



CAD-02519

FINANCIAL REPORTING COUNCIL

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Secretary: Sydney Treadgold

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Nigel Stapleton, The Hundred Group
Ian Plaistowe, Auditing Practices Board
Allan Cook, Accounting Standards Board

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Gina Cole, Cadbury Ctte
Robert Coker, FRC

FINANCIAL REPORTING AND CORPORATE GOVERNANCE 'OVERLOAD'

As you are already aware, the next meeting of the informal Overload Group will be held at 2-30pm on Tuesday 5th April at Nat West Bank, 41 Lothbury.

Rather belatedly, for which I apologise, I enclose a copy of the minutes of the meeting held on 13 December 1993.

Before we meet I hope to circulate a draft forward programme as mentioned on page 5 of the minutes, looking forward for six months from the date of our meeting. The draft will distinguish the various items into categories, as was suggested.

Sydney Treadgold

S W TREADGOLD
Secretary

22 February 1994

FINANCIAL REPORTING AND CORPORATE GOVERNANCE 'OVERLOAD'

Note of a meeting held on 13 December 1993 at the offices of
the Financial Reporting Council, 100 Gray's Inn Road, London WC1

PRESENT:

Sir Ron Dearing	Chairman
Sir Adrian Cadbury	Chairman, Cadbury Committee
Michael Chamberlain	Chairman, CCAB
Allan Cook	Technical Director, Accounting Standards Board
Henry Gold	Technical Director, ICAEW
Michael Lawrence	Chairman, The Hundred Group of Finance Directors
Bill Morrison	Chairman, Auditing Practices Board

IN ATTENDANCE

Sydney Treadgold	Secretary, FRC
Robert Coker	Assistant Secretary, FRC/ASB

The Chairman referred to the letter he had received from the Director-General of the CBI on 19 November 1993, copies of which had been circulated to those attending the meeting. Three main points were made in this letter, namely (1) a proposal that the ASB, APB and the English and Scottish Institutes should publish a joint programme of consultation for 1994, (2) the number of senior people able to handle the documents issued by the various financial reporting bodies might be very few, even in the largest companies, and (3) the accountancy profession might have gone further than the Cadbury Committee intended in developing some of the recommendations in its report.

Internal Control

On the third issue raised by the CBI, Mr Chamberlain suggested that the meeting should explore where it was that the accounting profession had gone further than the Cadbury Committee had intended. The Chairman thought that the CBI had had in mind the internal control document when making this comment. Sir Adrian referred to his letter of 9 December to Mr Morrison which had been copied to all those attending the meeting. This letter set out the views of the Cadbury Committee on what was needed to implement its recommendations. It was necessary to recognise at the outset that the Committee had a fairly limited base of authority and had been set up primarily by those bodies represented at this meeting plus the London Stock Exchange and CBI. It was important that the Committee's moral authority should not be undermined by a wrangle over one particular issue. The Chairman said he shared this concern: the Committee's code of practice covered four sides of paper and to produce a very long document on one aspect of the Committee's recommendations was out of tune with the underlying purpose of the

code. Sir Adrian thought that the problem was partly presentational in that the code was based on a statement of principles and was brief, with the examples and more detailed guidance kept separate. In this connection he referred to the four page document produced by ICAS.

Mr Gold said he was not sure that splitting the internal control document into two would deal with the nub of the problem. He sensed a resistance to the whole idea of reporting publicly on internal control. Mr Morrison agreed with this view. Mr Gold said that many leading companies had systems in place for internal assurance to be given to their board that their internal control system was satisfactory. He thought that directors, and especially auditors, might be worried about problems of liability and that a way through might be for any guidance which was issued, however amended as a result of the consultation process, to be regarded as a document which would be useful for the internal use of companies, especially their audit committees. He was beginning to obtain the impression that it was the public reporting step that companies would find difficult to accept, but more time was needed to be clearer on this since the consultation period had not yet ended.

The Chairman referred to what had been done in the case of the ASB's Operating and Financial Review (OFR) which set out what it would like companies to do but left it to them to decide how to do it. Even if the internal control document was primarily intended as guidance for audit committees, they would be likely to need a summary of the essence of the document rather than the whole document. Mr Gold said that it had never been intended that the internal control document should be read by directors; it was for those further down the line, though audit committees could use it as a source of reference. Mr Chamberlain suggested that there were three questions on the internal control document. The first was whether it had strayed into the area of non-financial internal controls, which he did not believe was the case; the second question was the resistance to public reporting and the possible use of the internal control document as an internal means of giving confidence; and the third question was the presentational one, whether the document should be split into a brief statement of principles and a longer document providing more detailed guidance.

Sir Adrian said that the intention of the Cadbury Committee had been to bring out obligations on directors which were already implicit and of which they might not be aware, as in the case of section 221 of the Companies Act in relation to internal controls, and the already existing going concern obligations. The Committee had only asked that these areas should be looked at as part of the financial aspects of corporate governance. He would like to look at the ICAS document, which he had not yet seen. He did not believe it appropriate for the Cadbury Committee, or any of its members, to suggest that the accountancy profession had gone too far in its work on internal controls or going concern; rather than being drawn into this, he believed it better to concentrate on the second and third questions raised by Mr Chamberlain. The relevant question was whether directors and auditors felt happy about their company's financial reporting and the effectiveness of their internal controls. Presentationally he would prefer to see a brief statement of principles, plus a more detailed working document for guidance which would be useful for the internal audit team, external auditors and the audit committee. This would take longer and

he would not wish to push too hard at present for it to be completed quickly. The Committee's recommendations were designed to ensure that proper checks were in place, not to require well organised companies which possessed them to do further special work to meet the Committee's recommendations. Unless the support of members of bodies such as the Hundred Group could be secured, the Committee's recommendations would not receive the response that was needed.

Mr Lawrence referred to the fact that a number of major companies had received letters from auditors and presentations had been given to audit committees, suggesting that auditors' services would be needed to assist in the extra work required in implementing the Cadbury Committee recommendations. One of the consequences of more explicit public reporting was that it heightened the sensitivity of non-executive directors in particular as well as involving auditors in extra responsibilities. The reality was therefore that companies were being pushed further. In reply to a question, he thought that most executive directors probably believed that further services from auditors in this area would not add value, but many non-executive directors felt the need for reassurance and comfort. The Chairman suggested that, in view of the feedback reported earlier by Mr Gold on the concern about companies providing a certificate of assurance, a better route was to include something in the OFR without any need for certification. Mr Lawrence said he had always been keen on using the OFR for these kind of issues, so that matters relating to internal control, going concern and treasury issues would each be treated as only one of around 20 issues. The Cadbury Committee had referred to the OFR as something which companies should consider introducing. Mr Chamberlain considered it necessary to remember why internal control and going concern were highlighted by the Cadbury Committee as two key issues, arising as they did from problems over recent years of over-dominant chief executives and companies collapsing. He was sympathetic of the idea which had been referred to by Mr Gold of regarding internal control as something which should develop, as part of the OFR, within the overall question of how companies related to auditors and audit committees.

Mr Morrison said that he had originally understood internal control as relating to 'no management override', but it had been developed in the recent document to cover the whole system of internal control. This was a higher level issue and had led to a detailed document setting out what companies should do when many of them had been already doing it. Mr Lawrence thought that the problem was that, while the internal control document was in some ways a very good document, it dealt with wider issues than the financial aspects of corporate governance. While he agreed that some of the issues were ones that companies should be thinking about, he did not believe that this should be done within the framework of the Cadbury Committee recommendations.

Summarising, the Chairman said that the meeting accepted the concerns reported by Mr Gold and the need to be cautious and not to attempt to impose detailed recommendations on internal control against the wishes of companies. The internal control document contained much good material which companies should be aware of, but should not necessarily need to report on publicly. It might be possible to distil some of this material into a relatively short, operational document, which

might after time feed into the OFR. The internal control working group might like to think about these points.

Mr Chamberlain suggested that the way forward was first of all to allow the consultation period to run through to the closing date. The working party could then be asked to look at the issue again, in the light of the results of the consultation and could pick up areas of interest which had been raised. He reminded the meeting that ICAS as well as ICAEW was represented on the working group. The document could then be represented with a sharper focus at the front on principles and making the point about management override. He did not believe that the rest of the contents in the document should be jettisoned. Mr Gold thought it could be difficult for the working party to meet the requirements to talk in terms of principles that allowed companies to implement internal control guidance in the OFR. As to management override, he thought that events had moved on and referred to the Queens Moat House case, which involved a lack of internal control as a major factor. Mr Morrison said that the APB's consultation paper attempted to reiterate what an auditor was expected to do on the question of internal control. Mr Lawrence suggested that the Queens Moat House case appeared to represent a fundamental breakdown in internal control, and a long report was not needed to counter this danger. He thought that an initial statement of principles on internal control would be useful provided it was not too much up in the air. Smaller companies preferred to have a few basic rules.

The Chairman suggested that this issue should now be passed back to the internal control working group. Mr Chamberlain agreed, and suggested that if it had difficulty with the approach which had been put forward at the meeting it could always if necessary come back for further guidance.

The Going Concern Principle

As to the Cadbury Committee recommendation on going concern, Mr Morrison said that the APB working party and the working group had tried hard to achieve unanimity but were unable to do so. It had therefore been decided to re-expose the auditing draft, with some changes made in the light of comments already received, and ask for further comments. The Chairman asked how it was proposed to resolve the main issue of the definition of 'foreseeable future'. Mr Morrison said that the auditors had always looked at going concern on the basis of whether there would be another set of accounts produced. The APB was virtually unanimous in refusing to change accepted past practice. Mr Chamberlain said that the Financial Reporting and Auditing Group (FRAG) of the ICAEW had written a letter to the APB stating that if the directors did not consider it necessary to go beyond the end of the current financial year then it was not for the auditors to disagree. He admitted that this could be said to be drawing back from generally accepted practice. But if the issue were contentious he agreed that it should be re-exposed. Mr Lawrence said that if, as a director, he knew of any major 'going concern' problem, either six months, one year or three years ahead, he would not wish to sign the accounts. He did not see the FRAG approach as drawing back from accepted practice; it was difficult formally to look far ahead, and 12 months from the date of signing the accounts was often too much if it had to be formalised. Sir Adrian said that the Committee had not

expected companies to do any additional budget exercise, but to agree that a further set of accounts would be coming out. Mr Lawrence agreed that it was companies experiencing difficulties that were likely to delay accounts, and it did not make sense for them to benefit from the situation.

Mr Gold suggested that there was room for a middle way through. The problem had arisen because public reporting was now being proposed of what had previously been implicit. Companies did not wish to go further than what they had been doing, and would make a positive statement up to the next balance sheet date. Equally, they needed to be sure that nothing further was coming up, and he thought that some kind of negative assurance, using words such as 'no reason to think that', would be appropriate for this. While this matter appeared cumbersome, to make such a split was to reflect actuality. Mr Morrison made the point that much of what was contained in the APB's going concern paper for auditors would have been included irrespective of the Cadbury Committee's recommendations. Mr Cook expressed the view that the essence of what management needed to state had to be in the form of a negative assurance; on the basis of reviewing all factors, the directors were not aware of anything that would cause them to think that their company was not a going concern. He would therefore prefer the whole statement to be in the form of a negative assurance. Mr Morrison said that the possibility of a much weaker statement following the balance sheet date had been explored as a possibility but no agreement could be reached. He believed that the APB had to re-expose, since if the rest of the profession could not agree then it would not be able to impose its views.

Publication of a Joint Programme

The Chairman turned to the first issue raised in the CBI letter, the publication of a joint programme of consultation for 1994. A list of 'forthcoming attractions' for the first six months of 1994, based on information provided by the APB, ASB and ICAEW, had been tabled. He believed that, if such a list were published it would be necessary to distinguish substantial items from those which were more trivial. Mr Cook also favoured a distinction between final and consultative documents since their impact was different. Once a document was finished, the sooner it was issued and the longer its lead time the better. In other cases, an indication of the consultation period could be provided. Sir Adrian thought that presentation of such a schedule would be critical and suggested using heavy type for more substantial and important issues and light type for those which would have smaller impact. Mr Lawrence also agreed that such a schedule would be helpful but that care should be taken in its drafting. Comments were made on the documents listed in the 'forthcoming attractions' list. It was agreed that reliable information could only be provided for a six month period rather than one year, and even then the dates shown would be indicative only. The list should cover future documents, not those already in issue. The Chairman requested Mr Treadgold to edit the list on this basis.

Other Matters

Mr Cook added that the IASC was issuing an important paper on financial instruments, including derivatives, in early January 1994 with an exposure period

up to 31 July 1994. The ASB would be looking into this issue together with other standard setting bodies over the next 6 months, and this could be added as a footnote to the list.

The Chairman asked if there were any other points relating to the 'overload' question. Mr Morrison reported that the APB had published its guidance for auditors on the Cadbury Code of Practice, and had therefore discharged its contribution to all the Cadbury Committee's areas.

Mr Chamberlain raised the question whether, when the internal control consultation ended and common ground had been found on 'going concern', the Cadbury Committee would look at the possibility of changing its code of practice, given the problem which had been raised about the heightening of exposure and public reporting in these areas. Sir Adrian said that the Committee was being very careful to avoid becoming a judge, but had just tried to make clear what it believed was required for proper governance. The Committee was logging issues which would need to be looked at by its successors, who would be taking over in June 1995. However, the Committee did wish to make clear that it would not wish to push companies beyond what was reasonable.

Mr Lawrence referred to the statement of directors' responsibility which the Cadbury Code of Practice required for the financial year end. This was leading some directors unwittingly to extend their responsibilities beyond those that had hitherto applied. Mr Gold said that the requirement was for a statement of what directors were responsible for and nothing more than this. It did not set out a form of words and he thought that companies were drawing on the auditing statement which did contain a form of words. Mr Cook said that the Law Society had written a letter on this to the APB which had been published. Mr Lawrence believed that if the Cadbury Committee was pushing out from the legal liabilities it was incumbent on it to say so. Sir Adrian said that he did not believe that the Committee was going beyond past requirements but agreed it should clarify this.