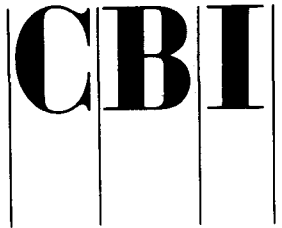


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From
Howard Davies
Director-General



HD/GCM

25 October 1993

Sir Adrian Cadbury
Committee on Corporate Governance
c/o The London Stock Exchange
London EC2N 1HP

For Adrian

I am sending you a copy of a paper on financial reporting and corporate governance which Council endorsed on 20 October.

The basic message is that there is strong support for what Ron Dearing and yourself are trying to achieve, but that the spate of proposals coming forward are more than even large companies can assimilate and respond to.

We know that you have given companies more time to report on compliance with your Committee's code and that Ron Dearing has arranged for coordination of the work programmes of the various bodies issuing proposals. All of this no doubt takes time to have effect, but there continues to be a strong note of concern about the workload from senior people in companies which our paper reflects.

We believe that detailed comment from the preparers of accounts is an important part of quality control, if proposals are to be workable and supported by companies.

Yours ever

Howard

Howard Davies

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Director-General
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Deputy Director-General and Secretary
Maurice Hunt



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C 66 93 (Summary)

TO COUNCIL FOR THE MEETING ON 20 OCTOBER 1993

FINANCIAL REPORTING AND CORPORATE GOVERNANCE

1. In the last two years companies have been faced with many reforms affecting financial reporting and auditing practices.
2. Proposals have emanated from three prime sources: the Accounting Standards Board, the Auditing Practices Board and the Cadbury Committee. A list of the reforms already introduced and those currently being debated are set out in the Annex of the attached paper.
3. CBI has given strong support to the establishment of the new regulatory bodies and for reforms which promote clear and transparent financial reporting. But companies have been facing increasing difficulties in terms of management time and the education and training of staff to cope with the reforms already introduced, let alone in responding to all the various proposals for reform. Many of these raise difficult and complex issues and could cause significant additional expense for companies.
4. Council is invited to comment on the issues raised in the paper and support the summary of conclusions and recommendations set out in Paragraph 52 as representing appropriate CBI policy in dealing with the proposals of the regulatory bodies.

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C 66 93

TO COUNCIL FOR THE MEETING ON 20 OCTOBER 1993

FINANCIAL REPORTING AND CORPORATE GOVERNANCE

The Issue

1. Companies, especially listed companies, are having to comprehend, evaluate and implement a large number of new accounting and auditing standards, actual and proposed, which make significant changes in long standing company reporting practices and requirements.
2. These changes are being introduced by the principal regulators, the Accounting Standards Board and the Auditing Practices Board, along with working groups of the professional accountancy bodies. Those bodies are also carrying out their own review of profession practices and procedures, which also impact on their clients, UK business.
3. At the same time companies must consider the implications or their business of the Cadbury Committee recommendations on corporate governance which also embrace financial reporting and auditing issues. Listed companies must now comply with a new Stock Exchange Listing Obligation that they incorporate in their annual accounts a statement, reviewed by the company's auditors, of the extent of their compliance with the Cadbury Code of Best Practice.

Position Now - Consequences for business

4. The number, variety and complexity of new accounting and auditing standards, codes, statements and guidance on best practice, and proposals for them, has far exceeded companies' power to assimilate them. The extent of the agenda is set out in the Annex.
5. Whilst strongly supporting the objectives of the standard setting bodies, changes in financial reporting and auditing practices have to be got right. They must undergo and pass a cost/benefit test. Although some may appear technical in character, they can strongly influence the commercial decisions of companies, require significant time and

attention by senior management, and can affect the degree of support for companies from shareholders and bankers, as well as from their customers and suppliers.

6. It is important that there is quality control of the proposals coming forward in the form of detailed comment from companies. Those issuing proposals need to ensure that the preparers of accounts find them workable. For this to happen companies must have enough time to consider them and, when new standards are promulgated, to put them into effect.
7. Financial Reporting Standard 1 (FRS1) on cash flow and FRS3 on the structure of the profit and loss account issued by the Accounting Standards Board have constituted a major change and have made a significant call on companies and management in providing the information and explaining the results disclosed to shareholders and investors. There are also other highly technical proposals coming forward, for example, Financial Reporting Exposure Draft 3 (FRED 3) on capital instruments and FRED 4 on off balance sheet items. Professionals within companies are not having enough time to give a considered opinion on them and an important element of quality assurance provided by consultation is undermined. The pressure is made more intense by companies complying with new standards in their accounts before due date, because they perceive the financial markets expect it.
8. Whilst some of the proposals coming forward may be aimed solely or initially at listed or large companies, nevertheless for the small or medium sized business the cost of preparing accounts and the cost of audit is also a material factor. In principle, high standards of financial reporting benefit the smaller company as much as the large, but the cost should be proportionate to the purpose; and the application of accounting and auditing standards to the smaller business should pay heed to the nature of the relationship between the management, the owners and the company's sources of finance.
9. All these developments are taking place when business has been primarily focused on dealing with the effects of the recession and the need to control costs and concentrate resources on maximising economic value.
10. There clearly needs to be more co-ordination in the work programmes of the standard setting bodies; a better phasing of the publication of new proposals; longer consultation periods for the more complex proposals; and longer periods of experimentation before the introduction of new requirements.

11. The CBI has reported its concerns to the Financial Reporting Council. The Council's chairman has accepted the need for better co-ordination in the issuing of proposals; and the Cadbury Committee has supported the view that more time should be allowed to put into effect some of its recommendations on financial reporting.

Background

12. Three main factors have created the present situation:

Accounting Standards and Financial Reporting

13. First, in recent years some spectacular corporate failures re-inforced already prevalent calls for stronger accounting standards policed with greater rigour.
14. The recognition of the need for change led to the establishment three years ago of the **Financial Reporting Council (FRC)** sponsored by the Government, the Bank of England, the accountancy profession, the Stock Exchange, the banks and institutional investors. The FRC exists to promote good financial reporting and its members are drawn from a wide cross-section, including leading figures from the accountancy and legal professions, industry and commerce, and the City.
15. In turn the FRC created the **Accounting Standards Board (ASB)** and **Financial Reporting Review Panel** who were given statutory authority to promulgate accounting standards and review a company's compliance with accounting standards, respectively.
16. The ASB is independent and acts upon its own authority. The Board is made up of leading accountants both from the profession and industry.
17. The ASB is assisted in its work by the **Urgent Issues Task Force (UITF)**. The main role of the UITF is to take urgent action to deal with particular accounting practices which cannot wait upon an extensive technical review and lengthy consultation. It has issued a number of "abstracts" to date on particular issues; and these abstracts have the force of accounting standards.
18. Initially there was criticism at the lack of prior consultation on published abstracts and information about the issues being considered by the UITF, some of which have been of very considerable significance to companies. They now do publish details of issues being considered and invite views, although being "urgent issues", the time scales for comment are tight.
19. A list of the accounting standards and proposals from the ASB and the UITF to date is set out in the Annex.

20. The **Financial Reporting Review Panel** examines departures by companies from the accounting requirements of the Companies Acts and, if necessary, can seek a court order to remedy them. The main focus is on material departures from accounting standards which result in accounts not giving a true and fair view. The Panel seeks, wherever possible, to secure reviews by boards of their accounts by voluntary means, but it has made clear that it will take companies to court if necessary to have changes made and the accounts re-issued. Already the accounts of some well known companies have attracted the attention of the Panel. The Review Panel has recently announced revised working procedures which draw on the practical experience of the Panel's first two years of operation.

CBI Policy on Accounting Standards

21. It has been CBI policy that the Companies Act 1989 drew the right line between the law and professional regulation in setting accounting standards. The new framework was intended to give companies and investors a system of regulation which dealt rapidly with questionable accounting practices and took a note of commercial realities in the proposals for standards brought forward.
22. Accordingly, the CBI strongly supports the objectives of the FRC and the ASB in promoting clearer and more transparent financial reporting.
23. However, it is imperative that important changes to accounting standards are only made after full consultation with all those concerned with the integrity and usefulness of published company accounts.
24. Because of the increasing globalisation of capital markets, it is also essential that UK accounting practices should have regard to the principles being formulated by the International Accounting Standards Committee (IASC) and other bodies who are fostering the convergence of accounting practices in the industrialised countries. The ASB should also take into account the risk to companies' international competitiveness, if the disclosures required of UK companies are far in excess of those required elsewhere in the EC or internationally.
25. Likewise, the drive for greater disclosure must be tempered by a proper balancing of the cost of assembling the data against the benefit to users of the information.

Auditors' Role and Responsibilities

26. The second main factor has been concern about the role and responsibilities of the auditor.

27. There has been criticism of auditors who approved accounts shortly before companies collapsed without warning. Auditors have been under heavy threat of litigation from aggrieved parties seeking a deep pocket.
28. The result has been the formation of the **Auditing Practices Board** to codify good practice for the profession by the issue of standards. Its first Statement of Auditing Standards (SAS) on the content of auditors' reports was issued earlier this year.
29. As noted below, the APB is also involved in the promulgation of auditing standards and guidance to implement some of the recommendations affecting auditors made by the Cadbury Committee.
30. A list of the auditing standards and proposals from the APB to date is set out in the Annex.

CBI Policy on the Role and Responsibilities of Auditors

31. Following the boom years of the 1980s there has been considerable debate about the responsibilities and liabilities of auditors. This was engendered by some major corporate failures, of which there was no warning in most cases. It could be said that the difficulties arose from two sources: an unrealistic notion of what the auditor can examine and verify; and confusion stemming from the fact that he is carrying out a public duty, defined in the Companies Acts, but on the basis of a private contract between the company and the audit firm.
32. The CBI view has been that, although auditors can inspect accounting systems to see whether they can reveal fraud, auditors cannot realistically be placed under a duty to detect fraud or other illegal acts. Auditors can reasonably be expected to be watchdogs but not bloodhounds.
33. As noted in the Annex, the APB has published a Discussion Paper on the Future Development of Auditing which raised many important issues and identified areas of possible new and wider responsibility for auditors. The CBI considered that many of the propositions put forward could not be supported by companies, at any rate not without much fuller investigation and public debate, including the practical implications and costs for business. Auditors should not be given new responsibilities which they are not qualified to undertake.
34. One issue raised by the APB is the possibility of providing some limitation on the extent of, or cap on the amount of, the auditors' legal liability, particularly if others such as directors were also culpable. The CBI has sympathy for the

auditors' position as having the deepest, and indeed perhaps the only, pocket if a business is insolvent and its directors bankrupt and accordingly supports further investigation of possible means to mitigate the auditors' position.

35. The CBI has also taken the view that the House of Lords in the legal decision of "Caparo" rightly decided that auditors do not, under the present law, owe a duty of care to individual shareholders or prospective shareholders or investors, but only to the shareholders as a class or body. A duty to a wider range of individual shareholders or potential investors or bankers (outside of a formal contract or other special duty) would lead to confusion and uncertainty about the role of the auditor and additional legal responsibilities could be expected to result in higher audit fees for companies.

Cadbury Committee Recommendations on Financial Reporting and Auditing

36. The third factor which has currently brought financial and auditing issues to the fore are the recommendations of the Cadbury Committee.

Respective Roles of Directors and Auditors

37. Cadbury was keen to clarify the respective roles of directors and auditors and codify the relationship between them to reduce "the expectations gap". Cadbury therefore reiterated the legal position that the board has responsibility for the management of a company and the obligation to prepare accounts showing a true and fair view.
38. The Code of Best Practice requires that directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities.
39. The APB's first Auditing Standard provides for this.

Audit Committees

40. To assist in the relationship between a company and its auditors Cadbury recommended the establishment of an audit committee of the board made up wholly or mainly of non-executive directors.
41. The CBI broadly supports the Cadbury recommendation.

Operating and Financial Review

42. The Code provides that it is the board's duty to present a balanced and understandable assessment of the company's position.

43. The CBI supported the ASB's proposals in principle for boards to issue an Operating and Financial Review (OFR), but thought that for a voluntary code its provisions were too detailed and prescriptive in nature.

Internal Control and Going Concern

44. The Cadbury Code says the directors should report on the effectiveness of the company's systems of internal control and on the assumption underlying the accounts that the business is a going concern.
45. Cadbury recognised that the accountancy profession and representatives of preparers of accounts would need to draw up the necessary guidance for companies and auditors. Draft guidance for directors on internal control has just been published which is being studied.

Going Concern

46. Draft guidance for directors from an ICAEW Working Group and a draft auditing standard for auditors from the APB have also recently been issued.
47. The CBI believes there should be consistency in what is being suggested for companies and auditors respectively in terms of procedures. The need is particularly strong in respect of the period boards must look forward in assessing their company's going concern status. The present accounting guideline (SSAP2) speaks of "the foreseeable future" which is presently interpreted as being at least until the end of the current financial year. The APB in particular is looking to extend this period to up to one year from the date the directors approve the accounts for the previous financial year. The ICAEW Working Group support this period as the aim rather than as an absolute requirement.
48. Also for the vast majority of companies where the going concern status is not in question, the cost of assembling information for evidential requirements should not be excessive in terms of management time or in auditors' fees for review. The CBI believes it may be appropriate to examine whether the board of every company should make a standard statement which could come to be regarded as "boiler plate", or whether it would rather be more appropriate to define in what circumstances a statement was expected and its scope and content.

Interim Reporting

49. Cadbury also recommended that interim reports include balance sheet information. Whilst not recommending a full audit Cadbury considered that interim reports be "reviewed" by the

auditors and that the APB should develop appropriate guidance. An ICAEW Working Group and the APB have recently issued draft guidance for boards and auditors respectively which is presently being considered.

50. The APB's proposed guidance for auditors appears excessive if a review, as envisaged by Cadbury, and not an audit is intended. Clarification of Cadbury's intentions may be required. For example, Cadbury did not make clear if the auditors' review was to be a private report to the Board or one published in the Interim Report sent to shareholders. The APB recommends the latter approach and proposes detailed procedures for auditors in the conduct of their review. But such an approach could cause significant additional auditors costs for companies.
51. CBI members have made the point that companies, as a matter of course, already regularly involve and consult with their auditors in the preparation of their interim results, and they believe that Cadbury was only intending to codify current best practice.

Summary of Conclusions and Recommendations

52. In considering the guidance and standards issued by the bodies responsible for accounting and auditing standards and by the Cadbury Committee, the CBI Financial Reporting Panel and the CBI Companies Committee have advocated the following:
- that the CBI should strongly support clear and informative accounts;
 - that the standard setting bodies should have regard to the different types and sizes of company and business, ranging from large listed companies to the small family business, when preparing standards and guidance on best practice and that all proposals pass a cost/benefit test;
 - that the financial reporting requirements for UK companies should have regard to the principles being developed by the International Accounting Standards Committee and pay heed to the level of disclosure usual in the main competitor countries in the EC and elsewhere;
 - that there should be more co-ordination in the work programmes of the ASB, APB and other standard setting bodies; more time allowed for consideration of proposals and for all their practical implications and consequences for business to be assessed; and more time allowed for education and training of employees and establishment of internal procedures prior to implementation;

- that the CBI should support the Cadbury Committee recommendations on audit committees, on a statement in the annual accounts on directors and auditors responsibilities and that boards make an "OFR" type statement;
- but that the CBI should press for consistency in the guidance and auditing standards currently being developed for board and auditors respectively in implementing the Cadbury recommendations on going concern, internal controls and interim reporting and that implementation should not cause excessive cost or burden for companies;
- that the proposals of the APB to extend auditors responsibilities need to be more fully investigated and that auditors should only carry out responsibilities they are qualified to undertake;
- that business should support the conclusion reached in the "Caparo" case that auditors normally only bear a legal responsibility to the shareholders as a body; and that the CBI should support further investigation of the possibility of some limitation on the extent of the auditors' legal liability, particularly when others are also culpable.

* * *

Council is invited to:

- comment on any of the issues raised in this Paper;
- support the conclusions and recommendations summarised above.

ANNEXSummary of New Accounting, Auditing and Cadbury Proposals

"FRS" means Financial Reporting Standard
 "FRED" means Financial Reporting Exposure Draft
 "SAS" means Statement of Auditing Standards

I ACCOUNTING STANDARDS BOARD**New Financial Reporting Standards**

September 1991	FRS 1	Cash Flow Statements
July 1992	FRS 2	Accounting for Subsidiary Undertakings
October 1992	FRS 3	Structure of Profit and Loss Account New statement of Total Recognised Gains and Losses Severe curtailment of use of extraordinary items How do you calculate earnings and earnings per share?

Guidance and Statements of Best Practice

July 1993	Statement on Operating and Financial Review
July 1993	Foreword to Accounting Standards including legal opinion on legal status of accounting standards

Proposals

July 1991	Exposure Draft - Foreword to Accounting Standards
July 1992	2 Chapters of draft Statement of Principles <ul style="list-style-type: none"> - Objective of Financial Statements - Qualitative Characteristics of Financial Information

October 1991		Accounting Treatment of Securitisations
December 1991		FRED 1 Re-shaping the Profit and Loss Account
December 1991		Discussion paper on Accounting for Capital Instruments
April 1992		Proposals for an Operating and Financial Review
July 1992		2 Chapters of draft Statement of Principles
		- Elements of financial statements
		- Recognition and measurement of items in financial statements
November 1992		New proposals on accounting treatment of securitisations
November 1992	FRED 2	Amendment to SSAP Accounting for Deferred Tax
December 1992	FRED 3	Accounting for Capital Instruments
February 1993	FRED 4	Reporting the Substance of Transactions (off-balance sheet finance)
March 1993	FRED 5	Amendment to FRS 3 in respect of insurance companies
March 1993		Discussion paper on Role of Valuation in Financial Reporting
March 1993		Draft Chapter 5 of Statement of Principles - Measurement in Financial Statements
April 1993		Discussion paper - Fair Values in Acquisition Accounting
May 1993	FRED 6	Accounting for Acquisitions and Mergers

II URGENT ISSUES TASK FORCE

July 1991	UITF 1	Backdated supplemental interest on Convertible Bonds
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October 1991	UITF 2	Disclosure of Restructuring Costs
December 1991	UITF 3	Treatment of Goodwill on Disposal of a Business
July 1992	UITF 4	Presentation of long term debtors in current assets
July 1992	UITF 5	Transfers from current assets to fixed assets
November 1992	UITF 6	Accounting for post retirement benefits other than pensions
December 1992	UITF 7	Use of true and fair view override in company accounts
March 1993	UITF 8	Accounting for repurchase of own debt
June 1993	UITF 9	Accounting for operations in hyper-inflationary economies
June 1993		Draft Foreword to UITF abstracts

III AUDITING PRACTICES BOARD

New Auditing Standards

May 1993 SAS 1 Auditors Reports

Proposals Discussion Papers and Exposure Drafts

May 1992 Auditors Reports

May 1992 Going Concern

May 1992 and May 1993 Scope and authority of APB Pronouncements

November 1992 Future Development of Auditing

April 1993 Revision of Auditing Standards and Guidelines Part I

June 1993 Revisions of Auditing Standards and Guidelines Part II

July 1993 Corporate Governance - Auditors review of Board's Statement of Compliance with Cadbury Code

July 1993	Draft Guidance on Review of Interim Financial Information
August 1993	Draft Auditing Standard on Going Concern

IV CADBURY RECOMMENDATIONS
CAJEC AND ICAEW WORKING GROUPS

September 1992	CAJEC Draft Guidance on Rotation of Audit Partners and Audit Firms
May 1993	Draft Guidance for Directors on Going Concern
September 1993	Draft Guidance for Directors on Interim Financial Information
October 1993	Draft Guidance for Directors on Internal Control