CAD-0218

Sir Adrian

This is the Institute's draft response by us.

Nigel
17/7

WITH THE COMPLIMENTS OF

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Nigel.

As promised, here is the Institute draft submission as agreed by our Management Committee for presentation to Council on 5th August.

As soon as Council has deliberated I shall pass any changes by you. 16/7

REPORT TO COUNCIL: 5 AUGUST 1992

FROM: FINANCIAL REPORTING AND AUDITING GROUP

MATTERS FOR DISCUSSION

1. Response of the Institute of Chartered Accountants in England and Wales to the draft report of the Committee on the financial aspects of corporate governance

The Institute welcomes the publication of the draft report of the Committee as a significant contribution towards providing better protection and assurance for shareholders of listed companies. It believes that implementation of the report's recommendations may well go beyond that objective, in increasing the effectiveness of company boards.

It supports the recently expressed views of the Governor of the Bank of England on corporate governance in urging, encouraging and promoting a plural approach, so as to obtain a balance between sensible safeguards, informed by experience, and freedom to take legitimate risks.

The Institute accepts that the Committee has seen that it would be unrealistic to propose radical reforms at the present time and has sought instead to increase the effectiveness of the present system of corporate governance. This has had the natural effect of containing the scope of the Committee's work within that of the existing legal framework.

It is recognised that implementation of the recommendations of the Committee or even the adoption of stronger statutory measures will not have the effect of preventing a determined law-breaker from causing serious damage. Nevertheless the recommendations should lead to a raising of standards generally and to a reduction both in the risk of loss to shareholders and in the time in which such damage can be perpetrated before it is checked.

It needs to be emphasised, in relation to that important part of the report dealing with non-executive directors, that the mere appointment of non-executive directors is not enough to ensure that corporate governance will be improved. Companies will have to ensure that non-executives are adequately qualified and that there is a proper structure in place to ensure that they can function effectively.

Before commenting on the detail of certain sections of the report some general views are offered on the following subjects:-

(a) The use of a voluntary code

This approach is supported. It allows practical experience to be obtained of implementation of the recommendations and, coupled with the review of that experience that is promised in two years' time, allows the opportunity for the lessons learnt to be acted upon thereafter. It also maintains in reserve the possibility of statutory action as a last resort where no other approach can be seen to have been satisfactory. It must be acknowledged that statutory definition and enactment in a number of areas of corporate governance would be difficult. Some degree of flexibility in interpreting the code of practice may be inevitable, given the differences that exist, for good reasons and often to good effect, in individual corporate cultures. There may be practical reasons, too, why some of the recommendations may be less easy to implement in some companies than in others (eg. a shortage of suitable candidates from time to time to allow a split of the chairman/chief executive role).

Action by the Stock Exchange, investment institutions, auditors and other interested parties to support compliance with the spirit and not just the letter of the code will be important if the proposals are to succeed. The planned appointment of a group to examine compliance with the code must involve scrutiny of whether compliance has been whole-hearted and not simply a matter of form. It is to be hoped that future revisions of the code will not lead to it becoming too detailed and prescriptive.

(b) Timing of implementation of compliance

There is seen to be difficulty in reporting on compliance with the code of practice as soon as recommended in the report, namely in respect of years ending on or after 31 December, 1992. Although some parts of the code can be put in place straight away or are already complied with by many companies, it is most unlikely that agreed guidance will be in place in time for complete implementation in the recommended timescale, notably guidance relating to reports on internal control and the going concern. Other action required, such as appointment of non-executive directors, may also take time. Reports on compliance will therefore be heavily qualified for some time to come. We suggest that, in order to avoid this, companies should be expected in the first two years to report on the extent to which they have been able to comply with the code, rather than on the extent to which they have not complied. This could be supplemented by a statement indicating the company's plans to bring about full compliance. At the time of the review of the code, the matter of the feasibility of a statement of compliance should be reconsidered.

(c) Applicability of the code

The code is directed to the boards of directors of all listed companies registered in the UK, but as many other companies as possible are encouraged to aim at meeting its requirements.

It would be helpful if the final report were to define more closely the types of unlisted company which would be expected to meet the requirements of the code. We believe that it would be realistic to include "public-interest" entities from the public and private sectors within this category, but that it is unlikely that smaller companies could apply the code. This should be recognised as unattainable. It may be, too, that major unincorporated entities, in which category some charities and pension funds would form an important element, should be encouraged to adopt as many of the recommendations as are feasible. So far as pension funds are concerned, we welcome the review of pension fund law and practice being undertaken by the Goode Committee, to which the Institute expects to contribute. While that Committee will examine these matters comprehensively, it is to be hoped that many of the principles embodied in the Cadbury report will be adopted in its recommendations.

There may be difficulties in obtaining the full range of compliance from public listed companies at the smaller end of the scale. The applicability of the code in such cases requires careful examination in order to see whether it is appropriate and whether certain concessions can be made.

(d) Audit endorsement in writing of the statement of compliance with the code

It is proposed that auditors should endorse in writing the statement of compliance with the code that the Stock Exchange should require companies to publish.

No doubt the Auditing Practices Board will consider carefully the issues of scope and feasibility that arise in recommending the extent and form that such an endorsement by auditors could take. While compliance with the code will be easily attested in some matters, in others it may be difficult, if not impossible, for auditors to form an opinion. An example is the code recommendation that non-executive directors are to bring an independent judgement to bear on issues of strategy, performance, etc. More generally, it could be very difficult to report on the substance of compliance where efforts had been made to make formal compliance only. We have serious misgivings about the practicability of this proposal.

Difficult matters of judgement for auditors can only reasonably be dealt with, once guidelines are available from the Auditing Practices Board.

(e) Costs

There is serious concern among our members who are directors of small and medium-sized listed plcs about the cost of implementing the recommendations. The great range in size of companies listed on the Stock Exchange undoubtedly has the effect of laying a relatively heavy burden of cost on those at the lower end of the scale. We believe that ways should be examined of seeking to alleviate this concern.

(f) Transparency in financial reporting

The report supports transparency in financial reporting, while warning against the dangers of information-overload. A further concern, mentioned by a number of our members who are company directors, is the problem that, by comparison with competitors in continental Europe in particular, the provision of ever more detailed information in UK company financial reports will lead to serious competitive disadvantage, if this point has not already been reached. The requirement for a "level playing field" means that transparency in the UK context should proceed at a pace which is matched by that of continental countries.

(g) Executives and non-executive directors

Business members in particular have commented on the emphasis placed in the report on the role of non-executive directors, whereas executive directors and their role receive little attention. The financial aspects of corporate governance are very much the concern of finance directors, perhaps to a greater degree than to other board members, and it would be helpful if the final report were to offer greater guidance on the finance director's particular responsibility in this connection.

Many have commented, too, that the report appears to recommend structures and systems which bring about the existence of something close to a two-tier board, in everything but name. The recommendation in favour of a leader for the independent element on the board, where the chairman and chief executive role is combined, and for the use of outside advisers by non-executives are examples in support of this perception. We believe that the truth or otherwise of this assessment should be more fully addressed in the final report and that it would be valuable if a discussion of the comparative merits of unitary and two-tier boards in the UK environment could be included, additionally. We do not, incidentally, favour the appointment of a leader for the non-executive directors.

In a number of companies, non-executive directors may not qualify as fully independent within the meaning of the code. In such circumstances, we would prefer the code to use the term "independent directors", since it is this feature on which the code relies.

(h) The supply of non-executive directors

A source of new non-executive directors will be needed in order to implement the recommendations. There are varied opinions on the availability of suitable candidates, but a general view exists that there should be a greater willingness on the part of companies to spare full-time executives for non-executive directors' duties elsewhere. It would be helpful if the final report were to encourage this approach. At the same time, it is strongly recommended that the report should note the importance of relevant business experience in qualifying as a non-executive director, particularly for one who is to be appointed to an audit committee.

It is further suggested that some way should be found of limiting the number of non-executive directorships that can be held by any individual.

(i) Auditors' liability

The arguments against either limiting auditors' liability or making it proportionate are set out in Appendix 4 to the report. While recognising these arguments, it is the intention of the Institute to investigate and discuss further with interested parties the possibility of overcoming the problems involved. Developments since the publication of the Likierman report must be considered, together with circumstances elsewhere, notably the recent introduction of a Bill to the New South Wales Parliament on this subject.

(j) The timing of publication of financial statements

There would be benefit to users if the obligation of listed companies to issue the annual report and accounts were to be reduced to four months after the year-end, as against the present Stock Exchange requirement of six months after the year-end.

The following comments are related to particular sections of the report:-

1) Para 4.19 and 4.20, Page 15 and Para 4.23, Page 16

Paragraph 4.19 recommends that "boards should have a formal schedule of matters reserved to them for their collective decision..... A schedule of these matters should be given to directors on appointment and should be kept up to date." In order to work effectively it is imperative that the schedule is distributed more widely throughout the company and not just to the board. This

might be obvious, but it would be helpful if it were made explicit. If Para 4.20 were to be fully comprehensive it might also include decisions over business strategy and business plans. Finally, whereas para 4.23 makes it clear that all employees should know what standards of conduct are expected of them, the Board should also have a system in place to ensure that breaches are reported internally and brought to its attention.

2) Para 4.34, Page 20

It would be desirable to make clear that recommendations to the board on directors' remuneration in all its forms were specifically to include non-monetary rewards and compensation generally.

As a further matter, recent cases have shown that the most highly remunerated persons employed by the company are not always directors. We believe that where there are employees in a group who earn more than the highest paid director, information on their remuneration should be disclosed in bands, in annual reports, in order that shareholders should be able to follow up the matter.

3) Para 4.47(i), Page 22

The Auditing Committee of the Institute has recently issued a consultative paper on published interim reports (FRAG 19/92). This recommends, inter alia, that the Auditing Practices Board should issue guidance to auditors on the form of auditors' reports appropriate for inclusion in half-yearly reports and on the work necessary to support such auditors' reports. It will be important that any such guidance should have the result of leaving users of half-yearly reports in no doubt as to the degree of responsibility that is being taken by auditors in these cases. The Cadbury Committee is silent on the question of whether a review report on interim statements should be published. In the event of disagreement between the company and its auditors on the content of interim statements, however, there should be a means by which that disagreement can be expressed. Public reporting will of course involve higher costs.

The Auditing Committee has also issued a discussion memorandum (FRAG 3/92) on preliminary announcements. In practice, most preliminary announcements of annual results are not published until management has the auditors' assurance that audit work is nearly complete and that any significant areas of uncertainty or disagreement have been resolved. This memorandum also calls for guidance from the Auditing Practices Board as to the form of report from auditors that would be appropriate for inclusion in preliminary announcements. Research exists to show that preliminary results announcements are of more importance to capital markets

than the publication of annual accounts. We would welcome, therefore, a recommendation from the Committee in support of our own belief that explicit audit approval of preliminary results should be made a requirement of the Stock Exchange listing agreement.

4) Para 4.47(iii), Page 22

We consider that cash flow information is usually as important to the user as balance sheet information. For that reason we would prefer a recommendation from the Committee that it should be included in the interim report forthwith, without the necessity for a review by the Committee's sponsors in two years' time, as proposed. Indeed, in some cases this information can be of more importance than balance sheet information. Companies are accustomed to publishing cash flow statements in their annual reports and have the necessary mechanism in place to collect the relevant information and process it. It is not believed that the costs of providing this information half-yearly would represent a significant burden on companies. It may be that an abbreviated form of statement would be appropriate in the context of half-yearly reports. The Financial Reporting Committee of the Institute would be pleased to examine this issue in more detail, should it be felt desirable.

5) Para 5.11, Page 26

There is some ambiguity in the recommendations of paragraph 5.11. The second sentence states, as an essential principle, that disclosure

> *"must enable the significance of the company's audit and non audit fees to the audit firm to be assessed, both in a UK context and, where applicable, a world wide context".*

If this means the separate disclosure of audit and non audit fees as required by Company legislation and for this to reflect the total fees for the group worldwide, we are content. If it means, (and it can be taken to mean), that disclosure must enable readers to compute the proportion that these fees bear to the total fees earned by the auditing firm, then we consider that such a figure or percentage would be meaningless.

6) Paras 6.9 - 6.11, Page 36

Shareholders must be able to submit written questions in advance of the AGM and should be entitled to receive a written reply, if unable to attend. Shareholders should also be entitled to expect the personal attendance of the auditors at the AGM who should be prepared to answer questions relevant to the conduct of their audit.

7) Para 3.3, Page 43 - Code of Best Practice

In many companies, non-executive directors will have limited detailed knowledge of the capabilities of individual executives. It might therefore be preferable if the remuneration committee, rather than be called upon to recommend executive directors' pay to the board, should at least be required to review and endorse the proposed remuneration.

8) Para 6(b), Page 49

It is not clear from this sub-paragraph whether a retired executive who has been appointed as a non-executive director should be regarded as sufficiently independent of management to make him or her eligible for membership of the audit committee. The issue is one which is not uncommon in practice and clear guidance on the subject would be welcome.

In our view, given the importance which the Committee rightly attaches to the independence of non-executive directors, it would be more satisfactory if the Committee were to recommend exclusion of retired executives from those eligible for membership of audit committees.

A further objective should be to recommend that retired partners of the audit firm are not included on the audit committee as non-executive directors.

C Swinson
Chairman

HPG\TP\
16.7.92