Sir Adrian

Copy for your retention.
I will acknowledge.

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RDG/CW
23 September 1991

N Peace Esq
Secretary - Committee on
Corporate Governance
P O Box 433
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Dear Nigel

CORPORATE GOVERNANCE: FINANCIAL REPORTING AND ACCOUNTABILITY

In your letter of 18 July you highlighted three aspects of Corporate Governance on which our views would be particularly welcome.

Our Law and Parliamentary Committee and its sub-committees have considered these in various contexts and have developed several proposals on how improvements might be made. The broad principles of these are set out in the attached outline paper.

We would, of course, be pleased to provide more detailed papers or discuss our ideas with the Committee or yourself if this would be helpful.

Kind regards.

Yours sincerely

Roger Gray

ROGER GRAY
Director - Public Affairs

Enc:

FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

1. REVIEWING AND REPORTING PERFORMANCE

One function of financial reporting is for management to explain its progress towards meeting its strategic objectives. The Institute believes that it follows that there is benefit therefore in publicly reporting more of the information which management use for internal decision making.

In "Corporate Reporting: The Management Interface" the Institute outlined the spiral of improvement in corporate health which it believes begins with increased disclosure. This is that:

- improved disclosure leads to improved shareholder understanding and increased shareholder loyalty;
- increased shareholder loyalty provides a better environment for managerial decision-making in which management can concentrate on long-term strategy without being diverted by the need to improve short-term profitability;
- a better decision-making environment leads to better decisions and improved performance. Management develops a long-term strategy and has the discipline to maintain it - or will need good reasons for seeking to change it;
- improved performance leads to increased willingness and confidence to make increased disclosure.

Increased disclosure permits increased scrutiny of management and this may explain the nervousness of some towards going down this route. However, management could expect that shareholders - financial institutions as well as individuals - would respond to the increased confidence that was being placed in them by paying more attention to their responsibilities as owners.

Information on company turnover and profits has, of course, traditionally been disclosed both internally and externally. Again, however, information central to a proper understanding of the figures and their relationship to the future prospects of the company has generally been made available only to those within companies. Management often makes this available to analysts and major institutional shareholders on a "confidential" basis. The Institute believes that this practice must be discouraged and that, as the Companies Acts require, all shareholders be treated equally.

"Corporate Reporting : The Management Interface" provided modest examples of how improvements in reporting practice might be practically realised. The Committee will already be familiar with these. To develop these further and to gain a greater appreciation of senior managements' receptivity towards change, the Institute has conducted a survey into the views of Chairmen and Chief Executives. Corporate reporting should not, we believe, be developed solely by the accountancy profession. It involves much wider groups and interests. In keeping with this belief, the Institute has received assistance on the project from the British Institute of Management and the Institute of Directors. Replies are currently being analysed and the results should be available shortly.

An area of particular interest, and contention, is the provision of information about a company's future prospects. The debate about disclosure of expenditure on R&D (one of the few forward looking figures in annual reports) typifies the issue. The Institute's Accounting Practices Group is currently preparing a paper on R&D for the Accounting Standards Board. It is also looking at the standard on EPS and the way in which the earnings figure has become a dominant influence in reporting practice.

If users are to be provided with information which management finds useful for decision-making then, CIMA believes, they should also have access to information, both financial and non-financial, about future prospects. However, there is a conflict here as competition will always prevent full disclosure of relevant facts. This difficulty is compounded by, as in the US, the possibility of litigation arising from the publication of what may later be deemed to be a misleading statement. A way forward could lie through adoption of an approach similar to that of the Management Discussion and Analysis in the US - although this itself is the subject of current comment - or through greater use of Interim Reports which have several advantages for taking a low-key approach. CIMA's ideas on this were detailed in "Corporate Reporting : The Management Interface".

Greater emphasis placed on the disclosure of more information prepared for internal management purposes leads naturally to consideration of internal reporting practice and "best practice". During the work that has been conducted, and which continues, into financial reporting practice the Institute has found a surprising lack of awareness of what a comprehensive set of management accounts submitted to a company's Board actually comprises. The Accounting Practices Group is currently refining ideas for developing a model set of monthly management accounts encompassing all common financial disciplines. This is also taking into account the work undertaken by our European Accounting Group into uniform charts of accounts. The development of charts of accounts into cost accounting could facilitate integrated management accounting and provide a framework on which to build a Pan-European to internal financial management. The Group's report 'Financial Reporting in Europe : The Management Interface' will be available early in October 1991.

The form in which increased disclosure is made is also important. Taking disclosure of market information as an example it is encouraging that particular sectors such as pharmaceuticals and chemicals provide much detailed information which is frequently accompanied by graphical or diagrammatic representation. Trends can be more easily identified. In its work on corporate reporting, the Institute's Working Party noted the approach taken by Scandinavian and continental European companies in this respect. It felt that there was scope for UK companies to consider developing similar approaches. Some examples are attached and may be of interest to the Committee.

2. AUDIT COMMITTEES

CIMA has been a strong supporter of the use of non-Executive Directors. It took a close interest in moves, such as those made by Sir Brandon Rhys-Williams, to legislate for their appointment. CIMA also strongly supports the Pro Ned Code. Together with Remuneration Committees made up of non-Executive Directors, Audit Committees are an essential outlet for advisory auditors to comment without direct involvement with all of the Executive Directors. The Committee recently reiterated its support for Audit Committees in the context of the EC Fifth Company Law Directive (and European Company Statute) where it recommended that all companies should have non-Executive Directors and Audit Committees. These would provide many of the benefits and safeguards quoted as coming from alternative Board structures. They would also go a considerable way towards meeting the concerns that it is often proposed to alleviate through mandatory rotation of auditors.

The Institute believes that there is a need for a Code of Practice to be developed for non-Executive Directors and for Audit Committees. This could be similar in coverage to the paper recently issued by the Australian Merchant Bankers Association and others entitled "Corporate Practice and Conduct" but should be much more detailed in content. In time this could then form an accepted basis on which legislation might be built if it was thought necessary.

3. RESPONSIBILITIES OF AUDITORS

To understand CIMA's proposals for the more effective regulation of auditors, it is necessary to see them in the wider context of the Institute's policy towards the statutory requirement for audit and, in particular, its application to small companies.

For many years the Institute has strongly advocated that mandatory audit of small companies should be discontinued and that, instead, small company accounts should carry a 'Certificate of Compliance' signed by an "authorised accountant" - a term that would be defined in the Companies Act. For many small companies there would be no immediate change. Accounts would continue to be prepared by small firms of accountants in practice, although the Certificate of Compliance would be a more valid statement of what took place. For slightly larger companies (perhaps even in the £1-2m range) there would be an incentive to employ an accountant. The main benefit to both categories would be that an employed accountant would prepare the accounts in a management context as an aid to greater efficiency in business. While recent changes in companies legislation have relieved small companies of the necessity to hold AGMs and to present accounts, it is recognised that the discipline of audit may not be given up lightly. There is, however, an encouraging level of support for this both within the accountancy profession and other business groups.

In terms of auditors' responsibilities adoption of this policy would mean that, given the remarkably few audit firms engaged in the audit of plcs, it would then be practical for their appointment to be better regulated and supervised. CIMA has long recommended that this should be done through the establishment of an Audit Commission for Public Limited Companies. Auditors would have a direct reporting responsibility to the Commission and companies would be required to confer with the Commission on the appointment or change of auditors. The Commission could also hold hearings if auditors wanted to appeal against what they considered to be unfair or unreasonable dismissal. The Commission would thus provide an independent external point of reference. This would complement the internal independent point of reference provided by Audit Committees. It is through providing and ensuring these independent reference points that the practices of management and auditors can be better evaluated and, where necessary, regulated. The concept of an Audit Commission for plcs could be integrated with the Financial Reporting Review Panel as both would have similar objectives.

Audit standards could also be better developed and audit reports improved if they focussed solely on plcs (the US provides some useful precedents). The role of internal audit is also sometimes overlooked in the corporate governance debate and the Institute has an Auditing Group looking at this in more detail.

RDG/cw
23/9/91