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Sir Adrian Cadbury
Chairman
Committee on the Financial Aspects of Corporate Governance
PO Box 433
Moorgate Place
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Dear Sir Adrian

I am pleased to attach a copy of National Westminster Bank's Submission to the Committee on the Financial Aspects of Corporate Governance.

If you require further clarification on any points in the submission, please contact Neil Hartley, Corporate Affairs Executive, at the above address (Telephone: 071 726 1402).

Yours sincerely

Phil Wise

P J S Wise
General Manager

Corporate Governance

a submission to the Committee
on the
Financial Aspects of Corporate Governance

November 1991

National Westminster Bank

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FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

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MEMORANDUM TO THE COMMITTEE ON

THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

1. Introduction

National Westminster Bank welcomes the review of the Financial Aspects of Corporate Governance and submits this memorandum for the consideration of the Cadbury Committee in the preparation of its consultation paper.

Banks rely more heavily on public confidence than many companies. Corporate governance plays a major role in maintaining confidence, not only in individual enterprises, but in the financial system as a whole.

Our history as a joint stock bank goes back 175 years. In more recent times banks have become subject to legislation and also regulatory supervision not applied to non-bank commercial companies. This tighter regime gives NatWest, as a Bank, a unique perspective from which to comment.

Our comments and recommendations are offered to the Cadbury Committee, therefore, in the light of both our experience as a bank and from the perspective we have gained in dealing with a large number of companies in the UK and around the world.

In the UK strong unitary boards of directors work best where they combine the right calibre, qualities and experience with the commitment of time and energy in setting policy, approving strategy and monitoring performance within an overall control environment for companies. **The objective of public policy should be to provide adequate safeguards while fostering an entrepreneurial climate.**

We strongly believe that the calibre and composition of individual boards and the way in which they are encouraged to do their work is a pre-requisite for sound corporate governance. There is an organisational balance to be struck which enables a company to function effectively without the imposition of unnecessary rules, either at the national or European level. For instance, in Germany the concept of the Management and Supervisory Boards acting separately is well established. In the United Kingdom, by contrast there is only the Unitary Board. It would be misleading to say that either system is intrinsically superior to the other, given the differences in culture and historical background. **For this reason it is important that changes to UK corporate governance stem from the basis of English law so that continuity is preserved.**

2. Corporate Governance - The Issue

As the Cadbury Committee will be aware, a number of factors have led up to the current debate on corporate governance. In the late 1980's, the short-termism issue, combined with the parallel debate on UK takeover policy, have thrown into sharp focus many of the topics included within the Cadbury Committee's terms of reference. In addition, the spate of corporate failures punctuating the beginning of the 1990's has also left questions in its wake. These are serious questions which if left unaddressed are capable of undermining confidence and therefore the international competitiveness and the prosperity of the UK.

The questions that must be answered confront many groups including, not only business and the City, but also the Government, the regulatory organisations, the professions, especially the accountants, and ultimately those responsible for professional education.

The key responsibilities for the management of companies, direction, execution, monitoring and accountability all fall within the corporate governance debate.

The UK has a strong record of flexible development and the wish is expressed that the Cadbury Committee will see their challenge as one of assisting the evolution of corporate governance, rather than seeking radical root and branch reform.

The success of companies has been, and in our view will continue to be, vital to the success of the UK economy. Viable structures, models and codes already exist. What seems to be happening in a few cases is that principle has become detached from practice. **It is suggested that the Cadbury Committee's ultimate objective should be to reinforce existing best practice by establishing a set of guiding principles for UK Industry.**

The corporate governance debate is often punctuated by the word accountability. Genuine accountability is not something which can be effectively enforced on individuals or groups. It depends on the clear recognition of the importance of joint and several responsibility for good corporate governance amongst all groups; shareholders, non-executive and executive directors, management and staff, regulators and auditors. **Accountability also depends on the existence of clear and acceptable standards of conduct to which the Cadbury Committee is well qualified to make a valuable contribution.**

3. The Composition Board of Directors

UK Company Law has been amended to incorporate a series of EC Directives; the First, the Second, the Third, the Fourth, the Sixth, the Seventh, the Eighth and the Eleventh are now a part of our legislative framework.

For the most part, these Directives cover form, reporting and accounting matters and they have led to greater consistency in reporting and transparency of information in the European market place. Nevertheless, it is important that the right to make sensible individual country choices regarding corporate governance should be preserved.

The Fifth Company Law Directive on Company Structures, Directors' Duties and Responsibilities remains as an EC Commission proposal despite recently being dropped from the Single Market Programme.

A prescriptive approach to the composition of boards such as that contained in the proposed Fifth Company Law Directive which would impose a majority of non-executive directors will not of itself prevent abuses or safeguard the interests of a company. Companies operating in the public domain will have increasing pressures placed upon them not only to have the right balance on their board, but also to show that they are operating effectively within appropriate structures and guidelines. **We recommend that decisions on the specific composition of boards be left to companies in line with the size, diversity and the nature of their business.**

The appointment of non-executive directors is an opportunity to supplement the capabilities of in-house directors with skills and expertise relevant to both a company's current activities and its future plans. Relevant experience and balance are essential for all companies. Balance covers the appointment of women directors and this is highlighted in the publication "*Women on the Board*" by the Policy Studies Institute. Shareholders through the AGM have the mechanism by which to influence the composition of the Board.

4. The Role and Responsibilities of Board of Directors

a) Chairman and Chief Executive

With the presence of a dominant personality, concentration of power can occur whether the roles of the Chief Executive Officers (or Chief Operating Officer) and Chairman are split or combined. No hard and fast rule is possible but where the roles are combined, as a lending bank, and possibly as an investor, we would like to see safeguards:

i) **A significant number of non-Executive directors as a counter balance**
ii) **A Board Committee with the right to remove a combined Chairman/CEO (COO)**
iii) **A process of consultation with financially interested parties prior to any merger of the roles.**

However, our major concern and one expressed by many company Receivers, is that companies have been shown to be vulnerable where "one person has too much executive authority". **Whilst such a situation may colour our view of a company, we believe it is the responsibility of individual boards to judge the matter in the first instance.**

Large individual shareholdings may often be used to reinforce personal dominance. Even so, the *Institute of Directors Guide for Board Room Practice* supports the view that, if the non-executive director discharges his duties correctly, then, such situations can be contained.

Nevertheless, a strong personality combined with a concentration of executive power may well create a barrier to the board carrying out its supervisory functions. The overall aim should be for the board as a whole to function effectively. It is the responsibility of companies to demonstrate that they are properly led and that the board composition is right. **The real key to this issue is often the very subjective one of personality. If the chemistry of a board is right, the quality of decision making across the business will be enhanced.**

b) Audit Committees

It is managements' role to ensure that the appropriate management and administrative controls are in place to provide the management, executive and board with relevant and accurate information. The primary role of an audit committee is to review those controls on behalf of the board. In this regard, the Cadbury Committee's attention is drawn to the recent report sponsored by our Ulster Bank subsidiary on the subject of Audit Committees.

National Westminster Bank has had an Audit Committee since 1977. Where appropriate, such committees are replicated throughout the Group structure.

Whilst NatWest originally took a voluntary approach towards the establishment of an Audit Committee, there now exist at least three regulatory influences which support the Audit Committee as a concept:

- *The Banking Act 1987 (Schedule 3, paragraph 4, clauses 7 and 8 as interpreted by "Section 16: Statement of Principles" 2.22)*
- *The 1986 Financial Services Act*
- *The New York Stock Exchange Listing Regulations, (1978)*

The Banking Act does not call for Audit Committees, neither does it specify a minimum number of non-executive directors, but subsequent supervisory and consultative papers have confirmed the Bank of England's preference for an Audit Committee. Also, in its capacity as a lead regulator under the Financial Services Act, the Bank of England has expressed a preference for the Audit Committee to review arrangements established by management for compliance with regulatory requirements.

In this regard as from November 1991 the NatWest Audit and Compliance Committee will have an additional function - that of approving the answers to be given by the Bank to IMRO in its annual *Statement of Representation*. This is effectively a Statement signed by the Chief Executive and Director of Group Compliance that the bank has complied fully with IMRO rules in the conduct of investment business.

Given that there is no universally accepted role for an audit committee it is essential that its terms of reference should be unambiguous. Ideally it may be worth considering publishing the terms of reference in the annual report, which some companies already do, alongside those of other board committees.

Nevertheless the need for corporate, as opposed to banking, Audit Committees remains a matter of self regulation. However the role which non-executive directors play in this context is pivotal to the Audit Committee process.

In 1987 the Treadway Commission in the United States, and more recently in 1990 the Bosch Committee in Australia, have both recommended the adoption of Audit Committees. Clearly the legal and regulatory climates are different in both of those countries, **but our strongly held view is that Audit Committees go a long way towards the reinforcing the independence of non-executive directors and providing the framework for more effective internal controls and external auditing. The terms of reference for the Audit Committee are therefore critical to its effectiveness * and it is recommended that the Cadbury Committee should distil a model set of terms of reference for use in the UK from existing sources, which can be modified to meet individual circumstances.**

Audit Committees are an effective means of increasing public confidence and are worthy of further attention from the regulatory authorities. **The London Stock Exchange (LSE) in particular should consider making the Audit committee * a listing requirement.**

* properly constituted.

* as is its membership.

c) Remuneration Committees

A Remuneration Committee is another example in which strong minded, well informed non-executive directors can add value to their company. They can also provide reassurance to shareholders and others that the long term interests of the business are being adequately reflected in pay and performance of the Executive. Service agreements for Executives should be agreed by the main Board and sealed by the Company Secretary. The NatWest Remuneration Committee recommends to the Board the emoluments of the Chairman, Deputy Chairmen and Group Chief Executive. It also recommends to the Chairman the salary ranges for the Executive Directors and Senior Management of the Bank. Transparency is an important part of the process and details of unexpired service agreements over one year are published in the annual report for the Executive Directors who will be proposed for re-election at the AGM.

d) Internal Control

Ultimately internal control of a company is the responsibility of the Board of Directors. To discharge this responsibility, the directors in all sizeable companies will need the support of an independent internal audit department, whose objectivity is unquestioned and preserved. The structures and reporting lines by which this is achieved should be reasonably transparent so as to provide external assurance of a well run company.

It is the responsibility of the Board to determine appropriate systems and controls for the company. Operating as it does in a directly regulated sector, National Westminster Bank is subject to conditions set by the Bank of England in this area. The relevant document is BSD-1987-2,"*Guidance Notes on Accounting and Other Records and Internal Control Systems and Reporting Accountants thereon*". The reporting accountants use this document as the basis of their review.

This document is extremely detailed and specifically relevant to banking. Commercial companies will undoubtedly have differing degrees of problems to resolve under the heading of Internal Control. Many of these areas, would, as a matter of course, be reviewed by the company's auditors. **Nevertheless, whether it be banking or normal commercial companies, all the internal control issues can be resolved into policy, policing and systems. As such, in view of the increasingly complex business environment, it would be a good idea for management to routinely report on how they control risks.** NatWest make such a report in the US 20F Form.

There is undoubtedly scope for standard practice in this area. The participants of the US Treadway Commission have issued an Exposure Draft, "*Internal Control - Integrated Framework*". **It is recommended that a standard framework for internal control should be established by the Cadbury Committee.**

Specifically the Audit Management letter prepared each year as part of the audit work could be made available for inspection by shareholders. Also the Directors could include a responsibility statement in the Report and Accounts for financial reporting and the controls and systems in place. Both matters could be dealt with by amendment to the LSE listing requirements.

e) Non-Executive Directors

i) **Status**

Whilst UK company law does not differentiate between executive and non-executive directors, it is now widely recognised that independent non-executive directors have an important role to play in the proper running of companies. NatWest strongly supports the presence of independent directors on company boards.

There are in existence comprehensive codes and guides addressed to non-executive directors, many of which are listed in the attached bibliography. It is apparent that these have proliferated to the extent that they have lost impact. There is a clear need at this stage for a definitive guide to be introduced which is both comprehensive and user-friendly. Clearly any such guide would not replace the need for non-executive directors to take separate legal advice. The question of separate legal advice is covered sensibly and sensitively in the January 1991 *PRONED Non-Executive Director letter of appointment guide.* It is an essential element in supporting the ability of non-executive directors to carry out their duties.

There should now be a concerted attempt to rationalise the general understanding of the concept and the scope of the term "Independent" as applied to non-executive directors and their duties. The New York Stock Exchange listing requirements include such a definition. It is not recommended that this become a formal requirement in the UK. However, public expectations need to be carefully managed as there is a tendency to over emphasise the role of "policeman" and under estimate the positive contribution well informed, strong minded independent directors can make.

ii) Information

Non-executive directors have a right to the same information as executive directors. Their right to consult senior staff and their right to consult a company's senior professional internal advisers should be acknowledged. **Professional codes for accountants and solicitors employed by companies covering their relationship with the board exist and should be more widely publicised.**

iii) Terms of Office

Questions also arise about the erosion of the independence of non-executive directors. Whilst it will not apply in every case, there should be a general level of agreement that an "evergreen" policy must be pursued in relation to non-executive directors.

To optimise the performance of the board a company will need to keep up a steady flow of fresh appointments. Suggestions such as the appointment of non-executive directors on a three year non-rolling contract and that non-executive directors should be employed for six years maximum have recently been put forward in the House of Commons. Others have suggested a quinquennial system. **The exact details of the terms of office of a non-executive director are not something easily turned into a formula, but we would expect the Cadbury Committee to put forward a recommendation on how "independence" can be best achieved and therefore preserved.**

In putting forward a recommendation, the Committee would have to bear in mind that the annual rotation of say a third of non-executive directors on its own could be counterproductive. It takes time to learn about a company before a useful contribution can be made.

Alternatively, there may a case for imposing restrictions on the number of active directorships one person may hold concurrently to avoid extremes which bring the system into disrepute. Following on from this selection procedures should include the question of motivation. Monetary reward is seldom the real reason for becoming a non-executive director. Mutual benefit to both company and non-executive director provides a strong foundation for preserving the principle of independence. **To aid shareholders and other financially interested parties, NatWest supports the idea of providing brief biographical details of each director in the annual report.**

v) Resignation

A number of company failures have been immediately preceded by directors' resignations and the infusion of the new directors can often have a counterproductive effect on the effectiveness of the company board. Clearly the performance of the board as a whole is crucial to the success of the company.

One issue which needs to be addressed is the circumstances in which it is appropriate to resign. Non-executive resignations tend to precede company difficulties. Ironically this occurs at the time they are most needed. It is recommended that there be guidelines on resignations.

vi) Directors Liabilities

Other problems may occur with directors' liabilities which potentially weaken the performance or induce the resignation of non-executive directors.

The uninsurability of some environmental risks and the growing uncertainties connected with directors personal liabilities has already been seen in the US. US experience with the *Van Gorkom* decision points to the potential for disruption to the board system if the matter is left to the courts to resolve.

There is clear evidence of the potential for concern amongst directors on the liability question which needs urgent legislative attention. The potential range of directors liabilities increases yearly and is capable of cutting across the whole corporate governance issue.

5. **Reporting on Performance to Shareholders and other financially interested parties**

a) Report and Accounts

Section 233 of the 1985 Companies Act, as amended by the 1989 Companies Act, provides that if annual accounts are approved, which do not comply with the requirements of the Act, every director of the company who was party to their approval and who knows that they do not comply or is reckless as to whether they comply is guilty of an offence and is liable to a fine. This section alone, however, will not guarantee the production of quality reporting for shareholders and other financially interested parties.

In terms of content in the UK, more could be done particularly in the Chairman's and Chief Executive's Statements to Shareholders in their Annual Reports to provide indicators of future prospects. In the US this is an obligation as a result of the Management Discussion and Analysis required for the 20F return to the SEC.

For industrial companies, the Management Discussion and Analysis process brings into play questions of:

- Disclosure
- Research and Development spend (required by UK Companies' Acts)
- Training spend
- Marketing spend
- Key industry issues
- Future prospects

The SEC has the right to call for the 20F return to be withdrawn and republished should it feel that there are any deficiencies. Also, it can request that companies include comment on specific topics.

In the UK many companies may not reach this level of disclosure until involved in a takeover bid or a new issue. This should be a more general practice and **we recommend that the Committee consider whether annual accounts should contain information based on the conditions set out in Section 3, chapter 2, part 7,1 of the Stock Exchange Admission of Securities to Listing requirements.** There may well be a case for the Stock Exchange making more general use of the powers it has under Section 1, Chapter 1, paragraph 9 to call for the publication of additional information and also the duty under Section 5, Chapter 3, paragraph 10 to give guidance on Annual Reports.

b) Corporate Governance of Groups

Unlike a number of European countries, the UK has not put in place the group as a legal entity. However, the concept of the Group is readily recognised in the banking supervisory regime and the Banking Act provides the necessary scope for action. Also the 1989 Companies Act implemented the EC 7th Company Law Directive on Consolidated Accounts. This legislation has curbed the extent of abuses using group structures, which was previously possible. To strengthen understanding, it is essential that the relationships and management policy within a group of companies are transparent and coherent.

From a corporate governance perspective there is worrying trend toward an increasing number of legislative actions on gróups aimed at "piercing the corporate veil". Examples include UK tax legislation and more recent environmental legislation such as the Environmental Protection Act and the Water Act. On an international level tax treaties and the EC tax directives create an extra-territorial perspective of group activity.

There is a danger of fragmentation leading to unwanted outcomes and also of a key issues for shareholders and financially interested parties being unresolved or aggravated to their detriment. There may come a time, therefore, when it is appropriate to review the situation.

However, the immediate concern should be to demonstrate that effective strategies, structures and systems are in place across a group of companies. The risks arising from group structures need to be closely controlled and therefore voluntary transparency aids confidence.

One practical step which may be considered on a voluntary basis is to put Audit Committees in place in appropriate subsidiaries. Neither legislation, nor external audit will provide adequate safeguards or assurances that International Groups are being properly administered. Only sound corporate governance can provide the answer.

c) Investor Relations

The statutory framework for investor relations in the UK is complex but imprecise and has been well set out in the *CBI Wider Share Ownership Task Force Report* published in 1989 and sponsored by National Westminster Bank. Many of these problems still exist and in particular the limitations posed by insider trading legislation were highlighted by many submissions to the recent House of Commons Trade and Industry Committee, Takeovers and Mergers Policy Review.

Sound investor relations can be achieved and promotes confidence in the company, but there may be a temptation to provide market-sensitive information to a restricted audience of investment analysts or institutional investors. Institutional investors would not, of course, welcome this if it were to be done without their permission as they would be forced to withdraw from the market.

The solution to such selective disclosure would appear to be the conduct of investor relations by the more frequent use of public announcements. This may well present the Stock Exchange with a greater workload and therefore logistical problems may have to be resolved.

The objective of investor relations is to enhance shareholders' understanding of the strategy, trading and management of the company. There should be clear guidelines within which this activity can take place effectively and legitimately. The current legal lacuna is unacceptable.

One solution which would reduce uncertainty is that there should be a new streamlined Stock Exchange event - "a suspension of dealings pending an announcement." The objective would be to allow full communication with all the key audiences and create a level playing field for information. It is quite wrong that some should be able to buy on the way up and to sell on the way down. This is a matter not satisfactorily resolved by Insider Trading legislation. The current rules in Section 1 Chapter 4 of the LSE listing requirements would need to be amended to meet this objective which would enhance public confidence.

This does not overcome the difficulty however of companies promoting their own shares. *The CBI Wider Share Ownership Report* makes it clear that there are legal obstacles to investor relations which need to be addressed before truly widespread ownership of industry in this country can be accomplished. In particular the Financial Services Act, the 1985 Companies Act (Section 151) and the underlying EC 2nd Company Law Directive.

Companies should be encouraged to develop clear communications policies for all types of shareholder. Also, to support such communication through the appropriate media and opinion forming groups especially investment analysts. The aim should be to promote objective comment and assessment as the essential pre-requisite to an informed market.

6. Role and Responsibilities of Shareholders

A number of critics have suggested that institutional investors who fail to take an active role in the governance of public companies have emasculated one of the key concepts of company law: that directors are responsible for their actions to the shareholders. There is no doubt that institutional ownership creates a potential difficulty in applying the classic model of UK Corporate Governance. A number of eminent commentators such as Peter Drucker have suggested that the proprietorial ground vacated by shareholders has been occupied by management and that this process must be reversed. Certainly the gap which exists in the UK between ownership and control is one which has created wide concern.

There are no strong arguments to suggest that a change of structure is necessary. The two tier boards structures in Europe with closely defined legal responsibilities do not fit well with our UK legal framework, culture or history. **Certainly, however, there is room for a change of behaviour and it is our view, therefore, that the Cadbury Committee can reinforce the message that there should be a strong dialogue at regular intervals between shareholders and companies.**

There has been a great temptation to allocate blame for short-termism in the UK which is neither helpful nor constructive. Again we draw the Committee's attention to the *CBI Wider Share Ownership Task Force Report* in which NatWest participated and its recommendations concerning the development of a clear understanding of and acceptance by shareholders of the strategy of the business and the type and scale of investment needed to support it.

In addition, major shareholders should ensure that they take active steps to assess the quality of management, as well as the strategy, current trading and longer terms plans of companies.

Shareholders should satisfy themselves that companies are being run by strong boards of directors. As shareholders ultimately have the power to sanction the appointment of both directors and auditors they are the only ones who can fill the gap between ownership and control.

Intervention by institutional shareholders should be seen as very much a last resort and perhaps as evidence that collaborative communication has broken down. It is recognised that institutions have a duty a maximise their financial gain and it is this that motivates them in taking an interventionist approach in a company's management. The increased tendency of institutions to discipline unsatisfactory company boards is to be welcomed. A constructive view by the institutions on corporate governance issues and regular dialogue would, in many instances, obviate the need for institutions to take decisions about the management of businesses.

The legal framework in which we operate in the UK gives shareholders ownership of a set of rights which they should be urged to exercise. These rights confer a set of responsibilities which need to be discharged.

This can be achieved by playing a formal part in the decision-making structure of the company. The active participation of all shareholders in decisions to dismiss and appoint directors, change the company's constitution as well as voting in general meetings, will add considerably to the quality of corporate governance. Abrogation of these responsibilities throws the basis of the system into doubt.

National Westminster Bank supports the nine key points contained in the Association of British Insurers Memorandum of 14 March 1991.

7. <u>Role and Responsibilities of Auditors</u>

a) <u>Independence</u>

The Companies Act sets out the procedures for appointment and removal of auditors. It will be noted from this that auditors are appointed by shareholders and in essence are therefore independent of management. The 1987 Banking Act supplements this process as far as banking is concerned by putting in additional notifications to assist the supervisory process in the event of the removal or resignation of auditors. An Audit Committee also has a role to play in ensuring the independence of auditors.

The legislation as it stands, however, does not go far enough to reinforce the concept of independence for auditors and an opportunity, therefore, exists for the Cadbury Committee to endorse this principle. **We do not recommend that independence is achieved by rotation of auditors after a certain number of years.** It is important that auditors should get to know the company and should understand its activities. This will enable them to compare the development and effectiveness of systems on a regular basis. The extra expense, disruption and inefficiencies inherent in winding down the work of one set of auditors and providing the necessary learning curve for another set, does not support the perceived benefits.

b) <u>Conflicts of Interest</u>

As with any professional activity there is clearly scope for conflicts of interest to arise during the auditing process. **This, however, is largely a matter for the individual firms' professional standards and professional etiquette of the accounting profession to resolve.**

c) <u>Consultancy Services</u>

We do not accept that there is any inherent conflict of interest or lessening of independence as a result of accountancy firms accepting consultancy work when they already act as auditors. It is extremely doubtful whether a prohibition of such appointments would achieve its objectives. There are a number of circumstances in which a firm's knowledge of the company it is auditing makes it particularly well qualified to undertake other activities on a cost-effective basis. **Disclosure of non-audit payments to auditors in the accounts provides transparency and this is our recommended way forward.**

d) Changing Auditors and Alternative Opinions

Seeking an alternative opinion on the application of accounting principles does occur in the UK. However, it can provide the basis for pressure upon an auditor's judgement and objectivity during the course of an audit. A change of auditors may, therefore, never occurs, so there is a need to reinforce the independence of appointed Auditors in this regard.

At present no formal standard of professional conduct exists in this area in the UK. The Committee's attention is therefore drawn to the Canadian Institute of Chartered Accountants exposure draft published in June 1991 covering this point. **We recommend that both technical and professional guidance be provided by the professional institutes of accountants on both change of auditors and alternative opinions which are inextricably linked.**

e) The Expectation Gap

The judgement in favour of Touche Ross in the *Caparo* decision, has created a situation which is fundamentally flawed if the accounting profession is to sustain the value of the auditing process. The distinction the House of Lords drew when holding that auditors do not owe a duty of care to potential investors, or to individual shareholders insofar as they may buy more shares on the strength of an audit report appears quixotic. It leaves a sense of real injustice. Whatever the niceties of the legal position there is clear evidence in the genesis of UK company law that the audit process was intended to benefit a wider group than the company itself.

We consider that it would not be unreasonable if, in exchange for an extension of responsibility, legislation imposed a ceiling on liability. However, this ceiling would have to be sufficiently onerous to ensure that audit standards do not suffer. There is genuine concern that unless this is resolved the accountancy profession will be faced with a scale of liability and the consequent difficulty of insuring against it which might not only impact upon professional charges, but also inhibit the objectivity with which the profession discharges its responsibilities and expresses its views.

There is great danger of unforeseen consequential changes arising out of any attempt to manufacture a duty of care. A piecemeal approach would be unhelpful in terms of restoring confidence. For this reason we recommend that the matter be referred to the Law Commission for review.

f) Questionable Accounting Practices

Naturally, there will always be a certain amount of tension between progressive views and questionable accounting practices or weaknesses in areas such as those the Corporate Affairs Minister, John Redwood, referred in April to the Accounting Standards Board (ASB); foreign currencies, leased assets, other off-balance sheet liabilities, goodwill and extraordinary items.

Similar findings emerged from a report prepared by the Head of Research at NatWest Investment Bank on "*Company Pathology*", which shows that very few questionable accounting practices are detectable from financial statements.

We must not forget that the Directors have primary responsibility for financial statements. The auditors merely express an opinion. However, the existence of questionable accounting practices undermines the credibility of the "true and fair view" for which auditors are responsible.

As a contributor to the Financial Review Panel, we are clearly interested in the enforcement process. Given the overall responsibility of directors for the report and accounts there is a case for stringent discipline to be imposed on both auditors and company directors. Directors must have a responsibility to adopt prudent accounting practices with adequate guidance from the ASB on the worst areas of abuse.

The important point is that a few highly publicised abuses are capable of damaging the reputation of the corporate community, hence the need for a stringent disciplinary regime.

g) Auditors' Report

There is a great temptation to seize upon the auditors' report as a means of overcoming other deficiencies. At the moment there is clearly a gap between public understanding of what an auditors' report is seeking to communicate and the purpose and limitations of the audit process. Unfortunately, the qualified audit report has become like a draconian measure , virtually unusable in any but the most extreme of circumstances.

Attempts to improve understanding by customising auditors' reports may prove to be detrimental to the quality of the audit process. Not only will they introduce problems of comparability and consistency, but they will create the circumstances in which auditors can be accused of developing a precedent to suit another client and therefore make alternative opinions and changing auditors a more commonplace occurrence.

Innovation in auditors' reports may prove difficult to sustain as it would soon become the norm and lose meaning. Nevertheless, there is a case for exploring ways in which the auditors' report could be made more useful in the context of supporting sound corporate governance. However, for the reasons of consistency and comparability stated above, this may not be fully achievable. **It is recommended that the Cadbury Committee investigate if there is some way that auditors' reports can give additional information on the quality of internal controls without destabilising the audit process.**

The Cadbury Committee could also perhaps take the opportunity to ensure a wider understanding of the tests and processes through which a company must pass in order to achieve a clean audit report.

Alternatively perhaps auditors should be required to report separately on the financials and the internal systems controls.

A further area worthy of consideration is that in the financial world the role and responsibility of auditors also includes that of submitting an annual report to regulators (such as IMRO) on the extent of compliance with certain conduct of business rules relating to investment business, ie the holding of clients money and documents of title to investments. This concept could certainly be extended in more general terms to the corporate sector where third party funds are held. A suitable regulator would need to be found.

h) Fraud and Illegal Acts - Confidentiality

It is significant that *Auditing Guideline* 418 suggests that an auditor may need to take legal advice before making a decision on whether to report a matter connected with the audit to a proper authority in the public interest. There are clearly two questions at stake under this heading:

- First the right or the duty of auditors to report on fraud or illegal acts
- Secondly the responsibility of auditors to detect fraud.

The Banking Act 1987, Section 47, creates the circumstances in which the auditor has the right to consult the Bank of England in such circumstances. Were this right to be converted to a duty, it would *ab initio* create a heavier burden on auditors to identify fraud. This would be unworkable as fraud is infinite and expectations of the audit process could never be met.

However, by the nature of their duties, from time to time auditors are likely to become aware of fraud. Traditionally auditors have always had the right to consult and to notify. *Auditing Guideline* 418 suggests that the point of consultation is the Investigation Division of the Department of Trade and Industry or possibly the Serious Fraud Office, the Police, the International Stock Exchange, the SIB and other SRO's.

Discretion must be left with the auditors to assess whether the magnitude of materiality of fraud or irregularity is sufficient to warrant comment or disclosure, bearing in mind that confidence in the company concerned could be undermined and the need to support "a true and fair view". This situation is even more delicately balanced with a financial institution. One of the difficulties for auditors in these circumstances is that public interest is not sufficiently identified and the question of reasonable certainty arises.

Suggestions that auditors should have no responsibilities stemming from these circumstances are unacceptable.

The law currently has not laid down any principles of when auditors do or do not owe a duty of care to a third party. **Nevertheless, our assessment is that public expectations currently placed too much onus on the audit profession in this area, given the uncertainty of qualified privilege available to them in normal circumstances and under Section 47 of the Banking Act, and also given the scale of damages to which they may subject themselves through breach of confidentiality. Confidentiality is therefore a key issue to be clarified for the audit profession.**

We do not recommend any action which would imperil the traditional candour of communication between management and auditor or the method of compartmentalisation by which auditing firms operate. **Nevertheless, the current situation with the duty of confidentiality and the lack of an informal consultation process with a regulatory body outside the accounting profession is one which needs to be reconsidered.**

8. <u>Management, Staff and other Stakeholders</u>

a) Written Codes of Corporate Conduct

Both the *Treadway Commission* in the US and the *Bosch Committee* in Australia recommend the development of written codes of corporate conduct to strengthen the ethical climate of companies.

Problems most frequently occur for companies when internal values fall out of line with those of their employees as individuals or the world at large.

The responsibility for the company's interface with the external environment falls squarely on the Board of Directors. It is commonplace in a modern company for the interest of various stakeholder groups to be managed, but UK company law places a fiduciary duty on directors to the company itself. There is a strong case, therefore, to make the process of stakeholder management as transparent as possible particularly where conflicts of interest arise. Arguably in financial services this is partially overcome through mandatory codes of conducts. However, there is a strong case for all companies to have a code of ethics to guide the corporate decision process, ensure robust reporting lines and set the tone for the business.

Further, the attention of the Cadbury Committee is also drawn to the Bank of England *Notice to Institutions* BD/1987/2, Section 3.3.3.c which calls for "a written code of officer and employee conduct and a policy statement governing conflicts of interest". In addition a written code of conduct is a strict requirement for investment business.

Appropriately the KPMG Peat Marwick McClintock publication, "*Audit Committees in the Financial Sector*" contains the following comment on the function of Audit Committees:

> "Review of the company's practice on business ethical matters, particularly in dealings with countries where business ethics differ from those in the UK."

In order to resolve potential conflicts of interest and to set the tone for corporate behaviour, it is recommended that the Committee include a recommendation encouraging written codes of corporate ethics, if necessary supported by more specific codes of conduct.

b) Professional Training and Education

The Bank of England *Notice to Institutions* BSD/1987/2, Section 3.3.3.d requires that:

> "a programme for training employees and arrangements to keep employees informed about their duties and any changes or developments in the institution; selection procedures designed to ensure that employees have professional and personal skills commensurate with their responsibilities; ongoing procedures for allocating responsibilities to appropriate employees and for reviewing their competence."

The issues of professionalism and professional standards crop up continuously in corporate governance literature. Whilst individual companies must maintain the option to train their staff, the key to maintaining and raising standards in the longer term lies with professional standards. The necessary skills, values and knowledge need to be imbued through a continuing process of professional training and education.

It is recommended that the Committee seek to give more prominence to the principles lying behind corporate governance in professional training whether in-house or through professional bodies.

9. **Regulatory Environment**

a) Standards

One of the comments we have received from our professional advisers is that the resources applied to regulation, whether they be statutory or self regulatory, do not always reach the high standards implicit in the motives which lie behind public policy.

In particular in the UK if the self regulatory environment within a statutory framework is to continue successfully, **regular attention needs to be paid to the quality of the regulators.**

Regular attention also needs to be paid to the regulators understanding of the markets for which they are responsible.

b) Cost

Whilst every effort should be made to minimise the cost of regulation, this should not be at the expense of public confidence. In the UK Regulatory bodies are now required by Section 204 of the 1989 Companies Act to have in place a "satisfactory arrangement for taking into account the cost to whom the rules would apply of complying".

Clearly with regulation there is a balance to be struck between cost effectiveness and credibility. As the situation in the US shows, statutory regulation is not a panacea. Neither is there a case for starving regulators of resources to the extent that they are forced to indulge in "trial by media" rather than pursue costly enforcement procedures.

c) Regulatory Gap?

Nevertheless, the current structure in the UK for corporate regulation is capable of being improved and it is recommended that the Cadbury Committee explore the extent to which self regulation with statutory backing can be extended to the corporate sector so as to facilitate dialogue on a range of corporate issues between boards of directors, regulators and auditors in a constructive atmosphere.

The present situation leaves auditors with too great a judgemental burden. To the extent that public expectations ascribe to both auditors, and non-executive directors, a "policeman" or "watchdog" role, there is perhaps a "regulatory gap". The need to preserve the entrepreneurial spirit and leaving scope for enterprise are important, but not at the expense of lack of public confidence.

10 Summary and Conclusions

a) Legal

A number of changes to the law are recommended. Three are designed to improve the climate for sound corporate governance in the areas of:

- directors' liabilities
- the principle of independence for non-executive directors
- investor relations and a level playing field for information.

The fourth area concerns the audit report and its value. The lack of clear principles on the question of the duty of care of auditors following Caparo Industries Limited v. Dickman is not conducive to the maintenance of confidence in the audit process. The legal position now looks unworldly.

Ad hoc changes or a piecemeal approach would inevitably lead to unforeseen consequences in such a complex area. For this reason it is recommended that the Law Commission review the position and make the recommendations necessary to restore public confidence in the audit process.

Finally it is recommended that the question of adequate privilege for auditors needs to be examined in the context of their duty of confidentiality and their traditional right to consult and notify.

b) Regulatory Environment

The key to self regulation within a statutory framework is active participation by all concerned. The trend towards administrative independence for regulators backed by statutory and therefore public accountability is one which is significant for the process of corporate governance.

The 1982 Gower Report declined to recommend the formation of a central regulatory agency such as the Securities and Exchange Commission in the USA. This should not be interpreted to mean that the resultant regulatory framework should in any way show deficiencies in determination.

Many of the recommendations in the submission are directed to the various elements of the regulatory framework and in particular cover the need for regulators to be:

- vigilant
- willing to use available powers
- concerned to provide high quality regulation
- seen to be enforcing the rules
- committed to challenging abuses.

c) Code of Good Practice

A set of guiding principles should be developed which will become the standard reference point for use by directors and others when considering their duties and responsibilities.

At the moment we are suffering a proliferation of statements and guidelines which although worthy in themselves, never seem to gain the great status or public recognition needed to determine the standard of behaviour or performance required. In order to rectify this situation, the support of all interested organisations and groups must be mobilised behind any new set of guidelines. To be fully acceptable, the Cadbury Committee must also seek Government endorsement and support to the promulgation of the guidelines.

The international dimension of the corporate governance debate should not be overlooked in terms of the need for international acceptability. The success of the UK economy is based on the success of our companies. The Cadbury Committee's ultimate objective should therefore be to take that which is best and to reinforce the principles of sound corporate governance.

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SECTION 3

CHAPTER 2

PART 7

The recent development and prospects of the group

7.1 Unless otherwise agreed by the Council in exceptional circumstances:– 7.1 (7.1)

(a) general information on the trend of the group's business since the end of the financial year to which the last published annual accounts relate, in particular:–

(i) the most significant recent trends in production, sales and stocks and the state of the order book, and

(ii) recent trends in costs and selling prices;

(b) information on the group's prospects for at least the current financial year. Such information must relate to the financial and trading prospects of the group together with any material information which may be relevant thereto, including all special trade factors or risks (if any) which are not mentioned elsewhere in the listing particulars and which are unlikely to be known or anticipated by the general public, and which could materially affect the profits. 7.2 (7.2)

Continuing obligations

9. A most important condition for listing is acceptance of the continuing obligations which will apply following admission. These obligations are set out in Section 5 and form the basis of the relationship between an issuer and The Stock Exchange, governing the disclosure of information necessary to protect investors and maintain an orderly market. Additionally, in order to maintain high standards of disclosure, the Council may require an issuer to provide to the Department for publication further information not specified in Section 5 in such form and within such time limits as they consider appropriate. The issuer must comply with such requirements and, if it fails to do so, the Council may themselves publish the information after having heard the representations of the issuer. 12.90

ANNUAL ACCOUNTS

10. The issuer must publish annual accounts within 6 months of the end of the financial period to which they relate together with an annual report if required by its national law. If the issuer has subsidiaries the accounts must be in consolidated form unless the issuer has in the past always presented accounts on another basis. The issuer's own accounts must be published *AD Sch.D A Para 3(a) & (b)*

in addition if they contain significant additional information.

AD Sch D A Para 3(c) **If the relevant annual accounts do not give a true and fair view of the assets and liabilities, financial position and profit or loss of the issuer or group, more detailed and/or additional information must be provided.**

10.1 In the case of an issuer incorporated or established in a non-member state which is not required to draw up its accounts so as to give a true and fair view but is required to draw them up to an equivalent standard, the latter may be sufficient.

Issuers which are in doubt as to what more detailed and/or additional information should be given, should apply to the Department for guidance.

Issuers having significant interests outside the country of incorporation may apply (through their sponsoring member firm) for an extension of the 6 months' period.

The foregoing may be summarised in the following principles of good practice:

1. Institutional investors should encourage regular, systematic contact at senior executive level to exchange views and information on strategy, performance, board membership and quality of management.

2. Institutional investors will not wish to receive price sensitive information as a result of such dialogue but will accept it on an exceptional basis as the price of a long-term relationship, although this may require that they suspend their ability to deal in the shares.

3. Institutional investors are opposed to the creation of equity shares which do not carry full voting rights.

4. Institutional investors should support Boards by a positive use of voting rights, unless they have good (and stated) reasons for doing otherwise.

5. Institutional investors should take a positive interest in the composition of Boards of Directors, with particular reference to:

    5.1 Concentrations of decision-making power not formally constrained by checks and balances appropriate to the particular company.

    5.2 The appointment of a core of non-executives of appropriate calibre, experience and independence.

6. Institutional investors support the appointment of Remuneration and Audit Committees.

7. Institutional investors encourage disclosure of the relevant details of directors' contracts.

8. In takeover situations institutional investors will consider all offers on their merits and will not commit themselves to a particular course of action until they have reviewed the best and most up-to-date information available.

9. In all investment decision-making institutional investors have a fiduciary responsibility to those on whose behalf they are investing, which must override other considerations.

To third parties

Confidentiality is an implied term of an auditor's contract. The duty of confidence, however, is not absolute. In certain exceptional circumstances the auditor is not bound by his duty of confidence and can disclose matters to a proper authority in the public interest (see paragraph 33) or for other specific reasons (see paragraphs 40 to 43). The auditor needs to weigh the public interest in maintaining confidential client relationships against the public interest in disclosure to the proper authority. Determination of where the balance of public interest lies will require careful consideration. In many cases, an auditor whose suspicions have been aroused will have to make a professional judgement on whether his misgivings justify him in carrying the matter further or are too insubstantial to deserve report. 31

Whilst 'public interest' is a concept recognised by the courts, no definition has ever been given by the courts. The auditor has to decide whether he considers disclosure of the matter is justified in the public interest. 32

Matters which should be taken into account when considering whether disclosure is justified in the public interest may include the following: 33

(a) the extent to which the fraud or other irregularity is likely to result in a material gain or loss for any person or is likely to affect a large number of persons;

(b) the extent to which the non-disclosure of the fraud or other irregularity is likely to enable it to be repeated with impunity;

(c) the gravity of the matter;

(d) whether there is a general management ethos within the entity of flouting the law and regulations;

(e) the weight of evidence and the auditor's assessment of the likelihood that a fraud or other irregularity has been committed.

The auditor may need to take legal advice before making a decision on whether the matter should be reported to a proper authority in the public interest.

34 Where it is in the public interest to disclose and where information is disclosed to an appropriate body or person and there is no malice motivating the disclosure, the auditor is protected from the risk of breach of confidence or defamation.

35 The auditor retains the protection of qualified privilege only if he reports matters to one who has a proper interest to receive information (per Denning in *Initial Services* v *Putterill* 1968). Which body or person is the proper authority in a particular instance will depend on the nature of the fraud or other irregularity. In cases of doubt, the auditor should consult the Investigation Division of the Department of Trade and Industry. Proper authorities could include the Serious Fraud Office, the Police, The International Stock Exchange, the Securities and Investments Board and the various self-regulating organisations under the Financial Services Act 1986.

36 The auditor also receives the same protection even if he only has a reasonable suspicion of a fraud or other irregularity. An auditor who can demonstrate to the court that he has acted reasonably and in good faith in informing the proper authority of a criminal offence which he thinks has been committed, would not be held in breach of duty to his client even if, an investigation or prosecution having occurred, it were found that there had been no offence.

37 Where the auditor becomes aware of a fraud or other irregularity which in his professional judgement he considers ought to be reported to the proper authority in the public interest, he should take the following action. He should ensure that the matter is drawn to the attention of senior management, including executive and non-executive directors and, if it exists, the audit committee, requesting them to report to the proper authority within a specified time. The auditor should subsequently obtain evidence to establish that the matter has been promptly reported. In the absence of such evidence, or if senior management refuse to inform the proper authority within the specified time, the auditor should report the matter direct to the proper authority.

38 In circumstances where there has been an occurrence which causes the auditor no longer to have confidence in the integrity of senior management, e.g. where he believes that a fraud or other irregularity has been committed or condoned by senior management or he has evidence of the intention of senior management to commit such a fraud or other irregularity, it may be inappropriate to discuss this matter with a more senior level of management such as the board of directors, or even non-executive directors or the audit committee. In such cases, where the auditor has decided that the matter should be disclosed in the public interest, he should report direct to the proper authority.

39 The auditor should satisfy himself that his decision as to whether to report and, if so, to whom, will stand up to examination at a future date on the basis of the following considerations:

- what he knew at the time;
- what he should have known in the course of his audit;
- what he should have concluded; and
- what he should have done.

The auditor should also consider any possible consequences in the event of financial loss occasioned by fraud or other irregularity of which he is aware or should be aware but decides not to report.