CAD-02215

cc Sir Adrian

RESPONSES

COMMITTEE
ON
THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

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23rd June, 1992

J. C. Dwek, Esq.,
Chairman,
Bodycote International, plc,
140, Kingsway,
MANCHESTER, M19 1BA.

Dear Mr Dwek,

Thank you very much for your letter of 17th June, 1992. I have passed a copy to Sir Adrian Cadbury, and I confirm that your comments will be taken into account when the Committee considers its final report.

I was particularly interested to read your comments about the resignation of auditors, and I shall highlight them for the Committee's attention. This is an area which the Committee has not addressed so far, but would appear from your letter to be one of some importance. I am grateful to you for raising it.

Yours sincerely,

N.J. Peace

Nigel Peace
Secretary

MEMORANDUM

TO: HENRY GOLD

FROM: NIGEL PEACE
(Ext. 2565)

RESIGNATION OF AUDITORS

I would be very grateful if you could let me know whether you think there is anything in the sidelined passage in the attached letter from Mr. J. C. Dwek, Chairman of Bodycote International, plc.

At this advanced stage I do not think the Committee will wish to get involved in new issues of substance on the technical auditing side, but if you think the Committee could give a helpful steer on the question of auditors' resignation, please let me know.

NDP

Nigel Peace
Secretary

FAX

BODYCOTE INTERNATIONAL PLC

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17th June, 1992.

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

Dear Mr. Peace,

Please find enclosed herewith my initial thoughts on the Cadbury Report, and I should be pleased to have your comments in due course.

Yours sincerely,

J. C. Dwek

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Re. The Cadbury Report.

The Cadbury Report in its draft stage, suggests that checks and controls by non-Executive Directors, Audit Committees, more rigorous auditing procedures, and more extensive disclosure will improve communications between companies and shareholders. One must pose the question as to whether these present communications are inadequate or ineffective. Much of the information required is available.

Most institutional shareholders have their own in-house analysts, who expect to be fully briefed by the company on a regular basis. Often going behind the figures and bland statements in reports, they conduct their own very intensive research into the company's activities. The quantum of institutional shareholding is often the seal of approval. Institutions don't generally invest in companies where the management is suspect, or where there are financial anxieties, and are thus very careful to do their homework properlly and thoroughly. It cannot be, therefore, that the Cadbury Report is aimed at primarily improving financial communication, since if it is, it surely is missing the point. The inspiration for this Report is surely the removal of any further frauds and scandals, which could be avoided through better Corporate Governance.

Broker's Circulars, media comment, particularly if either is adverse, is also a very effective way of bringing information to the public, and making Directors more accountable for their actions. No comment is more damning than "a sell recommendation".

Therefore, one has to ask the question as to, what is the question to which the Cadbury Report is the answer? Standards of behaviour by Directors are absolutely necessary. They ought to be enshrined in some form of legislation so as to create a degree of consistency and uniformity. Checks and balances are indeed proper forms of control in any organisational structure, and the Cadbury Report highlights many areas where companies can improve their housekeeping.

Public disquiet requires more public accountability, but this is a useful catch phrase, a palliative slogan, but does it really go to the heart of the problems, which are causing public concern?

Therefore, this report, to be effective, must give better protection for those who wish to lend money or invest in a listed company. Is the report hoping to introduce systems which will prevent fraud, dishonesty, and comfort shareholder anxieties. Clearly, it is the rogue company which will always seek to evade its responsibilities, and without legislation or sanction, simple exhortation through a Code of Best Practice, will be insufficient. Thus, there has to be some legal enforcement.

Recent scandals in the City over the last few years have produced a climate where change of Corporate Governance is essential, but it is not clear that the recommendations, if properly implemented, would have prevented those frauds in good time. Dishonesty is hard to detect, even by non-Executive Directors, and Auditors. Accounts, when produced, are often too late.

However, it is a start, but unless major shareholders are prepared to use their muscle on the proper occasions, then the report will amount to nothing more than a gentleman's agreement. Institutions have not displayed more than passing interest in the affairs of the companies in which they invest, preferring to vote by selling their shares when dissatisfied.

A delisting of the company by the Stock Exchange only penalises innocent shareholders, particularly where the Directors have a controlling interest in the company and are not too bothered what minority shareholders think. These companies are often very proprietorial in their attitude. The sanction for malpractice must surely be the discharge of the Director from office, without compensation, even though he may have a service contract.

Shareholders must be more involved, but since they cannot know all the facts, they must hope that their interests are best served through the efforts of the Auditors and non-Executive Directors. Some shareholders only invest in the short term, and therefore, probably feel it is not worth the effort to get involved when they can just as easily deal out of the shares.

The report does not deal with persons who invest money in companies, but are not shareholders of creditors. Monies handed over to Keith Hunt or Barlow Clowes, etc., would still have been lost, despite the recommendations of the Cadbury Report. The Auditors are not accountable to them and yet, investors rely very heavily on the accounts as a comfort for their investments. A similar comment could be made with other institutions who take in monies from individuals, i.e. Banks, Finance Houses, Money Dealers, whose Directors act as trustees for those monies. The report does not help this category to any extent. Clearly, it is this area where fraud and dishonesty has been most paramount in recent years. Yet, some of these companies are unlisted. Public accountability, therefore, is of immediate concern. The DTI Regulatory Bodies have proved inadequate, and probably the information they receive is out of date. The Code should deal with companies which take money from the public, which are unlisted, and insist that non-Executive Directors are appointed.

Public accountability must be such that there is a proper claim for damages, in respect of fiduciary duty. The Code must not merely be a public relations exercise which, from the draft report, it appears to be.

Turning now to the report itself, I would like to make the following comments:-

1. Not all companies are of the size to warrant a separation of roles between Chairman and Chief Executive.

2. All companies should have a non-Executive Director, who should not be a shareholder, so there is no conflict of interest between his independent duties and any personal gain or loss.

3. The remuneration of the non-Executive Directors should be fixed as a percentage of the M.D's salary, as is the case in Europe, so that they can't be bought by lucrative inducements.

4. Non-Executive Directors should only be sacked or resign at an AGM, when reasons can be given and shareholders have the opportunity of questioning the decision in open forum.

5. All Director's service contracts should be approved at the AGM. Similarly, pay increases, awards, benefits, etc., when increased, should also be endorsed at an AGM, after proper recommendation from the Remuneration Committee. This might prevent the large salary increases that the Directors have awarded themselves in previous years, despite their indifferent performance. The attendant publicity, before that AGM, might stimulate shareholders to take more interest.

Many of the recommendations made in the report are common sense, and should be quite acceptable to industry. They appear to be good housekeeping proposals, but one has to question whether they go far enough, since we are all anxious to see total transparency, ethical behaviour, and fiscal rectitude.

It seems to me that the main area of public accountability should be the concern of the Auditors, since it is on their figures that people tend to rely. Many feel, that the Caparo decision in the House of Lords, was the wrong decision. Auditors have the greatest access to discovery of fraud, malpractice, and abuse of office, and are often reluctant to speak out, or even to qualify accounts, lest the harmony of their relationship be disturbed.

Auditors, when they resign, are obliged to give a letter of resignation, under Section 16 (2)(a), of the Companies Act 1976. The usual format for that letter is as follows:-

> We hereby resign as auditors and taxation advisors of the company with immediate effect.
>
> In accordance with the provisions of Section 16(2)(a) of the Companies Act 1976, we confirm that we are aware of no circumstance connected with our resignation which we consider should be brought to the attention of the members or creditors of the company.

This letter is normally filed by the Company at Companies House, but the information for the resignation is not sufficient and, clearly, more detail and reasons are required, if only to help the incoming Auditor and to allay shareholder anxieties.

If the resigning Auditors cannot give a clean certificate of resignation, similar to the above, then they are obliged under Section 16 (2)(b), to give a different letter, but they are not obliged to give their reasons.

Clearly, this is a weakness in the system, since Auditors do resign when they are unhappy, but do not have sufficient proof to justify a Section 16 (2)(b) letter. If such a letter is received by the company, then there is more than a faint possibility that it will not be filed at Companies House, and this has been the general experience.

The writer has had a personal experience of such a situation. Auditors resigned, giving a clean certificate of resignation, when in truth, they ought not to have done so. Incoming Auditors being now unaware of any inherent problems, quickly completed the outstanding audit. Subsequently, the writer and a large number of investors lost a lot of money, and the both sets of Auditors were not accountable to anyone. Investors relied on the clean certificate of resignation, and the incoming Auditors had no contractual liability to anyone except the proprietor, who was of course the perpetrator of a massive fraud.

Therefore, Auditors should resign at an AGM or at an EGM during a financial year, so that interested parties can question the reason for that decision. Whatever certificate of resignation they give, it should be filed by them (and not by the company), at Companies House, but that resignation should not be complete until interested parties are satisfied that there was nothing sinister or untoward in that resignation. If Auditors are dismissed, then directors must give their reasons at an EGM/AGM.

Auditors should be accountable to anyone who may rely properly on the accounts. That is public accountability. Where funds are placed with companies, to be managed, then it is not sufficient for Auditors to give "a fair view". Auditors must give an exact view.

In the case of an unlisted company, where the shareholders are the Directors, the Auditors must ensure that the accounts are sent to all investors, who may then properly direct questions to them, where there are anxieties, and where monies taken by that company are only taken in trust. Many of the scandals recently reported, could well have been avoided if investors had access to Auditors who have produced the accounts.

Companies do adopt different accounting practices, but this should not be a problem, as analysts tend to get behind the figures.

An independent organisation should be created to consider complaints made against the Accountancy Profession. Many feel that the Institute and like Bodies, often close ranks, preferring to rebuke their own members behind closed doors. This prevents adverse publicity for the Profession, but it also undermines the confidence in the Institute. Perhaps this is unfair, but transparency is necessary and complaints should be considered by an independent Body, who would have the power to remove the licence to practice from an Auditor, who has been negligent, and who has not exercised independent judgement properly, such that others have lost money, having relied on the accounts.

Many companies in their dealings, rely on published accounts at Companies House, to ascertain the credit worthiness of their clients. Auditors have a very important role to play, and yet many are found wanting. The Cadbury Report does not touch on creditor protection. The Insolvency Act gives some relief, but Directors must be more accountable in unlisted companies to creditors and providers of finance.

In truth, the Auditors have a unique position, and are best placed to ensure that all those who deal with the company, can be satisfied as to the health of the company. They must be responsible and they must be accountable. It is in this area of the report that more intensive discussion should take place.

J. C. DWEK
CHAIRMAN
17th June, 1992.