

Ms. Gina Cole,  
Secretary,  
Committee on the Financial Aspects  
of Corporate Governance,  
c/o The London Stock Exchange,  
London,  
EC2N 1HP.

23 February 1994

Dear Gina,

**Fraud & Error and "Law & Regulations"**

I have a couple of points on the APB's exposure drafts on "Fraud & Error" and "Consideration of Law & Regulations" for consideration by the Committee.

The first is common to both documents, namely: do they pay adequate attention to the circumstances of private companies, and, in particular, small private companies? In the case of fraud and error, for instance, the draft (para 9) states that "It is not the auditors' function to prevent fraud and error. The fact that an annual audit is carried out may however act as a deterrent". This certainly reflects the position of auditors under the Companies Act, but in small companies the annual audit may be the only monitoring for fraud and error that can be economically justified. Small numbers of staff make internal audit, and even internal checks through the division of duties are extremely difficult in such companies. Annual audit may then assume a preventative rather than a deterrent significance if proprietor directors are prepared to specify (and pay for if necessary) a higher level of attention to the detection of fraud and error during the annual audit than might be necessary for a company with greater internal resources.

In the case of "Law & Regulations" paragraph 12 contains a non-exhaustive "list of policies and procedures which may assist the directors in discharging their responsibilities ....". The first of these is "Maintaining an up to date register of significant laws and regulations with which the entity has to comply ....". One wonders whether the authors of the draft can have any idea of the possible scale of such a register. A recent review by the DTI's Deregulation Unit identified some 3500 regulatory measures affecting business. Many of the most difficult and most detailed (notably tax and health and safety legislation, both of which may have substantial financial effects) apply to all businesses.

The draft requires a range of compliance procedures well beyond the resources of all but the largest company.

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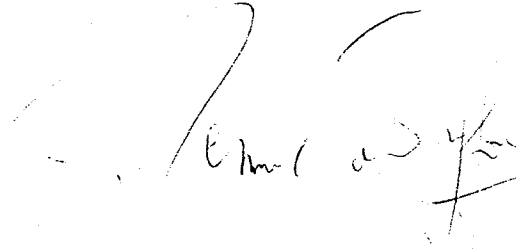
Irrespective of its potential impact on small companies, paragraph 11 needs careful consideration from the general corporate governance standpoint. The first question to ask is whether a Statement of Auditing Standards is necessarily the best vehicle for defining an important aspect of directors' duties, namely ensuring corporate compliance with the law. Secondly, it is extremely important to understand what is meant by "It is the responsibility of the directors ... to ensure that the entity complies with law .... and ... to establish effective arrangements for any non-compliance ....". Does this mean "In the opinion of the APB the following paragraphs present an appropriate split of responsibilities between directors (paras 11-14) and auditors (paras 15-17)". Or is it intended to display what the APB believes to be the position under the general law?

If it is the latter, it should be made clear that the responsibility is at most a private duty - an aspect of the director's duty of care owed to the company - not a public duty. It is the IOD's view that directors do not have a positive duty, per se, to ensure that a company complies with all its legal obligations. They have a duty not to commit unlawful acts themselves in a corporate capacity and, under many statutes imposing strict liability, have a duty not to neglect to ensure that the company complies with duties imposed by the Act, but they do not have a general duty to ensure compliance.

Thirdly, it is not correct to say that the assignment of particular responsibilities to management does not relieve directors of the responsibility to establish effective arrangements for prevention of non-compliance. This is quite contrary to the finding in Tesco Supermarkets v Nattrass 1971 2 ALL ER 127 (HL) "In the case of a large scale business ..... it would be consistent with the taking of reasonable precaution and the exercise of due diligence to initiate an effective system to avoid the commission of offences, under which superior servants were instructed to supervise inferior servants whose acts might otherwise lead to the commission of an offence : this was not the delegation of the duty to exercise due diligence but the performance of that duty". (emphasis added).

I therefore consider that the Committee should be wary of extending too warm a welcome to the exposure draft on "Consideration of Law and Regulations" until it is clear as to the implications of acceptance for companies and their directors.

Yours sincerely,



**Dermot de Trafford, Bt**