

**Coopers
& Lybrand**

chartered accountants

Plumtree Court
London EC4A 4HT

telephone 071-583 5000

cables Colybrand London
telex 887470
facsimile 071-822 4652

your reference

our reference
ROBD/DP073292

Nigel Peace Esq
Secretary
Committee on the Financial Aspects of
Corporate Governance
P O Box 433
Moorgate Place
London EC2P 2BJ

31 July 1992

Dear Sir

1 We are writing with our comments on the draft report of the Committee on the Financial Aspects of Corporate Governance. We restrict our comments to the thrust of the draft report and its main recommendations, recognising that it will be for other bodies to work up and consult on the details.

2 We comment in the enclosed note on each of the principal recommendations. Most of those comments are supportive, but we have reservations which we summarise below.

Governance

3 The code of best practice is welcome. If it were to be universally followed, it would do much to prevent the kind of problem which gave rise to the establishment of the Committee. We expect that most companies will take it seriously. We are less confident that, without some kind of non-statutory enforcement, it will be taken seriously by the kind of company which has previously been reluctant to put in place basic arrangements for good stewardship. Of course it is mainly in those companies that the recent problems have arisen.

4 As the Committee acknowledges, a properly balanced and effective board is the key. The question is who is going to ensure the quality of the board. As the report stands the sole onus for independent confirmation of compliance with the code would be on the auditor (paragraph 3.10). We do not think that it is either appropriate or reasonable to place responsibility on the auditor for those parts of the code (most of parts 1 and 2) which deal with the constitution and quality of the board.

Coopers & Lybrand is a member firm of Coopers & Lybrand (International)

London Aberdeen Armagh Bangor (N.I.) Belfast Birmingham Bournemouth Bristol Cambridge Cardiff Croydon Dungannon Edinburgh Glasgow Gloucester Irvine Lame Leeds Leicester Liverpool Maidstone Manchester Milton Keynes Newcastle upon Tyne Northampton Norwich Nottingham Omagh Plymouth Portadown Portsmouth Reading Sheffield Southampton Swansea Uxbridge

Partners are partners of Coopers & Lybrand, the Main Firm, or one of its associate firms. A list of partners' names for each firm is available at the above address. The Main Firm is authorised by the Institute of Chartered Accountants in England and Wales to carry on investment business. All partners of the associate firms are authorised to conduct business as agents of, and all contracts are made with, the Main Firm.

5 The appointment of the board is primarily the responsibility of shareholders. As the report acknowledges, the institutional shareholders have the major role. In practice the financial institutions can and should also exercise influence in their capacity as lenders. It is not clear to us how that institutional role will be given focus, given that the institutions will have different individual interests.

6 We recommend that the onus for endorsing the statement of compliance with the code, so far as it concerns the composition and quality of the board, should not rest with the auditor but with the City institutions collectively, and that the Committee should consider how that role might be focused.

7 We suggest that the Committee should consider recommending some kind of panel within the City which would assist in the monitoring of compliance with the code and provide a focus for instigating change where it appears to be required. The voluntary manner in which the Takeover Panel started with a light touch provides an analogy.

8 On a different matter, while we support the encouragement for non-executive directors, the language of the draft report as it stands tends to imply a sharper division between the roles of non-executives and executives than the Committee probably intends. We do not believe there is a satisfactory half way house between the two tier board and the collegiate board.

9 We believe that the role of audit committees should also be seen in the context of a collegiate board. In our view, audit committees are complementary to, not a substitute for, discussion of key financial reporting and control matters by the whole board, with the auditor present from time to time. Audit committees can even be damaging if they stop important audit issues reaching the main board agenda.

Auditing

10 On auditing, we are in principle supportive of the recommendations for the extension of the auditor's role, subject to our reservations above.

11 However, we believe that the Committee should acknowledge that as the proposals stand 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, while we support the view the Committee has reached 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 development of your proposals on auditing. Otherwise we fear that the Committee's proposals will be watered down in a way which would substantially negate its intentions which we otherwise fully endorse.

12 It is encouraging to us that, in common with other studies on the matter, the Committee does not seem to have found any evidence to support the assertion that auditor independence is compromised by the provision of non-audit services. Assuming this to be true, and given a public perception to the contrary, it would be helpful if the Committee would explicitly say so.

13 Finally, we do not agree there is a substantive reason for the statutory requirement for the disclosure of non-audit fees and it follows that we do not support the proposed extension. There may be political reasons for statutory disclosure but we believe it will distort competition in the business advisory market and may result in a net loss of business from auditing to non-auditing firms. The UK accounting profession has long had a tradition of successfully providing broader business advice and has contributed much to the economy by doing so. It would be useful if the Committee would acknowledge that fact as well.

Conclusion

14 In summary it is our view that the code of best practice should help to raise general standards of corporate governance. As auditors we are ready to play our part in raising those standards and to fulfil the enhanced role along the lines the Committee envisages, with one proviso: that the issue of professional liability is tackled as an integral part of the proposals.

15 We have one major concern:

- (a) We are not confident that the few companies which have been disinclined to adopt good standards will change their ways in the next bull market without a more robust enforcement of the code than the draft report envisages.
- (b) We do not think it is for the auditor to endorse compliance with the code insofar as it concerns the quality and composition of the board.
- (c) Shareholders and lenders have the primary responsibility for seeing effective boards in listed companies. We think the Committee should be as specific on the respective roles of all the various institutions in the City as it has been on the role of auditors.
- (d) Because institutional interests can differ, the Committee should consider a mechanism to focus their collective role in monitoring compliance and instigating change where it appears to be required.

16 Please let us know if it would be helpful if we were to elaborate our views. We should be pleased to meet you if that would assist. Please contact Roger Davis as head of audit (Tel: 071 - 212 4531).

Yours faithfully

Cooper & Lybrand

APPENDIX

DETAILED COMMENTS ON DRAFT RECOMMENDATIONS

1 We set out below comments on the Committee's recommendations as summarised on pages 39 to 41 of the draft report.

The code of best practice (paragraphs 1-5)

2 Subject to the points set out in our covering letter we support the Committee's recommendations on the code of best practice.

Audit committees (paragraph 6)

3 We support the recommendation that listed companies should establish effective audit committees but endorse the warning in paragraph 5 of appendix 3 that there are dangers if the audit committee is seen as a substitute for discussion of key financial reporting and control matters by the whole board. We suggest that more prominence be given to this concern and recommend that:

- (a) the auditor's first line of access on sensitive issues should be to the chairman provided he or she has sufficient independence;
- (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.

Directors' service contracts (paragraph 7)

4 We support the Committee's recommendation in relation to directors' service contracts.

Interim reporting (paragraph 8)

5 We support the Committee's recommendations that interim reports should include a balance sheet and be subject to auditor review.

6 On a practical issue, we suggest that the Committee recognise that there will be some difficulty in implementing the proposals immediately. Guidance will be needed as to the content of the balance sheet and certain of our multi-national clients have said that they will require time to set up procedures to collect the relevant information. We suggest a start date of interim accounting periods ending 30 June 1994.

Enhancing the perceived objectivity of the audit (paragraphs 9-10)

7 Our comments on non-audit services provided by the auditors are set out in the covering letter.

8 We support in principle the Committee's recommendation that there should be periodic rotation of audit partners within a framework that ensures continuity of service standards and proper benefit from cumulative knowledge of the company's affairs.

9 We believe that there should be a closer accountability of auditors to shareholders. We therefore suggest that chapter six of the report should at least encourage institutional shareholders to take a more positive interest in the appointment and value provided by their auditors. It would be helpful for the Committee to explain the possibilities which it had considered for establishing a more direct link between shareholders and auditors (para 5.3 and 6.2) and the reasons why they were rejected. The Committee's proposals on audit committees and non-executive directors should go some way to improving the accountability of auditors to shareholders. Independent directors can, for example, disarm the threat of removal which hangs over an auditor who takes a tough stance, provided the independent directors are willing to work with the auditors on the proper scope of the audit. Nevertheless we believe that more research is required into what might be done to establish a closer accountability.

Enhancing the effectiveness of audit (paragraphs 11-16)

10 We support the Committee's recommendations in respect of reporting on internal controls and going concern, subject to resolution of the liability problem discussed in our covering letter. We believe that the Committee should give further guidance to those responsible for developing the detailed requirements on going concern reporting: we suggest 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. The existing Stock Exchange requirement provides a mechanism which has been tried and tested.

11 We agree with the recommendation that the statutory protection for auditors reporting suspicion of fraud to the appropriate authorities should be extended to all sectors.

12 We also agree that the accountancy and legal professions and representatives of preparers of accounts should consider further the question of the proper extent of responsibilities in respect of illegal acts.

13 We agree that the accountancy profession should continue, as it always has, to improve standards and procedures, recognising that much has been done over the last couple of years. It would be wrong however to conclude that there were not many other parties in the corporate governance regime who should also be striving to improve standards and procedures.

Endorsement of work by others (paragraphs 17-19)

14 We share the Committee's wish to support the work of the ASB, APB and other bodies.

15 In relation to the work of the ASB, we also share the Committee's view that there is a need for rigorous explanation of the factors likely to influence the company's future progress (para 4.44). We therefore support in principle the proposals of the Accounting Standards Board for a more formal operating and financial review. We suggest that the Committee should recommend how the objectivity of this review can be assured as it is for example by the regulating mechanisms in the US. For example we can see merit in a requirement for auditors formally to review the operating and financial review, to provide assurance as to its reliability and objectivity.