SUBMISSION TO THE CADBURY COMMITTEE
ON FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

5 February 1992

Price Waterhouse

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Price Waterhouse

5 February 1992

Sir Adrian Cadbury
Chairman
Committee on Financial Aspects of Corporate Governance
PO Box 433
Moorgate Place
London
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Dear Sir Adrian,

I enclose a copy of a paper setting out my firm's views on corporate governance, including matters raised by the Secretary to your Committee in discussions with my partner, Mary Keegan, in late December last year.

I hope that you and your Committee will find our views and suggestions constructive and helpful in your difficult task. I would welcome the opportunity to meet with you, and with members of your committee, to discuss the issues arising both from the submission, and from your deliberations to date.

Yours sincerely,

Ian Brindle

Offices at Aberdeen, Birmingham, Bristol, Cardiff, Edinburgh, Glasgow, Hull, Leeds, Leicester, Liverpool, London, Manchester, Middlesbrough, Newcastle, Nottingham, Redhill, St. Albans, Southampton and Windsor.

The partnership's principal place of business is at Southwark Towers, 32 London Bridge Street, London SE1 9SY where a list of the partners' names is available for inspection.

The firm is authorised by the Institute of Chartered Accountants in England and Wales to carry on investment business.

PRICE WATERHOUSE SUBMISSION TO THE CADBURY COMMITTEE ON FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

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1 SUMMARY

1.1 The current recession and major corporate collapses have recently brought to the fore the issue of corporate governance. But this is no new issue. The famous East India Company was formed in 1600 and the Bank of England in 1694. It was in 1855 that a company was first able to assume limited liability and in 1897 that the separate personality of a company as an entity distinct from its shareholders was established by the House of Lords in Salomon v Salomon & Co. Ever since, businessmen and accountants, politicians and lawyers, have been grappling with the difficulties caused by the separation of ownership of a business from stewardship or management and with the need to balance enterprise and public accountability. Between 1862 and 1907, no less than sixteen Companies Acts were passed and there have since been several generations of Companies Acts and consolidating Acts.

1.2 This serves as a useful reminder that there is no 'quick fix' for the problems of corporate governance; if there were, someone would have found it by now. Today's answer will not necessarily endure but what is put in place today must be capable of meeting the challenges of tomorrow.

1.3 Essentially, business and investment are about risk taking. Any investor in a business hopes to obtain reward in return for business risk and must accept that for a whole variety of innocent and valid reasons a business may fail.

1.4 Developing a good system of corporate governance is about ensuring that the only risk shareholders and creditors are exposed to is honest business risk. Good corporate governance should therefore minimise investors' exposure to dishonesty, culpable mis-management and misleading information.

1.5 As we have already suggested, no single measure could transform corporate governance overnight and ensure that investors never again have cause for complaint. However, we do believe that a package of relatively simple measures (most of which could be implemented on the 'code of practice' basis envisaged by Sir Adrian Cadbury) could do much to address public concerns.

1.6 Not all of the measures we propose are necessarily new or merely 'good practice'. Some exist in current legislation but require new emphasis; some would need new legislation; some, we believe, should be adopted as part of the Stock Exchange's listing requirements. Indeed, it seems to us that the time is right for a regulator to take a more pro-active role in overseeing the operation of equity markets and companies' reporting to those markets. The Stock Exchange would seem to be well-placed to provide such enhanced regulation; it may be that, in the future, Government might choose to place such responsibility in independent hands.

1 SUMMARY (continued)

1.7 Our recommendations are summarised below. They are intended primarily to reduce the risk of failure of public interest companies; typically, plcs where there are likely to be many 'lay' investors unfamiliar with the detail and jargon of financial reporting. Once the issues have been resolved in relation to public companies, the question to be addressed is whether it is appropriate, or whether it can be justified, to apply different or lesser requirements to private, non-public interest companies.

1.8 The board of directors		Paragraph reference
1.8.1	Directors should be subject to ongoing 'fit and proper' vetting by the Stock Exchange as a condition of listing.	2.1.3
1.8.2	Each director should be subject to re-election by shareholders every three years.	2.1.4
1.8.3	Institutional investors must be encouraged to take the lead in nominating independent non-executive directors for election by the shareholders in general meeting.	2.2.4
1.8.4	Non-executive directors should hold the balance of power in key board decisions.	2.2.5
1.8.5	There should be both formal and 'ad-hoc' channels of communication between non-executive directors and regulators.	2.4.2
1.8.6	To give non-executive directors options other than resignation for dealing with difficult situations, disclosure to a proper authority should be considered for recognition as a defence to certain company law offences.	2.4.3

1.9 <u>Internal controls</u>

1.9.1	The Stock Exchange, together with representatives of various business sectors and the auditing profession, should develop authoritative guidance on the features of good systems of internal controls.	3.1.1
1.9.2	An appropriate and effective system of internal control should be a condition of listing. Auditors should report annually to the Stock Exchange on compliance with this requirement.	3.1.2

1 SUMMARY (continued)

		Paragraph reference
1.9	**Internal controls (continued)**	
1.9.3	Authorisation controls over major transactions should be strengthened by publication of required levels of authority for particular types or sizes of transaction (see also 1.10.4 below).	3.2.1
1.9.4	Financial statements should include a statement by directors that they are satisfied that the company has an appropriate and effective system of internal controls (see also 1.10.3 below)	4.4.2
1.10	**Financial Reporting**	
1.10.1	Financial statements should include a statement by the directors as to the adequacy of working capital for the next 12 months. Auditors should review the underlying working capital forecasts and report whether the directors have reasonable grounds for believing that the company will have adequate working capital.	4.2.2 and 4.2.3
1.10.2	Financial statements should include a narrative review of the factors expected to influence the results of the company over the following 12 months, including identification of the major exposures.	4.3
1.10.3	Directors should state annually whether an appropriate and effective system of internal controls is in place; auditors should report on whether the directors had a reasonable basis for such a statement.	4.4.2
1.10.4	Auditors should report publicly on compliance with published authority levels during the financial year.	3.2.3
1.10.5	Listed companies' half yearly statements should include both balance sheet and cash flow statement and should be subject to review by the auditors.	4.7.1 and 4.7.2
1.10.6	Financial information should be published within three months of the relevant period end.	4.8.1

1 SUMMARY (continued)

		Paragraph reference
1.10	**Financial Reporting (continued)**	
1.10.7	Rules should be introduced by the Stock Exchange providing that listed companies' preliminary announcements must be approved by their auditors.	4.9.4
1.10.8	It should be a Stock Exchange requirement that every preliminary announcement include (1) a balance sheet and cash flow statement together with other salient notes and (2) either a statement that there had been no material changes in accounting policies, or else disclosure of those changes.	4.9.8
1.10.9	The Stock Exchange should issue guidance on, and encourage more frequent, public announcements by companies.	6.3
1.10.10	There should be no requirement for statutory accounts or audit of a 100% subsidiary of a public company provided that the holding company guarantees the subsidiary's liabilities.	7.1
1.11	**Auditors**	
1.11.1	Only non executive directors and shareholders who are not executive directors should be able to nominate auditors for appointment and vote on matters relating to the auditors.	2.3.3
1.11.2	Executive directors should have no say in the remuneration of auditors beyond their ability to persuade non-executive directors and/or shareholders of the merits of their case.	2.3.4
1.11.3	Auditors should report to the non-executive directors of the board, preferably constituted formally as an audit committee.	2.4.1
1.11.4	Auditors should have both formal and 'ad-hoc' channels of communication to the regulator.	2.4.2
1.11.5	A statement of good practice should clarify the degree of reliance upon statutory financial statements by different users which might be reasonable in various circumstances.	5.6.1
1.11.6	The law should be amended so that liability relfects the actual or a reasonable degree of reliance on financial statements or other representations.	5.6.2

1 SUMMARY (continued)

1.11 Auditors (continued)

		Paragraph reference
1.11.7	It should be recognised that liability for financial statements may extend beyond the limited analysis of the Caparo judgement.	5.6.3
1.11.8	It should be recognised that an auditor's duty of care wider than that imposed by the Caparo judgement might be discharged other than by way of disclosure in an audit report (eg by disclosure to a proper authority).	5.6.4

As we commented above, not all of the measures we have proposed fall within the scope of a code of good governance. Nevertheless, we believe that the Cadbury Committee will find our suggestions constructive; where our suggestions go beyond the ambit of a code of practice, we invite the Cadbury Committee to put its authority behind a call for the necessary legislation or requirements to be put in place.

PRICE WATERHOUSE SUBMISSION TO THE CADBURY COMMITTEE ON FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

2 DIRECTORS, AUDITORS AND REGULATORS

2.1 The appointment of Directors

2.1.1 The Council of the Stock Exchange ('the Stock Exchange') is the competent authority for the purpose of admitting securities to listing, discontinuing or suspending listing. Its rules deal in particular with the admission of securities to listing and with continuing obligations for companies whose securities are listed. The basic conditions to be fulfilled on application for listing appear to be wider in scope than the continuing obligations. For example section 1, chapter 1, paragraph 5 of the Yellow Book requires that the sponsors of an applicant for listing should satisfy themselves that directors:

- can be expected to publish all information necessary for an informed market
- appreciate the nature of their responsibilities, and
- can be expected to honour their obligations in relation to both shareholders and creditors.

2.1.2 This 'fit and proper' test of directors seems a wholly necessary and appropriate test to be applied to a company seeking listing. But what happens once a company has obtained its listing and new directors are appointed? There seems to be no requirement for new directors to have to demonstrate their fitness for the appointment, and there is no requirement for existing directors to demonstrate their continued fitness for directorship of a listed company.

2.1.3 We recommend that it should be a continuing obligation of listed companies to satisfy the Stock Exchange that their directors are 'fit and proper' persons for the office they hold. In particular, whenever a director is re-elected to the board, the Stock Exchange (or a member acting as sponsor) should consider whether that director is a fit and proper person for membership of the board of a listed company; where there is public concern or other reason to question the fitness of a director the Stock Exchange should investigate the matter further, perhaps in discussion with non-executive directors and, if necessary in the public interest, requiring the resignation of a director as a condition of continued listing.

2.1.4 Where a company has Articles of Association which follow Table A, one third of the directors who are subject to retirement by rotation are required to retire from office at each annual meeting. In our opinion the appointment of any company director should, without exception, be subject to confirmation every three years by re-election by the shareholders in general meeting.

2 DIRECTORS, AUDITORS AND REGULATORS (continued)

2.2 Non-Executive Directors

2.2.1 One of the problems which has been highlighted by events over the past year or more is that of the dominant personality on a board of directors. The problem is characterised by the 'dominant chief executive'; he treats the company as his personal property, making little or no distinction between private interests and 'his' public company, which in reality represents the interests of many shareholders and lenders.

2.2.2 The Institute of Chartered Accountants In England and Wales' (ICAEW) report 'The changing role of the non-executive director' published in May 1991 commented that 'the problem of over-concentration of power may be ameliorated by the introduction of non-executives to the board' and recommended that non-executive directors should comprise around one-third of the board.

2.2.3 We believe that although they are not the answer to all problems in corporate governance, non-executive directors have a very important role in protecting investors from the unacceptable risks of dishonesty and bad management - but the ICAEW recommendations do not go far enough.

2.2.4 The term 'independent director' better describes the most important attribute of a 'non-executive director'. We would like to see this independence strengthened by securing the appointment of non-executive directors by shareholders. We suggest that, initially, institutional investors should take the lead in nominating candidates for election by shareholders in general meeting, although we recognise the practical problems in enforcing this - and the difficulties which could arise if executives are denied the right to nominate independent directors and investors do not exercise their influence constructively.

2.2.5 It has been suggested that the roles of chairman and chief executive should be split in order to preserve the chairman's independence. There may well be advantage in such a split but it does not tackle the fundamental question of independence and the risks of the two roles being nominally separate but in fact held by close colleagues with the same interests and outlook. A more effective way to secure a meaningful independent presence on a board of directors would be to ensure that non-executive directors hold the balance of power in a board. Although we foresee some difficulties in securing the services of a sufficient number of high quality non-executives to make up the majority of the boards of public companies, this could be overcome by, for example, giving non-executive directors two votes for every executive director's one vote. Another approach might be for a company to write into its articles of association a policy of only taking certain business decisions if supported by a majority of the non-executive directors, as well as a majority of the board overall.

2 DIRECTORS, AUDITORS AND REGULATORS (continued)

2.2 Non-Executive Directors (continued)

2.2.6 We are not suggesting that the entire or final responsibility for business decisions should rest with the non-executive directors. We are suggesting that executive directors should be able to demonstrate to non-executives, and thus obtain their support at board level, that a proposed course of action meets the declared objectives of the enterprise, that proper steps have been taken to obtain and verify all the information necessary as a basis for making such a decision (due diligence) and that those responsible for recommending a decision to the board appear to have reached their recommendation on the basis of objective business judgement properly applied.

2.3 Audit appointments and remuneration

2.3.1 Auditors are part of the system of external checks imposed on companies for the protection of shareholders' interests. We discuss further the role and responsibilities of auditors below. There is public concern that the effectiveness of auditors is hampered by a conflict of interest: company managements are portrayed as being concerned only to present their company's performance in the best light and to minimise the cost of audit; auditors are portrayed as desperate to protect their incomes and therefore too eager to please those who have the audit appointment in their gift (ie management). This concern could be addressed by severing the direct financial link between a company's executive management and its auditors.

2.3.2 Auditors report to shareholders and in law (section 385 Companies Act 1985) are appointed by the company in general meeting. In practice this appears to have become an exercise in 'rubber-stamping' an appointment made by the company's management.

2.3.3 We suggest two changes:

- shareholders, led by institutional investors, should make active use of the power they already have. If they are dissatisfied with an audit appointment, shareholders should be encouraged to propose a resolution for the appointment of an auditor of their choice.

- only non executive directors (themselves appointed by shareholders) and shareholders who are not executive directors should be able to nominate auditors for appointment and vote on matters relating to the auditors.

2 DIRECTORS, AUDITORS AND REGULATORS (continued)

2.3 Audit appointments and remuneration (continued)

2.3.4 Similarly, statute makes provision for a company in general meeting to determine the remuneration of auditors (Section 390A Companies Act 1985). In practice this power is generally delegated to the directors of the company. We suggest that executive directors of public companies should have no voting rights (at board level or in general meeting) in relation to auditors' remuneration, nor should they be able to propose any resolution relating to the auditors. In other words, the power of executive directors over audit appointments and remuneration would depend entirely upon their ability to persuade non-executive directors and/or shareholders of the validity of their arguments.

2.4 Communication between non-executive directors, auditors and regulators

2.4.1 The primary formal route for auditors to report their findings on internal control or to voice any concerns they may have, should be to non-executive directors, preferably constituted formally as an audit committee of the board. Executive directors should also be informed of significant weaknesses in internal control in the normal course of the audit.

2.4.2 Again as a measure to strengthen the position of non-executive directors, and to give them options other than resignation for dealing with difficult situations, we believe that there should be both formal and 'ad-hoc' channels of communication between non-executive directors and the Stock Exchange (as the body which has statutory responsibilities for the protection of investors). Auditors could attend such meetings at the invitation of either the non-executive directors or the Stock Exchange. When all is going well, when a company is well-managed and successful, regular meetings might be something of a formality, but they would establish channels of communication which could prove invaluable when something is going wrong.

2.4.3 It is a defence to certain company law offences for the accused director to show that he took all reasonable steps to prevent the offence being committed. Although it would require legislation, we suggest that a further defence for a director (whether executive or non-executive) acting in good faith should be that he disclosed the relevant facts to an appropriate authority (eg police, DTI, Stock Exchange). Such a provision should not, of course, absolve the director from all further responsibility.

3 INTERNAL CONTROLS

3.1 General

3.1.1 Any measures to strengthen the position of non-executive directors should be part of a strong and comprehensive system of internal controls for any public interest company. Auditors of such companies commonly evaluate systems of internal controls with a view to placing reliance on a good system; findings of weakness are reported to management. We believe that it would assist non-executive directors if there were some authoritative guidance on the sort of internal controls which might reasonably be expected to operate in a well-managed public company and on the risks associated with weakness in key control areas. Such guidance could be developed by the Stock Exchange, in co-operation with representatives of business and the auditing profession, so as to provide both general and industry specific guidance. Auditors could then present their findings on internal controls in terms which relate to publicly recognised standards of good practice (rather than in terms dictated by their statutory reporting obligations).

3.1.2 We believe that the time has come when investors and their professional advisers might reasonably require (though not yet expect to find) information about the quality of a listed company's internal control and management systems (including limits of authority). Without good internal control and management information systems, a company is unlikely to fulfil its potential. We have already suggested that the Stock Exchange might issue guidance as to the controls which might reasonably be expected to operate in well managed public companies; to that we would add a recommendation that the Stock Exchange require an appropriate system of controls as a condition of listing. An appropriate and effective system of internal controls should be a condition of admission to listing and of continuation of listing. Auditors could report annually to non-executive directors and/or to the Stock Exchange on compliance with the publicly recognised norm.

3.1.3 Such a change would not, we believe, necessitate a major new Stock Exchange requirement. The Stock Exchange's regulations already require listing particulars to contain all such information as investors and their professional advisers would reasonably require and reasonably expect to find for the purpose of making an informed assessment of (among other things) the financial position and prospects of the issuer (Financial Services Act 1986, section 146).

3 INTERNAL CONTROLS (continued)

3.2 Limits of Authority

3.2.1 Returning to the problem of the 'dominant chief executive', internal controls might be strengthened by adding an external dimension. Companies could publish details of 'high level' authorisations required for certain major transactions. For example a company could declare publicly that transactions above a certain financial value could only be validly entered with the written authorisation (signatures) of at least two non-executive directors. Although there might be some legal enforcement difficulties with regard to the doctrine of ultra-vires, the principle might work at a practical level if supported by the business community on a voluntary basis. If it were declared in the financial statements of a plc that all transactions above a certain sum required authorisation by non-executive directors, and if banks were prepared to transfer funds, company lawyers to draw up contracts, or other plcs to do business only on the basis of published authorisation levels, the dominant chief executive might find it more difficult to act without the consent of the board as a whole.

3.2.2 Clearly, some guidance to the business community as to appropriate authority levels would be useful, and might be developed as part of the internal control 'norms' suggested in 3.1.1 above. However, limits of authority would have to be set by each company with reference to its own size, operations and shareholders.

3.2.3 Auditors could report publicly on compliance during the financial year with published authority levels.

3.2.4 Authorisation controls are a key part of any effective system of internal controls. Our suggestion above is to make authorisation controls more effective by making them more public. In paragraph 4.4.2 below we consider whether there is a case for public reporting on internal controls generally.

4 FINANCIAL REPORTING

4.1 In our introduction we commented that investment is about risk taking. It is important that (within its constraints) financial reporting should provide shareholders and other investors with a sound basis on which to assess the risks of investment. In this section we propose a few measures which we believe could help shareholders in particular in assessing the financial position and prospects of their company.

4.2 Working Capital Statements

4.2.1 The question of whether a business will remain a going concern is of vital interest to investors. Stock Exchange listing particulars include a statement by directors that in their opinion working capital available to the group is sufficient, or a statement as to how the additional working capital is to be provided. For directors to make this statement, detailed working capital forecasts have to be prepared and considered. This in itself is a good management discipline.

4.2.2 Directors should be required to prepare working capital forecasts (for perhaps the next 12 months) as a basis for making a working capital statement in public companies' financial statements. The directors' statement should specify the period covered.

4.2.3 Naturally, the forecasts, and therefore the directors' statement, will have to be based on assumptions about the future - about the economic climate in general and the company's prospects in particular. Because the statement will necessarily be based on subjective assumptions, the directors' forecasts and statement should be the subject of review by the auditors. The auditors should report their opinion as to whether the directors have reasonable grounds on which to make their statement. This will require the auditors to form a view as to whether the directors' assumptions are reasonable, as they do in relation to forecasts for listing particulars.

4.3 Management's Discussion and Analysis (MD&A)

4.3.1 Investors are interested in what is going to happen to a business in the future. Two of the recognised drawbacks of financial statements in their statutory form are:

- they are backward-looking, being based on historical costs and past events
- they are difficult to understand.

4.3.2 This suggests to us that users of accounts, particularly 'lay' investors (or even those who are financially aware but do not have the financial analyst's ability to extract information from accounts), would appreciate a narrative and forward looking commentary on what the directors expect the company to achieve over the next year.

4 FINANCIAL REPORTING (continued)

4.3 Management's Discussion and Analysis (MD&A) (continued)

4.3.3 In the US, the SEC requires disclosure of 'management's discussion and analysis of financial condition and results of operations' (MD&A). The disclosure requirements include prospective information but only 'where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial condition or results of operation' (SEC Interpretive Release May 1989). Disclosure of what might be regarded as more speculative prospective information is optional.

4.3.4 We believe that there should be some narrative disclosure, in simple terms, of corporate objectives and of the factors directors expect to influence the results of the company over the next year. This would help investors to see what company management believe are their priorities. Investors would then more easily be able to match their own requirements with the companies they invest in. It is no good, for example, for an investor looking for a high dividend yield to invest in a company which is intent upon inward investment and more likely to yield capital growth than income.

4.3.5 If management is to disclose its expectations about the future, investors will need to know something about management's forecasting skills. For this purpose it would be useful for an MD&A type statement to include a review of the company's performance over the past year, using the prior year commentary as a reference point.

4.3.6 An MD&A might also directly address the issue of risk which we believe is so important for investors by identifying, for example, the major exposures facing the company in the coming year and the steps being taken to address those concerns. Such reporting has been envisioned, for example, by the US Financial Accounting Standards Board in requiring information on credit exposures to single debtors, markets or geographical sectors.

4.4 Internal Controls

4.4.1 We have already suggested that the Stock Exchange should require listed companies to maintain appropriate and effective systems of internal controls and that it should issue guidance on the features of good systems of internal controls for various business sectors (paragraphs 3.1 above).

4 FINANCIAL REPORTING (continued)

4.4 Internal controls (continued)

4.4.2 It might be appropriate for directors of listed companies to be required to consider the company's systems of controls and state in the financial statements whether they consider that an appropriate and effective system is in place (the appropriateness of the system might be related to the known future requirements of the business). This would provide investors with assurance that the matter had been addressed by directors and the publication of guidance on internal controls would inform investors as to the standards of control they might reasonably expect. Auditors could report whether they consider that the directors had a reasonable basis for their statement.

4.5 Authority Limits

4.5.1 We have suggested in section 3.2 that financial statements should include a statement of the levels of authorisation required for major transactions and that auditors could report on compliance with the limits set.

4.6 Accounting Policies

4.6.1 It is well understood by auditors that there is more than one way to present a true and fair view and that the application of different, but nevertheless acceptable, accounting policies can produce quite different results. We strongly support the endeavours of the Accounting Standards Board to limit the number of options available to companies and to provide more practical guidance as to particular interpretations of the concept of prudence in financial reporting.

4.7 Frequency of Reporting

4.7.1 The Stock Exchange requires listed companies to publish half yearly reports but the requirements for half-yearly reports fall far short of those for the full year's financial statements. We recommend that listed companies' half year announcements include a balance sheet and cash flow statement, in addition to the current requirement for profit information, together with a narrative review of the results and major footnotes as deemed relevant.

4.7.2 This half year statement should be subject to auditors' review. The auditors' report thereon would not be 'full scope'; our views on such reporting in relation to preliminary announcements are given in paragraphs 4.9.5 and 4.9.6 below.

4 FINANCIAL REPORTING (continued)

4.7 Frequency of Reporting (continued)

4.7.3 Conditions change so quickly in the financial world today that more frequent reporting has been suggested. We do not believe that the practicalities and management time involved would be cost-beneficial; in particular we believe that quarterly reporting might tend to increase 'short termism' in companies managing their financial results.

4.8 Timeliness of Financial Reporting

4.8.1 The usefulness of a set of financial statements declines over time. Company law allows public companies seven months from their year end to deliver financial statements to the Registrar of Companies (ten months for private companies). The Stock Exchange requires listed companies to issue the annual report and accounts within six months and an interim statement within four months of the period end. Any code of good governance should set a much tighter deadline for the publication of financial information; three months would be much more satisfactory than the present requirements. All well managed companies should be able, in normal circumstances, to issue annual reports and interim statements within this time limit, as many do.

4.9 Preliminary Announcements

4.9.1 It is common practice for listed companies to make public announcements of their annual results in advance of the publication of their full, audited financial statements.

4.9.2 There is no legislation governing preliminary announcements. Stock Exchange listing requirements specify minimum disclosures in relation to profit and loss account information; accounting policies should be consistent with those applied to annual accounts. There is no requirement to disclose notes to the accounts, even though they might be fundamental to an understanding of the figures released. (Although the Stock Exchange requires half-yearly reports to include any significant information enabling investors to make an informed assessment of activities, there is no such requirement in relation to preliminary announcements of full-year results). There is no requirement for an audit of the figures in preliminary announcements or indeed for any involvement of the auditors.

4.9.3 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.

4 FINANCIAL REPORTING (continued)

4.9 Preliminary Annoucements (continued)

4.9.4 Research has shown that the financial markets act on information, such as preliminary announcements, received in advance of the audited financial statements. By the time the annual report and financial statements are published, the market has already taken account of the information contained in preliminary announcements and share prices have been adjusted. It seems likely that the markets assume that auditors give their consent before preliminary announcements are issued but the announcements themselves often give no indication as to whether this was the case. This seems to present an opportunity for the expectation gap to be narrowed in favour of the markets; the Stock Exchange should introduce a requirement for listed companies' preliminary announcements to be approved by their auditors and to include an auditors' report to this effect.

4.9.5 A full scope audit report would be inappropriate for a preliminary announcement for two reasons:

- the value of preliminary announcements is in the public release of price-sensitive information at the earliest opportunity, and
- preliminary announcements generally contain only profit and loss account information without notes to the accounts or details of accounting policies.

4.9.6 Short of a full scope audit report, the markets have now become familiar with the wording of reports indicating approval of an investment advertisement under Section 57 Financial Services Act 1986. A report along the same lines would serve well in relation to preliminary announcements.

4.9.7 Guidance from the Auditing Practices Board should specify the audit work required to support reports on preliminary announcements. For an auditor to provide a level of assurance which would meet public expectations, the audit of the financial statements would have to be complete in respect of the figures to be disclosed in the preliminary announcement. Any guidance to auditors would have to address this issue.

4.9.8 It would also be a valuable improvement to the quality of the information provided to the markets if listed companies were required to include a balance sheet and cash flow statement, together with a narrative review of the results and major footnotes as deemed relevant. In addition, companies should be required either (1) to make a positive statement in their preliminary announcements that there had been no material changes in accounting policies from those disclosed in the last published audited accounts or, (2) where that is not the case, to disclose the changes.

5 LIABILITY AND RELIANCE ON FINANCIAL STATEMENTS

5.1 The Cadbury Committee, through its Secretary Nigel Peace, has asked us to comment upon the Caparo decision and what could be done to restore public confidence.

5.2 The Caparo decision turned upon the House of Lords' view of the purpose of statutory accounts. Their Lordships decided that statutory accounts were prepared for the purpose of enabling shareholders 'to question the past management of the company, to exercise their voting rights .... and to influence future policy and management', not to advise shareholders in relation to investment in the company.

5.3 Although we accept this as an analysis of the primary purpose of statutory accounts, we respectfully suggest that statute recognises another, wider purpose in the publication of statutory accounts. Section 238 Companies Act 1985 requires copies of accounts and reports to be sent to holders of the company's debentures; section 242 requires annual accounts and reports to be delivered to the registrar of companies; section 709 provides that 'any person may inspect any records kept by the registrar for the purposes of the Companies Act ....', the right of inspection extends to the originals of documents delivered to the registrar where the record kept by the registrar of the contents of the document is illegible or unavailable. Statute clearly intends that statutory accounts are for the public record.

5.4 What use then might the public reasonably be expected to make of the information made available by statute? As we are talking about a secondary and subsidiary purpose of accounts, it seems fair to expect that their intended use must be limited. Common practice reflects this analysis. It is generally recognised by the business and investing community that accounts are used for wider purposes than those identified by the House of Lords in Caparo. Bankers, trade creditors and potential investors all make use of publicly available financial information about companies, including statutory accounts. But it is also recognised among businessmen that statutory accounts are not ideally designed for their purposes; they have their limitations and must be used accordingly. For example, information on the public record is often long out of date; balance sheets are primarily a record of historic costs and not of current values. The prudent businessman would therefore only use statutory accounts as one of several sources of information on which to base an investment, lending or trading decision.

5.5 This is where the law as we understand it departs from normal business practice. Anyone who has relied upon a negligently prepared or audited set of accounts and suffered loss as a result has a claim for damages against anyone who owed him a duty of care in relation to the preparation or audit of those accounts. But the extent of the duty of care, or the extent of the liability, is not in any way restricted by the extent of reliance placed. It is sufficient for the law that a measure of reliance was placed. So, imagine (Caparo apart) that an investor placed equal reliance upon each of four different sources of information, one of which was a negligently prepared and audited set of accounts, and as a result suffered a loss of £10 million. Assuming that proximity and a duty of care can be established, the investor would have a valid claim against the preparers and auditors of the accounts for £10 million. Would it not be fair to say that because the degree of reliance placed on those accounts was only 25%, then the degree of liability should only be 25% of the £10 million loss?

5 LIABILITY AND RELIANCE ON FINANCIAL STATEMENTS (continued)

5.6 We therefore propose that:

5.6.1 A working party of users, preparers and auditors of accounts issue a statement of accepted practice setting out the extent to which it is reasonable to rely upon accounts for purposes other than their primary purpose (as identified in the Caparo case).

5.6.2 The law be changed in respect of reliance so that damages are restricted, for example in proportion to the lower of a) the actual degree of reliance or b) the degree of reliance which would have been reasonable in the circumstances.

5.6.3 Preparers and auditors of accounts recognise that their responsibility for statutory financial statements imposes a duty of care which extends beyond the duty recognised by House of Lords in the Caparo case (ie a duty to shareholders as a body to enable them to exercise their rights in general meeting).

5.6.4 It should be recognised that where auditors owe a duty to parties not addressed in their audit report and for wider purposes than those envisaged in the Caparo judgement, the audit report will not necessarily be the appropriate medium for discharging the wider duty of care. In particular, a duty to creditors or potential investors not known to the auditors might be satisfactorily discharged by the auditor reporting to the appropriate regulator (eg DTI, Stock Exchange, Bank of England).

6 OTHER INFORMATION FOR SHAREHOLDERS

6.1 The Yellow Book requires notification of 'any information necessary to enable holders of the company's listed securities and the public to appraise the position of the company and to avoid the establishment of a false market in its listed securities' (Section 5, chapter 2, paragraph 1).

6.2 Shareholders should, we believe, be provided with information more frequently during the financial year. We have mixed feelings about the benefits or inequities of private analysts' briefings; we would not propose an attempt to stop the practice, but we are concerned that such briefings might from time to time take the place of a public announcement to the detriment of the 'small shareholder'. There are probably more occasions during a company's financial year when it would be appropriate for it to make a public announcement in relation to a major development in its sphere of activity which is likely to affect its share price.

6.3 We would like to see further guidance from the Stock Exchange as to when companies should make public announcements circulated to all shareholders, and active encouragement for them to do so more frequently.

7 REDUCING BURDENS

7.1 In the Netherlands, subsidiaries of public companies do not have to produce full statutory accounts or have an audit provided that:

- the holding company prepares and files EC consolidated accounts
- the holding company guarantees the subsidiary's debt, and
- the shareholders give their approval.

This relieves the need for audit of subsidiaries' separate accounts, and indeed subsidiaries which are not material to the published group accounts may not need to be audited at all. We suggest that this example should be followed in the UK for wholly owned subsidiaries, subject to similar safeguards. Holding companies could be spared the time and cost involved in preparing statutory accounts, subsidiaries' creditors would be protected, and the group auditors would be freer to focus on the things which matter to investors and creditors outside the group.

PRICE WATERHOUSE
5 February 1992