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COMMITTEE
ON
THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

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17th June, 1992

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Dear Mr Hughes,

Thank you very much for your letter of 8th June. I have read your comments with interest, and passed a copy to Sir Adrian Cadbury. I was particularly interested in the historical background.

I confirm that your comments will be taken into account when the Committee considers its final report.

Yours sincerely,

Nigel Peace

Nigel Peace
Secretary

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Nigel Peace Esq.,
The Secretary,
Committee on the Financial Aspects of Corporate Governance,
PO Box 433,
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8th June 1992

Dear Sir,

The Financial Aspects of Corporate Governance

I am a Chartered Accountant working in industry and have a few detailed comments on your draft report.

Firstly, I am bound to say that, I do not believe that the Report recognises the seriousness of the problems currently facing shareholders in listed companies: in most cases, they have no control over their directors, whose remuneration packages have ballooned out of control, often with minimal regard to the performance of the company; in cases where the accounts misrepresent the financial position, their chances of obtaining restitution from the wrongdoers (not only the auditors) are slim. I believe your committee has failed to realise the extent of the crisis facing investors, which is not too far removed from the problems facing Lloyds. Already, private investors are falling as a proportion of total shareholders and, it seems inevitable that increasing regulation in the pension (post-Maxwell) and insurance areas will reduce these institutions' ability to continue to invest as heavily as previously.

Without in any way wishing to be disrespectful, I am afraid the draft report is far too British: it is genteel and gradualist and lacks any radical proposals to deal with the crisis, and seems a lost opportunity to help our capital markets move into the twenty-first century.

I have two points of detail:

Remuneration Committees

These will not be effective unless steps are taken to stop executive directors appointing non-executive. There are two obvious abuses:-

a) Reciprocity of appointments: directors, socially connected, sit on each other's boards (Executive on one: Non-Executive on the other); each non-executive sits on the other's Remuneration Committee and has an obvious incentive to feel "generous".

b) Well-publicised, highly-paid executive directors are popular non-executive directors elsewhere, for the obvious reason that they will be on the Remuneration Committee.

Don Hughes BSc(Econ) FCA FCT Adviser on financial aspects of property

The undesirability of cross-directorships clearly can be covered by your Code of Best Practice: the second abuse is unlikely to be dealt with unless there is a shift towards non-executive chairmen.

Caparo

I accept that Caparo was correctly decided, but would point out that the legal precedents originated in a very different era.

While I recognise the point you are trying to make in the introduction to paragraph 5.32, I think it is wrong to use the term "misconception" in relation to the "accuracy" of accounts.

Before the 1929 Companies Act, accounts of UK Companies were regarded with no credibility. They contained little information, no standard format, no revenue account, used reserve accounting and there was little control over the expansiveness of the Chairman's claims. Investors proceeded cautiously (very much caveat emptor). The succession of regulatory Companies Acts, starting in 1929 through 1947 to 1948, succeeded in increasing the credibility and reliability of Company accounts and made them the pre-eminent investment tool. The increased status given to auditors was a leading factor in this process.

I have cited the historical development of audited accounts to illustrate the point that Caparo was decided on precedents established pre-1929, ie before the audit became an important factor in the increased credibility of accounts.

The audit report in effect is a certificate of "good housekeeping"; it is evidence of the reliability, credibility and integrity of the accounts, and I believe most chartered accountants would therefore regard the Caparo decision as being against the long-term interests of the profession. After all, is it right that parties who rely upon accounts negligently audited are unable to sue because of the absence of proximity? Is it right that only members as a whole can sue? Is it right that legal action is only available to those who have already invested (and then not in respect of future investments) and not to those who do so as a direct result of the Accounts? Is it right that other classes who are not technically members (such as convertible loan stock holders) have no right of claim against auditors?

To allow the Caparo decision to stand is against the interests of shareholders and clearly is damaging to the accounting profession.

I believe the committee should therefore recommend some movement from the present position:-

1. The concept of "proximity" should be modified: accounts are, in effect, a prospectus for investor, lender or creditor., and auditors should be liable for all claims where the claimant can demonstrate that the loss resulted from accounts negligently prepared. Inevitably, audit fees will increase and the definition of the role of the auditor (in the expanded report) becomes increasingly important.

2. However, as a quid pro quo the liability of auditors should be limited: I am old enough to remember the (? pre-1948) contributary negligence rules, where an expert sat to apportion liability (between employer and employee). Were we to abandon the "joint and several" concept in this area and accept, instead, the apportionment of liability, on contributary negligence lines, by an expert (or expert panel), in this case between auditors and directors (occasionally also third parties), then I believe we have an equitable way forward.

I hope you feel able to take these comments into account when finalising your report.

Yours faithfully,

D.J.HUGHES

cc Sir Adrian.