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COMMITTEE
ON
THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

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Dear Committee members,

CATCHING FRAUD AT AN EARLY STAGE: "AUDIT TRUSTEE"
PROPOSAL BY A J MERRETT AND ALLEN SYKES

I am writing to draw your attention to a proposal by Mr. Tony Merrett and Mr. Allen Sykes that responsibility for appointing, remunerating and directing auditors should be transferred from the shareholders to independent trustees appointed by lenders and creditors. I understand that Mr Merrett is a former Professor of Finance at the London Business School and that Mr Sykes is a former Chief Executive of Consolidated Goldfields. They presented their paper to Sir Adrian Cadbury at a meeting on 25 June.

The main aim of the proposal would be to set up a new structure that would give auditors a much better chance of nipping fraud in the bud. The paper in which the proposal is contained is rather long, so I have prepared the precis attached. I also attach some comments on the proposal by Price Waterhouse.

Although there would clearly be many issues to consider if a proposal along the lines suggested were to be seriously developed, Sir Adrian thought that that the basic proposition was sufficiently interesting for it to be circulated to the Committee. Please let me know if you think it contains any ideas that the Committee should pursue.

Messrs Merrett and Sykes also presented a second paper, arguing the need for a longer-term relationship between executive directors and shareholders. In outline they propose that the executive directors and institutional shareholders of a company should negotiate 5 to 7 year performance targets, that directors' remuneration should be strictly related to the targets, and that the 3 to 5 investment institutions with the most significant stake should each appoint a non-executive director to the board to carry out the monitoring and target setting functions. Sir Adrian commented that the paper went beyond the Committee's remit, but that he would draw it to the Committee's attention. Please let me know if you would like a copy.

Yours sincerely,
Nigel Peace

Nigel Peace
Secretary

SUMMARY OF AUDIT TRUSTEE PROPOSAL BY A J MERRETT AND ALLEN SYKES

The proposal in brief

The power to appoint, remunerate and direct auditors should be transferred to independent Trustees appointed by lenders and creditors. Annex A gives details.

2 The proposal would resolve two difficulties:

i) the inherent conflict of interest under which management, with a strong interest in a favourable account of its stewardship and the major source of malpractice, effectively appoints and remunerates the auditors charged with reporting on these issues;

ii) the weakened effectiveness of auditors in deterring and exposing outright fraud. This arises because the need for auditors to act on suspicion of fraud, to be able to recover the very considerable costs of thorough investigation, and to be protected from unwarranted retaliation by senior management, is inconsistent with management effectively appointing and remunerating auditors. The auditor's position is also weakened by the laws of libel which an unscrupulous management can bring to bear against any entity raising the suspicion of malpractice.

Argument

3 Auditors' remuneration is normally determined largely in advance by management. It is predicated on the generally valid assumption that management have financial integrity, and makes no provision for the potentially huge costs of detecting large scale malpractice. Typically, any evidence will be inconclusive and only after intensive investigation will substantive proof (either that there is or is not malpractice) be obtained. Management, even if innocent, are likely to oppose the substantial costs of investigation and to be seriously alienated by the questioning of their integrity. Understandably therefore auditors use their extensive powers only when confronted with very strong evidence of malpractice - by which time much damage will have been done.

4 The major source of information regarding possible malpractice will generally be lenders, creditors and management. Informants will be unwilling to jeopardise their position however by approaching auditors without assurances of confidentiality, protection against unwarranted victimisation, and action for libel. Recent events have shown that managers seriously concerned at possible illegalities have not felt able to call upon the auditors or to risk a terminal confrontation with their bosses.

5 Auditors are in the unhappy position that they are increasingly exposed to legal action for failure to detect and expose malpractice, when the main reason for their failure is the fundamentally flawed structure.

6 Audit committees are not the answer because their members are still effectively appointed by incumbent management and no management intent on malpractice would appoint directors to the audit committee who were other than subservient. Indeed such directors could be a useful source of information to the fraudsters on how warm the hounds were getting.

7 Under the proposal, the conflict of interest and the scope for management to intimidate auditors would disappear since auditors would neither be appointed nor remunerated at the effective discretion of management. The complete independence from management and protection from the law of libel would also open up to the Audit Trustees the main sources of information on malpractice - employees, auditors, lenders and creditors. The Trustees would have the legal power to take up any concerns expressed, to order additional investigation at any time, and to force the company to meet the cost. As a result the auditors would have whatever resources were necessary to expose malpractice. The proposals would also have a very significant deterrent effect.

A J Merrett
Allen Sykes

In sum the defects of the present system are fundamental and require fundamental reform. This could be achieved by the following 'Audit Trustee Proposal'.

The Audit Trustee Proposal (ATP)

1. The first step would be legislation to create licensed Audit Trustees in whom audit sovereignty could be vested. These trustees could comprise bankers, lawyers and experienced businessmen but should obviously exclude accountants although these could be called upon for advice. (Similar bodies already exist in the shape of the Trustees for Debenture Holders.)
2. The second stage would be for the largest UK lender to the companies covered by the legislation to be required by law to propose an Audit Trustee. At the subsequent meeting of the proposed Trustees it would be open to all lenders and creditors to vote (in proportion to their monies owed) to confirm this trustee or nominate another.
3. Immediately after this confirmatory vote, audit sovereignty would be transferred from the shareholders to the Audit Trustee.
4. The Audit Trustees would have the following duties and powers:
 - a) to compile an annual short list of auditors for the lenders and creditors to vote on;
 - b) to take account in compiling this short list of any legitimate objection of the company such as excessive cost, inefficiency, etc, of the auditors (audit fees would in practice be negotiated between management and the auditors but with both having right of appeal to the Audit Trustees);
 - c) to form the interface between the auditors, shareholders, lenders, creditors and all other legitimately interested parties on all audit related matters;

- d) to have the legal power to take up any concerns expressed and, at their discretion, to order additional investigation or audits *at any time - ie, not only as part of the annual audit;*
- e) to have the legal obligation to respect the confidentiality of any informant;
- f) to have legal immunity in the performance of their duties from libel and to provide entities testifying to them or providing information the same immunity from libel that would be conferred in a court of law; and
- g) to ensure that the existing code of audit confidentiality is maintained and that the lenders and creditors are not placed in the position of having privileged access to information.

5. The Audit Trustees would be remunerated by the company on the basis of a sliding scale of fees linked to the audit cost itself although entitled, in exceptional circumstances, to apply to a panel (similar to the Costing Master in the Courts) for an order for the company to pay any justified exceptional costs incurred.

Price Waterhouse



16 April 1992

A Sykes Esq
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Dear Mr Sykes,

Audit Sovereignty

Early in March you very kindly sent a copy of your joint paper on Transferring Auditing Sovereignty to Independent Trustees to my partner, Howard Hyman, inviting comment on your proposals. Howard passed your letter to me in my capacity as partner in charge of our Audit and Business Advisory Services practice. I read your proposals with great interest.

I am inclined to agree that the public interest is not best served by a system which places "audit sovereignty" de jure in the hands of shareholders but de facto in the hands of executive management. However, I think that your radical proposals are, if I may be colloquial, in danger of throwing the baby out with the bathwater; your solution to the problem of a lack of de facto shareholder power is to take all power from shareholders and give it to creditors. I think that there would be more to be said for a scheme which would put the exercise of power back in the hands of shareholders and ensure that it did not fall by default to executive management. When things do go wrong in a company, the claims of lenders and trade creditors must be satisfied before shareholders can recover their funds. This means that there is a built in safeguard for lenders and creditors if we can make the protection of shareholders' interests a working reality.

I would like to see shareholders, perhaps led by institutional investors, encouraged to make active use of the powers they already have in relation to the appointment and remuneration of auditors. At the same time, I would like to see the powers of non-executive directors strengthened and the powers of executive directors over audit appointments and remuneration severely curtailed as follows:

- only non executive directors (themselves appointed by shareholders) and shareholders who are not executive directors should be able to nominate auditors for appointment



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A Sykes Esq
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- executive directors of public companies should have no voting rights (at board level or in general meeting) in relation to auditors' remuneration, nor should they be able to propose or vote on any resolution relating to the auditors.

You also saw a problem for potential informants wishing to provide information to auditors for further investigation. I agree that the potential exposure to action for defamation could indeed deter a potential informant from passing on information to auditors. My preferred solution would be to have some statutory recognition (a) for the auditor as a 'proper authority' to receive confidential information which might impact on a company's financial statements and (b) for communications to an auditor as communications attracting qualified privilege.

There then remains the problem of who is to pay for further investigation by auditors in receipt of information suggesting something is amiss. That, I believe, could be resolved by negotiation between the auditors and non-executive directors; it is not a matter I would want to see put in the hands of an authority which though not accountable to shareholders would have the power to spend their money.

In summary, I do see problems in the areas you have highlighted but I am optimistic that they can be resolved with less radical solutions than you propose. The problem with setting up a new system is that it inevitably generates new problems. Your proposals to give votes to creditors in proportion to monies owed and to remunerate Audit Trustees on a sliding scale linked to the cost of the audit are two examples; the former presents practical problems and the latter shows that it is not a completely straightforward matter to sever the link between audit sovereignty and reward. I should like to see some effort made to resolve the difficulties of the present system before we determine that it is indeed beyond repair and must be abandoned.

I am sorry that it has taken so long for us to reply but thank you again for giving us the opportunity to read your proposals and comment on them. Your paper was both interesting and thought provoking; I hope that you receive correspondingly lively responses.

Yours sincerely,

David Morris

cc The Secretary, The Cadbury Committee