

ARTHUR ANDERSEN & CO, SC

31 July 1992

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Committee on the Financial Aspects of
Corporate Governance
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Our ref ae/5474Y

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Dear Sir,

We welcome the publication of the Draft Report and the opportunity to comment thereon.

We believe that implementation of many of the recommendations in the Report will lead to a significant improvement in corporate governance and financial reporting to the benefit of all parties involved with listed companies.

Our detailed comments on the issues raised in the Report follow in the order in which they appear in the Report. Our recommendations for change or expansion in the Report are summarised below.

Summary of our recommendations

Our principal recommendation is that the Report should be more forthright with respect to the supervisory function of the board.

To this end, we suggest that the final Report:

- o Be unequivocal on the need for supervision rather than seek to achieve supervision by specific procedures.
- o Clarify the objectives and procedures that fall within the supervisory function and recommend that in all circumstances, the supervisory role should be led by a specific non-executive director.
- o Encourage alternative forms of governance and experimentation, such as two-tier boards or the use of substantive committees made up of non-executives.
- o Recommend to government that the law be changed to permit some form of two-tier structure.
- o Include a clearer statement of the role and function of non-executives.

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- o Recommend consideration of whether the present position whereby all directors are equally responsible for the board's actions and decisions should be amended.

On other matters, we suggest that the final Report:

- o Defer complete implementation of the Code to 31 December 1993 or introduce phased implementation.
- o Reconsider the requirement for auditors to review compliance with the Code.
- o Require companies to make a general statement on corporate governance which would be more comprehensive than the present proposed Code and describe in some detail how oversight and review are actually achieved.
- o Recognise that it is unlikely that enough men and women of sufficient calibre will be available to act as non-executive directors without a substantial change in corporate practice to recognise a broad public duty to make appropriate executives available for such service.
- o Require that nomination of all directors to the board be a matter for approval by all members of the board, perhaps with the assistance of a nominating committee.
- o Emphasise that non-executives have a duty themselves to ensure that they have sufficient information to discharge their oversight role.
- o Emphasise that the board's role in supervision can only be achieved if the company recognises this role and provides, through its management structure and policies, the appropriate corporate discipline to ensure its achievement.
- o Stress that the directors' and auditors' consideration of the effectiveness of the system of internal control embrace the management information system needed to control the business.
- o Contain a clearer statement on the purpose and responsibilities of audit committees, rather than a recital of certain tasks.
- o Emphasise that guidance is needed on the accounting principles that should govern the preparation of interim financial statements.
- o Include a recommendation for the more timely publication of annual and interim financial statements such as three months after the end of the period.
- o Recommend specific legislation covering internal financial control in line with the requirements already existing in the financial sector.
- o Recommend that auditors be permitted to limit their liability under contract in line with other providers of business services and that proportional liability be introduced in all circumstances.

- o Formalise the contribution of institutional shareholders to corporate governance by the establishment of shareholder committees which would include representatives of both institutional and individual shareholders.

Code of Best Practice

We endorse the recommendation for a Code of Best Practice and a Statement of Compliance. However, we are concerned as to the timetable, and the suggested auditor involvement in reviewing the Statement.

Implementation of both the specific requirements and the spirit of the Code will require major changes for many companies. Given the difficulties noted later concerning a number of proposals, implementation by the time of the release of 31 December 1992 accounts is unrealistic for many companies. We understand that the Committee's final Report will be available in the Autumn. While companies should aim for early implementation, an effective date of 31 December 1993 would be more appropriate. Alternatively, a phased approach should be used.

The Code should be complete in itself. As presently drafted, the Code refers to paragraphs in the Report which sometimes have further recommendations with the result that the actual content of the Code is unclear.

While auditors wish to contribute to the improvement of corporate governance, their involvement in reviewing the Statement of Compliance will need careful consideration. It would not be reasonable for auditors to express an opinion on matters that could only be determined by extensive observation of management practice (eg. whether the board retains full and effective control) or on those elements of the Code which are subjective (eg. the independence and calibre of non-executives). Given these inherent difficulties, it is not clear to us how the auditor is to report and what degree of responsibility he is to assume.

While the proposed Code is important, users of accounts are more concerned with the way in which corporate governance is actually achieved within a particular company. Our recommendation would be that listed companies be required to make a general statement on corporate governance which would cover in some detail how oversight and review is achieved, rather than make reference to a Code of general principles.

The Board

The Unitary Board

Under our 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, the ensuing debate and recent major submissions indicate quite fundamental differences of view on 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

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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 on the issue. While much of the Report addresses the supervisory role, the discussion is opaque. Further, the Report seeks to achieve supervision by specific procedures without stating clearly its view of the need for some form of supervisory function. This is important in that the public debate on the Report indicates that many boards reject the need for supervision.

We believe the Report should be more forthright with respect to the supervisory function of the board. It should clarify the objectives and procedures that fall within the supervisory function and recommend that in all circumstances, the supervisory role should be led by a specific non-executive director.

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

Alternative forms of oversight exist within the EC. In certain Member States, the law provides for separate supervisory and administrative boards, with the latter fulfilling the role of control and management. In North America, the heavy bias towards non-executives on the boards of most US listed companies emphasises their largely supervisory role, with the control and management of companies carried out by management boards and committees.

Given the myriad ways in which boards operate, and the significance attached to non-executive directors in corporate governance, we believe it is misguided to prescribe a single format for corporate governance. We suggest that the Report explores the alternatives and encourages companies to experiment. For instance, boards could become more supervision orientated by hiving down the management functions to operating committees. In this way it may well be that the supervisory board could be achieved by companies without any amendment to the law.

Nevertheless, we urge that the Report recommend to Government that the law be changed to permit the use of some form of two-tier structure.

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The Chairman

The Report rightly attaches importance to the role of chairman and recommends that, in principle, the role should be separate from that of the chief executive and, where this is not possible, there should be a strong, independent element on the board with an appointed leader.

Where the chairman is a non-executive, he will be the natural focus of the supervisory function. Where, rarely, the role of chairman and chief executive are combined, we endorse the view that there should be "an appointed leader" who is acknowledged to be responsible for the supervisory role and he should be designated as deputy chairman.

Non-executive directors

While we share the view of the Committee on the importance of the non-executive director, we question whether the role and heavy reliance placed on them in increasing the effectiveness of corporate governance is realistic. Our concerns and recommendations are:

o Role of the non-executive director

In view of the importance attached to the non-executive director, it is vital that there be a clear statement as to their role and function. While we recognise that under our present system of corporate governance, directors share collective responsibility for the functions of the board, non-executives have a primary role in supervision. The Report alludes to this role where it states "...the non-executive directors are in the best position to monitor the performance of the board and that of the chief executive", but it is far from unequivocal.

In our view, the issue of supervision needs to be more thoroughly addressed and it should be made clear that the primary responsibility for this function of the board should rest with the non-executives.

o Joint responsibility

A major feature of our companies' legislation is that all directors are equally responsible for the board's actions and decisions. The Report goes even further by providing that non-executive directors are in the best position to monitor the performance of the board and the chief executive. This statement could be construed to suggest that the responsibilities of non-executives are even more demanding than those of the executive directors.

While we recognise that the joint responsibility of directors has been a core element of our corporate laws, the need to increase considerably the numbers and ensure the calibre of non-executives suggests that such responsibility should be reconsidered. In this connection, it is noted that the responsibilities of directors on supervisory boards on the Continent are distinct from these of other directors and officers.

o Availability and calibre of non-executives

The proposal to require all companies to have non-executives of high calibre is predicated on the availability of such executives. It is unlikely that men and women of sufficient calibre will be available without some major changes in current corporate practice.

While the Report properly mentions adequate remuneration, the principal concern of the non-executive will be the risks, responsibilities and liabilities assumed. Without some change in the legal responsibility of non-executives, it may be difficult to attract sufficient qualified candidates. It may be that many non-executives will only be prepared to act if the time devoted to each company can be substantial. Indeed, it has been suggested by some that adequate corporate governance may necessitate not only non-executive directors but also part-time executive directors.

Moreover, it is unlikely that sufficient men and women of sufficient calibre will be available among retired executives and therefore the role envisaged for non-executives in the Report could only be achieved if current senior executives are made available. The Report should acknowledge this need which will require a significant change in practice among most companies in the UK. For these companies and the executives concerned, remuneration will not be a major factor. What will be needed is a substantial change in corporate ethic, whereby business recognises a broad public duty to make appropriate executives available.

o Nomination

The role envisaged for the non-executive can only be fulfilled by able, experienced and independent directors. A particular criticism of present practice concerns the method of appointment of non-executives and, in particular, the occasional appointment of parties "well known" to individual directors. We therefore endorse the suggestion that the appointments should be a matter for the board as a whole and perhaps based on the recommendation of a nominating committee. We urge the use of such committees. The composition of such a committee might include representatives of major institutional shareholders as well as the other non-executives. Alternatively, such appointments could be made or endorsed by a shareholder committee as discussed later.

We further believe that the nomination of all directors should be a matter for approval by the board as a whole.

o Right of access to financial and other information

If non-executives are to be equally responsible with executive directors for the affairs of the company, it is critical that they not only have the same right of access to information as executive directors but also have a duty to consider such operating and other financial information as will equip them to provide the oversight role envisaged in the Report.

We suggest that the Report stress this responsibility.

Board Structures and Procedures

The extent to which individual boards fulfil the roles of supervision, control and management is highly varied. In many cases the emphasis is solely on supervision and oversight. At the other extreme, the emphasis is on managing the business. While it must be for individual boards to decide the extent to which the board "controls" and "manages" the business, in terms of corporate governance, the "supervisory" role of the board should be paramount. Board practice, agendas and discipline should reflect the importance attached to this role.

The board's role in oversight can only be achieved if the company recognises this role and provides, through its management structure and policies, the appropriate discipline to ensure its achievement. While a formal schedule of matters reserved for collective decision as suggested is helpful, it will prove sterile unless there is clear recognition that the board has an important supervisory role.

We endorse the recommendation for codes of ethics and business practices to help assure this recognition.

Internal controls

We endorse the importance attached to internal control and the recommendation that directors publicly conclude as to their views on the effectiveness of their system and that the auditors report thereon.

So that there can be no doubt as to the breadth of this recommendation, 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.

A requirement for the auditor to "endorse" management's opinion on the company's control environment would serve to focus management's attention on the importance of the issue, provide structure to management's assessment and bring into play the auditor's special expertise in this area.

Audit committees

In view of the significance attached to audit committees, we endorse a requirement for such committees. We also recommend that the Report contain a clear statement on their purpose and responsibilities, rather than merely a recital of certain tasks. We believe that audit committees should be charged with:

- Understanding, assessing and monitoring the overall control environment,
- Promoting sound financial reporting, and
- Upholding standards of business conduct.

A clearer statement of the purpose and responsibilities of audit committees would help in judging what makes an audit committee effective and would give impetus to the Report's recommendations regarding committee structures, duties and procedures.

We enclose a copy of our recently published booklet, "Audit committees for the 1990s", which expands on these views.

With respect to standards of business conduct, we suggest the Report reinforce the statement that the publication of standards of conduct represents good practice by giving audit committees a responsibility in this area.

Board remuneration

We endorse the overriding principle that there should be disclosure and explanation of the directors' present and future remunerative benefits and how they have been determined. In this connection, we believe that there should be some form of disclosure of the value of share options granted to each director.

With respect to the recommendation for the separate disclosure of performance related elements, we believe this should apply to all directors and not just to the chairman and the highest paid UK director.

Reporting Practice

We particularly welcome the proposal that interim reports include balance sheet information and we would urge that cash flow information also be included. Guidance is also urgently needed on the accounting principles that should guide the preparation of interim financial statements. In particular, the rigour with which such interim reports are prepared varies widely between companies with many companies only properly reflecting provisions on contracts, developments and stock at the year-end.

We believe that the review of interim statements by auditors will enhance such reporting and in many cases lead to the earlier and more thorough consideration of accounting and reporting issues. While the extent of the review and the form of report should be resolved by the Auditing Practices Board, the Report should address the question of publication and how differences of view on the interim amounts are to be resolved.

We are disappointed that the Report does not contain recommendations with respect to the timing of the publication of financial statements. The usefulness of financial information is affected by not only how often it is presented and its content but also when it is available. The most comprehensive financial statements available many months after the year-end are inevitably less useful than more timely financial statements.

The annual financial statements and interim statements of listed companies should be published much sooner than at present. The present Stock Exchange requirement of six months for annual statements and four months for interim statements is too long. We believe a three month period for the publication of both annual and interim financial statements would improve the usefulness of information considerably with little or no additional cost to most companies.

We continue to recommend that major listed companies move to quarterly profit and loss reporting. Most major listed companies already have accounting systems that would permit such reporting and where such systems are lacking, a requirement for quarterly reporting would prompt the necessary improvements. Such reporting would restore some of the present imbalance between institutional and non-institutional shareholders.

Pensions Governance

The Goode Committee is currently reviewing the framework of law and regulation within which pension schemes operate, the status and ownership of funds and the accountability of trustees, managers, auditors and advisors. Consequently we agree that the Code of Best Practice should not contain any recommendations concerning pensions governance. Furthermore, we consider it premature for the Report to state that it should be the duty of boards to ensure that there is separate governance of companies and their pension funds.

Auditing

Professional objectivity

We recognise that the single most important criticism of the accounting profession is the assertion that its affinity with its clients through appointment, remuneration, familiarity, duration and other factors mitigates its objectivity, rigour, independence and integrity.

We therefore concur with the view that it is critical to ensure an appropriate relationship exists between auditors and management. The Report mentions the need for accounting standards and for audit committees. It should also mention the considerable efforts that the profession and individual firms are pursuing to ensure objectivity. The profession we have recently established the threshold of an entirely new self-regulatory system which the profession is determined will succeed.

Quarantining audit from other services

We welcome the conclusion that auditors should not be prohibited from providing other services to audit clients.

With respect to the disclosure of non-audit fees, we believe that independence should be ensured primarily through adherence to sound ethical standards as established by the accounting profession. We do not believe that the disclosure of non-audit fees will affect independence in any way or otherwise provide information which is useful to users in the context of their understanding of the accounts.

Nevertheless, we agree that where non-audit services are provided by the same firm to the overseas subsidiaries of their UK client, it would be logical to include such services in the disclosures to be made. Where such services are however provided by a non-affiliated practice to the overseas subsidiaries of a UK client, we believe disclosure would be inappropriate.

Rotation of auditors

We support the conclusion that the compulsory rotation of auditors would do little to enhance independence and would have adverse consequences.

We endorse the proposal for the periodic change of engagement partners. In addition, we believe that objectivity can be improved and the risk of audit failure reduced if audits of all listed companies included thorough consultation within the firms on both reporting and auditing issues. Such consultation can be best achieved by the formal assignment of a second partner to advise and concur.

Internal control

The Report suggests that the question of legislation to back its recommendation concerning internal financial control be decided in the light of experience.

While we would not favour the unnecessary involvement of Government in accounting and auditing, we believe that a voluntary code in this area would be unlikely to work. We already have some experience of the statutory requirement for proper systems of control in the financial sector and we suggest specific legislation covering this issue for all companies. The legislative requirement would need to be framed in quite general terms, leaving the details to be developed by the profession.

Going concern

The Report recommends that directors should state in the directors' report that the business is a going concern, with supporting assumptions or qualifications as necessary, and that the auditor should report on this statement. We concur.

The requirement to make a public statement, and the new guidelines for management and auditors recommended by the Report, should ensure that management prepares adequate profit and cash flow forecasts which, for many companies, will enhance management practice. The requirement for the statement should ensure that this difficult area is properly considered. The APB has already made recommendations for the role of auditors in this area.

Fraud and other illegal acts

The Report rightly points out that dealing with suspected fraud when senior management is involved is particularly difficult and current practice is unsatisfactory. While a strong audit committee is an important safeguard and should clearly be the first point of call, it is unrealistic to expect this safeguard to operate effectively in all circumstances. We therefore endorse the recommendation that the Government consider introducing legislation to extend to the auditors of all companies the statutory protection already available to auditors in the regulated financial sectors so that they can properly report suspicions of fraud.

With respect to illegal acts, we also 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. In our view, auditors' responsibilities in relation to illegal acts should be determined primarily by reference to what is material to the true and fair view given by financial statements.

Auditors' liability

This is a critical issue for the accounting profession and we regret that the Report suggests no way forward. This is particularly so when the Report recommends quite substantial extensions of auditor responsibilities.

There are two distinct issues. The first concerns the retention of a strong accounting profession to fulfil its present and new responsibilities such as those suggested in the Report. The second is to establish a duty of care which reflects the reasonable expectations of society. It is probably unrealistic to resolve both of these issues simultaneously.

There is no doubt that the accounting profession in the UK is being progressively and seriously weakened by litigation. The inexorable rise in the number and value of claims is such that even the most cautious and financially sound firms are threatened. If we are to remain a strong accounting profession, the issue of auditors' liability must be fully addressed.

With respect to tort, Caparo has already brought a large measure of reform. However, the position under contract remains unsatisfactory.

Under contract, the law pertaining to auditors presently permits the award of unlimited damages for negligence. At present, the insurance market is such that it is impossible for large firms to obtain insurance coverage against all but relatively minor claims. As a consequence, a major award against a firm could destroy the firm and its partners. A change in the law, whereby the auditor would be able to limit his liability under contract in line with most other professional organisations would partly redress this shortcoming. The law presently denies the auditor this right.

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. Since this proposal would merely bring auditors into line with other professionals, it would not require consideration of the implications for other professionals and it could be achieved without changing some of the basic tenets of our legal system. As a practical matter, competition between firms would ensure that the limit was set at an amount that would provide reasonable compensation in most circumstances.

The law should also be changed to deal more fairly with auditors and others where several parties are responsible for an alleged loss. Today the law provides that when only one of the parties causing the same damage is sued, that party can be held liable for the whole of the damage, although he may have been only partly to blame. This major defect in our legal system

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applies to the work currently performed by the auditor under contract and tort and probably to any extension of that work envisaged in the Report, ie. with respect to internal control, interim statements, etc. While permitting the auditor to limit his liability under contract would help mitigate this abuse, proportional liability, whereby each party would bear only that share of the loss that directly flows from its actions, remains a matter of fairness and a real need.

Returning to the reasonable expectations of society, the profession remains very concerned that its current duty of care does not reflect the expectations of society. While this public interest in accounts is not easily defined, we believe that it could embrace all of the current and prospective users of financial statements; including not only shareholders but also employees, customers, suppliers, banks and other providers of funds. Further, it may include the many regulatory governmental and quasi governmental bodies that have relationships with companies. However, it is unrealistic to expect the accounting profession to accept this broad role when under current legislation, such a role could result in the financial demise of the practice. We believe that an expanded duty of care in this context 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.

Shareholders

The Report concludes that there are few obvious ways whereby the accountability of boards of directors to individual shareholders can be enhanced. This is disappointing.

With respect to institutional shareholders, the Report recognises that institutions are in a position to maintain contact with the board of directors in a way which is not feasible for the individual shareholder and notes the recent statement published by the Institutional Shareholder Committee on the Responsibilities of Institutional Shareholders in the UK.

Institutions are a powerful force to monitor the interests of individual shareholders and it is a mantle they should be more willing to accept. The responsibilities envisaged for institutional shareholders could be formalised by the establishment of shareholder committees. Such committees could assume the responsibilities envisaged for institutions in the statement and could include representatives of non-institutional shareholders.

P Raymond Hinton would be pleased to discuss the contents of this letter if this would be helpful.

Yours faithfully,

Arthur Andersen