [Grays’] incomings and outgoings were checked and he could not see how this could be

52 BGA/Grays Board, Meeting of the 22 July 1976, ‘Other Business’: 2.
53 BGA/Grays Board, Meeting of the 19 August 1976, ‘Matters Arising’: 1.
54 BGA/Grays Board, Meeting of the 2 September 1976, ‘Matters Arising’: 1.
55 BGA/Grays Board, Meeting of the 30 September 1976, ‘Other Business’: 2.
improved...’

By the end of April 1977 it was still unclear whether the Grays should and would be one of the societies to be subjected to an investigation by the RFS. At this point Jaggard as chairman reported that the society’s liquidity was 14.49% and the reserve ratio had increased to 3.99% of total assets for the year ending 31 December 1976. Also due to the dead of W. E. Taylor in January 1977 and the retirement (as per rule) of four others it was planned to elect five new directors at the incoming annual general meeting in May.

At the Board meeting held on 12 May 1977, Jaggard was reappointed as chairman but ‘[A. W.] Gunn did not vote for as he thought that he could not agree with the method used [to select new directors], and he would much prefer for anybody wishing to stand to be properly nominated, seconded and voted on accordingly’. Other signs of cracks in Jaggard’s system also emerged in the same meeting when ‘[A. Halladay] was of the opinion that the Society should employ somebody to be trained over a period of a few years which would enable whomever…[to be] appointed as an Executive [Secretary] of the Society’. The meeting was adjourned with an agreement to advertise the position in the national press, though no real attempt was made to appoint and replace Jaggard during his tenure.

Upon the insistence of the CRFS, a delegation of the Grays’ Board met with him in London. The meeting was held on 12 October 1977 and was attended by Jaggard, as Chairman, W. H. Rate, Vice-Chairman and two directors (C. R. Glenny and A. K. Glenny). The meeting chiefly responded to the Registrar’s concerns regarding the way the society was being run and the inadequacy of its systems of control. Other matters discussed included the relocation of the main office to the centre of town and Jaggard’s succession. During the meeting, the Registrar pointed out that ‘the society should be dynamic in its outlook and with regard to the accounting system that further consideration should be given to mechanisation’.

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56 BGA/Grays Board, Meeting of the 30 September 1976, ‘Other Business’: 2.
58 BGA/Grays Board, Meeting of the 12 May 1977: 1.
61 After the defalcation came to light, the auditor of the society, Appleby English and Partner, stated in its report on the internal control of the society for the year ending 31 December 1977 that ‘[t]he Society has failed to keep proper books of account with respect to its transactions and its assets and liabilities…has failed to maintain a satisfactory system of control over its transactions and records…and has failed to establish and maintain a system to ensure the safe custody of all documents of title belonging to the Society and of the deeds relating to property mortgaged to the Society’ (Accountancy, July 1978: 12-3).
After meeting with Jaggard and the other directors, the CRFS wrote to the Association and expressed his concerns with the systems of control at the Grays. The Association caved in and agreed to send Wilkinson, a member of the Finance Committee of its Council, to meet with the Grays’s directors with a view to report on whether the Grays was following the Association guidelines. On reporting for the meeting held on 18 January 1978 with Wilkinson, Jaggard told his Board that Wilkinson ‘stated he did not know what all the fuss was about and agreed that the [Grays] was doing all it should be as far as keeping accounts and attending to the Liquidity and reserves’.62 Following the visit by Wilkinson, Norman Griggs, from the Association, confirmed ‘that the remarks of Mr Wilkinson…were…that he found things at the [Grays] as far as bookkeeping was concern quite satisfactory’.63

Finally the new auditors, Appleby English & Partner, were to carry out the annual revision and put forward a number of queries to Jaggard in the morning of Friday 17 March 1978, which was followed by his suicide a few hours later.64 Brading immediately arranged a meeting on 18 March 1978, which was attended by himself, the directors of the society and representatives of the Woolwich Equitable (the largest society in the vicinity). Staff from the Woolwich then started to work on the books and by 25 March 1978 they had come to the conclusion that the deficiency was substantially larger than had at first been envisioned.

At a further meeting took place on 28 March 1978 and it was attended by all the Grays’ directors, Walters representing both the CRFS and the Association, P. Dowson representing the auditors (Appleby English & Partners) as well as W. H. Johnson, M. C. Preston and M. E. Tuke of the Woolwich. It was reported that the preliminary investigation had revealed a loss of £2m or as much as £7m if interests were also considered. As a result, that same day the CRFS decided to issue an order under Section 48 of BSA62 to prohibit acceptance of further investment funds.65

Meanwhile, the Registrar promoted and won a special dispensation in the High Court for the amalgamation of the Grays and the Woolwich without approval of its members. The CRFS also commissioned I. H. Davison, a leading City chartered accountant at Arthur Andersen & Co., and M. Stuart-Smith, a barrister, to produce an independent report into the Grays debacle, which was eventually published on 17 May 1979. The

64 Unless otherwise stated this paragraph borrows freely from T386/ 308, ‘Grays Building Society (Note from M Bridgeman to Principal Private Secretary’, 28 March 1978.
65 BGA/Grays Board, Meeting of the 28 March 1978: 1.
report critically pointed to the lacklustre role played by the CFRS, the inattentiveness of the Association (for providing ‘support and comfort’ to Jaggard and thus helping him resist reforms suggested by the CRFS) as well as the negligence of the Gray’s directors who allowed all communication to come through Jaggard, though it was the auditors who the report most strongly criticised (see further Davison and Stuart-Smith, 1979).

**Recommendations of the Inquiry**

The report included a detailed examination of the quality of control systems in place at the Grays and as a result viewed that ‘the failures were gross’ with respect of (1) the segregation of duties, (2) the receipt and banking of cash and cheques, (3) the writing up of the ledgers and (4) the preparation of the accounts. In the view of the Inspectors the society was in breach of Section 76 of BSA62, which prescribed the directors’ duty to establish and maintain effective internal control systems (Davison and Stuart-Smith, 1979: 53).

The report by Davison and Stuart-Smith was foremost critical on the long standing appointment of Arthur Nudd, a former incorporated accountant and former member of the CWS Audit Department (*Accountant*, 24 May 1979: 646). He was the partner in charge of the Grays audit. Though having been appointed for 27 consecutive years from 1950, he consistently failed to pursue Jaggard’s disposition to appropriate large amounts of cash. His audits were unable to detect the classical pattern of fraud such as teeming and lading was judged as ‘a stereotyped and ineffectual annual audit’ (*Accountant*, 24 May 1979: 646). In fact, Nudd did not form an adverse opinion on the internal control systems at the Grays nor, obviously, did he report thereon.

The Inspectors concluded that ‘Nudd’s lengthy association with the Grays was a grave audit weakness. His auditing had become mechanical and predictable, facts of which Mr. Jaggard took full advantage’ (Davison and Stuart-Smith, 1979: 114). Moreover, ‘the combination of errors and failures…add up in sum to a consistent failure of the auditors to discharge their professional duties properly’ (Davison and Stuart-Smith, 1979: 152).

Commenting that ‘the lack of appreciation by auditors of these duties is not confined to the cases of the Wakefield and the Grays’ (Davison and Stuart-Smith 1979: 167), the report of the Inspectors also offered some recommendations for the prevention of a similar case in the future. These included the following:

- The CRFS should
  - monitor more closely the performance of the societies;
  - be able to object to the appointment of auditors whom they have reservations;
o judge the professional qualifications and efficiency in previous work of auditors;
o ask auditors to provide information about the societies directly to the RFS;
o upgrade the professional standards and qualifications of its own staff (particularly those conducting inquiries into the societies);
o make sure directors of the societies are aware of their duties and responsibilities under BSA62.

- Directors of societies should
  o meet with their auditors at least once a year to discuss accounting procedures;
o seek annual re-election after reaching the age of 70.

Within these recommendations the importance given to the RFS’s potential objection to the appointment of auditors, assessment of their qualifications and their performance are noteworthy. Indeed, the report of the Inspectors stated that ‘[t]he experience of the Grays shows that it may no longer be prudent for the Chief Registrar to rely solely upon the fact that the auditors is qualified under Section 86 of the Act as a guarantee that the audit has been properly performed’ (Davison and Stuart-Smith, 1979: 168) and that ‘if the Chief Registrar has serious reservations about the suitability of any appointed auditor for the task in hand, a society would be most unlikely to resist the suggestion that a change of auditor should be made’ (Davison and Stuart-Smith, 1979: 169).

As a measure to achieve that objective, the report suggested that ‘the auditor be appointed annually by a positive vote’ at the shareholders’ meeting (Davison and Stuart-Smith, 1979: 169). A suggestion that was in fact enacted later as Section 77 and Schedule 11 of the Building Societies Act 1986. Also and in order to make the intervention of the CRFS effective while avoiding over-long assignments such as occurred at the Grays, the report recommended that auditors informed the Registry directly on ‘the number of partners and staff assigned, their professional qualifications, the number of hours taken by each grade of staff, and the number of years they have been on the job’ (Davison and Stuart-Smith, 1979: 170). ‘This proposal [broke] new ground because it would require an auditor to give information which could lead to a Government department forming a view about the adequacy of his professional work’ (Davison and Stuart-Smith, 1979: 171).

Section 53 (1) of BSA62 stipulated a provision originally introduced by the 1874 Act. It stated that ‘[t]he Chief Registrar may at any time serve a notice on a building society, or on any person who has in his possession or under his control any books, accounts, deeds or other documents relating to the business of a building society, requiring the society or other person to produce to the Chief Registrar such of those documents as the Chief
Registrar considers necessary for the exercise of his powers’. However, this provision was not applicable to documents belonging to a person other than the officers of the society and an auditor was not yet regarded as the officer of the society. For this anomaly, the report of the Inspectors recommended that ‘Section 129 [of BSA62] should be amended so as to render an auditor an officer of a building society for the purposes of Section 53 and thus require him to furnish information to the Registry if called upon to do so’ (Davison and Stuart-Smith, 1979: 169). By amending Section 53 itself, the Registry could ‘call for the auditors’ working papers if [he thought it] appropriate’ (Davison and Stuart-Smith, 1979: 169).

The professional accountants in general, and their most influential body, the Institute of Chartered Accountants of England and Wales (ICAEW), in particular, accepted all but the last of the recommendations.66 The ICAEW rejected the idea of a government department (and in this case, the Registry of Friendly Societies) having access to the auditors’ working papers. Accountants argued that ‘[i]f…the reason for the suggestion…is concern about the standard of the audit work in relation to a particular society, then…the appropriate course is for the Chief Registrar to make his concern known to the appropriate professional body’ (Council Minutes Book AS: 757). In a sign of professional autonomy and self-regulation, the ICAEW added that ‘our suggestion has considerable advantages over any suggested procedure involving the Chief Registrar, since it enables disciplinary measures to be taken [by the appropriate professional body]…against the auditor’ (Council Minutes Book AS: 757).

The matter moved further inside the ICAEW. On 1 August 1979 its Council voted 33 (59 per cent) in support versus 23 (41 per cent) against the RFS having access to the auditors’ working papers (Council Minutes Book AS: 678). However and in spite of the motion to deny the recommendation had taken a majority of the Council, it was eventually resolved that ‘if the Chief Registrar is intent on seeking access, this should be only on the terms…that confidentiality is preserved’ (Council Minutes Book AS: 678). This concession on the part of the accountants was reported in its own organ, Accountancy (October 1979: 4) as follows: ‘[t]hey also accepted the need to rectify a

66 In fact, for recommendation for the information on experience of the audit staff to be directly provided by the auditors to the Registry, the ICAEW also rejected it on the ground that ‘the Registrar will have adequate powers under the provisions of section 53 of the 1962 Act (assuming that auditors are redesign as officers of the society, as proposed above) to enquire into the experience of auditors where he has cause for concern’ (Council Minutes Book AS: 759). Section 53 (2) of BSA62 provided that ‘[t]he Chief Registrar may also at any time serve notice on a building society, or on any person who is or has been an officer or servant of a building society, requiring the society or other person to furnish him with such information relating to the business of the society as the Chief Registrar considers necessary for the exercise of his powers’.
legal anomaly which at present prevents the Chief Registrar from having access to a society’s records if these are in the possession of the building society auditors’. Eventually the recommendation by the Inspectors was enacted into law, through Section 82 (9) of the Building Societies Act 1986.

Concluding Remarks

This study documents how regulatory innovations changed the corporate governance of building societies, a mutual financial intermediary working in British retail finance. These changes gave state authorities greater powers in the operations of the societies than to members. In other words, regulatory innovations of BSA60 increased the accountability of operations of building societies by introducing the ‘true and fair’ requirement to their financial reporting. But throughout the process of reform customers (many of whom were also shareholders), largely lost ‘voice’ as their power to influence the management of the societies was consistently eroded when compared with the increased powers of intervention awarded to the state authorities and external auditors. Throughout this process of evolution, the role of auditors of building societies was transformed to see them act as agents for the state in the supervision of the retail financial institutions. The cases of fraud at the Wakefield and the Grays building societies provided the empirical foundation to explore this process of evolution and change.

On the whole and given the exceptional nature of the cases of the Wakefield and the Grays, it would seem that the institutional arrangement was robust enough for adequate monitoring of staff by managers and directors by auditors to take place. These cases also show how state authorities tried to sort out as much as possible before going public with the defalcations. Keeping quiet was perhaps in the interest of depositors and shareholders, as it gave them some degree of certainty. For the larger investing public, it aimed to avoid a loss of confidence and subsequent run on the building society sector.

It is interesting to note that there was no suspicion of anomalies at the Wakefield because of its relatively sound financial position and the voluntary take-in of a relatively young man (36 years old then) as the successor of the general manager, whereas the CRFS had expressed serious concerns regarding the management of the Grays before the fraud came to light. The concern progressed ‘chiefly on the grounds of its aging board of directors, its antiquated accounting systems…and an unsatisfactory liquidity ratio’ (Accountant, 24 May 1979: 646). Indeed, the RFS sought to make its own
investigation of the Grays in April 1977. But ‘… the Registrar’s officers…lacked evidence which would have justified them, at that time, in taking stronger measures, including possible withdrawal of the Society’s trustee status’ (Accountant, 24 May 1979: 646). This points to the lack of appropriate resources available to the RFS to implement its duties, particularly with respect of small societies as they seem to have been the most problematic and in need of policing (large societies, after all, were happy to embrace the changes proposed by BSA60. See further Noguchi and Bátiz-Lazo, 2010).

Nevertheless, the auditors of both the Wakefield and the Grays failed to discharge their duties as expected under BSA60 in the sense that they failed to report not only on defalcations by dominant senior managers and the resulting material accounting misstatements included in the annual returns submitted to the CRFS, but also on the defects found in the internal control systems operated at the societies. One important cause for their failure was, as the report of the Inspectors of the Grays case suggested, the lengthy association with their clients for more than 20 years. To avert this evil, Davison and Stuart-Smith recommended for the RFS to formulate a mechanism that pressed the alternation of the auditors as well as the removal of those who seemed to be unsuitable under the eyes of the RFS. These suggestions included introducing a positive vote for the annual appointment of the auditor at the general meeting, thus reinforcing his formal position as an officer of the society.

The report of the Inspectors also proposed giving the RFS direct access to working papers belonging to the auditor and thus enabling for the Chief Registrar to directly examine the quality of the auditor’s work by recommending the removal of the limitation to the RFS powers specified in Section 53 of BSA62. Professional accountants, as represented by the ICAEW, who had played the substantial role as the auditors of building societies (and the passing of BSA60), initially resisted the recommendation. But, after all, could not help accepting the reform. Thus, reforms resulting from defalcations at both of the Wakefield and Grays strengthen the role of the auditors as agents of the state in the supervision of retail financial intermediaries.
**Appendix** – Balance sheet as of 31 December 1975

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Grays</th>
<th>Wakefield</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Num of shareholders</strong></td>
<td>7,376</td>
<td>29,554</td>
</tr>
<tr>
<td>Due to shareholders</td>
<td>8,570,272</td>
<td>18,015,831</td>
</tr>
<tr>
<td><strong>Num of depositors</strong></td>
<td>1,025</td>
<td>6,302</td>
</tr>
<tr>
<td>Due to depositors</td>
<td>1,147,626</td>
<td>1,496,258</td>
</tr>
<tr>
<td>Loans by HM Government</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Bank Loans &amp; Overdrafts</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Taxes and Other Liabilities</td>
<td>182,795</td>
<td>117,584</td>
</tr>
<tr>
<td>Special Reserves</td>
<td>-</td>
<td>75,000</td>
</tr>
<tr>
<td>General Reserves</td>
<td>349,004</td>
<td>1,269,805</td>
</tr>
<tr>
<td><strong>Total reserves</strong></td>
<td>349,004</td>
<td>1,344,805</td>
</tr>
<tr>
<td><strong>Sum</strong></td>
<td>10,249,697</td>
<td>20,974,478</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Num of mortgage borrowers</td>
<td>1,997</td>
<td>6,302</td>
</tr>
<tr>
<td>Mortgages not exceeding £13k</td>
<td>8,636,859</td>
<td>16,053,255</td>
</tr>
<tr>
<td>Mortgages exceeding £13k</td>
<td>13,987</td>
<td>35,600</td>
</tr>
<tr>
<td>From Housing Societies</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>From Other Bodies Corporate</td>
<td>17,545</td>
<td>108,225</td>
</tr>
<tr>
<td>(Advances during the year)</td>
<td>900,670</td>
<td>3,093,567</td>
</tr>
<tr>
<td><strong>Sum</strong></td>
<td>8,668,391</td>
<td>16,197,080</td>
</tr>
<tr>
<td>Mortgage Loan Provision</td>
<td>500</td>
<td>2,300</td>
</tr>
<tr>
<td><strong>Mortgage Assets</strong></td>
<td>8,668,891</td>
<td>16,199,380</td>
</tr>
<tr>
<td>Quoted</td>
<td>95,000</td>
<td>-</td>
</tr>
<tr>
<td>(Market Value)</td>
<td>68,942</td>
<td>-</td>
</tr>
<tr>
<td>Other Authorised Investments</td>
<td>1,130,000</td>
<td>3,629,000</td>
</tr>
<tr>
<td>Interest Accrued</td>
<td>16,673</td>
<td>45,321</td>
</tr>
<tr>
<td><strong>Total Investments</strong></td>
<td>1,241,673</td>
<td>3,674,321</td>
</tr>
<tr>
<td>Cash at Bank and in Hand</td>
<td>328,633</td>
<td>983,376</td>
</tr>
<tr>
<td>Office Premises</td>
<td>7,500</td>
<td>117,401</td>
</tr>
<tr>
<td>Other Assets</td>
<td>3,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Sum</strong></td>
<td>10,249,697</td>
<td>20,974,478</td>
</tr>
</tbody>
</table>

Reserve ratio (total reserves / total assets) 3.4% 6.4%
Reserve ratio (total reserves / mortgage assets) 4.0% 8.3%
Reserve ratio (total reserves / deposits + shareholders) 3.6% 6.9%
Total mortgage assets / total assets 85% 77%
Liquid assets / Total assets (min 7%) 15% 22%
Average mortgage per borrower £4,340.71 £2,570.15

*Source: Building Societies Yearbook (1976) and own estimates.*
References

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Accession 1023/0839 - Grays Building Society Board Meetings

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Accountancy, July and October 1979.
The Economist
‘Britain’s Auditing Oligopoly: 48 Year Itch, 18 May 2011’, The Economist
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SME Finance”, *Journal of Banking and Finance*, vol. 30: 613-73.


