

The Auditing Practices Board

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Sir Adrian Cadbury
Chairman
Committee on the Financial Aspects
of Corporate Governance
PO Box 433
Moorgate
London EC2P 2BJ

Dear Sir Adrian,

The Auditing Practices Board (the Board) welcomes the publication of the draft report of the Committee on the Financial Aspects of Corporate Governance (the Committee) as a step forward in the process of clarifying and improving standards of corporate governance. The Board also appreciates the support expressed in the draft report for its work.

In commenting on the proposals in the draft report, the Board confines its observations to those recommendations which either are addressed to it or have direct implications for auditing practice and the development of auditing standards.

The Committee will no doubt be aware that the Board has recently released its own proposals for new auditing standards relating to two areas mentioned in the draft report. In May 1992 the Board issued exposure drafts of two proposed Statements of Auditing Standards: 'The auditors' report on financial statements' and 'Going concern'. Both exposure drafts, the Board believes, are entirely compatible with the approach taken by the Committee. The working parties developing these proposals will give careful attention to the Committee's specific recommendations.

In addition, several of the subjects in the Committee's draft report come within the scope of the Board's current examination of the Future Development of Auditing; I hope a paper on this subject will be issued by the Board in October of this year.

The Code of Best Practice

Recommendation 3 proposes that companies should publish a statement about their compliance with the Code of Best Practice, with reasons for any areas of non-compliance, 'only after it has been the subject of review by the auditors'. The Board is asked to consider the extent and form of this endorsement by the auditors of the statement of compliance.

The Board's view

The Board recognises that auditors develop views on the boards of directors of their client companies, and on the attitude towards corporate governance within those companies. However, such views inevitably vary as between different auditors and as between different clients of the same auditor. The Board does not consider it a practicable proposition for these subjective and essentially personal views to be expressed formally, in what would undoubtedly be seen as a public judgement on the performance of the board of directors.

The extent of the auditors' endorsement

The nature of the various elements in the proposed Code reflects directly on the extent to which auditors could reasonably be required to endorse a statement of compliance.

Some of the elements of the Code are of a qualitative nature (for example: whether the board of directors retains full and effective control and whether the calibre and number of non-executive directors is such that their views carry significant weight), whilst others are of a factual nature (for example: whether the board of directors meets regularly, whether there is a formal process of selection for non-executive directors and whether there is a remuneration subcommittee).

The qualitative aspects of the proposed Code can, at best, be judged only on a subjective basis. This is not a reason to exclude such matters from the proposed Code. Nevertheless, it seems impossible to establish any satisfactory criteria which auditors could apply in order to evaluate the company's compliance. Furthermore, in order to form a view on (for example) the performance of the board of directors and on the practical impact of the non-executive directors, the auditors would need to attend every meeting of the board of directors, especially those at which contentious matters were under discussion.

On the other hand, the factual application of the proposed Code will usually be capable of evaluation on a more objective basis. The auditors could reasonably be expected to evaluate and attest to the company's compliance in those areas, and the Board considers that some users of the company's annual report would find this helpful. The Board believes that the Committee should give further consideration to the scope of the auditors' endorsement. In particular the auditors' endorsement should be restricted to only those elements of the proposed Code where compliance will be capable of objective evaluation. For this purpose it would be necessary to divide the proposed Code into two sections, so as to identify clearly those aspects which are within the auditors' remit. The following comments are based on the assumption that such a division of the proposed Code is feasible.

The form of the auditors' endorsement

There is a persuasive argument that, as a general principle, if the auditors are known to be associated with the directors' statement of compliance, the nature and extent of that association should be made clear to readers of the company's annual report.

The most convenient way of dealing with this would be in the Board's proposed expanded auditors' report in the section setting out auditors' responsibilities. Any non-compliance (for example: the absence of an audit committee) would either be reflected

by the directors in the statement of compliance or, failing that, in the auditors' report itself. The auditors' responsibility in relation to reporting on the statement of compliance would thus be broadly comparable to the reporting responsibility regarding the directors' report.

An alternative approach

So far as the qualitative aspects of the proposed Code are concerned, an alternative approach might be to require the statement of compliance to be considered and endorsed by the Audit Committee: this would be wholly in keeping with the Audit Committee's principal duties. It may be desirable for the external auditors to be given the right to attend the meeting of the Audit Committee and to participate in the discussion on this subject; such a right could itself be included as part of the proposed Code. This could provide the external auditors with an opportunity to give of their experience, but without them being required to approve the directors' statement of compliance.

The Board will consider further these matters in the light of the final version of the Committee's report.

Interim Reporting

Recommendation 8 proposes that the Stock Exchange should amend its rules to require expanded interim reports (including balance sheet information) and that these interim reports should be reviewed by the auditors. The Board is asked to develop appropriate review guidance.

Review by the auditors

The Board sees no obstacle in principle to the development of review guidance. In the USA, interim financial statements are subjected to review by the auditors. This review engagement consists essentially of enquiries of management and analytical review, and the report is expressed in terms of 'negative assurance'; it is thus clearly distinguished from an audit. The International Auditing Practices Committee (IAPC) also has issued guidance on review engagements. The Board considers that the current US approach (together with the IAPC guidance) indicates very clearly how a standard for review of interim reports could be developed in this country.

However, the Board believes that when the requirements for expanded interim reports are being prepared, proper account should be taken of the need to ensure that interim results continue to be made available to the market on a timely basis and that the new requirements should not cause any delay in this process.

Accounting rules for interim reports

The Board sees a need for greater clarification of the accounting rules which would apply to the preparation of interim reports. For example, although the Committee does not see a need to require cash flow information at the present time, many would believe that interim cash flow statements could be very valuable. Indeed it is arguable that interim reports should be prepared on the same basis, and give comparable information, as the annual financial statements, as required in the USA.

In addition, it needs to be established how items occurring unevenly (such as seasonal revenues and expenditure) should be accounted for in the interim results.

It is recommended to the Committee that the Accounting Standards Board together with the Stock Exchange be requested to clarify the accounting rules which companies would need to follow in preparing interim reports.

Other recommendations with auditing implications

The Board will form working parties to address the two areas identified above, which are the subject of recommendations made by the Committee to the Board. The Board will liaise with the Stock Exchange to ensure that proposals for implementing any additional responsibilities to be attributed to auditors are developed in a manner which is consistent with the way in which these requirements will be introduced through the continuing obligations.

The Board will also form a working party to bring forward proposals for an auditing standard on reports by auditors on the directors' statement on the effectiveness of internal control systems. This project will be coordinated with the development of criteria for assessing the effectiveness of internal controls and the appropriate guidance for companies.

The Board is considering the Committee's recommendations on the role of Audit Committees and on the rotation of audit engagement partners in conjunction with its project on the Future Development of Auditing.

Whilst not directly relevant to this submission, the Board has expressed, and will continue to express, keen interest in the debate surrounding the Caparo case, and any subsequent developments of that case, together with the related (but also distinct) issue of professional liability in general.

In conclusion, it is clear to the Board, both from the draft report and from its own deliberations, that some widening of auditors' responsibilities is sought by many. The draft report, for example, seeks to identify a new responsibility in relation to the proposed Code. When contemplating such changes, however, consideration must always be given to the relationship between the benefit which it is hoped to achieve, and the costs which will necessarily be borne by companies. It is also necessary to keep in mind the potential trade-off between widening auditors' responsibilities and keeping their legal liability within reasonable bounds.

Yours sincerely

Bill Morrison

W C C Morrison
Chairman