

SUMMARY OF RESPONSES BY ACCOUNTANTS

This note summarises the 24 responses received from accountants up to 14 August 1992. A full list of respondents is at Annex A.

General reaction to the report

Although all the respondents have criticisms on particular aspects of the report, 17 out of the 24 respondents comment to the effect that they are generally supportive of the report as a whole.

One respondent (Ernst & Young) does not express general support and their letter is not supportive in tone, although it does register agreement with many of the individual recommendations on audit.

The remaining 6 responses cannot readily be categorised as generally supportive or not. They are the Chartered Association of Certified Accountants (who say they support the spirit of the proposals but strongly criticise them as weak and imprecise); Pannell Kerr Forster (who regret the narrowness of the Committee's brief); and Reads & Co, C B Brayshaw, Jonathan Chaytor, and Noel Kelleway who make specific points but do not express a general view.

The Code of Best Practice, and statements of compliance (section 3)

Some (not all) respondents are worried whether the Code will be effective. The full range of views is as follows:

Chartered Association of Certified Accountants (ACCA): the general principles are laudable but the Code is too general and the mechanisms to ensure compliance are inadequate. The Code should be framed as a series of specific principles (as per suggested redraft of section 2 of the Code at Annex B). Rather than make a general declaration of compliance with a loose set of motherhood statements, companies should list the principles in their annual report and against each one should state the manner in which they have complied, and describe their corporate aspirations in that particular area, preferably in terms of quantifiable targets. In addition, the final version of the Committee's report must spell out the proposed methods of enforcement in detail. One available weapon is publicity.

Chartered Institute of Management Accountants (CIMA): the Code needs more status and should be made mandatory.

ICAEW support the approach of a voluntary Code. Believe it will lead to a raising of standards generally although it will not stop a determined law-breaker (neither would stronger statutory measures).

Institute of Chartered Accountants of Scotland: more detail should be given on how the enforcement mechanism will work in practice - eg how will the Stock Exchange ensure that non-compliance with the Code is publicised?

Arthur Andersen endorse the recommendation for a Code. The Code should be complete in itself. Companies should be required to make a general statement on corporate governance, covering in some detail how oversight and review is achieved, rather than make reference to a Code of general principles.

BDO Binder Hamlyn: financial corporate governance and communications between the company and its shareholders will not be improved merely by a requirement to report on compliance with the Code. 'We would prefer to see a requirement that boards make a general statement about how their companies are run. It will then be for shareholders to determine whether the mechanisms are sufficient and appropriate...'

Coopers and Lybrand expect most companies to take the Code seriously, but unless robust enforcement is put in place are less confident that it will be taken seriously by the kind of company that has previously been reluctant to put in place basic arrangements for good governance. Do not believe it is reasonable to place responsibility on the auditor for independent confirmation of compliance with those parts of the Code dealing with the constitution and quality of the board. The onus for endorsing the statement of compliance so far as it concerns the composition and quality of the board should rest with the City institutions collectively. Because institutional interests can differ, the Committee should recommend some kind of panel within the City to assist in the monitoring of compliance and provide a focus for instigating change where it appears to be required (cf the origins of the Takeover Panel).

Ernst & Young do not believe that Code will be effective. 'Directors and boards that have not thus far felt the need to abide by the principles of openness, integrity and accountability are unlikely to feel driven to do so now.' The requirement to publish a statement of compliance will cause directors to reflect on their standards of corporate governance. However such statements will inevitably be highly subjective. To be reliable they need to be based on relatively objective criteria.

'We are doubtful whether self-regulation can provide the robust and responsive framework necessary in today's business environment. We believe that the present regime, of government-sponsored self-regulation by various discrete bodies which appear to have little or no meaningful contact with each other, and to reach decisions almost entirely on the basis of consensus among the regulated, is failing to meet public expectations. While this situation continues, we do not believe the Committee's endeavours will bear fruit. Moreover, failure to implement a more effective regulatory regime in the UK now may well deprive the UK of the ability to influence future proposals which, we believe, will emerge from the European Commission for a European SEC.'

Grant Thornton support the Code. 'Although more radical proposals could have been made, experience shows that targets set need to be seen to be attainable to make a real impact in practice. We therefore applaud the level at which the Committee has set its sights. This level, with the proposed review after two years, offers the most effective way forward.

'As auditors, we know only too well that no systems of internal control or reporting requirements will totally frustrate the activities of rogues or the inept. Collusion, deceit, and concealment will evade any set of rules. The Committee should not be deterred in its efforts by those who expect its pronouncements to eliminate mismanagement at a stroke.'

Kidsons Impey support the 'essentially pragmatic' nature of the proposals.

Neville Russell: 'We support the idea of a Code but feel there will be a need for statutory backing for some aspects, eg the directors' report on the effectiveness of the system of internal control.'

Pannell Kerr Forster: 'We accept the concept of the Code but we are not clear as to its status and what if any is the effect of non-compliance.'

Price Waterhouse support the guidance aspects of the Code as helpful to directors, but have serious reservations about whether it is capable of being a device for regulating companies either directly or through the markets. The wording of the Code includes many subjective phrases which will lead directors, shareholders, auditors and regulators each to have their own understanding of the standards implied by the Code.

PW recommend that the report should clearly distinguish:

- general guidance to directors on the way in which Boards might act so as to fulfil their responsibilities to shareholders; and
- recommendations to standards-setting bodies and legislators as to the action they should be taking to improve corporate reporting.

A clear 'action plan' should be established with regard to the latter so there is no doubt as to responsibility for action. To maintain the momentum which the Committee has succeeded in establishing, the FRC should establish a standing committee forthwith to co-ordinate and promote implementation of the proposals and act as a catalyst for further change. (PW's suggested 'action plan' is at Annex C.)

Stoy Hayward support the approach of the Code, but in the absence of guidance on how failure to comply with the Code will be regarded, and the sanctions available, are not convinced that the proposed Stock Exchange listing requirement is appropriate.

Touche Ross fully support the Code and suggested review after two years. Critical to the chances of success are the proposed listing requirement, and publicity to statements of significant non-compliance.

Start date (3.7)

The ICAEW foresee difficulty in requiring reports on compliance as soon as recommended in the report (ie in respect of years ending on or after 31 December 1992). Guidance on reports on internal control and going concern will not be in place in time, and other action required, such as the appointment of NEDs, may also take time. The ICAEW suggest that companies should be expected in the first two years to report on the extent to which they have been able to comply with the Code, rather than on the extent to

which they have not. This could be supplemented by a statement indicating the company's plans to bring about full compliance. Grant Thornton take a similar line. BDO Binder Hamlyn would separate the proposals into those capable of implementation forthwith, and those requiring more detailed work and suitable for implementation in say two years' time. Arthur Andersen and Stoy Hayward would put back the start date to 31 December 1993. Pannell Kerr Forster think 31 December 1992 is unrealistic.

Endorsement by the auditors (3.10)

The Auditing Practices Board (submission at Annex D) argue that the auditors' endorsement should be restricted to those elements of the Code where compliance is capable of objective evaluation, and that for this purpose the Code should be divided into two sections, so as to identify clearly those aspects which are within the auditors' remit. So far as the qualitative aspects of the Code are concerned, the APB suggest that the statement of compliance should be considered and endorsed by the audit committee. The auditors should have a right (perhaps included as part of the Code) to attend the meeting and participate in the discussion. This would enable them to give of their experience without requiring them to make what would be seen as a public judgement on the performance of the board.

Many other respondents (ICAEW, Arthur Andersen, Coopers & Lybrand, Ernst and Young, Neville Russell, Pannell Kerr Forster, Price Waterhouse, Stoy Hayward) comment that it would be impractical for auditors to report on the quality of their clients' standards of corporate governance. Touche Ross would support an auditors' report but suggest that it should take the form of negative assurance ('the auditor is not aware of anything to indicate that the directors' statement is unreasonable in all the circumstances'). BDO Binder Hamlyn suggest the question of an auditors' report is put off to the two year review.

Review of the Code (3.13)

The ICAEW stress that the group appointed to examine compliance must scrutinise whether compliance has been whole-hearted and not simply a matter of **form**. The ICAEW hope that future revisions of the Code will not lead to it becoming too detailed and prescriptive. The ICAS suggest that the group should inter alia consider the extent to which the Code has been taken up by

non-listed companies. CIMA suggest that the reference in 3.13 to 'whether the Code needs updating' should be replaced by 'whether the Code needs strengthening'.

Small companies (3.16) and companies other than listed companies (3.1)

Several respondents (the ICAEW, Clark Whitehill, Neville Russell, and Pannell Kerr Forster) note the costs of the proposals in the Code for smaller companies and question whether they should be expected to comply fully. Clark Whitehill suggest that companies below a certain threshold should be exempted (perhaps with the concurrence of the shareholders) or they should be allowed a much longer time span over which to introduce the changes. Neville Russell would wish to promote a 'scaled down' version of the Code for the majority of their clients.

Grant Thornton state 'We have been contacted by a number of small listed companies, with large family holdings, who argue that the report is based on the assumption that directors and shareholders are substantially different and that the proposals are designed to increase the accountability of the one to the other. They argue that where the two are essentially the same, the problem of the remoteness of the board from the shareholders does not exist, and applying a cost-benefit test they see a potentially large cost, as well as an invasion of privacy, for little benefit to shareholders. Grant Thornton continue 'whilst understanding their concern, we do not support the argument. Family companies that are listed are accountable outside the family shareholders, and must recognise that the cost of complying with the recommendations is a cost of having shares listed, with all the potential benefits that brings.' On the cost of employing NEDs, Grant Thornton say that the report should seek to convince small listed companies that the benefits of NEDs outweigh the costs, and that there should be recommendations aimed at small listed companies on how many NEDs would be appropriate and what their roles should be.

The ICAS suggest that large private companies should specifically be encouraged to abide by the Code. The ICAEW would like to see a closer definition of the types of unlisted entity that would be expected to meet the Code (including eg some charities and pension funds).

The Board (section 4)

A number of responses echo companies' concerns that the report draws too great a distinction between the responsibilities of executive and non-executive directors and undermines the concept of a unitary board: the ICAEW, BDO Binder Hamlyn, Coopers & Lybrand ('We do not believe that there is a satisfactory half-way house between the two-tier board and the collegiate board'); Ernst & Young ('If NEDs are to assume the responsibilities proposed by the Committee, it will be necessary to bring the law into line'); Pannell Kerr Forster ('The vision of the non-executive is that he is there to dismiss the chief executive should this prove necessary rather than provide positive input to the future direction and success of the company'); Price Waterhouse; and Stoy Hayward.

Touche Ross suggest that one way of helping to meet such concerns, especially in relation to the audit committee, would be to include in the Code a requirement that the auditor should attend the board meeting each year which approves the annual accounts.

Arthur Andersen have written as follows:

'Under the present system, the unitary board has three quite separate functions - 'supervision' (the oversight and review of the entity's business, management and its financial and reporting policies), 'control' (implementation of management policies), and 'management' (the actual conduct of the business).

'The report and ensuing debate indicate quite fundamental differences of view of the role of the board in discharging these functions. At one extreme, the board is viewed as solely an oversight body concerned only with supervision. While executive members of the board have responsibility to control and manage the business in their capacity as executives, as board members their role should be that of supervision and oversight. At the other extreme, the board is viewed as concerned only with control and management and, while non-executives may have some oversight responsibility as board members, their primary role is to share with the executives the control and management of the business. This latter view is one which is widely held by management.

'Since corporate governance is primarily concerned with 'supervision', the report needs to be much more forthright with respect to the supervisory function of the board. We suggest that the final report

- be unequivocal on the need for supervision rather than seek to achieve supervision by specific procedures;
- clarify the objectives and procedures that fall with the supervisory function and recommend that in all circumstances, the supervisory role be led by a specific NED;
- make clear that the primary responsibility for the supervisory function of the board rests with the NEDs.

'The report is predicated on the view that the unitary system is appropriate and the unitary board is itself capable of fullfilling the supervisory function. While we accept that the recommendations in the report will facilitate supervision, it is disappointing that it does not discuss the advantages and disadvantages of alternative forms of governance and encourage experimentation. In particular, its acceptance without discussion that the unitary board can realistically fulfil the roles of supervision, control and management in all circumstances is open to challenge....

'We believe it is misguided to prescribe a single format for corporate governance. We suggest that the report should

- encourage alternative forms of governance and experimentation, such as two-tier boards or the use of substantive committees made up of NEDs;
- recommend to government that the law be changed to permit the use of some form of two-tier structure.

The ICAS have written as follows:

'Given the need to make practical recommendations for improvement in corporate governance in the short term, the report quite correctly makes its recommendations within the existing one-tier board structure. We firmly support the concept of NEDs who can bring independence, knowledge and control to the board...

'We believe that, in the longer term, we should not lose sight of the unitary versus two-tier board debate. The arguments for a unitary board are well-rehearsed in the UK, but this is not the case with the two-tier

board. Such debate as has taken place has been flavoured by an over-emphasis on the 5th Directive worker participation aspects. The applicability of the two-tier board to the UK economy is worthy of a more balanced investigation.'

The board must meet regularly, retain full and effective control over the company and monitor the executive management (Code 1.1)

Kidsons Impey propose that the Committee should recommend that sufficient notice must be given of all board meetings, and that companies should set a quorum of NEDs at board meetings.

Combined roles of chairman and chief executive (4.6 and Code 1.2)

Ernst & Young, Kidsons Impey, and Neville Russell say the Committee should come out firmly against combining the two roles. Arthur Andersen on the other hand endorse the Committee's line, and recommend that the 'appointed leader' should be designated as deputy chairman.

CIMA accept the Committee's line in general but comment that there is insufficient evidence to show that a clearly accepted division of responsibilities is always appropriate, and that in some cases it could increase costs and top loading. They call for further investigation to be undertaken so that conclusions are available for the review in two years' time. The investigation should include examination of the use of non-executive chairmen.

Role of Executive Directors

The ICAEW would like to see more attention paid to the role of executive directors in financial corporate governance, especially finance directors. Neville Russell comment 'the role of all directors is important and they are all expected to behave with integrity. We must not lose sight of this fact in an effort to strengthen the role of the NED.'

Role of Non-Executive Directors

Grant Thornton support the general objectives of widening the role of NEDs, but point out that they can be appointed for many different reasons, including eg the knowledge of the industry or how business is carried out in a particular country. To involve them in board committees such as audit and remuneration committees may not be the best use of their time or talents. The report should recognise that NEDs can be appointed for various reasons and should encourage companies to gain maximum benefit from them. The report should also recognise that NEDs quite properly want their companies to succeed and they should not be required to bring an 'audit mentality' to the table.

Ernst & Young argue strongly that by emphasising the control function of NEDs and encouraging unrealistic expectations of them, the Committee may actually discourage the best-qualified NEDs from serving on any but the best-run companies for fear of negligence claims if the company subsequently experiences difficulties through fraud or incompetence.

The ICAEW would wish to find some way of limiting the number of non-executive directorships that can be held by an individual. Pannell Kerr Forster believe that NEDs should be entitled to take on as many posts as they can sensibly handle but that their reappointment should depend on the positive support of the executive directors.

Supply of NEDs

A number of respondents comment on the supply of suitably qualified NEDs. Ernst & Young and Stoy Hayward very much doubt that adequate numbers are available. The ICAEW suggests the Committee should encourage companies to spare full-time executives for NED duties elsewhere. Arthur Andersen say that what will be needed is a substantial change in corporate ethic, whereby business recognises a broad public duty to make appropriate executives available. Touche Ross and Grant Thornton say there is a case for recognising that the board of a small listed company can be a valuable training ground for the senior staff of a larger company (eg divisional directors being groomed for full board involvement), to the mutual advantage of both. Touche Ross add that there is nothing in the report about the relative benefit to companies from choosing their NEDs from those with current hands-on management experience compared with those who specialise in acting as NEDs in a number of companies.

Liability of NEDs (4.3)

CIMA comment that their report "Non-Executive Directors: Their Value to Management" identified that some well-qualified and able people might be deterred from taking up non-executive directorships because in law part-time NEDs carried the same responsibilities as their executive colleagues. 'The legal obligations and responsibilities of NEDs need to be identified and differentiated from those of executive directors. The report should specifically encourage follow-up action on this.'

Arthur Andersen also recommend consideration of whether the present position whereby all directors are equally responsible for the board's actions and decisions should be amended.

Independence of NEDs (4.9, 4.10, and Code 2.2)

Ernst & Young believe the thrust of the recommendations should be towards independent directors rather than non-executive directors; and that the shareholding of independent directors should be no more than nominal. Grant Thornton would like to see guidance on what independence means, and on the borderline between executive and non-executive. CIMA comment that companies will often want to appoint NEDs who have a knowledge of the industry in which they are operating. Since they will not wish to appoint the executive directors of competitors as NEDs, they may look for the necessary expertise among the executive directors of customers and suppliers. CIMA say that 2.2 of the Code would appear to prohibit this, but should not be allowed to do so. However such NEDs should not be eligible to serve on either the audit or remuneration committees. CIMA also comment that no dependence on fees should be created. Fees earned by executives of another company should generally be for the credit of that company, and whatever arrangements are in place should be exposed for shareholder approval.

An agreed procedure for NEDs to take independent advice (4.12, Code 2.4)

Pannell Kerr Forster suggest that all directors should be covered by some form of legal advice insurance. On the question of establishing an agreed procedure, CIMA suggest that channelling through the audit committee could be a way forward and should help to ensure co-ordination among the NEDs.

NEDs should be selected through a formal process and their nomination should be a matter for the board as a whole (4.13, Code 2.5); nomination committees (4.24)

Arthur Andersen support the Committee's line. Kidsons Impey comment that membership of the nomination committee should be disclosed in the annual accounts. Stoy Hayward are not in favour of nomination committees.

Directors' Training (4.15 - 4.16)

Stoy Hayward would like more consideration given to the need for proper and effective training for directors. 'It is essential that directors have not only relevant skills, but also fully understand the responsibilities of stewardship and governance.... We believe that some mandatory attendance, and success, at some specialist educational establishment should be the basis on which individuals are allowed to act as directors.' The Association of Authorised Public Accountants argue that initial training for new board members is not enough, and recommend that the directors of listed companies should undertake ongoing training to update knowledge and skills. CIMA propose that there should be a specific recommendation that all directors should ensure they are fully aware of their duties and obligations and that they should receive appropriate training.

Fitness of Directors (not covered in draft report)

Price Waterhouse recommend that companies should be required through the continuing obligations to satisfy the Stock Exchange that their directors are 'fit and proper persons' for the office they hold; and that monitoring procedures should be established.

Boards should have a formal schedule of matters reserved to them for decision to ensure that the direction and control of the company is firmly in their hands (4.19 and 4.20, Code 1.4)

Comments are as follows:

ICAEW: an obvious point is that the schedule should be distributed throughout the company, not just to the board. The schedule might include decisions on business strategy, and business plans.

ICAS: the schedule should be made available to the shareholders, perhaps by way of inclusion in the annual report.

Pannell Kerr Forster: material guarantees must be a matter reserved for the board.

Statement of directors' responsibilities (4.22, Code 4.5)

Neville Russell and Stoy Hayward agree that an explanation of the respective duties of directors and auditors will be useful. The ICAS suggest that the model in Appendix 2 should be considered for review in 4 to 6 years time.

Codes of Ethics/Statements of Business Practice (4.23)

Kidsons Impey would like the Committee positively to recommend that such documents should be drawn up, rather than merely saying they are good practice.

Directors should report on the effectiveness of their system of internal financial control, and auditors should report on their statement (4.26, 5.16, Code 4.2)

Comments on balance support the recommendations, although there is concern that the Committee does not say what it means by 'internal financial control' (or 'internal control'), and that the recommendations will increase audit costs:

The ICAEW report that they have set up a working group in conjunction with the ICAS and the Hundred Group of Finance Directors to provide guidance on reporting by company boards on internal controls.

The APB state that the Board will form a working party to bring forward proposals for an auditing standard on reports by auditors on the directors' statement on the effectiveness of internal control systems. The project will be co-ordinated with the work of the ICAEW-led working party.

The ICAS welcome the recommendations. They comment 'No one model of internal control can apply to all companies. We therefore suggest that the directors' report should reflect what actually happens in the company rather than having a standard imposed applicable to all companies. Also, the cost/benefit analysis as to the appropriate system of internal control must be tailored to suit the company.'

The Chartered Institute of Management Accountants (CIMA) argue that the report's treatment of internal control and internal audit is inadequate and that it is inconsistent in the use of the terms 'internal control' and 'internal financial control'. They point out that much work is being done to establish a framework for internal control (eg CIMA's Auditing Group's forthcoming "Statement on a Framework for Internal Control"). They state that the report should take this into account and give positive encouragement to its further development.

Arthur Andersen endorse the recommendations. 'So that there can be no doubt as to their breadth, we suggest that a definition of internal financial control be included so as to emphasise that it embraces not only the safeguarding of assets but also addresses the management information needed to control the business.' Arthur Andersen would like to see legislative backing for the recommendations.

BDO Binder Hamlyn: 'We firmly believe that this proposal is not capable of implementation in the short term and would encourage further research and consultation on this issue.'

Clark Whitehill: 'Although the report hopes that the accountancy profession and others will draw up criteria for assessing effective systems of internal control, we fear that the result will nevertheless be the declaration of a bland statement which will soon become meaningless.'

Coopers & Lybrand support the recommendation, subject to resolution of their concerns about liability (see under 5.31).

Ernst & Young support the recommendations in principle.

Grant Thornton agree that legislation should be considered only in the light of experience.

Kidsons Impey suggest the report should give a clearer indication of what constitutes financial controls and what constitutes non-financial controls.

Neville Russell: 'A report by the directors would be very useful but it would represent a fundamental change in the nature of an audit for auditors to report positively on the internal controls. This change and its consequent difficulties and expense should not be underestimated.'

Stoy Hayward support the recommendations.

Touche Ross: research into the levels of cost might be advisable. 'The final report should recognise fully the probable extent of the burden, not least in respect of smaller listed companies.'

Audit Committees (4.27 to 4.31; Code 4.1, 4.7)

Audit committees are generally supported but a range of views is expressed on particular aspects as follows:

BDO Binder Hamlyn, Pannel Kerr Forster, and Touche Ross oppose the suggestion that membership should be confined to the NEDs. Coopers & Lybrand also see audit committees in the context of a collegiate board. They state that audit committees are complementary to, not a substitute for, discussion by the full board. They suggest more prominence should be given to this point and that (a) the auditor's first line of access on sensitive issues should be to the chairman provided he or she has sufficient independence; and (b) the whole board should give sufficient emphasis to discussing financial reporting and control matters, with internal and external auditors present from time to time.

The ICAEW stress the importance of business experience for audit committee members. They do not believe however that retired executives, or retired partners of audit firms, should be eligible for membership.

Arthur Andersen propose that the report should contain a clear statement of the purpose and responsibilities of audit committees, rather than just

a recital of their tasks, namely

- understanding, assessing and monitoring the overall control environment;
- promoting sound financial reporting;
- upholding standards of business conduct.

This would help in judging what makes an audit committee effective.

BDO Binder Hamlyn comment that auditors should meet the full board at least annually to discuss any problems arising from the audit and any matters which the auditors wish to bring to the board's attention.

Ernst & Young comment that the quality of audit committees is extremely variable, in part because they can only be as effective as the board/chairman/chief executive/finance director allow them to be, and in part because the task of serving on an audit committee is very demanding and many current members are not of sufficient calibre.

Pannell Kerr Forster see no merit in a formal meeting with the auditors once a year without any executive director present. Auditors should be encouraged to raise issues in the presence of the executives rather than in their absence. On the few occasions where a need to raise matters privately does arise the auditor should, and in practice does, have a right of audience with the senior NED.

Stoy Hayward do not believe audit committees should be mandatory for all companies, irrespective of size. Neville Russell also question their practicability in smaller companies.

CIMA believe that audit committees should be mandatory for all listed companies and nationalised industries, and that the audit committee should report annually to shareholders through the annual report. ACCA echo this line, and argue that the audit committee should be truly independent and not overly sub-ordinated to the main board.

Internal audit (4.31)

Comments are as follows:

The Chartered Association of Certified Accountants (ACCA): 'The draft should make a much stronger assertion of the need for strong internal

controls, and, in particular, for an effective internal audit function. It is mainly through the latter function that directors can have an effective knowledge of the affairs of their company or group. All major companies should be required to have internal audit departments. They should be required to report on their system of internal control and its effectiveness.

'The effectiveness of internal audit will depend upon its relationship with management. If it is subservient and insufficiently or poorly staffed, it will be ineffective. Internal audit is one of the internal control functions that external auditors may need to report on.

'The internal audit department's reporting line is a key component of effectiveness. The draft should recommend that the internal audit department reports either to the audit committee or to an NED who is a member of that committee.'

The Chartered Institute of Management Accountants (CIMA) make a similar case. 'It is desirable for companies to have internal audit functions as they are an effective way of ensuring that internal controls work in practice and that they are adhered to. This should be stated. Through reliance on internal audit, external auditors are also better placed to appraise the overall effectiveness of internal control. It should be at the heart of the final report.'

Disclosure of board remuneration (4.32, and Code 3.2)

A variety of comments, as follows:

Arthur Andersen state that separate disclosure of performance-related elements should apply to all directors and not just the chairman and highest-paid director.

Ernst & Young see no reason why disclosure of the emoluments of the highest-paid director should be restricted to the highest-paid UK director.

The ICAEW say that where employees who are not directors earn more than the highest-paid director, information on their remuneration should be disclosed in bands, so that shareholders should be able to follow up the matter.

The ICAS suggest that executive and non-executive directors should be shown separately in the remuneration bands disclosed under the Companies Act.

Arthur Andersen and BDO Binder Hamlyn comment that disclosure should cover share options.

Directors' service contracts (4.33; Code 3.1)

Coopers & Lybrand support the recommendation. BDO Binder Hamlyn do not believe that service contracts should exceed 3 years even with shareholders' approval. CIMA propose that service contracts should not exceed one year except with the agreement of shareholders

Remuneration Committees (4.34; Code 3.3, 4.7)

Ernst & Young comment that membership should consist of independent NEDs. Kidsons Impey say membership should be confined to NEDs, and chairmanship should be voted on at the AGM. CIMA comment that the chairman and chief executive of the company should attend meetings of the committee and contribute to its deliberations; and that the committee should have responsibility for confirming the appointment of senior personnel.

BDO Binder Hamlyn and Stoy Hayward do not believe that the mechanism of remuneration committees should be mandatory for all companies. CIMA believe that it should.

Financial Reporting (4.38 ff)

The ICAEW state that a number of their members who are company directors are concerned that the provision of ever more detailed information in company reports will lead to serious competitive disadvantage vis-a-vis competitors in continental Europe.

Kidsons Impey would like to see more stress on the necessity for complete explanation and disclosure of significant accounting treatments, rather than the need to narrow the scope for alternative treatments.

Stoy Hayward support the view that it is the board's duty to present a balanced and understandable assessment, but would like to see further guidance as to what is required.

Operating and Financial Review (4.44)

Coopers & Lybrand support the ASB's proposals for an OFR in principle. They suggest the Committee should recommend how the objectivity of the review can be assured, for example by a requirement for auditors formally to review it.

Ernst & Young dispute that the OFR should be essentially forward-looking. The purpose of reports and accounts is to report on stewardship. Companies should be required to discuss their past performance and current position, including known trends, events and uncertainties that are reasonably expected to have a material effect.

CIMA would like the proposed OFR to be specifically required under the Code.

Quarterly reporting (4.46)

Arthur Andersen and Ernst & Young recommend a move to quarterly reporting, commenting that it would restore some of the present imbalance between institutional and non-institutional shareholders and reduce the ability of companies to manipulate market expectations.

Interim reports (4.47)

The inclusion of balance sheet information in interim reports is widely supported (by the AAPA, CIMA, Arthur Andersen, Coopers & Lybrand, Ernst & Young, Kidsons Impey, Pannell Kerr Forster, and Stoy Hayward).

The following would also support inclusion of cash flow information: AAPA, CIMA, ICAEW, Arthur Andersen, BDO Binder Hamlyn, and Ernst & Young. The ICAEW comments that companies are accustomed to publishing cash flow statements in their annual reports and have the necessary mechanism in place to collect the relevant information and process it. The cost of providing the information half-yearly should not therefore represent a significant cost burden for companies.

The proposal that the interim report should be reviewed by the auditors is also widely supported, although a number of respondents (eg BDO Binder Hamlyn, Coopers & Lybrand) argue that the recommendation should not be put into effect until the APB has developed appropriate review guidance, and procedures to collect the relevant information have been established in clients. Coopers & Lybrand suggest a start date of interim accounting periods ending 30 June 1994.

The Auditing Practices Board (APB) sees no obstacle in principle to the development of review guidance. It comments that interim financial statements in the USA are subjected to review by the auditors. The report is expressed in terms of 'negative assurance' and thus clearly distinguished from an audit. The US approach indicates clearly how a standard for review of interim reports could be developed in the UK. It will be important however, in working up requirements, to ensure that they do not cause any delay in making interim results available to the market. The ICAEW note that the Committee is silent on whether the review report on interim statements should be published, and comment that public reporting would involve higher costs.

The APB sees a need for greater clarification of the accounting rules which would apply to the preparation of interim reports (eg in respect of items occurring unevenly such as seasonal revenues and expenditure) and recommends that the Committee should request the Accounting Standards Board (ASB) together with the Stock Exchange to clarify the rules. Arthur Andersen also see a need for urgent guidance on the accounting principles to guide the

preparation of interim financial statements. The ICAS state that they would support a general review by the ASB of the content of interim reports before the consequential audit issues are addressed by the APB.

Preliminary announcements (not covered in draft report)

The ICAEW state that research exists to show that preliminary results are of more importance to capital markets than the annual accounts. In practice, most preliminary announcements are not published until management has the auditors' assurance that audit work is nearly complete and that any significant areas of uncertainty or disagreement have been resolved. The Committee should recommend that explicit audit approval of preliminary results should be made a Stock Exchange listing requirement. BDO Binder Hamlyn say that preliminary announcements should be extracts from audited accounts and should not be made until the audit is complete. The full accounts should then be issued within a maximum of 21 days. This would avoid false expectations being created in the market

Timeliness of reporting (not covered in draft report)

Arthur Andersen and Ernst & Young believe that the periods currently allowed by the Stock Exchange are too generous. The period for issue of the annual and interim accounts should be reduced from 6 and 4 months respectively to 3 months in both cases. The ICAEW propose that the deadline should be 4 months in both cases.

Pensions Governance

Arthur Andersen agree that the Code should not contain any recommendations about pensions fund governance. They consider it premature for the report to state that it should be the duty of boards to ensure that there is separate governance of the company and its pension fund.

Auditing (section 5)

The 'expectation gap' (5.4)

Ernst & Young argue that there is also a financial reporting expectation gap (reflecting widespread misconception about the nature, purpose and inherent limitations of accounts) which lies at the heart of the problem.

Present regulatory arrangements (5.5)

Touche Ross believe a strong case can be made for bringing the Auditing Practices Board and the regulation of auditors under the auspices of the FRC. Price Waterhouse agree in respect of the APB.

Quarantining of audit services (5.10 to 5.11)

ACCA agree the Committee's position, although it would like to see the justification argued more persuasively. ICAS believe the Committee does not go far enough. 'The onus should be on the auditor to demonstrate his independence and we recommend that auditors be encouraged to suggest enhanced disclosure (eg the nature of the various services provided). This matter could be raised with management at the time of the disclosure.'

There is agreement that auditors should not be prevented from providing non-audit services to their clients. Pannel Kerr Forster comment that the crucial point is that the client should be able to get the best advice he can from whatever source he wants and not have artificial business restrictions imposed upon him. Coopers & Lybrand would like to see an explicit statement by the Committee that auditor independence is not compromised by the provision of non-audit services.

The recommendation that the Regulations under the Companies Act on disclosure of non-audit fees should be reviewed and amended as necessary has attracted the following comments:

Arthur Andersen do not believe that disclosure will provide useful information but nevertheless agree that where non-audit services are supplied to overseas subsidiaries of the UK client, it would be logical to include them in the disclosure, provided that they are supplied by the same firm and not by a non-affiliated practice.

BDO Binder Hamlyn would like the recommendation to go further: 'not only should the audit and non-audit fees involving the auditor of the parent company be disclosed, but also all fees paid to all other auditors within the group.'

Coopers & Lybrand oppose disclosure arguing that it will distort competition in the business advisory market and may result in a net loss of business from auditing to non-auditing firms. They comment that the UK accounting profession has long had a tradition of successfully providing broader business advice, thereby contributing much to the economy.

Ernst & Young support full disclosure.

The ICAEW are content for disclosure to cover total fees paid by the group worldwide, but not details of what proportion these fees bear to the total fees of the audit firm. They suggest that the recommendation is unclear on this point.

Rotation of auditors (5.12)

The ICAEW announced when the Committee's draft report was published that it planned to carry out follow-up work on the proposal that the profession should draw up guidelines for periodic changes of audit partners, with a view to the possible production of ethical guidance through the Joint Ethics Committee.

Support for the recommendation comes from the ICAS, the Association of Authorised Public Accountants, Arthur Andersen, BDO Binder Hamlyn, Coopers & Lybrand, Ernst & Young, Neville Russell, Stoy Hayward, and Touche Ross. CIMA and ACCA agree that the recommendation deserves further consideration. Touche Ross comment that in the best interests of the client, guidance should not preclude the rotated audit partner from some continuing role as advisor to the new lead partner, in order not to discard the detailed knowledge of the client's business built up over several years. Stoy Hayward believe rotation

of audit partners and managers should be a matter for the audit firm, and not prescribed. CIMA comment that companies can and should call for presentations from their auditors; and that the audit profession could make more use of, and give more prominence to, independent partner reviews.

Opposition comes from the following:

Grant Thornton: the recommendation will not add to the quality of the audit, except in the public perception. Fresh approaches are constantly being brought in by changes of audit staff and usually by the involvement of more than one partner.

Kidsons Impey: 'It is quite a usual pattern in a job of any size for a partner to be first introduced at a junior partner level and perhaps become the partner in charge when a senior partner retires and continue in their role as senior partner in charge for 15 to 20 years. Most firms however will ensure that there is an independent review by other partners of the work carried out and indeed this is required under Audit Regulations. In our view it would be damaging in the extreme if there were arbitrary guidelines requiring partner succession after a fixed period of years.'

Pannel Kerr Forster fear change for change's sake and recommend a more informal system whereby the audit committee satisfies itself as to the independence and criticality of those involved in the audit.

Reads & Co would prefer a system within the firm 'whereby firstly there is a second partner opinion on any problem areas that arise, and more particularly that a second partner does a review of the accounts and various papers before the audit report is signed off.'

Extension of the auditors' role and costs/benefits (5.15 and ff)

General comments are as follows:

The Auditing Practices Board: some widening of auditors' responsibilities is sought by many. When contemplating changes, however, consideration must always be given to the costs and benefits. It is also necessary to keep in mind the trade-off between widening auditors' liabilities and keeping their legal liability within reasonable bounds.

Touche Ross also point to the need to balance costs and benefits and urge the Committee to refer to this in the final report.

Directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary, and auditors should report on their statement (5.18 to 5.23; Code 4.6)

Comments on balance support the recommendations, but a number of detailed concerns are expressed and two respondents suggest that a way forward will depend on negotiations with the banks:

The ICAEW report that they have set up a working party in conjunction with the ICAS and the Hundred Group of Finance Directors to provide guidance for companies on the use of the going concern basis.

The ICAS are pleased to see the recommendation, but are under no illusion as to the difficulty of implementing it. 'For instance, having come to the opinion that the disclosure of uncertainties by the directors is inadequate, the auditor will have to disclose matters in the audit report. Great care will be needed to ensure that the disclosure does not bring about a failure which otherwise would not have happened.' The ICAS go on to note that a company may be particularly susceptible to going concern problems given the ability of banks to reclaim facilities on demand, and recommend that there should be a re-examination of the banks' ability to give comfort in relation to the going concern basis.

The APB comments that it issued an exposure draft of a proposed auditing standard on Going Concern in May 1992, which is entirely compatible with the approach taken by the Committee. It confirms that the working party developing the proposals will give careful attention to the Committee's specific recommendations.

CIMA welcome the APB's current exposure draft and particularly the proposal that if the auditors disagree with the directors' presumption that the company is a going concern they should give an adverse audit opinion and provide relevant additional information in their report. 'Directors and auditors must take adequate steps to satisfy themselves that essential resources such as cash, rare raw materials or essential skills will continue to be made available.' CIMA go on to note that a lack of liquidity is a major risk and that it would aid the

interpretation of the accounts if borrowings currently disclosed on the basis of 'due within one year' and 'after more than one year' were required to be disclosed in accordance with a further short category such as 'due or callable within a month'.

Arthur Andersen support the recommendation, and comment that it should

ensure that management prepares adequate profit and cash flow forecasts, which for many companies will enhance management practice.

BDO Binder Hamlyn consider that the APB's proposals are workable in larger companies but will be onerous for many smaller companies.

Coopers & Lybrand support the Committee's recommendations, subject to resolution of their concerns about liability (see under 5.31). They suggest that the Committee should specify that the requirement should be comparable to that for a statement of working capital adequacy in a prospectus, in order to ensure that a rigorous standard is applied. They state that the existing Stock Exchange requirement on this provides a mechanism which has been tried and tested.

Ernst & Young support the recommendations in principle.

Grant Thornton, Neville Russell and Stoy Hayward support the recommendations.

Kidsons Impey: the Committee should recommend that the statutory definition of going concern basis is clarified. One view is that the legislation only requires the assumption that the company is a going concern at the balance sheet date, and that later developments (as a result of which the company's position may be less stable) are not matters which should affect the balance sheet unless they assist in determining whether the company was a going concern on the balance sheet date. If this view were enshrined in legislation, any responsibility on the auditor to report whether the business will continue in business for the next 6/12 months should be a separate, non-statutory responsibility.

Pannell Kerr Forster agree with the Committee's recommendations but point out that they do not resolve the questions of what is the legal liability of directors in making a going concern statement, and what additional

work will need to be done by auditors. Work in respect of prospectuses and working capital statements is expensive and it will be difficult to introduce a lesser standard of care for annual accounts.

Touche Ross: the difficulties associated with obtaining more positive assurance that the company is a going concern should not be

underestimated and should be acknowledged. 'Lenders are not presently accustomed to committing facilities for far enough ahead to meet the levels of assurance proposed. It seems to us probable that some body of real influence will need to enter into discussions with representatives of the principle lenders to explore a way forward here.'

Fraud (5.24 to 5.28)

Touche Ross suggest the section should be strengthened by formally recognising the impracticability of eliminating, by any regulatory process or other recommendation, the activities of the determined fraudster. 'Experience here and in the US shows that, if the sums of money are large enough, there will always be ingenious attempts to by-pass or exploit the most sophisticated systems of governance and regulation, and some of the attempts will succeed, for a period. The Committee needs to make clear that it does not expect to eliminate fraud, only to raise standards of corporate governance generally and to make the fraudster's life more difficult.'

Kidsons Impey would support a statutory duty to report fraud (5.25). 'At present there are some circumstances about which an auditor takes no action although he certainly would be preparing a report if he were acting as liquidator with a view to recommending that a director or directors be debarred from holding office. In our view there should be a parallel channel of reporting the irresponsible directors of companies which are not subject to an insolvency administration.'

The recommendation at 5.28 is supported by Arthur Andersen, BDO Binder Hamlyn, Coopers & Lybrand, and Neville Russell. The Chartered Association of Certified Accountants (ACCA) also supports the recommendation but comments that it omits the most exposed category of accountant requiring protection, those working in companies who encounter fraud. It asks whether any form of protection can be provided for accountants or others who blow the whistle.

Grant Thornton have reservations about the recommendation at 5.28 on the grounds that the DTI, as the appropriate regulatory body, does not have the resources to deal with suspected frauds.

Other illegal acts (5.29 to 5.30)

Arthur Andersen endorse the report's view that it is primarily the responsibility of boards to identify the legal responsibilities of companies and to monitor compliance therewith. Auditors' responsibilities should be determined primarily by reference to what is material to the true and fair view given by the financial statements. Coopers & Lybrand agree the question should be considered further. Kidsons Impey query whether the auditors can give very much assurance on whether the compliance system is working, if they do not possess the expertise to test the controls. Neville Russell do not believe that the scope of auditors' work should be extended to investigating and reporting on illegal acts since they lack the legal expertise required to do so.

Auditors' liability (5.31 to 5.33)

Several of the major firms express serious concerns about liability. Comments are as follows:

Coopers & Lybrand: 'We are in principle supportive of the recommendations for the extension of the auditor's role. However they could add substantially, and probably unacceptably, to the potential liability of auditing firms which is already a major problem. There is insufficient capacity in the insurance market to cover the auditor's existing risks. Conversely, whilst we support the view of the Committee on Caparo as such, it does not seem satisfactory that there should be no accountability at all to other stakeholders in the audit. We ask that the Committee recommends that the whole subject of auditor liability should be taken forward as an integral part of the proposals on auditing. Otherwise we fear that they will be watered down in a way which would substantially negate its intentions which we otherwise fully endorse.'

auditors must weigh the risks involved... There has been an escalation of claims against auditors out of all proportion to their responsibility. In this situation, auditors have been reluctant to expand their responsibilities. Indeed, they have felt driven progressively to insert more caveats and to resort to negative rather than positive assurance in their reporting principally out of fear of subsequent litigation. This is not a healthy state of affairs. We strongly support the extension of the scope of the audit in the direction recommended by the Committee and further still as the needs and expectations of users of information evolve. However this must be accompanied by a change in the law which results in a more equitable approach to risk and liability.'

Arthur Andersen express the same concerns as Coopers & Lybrand and Ernst & Young, commenting that a major award against a firm could destroy the firm and its partners. They recommend

- a) The law should be changed to permit the auditor to limit his liability, with the approval of shareholders in general meeting and this should be recorded at Companies House for all to know. This proposal would do no more than bring auditors into line with other professionals and would therefore not require consideration of the implications for other professionals or change to basic tenets of the legal system. Competition between firms would ensure that the limit was set at a reasonable amount.
- b) The law should be changed to deal more fairly with auditors and others where several parties are responsible for the alleged loss.
- c) An expanded duty of care to other users of financial statements must await the reform of proportional liability and a rule to ensure that any contractual limitation of liability would bind those who have no contract with the auditor.

Price Waterhouse also call for a review of the law. After some detailed legal comment they conclude that the law should be changed 'to relate damages for misrepresentation in financial statements to the degree of reliance reasonably placed on financial statements. Auditors need not be treated as a special case; a change in the law regarding reliance could be extended to misrepresentation generally. Most particularly, a change in the law on reliance might allow statutory recognition of uses of accounts wider than the stewardship purpose set out in the Caparo case

without introducing liability of the sort which the courts are keen to avoid - ie potentially limitless.'

Clark Whitehill: 'We do not believe the report is justified in its

acceptance of the position of the legal responsibility of the auditor in

the light of Caparo. The auditor must accept a wider duty of care to a

wider section of the community. This is not to say that this increased obligation should not be without some limit of the burden what would be thereby placed upon the auditor, but it is to accept a responsibility that is more in tune with the public perception.'

ICAEW: 'Whilst recognising the arguments against limiting auditors' liability or making it proportionate, we intend to investigate and discuss further with interested parties the possibilities of overcoming the problems involved.' The ICAEW note the recent introduction of a Bill to the New South Wales Parliament on the subject.

Shareholders (section 6)

Arthur Andersen and Stoy Hayward are disappointed with the report's conclusion that there are few obvious ways of enhancing the accountability of the board to individual shareholders. Arthur Andersen would like to see the establishment of shareholder committees, which would include representatives of both individual and institutional shareholders, to formalise the contribution of the institutions to corporate governance along the lines of the ISC statement.

Grant Thornton comment 'The requirement when we resign to make a statement of circumstances that need to be brought to the attention of members can be a useful means of communication with shareholders. We recommend that there should be a similar requirement for directors who resign.' CIMA propose that the circumstances in which NEDs leave their posts should be commented on in the annual report and reasons for departure given.

Ernst & Young conclude that the failure to find new and effective mechanisms for strengthening the accountability of boards to shareholders means that the present system is unable to meet today's expectations. Pannell Kerr Forster argue that shareholders should be seen as investors, not owners.

Establishing a more direct link between shareholders and auditors (5.3 and 6.2)

There is little comment on this. Coopers & Lybrand however say they believe there should be a closer accountability of auditors to shareholders, and that the report should at least encourage institutional shareholders to take a more positive interest in the appointment and value provided by auditors. They believe that more research is required into what might be done to establish a closer accountability.

AGMs (6.5)

The ICAEW say that shareholders should be entitled to expect the personal attendance of the auditors who should be prepared to answer questions relevant to the conduct of their audit. Kidsons Impey say that the Committee should consider recommending approval of the accounts at the AGM.

Shareholder communications (6.9 to 6.11)

BDO Binder Hamlyn would like to see clarification of the information that companies may give to institutional investors and analysts. They suggest the approach of specifying what may be covered at such meetings.

The ICAS say the report could consider further the manner in which the directors of listed companies communicate informally with the financial community, such as briefing meetings with analysts at the time of preliminary announcements, ad hoc discussions with individuals and the release of information through PR and press agents. The ICAS suggest that two points flow from this which are relevant to the report. 'The first is the need to offer guidance to companies on what use of these channels is appropriate; the natural desire to inform the market of important developments which influence the value of the company's securities must be balanced against the needs to ensure the quality of the information and to preserve the right of equal access to it for all market participants. The second is that the structure of controls over the formal channel of financial reporting, which the report discusses at length, might in fact be being bypassed by these more informal means. We recommend that the Committee should give consideration to these matters.'

LIST OF RESPONDENTS

Association of Authorised Public Accountants (AAPA)

Chartered Association of Certified Accountants (ACCA)

Chartered Institute of Management Accountants (CIMA)

Institute of Chartered Accountants in England and Wales (ICAEW)

Institute of Chartered Accountants in Ireland

Institute of Chartered Accountants of Scotland (ICAS)

Auditing Practices Board (APB)

Arthur Andersen

BDO Binder Hamlyn

Clark Whitehill

Coopers & Lybrand

Ernst & Young

Grant Thornton

Kidsons Impey

Neville Russell

Pannell Kerr Forster

Price Waterhouse

Reads & Co

Stoy Hayward

Touche Ross

C B Brayshaw

Jonathan Chaytor

Noel Kellaway

Professor J P Percy

Example 1

Example section from proposed Statement of Principles

This is based upon section 2 of the Code of Practice.

Non-executive directors

- 2.1 The annual report should disclose the role of the non-executive directors in the direction of corporate strategy, the assessment of performance and rewards, the stewardship of resources, key appointments, and standards of conduct. A profile of each non-executive director's business interests and experience should demonstrate his or her appropriateness for stewardship.
- 2.2 The annual report should describe the mechanisms to ensure the independence of the non-executive directors from the management of the company.

These directors should be free of any business, family or financial connection with the company. Any such connections should be disclosed, along with fees and shareholdings. The former should also be related to each director's time commitment to the company.
- 2.3 Their specific terms of office and length of service should be disclosed. *Reappointment should not be automatic. Service contracts should be limited to three years, renewable by members of the company in general meeting.*
- 2.4 The procedure by which non-executive directors can take independent professional advice, if necessary at the company's expense, should be outlined.
- 2.5 The process by which non-executive directors are selected should be described. Reasons for any resignations from the Board should be disclosed. *They should be selected through a formal process and their nomination should be a matter for the Board as a whole.*
- 2.6 The annual time commitment required of each non-executive to the company should be disclosed.

FINANCIAL ASPECTS OF CORPORATE GOVERNANCE
A SUGGESTED ACTION PLAN



Appendix 2
Page 1

| Action | Suggested responsibility | Reference |
|---|--------------------------|--|
| The Financial Reporting Council should establish a standing committee to co-ordinate and promote implementation of the Cadbury Committee's proposals, and to act as a catalyst for further change. Representatives of the London Stock Exchange should be actively involved in such a committee. | FRC and LSE | R5 R13 |
| The London Stock Exchange should assume a pro-active role in acting as a regulator/moderator with regard to the conduct of Boards of Directors and their interaction with the equity markets. "Tri-lateral meetings" should be held between the regulator, Directors and auditors to open channels of communication to be used when serious concerns arise. Legislation to protect reporters in such circumstances should be put in place. | LSE DTI | - R14 |
| The listed companies' "continuing obligations" and the USM "general undertaking" should be amended to require companies to satisfy the London Stock Exchange that their directors are "fit and proper persons" for the office they hold. Monitoring procedures should be established. | LSE | - |
| The Financial Reporting Council should enter discussions with the Consultative Committee of Accountancy Bodies, with a view to taking responsibility for the Auditing Practices Board and coordinating its work with that of Accounting Standards Board. | FRC and CCAB | - |
| The "Code of Best Practice" should be further considered by the London Stock Exchange to determine whether objective indicators for the functions of Boards of Directors can be developed. The Auditing Practices Board should participate in such an initiative, to the extent that it is proposed that auditors should attest compliance with such objective indicators. Only then should the "functional aspects" of the Code be considered for introduction as a "continuing obligation", with appropriate annual statements of compliance. | LSE with APB | C1 C2 C3.3 C4.1 C4.3 C4.7 R2 R3 R6 |
| In the meantime, directors are encouraged to provide, in their annual report to shareholders, a description of the way in which their Board of Directors functions. | Directors | R1 |



| Action | Suggested responsibility | Reference |
|--|---|--|
| <p>The London Stock Exchange should amend its "continuing obligations" with regard to aspects of the Code: to provide the maximum limit on service contracts (para 3.1); and to require the disclosures on performance related remuneration (para 3.2) and responsibility for preparation of the accounts (para 4.5).</p> | LSE | <p>R7 C3.1 C3.2 and C4.5</p> |
| <p>The Department of Trade and Industry should amend the law to include a requirement for the disclosure of responsibility for preparation of accounts, as this is relevant to all (and not just listed) companies.</p> | DTI | C4.5 |
| <p>The London Stock Exchange should work with the Accounting Standards Board to develop the latter's recent proposals for an Operating and Financial Review, with a view to introducing this as a continuing obligation for listed and USM companies. There should be consultation with the Department of Trade and Industry as to whether the "OFR" may be included within the statutory Directors Report, to ensure that the information provided falls within the legal obligations for review by auditors.</p> | <p>LSE and ASB with DTI</p> | C4.4 |
| <p>The Accounting Standards Board should develop detailed guidance for the preparers of financial statements as to what constitutes "the going concern basis" of accounting and the relevant disclosures which should be made in financial statements if there is any uncertainty as to whether such an accounting basis is appropriate. (There should not need to be a specific reference to the basis being appropriate, as paras 10 and 15 Sch 4, CA 85 cover this). Parallel guidance as to the "going concern" responsibilities of auditors can then be issued by the Auditing Practices Board.</p> | <p>ASB and then APB</p> | <p>R12 C4.6</p> |
| <p>The Accounting Standards Board should issue guidance to preparers of financial statements as to the application of the "accruals" and "prudence" concepts in relation to interim accounts. The London Stock Exchange should amend its continuing obligations to require the inclusion in interim announcements of <u>all</u> the primary statements identified as such by the Accounting Standards Board.</p> | <p>ASB LSE</p> | R8 |

FINANCIAL ASPECTS OF CORPORATE GOVERNANCE
A SUGGESTED ACTION PLAN



| Action | Suggested responsibility | Reference |
|---|--------------------------------|-------------|
| In the meantime, directors are encouraged to provide further information in interim reports. | Directors | R8 |
| The Auditing Practices Board should develop guidance for the performance - and for reporting the results - of reviews of interim financial information. The London Stock Exchange should then include in its continuing obligations a requirement for the auditors to review interim reports. The same considerations should be given to auditors' reporting on preliminary announcements. | APB | R8 |
| The London Stock Exchange, with assistance from the Auditing Practices Board, should develop authoritative and objective guidance on the features of a good system of internal control. An appropriate and effective control system should then be a condition of listing and a continuing obligation, with directors required to report annually on compliance with this requirement. | LSE with APB | R11 C4.2 |
| The Auditing Practices Board should issue guidance for reporting the results of reviews by auditors of compliance with the London Stock Exchange's internal control requirements, and the continuing obligations should be amended to require auditor attestation of the directors' statement of compliance. | APB LSE | R11 |
| The bodies responsible for the regulation of auditors should continue their efforts for an urgent up-grading of ethical guidance to the auditing profession, in particular on the question of auditor independence, including the rotation of audit partners. The Financial Reporting Council should be involved in approving the guidance produced. | Auditor SROs with FRC | R16 R10 |
| The Department of Trade and Industry should amend the law to require the disclosure of non-audit fees paid to auditors and their associated firms world-wide, in respect of the auditors of the company and of its subsidiary undertakings. In order to enable an understanding of the context of this disclosure, companies should also be required to disclose the aggregate of fees paid to all professional advisers. | DTI | R9 |

**FINANCIAL ASPECTS OF CORPORATE GOVERNANCE
A SUGGESTED ACTION PLAN**



| Action | Suggested responsibility | Reference |
|---|-----------------------------|-----------|
| The Auditing Practices Board should accelerate the work it has already started on considering, with representatives of the legal profession, the role of the auditor in identifying and reporting illegal acts. | APB | R15 |
| The Law Commission should consider the law on damages - with particular regard to amendments so that damages awarded in relation to loss are restricted in proportion to the lower of the actual degree of reliance or the degree of reliance which would have been reasonable in the circumstances. The Financial Reporting Council should then set up a working party to prepare a statement of accepted practice setting out the extent to which it is reasonable to rely upon accounts for purposes other than their primary purpose as established in the Caparo decision. | Lord Chancellor FRC | |

Reference key

- R: Paragraph reference to the Summary of Recommendations on pages 39 to 41 of the draft Cadbury Report.
- C: Paragraph reference to the Code of Best Practice on pages 42 and 43 of the draft Cadbury Report.

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Our Ref: RC/WCCM/KTB

4 August 1992

Sir Adrian Cadbury
Chairman
Committee on the Financial Aspects
of Corporate Governance
PO Box 433
Moorgate
London EC2P 2BJ

Dear Sir Adrian,

The Auditing Practices Board (the Board) welcomes the publication of the draft report of the Committee on the Financial Aspects of Corporate Governance (the Committee) as a step forward in the process of clarifying and improving standards of corporate governance. The Board also appreciates the support expressed in the draft report for its work.

In commenting on the proposals in the draft report, the Board confines its observations to those recommendations which either are addressed to it or have direct implications for auditing practice and the development of auditing standards.

The Committee will no doubt be aware that the Board has recently released its own proposals for new auditing standards relating to two areas mentioned in the draft report. In May 1992 the Board issued exposure drafts of two proposed Statements of Auditing Standards: 'The auditors' report on financial statements' and 'Going concern'. Both exposure drafts, the Board believes, are entirely compatible with the approach taken by the Committee. The working parties developing these proposals will give careful attention to the Committee's specific recommendations.

In addition, several of the subjects in the Committee's draft report come within the scope of the Board's current examination of the Future Development of Auditing; I hope a paper on this subject will be issued by the Board in October of this year.

The Code of Best Practice

Recommendation 3 proposes that companies should publish a statement about their compliance with the Code of Best Practice, with reasons for any areas of non-compliance, 'only after it has been the subject of review by the auditors'. The Board is asked to consider the extent and form of this endorsement by the auditors of the statement of compliance.

The Board's view

The Board recognises that auditors develop views on the boards of directors of their client companies, and on the attitude towards corporate governance within those companies. However, such views inevitably vary as between different auditors and as between different clients of the same auditor. The Board does not consider it a practicable proposition for these subjective and essentially personal views to be expressed formally, in what would undoubtedly be seen as a public judgement on the performance of the board of directors.

The extent of the auditors' endorsement

The nature of the various elements in the proposed Code reflects directly on the extent to which auditors could reasonably be required to endorse a statement of compliance.

Some of the elements of the Code are of a qualitative nature (for example: whether the board of directors retains full and effective control and whether the calibre and number of non-executive directors is such that their views carry significant weight), whilst others are of a factual nature (for example: whether the board of directors meets regularly, whether there is a formal process of selection for non-executive directors and whether there is a remuneration subcommittee).

The qualitative aspects of the proposed Code can, at best, be judged only on a subjective basis. This is not a reason to exclude such matters from the proposed Code. Nevertheless, it seems impossible to establish any satisfactory criteria which auditors could apply in order to evaluate the company's compliance. Furthermore, in order to form a view on (for example) the performance of the board of directors and on the practical impact of the non-executive directors, the auditors would need to attend every meeting of the board of directors, especially those at which contentious matters were under discussion.

On the other hand, the factual application of the proposed Code will usually be capable of evaluation on a more objective basis. The auditors could reasonably be expected to evaluate and attest to the company's compliance in those areas, and the Board considers that some users of the company's annual report would find this helpful. The Board believes that the Committee should give further consideration to the scope of the auditors' endorsement. In particular the auditors' endorsement should be restricted to only those elements of the proposed Code where compliance will be capable of objective evaluation. For this purpose it would be necessary to divide the proposed Code into two sections, so as to identify clearly those aspects which are within the auditors' remit. The following comments are based on the assumption that such a division of the proposed Code is feasible.

The form of the auditors' endorsement

There is a persuasive argument that, as a general principle, if the auditors are known to be associated with the directors' statement of compliance, the nature and extent of that association should be made clear to readers of the company's annual report.

The most convenient way of dealing with this would be in the Board's proposed expanded auditors' report in the section setting out auditors' responsibilities. Any non-compliance (for example: the absence of an audit committee) would either be reflected

by the directors in the statement of compliance or, failing that, in the auditors' report itself. The auditors' responsibility in relation to reporting on the statement of compliance would thus be broadly comparable to the reporting responsibility regarding the directors' report.

An alternative approach

So far as the qualitative aspects of the proposed Code are concerned, an alternative approach might to be require the statement of compliance to be considered and endorsed by the Audit Committee: this would be wholly in keeping with the Audit Committee's principal duties. It may be desirable for the external auditors to be given the right to attend the meeting of the Audit Committee and to participate in the discussion on this subject; such a right could itself be included as part of the proposed Code. This could provide the external auditors with an opportunity to give of their experience, but without them being required to approve the directors' statement of compliance.

The Board will consider further these matters in the light of the final version of the Committee's report.

Interim Reporting

Recommendation 8 proposes that the Stock Exchange should amend its rules to require expanded interim reports (including balance sheet information) and that these interim reports should be reviewed by the auditors. The Board is asked to develop appropriate review guidance.

Review by the auditors

The Board sees no obstacle in principle to the development of review guidance. In the USA, interim financial statements are subjected to review by the auditors. This review engagement consists essentially of enquiries of management and analytical review, and the report is expressed in terms of 'negative assurance'; it is thus clearly distinguished from an audit. The International Auditing Practices Committee (IAPC) also has issued guidance on review engagements. The Board considers that the current US approach (together with the IAPC guidance) indicates very clearly how a standard for review of interim reports could be developed in this country.

However, the Board believes that when the requirements for expanded interim reports are being prepared, proper account should be taken of the need to ensure that interim results continue to be made available to the market on a timely basis and that the new requirements should not cause any delay in this process.

Accounting rules for interim reports

The Board sees a need for greater clarification of the accounting rules which would apply to the preparation of interim reports. For example, although the Committee does not see a need to require cash flow information at the present time, many would believe that interim cash flow statements could be very valuable. Indeed it is arguable that interim reports should be prepared on the same basis, and give comparable information, as the annual financial statements, as required in the USA.

In addition, it needs to be established how items occurring unevenly (such as seasonal revenues and expenditure) should be accounted for in the interim results.

It is recommended to the Committee that the Accounting Standards Board together with the Stock Exchange be requested to clarify the accounting rules which companies would need to follow in preparing interim reports.

Other recommendations with auditing implications

The Board will form working parties to address the two areas identified above, which are the subject of recommendations made by the Committee to the Board. The Board will liaise with the Stock Exchange to ensure that proposals for implementing any additional responsibilities to be attributed to auditors are developed in a manner which is consistent with the way in which these requirements will be introduced through the continuing obligations.

The Board will also form a working party to bring forward proposals for an auditing standard on reports by auditors on the directors' statement on the effectiveness of internal control systems. This project will be coordinated with the development of criteria for assessing the effectiveness of internal controls and the appropriate guidance for companies.

The Board is considering the Committee's recommendations on the role of Audit Committees and on the rotation of audit engagement partners in conjunction with its project on the Future Development of Auditing.

Whilst not directly relevant to this submission, the Board has expressed, and will continue to express, keen interest in the debate surrounding the Caparo case, and any subsequent developments of that case, together with the related (but also distinct) issue of professional liability in general.

In conclusion, it is clear to the Board, both from the draft report and from its own deliberations, that some widening of auditors' responsibilities is sought by many. The draft report, for example, seeks to identify a new responsibility in relation to the proposed Code. When contemplating such changes, however, consideration must always be given to the relationship between the benefit which it is hoped to achieve, and the costs which will necessarily be borne by companies. It is also necessary to keep in mind the potential trade-off between widening auditors' responsibilities and keeping their legal liability within reasonable bounds.

Yours sincerely

Bill Morrison

W C C Morrison
Chairman