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CFACG(91)9 FRAG

COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

GIVING MORE POWER TO SHAREHOLDERS IN THEIR DEALINGS WITH AUDITORS

Memorandum submitted in October 1991 by the Financial Reporting and Auditing Group (FRAG) of the Institute of Chartered Accountants in England and Wales to the Committee on the Financial Aspects of Corporate Governance (the Cadbury Committee).

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This memorandum should be read in conjunction with the Foreword.
(Annexed to CFACG(91)7)

INTRODUCTION

1. In considering ways of giving more power to shareholders in their dealings with auditors, we think it appropriate that a distinction should be drawn between public and private companies. Now that private companies may dispense with the obligation to appoint auditors annually (section 386 of the Companies Act 1985) and adopt the elective resolution procedure generally (section 379A of the Act), the differences in legislative treatment between a private and a public company have become greater than hitherto. We believe that any adjustments to the present arrangements in regard to the appointment and remuneration of auditors should only be considered in relation to public companies. Indeed, for the initial introduction of any change, there may be advantages in considering the position of listed companies only at the outset.

2. There would naturally be nothing to preclude private companies from following a code of practice designed for public companies if they chose to do so.

3. We have sought in this memorandum to set out some of the steps which might be considered as leading to an enhancement of the existing powers of shareholders in their dealings with auditors. We make no specific recommendations as such steps will, we believe, need to be debated in the light of the views of other interested parties. The Cadbury Committee provides a particularly appropriate forum for that debate. We have, however, identified five principal options for action. These are amplified in later paragraphs, which also raise some considerations as regards appointment and remuneration of auditors.

SUMMARY OF ISSUES FOR CONSIDERATION

4. FRAG invites the Cadbury Committee to consider the following issues.

(a) To require every listed company to appoint an audit committee consisting of shareholders' representatives and not only of directors. Its composition to be approved by shareholders, other than directors, who would be able to volunteer or to put forward nominees as candidates. The audit committee (in addition to its central functions in relation to financial statements, accounting policies and internal controls) to report to shareholders on the choice of auditors, the selection process and the amount or basis of the proposed auditors' remuneration. Auditors to continue to be subject to annual appointment.

(b) The same proposal as in (i) above but with the audit committee consisting only of non-executive directors.

(c) The introduction of two-tier boards (on continental lines but exclusive of the employee participation requirements). The supervisory board to oversee the board of management, providing a formal framework for a greater degree of independence between executive and non-executive directors, strengthening the hand of the latter and of the audit committee.

(d) A shareholder committee, separate from the audit committee, concerned with matters relating only to the appointment, remuneration and

removal of auditors and possibly with the appointment of non-executive directors.

(e) The use of a nominating committee, appointed by the shareholders, to select non-executive directors and/or the audit committee.

AUDIT COMMITTEES

5. There is no legal provision for the appointment of an audit committee, although a number of companies operate them successfully. The subject received close attention during the debate on the 1988 Companies (Audit Committees) Bill in the House of Lords (Hansard 18 May 1988 cols 380-406). The Bill failed to pass, but its principal provision that major public companies should be required to include consideration of the appointment of an audit committee in every notice calling an annual general meeting was one which the Institute supported in principle at the time.

6. The primary function of an audit committee is to act as an interface between the board and the auditors. The audit committee will typically be charged with the functions of reviewing the financial statements before their approval by the board, of considering the appropriateness of the accounting policies adopted and examining the systems of internal control. Its functions are carried out in close liaison with the auditors. An audit committee will normally consist, or contain a significant proportion, of non-executive directors.

7. The practice among many major companies of appointing non-executive directors has in general been found to be beneficial and has, rightly in our view, received official encouragement. While sharing collective responsibility with the executive directors for the company's affairs, non-executive directors can provide the board with valuable advice from their experience, often as directors of other companies or as having other commercial expertise. There remain, however, problems associated with the influence which non-executive directors can bring to bear on management, particularly where there is a small board headed by a strong executive chairman.

8. It may be that one approach to identifying shareholders more closely with the auditors who are reporting to them would be to consider the formation of an audit committee whose composition was approved by the shareholders. The approach could be taken further by the inclusion in the annual report of a report by the audit committee. The report might deal with the membership of the committee; the criteria for selection of auditors where a change is contemplated; the recommended amount of auditors' remuneration for the coming year; and the basis of remuneration, for example on a tender or time basis. Quantification in particular would, however, require careful consideration as there will be many instances where, even in apparently straightforward cases, some adjustment to the remuneration may be necessary and proper to cater for unforeseen circumstances.

9. We would not see an audit committee as having any liability to shareholders or other parties as regards the accounts which are the responsibility of the directors. Indeed, for the audit committee to be able to attract volunteers it will probably be necessary to provide some sort of indemnity from liability for the committee's own acts and omissions (as well as from liability for the accounts).

This might be in the form of a statutory exemption or perhaps by extending the scope of section 310 of the Companies Act 1985 so that the company can indemnify or obtain insurance for shareholders serving on audit committees as well as for its other officers.

10. As regards the practical aspects of the operation of an audit committee, we envisage that shareholders other than those who are directors might be given the opportunity to volunteer or put forward nominees to serve on the committee. The shareholders as a body might be given the opportunity to vote on a resolution proposing the formation of an audit committee but directors would be precluded from proposing a resolution against the formation of a committee. Institutional shareholders, in particular, may, however, be unwilling to serve on an audit committee because of the limitations this would impose on their freedom to deal in the company's shares by virtue of the knowledge they would obtain from unpublished information about its affairs. If that is the case, this would result in a reduction of the pool of potential members of an audit committee, so increasing the possibility of unrepresentative minorities securing support for unsuitable candidates.

TWO-TIER BOARDS

11. Company law in the UK has always regarded the board as a single entity having collective responsibility for the management of the company's affairs. This has hitherto provided a satisfactory and workable basis for corporate operation. A legal requirement for the appointment of non-executive directors would, however, bring into sharper focus the potential difficulty of reconciling the position of a director without executive power with the concept of the collective responsibility of all the directors both executive and non-executive.

12. In certain other member states of the EC the law provides for a two-tier board system consisting of separate supervisory and administrative boards. This position is recognised in several EC Directives where the emphasis is primarily on the two-tier board system. Study of the merits of the single and two-tier board system has, however, been complicated by the debate on the introduction of mandatory employee participation requirements and the rights employees should have as regards the election of directors. The debate in relation to the proposed Fifth Directive on the structure of public limited companies is an example.

13. It is perhaps arguable that a two-tier system would help to clarify the position of non-executive directors who would consequently sit on the supervisory, as opposed to the administrative, board. The existence of a supervisory board would not diminish the influence of the audit committee. Indeed, it could be argued that it might strengthen its influence.

SHAREHOLDER COMMITTEES

14. As a possible complement to an audit committee, a committee consisting solely of shareholders could be considered. The shareholder committee would be concerned only with the appointment, remuneration and removal of auditors, although its powers could be extended to the appointment of non-executive directors. The

appointment of members of the shareholder committee might itself, however, present difficulties of the kind to which we refer in paragraph 10.

NOMINATING COMMITTEES

15. A nominating committee, appointed by the shareholders, could be another option. The nominating committee would have narrower powers than the shareholder committee not being concerned with the appointment, remuneration and removal of auditors, but rather with the selection of members of the audit committee. The nominating committee would also be involved in the selection of non-executive directors. This practice is followed by certain companies in the USA.

SOME CONSIDERATIONS AS REGARDS APPOINTMENT OF AUDITORS

16. At each general meeting at which accounts are laid, a company is required to appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next general meeting at which accounts are laid (section 385 of the Companies Act). The appointment of the first auditors of a company may be made by the directors at any time before its first annual general meeting. This, however, is an exceptional provision designed to cater for the period up to the conclusion of the first annual general meeting. The general rule is that the auditors are appointed by the shareholders to whom the auditors' report is addressed.

17. In the majority of other EC Member States auditors are appointed by the shareholders in general meeting. In the USA the appointment of auditors is frequently delegated by shareholders to the audit committee.

18. Some commentators have suggested that an outside body, rather than the company concerned, should appoint auditors. Even if, contrary to our view, such a course were considered desirable, we doubt that this would be a practical proposition having regard to the difficulties of administration and of financing which would necessarily arise.

19. Where directors are proposing the appointment of a firm of auditors, it is for consideration whether they should include in their proposal a statement of their reasons for proposing a particular auditor and disclose what selection process has been adopted. The audit committee might also report on similar lines. If the proposals differ, it would be for the shareholders to decide between the proposals.

20. In the UK auditors are subject to annual appointment and this is also the case in the USA. Certain other EC Member States require the appointment to be for a period of three, or sometimes six, years. There may also be an absolute time limit during which one auditor is permitted to act.

21. Provisions of this nature are designed to act as a disincentive to companies to change their auditors without good and sufficient reason. The UK approach, which we support, does not appear to have resulted in changes of auditors for improper reasons and we believe

it right that shareholders should have the opportunity annually of considering the appointment. We have seen no substantive evidence of any real benefit to companies or shareholders in imposing an absolute time limit during which one firm of auditors can hold office. Any steps to introduce either a minimum or a maximum period for audit appointments would diminish shareholder power and we can see no good reason to restrict the freedom of shareholders either to remove an auditor with whom they were dissatisfied, as would a minimum term appointment, or to retain an auditor with whom they are satisfied.

SOME CONSIDERATIONS AS REGARDS REMUNERATION

22. The remuneration of auditors is required to be fixed by the company in general meeting or in such manner as the company in general meeting may determine (section 390A of the Companies Act). In the majority of other EC Member States auditors' remuneration is fixed by the shareholders in general meeting. In the USA the management fixes the remuneration subject to the audit committee's approval.

23. It is common practice for the shareholders' resolution as regards the auditors' remuneration to be expressed as giving the directors authority to fix the remuneration. This is because the directors are a more convenient body to conduct any necessary negotiations with the auditors than would be the shareholders as a whole.

24. Although shareholders may not necessarily be in a position to make an informed judgement as to what remuneration is appropriate and reasonable, audit work is the subject of intense competition among professional firms. This in itself should go a considerable way towards ensuring that the remuneration is at a reasonable level consistent with the audit work involved.

25. Not only is the auditors' remuneration to be disclosed in the accounts, but regulations, effective on 1 October 1991, provide for the disclosure of the amount of any remuneration received or receivable by a company's auditors or their associates in respect of services other than those of auditors in their capacity as such. Shareholders will thus be given details of both audit and non-audit remuneration, enabling them to see the company's total expenditure with the audit firm in question.

RESIGNATION AND REMOVAL

26. An auditor may resign his office on written notice to the company and, whether he resigns or ceases to hold office for any reason, he is required to make a statement of any circumstances connected with his ceasing to hold office which he considers should be brought to the attention of the members or creditors of the company or, if he considers that there are no such circumstances, to make a statement to that effect (section 394 of the Companies Act). This we consider to be a good provision, considerably strengthening the hand of an auditor who faces removal for improper reasons and alerting interested parties to the matter. There are also helpful provisions giving the auditor the right to be heard at any general meeting on any matter which concerns them (section 390 of the Act) and to require the company to circulate written representations in certain circumstances (section 392A).

27. Recently, however, a practical problem has emerged in connection with the operation of the resignation provisions. The problem arises when, on receiving an auditor's notice of resignation and an accompanying statement of circumstances which the auditor considers should be brought to the attention of members or creditors, a company applies to the court under section 394(3)(b). If the court orders that the statement need not be sent to the members of the company pending a trial of the issues raised in the proceedings, there can be a significant lapse of time between the date of the resignation and its being made public. This is because, if the company does not send a copy of the notice of resignation to the register of companies as required by section 392(3), there is no power for the auditor himself to notify the registrar. It seems to us undesirable that news of the resignation of an auditor can effectively be withheld in such a way.

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COMMITTEE ON THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

THE FORM AND CONTENT OF FINANCIAL REPORTING

Memorandum submitted in October 1991 by the Financial Reporting and Auditing Group of the Institute of Chartered Accountants in England and Wales to the Committee on the Financial Aspects of Corporate Governance (the Cadbury Committee).

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This memorandum should be read in conjunction with the Foreword.

COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

THE FORM AND CONTENT OF FINANCIAL REPORTING

INTRODUCTION

1. In this report we consider aspects of the form and content of financial reporting in the context of listed companies.

SUMMARY OF ISSUES FOR CONSIDERATION

2. FRAG invites the Cadbury Committee to consider the following issues.

   (a) Should the London Stock Exchange require listed companies to include in their annual reports and accounts information similar to the Management's Discussion and Analysis (MD&A) required in the US by the SEC?

   (b) If so, should such information, like the directors' report, be reviewed for consistency with the financial statements?

   (c) Should the MD&A requirements be restricted to past performance and current position, including known trends, events and uncertainties?

   (d) On quarterly reporting does the Committee agree with FRAG that the possible advantage of keeping the market supplied more frequently with up-to-date information is outweighed by the problems of accounting fairly within such a short period and the further emphasis it might give to "short-termism"?

   (e) Does the Committee agree that a requirement to disclose "discretionary" expenses is not practical and that it would be preferable to require a much fuller explanation of the year's performance in the MD&A?

SUMMARY OF MAIN CONCLUSIONS

3. We recommend that the London Stock Exchange should require listed companies to include information along the lines of the US MD&A in their annual reports and accounts. As in the US we would like the required discussion and analysis to be of past performance and current position, including known trends, events and uncertainties. Forward-looking information should be voluntary.

4. We believe that the requirement for listed companies to report half-yearly should not be extended to require quarterly reporting. We suggest that research is carried out on the costs and benefits of quarterly reporting based on US experience.

5. We do not believe that it is practicable for companies to disclose "discretionary" expenses in the way envisaged by the Accounting Standards Board, and consider that more valuable information would be given by means of MD&A.

THE OBJECTIVE OF FINANCIAL STATEMENTS AND THE ROLE OF FINANCIAL REPORTING

6. At present, the objective of financial statements is to give a true and fair view of the profit or loss for the financial year and of the state of affairs at the end of the financial year. Currently the role of financial reporting is principally one of stewardship; the managers of a business report on the resources entrusted to them by the owners. We believe that this is the right approach and while we welcome initiatives aimed at improving UK financial reporting the improvements should be within this general objective and role of financial reporting.

7. In addition to the shareholders of a company there are many other users of annual reports and accounts. They include potential investors, present and potential creditors, employees and customers. The needs of these other users may be met, if only in part, by the reports and accounts prepared for stewardship purposes.

8. Although the managers of a business are reporting on the resources entrusted to them by the owners, the users of the reports and accounts, both shareholders and others, use the information to help formulate their judgement about the company's future and to assist in decision-making.

CONTENT OF REPORTS AND ACCOUNTS

9. The content of annual reports and accounts can be divided into five:

   (a) financial statements, which are required to give a true and fair view;
   (b) auditors' report on the financial statements;
   (c) other statutory prescribed information, ie- directors' report;
   (d) information prescribed, for quoted companies, by the London Stock Exchange, for example, a statement by the directors as to whether the company is a close company for taxation purposes; and
   (e) voluntary disclosures, for example, Chairman's statement.

10. The content of financial statements is prescribed by statute and accounting standards. We do not propose to comment on the accounting treatments that could be adopted in preparing the financial statements. However, there are other changes to financial reporting that could be made and we address these in this report.

MANAGEMENT'S DISCUSSION AND ANALYSIS

11. One of the criticisms of the present UK financial reporting system is that it is essentially backward looking, involving the measurement of past performance and current position. In response to this it has recently been suggested that accounts should contain information about the company's future.

12. The ASB in its discussion draft "The structure of financial statements - reporting of financial performance", issued in April 1991, proposed that a company's profit and loss account should analyse the results into those arising from continuing operations and those arising from discontinued operations. This information would

assist users of financial statements to make their assessment of the company's future and we support this suggestion although not the particular format adopted by the ASB.

13. We believe that information similar to the information provided in the management's discussion and analysis (MD&A) required in the US by the SEC would, in addition to the continuing/discontinuing analysis of the profit and loss account results, be the best way of assisting users of financial statements to assess the company's future. In particular, we think it is important for management to discuss known trends and factors that have affected past performance and to discuss matters that will affect future results.

14. The SEC's current requirements for the MD&A, which are based on rules issued in 1980, focus on the financial statements rather than on the operations. The current requirements are listed in Appendix 1.

15. In 1981, the SEC issued an interpretive release giving the staff's evaluation of disclosures made in response to the MD&A requirements adopted in 1980. This release focused on areas where further improvements were needed. For instance, it stressed the MD&A requirement to discuss known trends and matters that have had an impact on past operations but are not expected to continue to do so, as well as matters expected to affect future operations even though they have not had an impact in the past.

16. In May 1989 the SEC issued an interpretive release regarding the MD&A disclosures. The release was the result of a 1987 Concepts Release requesting comments concerning the adequacy of the MD&A requirements. Virtually all commentators took the position that there was no need to change the MD&A requirements. The commentators did, however, suggest that additional guidance would improve compliance with the existing requirements.

17. The release, a copy of which forms appendix 2 to this report, contains interpretive guidance in the following areas:

    (a) Prospective information
    (b) Long and short-term liquidity and capital resources analysis
    (c) Material changes in financial statement line items
    (d) Interim period disclosures
    (e) Segment analysis
    (f) Participation in high-yield financings, highly leveraged transactions, or noninvestment grade loans and investments
    (g) Effects of federal financial assistance on the operations of financial institutions
    (h) Preliminary merger negotiations.

18. The section of the 1989 release dealing with prospective information emphasises that **required** disclosure is based on **currently known trends, events and uncertainties that are reasonably expected to have material effects** and that optional forward-looking disclosure involves anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty. We support a similar split between required and voluntary disclosures in the UK; such a split is in keeping with the stewardship role of financial reporting.

19. Appendix 3 to this report is the Management's discussion and analysis of financial condition and results of operations from the 1990 "Shell" report and accounts. We append the example to illustrate the type of report that we consider should form part of UK financial reports.

20. We recommend that the London Stock Exchange should introduce a requirement for listed companies to include an MD&A in their annual reports and accounts and that the requirements regarding the content of the MD&A, as in the US, should not include projections and other forward-looking information but should be restricted to past performance and current position, including known trends, events and uncertainties.

21. The MD&A, like the directors' report, should be reviewed by the auditors for consistency with the financial statements.

22. **FRAG invites the Cadbury Committee to consider whether it agrees that:**

    (a) The London Stock Exchange should require listed companies to include in their annual reports and accounts information similar to the MD&A required in the US by the SEC.

    (b) Such information should, like the directors' report, be reviewed for consistency with the financial statements.

    (c) The requirements should be restricted to past performance and current position, including known trends, events and uncertainties.

FREQUENCY OF REPORTING

23. Another response to the criticism that UK financial reporting is essentially backward looking would be to require more frequent reporting of results, say, quarterly. While this would not be forward looking, it would be less backward looking.

24. Views about quarterly reporting are divided. Those in favour feel that by keeping the market supplied more frequently with up-to-date information it would benefit shareholders; they argue that analysts are currently updated by management on a regular basis whereas shareholders receive information from management only twice a year and quarterly reporting would help to redress the balance. In particular, if a company experiences problems, six months is a long-time to wait before reporting to shareholders; quarterly reporting would enable a more timely update. Those against quarterly reporting, however, feel that it would have an adverse effect on the way that companies are managed by causing management continually to focus on the next quarter's results rather than considering the company's long-term future.

25. If quarterly reporting were to be introduced clarification about the basis of preparation would be required; should a company report the results for the three months or report the results for a quarter of the financial year (the "integral" approach)? For example, if a company incurs expenditure unevenly throughout the year, in its quarterly results should it reflect the expenditure incurred in the

three months or should it reflect a quarter of the expenditure estimated, taking account of the expenditure incurred to date, for the full year? This is a fundamental issue that, while it remains unresolved, reduces the usefulness and reliability of the reported results.

26. The problem, which applies to quarterly and half-yearly reporting, is more pronounced the longer a company's operating cycle.

27. If quarterly reporting were to be introduced, the period available to companies in which annual accounts are to be filed would need to be considered. It would be necessary to ensure that the results for one year are reported before the results of the first quarter in the subsequent period.

28. On balance, however, we believe that the requirement for listed companies to report half-yearly should not be extended to require quarterly reporting. We suggest that research is carried out on the costs and benefits of quarterly reporting based on US experience.

29. At present the minimum prescribed content of half-yearly statements is limited; only profit and loss account information is required. The content needs to be revised and we are to undertake a project on this.

30. **On quarterly reporting FRAG invites the Cadbury Committee to consider Whether it agrees that the possible advantage of keeping the market supplied more frequently with up-to-date information is outweighed by the problems of accounting fairly within such a short period and the further emphasis it might give to "short-termism".**

Discretionary expenditure

31. The ASB, in its April 1991 discussion drafts, proposed requiring the disclosure of the amount of discretionary expenses incurred in a period. The ASB defined discretionary expenses as being "categories of expenses whose amount is material and can be varied within a relatively wide range without significantly affecting current revenues and which have been incurred in a period partly in order to enhance future profitability".

32. Such a requirement would be a further response to provide information to assist users in their estimation of a company's future prospects. However, we are concerned that, while the ASB's aims may be good in principle, the proposals will not work in practice. What is "discretionary" is subjective and in the long-term most items of expenditure are discretionary. We believe that different companies would interpret the meaning of "discretionary" in different ways.

33. **FRAG invites the Cadbury Committee to consider whether it agrees that such a requirement is not practical and that it would be preferable to require a much fuller explanation of the year's performance in the MD&A?**

Provided consistent would show trend.

MANAGEMENT'S DISCUSSION AND ANALYSIS

The current SEC requirements are as follows:

(a) Discussion should include three financial aspects of the registrant's business - liquidity, capital resources, and results of operations.

(b) Favourable or unfavourable trends should be emphasised, and significant events or uncertainties identified.

(c) Management discussion of segment information is required only if, in the registrant's judgement, it would be appropriate to an understanding of the business.

(d) Information concerning the effects of inflation and changing prices is required only if such effects are material to financial statement trends. No specific numerical data is prescribed.

(e) The causes for material changes in line items should be discussed.

(f) Although projections or other forward-looking information are not specifically required, presentation on a voluntary basis is encouraged.

(g) There are no specific provisions with respect to the location of management's discussion, except for the general requirement that the discussion should be included within the annual shareholders' report.

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