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MAKING CORPORATE GOVERNANCE MORE EFFECTIVE

Sir Adrian

Some time ago you asked me, in advance of our meeting with Bill Morrison, to dig out Rep. Percy's old paper dealing inter alia with fraud issues.

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MAKING CORPORATE GOVERNANCE MORE EFFECTIVE

A personal paper by Professor J P (Ian) Percy, CA, FRSA, President of the Institute of Chartered Accountants of Scotland.

INTRODUCTION

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. Questions which arise are, "Why do companies persist in having Chairman Chief Executives, and not splitting the role?" "Where were the non-executive directors and were they given proper information to make their judgements?" "What role should significant shareholders such as financial institutions and fund managers play and should they not be asking questions of the board?" "What information should key lenders obtain and should they be more vigilant in deciding whether a company has sufficient cash creation resources to pay high interest rates and repay loans?"

There are no doubt many other questions which could be asked and need to be reviewed in the light of the present economic circumstances, particularly at a time of recession.

Confidence in the governance of public companies, financial reporting and the audit role is critical to the health of the market economy. Following my speech to members and guests at the Dinner of The Institute of Chartered Accountants of Scotland at the Savoy on 5 November, I have been encouraged to think further on this topic. The views are my own and have not been discussed with the Council of the Institute or the partners in my firm. Now I believe is the time to examine whether there are steps that could be taken by the accountancy profession, the Stock Exchange and Government, to meet recent public concern. This paper is written to encourage debate on 8 January. The Recommendations will, I am sure, not be the definitive answer to the problem but I hope they will act as a catalyst for considering some practical ways forward.

In July 1985 The Institute of Chartered Accountants of Scotland, at the invitation of the late Sir Alex Fletcher, then Parliamentary Under Secretary of State for Corporate and Consumer Affairs, presented a memorandum on the Auditor's Role with regard to Fraud and Irregularities in the Financial Services Industry. In December 1986, at the invitation of Michael Howard, Sir Alex Fletcher's successor, The Institute of Chartered Accountants of Scotland issued a memorandum on 'The Development of Company Law'. I had the pleasure of being chairman of both these committees, the latter of which had representatives from the Institute of Chartered Accountants in England & Wales and the Institute of Chartered Accountants in Ireland.

Both reports were endorsed by the Council of The Institute of Chartered Accountants of Scotland. Both committees consisted of members from industry, commerce, academia and both large and small accountancy practices. In the preparation of this paper I have used those memoranda as a base and have attempted to update the ideas from consultations I have had since.

This paper does not refer to changes in financial reporting. This is presently being considered by the Financial Reporting Council and the Accounting Standards Board. In addition, the Companies Act 1989 has enacted important changes for the encouragement of the use of accounting standards as a means of disclosing a true and fair view, and we have yet to see the success of the Review Panel in this regard.

KEY BACKGROUND POINTS

The paper on 'The Development of Company Law' made a number of important statements as regards the purpose of company law and the environment in which we operate. They are still valid today and the following are those which are relevant to this issue.

a) In considering the objective of company law the legal framework should be such that company business can flourish within a mixed market economy without undue restriction, whilst being conducted in a regulated manner to maintain public confidence. Corporate managers with entrepreneurial spirit and flair for developing business should not be frustrated by over prescription. It is important that company law is presented as a framework for the proper conduct of business which will seek to maintain the business integrity and encourage business to flourish.

Likewise the International Stock Exchange and agencies of shareholders, fund managers and lenders should lay down principles which enable boards of directors to have the flexibility to operate in an environment of wealth creation, whilst acting in a manner which is responsive to the public interest and maintain confidence in coporate governance.

b) The regular and timely availability of relevant and objective information is essential to the effective working of the economy. There is a market place demand for fast communication of financial and commercial information, both in the UK and increasingly internationally. Stemming from advances in information technology, it is now practical (and becoming customary) for a wide range of financial and commercial information to be available on screen and to be accessed by means of databases, albeit that a hard copy may be available at a later time. There is a growing tendency to globalisation and evidence of increasing levels of international activity. Consequent on these changes investment and other decisions which in the past may have been made on the basis of audited financial statements or at least other hard copy documents are now made on more immediate information. There is a need to consider public confidence in the reliability of such information and it is for consideration whether company law needs to be extended to require that the information is reliable, not only in the year end accounts but in other statements and information available throughout the year.

c) Confidence has to be maintained in the functioning of limited companies and financial reporting because society demands it and because confidence is essential to the operation of the market economy.

The confidence factor has particular validity to public listed companies in which there is a wide share ownership and also large private companies in which there is considerable investment in terms of finance and/or employment. It can be argued that greater responsibility and reliance is therefore placed on the management of those companies because of the general public interest. This reflects the fact that the public generally expects higher standards of conduct in public listed companies while, in any dealings with smaller companies (in which owners and managers are very frequently the same grouping), a higher degree of risk appears to be usually recognised and accepted. This paper does not consider private companies as the writer believes that the corporate governance of public companies needs action first, and that practices in private companies can be considered at a further stage.

d) A primary role of Chartered Accountants, whether in practice or industry is to uphold the integrity of, and confidence in financial information. In the public interest the accountant in public practice should continue his role of independent attestor, which assists in maintaining confidence in the business community and which is of particular relevance at a time when the government is encouraging wider share ownership. Whilst this role should not deter the auditor in advising or offering other services to assist businesses in their development, the public interest concept should remain central to the profession.

ISSUES REGARDING FRAUD

On the subject of the auditor's responsibility in relation to fraud and irregularities, there is clearly a public perception and expectation that the auditor should report on such activity.

To paraphrase, the Financial Services regime requires the auditor to consider the adequacy of a company's accounting system and internal controls and to report to the regulators if these are not adequate. It also gives the auditor the right to discuss with regulators, either with the client present or not, (depending on the circumstances), any findings he may have regarding the possibility of fraud or irregularity, particularly at senior management level. Such an environment does not generally exist in the rest of the business sector.

In order to fully comprehend the recommendations for discussion, outlined below are some of the issues at present. These are listed under the headings of definition, management responsibility, audit confidentiality and audit responsibility.

DEFINITION: Irregularities refer to the intentional distortions of financial statements, for whatever purpose, and to mis-appropriations of assets, whether or not accompanied by distortions of financial statements. Fraud is one type of irregularity.

The problem which is disguised by apparently simple statements such as these, is the underlying complexity of the legal definitions of crimes of dishonesty. This is particularly so in England and Wales and in Northern Ireland where modern crimes of dishonesty are largely creatures of statute. Unless all necessary constituents of the crime, as provided by the statute, are present, no crime has been committed.

Scots law depends much more on basic principles and the common law. However, even under this system experts in criminal law are confronted by many subtleties of definition and the law undergoes a constant process of mutation which presents substantial problems to prosecutors. For example, although Scots law provides an apparently simple definition of theft as "the dishonest appropriation of the property of another with the intention of permanently depriving the owner thereof", there are circumstances where theft can be established in the absence of that intention.

Similarly, since Scots law defines fraud as "a false pretence, dishonestly made, leading to a definite result", there is no requirements that the fraudster should derive financial benefit from the fraudulent act. There are also nice problems in establishing the necessary casual link between the false pretence and the result in many cases and the difficulties which have faced the Serious Fraud Office in recent years adds weight to this view.

The auditing guideline relating to fraud defines "fraud and other irregularities" as

(a) fraud which involves the use of deception to obtain an unjust or illegal financial advantage;
(b) intentional misstatements in, or omissions of amounts or disclosures from, an entity's accounting records or financial statements;
(c) theft, as defined by the Theft Act 1968 ... whether or not accompanied by misstatements of accounting records or financial statements."

Whilst it is important, and perhaps seems relatively easy, to agree on commonly-understood definitions of "fraud", it is in reality an extremely complex area. It is the courts who decide what is classified as fraud and what is not, not the auditor, nor even the regulator. There can be a very fine dividing line between "irregularity" and "sharp commercial practice" and it is very difficult even to attempt to draw that line.

Management Responsibility: The responsibility for the prevention and detection of irregularities and fraud rests with the management of a company. This responsibility is usually discharged by instituting an adequate system of management information and internal control and the proper performance of boards of directors in questioning and being vigilant.

It is recognised however, that a system of control can help only to prevent certain fraud and irregularities being perpetrated. A system of control normally cannot prevent fraud and irregularities occurring as a result of intervention by management or by the collusion between management and third parties. Intervention and collusion are extremely difficult, if not sometimes impossible facets for an auditor or director to uncover.

Audit Confidentiality: Auditors have regard to the Ethical Guidance issued by their professional bodies. The current statement of Professional Conduct on "Unlawful Acts or Defaults by Clients or Members" clearly states that, except in cases of treason, an auditor/member who obtains knowledge of the commission of a crime or statutory offence by a client has no duty to act as an informer and would very seldom be justified in volunteering information against the client (the term "client" is undefined in the Ethical Guidance statement but may, in certain circumstances, be interpreted as the organisation as well as including any director, officer, employee of an organisation to which the auditor has been appointed). Auditors are recommended not to disclose past or intended civil wrongs, crimes (except treason) or statutory offences unless they feel that the damage to the public likely to arise from non-disclosure is of a very serious nature and that in any such cases auditors should, if time allows, always take legal advice before making the disclosure. It is worthy of note however, that the Auditing Practices Committee is presently preparing a guideline on the disclosure of illegal acts.

It is recognised that management, relying on the confidential relationship which exists, are frank with their auditors, and this is vital if trust and audit efficiency is to be achieved. Candour on the part of the directors and staff is of great importance and it is in the public interest that in general this confidence in the confidentiality of the relationship between company and auditor should be maintained.

However, the auditor has to remember that his ultimate duty is to the shareholders. It is extremely difficult to communicate with shareholders publicly both due to the litigious environment that exists, given the law of defamation, and due to the over reaction there may be by the market to unproven statements which could lead to erroneous or impossible circumstances for trading.

Audit Responsibility: The simple assumption by the public is that the auditor can report fraud publicly without appreciating the complexity of the law outlined above. However, as things stand the auditor who identifies what he considers to be irregular activity is faced with a dilemma of making a decision which can only properly be determined by the criminal courts, namely whether the activity in question constitutes a crime of dishonesty. The auditor is therefore in an inhibited position. A considerable amount of judgement and experience is required by an auditor to determine complex irregularity and fraud and it is important that the auditor has a forum in which to discuss any suspicions he might have. In the case of the employee fraud or irregularity such a forum exists at the senior management level. In the case of management fraud or irregularity the problem is that no such forum presently exists.

The terms of the Auditor's Operational Standard are that "if the auditor wishes to place reliance on any internal controls, he should ascertain and evaluate those controls and perform compliance tests on their operations." The present audit responsibility is to express an opinion on the truth and fairness of the financial statements; there is no general statutory responsibility or audit standard to report on the system of internal control.

There is an auditing guideline on the subject but it is not mandatory, it is only good practice. It therefore is possible at present, and indeed is the practice of certain auditors, not to examine in any detail or rely on the system of internal control. I would suggest that such a practice may be prevalent where there are considerable cost pressures and where management do not value the auditor's guidance on this subject.

The auditor's responsibilities in certain business sectors are at present extended; such extensions, as the following examples illustrate, have been brought in by statute, by regulation or by practice. Auditors of banks and building societies have the additional duty of reporting any inadequacy in systems of control. Auditors of Stock Exchange member firms are required by the Rules of The Stock Exchange to report, inter-alia, on whether the firms have maintained adequate liquidity margins and have kept adequate records of clients' securities. In the audit of local authorities in Scotland, auditors have, via the terms of their engagement as auditors by the Accounts Commission, accepted a responsibility for following up any indication of fraud coming to their notice from whatever source and whatever the likely amount involved: this responsibility has been accepted by the auditors in awareness of the fact that the integrity of public funds is at all times a matter of general concern. These examples illustrate that precedents exist for the extension of the role of the auditor in relation to particular sectors.

RECOMMENDATIONS

Listed below are a number of recommendations for discussion, which could enhance confidence both in corporate governance and the auditing profession. They need, of course, to be considered in the light of the fine balance that needs to be made between flexibility to achieve wealth creation and regulation to enhance public confidence, and the fine balance between cost and benefit.

There are no recommendations relating to accounting information, as those are well rehearsed in 'Making Corporate Reports Valuable', the 'Solomons Report on the future of accounting standards' and reports by the joint action group of ICAEW and ICAS and others, all of which are being considered by the Financial Reporting Council and the Accounting Standards Board.

It is suggested that the following recommendations should relate only to public listed companies at this time, even though it could be argued that they should transcend large and medium sized private companies. In practice however, a step in the public listed domain would be a major step forward. It is for consideration that if the law cannot be changed in the immediate future whether some of the recommendations could not be implemented by the International Stock Exchange.

MANAGEMENT INFORMATION SYSTEMS AND CONTROLS

Recommendation 1

All public listed companies should be required by law to institute and maintain adequate management information systems and controls.

Recommendation 2

It should be a requirement in law that annual accounts should include a statement by the directors, to the extent that adequate systems have been maintained during the year, that management are responsible for the preparation of the accounts and believe that they show a true and fair view.

Existing company legislation places minimal responsibility on company directors to maintain adequate information systems and focuses instead on the narrower need to maintain proper accounting records. The accountancy profession and management are accustomed to calling these systems "systems of internal control" and their reliability and efficiency are becoming of central importance to the effective functioning of the economy. An internal control system is defined in the Auditing Guideline "Internal Controls" as "the whole system of control, financial and otherwise established by management in order to carry on the business of an enterprise in an orderly and efficient manner, to ensure adherence to management policies, to safeguard the assets and to secure as far as possible the completeness and accuracy of the records". This definition should be re-examined by the Audit Practices Board as it was written in the 1970's and needs to be re-visited in view of changes which have taken place as a result of information technology and globalisation of business.

To enable economic decisions to be made effectively, they must of course be based on timely, relevant and reliable information. There is an increasing trend for markets as well as management to rely on screen based information (whether derived from accounting systems or independent databases). It is therefore important that the integrity of this information is established and maintained.

The role of the accountant is essentially to provide information, derived from the accounting records, which because of his professional training should automatically have ascribed to it a level of confidence that the information is relevant, appropriate, complete, timely and fair. Thus it is evident that an adequate internal control system ought to be established by the management of all public listed companies not only for internal purposes, but also to meet external expectations.

The importance of strong internal control systems has already been recognised in the financial services sectors. In the recent legislation affecting banks, building societies and financial services organisations, there are requirements relating to internal control systems. It is suggested that there is a strong case for similar requirements being placed on public listed companies in the industrial and commercial sectors.

The second recommendation is suggested for two reasons. First, it would bring home to boards of directors their responsibilities and secondly it would give them the opportunity to disclose the positive steps that they take in controlling the financial aspects of their company. The public would be better informed of the respective duties of directors and auditors with respect to those issues.

THE INTEGRITY OF INFORMATION AND COMPLIANCE WITH LEGAL REQUIREMENTS

For Public Listed companies, information on financial results and prospects is generally available from the following sources;

(a) Interim profit statements
(b) Preliminary profit statements
(c) The annual report and financial statements
(d) Press comments given by company officials, given perhaps on publication of the results at (a) and (b)
(e) Information provided to stockbrokers/analysts at meetings held with company officials throughout the year.

If one examines the movement in share prices and the workings of the stock market, it is clear that many movements take place on the basis of unaudited information. Indeed it is argued that the published annual report of a company seldom has any effect on share prices and brokers' views, particularly if the annual report merely confirms their expectations. It would be impractical for all information to be audited, but there is a case for ensuring the integrity of the information systems which provide the information on which statements can be made.

Recommendation 3

All public listed companies should be required to identify a director (normally the finance director) who would assume the duty of reporting not less than annually to the board on whether or not the legal requirements relating to accounting records and financial statements and the requirement in Recommendation 1 had been met.

In practice not all directors take the same steps to satisfy themselves that the company has complied with the existing legal requirements regarding accounting records and financial statements. Indeed, directors rely heavily on the Finance Director, Company Secretary and auditors for such confidence which is natural given the complexity of present day requirements. Accordingly it is recommended that every board of directors of public listed companies should nominate one of their number, (normally the Finance Director), to assume the duty of reporting not less than annually to the board on whether or not the three specified provisions (internal control, accounting records and financial statements) have been met.

Such a recommendation if adopted, would give significant backbone to the finance director, without lessening the responsibility of the whole board for their responsibilities. A not dissimilar requirement is prevalent in the insurance industry where there is a requirement for an 'Appointed Actuary' who has specific responsibilities for reporting, and in doing so, satisfying himself that the information and systems which he uses as his base are adequate.

Recommendation 4

Auditors should be required to report to shareholders if adequate systems of management information and control are not maintained, in addition to their responsibility regarding accounting records and financial statements.

In order that there is public confidence in the integrity of the systems, it is suggested that auditors of Public Listed companies should be required every year to examine and test the internal control procedures. If a company fails to maintain such systems the auditor should refer to this in his audit report. It is therefore recommended that this responsibility be introduced for public companies along similar lines to those in the Financial Services Act 1986 so that those involved with or interested in such companies may know whether or not adequate systems are being maintained.

DIRECTORS' RESPONSIBILITIES

Recommendation 5

Government or The Stock Exchange should;

1. **Require all public listed companies to have as directors a minimum (to be defined) of independent non-executive directors.**

2. **Require that the Chairman and Chief Executive of a public listed company should be different individuals.**
3. **Prepare a Code of Practice which would define the role of non-executive directors as well as suggesting suitable qualifications.**
4. **Encourage the use of audit committees.**
5. **The Auditing Standards should require the auditor of a public listed company to discuss with the Chairman (independent of the Chief Executive) and the non-executive directors or audit committee, the accounts of the company before finalising their audit opinion and any comments on the adequacy of the systems of control. Notwithstanding such discussions he should be required to attend and be permitted to speak at the meeting of the full board when the annual accounts are approved.**

The issue regarding the appointment of non-executive directors is not a new one and indeed there is a growing tendency towards their appointment. It is interesting to note the emphasis placed on non-executive directors appointments in the draft fifth European Directive on Company Law. Non-executive directors, because they are not involved in the day-to-day running of a company, have a valuable and objective role to play in assessing a company's performance, both externally in terms of published results and internally in terms of reviewing the effectiveness of the management. In addition they bring to the company additional experience in many forms which is of assistance to executive directors and the company as a whole.

The case for the mandatory appointment of non-executive directors has not been pursued in the past for two reasons - first, concern over the lack of individuals available to act as non-executive directors and secondly, doubts regarding the suitability and effectiveness of those appointed.

While neither of these concerns can be lightly dismissed, it has been interesting to note the number of organisations, such as Pro-NED and the Institute of Directors, which maintain registers of persons willing to act as non-executives.

Regarding the suitability and effectiveness of the non-executive directors it is suggested that these may be monitored in two ways - by the shareholders, in particular institutional shareholders, in approving their appointment or reappointment, and by The Stock Exchange which could have regard to the composition of a listed company's Board in its regulations.

Consideration needs to be given as to the number of non-executive directors. Whilst the draft fifth directive of the European Community suggests that a majority of the board should be non-executive, this may be contrary to the ability of a company to operate flexibly for the achievement of wealth creation. On the other hand, the public confidence argument would suggest that a small minority on the board is unhealthy. Perhaps somewhere between 30% and 50% with a minimum of two plus the independent chairman is an answer.

There has been much debate as to whether the Chief Executive of a company should also be the Chairman. There is a growing tendency in well run companies for the position to be separated as the roles are different. There could be merit now in requiring the separation of the function in the public interest. This is however, not to suggest that the Chairmanship is a small part time role. It is a position of significant responsibility.

It is suggested that some boards of public limited companies leave the question of the financial accounts and interim statements to the finance director without discussing in detail or fully understanding the view expressed by the statements. It is also suggested by some that non-executive directors are not always privy to all information necessary for a full understanding of a company's financial position. Further, the executive directors can have a conflict between marketing the company and its share price and representing a full disclosure of the facts lying behind the figures.

Whilst it is the auditors role to ensure that accounts show a true and fair view, notwithstanding that they comply with accounting standards, it is primarily the responsibility of the board. It could be said that the auditor's report is a second opinion. Board responsibility would be highlighted if it was a requirement that the auditor and the non-executive directors or audit committee, with the assistance of the finance director and other relevant executive directors, were required to discuss the accounts in some detail before they are approved by the whole board. Such a discussion should not be a substitute for proper board consideration and it is suggested that the auditor attends such a meeting to satisfy himself as to the board's approval.

Further, such a forum would be ideal for the director appointed under recommendation 3, to report annually on his findings as to whether or not the requirements relating to adequate systems of control, accounting records and financial statements had been met.

The value of audit committees is supported by the results of a research project carried out in 1988 on behalf of the ICAS Research Committee ("Audit Committees", IFY Marrian). 93% of the companies surveyed believed that the formation of an audit committee had been worthwhile. The two main reasons given for this belief were that:

(i) the involvement gave non-executive directors a deeper understanding of the business and
(ii) the existence of the audit committee gave rise to an increasing awareness of the importance of controls within a business.

At present ICAS is carrying out the second part of this research involving a survey of external auditors, a literature survey (leading to a comparative international study) and an investigation into audit committees in action.

AUDITORS RESPONSIBILITY WITH REGARD TO FRAUD IRREGULARITIES OR ILLEGAL ACTS

The Audit Practices Committee has published a guideline with regard to Fraud and Irregularities and a further exposure draft has been published regarding Illegal Acts. Notwithstanding those developments and in the light of the issues raised previously in this paper, the following recommendations are suggested.

Recommendation 6

The auditor should have an explicit responsibility to design his audit of a public listed company, with a view to recognising material irregularities or fraud.

Recommendation 7

The auditor, when coming across information that could lead or has led to suspected fraud, irregular or illegal acts, should have the responsibility of informing the non-executive directors or audit committee formed under recommendation 5.

Recommendation 8

To the extent that the auditor believes his concerns are in the shareholders and public interest, and the directors are not taking adequate steps in his view, the auditor should have the right to report to the Department of Trade and Industry Companies Division, or such regulatory body that exists for certain sectors of business, (such as the Securities and Investment Board, The Bank of England or the International Stock Exchange).

Such a recommendation is compatible with his rights under the Financial Services legislation.

ADDITIONAL RECOMMENDATIONS

Recommendation 9

The Audit Report should be lengthened to include statements as to 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 his attendance at the board meeting at which the accounts were approved, in addition to his opinion on truth and fairness and compliance with legal requirements.

The Audit Practices Committee is presently considering this as a means of reducing the 'Expectation Gap' as between the public's perception of an audit and the reality. A similar form of report is now being used in the United States of America. The recommendations in this paper go further than those being considered by our Audit Practices Committee.

Recommendation 10

In the face of public criticism, that the auditor is appointed by the executive directors and paid by them, consideration should be given to recommending that the non-executive directors or audit committee should make the recommendation to the whole board as to the appointment and remuneration of auditors. Subsequently the non-executive directors or audit committee should make the proposal to the shareholders at the Annual General Meeting.

Recommendation 11

Consideration should be given by the International Stock Exchange to the part played by and availability of information to, significant institutional shareholders, fund managers and major lenders so that they can re-assert their position along with other shareholders as owners and lenders to the public company.

CONCLUSION

The above recommendations will be seen as constructive by some members of the profession, and probably heresy by others in that they seek to extend audit responsibility. Directors in some public listed companies will be sympathetic to some of the suggestions, others will see them as bureaucratic, unworkable and costly.

Those discussing this paper will have other suggestions and disagree with some or all of the suggestions. A balance clearly needs to be struck if those discussing this paper share the concern for confidence to be enhanced in corporate governance and the accountancy profession.

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