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RDG/CW
23 July 1992

Ach'd.

N Peace Esq
Secretary
Committee on the Financial Aspects
of Corporate Governance
P O Box 433
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LONDON, EC2P 2BJ

Dear Nigel

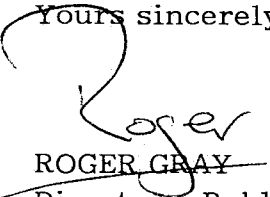
DRAFT REPORT

Attached are our comments on the Committee's draft report.

As always, if there are any points you would like to discuss further or on which you would like more information please let me know.

Kind regards.

Yours sincerely


~~ROGER GRAY~~
Director - Public Affairs

Enc:

THE CHARTERED INSTITUTE OF MANAGEMENT ACCOUNTANTS

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

POINTS OF PRINCIPLE

The majority of the draft report's recommendations are a codification of existing best practice. They are sensible and realistic and as such are supported. However, to be effective they will need teeth as those companies which most need to follow them, that is, those which are not well-governed at the moment, will be the most reluctant to do so. There has to be a process of establishing minimum standards if we are to move from the present position to that envisaged by the Committee. The Code of Best Practice therefore needs to have more status and should, we believe, be made mandatory. It should also specifically include the proposals for an Operating and Financial Review currently being suggested by the Accounting Standards Board.

We are particularly concerned over the inadequacy of the treatment of internal control and internal audit even to the level where the report is inconsistent in its use of the terms internal control and internal financial control. This is a major weakness. Much work has been, and is being, done to establish a framework for internal control. The report should take this into account and give positive encouragement to its further development.

While the report demonstrates the role and function of non-executive directors and highlights the need for companies to appoint and utilise them, it does not establish any requirements or provide guidance on appropriate action to be taken in the event of a non-executive director resigning or being released. This should be addressed.

In its report "Non-Executive Directors: Their Value to Management" CIMA identified that some well-qualified and able people may be deterred from taking up non-executive directorship owing to the status of the appointment in law whereby part-time non-executive directors carry the same responsibilities as their executive colleagues. The legal obligations and responsibilities of non-executive directors need to be identified and differentiated from those of executive directors. The report should specifically encourage follow up action on this.

THE BOARD

The Chairman

In general, the recommendation that there should be a clearly accepted division of responsibilities at the head of a company is supported. However, there is insufficient evidence to show that this is appropriate in every case. We are aware that there are instances when separating the posts of Chairman and Chief Executive may not always be necessary and could, in some cases, only increase both costs and top loading. Further investigation is required. This should be undertaken now so that conclusions will be available for consideration when the Code of Best Practice is reviewed in two years time. It should include examination of the use that could be made of non-executive Chairmen and the possibility of developing Guidelines on the criteria which could lead to consideration being given to separation of the roles.

Non-Executive Directors

The proposal that the majority of non-executive directors should be independent and free of any business and financial connection with the company, apart from their fees, sounds unexceptionable. However, there is something of a conflict. The ideal non-executive director should know something of the industry in which the company concerned is operating. This can best be secured by adequate induction, for example, through planned familiarisation programmes and continuing training. Executive directors of other companies in the same field are most likely to be the ones with relevant up-to-date knowledge. Since most companies do not wish to appoint the executive directors of competitors as non-executive directors, they may look for the necessary expertise among the executive directors of customers and suppliers. Section 2.2 of the Code of Best Practice would appear to prohibit this. It should not be allowed to do so. However, if non-executive directors who have associations with the company are appointed, including former executive directors or senior executives, they should not be eligible to serve on either the Audit Committee or the Remuneration Committee.

Companies should avoid appointing more than one non-executive from the same company or group of companies.

The independence of non-executive directors needs to be transparent. Fees should be of a dimension which encourages the spread of part-time involvement. Since resignation is the ultimate sanction of the non-executive director no dependence on fees should be created. Fees earned by executives of another company should generally be for the credit of that company. Whatever arrangements are in place they should be exposed for shareholder approval.

Executive style resources such as third party legal advice should be made available to non-executive directors by agreement on appointment, with a budget identified for the purpose. There could be difficulties in establishing an agreed procedure under which non-executive directors could take independent professional advice. Channelling through the Audit Committee could be a way forward and would help ensure co-ordination amongst non-executive directors.

There are many high-calibre directors or senior executives now retiring at increasingly earlier ages. They could be well placed to take up non-executive directorships. Their availability could mean that companies would find it easier to change their non-executive directors in line with any new challenges they may face.

The term of office for non-executive directors should be fixed at a maximum of three years with re-appointment only at an AGM.

The release of non-executive directors from the Board is not dealt with adequately. The circumstances in which non-executive directors leave their posts should be commented on in the Annual Report and reasons for departure given.

Directors' Training

We welcome the recognition given to the importance of training.

There should be a specific recommendation that all directors should ensure that they are fully aware of their duties and obligations and that they should receive appropriate training.

Internal Controls

While the report acknowledges that an effective internal control system is a key aspect of efficient management it does not demonstrate adequately how this is so. Nor does it deal adequately with the contribution internal audit makes to internal control and the way in which it helps secure effective corporate governance. The report should set out clearly what it means by internal control and the distinction it is making between internal control and internal financial control.

It will be difficult for directors of large companies to make a statement on the effectiveness of their system of internal control unless they receive reports from the internal audit function that the controls which have been introduced are actually working in practice. It is desirable for companies to have internal audit functions as they are an effective way of ensuring that internal controls work in practice and that they are adhered to. This should be stated. Through reliance on internal audit, external auditors are also better placed to appraise the overall effectiveness of internal control. It should be at the heart of the final report. More guidance also needs to be given or encouraged on how directors can better appraise the effectiveness of their internal control system. This has been looked at by CIMA's Auditing Group whose "Statement on a Framework for Internal Control" will be published shortly. Internal audit should not be restricted to reviewing solely the financial aspects of business activity but should review all aspects of management control.

Audit Committees

Audit Committees should be mandatory for all listed companies and other public interest companies such as nationalised industries.

The recommendations on Audit Committees would benefit from being preceded by the discussion of the function of internal auditors.

The report should additionally require the Audit Committee to report annually to shareholders on the extent to which the Committee has fulfilled its Terms of Reference. There is scope for standardising or establishing minimum disclosure requirements for this report, possibly through a new schedule to the Companies Act, similar to the existing Schedule 7, but dealing with "Matters to be dealt with in an Audit Committee Report".

Board Remuneration

Remuneration Committees should be mandatory for all listed companies and other public interest companies such as nationalised industries.

The Chairman and the Chief Executive of the company should attend meetings of the Committee and contribute to its deliberations.

The Remuneration Committee should have responsibility for confirming the appointment of senior personnel.

Other than with the agreement of shareholders, directors' service contracts should be renewable annually rather than every three years.

Financial Reports

The Accounting Standards Board's proposed Operating and Financial Review will, when implemented, do much to encourage the provision of this information. The Code of Best Practice should specifically include a reference to it.

Reporting Practice

We agree that Interim Reports should be expanded to increase their value to users. The balance sheet and profit and loss data should be augmented by a reasonably detailed Cash Flow Statement and disclosure of all material events which have occurred in the period covered by the Report. Good accounting practice should be observed for all accounting periods - not merely year end.

AUDITING

Confidence in audit is more likely to be enhanced through mandatory disclosure requirements in well developed Financial Reporting Standards issued by the Accounting Standards Board supported by rigorous audit standards and practice issued by the Auditing Practices Board.

The proposed rotation of audit partners is not without disadvantage but as a means of minimising the likelihood of a too comfortable relationship developing with a client it deserves further consideration by the accountancy profession. The desirable continuity of audit managers for operational reasons should be counterbalanced by the partners exercising a continuing professional impartiality. This could be aided by a reasonable period in charge of an audit before transfer. Companies can and should call for presentations from their auditors. The audit profession could give more prominence to, and make more use of, independent partner reviews.

The discussion of internal control and fraud in this section is where it would be reasonable to expect references to internal audit. There are none. The role of internal audit must be discussed.

We welcome the work being done by the Auditing Practices Board to set out requirements for assessing whether or not it is appropriate for directors to prepare financial statements on the going concern basis, particularly the proposal in the Board's current Exposure Draft that if the auditors disagree with the directors' presumption that the company is a going concern they should give an adverse audit opinion and provide relevant additional information in their report. Directors and auditors must take adequate steps to satisfy themselves that essential resources such as, for example, cash, rare raw materials or individual skills will continue to be made available.

A lack of liquidity is a major risk. It would aid the interpretation of accounts if borrowings currently disclosed on the basis of "due within one year" and "after more than one year" were required to be analysed and disclosed with at least one other short category such as "due or callable within a month". Further disclosure of arrangements with major lenders should be pursued in due course.

THE SHAREHOLDERS

Written questions should only be encouraged if written answers are also given in advance of the AGM, published with the AGM papers and distributed to all shareholders.

Greater care should be taken, and regulations imposed if necessary, to ensure that all shareholders are treated equally and that, for example, analysts and major institutional investors do not receive information that is not made available to others.

Internal security requirements regulating dealing in the company shares by key employees with access to confidential operational and/or financial information, should be made compulsory.

RDG/cw
23/7/92

COMMENTS ON THE SUMMARY OF RECOMMENDATIONS

1. The term "listed companies" should be expanded to include nationalised industries such as the Post Office.

The reference to "As many other companies as possible" should be sharpened and made more specific.
2. Agreed.
3. Agreed. The latitude in the last line given through use of "could" needs to be replaced by "should".
4. "All parties" needs to be defined.
5. "Updating" should mean "strengthening". This should be specifically stated.
6. Audit Committees should be mandatory for all listed companies and nationalised industries.
7. Other than with shareholders agreement directors' service contracts should be renewable annually rather than every three years.
8. Interim Reports should be expanded. Balance sheet and profit and loss data should be augmented by a reasonably detailed Cash Flow Statement and disclosure of all material events which have occurred in the period covered by the Report.
9. This is a welcome step in the right direction but does not go far enough.
10. The proposed rotation of audit partners is not without disadvantage but as a means of minimising the likelihood of a too comfortable relationship developing with a client it deserves further consideration by the accountancy profession. CIMA will participate in any work done on this by the Auditing Practices Board. Companies can and should call for presentations from their auditors. The audit profession could give more prominence to, and make more use of, independent partner reviews.

11. Agreed. The distinction being made in the report between internal control and internal financial control needs to be made clear. There should be consistency in the references both here and in 13. The role of internal audit needs to be emphasised and there should be a recommendation that it is desirable for companies to have internal audit functions as they are an effective way of ensuring that internal controls are adhered to and work in practice.
12. Agreed.
13. Agreed.
14. Agreed.
15. Reference should be made to the importance of effective internal control and internal audit. Through reliance on internal audit external auditors are better placed to appraise the overall effectiveness of the systems of internal control.
16. Agreed.
17. Agreed.
18. Agreed.
19. Agreed.

COMMENTS ON THE CODE OF BEST PRACTICE

- 1.1 Agreed.
- 1.2 In general, the recommendation that there should be a clearly accepted division of responsibilities at the head of the company is supported. However, there is insufficient evidence to show that this is appropriate in every case. Further investigation should be undertaken now so that conclusions are available for consideration when the Code of Best Practice is reviewed in two years time. This should include examination of the use that could be made of non-executive Chairmen and the possibility of developing guidelines on the circumstances in which separation of the roles should be considered.
- 1.3 Agreed.
- 1.4 The difference between hierarchial companies and entrepreneurial companies means that this is particularly important.

- 2.1 Agreed.
- 2.2 All on-executive directors serving on the Audit Committee and Remuneration Committee should be independent.
- 2.3 Agreed.
- 2.4 There could be difficulty in gaining an "agreed procedure". Channelling through the Audit Committee could be a way forward.
- 2.5 Agreed.

- 3.1 Other than with the agreement of shareholders directors' service contracts should be renewable annually rather than every three years.
- 3.2 Agreed.
- 3.3 Remuneration Committees should be mandatory for all listed companies and other public interest companies. The reference to "should be subject to the recommendations of" should be amended to "should be determined by". The Remuneration Committee should determine the remuneration of the Chairman, Chief Executive and the senior executives.

- 4.1 Agreed.
- 4.2 The major weakness is the absence of a reference to internal audit. It should be stated that it is desirable for companies to have internal audit functions as they are an effective way of ensuring that internal controls work in practice and are adhered to. In this way the directors statement would have more credibility.
- 4.3 Agreed. Boards should be encouraged to not just accept what their auditors tell them.
- 4.4 Agreed. The ASB's proposed Operating and Financial Review will go some way towards ensuring this and should be specifically required under the Code of Best Practice.
- 4.5 Agreed.
- 4.6 Agreed.
- 4.7 Agreed. The Audit Committee should report annually to shareholders through the Annual Report. There is scope for standardising or establishing minimum disclosure requirements possibly through a new schedule to the Companies Act.
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RDG/cw
23/7/92