INSTITUTE OF INVESTMENT MANAGEMENT AND RESEARCH

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Formerly
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Mr Nigel Peace
Secretary
Committee on the Financial Aspects of
Corporate Governance
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30 July 1992

Dear Mr Peace

The Financial Aspects of Corporate Governance

Please find enclosed the Institute's response to the Committee's Draft Report dated 27 May 1992.

Yours sincerely

A H Newman
Secretary General

COMMENT BY

INSTITUTE OF INVESTMENT MANAGEMENT AND RESEARCH

ON

THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

July 1992

109/92

COMMENTS BY THE

INSTITUTE OF INVESTMENT MANAGEMENT AND RESEARCH
(the 'Institute')

ON THE DRAFT REPORT OF
THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE
('the Committee')

1. INTRODUCTION

The Institute of Investment Management and Research (the 'Institute') recently changed its name from that of The Society of Investment Analysts. The Society was established 37 years ago to improve the general quality of investment analysis and analytical techniques in the investment community by the development and practice of formal analytical skills in research, portfolio management and related disciplines.

Part of this development has included i) the establishment of an 8-paper Associate examination (at University degree level) which is recognised internationally; ii) the establishment of a Code of Conduct reinforced by a professionally operated disciplinary procedure; iii) representation of the views of the profession to Government, accounting bodies and regulatory organisations; iv) arranging for all the major UK companies to make presentations to members; and v) publishing a professional journal - the Professional Investor.

The qualified membership is changing rapidly and although, at the present time, is more or less evenly balanced between investment managers and investment analysts, the 980 strong student membership make it a statistical certainty that investment managers will be in a significant majority within two to three years. The name therefore reflects more accurately the composition of the membership who are located throughout the City in every significant investment management company or stockbroking house.

The Institute welcomes and supports in full the recommendations and Code of Best Practice (the 'Code') put forward in the Draft Report of the Committee. The Institute has put forward similar suggestions in other contexts. In particular, the Institute believes that the formation of an audit committee should be essential for all listed and USM companies. The Institute also agrees that compliance with the Code should become a requirement for all listed and USM companies and enforced by the London Stock Exchange. The text does not refer to USM companies some of which are quite large. The Institute recommends that these be included.

The Institute has a number of detailed comments.

2. PARAGRAPH 5.8

The Institute agrees that the option of alternative accounting treatments should not exist and suggests that this could be a recommendation in the Report.

3. PARAGRAPH 5.16

This paragraph suggests that the accountancy profession together with preparers of accounts should take the lead in bringing forward proposals on the subject of directors reporting on the effectiveness of Internal Control. The Institute is aware that many committees established to consider developments in Accounting include preparers of accounts among their members. The Institute believes that all such committees should also include representatives of users of accounts. It is not sufficient for users of accounts to be invited to comment on draft proposals - they should be involved in their formulation.

4. GOING CONCERN

There is an alternative way of dealing with the concept of 'going concern' which is by means of a statement about working capital such as is required by the London Stock Exchange for inclusion in listing particulars and certain circulars to shareholders. The supporting information for such a statement is prepared by the company and reviewed by the auditors and covers a period of 12 months. Such a statement could assist in dealing with the question of going concern in a way that is already well understood.

5. FRAUD

Paragraph 5.27 suggests that an 'effective and independent minded audit committee is an essential safeguard' against fraud. However, as is rightly stated elsewhere in the Draft Report, it is not the responsibility of the auditors to detect fraud. If it is intended by the Committee that audit committees should have some responsibility for detecting fraud which goes beyond that envisaged in the recommendations on Internal Control (see paragraphs 5.16 and 5.17) then guidance or guidelines should be brought forward. The responsibility for formulating such guidance could be included in the tasks recommended to be undertaken in paragraph 5.16 on Internal Control.

6. OTHER ILLEGAL ACTS

Paragraph 5.30 recommends that further work be undertaken by a group which again does not include users of accounts. We refer to our suggestion in section 3 above.

7. COMPOSITION OF AUDIT COMMITTEES

Although the Draft Report refers to the composition of audit committees as comprising non-executive directors in the plural, it would be helpful if there was a specific recommendation as to the minimum number of non-executive directors on a board. Recommending that the number of non-executives should be such that their views carry significant weight is clear but interpretation into practice

could be varied. A clear statement about the composition of boards and committees would be helpful.

8. THE CAPARO CASE

The Institute does not agree with the conclusion reached by the Committee in respect of the Caparo case. The members of the Institute are concerned in their professional lives in making recommendations and decisions about the purchase and sale of shares. In all cases, there is considerable dependence on the latest audited accounts.

The conclusion reached in the Caparo case is doubtless correct in law. However, the Institute considers that the law should be changed. The Draft Report sets out arguments against 'extending' the auditors' duty of care in paragraph 6 of Appendix 4. The Institute comments on each of these arguments as follows:

Argument 1

This argument seems to relate to the idea that liability would be increased by an unknown amount to an unknown group and hence the 'classic words of Cardozo CJ'. Indeed, there is a reference to an 'unlimited liability' in paragraph 4 Appendix 1. However, an analysis of the situtation shows that the effect of the Caparo case is potentially to reduce the liability of the auditors where there have been changes in shareholders.

The Caparo case judgement seems to imply that those shareholders to whom the audit report is made can as a body bring a claim against the auditors. However, if some of the shareholders sell their shares after the audit report and before a problem related to the accounts (ie before the need to make a claim) becomes public knowledge, then that shareholder will have suffered no loss (since the share price at the time of sale should not then have been affected by knowledge of the problem related to the accounts). As the new shareholder is precluded from claiming (because of Caparo) and since the old shareholder has suffered no loss, the potential claim against the auditors will have been reduced purely as a consequence of a change of ownership.

It should be possible for legislation to identify the shareholders who have actually suffered loss irrespective of the date of purchase of their shares.

Argument 2

While it may be difficult as a matter of law to 'prove' that an investor had relied on audited accounts, as a matter of fact it is almost certainly the case that purchasers of shares rely on the accuracy of previously published audited accounts. It ought to be possible for the law to be adjusted so that it was for the auditors to prove that the investor had not relied on the audited acocunts.

Argument 3

This argument cannot work. The law relating to prospectuses is very detailed and penalties are significant. The legislature in a wider sense is very concerned with the protection of both the public at large and investors. Prospectus law deals with the primary markets. The Institute is recommending that there should be comparable legal protection for the secondary market. Furthermore, the Caparo case itself made it clear that the shareholders as a body have a right to claim against the auditors.

Argument 4

The liability should reflect the loss suffered. There is no obvious reason why a relationship should exist between liability and audit fee.

Argument 5

While directors do bear ultimate responsibility, they also rely on the auditors as do the shareholders. Only the auditors should or could be responsible for their own negligence and must therefore foot the bill on their own. This is not a valid argument against extension.

Argument 6

The availability of adequate insurance cover is a reflection of the perception in the insurance market of the likelihood of claims. Presumably, for the most competent firms, claims are low and insurance cover is available. The Institute believes that the threat of legal action is an important tool in motivating auditors to maintain the highest professional standards.

Argument 7

The third parties have relied on the audited accounts to make an investment. This should be sufficient to establish the liability of the auditors. As regards payment, if the auditors have been paid surely no further payments are necessary. It should be possible for legislation to deal with the situation where third parties rely on the auditors but make no payment to them. At present, auditors are paid by the company and not by shareholders.

Argument 8

This is unlikely since, as argued above, extending the liability of auditors to prospective shareholders does not, in the view of the Institute, increase the overall liability of the auditors to shareholders - it merely prevents the auditors benefitting from a reduction in their liability which results directly from the Caparo case.

However, the question of liability to other third parties who are not shareholders needs to be considered separately. This group includes lenders and other security holders (eg bond holders), suppliers who grant trade credit and so on. The

Institute can see no reason why auditors should not be liable to these groups. In this way, the liability of auditors will be extended. This may lead to an increase in cost but it seems most unlikely that it would become 'uneconomic'.