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Tuesday 24 September, 1991

Adrian Cadbury  
Committee on the Financial Aspects  
of Corporate Governance  
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Dear Adrian

Just a note to thank you very much for taking the time to come in and meet me last week. I found the meeting most useful. One point I did mean to raise in our discussions relating to Non-Executive Directors was the number of women. I would clearly like to see this increase.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Marjorie Mowlam', written in a cursive style.

MARJORIE MOWLAM

Sir Adrian

RECORD OF MEETING WITH MARJORIE MOWLAM MP, OPPOSITION SPOKESWOMAN ON CORPORATE AND CITY AFFAIRS, ON 19 SEPTEMBER 1991

Present:

Marjorie Mowlam MP  
Sir Adrian Cadbury  
Nigel Peace

Marjorie Mowlam handed over the notes at Annex A which had been prepared for her lunch with the profession in June. They had not been published but represented Labour's position.

2 Ms Mowlam commented on the notes as follows:

- role of the Institutes as supervisory bodies. Her stated position was that if in office she would consult on this issue. She suspected however that she would be pressured by the back benches into transferring the supervisory role to the FRC. She understood that this would be likely to have serious financial consequences for the Institutes and would force them to merge. She would not mind. The fact was that there was a public perception that auditing and accounting was a 'dodgy area', and as a politician she was obliged to tackle it. Part of the problem was that in accountancy (alone of the professions) regulation was carried out by the trade associations. Transferring the supervisory role to the FRC might not catch a lot more bad practice but it would help change the perception.

Ms Mowlam added with regard to the ASB that she believed it should be given time to show what it could do. If industry began to backtrack, however, there would be a need (more in sorrow than anger) for more government intervention.

- auditors' independence. She was again worried by the perception problem. However she was not convinced by either of the proposals discussed in the notes and saw no point in legislation. 'Quarantining' audit would be evaded by setting up subsidiaries (as happened in France) and rotation would on US evidence lead to more audit failures.

- Europe. The Institute ~~e~~s had to learn to look not just to North America but to Europe as well. It was arrogant to assume that Europe would fall into line with Britain and the US.

2 Ms Mowlam said that she did not know the answer on auditors' liability in the light of the Caparo judgement. Similarly she did not know whether Audit Committees - which were essential - should be subject to a statutory requirement. It was essential for both issues to be looked at.

3 Ms Mowlam also handed over the notes at Annex B and ran briefly through the main points.

4 Ms Mowlam said that if the Committee's report ducked the basic issues, it would be hammered. She did not want a waffly report with no teeth, but something the City would do. Sir Adrian said that he was accutely aware of the problem. He hoped to get behind the work of other bodies and to make it stick. Ms Mowlam said her concern was that 'the club' was not working. She would be prepared to give the approach breathing space if it offered something concrete. She reiterated however that it would be strongly criticised if it led to nothing happening.

5 Sir Adrian mentioned that he would be meeting Austin Mitchell MP and colleagues.

NDP

20 September 1991

## GUIDELINES FOR DISCUSSION AT THE INSTITUTE OF ACCOUNTANCY

### INTRODUCTION

- 1 The objectives of Labour party policy in the field of auditing and accountancy are simple and clear. They are to ensure that accurate and comprehensive financial information is generated for the user in general and for the investor in particular. There is agreement that accounting standards need to be improved, although naturally there is disagreement over the degree of change that is necessary. Recent company collapses and substantial frauds have raised serious questions about the purpose of audit and the duty of auditors. Concern has been increased by the Caparo case.
- 2 In approaching the subject of accountancy and auditing we have been concerned as with all other areas of policy to take account of the differing systems which exist particularly in the European Community and the United States. We believe that the UK has an important role to play in providing a bridge between these differences. We also believe that it is vital to protect and enhance the historical role in training and education which the UK has held and which places the UK in a lead role in this respect.
- 3 Proposed changes which the Labour party in government would wish to make should be viewed in the wider context of investor protection, corporate governance and accountability, rather than against the background of technical rules. We are conscious that share holders, creditors, policy holders, unit trust investors and members of pension funds are all affected by how profits are calculated and disposed of. Furthermore, disclosures have implications for risk assessment, wealthiness, director propriety and confidence in our democratic traditions.

### PRESENT REFORMS

- 4 We welcome the recent proposals for discussion from the Accounting Standards Board (ASB) as a preliminary move in the right direction. We look forward to implementing these proposals under a Labour government. We believe that the reforms proposed by David Tweedie make good sense, in that they deny companies some of their present ability to obscure the facts, by shifting the balance of deciding what is put in reports away from the producer of accounts.
- 5 The proposals which are now in the process of consultation with the Financial Reporting Council (FRC) and the ASB bring significant outside oversight and involvement, particularly from the users of financial statements.

We believe that, similar to the Financial Services Act 1986, the current arrangements for accounting and auditing will require time to bed down properly and to demonstrate that they can work. We will want to see the full effect of the current reforms before other changes are considered. In particular we wish to see how the Review Board - which will be responsible for investigation of breaches of reporting standards - will work in practice. We await the publication of the Board's detailed working practices.

We welcome the following proposals:

- 6 \* The call for a statement of realised profits to be published immediately below the profit and loss account, and for the more prominent showing of reserve movements.
- 7 \* The outlining of new profit and loss accounts with columns identifying separately the effect of acquisitions and discontinued operations at every point from turnover down to attributable profit.
- 8 While we believe that it is important to give the recent changes and proposals a reasonable length of time to bed down, we are also persuaded that a number of other concurrent steps must be taken to help cement the fortunes of those changes.
- 9 \* It will be necessary for the ASB to demonstrate a commitment to act in dealing with those companies which fail to adhere to its rules.
- 10 \* It will be necessary for the real independence of the ASB and related bodies to be demonstrated together with an openness in its procedures of which there is as yet no real indication.
- 11 \* We believe that it is important to keep up the pressure on the accounting profession to make incremental improvements in both reporting and auditing. The increase in audit committees reporting to non-executive directors should have the effect of exposing potential frauds at an early stage. We believe it is worth considering the introduction of a legal requirement for all companies to maintain satisfactory systems of internal control.
- 12 \* The 1985 Act requires companies to maintain proper books of accounts, sufficient to enable the preparation of a financial statement. We believe there is a case to report publicly on the internal control systems. Research should be undertaken to examine the likely costs of such an initiative and the potential benefits in terms of reduced opportunities for fraud.

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## THE WAY FORWARD

There are a number of changes which we believe should be acted upon swiftly.

- 13 \* Audit Committees, with the active participation of non-executive directors should be compulsory.
- 14 \* Institutional improvements in the regulatory framework for audit should be made, specifically the movement of the Audit Practice Board (APB) to within the framework of the FRC.
- 15 \* The Statutory Instrument which would enable the requirement of disclosure of non-audit fees paid to company auditors should be implemented. If this step has not been taken before the next election, a Labour government would so do.
- 16 \* There should be liaison between the ASB and the Central Statistical Office (CSO) to ensure that company reports are in a form of immediate value for statistical returns. The CSO will need some statistics to place in the public domain, while others will have to remain confidential for commercial reasons. The auditor should have a statutory duty to collect them in a format which is useful to government.
- 17 \* Company accounts should be issued on a timely basis. All PLCs should be required to file accounts with the Registrar of Companies within 90 days of the end of the financial year.
- 18 \* In general the accountancy profession should disclose far more of its meetings and discussions to interested parties, where there are no good legal reasons for this not to happen. A positive step in this direction for the profession would be the introduction of a bigger percentage of non-accountants onto boards. We realise that this will involve a trade off between non-accountant independence and detailed knowledge and understanding. We believe that in pursuing this development it is important that nominees should not be politically appointed and that such representatives should come from a wide variety of bodies.

## REVIEW AREAS

- 19 It is not our intention to set down a series of rigid statements of intent. We believe that there are areas of concern that will require time and consultation to resolve and in many of these areas we will want hold comprehensive reviews.

- 20 \* A fundamental review should be carried out on corporate governance. We believe that changes in this area could remove the necessity of other policy 'tools'.
- 21 \* The position of auditors with regard to the discovery or suspicion of fraud needs to be reviewed. There is clearly a case for the auditor to have a link to the regulator in order that serious fraud can be pursued effectively. However, it is also true that auditors may rightly feel obliged to report minor fraud to management instead of the regulator.
- 22 \* In the light of the Caparo decision there have been calls for auditors to be liable for negligence to users of accounts who suffer loss from decisions based on those accounts. Such a requirement would also demand that auditors have better defence against such a liability and that auditors should issue summary reports to share holders of their report to management. Further, any liability for negligence would have to be based upon a more clearly defined system of responsibilities for auditors.

#### OTHER STEPS

##### Regulation and Compliance

- 23 Under the 1989 Companies Act the accounting Institutes are entitled to apply to be supervisory bodies of the auditing profession ie. to maintain and enforce rules as to eligibility of persons to seek appointment as company auditors and as to the conduct of company audit work. This will mean that once their current applications to take on this role have been accepted, they will then be in a position to register auditors, define standards of auditing and monitor compliance. We are aware of the concerns expressed by Sir Gordon Borrie of the Office of Fair Trading in this area with regard to the issue of anti-competitiveness about which we also have concerns. We will expect to take account of those concerns on competition while looking into the role of the supervisory bodies.
- 24 The Institutes are run by members elected from within the profession and perceived - not wholly correctly - to be dominated by the big firms. Given the real concerns about the role and value of audit (and also the independence of auditors discussed below), it is especially important that there is seen to be an objective and effective regulator.
- 25 The choices are to create a new - and wholly independent - body, or to try to improve the current self-regulation arrangements. Any changes proposed must take into account levels of funding and the levels of skills of people employed.

In the short term it is almost certainly more productive to try to improve the current arrangements which have the advantage that they can draw on the full range of the audit profession's experience in practice. There is no doubt that the current institutional arrangements are unsatisfactory and there is a need for more outside input reinforced by a generally greater transparency of proceedings and recommendations. Neither greater outside input nor transparency nor input are likely to come about with the current regime. Arrangements analogous to that of the FRC and the ASB would seem to be more appropriate; there would thus be a supervisory body like the FRC with extensive and heavy outside involvement; a body for establishing eligibility and registration of auditors; a standard setting body to involve both providers and users of audit statements and the audit service; and a separate investigatory and enforcement mechanism with the power to investigate and report on actual audit practice. There seems no reason why such a body should be wholly separate from the current arrangements, and a possible solution might be to put it within the same framework ie. an audit practice board plus investigatory mechanisms reporting to the FRC.

#### Independence

- 27 The concern that auditors are insufficiently independent to give an unbiased view or may compromise on their audit judgement stems from the unsatisfactory regulatory regime referred to above and the interrelationship of audit and the other professional services offered, particularly by the larger audit firms.
- 28 In the second connection, audit is a diminishing part of the service firms are offering to their clients. In the major firms, while audit may still be the largest individual service offered in revenue terms, it is not necessarily the major part of the business, nor is it the most profitable, particularly in recent years. Thus it can be argued that auditors could be discouraged from challenging management or giving adverse opinions on audit matters for fear of prejudicing the (potential more lucrative) other services they are offering the same management. The probability of this behaviour is exacerbated by the increasing competitiveness in the audit market and the fact that the strategies of the major accountancy firms are based on strengthening relationships with their major clients (and thus client management) to widen the range of services sold.
- 29 There is no doubt that there is a potential conflict between the commercial interests of the accountancy firms which involve maximising their sales to existing clients and their responsibility to challenge management when required to.



The professional ethic of the past may no longer be enough and it certainly won't be perceived by the outside world to be adequate.

- 30 There is a range of suggested mechanisms for addressing auditor independence including pure and client quarantining and rotation.

#### Quarantine

- 31 Quarantining audit from other advisory services offered was suggested in the European Commission's draft Eighth Directive, but was dropped from its final version under pressure from the British Government. It could take two forms; pure quarantine ie. an audit firm could do nothing else other than audit, or an arrangement whereby a firm could not offer any other service to its audit clients (client quarantine). In either case there are likely to be significant definitional problems as to what is and is not an audit (eg. would any of the following be allowed)
- \* tax compliance work
  - \* verification of share holder circulars
  - \* reporting on profit and working capital forecasts in such circulars
  - \* acquisition reviews and due diligence
  - \* advice on rectification of control weaknesses)
- 32 This approach would probably narrow rather than broaden the focus of audit, and thus any requirements to widen its scope such as with 'social' audit aspects (environment, employment issues) would be more difficult to provide from within the then auditing profession.
- 33 This narrowing of audit would almost certainly make the profession itself a less attractive place to work and diminish the quality of people in it. The current UK accountancy profession is by any standards a success story. It has developed a wide range of services, provides the UK's major source of management training for graduates (at no expense to the tax payer), and is especially well placed to compete in the advisory services market in Europe. Enforced separation would potentially damage these aspects and would seriously disrupt the profession when it is beginning - at last - to get itself into Europe.
- 34 It is not wholly clear that separation would sustain integrity (there is no evidence that it has done so in the rest of Europe where there is pure quarantine.
- 35 These arguments do not apply with the same force to client quarantine and indeed those firms which are active in the local and health authority audit markets are subject to this kind of quarantine already.

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If this measure was adopted it would, therefore, inevitably result in some redistribution of work, probably among the larger firms and, possibly, ultimately in the creation of specialist audit firms. It is not wholly clear whether the creation of such specialists would be beneficial as, again, narrowing the focus of audit would almost certainly reduce the vitality, skills and quality of people in the auditing profession. A further complication would be the implications for the management of multinationals who frequently prefer to use the same auditors internationally; UK advisers, could, in effect be at some disadvantage in the multinational market. While it is hard to evaluate the probably impacts of such changes, client quarantine is undoubtedly more attractive than pure quarantine but would have some unpredictable effects on the current structure of the profession.

### Rotation

36 It is argued that the dependence of auditors on client management and the cosiness which can result from long term relationships would be lessened if auditors were compulsorily rotated. While such an arrangement could reduce cosiness, there would undoubtedly be some cost penalties to the client each time the auditor is replaced. More importantly, it is not clear if rotation would have the desired effect. Assuming no quarantine at the same time, those bidding for audit work would have exactly the same, or an even greater incentive, to bid low to win audits as a means of winning other advisory service work with all the possible adverse implications for the quality of the audit work itself. If there was also pure quarantine, price would be even more likely to be the key factor in selection with uncertain implications for quality unless the price was in some way regulated by an outside party or by a scale of charges. But in this instance the audit profession would become a narrow-based regulatory function, in practice almost an arm of the state. Where services were provided by multi-disciplinary firms under a client quarantine regime, the time when the auditor would be prepared to give a totally unbiased opinion could be limited to the early years of the appointment, as in the later years there would be advantages in exploiting the knowledge of the client after the end of the audit term - in selling non-audit services. In this connection, it is interesting to note that American research has demonstrated that audit failures take place most frequently in the first two or three years after appointment.

37 Rotation and client quarantine are policy options in addressing the question of the independence of auditors. The need for these policy options may be mitigated if the duty of directors and auditors were more clearly spelled out and if it were easier for aggrieved parties to proceed against them.

Market pressure in the form of the threat of aggrieved parties seeking recompense for inadequate performance should ensure that the auditors maintain their integrity. The problem would also be lessened if there were greater independence in the supervisory bodies. It can therefore be argued that consideration of client quarantine and rotation are not necessary if a more fundamental look at governance and changes in the legal framework take place. A fundamental look at corporate governance and the legal framework is going to take time as will also a subsequent consultative process. We would only move on rotation or client quarantine in the light of the review of corporate governance. It is only necessary to consider moving down either of these policy routes if it is thought that the legal framework and processes cannot be satisfactorily altered. While strictly speaking they are not mutually exclusive, they are, in effect, policy options.

- 38 This brief discussion paper inevitably fails to cover many areas of importance eg. there are many other policy areas which are integrally related to accounting and auditing, these include pollution concerns, energy efficiency, research and development, low paid workers and delivery of commitments to the disabled. Similarly there is growing concern on the grounds of accountability of the auditing of the plethora of new bodies such as Trust Hospitals and opted-out schools which will require discussion with both the National Audit Office and the Audit Commission.

## CADBURY MEETING

Role and Responsibility of Directors

Accepting many of the recommendations of Institutional Shareholders Committee

- AB1.
- A Statement of Best Practice
    - separation of Chairman and Chief Executive roles
    - role of non executive directors (who are genuinely independent)
    - to contribute towards maintenance of high standards

Particular role of Non Executives

- 1) Should represent "outside" shareholders ie not be in the "pocket" of the executive directors or be their financial advisors. Possible shortage of suitable candidates - evidence by number of people with multiple directorships.
- 2) Perhaps non execs should be proposed and formally elected by shareholders (in effect the leading institutions)
- 3) How do we ensure that non-execs perform their function eg many companies which ran into trouble also had non execs. Perhaps they tend to identify too readily with the rest of the Board
- 4) Non execs should form majority of audit and remuneration Committees although there is little evidence that this makes much difference to policies and pay.

The problem lies in implementing this policy in a way that makes any difference to corporate conduct. Non execs should represent a genuine check on the rest of the Board.

Disclosure and Presentation of information to Shareholders

- 80% of ordinary shares held by institutions who are generally powerful and well informed but have hitherto been overinvolved to take a passive view.
- Institutions must give a lead to ensure best practice in effect to ensure the interests of minority of smaller shareholders are heard also
- if private companies are only statutorily required to report twice a year - interim official results and Annual Report and Annual General Meeting. This is the sum of the contact.

- 1) Standards of disclosure and presentation in Annual Reports need to be improved to the highest practice. More information - perhaps on the lines of the 10K Report.
- 2) Relationship with investment analyst - specialists working for stockbrokers or institutions generally frequent contact with company managements - problem of how information should be disclosed, without ~~of~~ insider knowledge
 

market analyst = important role
- 3) Growing frequency of direct contact with institutions to be encouraged but again how do we form the relationship
  - institutions represent the public as policy holders/pensioners
  - a genuine two way constructive relationship should be encouraged - supportive but constructively critical -eg M+G's example

### Contact with shareholders

- contact difficult. AGMs poorly attended and inaccessible and often standards of public knowledge inadequate. However, pensioners and employee shareholders are in a stronger position and should receive more encouragement.
- employee reports should become statutory and informative as in the best practice therefore we should concentrate on employees and shareholders

### Planning and Performance

- some companies produce a "mission statement". Companies should be expected to set out their long term strategy in Annual Report, in as much detail as competitive pressures will allow. Non Execs should have a role in this

### Review of performance

- Inevitably the judges are the institutional shareholders and non executive directors
- means to judge performance in relation to objectives
- matching directors' emoluments more closely to performance - remuneration policy should be put to vote at AGM.

### 4) Voting

-How do we encourage institutions to exercise voting powers at AGMs? At present too many fail to vote. Too often institutions have allowed company affairs to continue away without doing anything or exercising any check.

- at present votes on issuing new capital for takeovers but how accurate is information
- voting on directors' emoluments
- voting on political contributions

*voted separately*

### 5) Education

-may be as important as tightening the law on Directors responsibilities - in fact the two go together.

*Management training*

### Audit committees

- yes
- should be predominantly non-executive directors. Should exercise a greater role in governing corporate affairs, especially the proper keeping of accounts
- limiting scope for secrecy of certain exec directors as has been brought out most extremely in Polly Peck
- proper content of accounts according to statute

### 6) Role of Auditors

- we have already set out our views of how their roles should be strengthened

### Role and Responsibility of Shareholders

Shareholders obviously recognise the role of managers/directors in running a business on their behalf and generally so not seek to run it themselves. But to know that it is being run effectively they must be kept well informed of developments especially in relation to longer less strategic plans.

- shareholders influence may be reflected by non execs
- higher quality of corporate communication

*of voting on whole or part*

willingness of institutional shareholders acting together eg thru ISC to take preemptive action, rather than a passive role. However the debate on long termism/ short termism - the ideal relationship is the Pru/M+G type. This should be encouraged.

#### The Wider Role

Responsibilities of companies to employees, community, wider natural strategy and employee relationships decided by law.