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RECORD OF MEETING WITH SIR DERMOT DE TRAFFORD, CHAIRMAN, INSTITUTE OF DIRECTORS, ON 25th JUNE, 1991

Present:

Sir Dermot de Trafford
Blenyth Jenkins, Director of Corporate Affairs, IOD
Sir Adrian Cadbury
Nigel Peace

1. This was primarily a courtesy call.

2. Sir Dermot suggested that the Committee's fifth term of reference (on the role of directors) should logically be its first. He commented that he would be interested in a comparison of the legal position of auditors in the USA.

3. Sir Dermot said that he would expect to obtain his Council's approval to any position which IOD took on the work of the Committee. The Council would be meeting in March which might fit in well with the timing of the Committee's consultation on a draft report.

4. Sir Adrian said that he would be grateful for IOD's views at the first meeting of the Committee on the terms of reference and on the topics that most needed looking at.

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NDP/PJS
28th June, 1991

COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

The Origins of the Committee

The Committee appears to originate principally from concern within the accountancy profession about loss of public confidence in the audit role:

Professor Percy: (then President , The Institute of Chartered Accountants of Scotland, in a private paper presented on 8th January, 1991): "Over the past year, public interest in the auditor's responsibility with regard to corporate failure and fraudulent activity has been heightened. Much confusion exists in the public's mind as to the auditor's duties and who should be able to rely on their reports, as a result of the House of Lords decision on Caparo. There is a widespread view that present forms of financial reporting are inadequate in today's environment. This debate has been exacerbated by the controversy over accounting for brands and goodwill. The spectacular cases of Ferranti, British and Commonwealth, and Polly Peck have all raised important questions as to the role of auditors and directors. In recent times the emphasis in the press has been on "Where were the auditors? "Little emphasis has been given to whether there are problems with the governance of companies themselves."

Brandon Gough: (Senior Partner, Coopers & Lybrand Deloitte, in paper dated 30th January, 1991): "There is widespread confusion about the role of the auditor. Many people expect from the audit something far different from that which is required by statute - the so-called expectation gap. This is particularly so in relation to the role of the auditor with respect to fraud, management efficiency and the prevention of insolvency. As a result, the value of the audit is increasingly doubted and the usefulness of company accounts, both to investors and other shareholders in companies, has been called into question. The interrelationship between the auditor's responsibilities and those of a company's directors is particularly misunderstood. Against the above background, there is an urgent need to codify the responsibilities of those involved in corporate governance and to describe what best practice should be. To help to secure proper administration of companies and fair stewardship, directors and senior management need to have unambiguous reference points for guidance .... What can resonably be expected of a company's auditor also needs to be clarified and, as far as possible, the legal position made clear."

Sir Ron Dearing: (Chairman, Financial Reporting Council) notes in a paper of 20th March 1991 that shareholders look to the auditor (whom in law they appoint at the AGM) to act as a prudent safeguard of their interests and, as the complexity of financial developments increases, tend to rely on the audit report as a general guarantee that all is well; but that arguably the auditor has insufficient independence of management to act robustly in the face of a demanding board when he feels that a proposed practice represents a departure from good practice, even though it cannot be shown to contravene an accounting standard. He comments that the auditor's position is vulnerable and goes on to suggest the establishment of a Committee to produce a Manual of Recommended Practice to look at the roles and reponsibilities of the various parties in relation to financial reporting.

Suggestions about what the Committee should consider, grouped in accordance with the draft terms of reference

(v) the responsibilities of executive and non-executive directors and other layers of management for planning, for reviewing and reporting on performance, and in relation to illegal acts.

(a) Brandon Gough has suggested
The need to identify who is responsible within the framework of corporate governance. Most legal responsibility rests with the board of directors, but other levels of senior management have an important role, and non-executive directors, large shareholders, the Audit Committee and the auditors are also part of the framework.

The need for guidance

(i) on the responsibilities of directors

- to formalise their strategy, and have in place a process for preparing business plans and budgets;
- to establish adequate systems of control (financial and otherwise);

- to measure performance;
- to report to shareholders;
- in relation to legal acts;
- in relation to their own personal interests.

(ii) on the role of non-executive directors and the extent of their involvement on boards.

(b) Professor Percy has made five specific proposals, on the first two of which the ICAS have set in hand follow-up projects;

	Proposal	Comment
1.	All plcs should be required by law to institute and maintain adequate management information systems and controls.	The ICAS have set in hand a project to consider the need for a statutory requirement for the maintenance of internal control systems; to draft guidance for companies; to consider the auditor's role in reporting on compliance; and to consider the role of the non-executive directors in ensuring the control system is adequate. [The ICAEW secretariat believes that the proposed requirement will give rise to serious definition problems.]
2.	There should be a legal requirement for annual accounts to include a statement by the directors that adequate systems have been maintained during the year, that management are responsible for the preparation of the accounts, and believe they show a true and fair view.	The ICAS have set in hand a project to consider the need for a report by management explaining the duties of the directors in relation to the financial statements; to draft suggested wording for the report; to consider how the suggestion might be implemented; and to consider the implications for directors' indemnity insurance.

3. The Government or Stock Exchange should require all plcs to have as directors a minimum number of non-executive directors.

4. The Chairman and Chief Executive of plcs should be different individuals.

5. A Code of Practice should define the role of non-executive directors and suggest suitable qualifications.

ICAEW secretariat support this recommendation and suggests that it builds on the report of the study group under chairmanship of Mr. B. D. Price "The Changing Role of the Non-Executive Director."

(iii) The auditors' responsibilities, including the extent and value of the audit report - the appointment, remuneration, resignation and dismissal of auditors and their relationship with audit committees.

(a) **Brandon Gough** has suggested
The need to identify where users of accounts are looking for assurance from auditors, and why - perhaps

- (a) that the accounts are "certified" as "correct"
- (b) that the business has been properly administered
- (c) that the directors and management have exercised their stewardship fairly
- (d) that there are no hidden problems, especially fraud or a risk of insolvency.

The need to consider what auditors should so and what additional information they should be reporting on (if any).

The need for guidance covering

- the role and responsibilities of auditors
- the scope and form of the audit report
- auditors' appointment, remuneration and replacement.

(b) **Professor Percy** has made six specific proposals:

	Proposal	Comment
1.	Auditors should be required to report to shareholders if adequate systems of management information and control are not maintained.	Covered by ICAS project above. ICAEW secretariat are worried by problems of definition, and increases in audit fees, but recognise the merit of a <u>positive</u> report by the auditors that adequate systems <u>are</u> maintained from the point of view of public confidence. Similar proposals are being considered in the US.
2.	Auditing Standards should require the auditor of a plc to discuss with the Chairman and non executive directors, or Audit Committee, the accounts of a company before finalising their audit opinion and any comments on the adequacy of the systems of control. The auditor should also attend the meeting of the full board when the accounts are approved.	ICAEW secretariat consider the proposal of doubtful value, on the grounds that meetings may not be necessary.
3.	The audit report should cover the responsibility for the preparation of the financial statements, the auditor's opinion regarding adequate systems of control, the nature of audit procedures carried out, the standards applied, and reference to auditors' attendance at the board meeting at which the accounts were approved.	The Auditing Practices Committee is working on a longer form of audit report. ICAEW have no objection to the proposal subject to the comments above.

4.	The appointment and remuneration of auditors should be on the recommendation of the non-executive directors or Audit Committee to the whole board; and subsequently to the shareholders at the AGM.	ICAEW support.
5(a)	The auditor should have an explicit responsibility to design the audit of a plc with a view to recognising material irregularities or fraud. He should be responsible for informing the non-executive directors or Audit Committee of information giving rise to suspicion.	ICAEW secretariat believes this does not depart from the profession's current position, which is that an auditor is obliged to conduct his audit so as to have a reasonable expectation of detecting material mis-statements resulting from fraud.
5(b)	The auditor should have the right to report to the DTI, or relevant statutory body such as the SIB, Bank of England, or Stock Exchange, if in his view the directors are not taking adequate steps.	ICAEW secretariat comment that under the existing guideline, the auditor has a right to report fraud in the public interest to a proper authority if he has reasonable grounds and acts in good faith. Should the right become a (statutory) duty?

(c) James Leek, Chief Executive of the Caparo Group, has presented five proposals for reform:

1. The law should be changed to make auditors liable for their negligence to accounts users who suffer loss.

2. Auditors should be encouraged to use qualified audit reports more frequently, where there is reasonable ground for discomfort on either the accuracy or presentation of the figures or of the accounting systems, in order to make investors better informed of

the stewardship of their directors, and give auditors a valid legal defence against liability claims.

3. Auditors should be encouraged to make available to shareholders, on request, a summary of their "Reports of Management".

4. There should be a limit on the number of years for which an auditor may be reappointed by a plc, and the amount of fee income from services other than audit and taxation. A better mechanism should also be found for the involvement of shareholders in the appointment and selection of auditors.

5. There should be an independent review body to hear cases of auditors' negligence - i.e. to establish negligence and assess damages.

(ii) The case for audit committees, including their composition and role, with special reference to the audit and auditors and the internal audit.

The ICAEW and ICAS appear to be in agreement that the use of Audit Committees should be encouraged.

Brandon Gough has suggested that guidance should cover the role of internal audit, and the role of Audit Committees.

The ICAS has set in hand a project to consider in general the role of Audit Committees, taking into account the results of Professor Marrian's 1988 research "Audit Committees", and current follow-up work; and to consider specifically the Committee's role in the appointment, renumeration and dismissal of auditors, and in ensuring that adequate internal control systems are maintained.

(i) Communications between boards, shareholders (including shareholders' committees) and other shareholders

(iv) The frequency, clarity, and nature of corporate reporting

The papers leading up to the establishment of the Committee have little to say on the issues that might be addressed under these headings. The question of reporting by directors, to provide comfort that responsibilities are being properly met, is touched on under terms of reference (v). (Brandon Gough questions whether directors should report annually on their systems of internal control, on the preparation of budgets, on a company's "going concern", etc.) Sir Ron Dearing notes the various measures that are in hand to strengthen the quality of financial reporting - the creation of the Accounting Standards Board and the Urgent Issues Task Force, the creation of the Auditing Practices Board, and steps being taken by the Financial Reporting Review Panel.

Professor Percy suggests that consideration should be given by the Stock Exchange to the part played by and availability of information to significant institutional shareholders, fund managers and major lenders so that they can reassert their position along with other shareholders as owners and lenders to the company. [The ICAEW secretariat comment that the time may well be ripe for another initiative to encourage institutions to take a more active part as shareholders in encouraging good management.]

Professor Percy also proposes that all public companies should identify a director to report at least annually to the board on whether the legal requirements on accounting records, financial statements, and internal control (if introduced) have been met. [The ICAEW secretariat see no technical objection, but do not see what the proposal would achieve.]

NDP/PJS
5th June, 1991