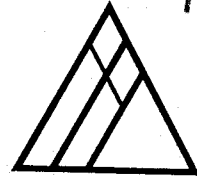


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Mr Nigel Peace
The Secretary
Committee on the Financial
Aspects of Corporate Governance
P O Box 433
Moorgate Place
London
EC2Y 2BJ

24th July 1992

Dear Mr Peace

Please find enclosed three copies of the Institute of Internal Auditors - UK's comments on the draft report on the Financial Aspects of Corporate Governance.

Yours sincerely,

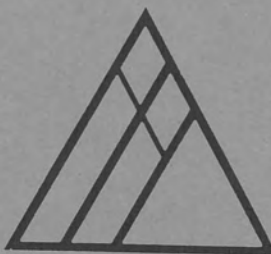
Gail Easterbrook
Chief Executive Officer

COMMENTS ON
THE DRAFT REPORT OF THE COMMITTEE ON
THE FINANCIAL ASPECTS OF CORPORATE
GOVERNANCE

By

THE INSTITUTE OF INTERNAL AUDITORS -
UNITED KINGDOM

July 1992



PRINCIPLES OF THE RESPONSE

- 1 The Institute of Internal Auditors - United Kingdom (IIA-UK) welcomes the Report of the Committee on the Financial Aspects of Corporate Governance.
- 2 We believe that the concept of the Code of Best Practice (COBP) is an important innovation which could result in significant improvements in corporate governance in the UK.
- 3 However, the IIA-UK considers that there are serious omissions in the Report.

These omissions are summarised below and are developed in Issues 1-3:

- i the COBP does not require companies to lay down standards of conduct for employees and directors in a Corporate Code of Conduct; (Issue 1)
 - ii the COBP does not require companies to set up and maintain effective independent internal audit functions; (Issue 2)
 - iii The London Stock Exchange is intended to act as the COBP watchdog but the Chairman has stated publicly that, "the Exchange is not offering sanctions and punishment". (Issue 3)
- 4 These omissions mean that corporate control will continue to be reliant on boards of directors, making proper provision, and on external auditors, auditing financial controls.

Boards of directors may, therefore, continue to lay down standards of control acceptable to them and may decide whether their control arrangements should be subject to internal monitoring.
- 5 The apparent initiative of the Cadbury Committee in recommending that the accountancy profession should develop, "a set of criteria for assessing effectiveness" of the internal financial controls breaks no new ground. The external auditors, however, will only audit those controls that are relevant to the annual accounts. The recommendations will not extend the external auditor's review of controls.
- 6 Moreover, in the absence of an internal audit function, the directors will have to rely on the external auditors to provide the information with which to comment on "their system of internal financial control", as required in the COBP. This will defeat the purpose of the external auditors subsequently auditing the report.
- 7 Effective corporate control cannot be achieved by boards of directors relying on external auditors or consultants. It can only be achieved by boards of directors employing professional internal auditors to advise them on the adequacy of all control systems (financial and operational) and subsequently to monitor adherence to such systems.

CONCLUSION

The IIA-UK recommends that the Committee should require boards of directors to take proper measures to ensure adequate and effective internal control, including the establishment of an internal audit function.

CODE OF CORPORATE CONDUCT FOR ALL EMPLOYEES AND DIRECTORS

- 1 The Cadbury Report states in paragraph 4.23 that,

"It is important that all employees should know what standards of conduct are expected of them. We regard it as good practice for boards of directors to draw up codes of ethics or statements of business practice and to publish them both internally and externally."

- 2 In spite of this support for the recommendation made by IIA-UK, it is significantly absent from the "Controls and Reporting" section of the COBP.
- 3 The IIA-UK considers it is a fundamental requirement for all plcs to clarify to their employees, directors and agents the standards of behaviour expected of them by the organisation.
- 4 This will provide a yardstick against which individual behaviour can be measured and a basis for disciplinary action.
- 5 It is particularly vital for employees, directors and agents who are involved in negotiations with third parties to know the standard of conduct required of them.

THE NEED FOR INDEPENDENT PROFESSIONAL INTERNAL AUDIT

- 1 The Cadbury Report touches on the role of internal auditors in paragraphs 4.29 and 4.31. There are, however, no recommendations in the Report on the role of internal audit in enhancing corporate governance, nor does the COBP require directors to report on how they maintain adequate internal control systems.
- 2.1 The Report is very positive on the need for audit committees and the COBP states, "Boards must establish effective audit committees".
- 2.2 The IIA-UK agrees with this view. However, if non executive directors, formed into audit committees, are to be effective in improving corporate governance they will need assistance to obtain the information they require.
- 2.3 The Report appears to assume that the information required by non executive directors will be readily accessible and will be made available to them. Clearly, in some recent instances of inadequate corporate governance, this was not the case. In such organisations, the nature and scope of the problems could be concealed from the audit committee. Part of the board could therefore publish a statement of compliance with the COBP and have it reviewed by the external auditors, in ignorance of the true state of affairs.
- 2.4 When a company is in difficulty, reliable and relevant information is rare. Calling for external advice (para 4.29) at that stage is too late and is of dubious value. In these circumstances, the audit committee must have the direct support of a group of professionals, independent of line management, who will monitor and report back on activities on a continuous basis.
- 2.5 The IIA-UK believes that an internal audit department is the only means of providing the essential information on control that the audit committee requires.
- 2.6 In arriving at this conclusion, the IIA-UK has taken the following points into account:

Limitations of the External Audit Review

- i External audit, on which the Cadbury Committee seems willing to rely absolutely, can never be regarded as wholly reliable, unless it has been underwritten by an independent internal audit function, which has reviewed and reported on the underlying basis of internal control within the organisation.

The external auditor, restricted by his fee, will always have to make a subjective judgement as to the controls which it is necessary to review. They must concentrate on controls that are essential to support the financial audit, which will not necessarily include those which should give most concern to the audit committee.

The Role of Internal Audit

- ii All problems occur within organisations. An internal audit department is established within the organisation with the responsibility to, "independently examine and evaluate the adequacy and effectiveness of an organisation's system of internal control and thereby reassure management that:
 - a business objectives are being achieved economically, efficiently and effectively;
 - b financial and operating information is reliable and has integrity;
 - c laws, regulations, policies, plans and procedures are complied with;
 - d assets are safeguarded."

Such a service is an essential reassurance to the board that the environment of control is adequate to conduct business operations properly, and is also essential to the external auditors as a reassurance of the integrity of management.

Internal Audit's Access to the Audit Committee

- iii The Report appears to understand the importance of internal auditing in its support of the independence of the function in paragraph 4.31, as follows: "it is good practice that heads of internal audit should have the same right of access to the chairman of the audit committee as the external auditor, in order to strengthen the independence of their position."

This is very helpful. Internal auditors are often in a position to know what is wrong long before the directors and external auditors. If they can combine this knowledge with an effective working relationship with, and reporting responsibility to, an audit committee they can ensure that all the directors are aware of problems that have occurred and problems that could occur unless sufficient actions are taken.

Detecting and Reporting Fraud

- iv The problem of not making internal auditing mandatory is highlighted in the discussion on fraud (paragraphs 5.23 - 5.28). The Report states that, "prime responsibility for the prevention and detection of fraud (and other illegal acts) is that of the board." The Report then discusses the external auditor's responsibility and concludes that, "The Government should consider introducing legislation to extend to the auditors of all companies the statutory protection already available to auditors in the special regulated sector ... so that they can report reasonable suspicion of fraud freely to the appropriate investigatory authorities".

Unfortunately, as a result of the Cadbury Committee's acceptance that plcs do not need internal auditing to secure adequate corporate governance, the Report does not address the point that it is usually the internal auditors (ie the board appointed function) that has, or should have, primary reasonable suspicion of fraud.

This point is re-inforced by the computer audit surveys carried out by the Audit Commission (1981/84/87/90) which indicate that internal auditors are more likely than external auditors to detect fraud.

It is the employee internal auditor, who is in the position to know far more of the problems than the external auditor, who feels the need for support when, "he no longer has the confidence that senior management will deal adequately with the matter." (paragraph 5.28).

While it may be inappropriate to seek access to investigatory bodies for an employee internal auditor, the means of enabling internal auditors of integrity to avoid appearing to condone or support a management/board cover-up should be a concern of the Cadbury Committee.

To give internal auditors the support they need, internal auditing would need to be made mandatory in plcs and chief internal auditors could then be required to inform their audit committee, with the external auditors present, (who would themselves have access to the investigatory authorities) of any illegal matters that come to their knowledge.

LONDON STOCK EXCHANGE MONITORING OF COBP

The Chairman of the London Stock Exchange is on record stating that, "The Exchange is not offering sanctions and punishment."

This appears to mean that non compliance with the COBP will be regarded as little more than information for external audiences.

It is understood that the only sanction possessed by the Exchange would be delisting and that would be drastic.

The IIA-UK recommends that consideration be given to introducing sanctions for non compliance with COBP when a plc is at its most vulnerable and most needs support.

It is suggested that two suitable occasions would be:

- 1 when a plc needs additional funding from any source eg banks, the market; and
- 2 when a plc intends to merge with, or be taken over by, or take over another plc.

A plc that has not complied with the COBP could, at these specific times, be subject to an external investigation to reassure shareholders, investors and bankers of the true position of the company.