



FINANCIAL REPORTING COUNCIL

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

Dear Nigel,

Andrew Hugh Smith sent round the Executive Summary of the research undertaken by Proned into the role of the non-executive director.

I noticed in particular that 84 per cent of the institutional investors and auditors agree strongly that the non-executive directors have a responsibility as a shareholders watchdog. I see at the same time and on the same page (page 8) that only three per cent of the institutional investors and auditors would agree that the non-executive directors are very affective.

That suggests the institutional shareholders, who are very largely the owners of British industry, do want the non-executives to have distinctive and strong role on boards in the financial aspects of corporate governance, and that we must therefore resist being knocked off our perch by people like the CBI, who do not speak for the shareholders. As I have previously indicated, however there are ways in which we can respond to the CBI concerns that we have unwittingly seemed to polarise the board into non-executives and executives.

A final thought on this, and the real reason for writing is to ask whether the institutional investors can be encouraged to make some strong public statements in support of the role of the non-executive directors.

The Arthur Andersen Thoughts on Audit Committees for 1990s

The briefest of comments on the Arthur Andersen document: I liked the suggestions for questions to external auditors on pages 29 to 31, but I quailed at the extent of the proposals as a whole; they go well beyond what I have personally come across and I would not add to our recommendations.

Yours sincerely,
[Signature]

ATTITUDES TOWARDS NON-EXECUTIVE DIRECTORS

1. The Perceived role of non-executive directors

From a list of eight statements about the role of non-executive directors, overall, three emerge as being vital:

- their responsibility to the shareholders
- to be aware of strategy and comment upon it
- to be involved in developing strategy

However, opinion is divided over the extent to which non-executives should be involved in the development of a company's strategy. The executive directors (notably the CEO), institutional investors and audit partners feel that the role of non-executive directors is *to comment on strategy*. Chairmen and non-executives themselves feel more strongly that NEDs should be instrumental in *developing strategy*. This difference in perspective may lead to misunderstandings about the role of the non-executive director, especially if there is no clear job description. Furthermore, the executive members of the board may feel threatened if they perceive that non-executive directors are encroaching on what they see to be their area of responsibility.

NED role: % agreeing strongly	Chairman	NED	CEO	Inst/Audit
responsibility as shareholders' watchdog	56%	72%	64%	84%
involved in developing strategy	58%	66%	31%	16%
aware of strategy and comment upon it	52%	51%	64%	78%

2. The Perceived effectiveness of non-executive directors

The majority of chairmen believe that the contribution of the non-executive directors on their boards is very effective. Their view is more positive than any other audience researched – including non-executive directors themselves.

Institutional investors and audit partners are especially critical.

	Chairmen	NED	CEO/Exec	Inst/Audit
% agreeing NEDs "very effective"	62%	45%	37%	3%

Appendix IV Questions to external auditors

Risk assessment

- What issues or concerns exist that could have a serious adverse impact on the financial or operating stability of the company? Do you believe that these are being addressed by management?
- How have you satisfied yourselves that non-audit work performed for the company will not impair your independence?
- To what extent, and why, have you altered the scope and content of your audit work from the previous year?
- Putting yourself in the audit committee's position, are there any other key questions which you, as the external auditors, believe should be asked by us as non-executive directors?

Controls

- Are the personnel in the financial organisation sufficient in number, experience and capability for the size and complexity of the company and its activities?
- To what extent can the planned audit scope be relied on to detect errors and irregularities and material weaknesses in internal control? Does the planned audit scope allow the production of useful management letters?
- To what extent does the audit include assessing and testing controls in the EDP area? How is security over data files subject to review?
- Has the audit identified any areas of serious concern relative to the overall control environment?

Regulatory issues

- To what extent is a review of compliance with government or other regulatory requirements seen as part of the annual audit? Do the audit procedures include a review of company controls and internal audit work in these areas? Are you aware of any significant risks or instances of non-compliance?

Financial reporting

- What is the scope of your involvement in interim information reported to shareholders?
- Are there any accounting principles or reporting practices used by the company that are marginal or acceptable only because they are not material in their current impact? Should any of these be of current concern to the committee? What is your assessment of the future impact?
- Are you satisfied with management's resolution of important issues of judgement relating to financial statements and disclosures?
- Did the audit disclose any significant transactions with entities or individuals that are closely linked to major shareholders, board members or management? Are you satisfied that these are appropriately reflected in the financial statements?

Internal auditors

- What is your assessment of the internal audit function? Is the internal audit programme adequate and responsive to risk and is it respected within the company?
- What are your views on the combined scope of internal and external audit work in assessing and monitoring controls?

Executive management

- Is management responsive to your findings and recommendations? Are there any areas where you have expressed concern which are apparently not being addressed with sufficient urgency?