

**COMMITTEE ON THE FINANCIAL ASPECTS  
OF CORPORATE GOVERNANCE**

**Issues for the Committee's Successor Body**

1. Committee members were sent papers relating to this subject under cover of my letter of 10 November 1994. Copies of these papers are appended below. They comprise:-

Issues for the Committee's Successor body - both those highlighted in the Report and those which have arisen out of discussions at Committee Meetings.

Research into Compliance with the Code.

The Committee's Recommendations for amendment to the Companies' Acts.

A box chart showing a Summary of the Committee's Recommendations.

2. The following amendments have been made to the papers previously circulated.

2.1 At the request of the Chairman, a further item has been included in the **Issues for the Committee's Successor Body**, at 2.13 - The independence of shareholder directors.

2.2 Under **Research into Compliance with the Code**, a further regional survey covering the West Midlands has been added to paragraph 3.1.

2.3 With regard to the **Committee's Recommendations for amendments to the Companies Acts**, a response has now been received from the DTI concerning the three topics raised and this is attached.

3. No further suggestions for additions or amendments to the list have been received by the Secretary from Committee members. She would be grateful for the Committee's confirmation that they are happy with the format in which the information is presented.

Gina Cole  
Secretary  
30 November 1994

## Issues for the Committee's Successor Body

### 1. Highlighted in the Report

Paragraph 20 of the committee's Report, lists the following issues which the successor body "may wish to review or consider in greater depth".

- 1.1 the application of the code to smaller listed companies - paragraph 3.15. The Committee recognised that smaller companies may initially have difficulty in complying with some aspects of the Code and said that any practical issues which arose would be thoroughly reviewed by the Committee and its successor body.
- 1.2 Directors' training - paragraph 4.20. The new courses for directors mentioned in paragraph 4.20 are now up and running and the current Committee will be able to report to its successor on their success.
- 1.3 the rules for disclosure of directors' remuneration, and the role which shareholders could play - paragraph 4.46.
- 1.4 a requirement for inclusion of cash flow information in interim reports - paragraph 4.56. This has been taken forward by the Institute of Chartered Accountants Financial Reporting Committee.
- 1.5 the procedures for putting forward resolutions at general meetings - paragraph 6.4
- 1.6 developments regarding the nature and extent of auditors' liability - paragraph 5.35.

### 2. Considered by the Current Committee

In addition, the Committee has consider the following issues at meetings since the publication of the report and Code, with agreement that they should be considered again by the successor body when it is convened. The list is in no particular order of importance.

- 2.1 the wider issue of compliance with the spirit as opposed to the letter of the code, and the reaction of the accountancy profession.
- 2.2 follow-up by shareholders on non-compliance statements.
- 2.3 nomination committees to follow the same procedures in the appointment of both executive and non-executive directors.
- 2.4 the length of directors' rolling contracts; specific disclosure of directors' notice periods.
- 2.5 directors' pay.
- 2.6 need for special provision for smaller companies discussed but not accepted by the Committee. Need to ensure that the Guidance put out by CISCO (City Group for Smaller Companies) not used as an "alternative" to the Code. Need for research into compliance levels of smaller companies.
- 2.7 definition of executive/non-executive director labels, number of non-executive directors on sub-committees. Confusion if Chairman is not explicitly non-executive.
- 2.8 extension of the report and code to large private companies.
- 2.9 the position of controlling shareholders and their effect on non-executive directors' tenure of office and independence.
- 2.10 need for the successor body to remain cognisant of the "overload" position.
- 2.11 need to reconsider the wording of paragraph 4.12 and the independence of non-executive directors.
- 2.12 four areas of possible further research on which a longer term view needed to be taken:-

directors' remuneration  
smaller companies' ability and willingness to comply  
availability and quality of non-executive directors  
role of shareholders at AGMs.

2.13 the independence of shareholder directors.

3. Other matters arising

3.1 The successor body will need to monitor the introduction of the final two requirements of the Code relating to Internal Control and Going Concern. In particular, it may wish to look at the wording of paragraph 4.5 of the code relating to internal control, in view of the fact that the guidance for directors is likely not to insist on directors making a statement as to the *effectiveness* of the system of internal control, as at present specified in the Code.

3.2 The Committee considered that the work of its successor body could be placed under three broad headings:-

1. matters on which action is needed
2. matters which have not been addressed by the Committee to date
3. matters covered by the Code which should perhaps not be.

## Research into Compliance with the Code

The furtherance of research and monitoring compliance with the Code of Best Practice has been taken forward by the Monitoring Sub-Committee, under the Chairmanship of Professor Andrew Likierman.

### 1. Computer Database

1.1 In conjunction with the Association of British Insurers, the Committee is financing a research project into levels of compliance by listed companies. A dedicated researcher has been appointed, partly funded by the Committee. The Committee's financial commitment has to date been £15,000 for each of the years September 1993 to August 1994 and September 1994 to August 1995. It has been made clear to the ABI that joint funding after this date will be dependent on decisions made by the successor body.

1.2 The database contains details of levels of compliance of all the top 500 FT/SE companies, and a stratified sample of one in five of the remainder of listed companies. The first report from the database was considered by the Monitoring Sub-Committee on 1 November 1994 and will be put to the full Committee on 7 December 1994. This report covers approximately 630 of the 750 companies in the sample and the researcher hopes to deal with the outstanding companies prior to the end of December, when he will compile a final report.

1.3 At its meeting on 1 November, the Sub-Committee agreed that further research should be commissioned from this source, covering published reports and accounts for years ending after 30 June 1991, and extracting information on the role of Chairman/CEO, and the existence and composition of nomination, remuneration and audit committees. This will provide a benchmark against which developments in these aspects of corporate governance can be measured, and the influence of the Report and Code assessed. The additional research is costing the Committee £4,500.

### 2. ICAEW Corporate Governance Research Board

2.1 Both Professor Likierman and Gina Cole attended meetings of the ICAEW Corporate Governance Research Group. The Group invited submissions for research funding for corporate governance projects, which would be of specific interest to the Committee, and whose results would be made available to the successor body when convened in mid-1995. The projects approved by the Group were:-

- (a) Board Structures and Qualifications in Firms gaining quotation in the UK.

- (b) The role of Institutional Shareholders in Corporate Governance.
- (c) Corporate Governance and Institutional Shareholders.
- (d) CEO Remuneration and Corporate Governance.
- (e) Corporate Governance, Internal Controls and the Management Audit.
- (f) Audit Committees in Small Listed Companies.

The Group will be meeting in early 1995 and will advise on progress of the above projects. The question of further ICAEW funding of corporate governance research may also be raised.

### 3. Regional Surveys

3.1 Regional surveys into corporate governance in listed companies in the North East and North West were carried out on the Committee's behalf by Dibb Lupton Broomhead and published in October 1994. A research report by Professor John Samuels of Birmingham University "Cadbury Code of Best Practice and Midland Quoted Companies" was published in September 1994.

The following, less comprehensive, surveys have also been published and copies will be made available to the successor body, as required:-

|  |                                     |
|--|-------------------------------------|
| Corporate Governance Survey of Quoted Companies in the East Midlands | Touche Ross<br>December 1993        |
| Implementing the Recommendations of the Cadbury Committee            | Coopers & Lybrand<br>June 1993      |
| Implementing Cadbury in the Medium Sized Listed Company              | Coopers & Lybrand<br>November 1993. |

### 4.

In addition, Touche Ross have published quarterly reports on the implementation of the Code's requirements.

## **Committee's Recommendations for amendments to the Companies Acts**

There are three specific issues on which the Committee made recommendations which would involve amendments to the Companies Acts.

1. That the Acts should be amended to come into line with the requirement of the Code that directors' service contracts should not exceed three years without shareholders' approval (paragraph 4.41).
2. The disclosure of fees paid to audit firms for non-audit work (paragraph 5.12).
3. The question of the Government interdicting legislation to extend to the auditors of all companies the statutory protection already available to auditors in the regulated sector (paragraph 5.28).

The Secretary has written to the Head of Companies Division in the Department of Trade and Industry for up to date information on whether any such amendments to the Acts are envisaged.



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Our ref  
Your ref  
Date 10 November 1994

Dear Gina,

Thank you for your letter of 26 October enquiring about progress in implementing the three recommendations in the Committee's report addressed to the Department.

Directors' service contracts not to exceed three years without shareholder approval

As part of our programme of reviewing company law, we set up a working party last year to examine the law on directors' duties - in particular, directors' fiduciary duty to act in good faith in the interests of the company, the duty of care and skill, and the rule of equity which states that a director may not make a personal profit from any transaction with the company other than by way of his lawful remuneration. The working party is also examining the detailed provisions of Part X of the Companies Act (sections 311 to 347) which in effect restate the equitable rule in respect of specific matters such as loans to directors, directors' service contracts, and directors' dealings in their company's shares. A consultation document is in an advanced state of preparation and if all goes well it will be issued early in 1995. It will specifically invite comments on the Committee's recommendation that section 319 should be amended so as to require shareholder approval for service contracts in excess of three years.

As Nigel Peace said in his letter of 12 September to Sir Adrian Cadbury, we should be very pleased to make a short presentation about the consultation document to the Committee once it has been issued, if the Committee would be interested.

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### Disclosure of fees paid to audit firms for non-audit work

Preliminary research that we have undertaken has shown that many companies are going beyond the existing statutory disclosure requirements and are complying voluntarily with Cadbury's recommendation that fees paid for non audit work should be fully disclosed both in a UK and, where appropriate, worldwide context. However our research also shows that the diverse international structure of the auditing firms will make it difficult to draft regulations that would apply consistently. We intend to consult next year, reviewing current practice and possible options (both regulatory and through encouraging best practice) so as to ensure that the spirit of the recommendation is met.

### Statutory protection for auditors reporting fraud

Informal consultation has suggested that many auditors do not appreciate the extent to which there is already legal protection for those reporting fraud in the public interest. The Auditing Practices Board will shortly be publishing a new standard on fraud and error which will explain more clearly and accessibly the scope of the existing protection and the circumstances in which auditors should report suspected fraud. (The Board has already published standards on reporting to regulators.) The Department will consider, in the light of experience with the new standard, whether this meets the need identified by the Committee or whether further protection is needed; if so, primary legislation would be required.

Yours sincerely

*Sarah E Brown*

**SARAH E BROWN (Mrs)**  
**Head of Companies Division**

**SUMMARY OF COMMITTEE'S  
RECOMMENDATIONS**

| Compliance with the Code of Best Practice   | FOR ACTION BY:-   | COMMENTS   |
|---|---|--|
| <p>1. The boards of all listed companies registered in the UK should comply with the Code of Best Practice set out on pages 58- 60. As many other companies as possible should aim at meeting its requirements (paragraph 3.1)</p>  | <p>Listed Companies</p>                                   | <p>See 5(b) below</p>  |
| <p>2. Listed companies reporting in respect of years ending after 30 June 1993 should make a statement about their compliance with the Code in the report and accounts and give reasons for any areas of non-compliance (paragraph 3.7).</p>  | <p>Listed Companies</p>                                   | <p>See 5(b) below</p>  |
| <p>3. Companies' statements of compliance should be reviewed by the auditors before publication. The review should cover only those parts of the compliance statement which relate to provisions of the Code where compliance can be objectively verified. The Auditing Practices Board should consider guidance for auditors accordingly (paragraph 3.9)</p>   | <p>Auditors<br/>APB</p>                                   |  |
| <p>4. All parties concerned with corporate governance should use their influence to encourage compliance with the Code (paragraph 3.14). Institutional shareholders in particular, with the backing of the Institutional Shareholders' Committee, should use their influence as owners to ensure that the companies in which they have invested comply with the Code (paragraph 6.16).</p>  | <p>Institutional Shareholders /ISC</p>                    | <p>Extent of use of influence?</p>   |
| <p><b>Keeping the Code up to date</b></p> <p>5. The Committee's sponsors, convened by the Financial Reporting Council, should appoint a new Committee by the end of June 1995 to examine how far compliance with the Code has progressed, how far our other recommendations have been implemented, and whether the Code needs updating. Our sponsors should also determine whether the sponsorship of the new Committee should be broadened and whether wider matters of corporate governance should be included in its brief. In the meantime the present Committee will remain responsible for reviewing the implementation of its proposals (paragraph 3.12).</p> <p><b>Directors' service contracts</b></p> | <p>a) Financial Reporting Council</p> <p>b) Committee</p> | <p>a) On FRC agenda for November meeting</p> <p>b) Remit of Monitoring Sub-Committee. ABI/Cadbury database, ICAEW funded research projects and other studies</p> |
| <p>6. The Companies Act should be amended to come into line with the requirements of the Code that directors' service contracts should not exceed three years without shareholders' approval (paragraph 4.41)</p>   | <p>DTI</p>  |  |
| <p>7. Companies should expand their interim reports to include balance sheet information. The London Stock Exchange should consider amending the continuing obligations accordingly. There should not be a requirement for a full audit, but interim reports should be reviewed by the auditors and the Auditing Practices Board should develop appropriate guidance. The Accounting Standards Board in conjunction with the London Stock Exchange should clarify the accounting rules which companies should follow in preparing interim reports. The inclusion of cash flow information should be considered by the Committee's successor body (paragraph 4.56).</p>  | <p>ICAEW<br/>Financial Reporting Committee/ASB</p>        |  |

**Enhancing the effectiveness of the audit**

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|--|--|--|
| <p>8. Fees paid to the audit firms for non-audit work should be fully disclosed. The essential principle is that disclosure should enable the relative significance of the company's audit and non-audit fees to the audit firm to be assessed, both in a UK context and, where appropriate, a worldwide context. The 1991 Regulations under the Companies Act should be reviewed and amended as necessary (paragraph 5.11).</p> | <p>DTI</p>                               |  |
| <p>9. The accountancy profession should draw up guidelines on the rotation of audit partners (paragraph 5.12).</p>   | <p>Accountancy Profession</p>            |  |
| <p>10. Directors should report on the effectiveness of the system on internal control, and the auditors should report on their statement. The accountancy profession together with representatives of preparers of accounts should draw up criteria for assessing effective systems of internal control and guidance for companies and auditors (paragraph 4.32 and 5.16).</p>   | <p>ICAEW Working Group &amp; APB</p>     |  |
| <p>11. Directors should state in the report and accounts that the business is a going concern, with supporting assumptions or qualification as necessary, and the auditors should report on this statement. The accountancy profession together with representatives of preparers of accounts should develop guidance for companies and auditors (paragraph 5.22).</p>   | <p>ICAEW Working Group &amp; APB</p>     |  |
| <p>12. The question of legislation to back the recommendations on additional reports on internal control systems and going concern should be decided in the light of experience (paragraph 5.17 and 5.22).</p>   | <p>Successor body/DTI</p>                |  |
| <p>13. The Government should consider introducing legislation to extend to the auditors of all companies the statutory protection already available to auditors in the regulated sector (banks building societies, insurance and investment business) so that they can report reasonable suspicion of fraud freely to the appropriate investigatory authorities (paragraph 5.28).</p>  | <p>DTI</p>                               |  |
| <p>14. The accountancy profession together with the legal profession and representatives of preparers of accounts should consider further the question of illegal acts other than fraud (paragraph 5.30).</p>  | <p>Accountancy/<br/>legal profession</p> |  |
| <p>15. The accounting profession should continue its efforts to improve its standards and procedures so as to strengthen the standing and independence of auditors (paragraph 5.36).</p>   | <p>Accountancy profession</p>            |  |
| <p><b>Voting by Institutional Investors</b></p>  |  |  |
| <p>16. Institutional investors should disclose their policies on the use of their voting rights (paragraph 6.12).</p>  | <p>Institutional Investors</p>           |  |