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THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

The purpose of this briefing is to launch a high level review of the way in which the boards of directors of listed companies interact with their shareholders and with their professional advisers. I am flanked by Sir Ron Dearing, Chairman of the Financial Reporting Council, Michael Lickiss, President of the ICAEW, and Andrew Hugh Smith, Chairman of the International Stock Exchange.

They represent the financial sponsors for the review. Behind us, but unseen today, are an impressive list of other organisations and individuals who have agreed to take part. The full list is attached to your press release. I am sure that you will agree that a review which commands such senior people from the CBI, the accountancy profession, the Law Society, the Institutional Shareholders Committee, the IOD, the Hundred Group, the DTI and the Bank is at the very least comprehensive in its coverage of the business and financial community. Equally important, it reflects a common perception among influential organisations that there are serious issues to address, particularly with regard to the financial aspects of corporate governance.

I believe that there is a gap between the theoretical control, which shareholders exercise over the running of the companies in which they hold shares and their ability and willingness to exercise this control in practice. The constitutional position is that the shareholders elect the directors and the directors appoint the managers, who then manage the business from day-to-day. Thus, the chain of responsibility runs direct from shareholders to managers, with professional advisers having a key role to play in enabling those responsibilities to be properly discharged.

But we all know that there is a wide gap between that model of shareholder control and the reality; between, if you like, principle and practice. So what should be done to narrow that gap and, incidentally, to put together the various initiatives already in hand for clarifying the responsibilities of shareholders, boards and professional advisers?

The proposed terms of reference which we will be putting to the Working Party raise a number of issues, which we intend to examine.

One concerns the communication links between boards, shareholders (including shareholders' committee) and other stakeholders.

What information do all those with a direct interest in the performance and conduct of companies require? What are their legitimate expectations in this regard? How does the general level of companies' external communications compare with best practice and what guidance can the Working Party usefully give as to the form and content of board communications?

A second issue is the case of audit committees. An effective audit committee sharpens the accountability of boards to shareholders. It not only strengthens the hand of the auditors, on the shareholders' behalf, it also provides a framework within which a constructive dialogue between auditors and board members can take place. There is now a good deal of experience of audit committees on both sides of the Atlantic; how can we build on that experience?

A third issue concerns the responsibilities of auditors, including the extent and value of the audit report, and their relationship with audit committees. When companies collapse financially, the cry goes up "Where were the auditors?" Auditors are at times in an anomalous position, where outside expectations of what they could and should be doing are at variance with their real powers and duties. If the Working Party can help to bring about a greater degree of certainty as to the proper role of auditors in the chain of responsibility from boards to shareholders, it will have performed a useful service.

As part of our concern with communications, we will want to review the nature, clarity and frequency of corporate reporting. A company's Annual Report and Accounts are its main channel of communication with its shareholders, but too often they have become so encrusted with legal and financial barnacles as to be both unreadable and unread by the average shareholder. There is an expectations gap between the information which the Report and Accounts provide and what shareholders and analysts are looking for. How can that gap be narrowed? Once again, when companies fail, how is it that their earlier reports often appeared to give no indication of the true state of their finances?

Finally, there are issues concerning the responsibilities of directors for planning and for reviewing and reporting on performance which we intend to examine.

The aim of our enquiries will be to put forward a code of best practice, which will carry weight because of the authority of the institutions which are putting it in hand and will therefore be adopted by all forward-looking companies. We will draw on the other initiatives which have been taken in this field and will be glad to receive evidence from any interested bodies or individuals. What is different about this particular project is that it will aim to bring together the fruits of work and study undertaken by a number of groups, and it will do so in a form which will lead to action. None of us wish to be involved in compiling more paper; we have better things to do. Our aim is to contribute to the effectiveness with which companies are run.

The main driving force behind the need for this review has been the pace of change. Businesses have become more complex, more international and more competitive. Ownership is now largely divorced from management. At the same time, we have seen the rise of institutional investors, who have the resources to take on responsibilities towards their companies which the individual shareholder cannot.

Deregulation has added to the short-term pressures and relationships between companies and those who provide them with services have tended to become more transactional and less long-term. Professional firms have grown rapidly in size and in the range of services which they offer; also the boundaries between professions and between them and the institutions which they advise are continually shifting.

Given this state of flux, there is an urgent need to define the responsibilities of directors, shareholders and of those who advise them more clearly and to obtain general agreement to those definitions. In a moving situation, best practice has to give the lead. Regulation may or may not follow in its wake, but it cannot make the pace.

The distinctive features of this particular review are first the standing of the people involved and secondly that we will be examining the issues relating to the financial aspects of corporate governance, including the information which boards make available to their shareholders and therefore how boards, shareholders and auditors should best interact. This is essential if we are to maintain confidence in the corporate sector, and confidence is crucial.