

●● REPORT OF THE COMMITTEE ON ●●

THE

FINANCIAL ASPECTS

OF

CORPORATE GOVERNANCE

1 DECEMBER 1992

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PREFACE

When our Committee was formed just over eighteen months ago, neither our title nor our work programme seemed framed to catch the headlines. In the event, the Committee has become the focus of far more attention than I ever envisaged when I accepted the invitation to become its chairman. The harsh economic climate is partly responsible, since it has exposed company reports and accounts to unusually close scrutiny. It is, however, the continuing concern about standards of financial reporting and accountability, heightened by BCCI, Maxwell and the controversy over directors' pay, which has kept corporate governance in the public eye.

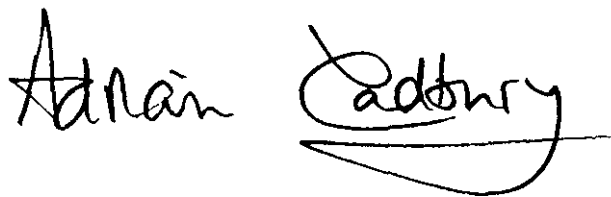
Unexpected though this attention may have been, it reflects a climate of opinion which accepts that changes are needed and it presents an opportunity to raise standards of which we should take full advantage. Our draft proposals have been thoroughly aired and have attracted a considerable weight of informed comment from a wide range of individuals and bodies with an interest in matters of corporate governance. While it has not been uncritical, the great majority of our respondents have supported the Committee's approach and it is this consensus which gives us a mandate to proceed. The Committee is being looked to for a lead, which we have a duty to provide.

I wish to thank the members of the Committee for their diligence and above all our Secretary, whose single-minded commitment to the Committee's progress has enabled us to complete the task we were set in May of last year. The report represents a shared view of the action which needs to be taken in the field of financial reporting and accountability and it is one to which every member of the Committee has contributed. The Committee has benefited from the breadth of its representation, which has included members of those bodies best placed to support the implementation of its recommendations.

I would also like on behalf of the Committee to express our gratitude to everyone who has contributed to our work either by submitting evidence to us directly, or through the press or by providing platforms for debates on governance issues.

PREFACE

Acceptance of the report's findings will mark an important advance in the process of establishing corporate standards. Our recommendations will, however, have to be reviewed as circumstances change and as the broader debate on governance develops. We will continue in existence as a Committee until a successor body is appointed, to act as a source of authority on our recommendations and to review their implementation.

A handwritten signature in black ink. The name 'Adrian' is written in a cursive style, followed by 'Cadbury' in a more stylized, looped cursive. A horizontal line is drawn underneath the signature.

Adrian Cadbury
Chairman
1 December 1992

THE SETTING FOR THE REPORT

- 1.1 The country's economy depends on the drive and efficiency of its companies. Thus the effectiveness with which their boards discharge their responsibilities determines Britain's competitive position. They must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance.
- 1.2 The Committee's recommendations are focused on the control and reporting functions of boards, and on the role of auditors. This reflects the Committee's purpose, which was to review those aspects of corporate governance specifically related to financial reporting and accountability. Our proposals do, however, seek to contribute positively to the promotion of good corporate governance as a whole.
- 1.3 At the heart of the Committee's recommendations is a Code of Best Practice designed to achieve the necessary high standards of corporate behaviour. The London Stock Exchange intend to require all listed companies registered in the United Kingdom, as a continuing obligation of listing, to state whether they are complying with the Code and to give reasons for any areas of non-compliance. This requirement will enable shareholders to know where the companies in which they have invested stand in relation to the Code. The obligation will be enforced in the same way as all other listing obligations. This may include, in appropriate cases, the publication of a formal statement of censure.
- 1.4 The Committee will remain responsible for reviewing the implementation of its proposals until a successor body is appointed in two years' time, to examine progress and to continue the ongoing governance review. It will be for our sponsors to agree the remit of the new body and to establish the basis of its support. In the meantime, a programme of research will be undertaken to assist the future monitoring of the Code.
- 1.5 By adhering to the Code, listed companies will strengthen both their control over their businesses and their public accountability. In so doing, they will be striking the right balance between meeting the standards of corporate governance now expected of them and retaining the essential spirit of enterprise.

THE SETTING FOR THE REPORT

- 1.6 Bringing greater clarity to the respective responsibilities of directors, shareholders and auditors will also strengthen trust in the corporate system. Companies whose standards of corporate governance are high are the more likely to gain the confidence of investors and support for the development of their businesses.
- 1.7 The basic system of corporate governance in Britain is sound. The principles are well known and widely followed. Indeed the Code closely reflects existing best practice. This sets the standard which all listed companies need to match.
- 1.8 Our proposals aim to strengthen the unitary board system and increase its effectiveness, not to replace it. In law, all directors are responsible for the stewardship of the company's assets. All directors, therefore, whether or not they have executive responsibilities, have a monitoring role and are responsible for ensuring that the necessary controls over the activities of their companies are in place – and working.
- 1.9 Had a Code such as ours been in existence in the past, we believe that a number of the recent examples of unexpected company failures and cases of fraud would have received attention earlier. It must, however, be recognised that no system of control can eliminate the risk of fraud without so shackling companies as to impede their ability to compete in the market place.
- 1.10 We believe that our approach, based on compliance with a voluntary code coupled with disclosure, will prove more effective than a statutory code. It is directed at establishing best practice, at encouraging pressure from shareholders to hasten its widespread adoption, and at allowing some flexibility in implementation. We recognise, however, that if companies do not back our recommendations, it is probable that legislation and external regulation will be sought to deal with some of the underlying problems which the report identifies. Statutory measures would impose a minimum standard and there would be a greater risk of boards complying with the letter, rather than with the spirit, of their requirements.

THE SETTING FOR THE REPORT

- 1.11 The Committee is clear that action by boards of directors and auditors on the financial aspects of corporate governance is expected and necessary. We are encouraged by the degree to which boards are already reviewing their structures and systems in the light of our draft recommendations. The adoption of our recommendations will mark an important step forward in the continuing process of raising standards in corporate governance.

REPORT OF THE COMMITTEE

INTRODUCTION

Reasons for setting up the Committee

- 2.1 The Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange and the accountancy profession to address the financial aspects of corporate governance. The Committee's membership and terms of reference are set out in *Appendix 1*. Its sponsors were concerned at the perceived low level of confidence both in financial reporting and in the ability of auditors to provide the safeguards which the users of company reports sought and expected. The underlying factors were seen as the looseness of accounting standards, the absence of a clear framework for ensuring that directors kept under review the controls in their business, and competitive pressures both on companies and on auditors which made it difficult for auditors to stand up to demanding boards.
- 2.2 These concerns about the working of the corporate system were heightened by some unexpected failures of major companies' and by criticisms of the lack of effective board accountability for such matters as directors' pay.. Further evidence of the breadth of feeling that action had to be taken to clarify responsibilities and to raise standards came from a number of reports on different aspects of corporate governance which had either been published or were in preparation at that time.
- 2.3 The Committee wherever possible drew on these documents, and a wide range of submissions from interested parties, in producing its draft report which was issued for public comment on 27 May 1992.
- 2.4 Since then, the Committee has received over 200 written responses to its proposals, the great majority of which broadly support the Committee's approach, and has carefully considered the balance of opinions expressed on particular issues. The Committee is most grateful to all those who have taken the time and trouble to give us their comments. They have helped to shape our final report and, in addition, they are a valuable reference source for our successors. A list of contributors and of relevant published statements appears in *Appendix 7*.

Corporate Governance

- 2.5** Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting.
- 2.6** Within that overall framework, the specifically financial aspects of corporate governance (the Committee's remit) are the way in which boards set financial policy and oversee its implementation, including the use of financial controls, and the process whereby they report on the activities and progress of the company to the shareholders.
- 2.7** The role of the auditors is to provide the shareholders with an external and objective check on the directors' financial statements which form the basis of that reporting system. Although the reports of the directors are addressed to the shareholders, they are important to a wider audience, not least to employees whose interests boards have a statutory duty to take into account.
- 2.8** The Committee's objective is to help to raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them.

Report Content

- 2.9** The report begins by reviewing the structure and responsibilities of boards of directors; here we have summarised our recommendations in a Code of Best Practice. Next, we consider the role of auditors and address a number of recommendations to the accountancy profession. We then deal with the rights and responsibilities of shareholders. The report concludes with several appendices, including at **Appendix 2** notes on the roles of some of the bodies referred to in the report.

Companies to whom directed

- 3.1 The Code of Best Practice (on pages 58 to 60) is directed to the boards of directors of all listed companies registered in the UK, but we would encourage as many other companies as possible to aim at meeting its requirements.

Code Principles

- 3.2 The principles on which the Code is based are those of openness, integrity and accountability. They go together. Openness on the part of companies, within the limits set by their competitive position, is the basis for the confidence which needs to exist between business and all those who have a stake in its success. An open approach to the disclosure of information contributes to the efficient working of the market economy, prompts boards to take effective action and allows shareholders and others to scrutinise companies more thoroughly.
- 3.3 Integrity means both straightforward dealing and completeness. What is required of financial reporting is that it should be honest and that it should present a balanced picture of the state of the company's affairs. The integrity of reports depends on the integrity of those who prepare and present them.
- 3.4 Boards of directors are accountable to their shareholders and both have to play their part in making that accountability effective. Boards of directors need to do so through the quality of the information which they provide to shareholders, and shareholders through their willingness to exercise their responsibilities as owners.
- 3.5 The arguments for adhering to the Code are twofold. First, a clear understanding of 'responsibilities and an open approach to the way in which they have been discharged will assist boards of directors in framing and winning support for their strategies. It will also assist the efficient operation of capital markets and increase confidence in boards, auditors and financial reporting and hence the general level of confidence in business.
- 3.6 Second, if standards of financial reporting and of business conduct more generally are not seen to be raised, a greater reliance on regulation may be inevitable. Any further

degree of regulation would, in any event, be more likely to be well directed, if it were to enforce what has already been shown to be workable and effective by those setting the standard.

Statement of Compliance

- 3.7** We recommend that listed companies reporting in respect of years ending after 30 June 1993 should state in the report and accounts whether they comply with the Code and identify and give reasons for any areas of non-compliance. The London Stock Exchange intends to require such a statement as one of its continuing listing obligations.
- 3.8** We envisage, however, that many companies will wish to go beyond the strict terms of the London Stock Exchange rule and make a general statement about the corporate governance of their enterprises as some leading companies have already done. We welcome such statements and leave it to boards to decide the terms in which they make their statement of compliance. Boards are not expected to comment separately on each item of the Code with which they are complying, but areas of non-compliance will have to be dealt with individually.
- 3.9** The continuing obligations laid down by the London Stock Exchange should require companies' statements of compliance to have been the subject of review by the auditors before publication. The review should cover only those parts of the compliance statement which relate to provisions of the Code where compliance can be objectively verified (see footnote to the Code). The auditors should not be required to report formally a satisfactory conclusion to their review, but if they identify an area of non-compliance which is not properly disclosed, they should draw attention to it in their report on the financial statements. We recommend that the Auditing Practices Board should consider guidance for auditors accordingly

THE CODE OF BEST PRACTICE

3.10 The Code is to be followed by individuals and companies in the light of their own particular circumstances. They are responsible for ensuring that their actions meet the spirit of the Code and in interpreting it they should give precedence to substance over form.

Keeping the Code up to date

3.11 We have addressed those issues which appeared from the evidence before us to require the most immediate attention. The situation, however, is developing. The Accounting Standards Board has in hand a programme of work on the basis of financial reporting. Revised accounting standards and improved methods of financial presentation will result. At the same time, views on best boardroom practice will evolve in the light of experience, and European Community directives and regulations may give rise to new issues. It is essential, therefore, that the Code, in addition to being monitored, is kept up to date.

3.12 We recommend that our sponsors, convened by the Financial Reporting Council, should appoint a new Committee by the end of June 1995 to examine how far compliance with the Code has progressed, how far our other recommendations have been implemented, and whether the Code needs updating in line with emerging issues. Our sponsors should also determine whether the sponsorship of the new Committee should be broadened and whether wider matters of corporate governance should be included in its brief. In the meantime, the present Committee will remain responsible for reviewing the implementation of its proposals and for identifying further issues which its successor body might usefully consider. These steps will establish a continuing process of governance review.

Compliance

3.13 Raising standards of corporate governance cannot be achieved by structures and rules alone. They are important because they provide a framework which will encourage and support good governance, but what counts is the way in which they are put to use.

3.14 The responsibility for putting the Code into practice lies directly with the boards of directors of listed companies to

THE CODE OF BEST PRACTICE

whom it is addressed. Compliance itself, however, is a matter for everyone concerned with corporate governance. We look to the financial institutions and the wide range of bodies backing our work to encourage the adoption of our recommendations by companies in which they have an interest. The media also have a part to play in drawing attention to governance issues of public or shareholder concern. It is vital to seize the opportunity presented by a climate of opinion which accepts that changes are needed and which is expecting the Committee to give the necessary lead.

- 3.15 The Committee recognises that smaller listed companies may initially have difficulty in complying with some aspects of the Code and we have given careful consideration to the responses to the draft report which addressed this point. The boards of smaller listed companies who cannot, for the time being, comply with parts of the Code should note that they may instead give their reasons for non-compliance. We believe, however, that full compliance will bring benefits to the boards of such companies and it should be their objective to ensure that the benefits are achieved. In particular, the appointment of appropriate non-executive directors should make a positive contribution to the development of their businesses. Any practical issues which may arise in respect of smaller listed companies will be thoroughly reviewed by the Committee and its successor.
- 3.16 The Committee notes that companies will not be able to comply with items 4.5 and 4.6 in the Code until the necessary guidance for companies has been developed.

Board Effectiveness

- 4.1 Every public company should be headed by an effective board which can both lead and control the business. Within the context of the UK unitary board system, this means a board made up of a combination of executive directors, with their intimate knowledge of the business, and of outside, non-executive directors, who can bring a broader view to the company's activities, under a chairman who accepts the duties and responsibilities which the post entails.
- 4.2 Tests of board effectiveness include the way in which the members of the board as a whole work together under the chairman, whose role in corporate governance is fundamental, and their collective ability to provide both the leadership and the checks and balances which effective governance demands. Shareholders are responsible for electing board members and it is in their interests to see that the boards of their companies are properly constituted and not dominated by any one individual.
- 4.3 All directors are equally responsible in law for the board's actions and decisions. Certain directors may have particular responsibilities, as executive or non-executive directors, for which they are accountable to the board. Regardless of specific duties undertaken by individual directors, however, it is for the board collectively to ensure that it is meeting its obligations.
- 4.4 Whilst it is the board as a whole which is the final authority, executive and non-executive directors are likely to contribute in different ways to its work. Non-executive directors have two particularly important contributions to make to the governance process as a consequence of their independence from executive responsibility. Neither is in conflict with the unitary nature of the board.
- 4.5 The first is in reviewing the performance of the board and of the executive. Non-executive directors should address this aspect of their responsibilities carefully and should ensure that the chairman is aware of their views. If the chairman is also the chief executive, board members should look to a senior non-executive director, who might be the deputy chairman, as the person to whom they should address any concerns about the combined office of chairman/chief executive and its consequences for the

effectiveness of the board. A number of companies have recognised that role and some have done so formally in their Articles.

- 4.6 The second is in taking the lead where potential conflicts of interest arise. An important aspect of effective corporate governance is the recognition that the specific interests of the executive management and the wider interests of the company may at times diverge, for example over takeovers, boardroom succession, or directors' pay. Independent non-executive directors, whose interests are less directly affected, are well-placed to help to resolve such situations.

The Chairman

- 4.7 The chairman's role in securing good corporate governance is crucial. Chairmen are primarily responsible for the working of the board, for its balance of membership subject to board and shareholders' approval, for ensuring that all relevant issues are on the agenda, and for ensuring that all directors, executive and non-executive alike, are enabled and encouraged to play their full part in its activities. Chairmen should be able to stand sufficiently back from the day-to-day running of the business to ensure that their boards are in full control of the company's affairs and alert to their obligations to their shareholders.
- 4.8 It is for chairmen to make certain that their non-executive directors receive timely, relevant information tailored to their needs, that they are properly briefed on the issues arising at board meetings, and that they make an effective contribution as board members in practice. It is equally for chairmen to ensure that executive directors look beyond their executive duties and accept their full share of the responsibilities of governance.
- 4.9 Given the importance and particular nature of the chairman's role, it should in principle be separate from that of the chief executive. If the two roles are combined in one person, it represents a considerable concentration of power. We recommend, therefore, that there should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief

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executive, it is essential that there should be a strong and independent element on the board.

Non-Executive Directors

- 4.10** The Committee believes that the calibre of the non-executive members of the board is of special importance in setting and maintaining standards of corporate governance. The emphasis in this report on the control function of non-executive directors is a consequence of our remit and should not in any way detract from the primary and positive contribution which they are expected to make, as equal board members, to the leadership of the company.
- 4.11 Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct. We recommend that the calibre and number of non-executive directors on a board should be such that their views will carry significant weight in the board's decisions. To meet our recommendations on the composition of sub-committees of the board, all boards will require a minimum of three non-executive directors, one of whom may be the chairman of the company provided he or she is not also its executive head. Additionally, two of the three should be independent in the terms set out in the next paragraph.
- 4.12 An essential quality which non-executive directors should bring to the board's deliberations is that of independence of judgement. We recommend that the majority of non-executives on a board should be independent of the company. This means that apart from their directors' fees and shareholdings, they should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. It is for the board to decide in particular cases whether this definition is met. Information about the relevant interests of directors should be disclosed in the Directors' Report.
- 4.13** On fees, there is a balance to be struck between recognising the value of the contribution made by non-executive directors and not undermining their independence. The demands which are now being made on conscientious non-executive directors are significant and

their fees should reflect the time which they devote to the company's affairs. There is, therefore, a case for paying for additional responsibilities taken on, for example, by chairmen of board committees. In order to safeguard their independent position, we regard it as good practice for non-executive directors not to participate in share option schemes and for their service as non-executive directors not to be pensionable by the company.

- 4.14 Non-executive directors lack the inside knowledge of the company of the executive directors, but have the same right of access to information as they do. Their effectiveness turns to a considerable extent on the quality of the information which they receive and on the use which they make of it. Boards should regularly review the form and the extent of the information which is provided to all directors.
- 4.15 Given the importance of their distinctive contribution, non-executive directors should be selected with the same impartiality and care as senior executives. We recommend that their appointment should be a matter for the board as a whole and that there should be a formal selection process, which will reinforce the independence of non-executive directors and make it evident that they have been appointed on merit and not through any form of patronage. We regard it as good practice for a nomination committee (dealt with below) to carry out the selection process and to make proposals to the board.
- 4.16 Companies have to be able to bring about changes in the composition of their boards to maintain their vitality. Non-executive directors may lose something of their independent edge, if they remain on a board too long. Furthermore, the make-up of a board needs to change in line with new challenges. We recommend, therefore, that non-executive directors should be appointed for specified terms. Their Letter of Appointment should set out their duties, term of office, remuneration and its review. Reappointment should not be automatic, but a conscious decision by the board and the director concerned.
- 4.17 Our emphasis on the qualities to be looked for in non-executive directors, combined with the greater demands now being made on them, raises the question of whether the supply of non-executive directors will be adequate to meet the demand. When companies encourage their executive directors to accept appointments on the hoards of other

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companies, the companies and the individuals concerned all gain. A policy of promoting this kind of appointment will increase the pool of potential non-executive directors, particularly if the divisional directors of larger companies are considered for non-executive posts, as well as their main board colleagues.

Professional Advice

4.18 Occasions may arise when directors have to seek legal or financial advice in the furtherance of their duties. They should always be able to consult the company's advisers. If, however, they consider it necessary to take independent professional advice, we **recommend** that they should be entitled to do so at the company's expense, through an agreed procedure laid down formally, for example in a Board Resolution, in the Articles, or in the Letter of Appointment.

Directors' Training

4.19 The weight of responsibility carried by all directors and the increasing commitment which their duties require emphasise the importance of the way in which they prepare themselves for their posts. Given the varying backgrounds, qualifications and experience of directors, it is highly desirable that they should all undertake some form of internal or external training; this is particularly important for directors, whether executive or non-executive, with no previous board experience. Newly-appointed board members are also entitled to expect a proper process of induction into the company's affairs. It is **then** up to individual directors to keep abreast of their legislative and broader responsibilities.

4.20 There are already courses for newly-appointed directors run by the Institute of Directors and business schools. With the support of the Bank of England, the Confederation of British Industry, the Institute of Directors, and PRO NED, a new course covering the full range of board responsibilities will be open to directors shortly. The training and development of directors is of importance to good governance and it is one of the issues which we suggest our successor body should keep under review.

Board Structures and Procedures

4.21 The effectiveness of a board is buttressed by its structure and procedures. One aspect of structure is the appointment of committees of the board, such as the audit, remuneration and nomination committees, referred to later in the report.

4.22 Another is that boards should recognise the importance of the finance function by making it the designated responsibility of a main board director, who should be a signatory to the accounts on behalf of the board, and should have the right of access to the Audit Committee.

4.23 The basic procedural requirements are that the board should meet regularly, with due notice of the issues to be discussed supported by the necessary paperwork, and should record its conclusions. We recommend that boards should have a formal schedule of matters specifically reserved to them for their collective decision, to ensure that the direction and control of the company remains firmly in their hands and as a safeguard against misjudgements and possible illegal practices. A schedule of these matters should be given to directors on appointment and should be kept up to date.

4.24 We envisage that such a schedule would at least include:

- (a) acquisition and disposal of assets of the company or its subsidiaries that are material to the company;
- (b) investments, capital projects, authority levels, treasury policies, and risk management policies.

Boards should lay down rules to determine materiality for any transaction, and should establish clearly which transactions require multiple board signatures. Boards should also agree the procedures to be followed when, exceptionally, decisions are required between board meetings.

The Company Secretary

4.25 The company secretary has a key role to play in ensuring that board procedures are both followed and regularly reviewed. The chairman and the board will **look to the company secretary for guidance on what their responsibilities are under the rules and regulations to which they are subject and on how those responsibilities**

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should be discharged. All directors should have access to the advice and services of the company secretary and should recognise that the chairman is entitled to the strong and positive support of the company secretary in ensuring the effective functioning of the board. It should be standard practice for the company secretary to administer, attend and prepare minutes of board proceedings.

4.26 Under the Companies Act the directors have a duty to appoint as secretary someone who is capable of carrying out the duties which the post entails. The responsibility for ensuring that the secretary remains capable, and any question of the secretary's removal, should be a matter for the board as a whole.

4.27 The Committee expects that the company secretary will be a source of advice to the chairman and to the board on the implementation of the Code of Best Practice.

Directors' Responsibilities

4.28 So that shareholders are clear where the boundaries between the duties of directors and auditors lie, we recommend that a brief statement of directors' responsibilities for the accounts should appear in the report and accounts, as a counterpart to a statement by the auditors about their reporting responsibilities. The ground which would need to be covered by the directors' statement is set out in **Appendix 3**. The appropriate position for the directors' statement is immediately before the auditors' report, which in future will include a statement of auditors' responsibilities. The two statements will thus complement each other.

Standards of Conduct

4.29 It is important that all employees should know what standards of conduct are expected of them. We regard it as good practice for boards of directors to draw up codes of ethics or statements of business practice and to publish them both internally and externally.

Nomination Committees

4.30 One approach to making board appointments, which makes clear how these appointments are made and assists boards in making them, is through the setting up of a nomination committee, with the responsibility of proposing to the board, in the first instance, any new appointments, whether of executive or of non-executive directors. A nomination committee should have a majority of non-executive directors on it and be chaired either by the chairman or a non-executive director.

internal Controls

4.31 Directors are responsible under s.221 of the Companies Act 1985 for maintaining adequate accounting records. To meet these responsibilities directors need in practice to maintain a system of internal control over the financial management of the company, including procedures designed to minimise the risk of fraud. There is, therefore, already an implicit requirement on directors to ensure that a proper system of internal control is in place.

4.32 Since an effective internal control system is a key aspect of the efficient management of a company, we recommend that the directors should make a statement in the report and accounts on the effectiveness of their system of internal control and that the auditors should report thereon. The criteria for assessing effectiveness and the detailed guidance for auditors will need to be established and our recommendation to this effect is in paragraph 5.16.

Audit Committees

4.33 Since 1978, the New York Stock Exchange has required all listed companies to have audit committees composed solely of independent directors and the 1987 report of the American Treadway Commission concluded that audit committees had a critical role to play in ensuring the integrity of US company financial reports. While experience of audit committees in this country is shorter, it is encouraging, and around two-thirds of the top 250 UK listed companies now have them in place.

4.34 Experience in the United States has shown that, even where audit committees might have been set up mainly to meet

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listing requirements, they have proved their worth and developed into essential committees of the board. Similarly, recently published research in the United Kingdom concludes that the majority of companies with audit committees are enthusiastic about their value to their businesses. They offer added assurance to the shareholders that the auditors, who act on their behalf, are in a position to safeguard their interests.

- 4.35 The Committee therefore recommends that all listed companies should establish an audit committee. Our further recommendations on audit committees are as follows:
- (a) Audit committees should be formally constituted to ensure that they have a clear relationship with the boards to whom they are answerable and to whom they should report regularly. They should be given written terms of reference which deal adequately with their membership, authority and duties, and they should normally meet at least twice a year.
 - (b) There should be a minimum of three members. Membership should be confined to the non-executive directors of the company and a majority of the non-executives serving on the committee should be independent, as defined in paragraph 4.12 above. Membership of the committee should be disclosed in the annual report.
 - (c) The external auditor should normally attend audit committee meetings, as should the finance director. As the board as a whole is responsible for the financial statements, other board members should also have the right to attend. The committee should have a discussion with the external auditors, at least once a year, without executive board members present, to ensure that there are no unresolved issues of concern.
 - (d) The audit committee should have explicit authority to investigate any matters within its terms of reference, the resources which it needs to do so, and full access to information. The committee should be able to obtain external professional advice and to invite outsiders with relevant experience to attend if necessary.
 - (e) The audit committee's duties should be determined in the light of the company's needs but should normally include:
 - (i) making recommendations to the board on the

- appointment of the external auditor, the audit fee, and any questions of resignation or dismissal;
- (ii) review of the half-year and annual financial statements before submission to the board;
 - (iii) discussion with the external auditor about the nature and scope of the audit, co-ordination where more than one audit firm is involved, any problems or reservations arising from the audit, and any matters which the external auditor wishes to discuss, without executive board members present;
 - (iv) review of the external auditor's management letter;
 - (v) review of the company's statement on internal control systems prior to endorsement by the board;
 - (vi) review of any significant findings of internal investigations.
- (f) Where an internal audit function exists, the audit committee should ensure that it is adequately resourced and has appropriate standing within the company. The internal audit programme should be reviewed by the audit committee, and the head of internal audit should normally attend its meetings.
- (g) The chairman of the audit committee should be available to answer questions about its work at the Annual General Meeting.

Further discussion of audit committees including specimen terms of reference is in *Appendix 4*.

- 4.36** The Committee believes that boards should appoint audit committees, rather than aiming to carry out their functions themselves. A separate audit committee enables a board to delegate to a sub-committee a thorough and detailed review of audit matters, it enables the non-executive directors to contribute an independent judgement and play a positive role in an area for which they are particularly fitted, and it offers the auditors a direct link with the non-executive directors. The ultimate responsibility of the board for reviewing and approving the annual report and accounts and the half-year report remains undiminished by the appointment of an audit committee, but it provides an important assurance that a key area of a board's duties will be rigorously discharged.

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4.37 The Committee therefore regards the appointment of properly constituted audit committees as an important step in raising standards of corporate governance. Their effectiveness depends on their having a strong chairman who has the confidence of the board and of the auditors, and on the quality of the non-executive directors. Membership of an audit committee is a demanding task requiring commitment, training and skill. The directors concerned need to have sufficient understanding of the issues to be dealt with by the committee to take an active part in its proceedings. This is why committees should, if it is appropriate and within their authority, be able to invite outsiders with relevant experience to attend meetings.

4.38 The external auditors should be present at the board meeting when the annual report and accounts are approved and preferably when the half-yearly report is considered as well.

Internal Audit

4.39 The function of the internal auditors is complementary to, but different from, that of the outside auditors. We regard it as good practice for companies to establish internal audit functions to undertake regular monitoring of key controls and procedures. Such regular monitoring is an integral part of a company's system of internal control and helps to ensure its effectiveness. An internal audit function is well placed to undertake investigations on behalf of the audit committee and to follow up any suspicion of fraud. It is essential that heads of internal audit should have unrestricted access to the chairman of the audit committee in order to ensure the independence of their position.

Board Remuneration

- 4.40 The overriding principle in respect of board remuneration is that of openness. Shareholders are entitled to a full and clear statement of directors' present and future benefits, and of how they have been determined. **We recommend** that in disclosing directors' total emoluments and those of the chairman and highest-paid UK director, separate figures should be given for their salary and performance-related elements and that the criteria on which performance is measured should be explained. Relevant information about stock options, stock appreciation rights, and pension contributions should also be given.
- 4.41 In addition, we **recommend** that future service contracts should not exceed three years without shareholders' approval and that the Companies Act should be amended in line with this recommendation. This would strengthen shareholder control over levels of compensation for loss of office.
- 4.42 We **also recommend** that boards should appoint remuneration committees, consisting wholly or mainly of non-executive directors and chaired by a non-executive director, to recommend to the board the remuneration of the executive directors in all its forms, drawing on outside advice as necessary. Executive directors should play no part in decisions on their own remuneration. Membership of the remuneration committee should appear in the Directors' Report. Best practice in this field is set out in PRO NED's Remuneration Committee guidelines, published in 1992.
- 4.43 The Committee has received proposals for giving shareholders the opportunity to determine matters such as directors' pay at general meetings, but does not see how these suggestions could be made workable. A director's remuneration is not a matter which can be sensibly reduced to a vote for or against; were the vote to go against a particular remuneration package, the board would still have to determine the remuneration of the director concerned. In addition, there are such practical considerations as the need to agree directors' remuneration on appointment.

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- 4.44 Shareholders require that the remuneration of directors should be both fair and competitive. Striking this balance involves detailed consideration of the kind which a remuneration committee, whose members have no personal interest in the outcome, can give to the matter. Remuneration committees need to have the interests of the company and the shareholders always in mind in coming to their decisions and the chairman of the committee should be available to respond to any concerns of shareholders at the Annual General Meeting.
- 4.45 The Annual General Meeting provides the opportunity for shareholders to make their views on such matters as directors' benefits known to their boards. It is the Committee's view that shareholders can play a more practical governance role by aiming to influence board policies in this way, than by seeking to make the detail of board decisions subject to their vote.
- 4.46 Further changes to the rules for disclosure, such as lengthening the list of directors whose remuneration is individually identified, and the role which shareholders could play, either in voting on particular aspects of remuneration or in tabling advisory resolutions along lines now developing in the USA, will need to be reviewed in the light of experience. Directors' contracts and pay are aspects of board accountability which the Committee will continue to monitor in the expectation that they will be on the agenda of our successor body.

Financial Reports

- 4.47 A basic weakness in the current system of financial reporting is the possibility of different accounting treatments being applied to essentially the same facts, with the consequence that different results or financial positions could be reported, each apparently complying with the overriding requirement to show a true and fair view. Regardless of how far the market can understand the implications of alternative accounting treatments or see through presentational techniques designed to show a company's figures in the most flattering light, there are advantages to investors, analysts, other accounts users and ultimately to the company itself in financial reporting rules which limit the scope for uncertainty and manipulation.

- 4.48 The lifeblood of markets is information and barriers to the flow of relevant information represent imperfections in the market. The need to sift and correct the information put out by companies adds cost and uncertainty to the market's pricing function. The more the activities of companies are transparent, the more accurately will their securities be valued.
- 4.49 In addition, the wider the scope for alternative treatments, the less useful financial reports become in terms of comparability – over time and between companies.
- 4.50 What shareholders (and others) need from the report and accounts is a coherent narrative, supported by the figures, of the company's performance and prospects. We **recommend** that boards should pay particular attention to their duty to present a balance,; and understandable assessment of their company's position. Balance requires that setbacks should be dealt with as well as successes, while the need for the report to be readily understood emphasises that words are as important as figures.
- 4.51 The cardinal principle of financial reporting is that the view presented should be true and fair. Further principles are that boards should aim for the highest level of disclosure consonant with presenting reports which are understandable and with avoiding damage to their competitive position. They should also aim to ensure the integrity and consistency of their reports and they should meet the spirit as well as the letter of reporting standards.
- 4.52 The Committee wholeheartedly endorses the objectives of the Financial Reporting Council and the Accounting Standards Board in setting reporting standards. It also welcomes the action being taken by the Financial Reporting Review Panel over companies whose accounts fall below accepted reporting standards.
- 4.53 The Committee recognises the advantage to users of reports and accounts of some explanation of the factors likely to influence their company's future progress. The inclusion of an essentially forward-looking Operating and Financial Review, along the lines developed by the Accounting Standards Board for consultation, would serve this purpose.

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Reporting Practice

- 4.54 Listed companies publish full financial statements annually and half-yearly reports in the interim. In between these major announcements, boards may need to keep shareholders and the market in touch with their company's progress. The guiding principle once again is openness and boards should aim for any intervening statements to be widely circulated, in fairness to individual shareholders and to minimise the possibility of insider trading.
- 4.55 If companies reported quarterly, the need for more informal methods of keeping investors informed would be diminished. Quarterly reporting would, however, involve additional costs for companies and ultimately for their shareholders and has not been recommended to us by shareholder bodies, who accept the present pattern of reporting by boards.
- 4.56 We consider that interim reports should be expanded in order to increase their value to users. **We** recommend that:
- (a) balance sheet information should be included with the interim report. There should not be a requirement for a full audit, but the interim report should be reviewed by the auditors, who should discuss their findings with the audit committee;
 - (b) the continuing obligations laid down by the London Stock Exchange on UK companies admitted to listing should be amended to that effect and the Auditing Practices Board should develop appropriate review guidance;
 - (c) the Accounting Standards Board in conjunction with the London Stock Exchange should clarify the accounting principles which companies should follow in preparing interim reports;
 - (d) a requirement for inclusion of cash flow information in interim reports should be considered by our successor body.
- 4.57 Research has shown that the most widely read part of company reports is the opening statement, normally by the chairman. It is therefore of special importance that it should provide a balanced and readable summary of the company's performance and prospects and that it should represent the collective view of the board.

- 4.58 The demand for an ever-increasing amount of detail in reports and accounts has to be weighed against the need for them to be understandable by the reasonably informed shareholder. Simplified forms of report, including the shortened version of the accounts, allow boards to address shareholders who would prefer such a statement, but make the need for the assessment to be balanced even more exacting.
- 4.59 Although a company's published reports and its Annual General Meeting are its primary channels of communication with shareholders, companies and their major shareholders may need to be in touch more frequently. The Institutional Shareholders' Committee's Statement on the Responsibilities of Institutional Shareholders gives practical guidance on how shareholders can best exercise their responsibilities as owners in this regard. We fully endorse their recommendation that there should be regular contact between companies and their major institutional shareholders at senior level and that such matters as board strategy and structure should be kept under review.

Pensions Governance

- 4.60 There are governance issues relating to company pension funds, highlighted by the Maxwell affair, but they fall within the remit of the Pension Law Review Committee under the chairmanship of Professor Goode, which is currently reviewing the framework of pension fund legislation and regulation. In the light of this, the Committee decided that it would be inappropriate for it to deal specifically with pension fund governance issues.

Importance of Audit

- 5.1 The annual audit is one of the cornerstones of corporate governance. Given the separation of ownership from management, the directors are required to report on their stewardship by means of the annual report and financial statements sent to the shareholders. The audit provides an external and objective **check** on the way in which the financial statements have been prepared and presented, and it is an essential part of the checks and balances required. The question is not whether there should be an audit, but how to ensure its **objectivity** and **effectiveness**.
- 5.2 Audits are a reassurance to all who have a financial interest in companies, quite apart from their value to boards of directors. The most direct method of ensuring that companies are accountable for their actions is through open disclosure by boards and through audits carried out against strict accounting standards.
- 5.3 The framework in which auditors operate, however, is not well designed in certain respects to provide the objectivity which shareholders and the public expect of auditors in carrying out their function. The main reasons are as follows:
- (a) Accounting standards and practice sometimes allow boards too much scope for presenting facts and the figures derived from them in a variety of ways. Auditors cannot stand firm against a particular accounting treatment if it is permitted within the standards.
 - (b) Although the shareholders formally appoint the auditors, and the audit is carried out in their interests, the shareholders have no effective say in the audit negotiation and have no direct link with the auditors. Indeed the Committee can see no practicable way of establishing one. Auditors do, however, have to work closely with those in management who have prepared the financial statements which they are auditing in order to carry out their task, and audit firms, like any other business, will wish to have a constructive relationship with their clients.

- (c) Audit firms are in competition with each other for business. They wish to maximise their business with companies, of which auditing may only be a part. To the extent that they compete on the basis of their professional reputation, this will act as an incentive to maintain high standards. So will the ethical guidance of the profession, and the threat of litigation. To the extent however that audit firms compete on price and on meeting the needs of their clients (the companies they audit), this may be at the expense of meeting the needs of the shareholders.
 - (d) Companies too are subject to competitive pressures. They will wish to minimise their audit costs and they are likely to have a clear view as to the figures they wish to see published, in order to meet the expectations of their shareholders.
- 5.4 A further problem is the lack of understanding of the nature and extent of the auditors' role. This is the so-called 'expectations gap' – the difference between what audits do achieve, and what it is thought they achieve, or should achieve. The expectations gap is damaging not only because it reflects unrealistic expectations of audits but also because it has led to disenchantment with their value in the wake of the *Caparo* judgment (paragraphs 5.31 to 5.35 below).
- 5.5 Steps have already been taken, within the last three years, to strengthen the audit system through the establishment of a new regulatory framework. The Financial Reporting Council and its associated bodies – the Accounting Standards Board, the Urgent Issues Task Force, and the Financial Reporting Review Panel – have been set up to improve and tighten accounting standards, to deal with problem areas as they emerge, and to examine departures by individual companies from the statutory requirements and accounting standards. The new statutory regime for regulating auditors requires all auditors to satisfy a supervisory body as to their competence, experience and training, and to be subject to regular monitoring. The arrangements for setting auditing standards have also been reformed with the establishment of the Auditing Practices Board.

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- 5.6** The new system has only recently been established and its full impact has yet to be felt. In the following paragraphs we endorse the steps that are being taken and recommend additional action to strengthen public confidence in the audit approach.

Professional objectivity

- 5.7** The central issue is to ensure that an appropriate relationship exists between the auditors and the management whose financial statements they are auditing. Shareholders require auditors to work with and not against management, while always remaining professionally objective – that is to say, applying their professional skills impartially and retaining a critical detachment and a consciousness of their accountability to those who formally appoint them. Maintaining such a professional and objective relationship is the responsibility both of boards of directors and of auditors, as is that of taking appropriate action if the basis for that relationship no longer holds.
- 5.8** An essential first step must be the development of more effective accounting standards. Accounting standards provide important reference points against which auditors exercise their professional judgement. Their position is strengthened if standards do not allow alternative accounting treatments. The work of the Accounting Standards Board is well in hand and has our full support.
- 5.9** A second step should be the formation by every listed company of an audit committee which gives, the auditors direct access to the non-executive members of the board. Shareholders look to the audit committee to ensure that the relationship between the auditors and management remains objective and that the auditors are able to put their views in the event of any difference of opinion with management.

'Quarantining' audit from other services

- 5.10** Among the propositions made to the Committee to strengthen the objective relationship between auditors and management, one was that audit firms should not provide other types of service to their audit clients. The argument runs that such a prohibition would remove any pressure on the auditors to give way to management on audit matters in order not to jeopardise their other business services; and

that it would remove any incentive for auditors to take on audits at rates which could risk corner-cutting in the hope of obtaining more remunerative non-audit work.

- 5.11 Such a prohibition would limit the freedom of companies to choose their sources of advice and could increase their costs. The Committee was not persuaded that any potential gains in objectivity would outweigh these disadvantages. It does, however, strongly support full disclosure of fees paid to audit firms for non-audit work. The essential principle is that disclosure must enable the relative significance of the company's audit and non-audit fees to the audit firm to be assessed, both in a UK context and, where appropriate, a worldwide context. We **recommend** that the 1991 Regulations under the Companies Act on the disclosure of remuneration for non-audit work should be reviewed and amended as necessary in order to apply this principle. We also regard it as good practice for audit committees to keep under review the non-audit fees paid to the auditor both in relation to their significance to the auditor and in relation to the company's total expenditure on consultancy.

Rotation of auditors

- 5.12 Another proposal was that some form of compulsory rotation of audit firms should be introduced, to prevent relationships between management and auditors becoming too comfortable. The Committee felt that any advantages which this could bring would be more than outweighed by the loss of the trust and experience which are built up when the relationships are sound, and by the risk to audit effectiveness at the changeover. The Committee agreed, however, that in the case of listed companies a periodic change of audit partners should be arranged to bring a fresh approach to the audit. We recommended in our draft report that the accountancy profession should draw up appropriate guidelines and we support the steps which it is now taking to do so. We would expect the guidelines to allow a measure of flexibility over timing to take account of the incidence of other changes in senior personnel, both in the audit team and in the client company, which have helped to keep a distinction in relationships between client and auditor.

Ways to increase effectiveness and value of the audit

The 'Expectations Gap'

- 5.13 An essential first step is to be clear about the respective responsibilities of directors and auditors for preparing and reporting on the financial statements of companies, in order to begin to narrow the 'expectations gap'.
- 5.14 The auditors' role is to report whether the financial statements give a true and fair view, and the audit is designed to provide a reasonable assurance that the financial statements are free of material misstatements. The auditors' role is not (to cite a few of the misunderstandings) to prepare the financial statements, nor to provide absolute assurance that the figures in the financial statements are correct, nor to provide a guarantee that the company will continue in existence. The Auditing Practices Board is at present developing proposals for an expanded report which would describe the key features of the audit process. The Committee supports this initiative. Auditors' reports should state clearly the auditors' responsibilities for reporting on the financial statements, as a counterpart to a statement of directors' responsibilities for preparing the financial statements (see paragraph 4.28 above).
- 5.15 The Committee strongly supports the lead which the Auditing Practices Board is taking on the development of auditing practice generally. We believe that there should be an extension of the audit which will add to its value to all users of accounts and bring it closer into line with public expectations. We discuss below some of the proposals currently under consideration and have set out background information on the current rules at *Appendix 5*. Widening the scope of the audit is likely to require boards to widen the scope of their reports, since auditors can normally only audit matters on which the directors have themselves reported.

Internal Control

5.16 The Committee is convinced that an effective internal control system is an essential part of the efficient management of a company. We have already recommended that directors should report on the effectiveness of their system of internal control, and that the auditors should report on their statement. A great deal of detailed work is now necessary to develop these proposals, and we recommend that the accountancy profession, in conjunction with representatives of preparers of accounts, should take the lead in:

- (a) developing a set of criteria for assessing effectiveness;
- (b) developing guidance for companies on the form in which directors should report; and
- (c) developing guidance for auditors on relevant audit procedures and the form in which auditors should report.

5.17 We recommend that the question of legislation to back these developments should be decided in the light of experience.

Going Concern

5.18 Under company law, accounts are prepared on the assumption that the company is a going concern. There is, however, no explicit requirement for directors to satisfy themselves that it is reasonable to make this assumption, for example by the preparation of an adequate cash flow forecast. There is also scope for amending auditing guidelines to require the auditor to take a more active role in testing going concern assumptions.

5.19 In view of the understandable public criticism of the audit process when companies collapse without apparent warning, there are strong arguments for amending company law to place an explicit requirement on directors to satisfy themselves that the going concern basis is appropriate, and to report accordingly to shareholders. There is also a strong case for extending the scope of the audit, to test going concern assumptions more specifically, and for requiring the auditors to give an opinion on the directors' report. Many proposals have been made to the Committee along these lines.

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5.20 The Committee believes that going concern problems are more likely to be addressed successfully if they are identified early. There are, however, two grounds for concern:

- (a) There must be a risk that any qualification about the company's financial viability, however it is expressed, will precipitate the company's collapse. There is a fine balance to be drawn between drawing proper attention to the conditions on which continuation of the business depends, and not thereby bringing the business down.
- (b) The Committee does not believe that the implications of the legal presumption that the accounts are prepared on a going concern basis are widely understood by directors. In particular the Committee doubts that it is generally appreciated that 'going concern' is interpreted in present auditing guidelines as meaning that the company will still be operating six months following the date of the audit report or one year after the date of the balance sheet, whichever is the later. This may be further ahead than many companies can see, for example in a recession.

5.21 The Committee concludes that as a fundamental concept of accounting the going concern principle should be conscientiously applied and that new guidelines should be developed. It emphasises however that new guidelines must strike a careful balance between drawing proper attention to the conditions on which the continuation of the business depends, and not requiring directors to express unnecessarily cautious reservations that could of themselves jeopardise the business. Directors should be required to satisfy themselves that the business is a going concern on the basis that they have a **reasonable expectation** that it will continue in operation for the time period which the guidelines define. Directors should not be expected to give a firm guarantee about their company's prospects because there can never be complete certainty about future trading. The guidelines should also recognise the position of' smaller companies.

5.22 The Committee **recommends** that:

- (a) directors should state in the report and accounts that the business is a going concern, with supporting assumptions or qualifications as necessary;
- (b) the auditors should report on this statement;
- (c) the accountancy profession in conjunction with representatives of preparers of accounts should take the lead in developing guidance for companies and auditors;
- (d) the question of Legislation should be decided in the light of experience.

Fraud

5.23 The prime responsibility for the prevention and detection of fraud (and other illegal acts) is that of the board, as part of its fiduciary responsibility for protecting the assets of the company. The auditor's responsibility, as defined in auditing guidance, is 'properly to plan, perform and evaluate his audit work so as to have a reasonable expectation of detecting material misstatements in the financial statements'.

5.24 One problem for the auditors is that by its very nature fraud, if it involves forgery, collusion or management override of control systems, is hard to detect. It is no solution, as some have suggested, simply to place a duty on the auditor to detect material fraud because he will never be in a position to guarantee that no such fraud has taken place. A higher level of safeguard against some categories of fraud can be attempted by carrying out a more extensive audit, but at a cost. The question is whether that extra cost is justified.

5.25 Another problem for the auditors is when they suspect that top management itself is implicated in the fraud, without having the necessary evidence to back up their suspicions. They are not in a strong enough position to confront management, nor have they a case to report to the appropriate authorities.

5.26 These are not easy problems to resolve, but an effective and independent-minded audit committee is an essential safeguard. It has an important role to play in considering

whether any extra work should be undertaken in addition to the normal audit procedures to investigate defences against fraud, and in reviewing reports on the adequacy of internal control systems. The audit committee also provides a forum in which auditors can discuss at board level any concern they may have about the possibility of fraud by senior management. It can then commission whatever investigations are necessary to resolve the matter.

- 5.27 One proposal made to the Committee was that auditors should have a duty to report fraud to the appropriate authorities. The auditor's duty is normally to report fraud to senior management (see *Appendix 5*). Where, however, he no longer has confidence that senior management will deal adequately with the matter, he is encouraged by professional guidance to report fraud to the proper authorities. Lord Justice Bingham, in his recent report on BCCI, has recommended that in the case of banks it would be better for there to be a statutory duty, and the Government, in accepting the recommendation, has announced that a similar approach will be extended to the rest of the regulated sector (namely building societies, insurance, and investment business).
- 5.28 The Committee does not recommend that a statutory duty to report fraud should be extended beyond the regulated sector to the generality of companies. The Committee does however see scope for extending to the auditors of all companies the statutory provisions applying to auditors in the regulated sector which enable them to report reasonable suspicion of fraud freely to the appropriate investigatory authorities. This would strengthen the position of auditors who report fraud against the risk of a suit brought against them by their client for (for example) breach of duty to maintain a confidential client relationship or defamation. We recommend that the Government should consider introducing legislation accordingly.

Other illegal Acts

- 5.29 Companies are now subject to a wide range of legal requirements, many of which fall outside the scope of an audit of the financial statements. Auditing guidance on the respective responsibilities of management and the auditor is in preparation but there are a number of difficult issues on which there is no clear consensus at present.

5.30 The Committee's view is that it is the responsibility of boards to establish what their legal duties are and to ensure that they monitor compliance with them. It is also our view that this would be enhanced if the auditors' role were to check that boards had established their legal requirements and that a working system for monitoring compliance was in place. There would be difficulty in ascribing a wider role to auditors, for example requiring them to investigate any identified failures in the system and any suspected illegal acts which are encountered, because they are unlikely to have the appropriate expertise. They will not know the legal requirements in fields which are outside their scope, nor are they likely to have the expertise to investigate the legality of particular acts if their suspicions are aroused. We recommend that this subject should be further considered by the accountancy and legal professions and representatives of preparers of accounts.

Auditors' Liability

5.31 In the *Caparo* judgment, the House of Lords laid down that auditors owed a legal duty of care to the company and to the shareholders collectively, but not to the shareholders as individuals nor to third parties. It was established in particular that in the absence of special features, no duty of care was owed to subscribers to new shares (whether existing shareholders or not), purchasers or intending purchasers of shares from third parties including those conducting takeover bids, bankers or other lenders, or persons doing business with the company.

5.32 A discussion of the principles established by the *Caparo* case is at *Appendix 6*. The case has aroused controversy because it exposed two widely held misconceptions:

- (a) that the audit report is a guarantee as to the accuracy of the accounts, and perhaps even as to the soundness of the company;
- (b) that anyone (including investors and creditors) can rely on the audit, not only in a general sense but also very specifically by being able to sue the auditors if they are negligent.

In deciding the case, the House of Lords studied with great **care the complex** issues involved in balancing the interests of the parties involved and the public interest in having a

fair, viable and affordable system. The size of auditors' potential liabilities, the difficulties in defining wider liability in any fair yet practicable way, and the likely difficulties in establishing whether third party losses were in fact due to reliance on the accounts were among the principal concerns underlying the conclusions reached by the House of Lords. Rearing in mind the wide range of users of accounts, the Committee is unable to see how the House of Lords could have broadened the boundaries of the auditors' legal duty of care without giving rise (in the words of Cardozo CJ deciding a case in 1931 and frequently quoted since) 'to a liability in an indeterminate amount for an indeterminate time to an indeterminate class'. Nor, in consequence, do we recommend that the legal position with regard to civil liability laid down by *Caparo* should be altered by statute at the present time.

5.33 In coming to this conclusion, we recognise that the current position is a source of concern to both auditors and investors. There are two main reasons:

- (a) the scale of existing litigation against auditors or former auditors. Auditors are fully liable in negligence to the companies they audit and their shareholders collectively, and *Caparo* has not changed this. The size of settlements has been increasing in Britain and auditors are concerned that this trend may continue;
- (b) the belief of some that, notwithstanding *Caparo*, auditors should in principle be liable to those (such as individual investors and creditors) who rely on audited accounts.

Auditors are naturally concerned about the increased litigation that would result if their liability were extended to other accounts users. They are also concerned about increased litigation that could arise from adapting the audit to meet changing needs and expectations – a process which the Committee's report itself is intended to encourage.

5.34 Proponents of change argue that a better balance between the interests of the parties involved would be achieved if auditors' duty of care were to be extended on a defined basis, but at the same time the present system under which auditors can be liable for the full loss caused were to be replaced by one of proportionate liability, and/or a ceiling were placed on auditors' liability. There would, however, be major problems over such changes, some of which are

outlined in *Appendix 6*. Changes could not be undertaken without a detailed review and wide consultation and might well require major legal reform.

- 5.35 At present there is no consensus on a satisfactory way of reconciling the conflicting interests of all those involved. As the debate on the nature and extent of auditors' liability continues, however, the Committee will keep watch on developments.

Audit Confidence

- 5.36 The accounting profession has done much recently to improve its standards and procedures. It is essential that this effort should continue. We welcome the initiatives which are being taken on professional conduct issues – particularly the profession's ethical rules and disciplinary arrangements. We also support the work which is being done by the profession's Joint Ethics Committee to tackle problem areas such as opinion shopping and partner rotation. A lead on these and other matters such as audit tendering will strengthen the standing and independence of auditors.
- 5.37 We have indicated our strong support for tighter accounting standards, effective audit committees, rigorous and objective auditing and action by the accountancy profession to improve and enforce auditing standards. This combination of actions uncompromisingly pursued will enhance the perceived value of the audit system.

Accountability of Boards to Shareholders

- 6.1 The formal relationship between the shareholders and the board of directors is that the shareholders elect the directors, the directors report on their stewardship to the shareholders and the shareholders appoint the auditors to provide an external check on the directors' financial statements. Thus the shareholders as owners of the company elect the directors to run the business on their behalf and hold them accountable for its progress. The issue for corporate governance is how to strengthen the accountability of boards of directors to shareholders.
- 6.2 A number of proposals addressing this issue were put forward by individual shareholders and shareholder organisations. One was that shareholders should be more closely involve-d in the appointment of directors and auditors through the formation of shareholders' committees. Other proposals were directed at making it easier for shareholders, individually or collectively, to put forward resolutions at general meetings.
- 6.3 On the first proposal, we have not seen evidence explaining how it would be possible to form shareholder committees in such a way that they would be both truly representative of all the company's shareholders and able to keep in regular touch with their changing constituencies. Unless these tests of legitimacy are met, the Committee is unable to see how shareholder committees can become the accepted link between a board and its shareholders.
- 6.4 The second set of proposals raises such questions as what legislation would be needed to alter the present thresholds for tabling shareholder resolutions, and where the costs involved in circulating shareholder communications should fall. How far these suggestions are followed up should depend, in the Committee's view, on the degree of support which they command from the shareholder body as a whole. This may be a matter which our successor body will wish to review,
- 6.5 In the meantime, shareholders can make their views known to the boards of the companies in which they have invested by communicating with them direct and through their attendance at general meetings. Shareholder organisations set up to represent shareholder interests generally may provide individual shareholders with the choice of acting

collectively in the case of particular companies if they prefer.

- 6.6 Shareholders have delegated many of their responsibilities as owners to the directors who act as their stewards. It is for the shareholders to call the directors to book if they appear to be failing in their stewardship and they should use this power. While they cannot be involved in the direction and management of their company, they can insist on a high standard of corporate governance and good governance is an essential test of the directors' stewardship. The accountability of boards to shareholders will, therefore, be strengthened if shareholders require their companies to comply with the Code.
- 6.7 Reports and accounts are presented to shareholders at the Annual General Meeting, when they have the opportunity to comment on them and to put their questions. In particular, the Annual General Meeting gives all shareholders, whatever the size of their shareholding, direct and public access to their boards. If too many Annual General Meetings are at present an opportunity missed, this is because shareholders do not make the most of them and, in some cases, boards do not encourage them to do so.
- 6.8 In the Committee's view, both shareholders and boards of directors should consider how the effectiveness of general meetings could be increased and as a result the accountability of boards to all their shareholders strengthened. Possible ways forward include providing forms in annual reports on which shareholders could send in written questions in advance of the meeting, in addition to their opportunity to ask questions at the meeting itself, and the circulation of a brief summary of points raised at the Annual General Meeting to all shareholders after the event. Consideration might also be given to ways of boards keeping in touch with their shareholders, outside the annual and half-yearly reports. The Committee encourages boards to experiment with ways of improving their links with shareholders along the above lines and shareholders to put proposals to their boards to the same end.

THE SHAREHOLDERS

Institutional Shareholders

- 6.9** The proportion of shares held by individuals and by institutions has broadly reversed over the last thirty years, so that institutional shareholders now own the majority of shares of quoted companies. They are, however, largely holding their shares on behalf of individuals, as members of pension funds, holders of insurance policies and the like. As a result, there is an important degree of common interest between individual and institutional shareholders. In particular, both have the same stake in the standards of financial reporting and of governance in the companies in which they have invested.
- 6.10** Given the weight of their votes, the way in which institutional shareholders use their power to influence the standards of corporate governance is of fundamental importance. Their readiness to do this turns on the degree to which they see it as their responsibility as owners, and in the interest of those whose money they are investing, to bring about changes in companies when necessary, rather than selling their shares.
- 6.11** The Committee, therefore, warmly welcomes the statement recently published by the Institutional Shareholders' Committee on the Responsibilities of Institutional Shareholders in the UK and we draw attention to three key conclusions which are basic to the development of a constructive relationship between companies and their owners.
- 1 Institutional investors should encourage regular, systematic contact at senior executive level to exchange views and information on strategy, performance, board membership and quality of management.
 - 2 institutional investors should make positive use of their voting rights, unless they have good reason for doing otherwise. They should register their votes wherever possible on a regular basis.
 - 3 Institutional investors should take a positive interest in the composition of boards of directors, with particular reference to concentrations of decision-making power not formally constrained by appropriate

checks and balances, and to the appointment of a core of non-executive directors of the necessary calibre, experience and independence.

- 6.12 The Institutional Shareholders' Committee's advice to its members to use their voting rights positively is important in the context of corporate governance. Voting rights can be regarded as an asset, and the use or otherwise of those rights by institutional shareholders is a subject of legitimate interest to those on whose behalf they invest. We recommend that institutional investors should disclose their policies on the use of voting rights.

Shareholder Communications

- 6.13 These conclusions on the role of institutional shareholders raise issues over the lines of communication between boards and their shareholders. The first issue is one of parity between shareholders. The institutions are in a position to keep in touch with the boards of the companies in which they have invested, in a way which is not feasible for the individual shareholder. It is not possible in this respect to put both classes of shareholder on the same footing. What boards must do, however, is to ensure that any significant statements concerning their companies are made publicly and so are equally available to all shareholders.
- 6.14 A second issue which arises over communications between institutional investors and companies is the danger of imparting inside information. If price-sensitive information is to be given (and it is the company's responsibility to decide what might be price-sensitive), it must only be with the prior consent of the shareholder, who will then be unable to deal in the company's shares until that information has been made public. It is for shareholders to decide whether their longer-term interests are impaired by becoming insiders, because of the short-term constraints on share dealing which that position imposes.
- 6.15 If long-term relationships are to be developed, it is important that companies should communicate their strategies to their major shareholders and that their shareholders should understand them. It is equally important that shareholders should play their part in the communication process by informing companies if there are

THE SHAREHOLDERS

aspects of the business which give them cause for concern. Both shareholders and directors have to contribute to the building of a sound working relationship between them.

Shareholder Influence

6.16 Because of the importance of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholders' Committee, to use their influence as owners to ensure that the companies in which they have invested comply with the Code. The widespread adoption of our recommendations will turn in large measure on the support which all shareholders give to them. The obligation on companies to state how far they comply with the Code provides institutional and individual shareholders with a ready-made agenda for their representations to boards. It is up to them to put it to good use. The Committee is primarily looking to such market-based regulation to turn its proposals into action.

- 7.1 The Committee's proposals are mutually supportive and should be taken as a whole. The Code reflects existing best practice and few of our recommendations require legislation. We believe that they will reinforce good corporate governance without stifling entrepreneurial initiative.
- 7.2 No system of corporate governance can be totally proof against fraud or incompetence. The test is how far such aberrations can be discouraged and how quickly they can be brought to light. The risks can be reduced by making the participants in the governance process as effectively accountable as possible. The key safeguards are properly constituted boards, separation of the functions of chairman and of chief executive, audit committees, vigilant shareholders and financial reporting and auditing systems which provide full and timely disclosure.
- 7.3 Although the great majority of companies are both competently run and audited under the present system of corporate governance, it is widely accepted that standards within the corporate sector have to be raised.
- 7.4 The way forward is through clear definitions of responsibility and an acceptance by all involved that the highest standards of efficiency and integrity are expected of them. Expectations of corporate behaviour are continually rising and a corresponding response is looked for from shareholders, directors and auditors. The machinery is in place. What is needed is the will to improve its effectiveness.
- 7.5 This will involve a sharper sense of accountability and responsibility all round – accountability by boards to their shareholders, responsibility on the part of all shareholders to the companies they own. and, accountability by professional officers and advisers to those who rely on their judgement. All three groups have a common interest in combining to improve the working of the corporate system.

SUMMARY OF RECOMMENDATIONS

Compliance with the Code of Best Practice

- 1** The boards of all listed companies registered in the UK should comply with the Code of Best Practice set out on pages 58 to 60. As many other companies as possible should aim at meeting its requirements (paragraph 3.1).
- 2** Listed companies reporting in respect of years ending after 30 June 1993 should make a statement about their compliance with the Code in the report and accounts and give reasons for any areas of non-compliance (paragraph 3.7).
- 3** Companies' statements of compliance should be reviewed by the auditors before publication. The review should cover only those parts of the compliance statement which relate to provisions of the Code where compliance can be objectively verified. The Auditing Practices Board should consider guidance for auditors accordingly (paragraph 3.9).
- 4** All parties concerned with corporate governance should use their influence to encourage compliance with the Code (paragraph 3.14). Institutional shareholders in particular, with the backing of the Institutional Shareholders' Committee, should use their influence as owners to ensure that the companies in which they have invested comply with the Code (paragraph 6.16).

Keeping the Code up to date

- 5** The Committee's sponsors, convened by the Financial Reporting Council, should appoint a new Committee by the end of June 1995 to examine how far compliance with the Code has progressed, how far our other recommendations have been implemented, and whether the Code needs updating. Our sponsors should also determine whether the sponsorship of the new Committee should be broadened and whether wider matters of corporate governance should be included in its brief. In the meantime the present Committee will remain responsible for reviewing the implementation of its proposals (paragraph 3.12).
-

SUMMARY OF RECOMMENDATIONS

Directors' service contracts

- 6 The Companies Act should be amended to come into line with the requirement of the Code that directors' service contracts should not exceed three years without shareholders' approval (paragraph 4.41).

Interim reporting

- 7 Companies should expand their interim reports to include balance sheet information. The London Stock Exchange should consider amending the continuing obligations accordingly. There should not be a requirement for a full audit, but interim reports should be reviewed by the auditors and the Auditing Practices Board should develop appropriate guidance. The Accounting Standards Board in conjunction with the London Stock Exchange should clarify the accounting rules which companies should follow in preparing interim reports. The inclusion of cash flow information should be considered by the Committee's successor body (paragraph 4.56).

Enhancing the perceived objectivity of the audit

- 8 Fees paid to audit firms for non-audit work should be fully disclosed. The essential principle is that disclosure should enable the relative significance of the company's audit and non-audit fees to the audit firm to be assessed, both in a UK context and, where appropriate, a worldwide context. The 1991 Regulations under the Companies Act should be reviewed and amended as necessary (paragraph 5.1 I).
- 9 The accountancy profession should draw up guidelines on the rotation of audit partners (paragraph 5.12).

Enhancing the effectiveness of the audit

- 10 Directors should report on the effectiveness of their system of internal control, and the auditors should report on their statement. The accountancy profession together with representatives of preparers of accounts should draw up criteria for assessing effective systems of internal control and guidance for companies and auditors (paragraphs 4.32 and 5.16).

SUMMARY OF RECOMMENDATIONS

- 11 Directors should state in the report and accounts that the business is a going concern, with supporting assumptions or qualifications as necessary, and the auditors should report on this statement. The accountancy profession together with representatives of preparers of accounts should develop guidance for companies and auditors (paragraph 5.22).
- 12 The question of legislation to back the recommendations on additional reports on internal control systems and going concern should be decided in the light of experience (paragraphs 5.17 and 5.22).
- 13 The Government should consider introducing legislation to extend to the auditors of all companies the statutory protection already available to auditors in the regulated sector (banks, building societies, insurance, and investment business) so that they can report reasonable suspicion of fraud freely to the appropriate investigatory authorities (paragraph 5.28).
- 14 The accountancy profession together with the legal profession and representatives of preparers of accounts should consider further the question of illegal acts other than fraud (paragraph 5.30).
- 15 The accounting profession should continue its efforts to improve its standards and procedures so as to strengthen the standing and independence of auditors (paragraph 5.36).

Voting by institutional investors

- 16 Institutional investors should disclose their policies on the use of their voting rights (paragraph 6.12).

SUMMARY OF RECOMMENDATIONS

Endorsement of work by others

- 17** The Committee gives its full support to the objectives of the Financial Reporting Council and the Accounting Standards Board. It welcomes the action by the Financial Reporting Review Panel over companies whose accounts fall below accepted reporting standards (paragraphs 4.52 and 5.8).
- 18** The Committee supports the initiative of the Auditing Practices Board on the development of an expanded audit report. It also gives its full support to the lead which it is taking on the development of auditing practice generally (paragraphs 5.14 and 5.15).
- 19** The Committee welcomes the statement by the Institutional Shareholders' Committee on the Responsibilities of Institutional Shareholders in the UK (paragraph 6.1 1).

Issues for the Committee's successor body

- 20** Issues which the Committee has identified that its successor body may wish to review or consider in greater depth include: the application of the Code to smaller listed companies (paragraph 3. 15); directors' training (paragraph 4.20); the rules for disclosure of directors' remuneration, and the role which shareholders could play (paragraph 4.46); a requirement for inclusion of cash flow information in interim reports (paragraph 4.56); and the procedures for putting forward resolutions at general meetings (paragraph 6.4). The Committee and its successor will also keep watch on developments regarding the nature and extent of auditors' liability (paragraph 5.35).

1 The Board of Directors

- 1.1 The board should meet regularly, retain full and effective control over the company and monitor the executive management.
- 1.2 There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board, with a recognised senior member.
- 1.3 The board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions.
- 1.4 The board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands.
- 1.5 There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense.
- 1.6 All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are followed and that applicable rules and regulations are complied with. Any question of the removal of the company secretary should be a matter for the board as a whole.

2 Non-Executive Directors

- 2.1 Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.
- 2.2 The majority should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. apart from their fees and shareholding. Their fees should reflect the time which they commit to the company.

THE CODE OF BEST PRACTICE

2.3 Non-executive directors should be appointed for specified terms and reappointment should not be automatic.

2.4 Non-executive directors should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole.

3 Executive Directors

3.1 Directors' service contracts should not exceed three years without shareholders' approval.

3.2 There should be full and clear disclosure of directors' total emoluments and those of the chairman and highest-paid UK director, including pension contributions and stock options. Separate figures should be given for salary and performance-related elements and the basis on which performance is measured should be explained.

3.3 Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors.

4 Reporting and Controls

4.1 It is the board's duty to present a balanced and understandable assessment of the company's position.

4.2 The board should ensure that an objective and professional relationship is maintained with the auditors.

4.3 The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties.

4.4 The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities.

4.5 The directors should report on the effectiveness of the company's system of internal control.

4.6 The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

THE CODE OF BEST PRACTICE

Footnote

The company's statement of compliance should be reviewed by the auditors in so far as it relates to paragraphs 1.4, 1.5, 2.3, 2.4, 3.1 to 3.3, and 4.3 to 4.6 of the Code.

THE COMMITTEE'S MEMBERSHIP AND TERMS OF REFERENCE

APPENDIX 1

Terms of Reference

The Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession. It adopted as its terms of reference:

To consider the following issues in relation to financial reporting and accountability and to make recommendations on good practice:

- (a) the responsibilities of executive and non-executive directors for reviewing and reporting on performance to shareholders and other financially interested parties; and the frequency, clarity and form in which information should be provided;
- (b) the case for audit committees of the board, including their composition and role;
- (c) the principal responsibilities of auditors and the extent and value of the audit;
- (d) the links between shareholders, boards, and auditors;
- (e) any other relevant matters.

Membership

The Committee's members were as follows:

Sir Adrian Cadbury (Chairman)

Ian Butler

Council Member. CBI and former Chairman, CBI Companies Committee

Jim Butler

Senior Partner, KPMG Peat Marwick

Jonathan Charkham

Adviser- to the Governor, Bank of England

Hugh Collum

Chairman. Hundred Group of Finance Directors

Sir Ron Dearing

Chairman, Financial Reporting Council

THE COMMITTEE'S MEMBERSHIP AND TERMS OF REFERENCE

Andrew Likierman

Professor of Accounting and Financial Control, London Business School

Nigel Macdonald

Vice President, Institute of Chartered Accountants of Scotland

Mike Sandland

Chairman, Institutional Shareholder-s' Committee

Mark Sheldon

President, Law Society

Sir Andrew Hugh Smith

Chairman, London Stock Exchange

Sir Dermot de Trafford, Bt

Chairman, Institute of Directors

Observers: Mrs Sarah Brown (until October 1991), Mr Arthur Russell (from November 1991), *Head of Companies Division, DTI*

Secretary: Nigel Peace (on *secondment from DTI*)

Sir Christopher Hogg (*Chair-man, Reuters Holdings PLC, Courtaulds plc, and Courtaulds Textiles plc*) acted as an adviser to the Committee.

NOTES ON THE ROLE OF SOME OF THE BODIES REFERRED TO IN THE REPORT

APPENDIX 2

Auditing Practices Board

- 1 The Auditing Practices Board is responsible for the standards.
from the Auditing Practices Committee in 1991.
has outside representation and the ability to issue auditing

Financial Reporting Review Panel

- 2 The Financial Reporting Council was set up in 1990 to establish and support the two bodies under its aegis, the Accounting Standards Board and the Financial Reporting Review Panel, and to promote good financial reporting generally. The three bodies draw their funding broadly equally from the accountancy profession, the City, and the Government.
- 3 The role of the Accounting Standards Board is to make, amend, and withdraw accounting standards. It took over from the former Accounting Standards Committee on 1 August 1990. The Board is autonomous – although it consults widely on its proposals, it does not need outside approval for its actions.
- 4 The Secretary of State has authorised the Financial Reporting Review Panel to examine departures from the accounting requirements of the Companies Act 1985 and if necessary to seek an order from the court to remedy them. The Panel's ambit is public and large private companies, the Department of Trade and Industry dealing with all other cases. The Panel's main focus is on material departures from accounting standards where this results in the accounts in question not giving a true and fair view as required by law. Where a company's accounts are defective the Panel will, wherever possible, endeavour to secure revision by voluntary means; but if this approach fails it will make an application to the court for an order compelling the revision. Where accounts are revised at the insistence of the Panel, but the company's auditors have not qualified their audit report on the defective accounts,

THE ROLE OF BODIES REFERRED TO IN THE REPORT

the panel will draw this fact to the attention of the auditors' professional body.

Institutional Shareholders' Committee

- 5 The Institutional Shareholders' Committee (ISC) has five members: the Association of British Insurers, the National Association of Pension Funds, the Association of Investment Trust Companies, the British Merchant Banking and Securities Houses Association, and the Unit Trust Association. Together they represent the overwhelming majority of institutional shareholders in the UK. The ISC provides a channel of communication and forum for discussion between institutional shareholders, corporate management and others on wider issues. It also seeks to identify areas of common ground amongst its members and thereafter to promulgate those jointly held views. It does not normally become involved in matters concerned with particular investments or companies.

London Stock Exchange

- 6 The London Stock Exchange is empowered through its Competent Authority status to grant listings of securities under the Financial Services Act 1986 and it has responsibility for the Unlisted Securities Market.
- 7 The Exchange through its rules contained in the Admission of Securities to Listing (often known as the 'Yellow Book') requires issuers of securities not only to meet certain disclosure requirements at the time of listing but also to comply with a number of continuing obligations. The purpose of this is to ensure that all potentially price-sensitive information, or information about the company which might have an effect on its share price or trading in its shares, is released to the market promptly. These requirements impose specific content and timing requirements in relation to the issuer's interim and final accounts and impose guidelines governing dealings by directors of listed companies in their own companies' securities.

THE ROLE OF BODIES REFERRED TO IN THE REPORT

The Hundred Group of Finance Directors

- 8** The Hundred Group of Finance Directors has approximately one hundred and forty members, including more than 90% of the finance directors of those companies included in the FT-SE 100 and also those with the highest market capitalisation.

- 9** The main purpose of The Hundred Group is to provide a forum for discussion and to make contributions and representations on issues of importance for financial management. Members are actively involved to ensure that the views of users and preparers of accounts are fully understood. Submissions are made to Government and other organisations highlighting the practical implications of existing financial procedures, related legislation and proposed changes.

STATEMENT OF DIRECTORS' RESPONSIBILITY FOR PREPARING THE ACCOUNTS

APPENDIX 3

- 1 In paragraph 4.28 of the report, and in the Code of Best Practice, the Committee recommends that a brief statement of directors' responsibility for preparing the accounts should appear in the report and accounts. The purpose of such a statement is to make clear that responsibility for preparing the accounts rests with the board of directors, and to remove any misconception that the auditors are responsible for the accounts. The directors' statement should be placed immediately before the auditors' report which in future will include a separate statement (currently being developed by the Auditing Practices Board) on the responsibility of the auditors for expressing an opinion on the accounts. Positioning the two statements alongside each other in this way will achieve maximum clarity about respective responsibilities.

- 2 The explanation of directors' responsibilities will require a relatively formal statement, which should cover the following points:
 - (a) the legal requirement for directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company (or group) as at the end of the financial year and of the profit and loss for that period;
 - (b) the responsibility of the directors for maintaining adequate accounting records, for safeguarding the assets of the company (or group), and for preventing and detecting fraud and other irregularities;
 - (c) confirmation that suitable accounting policies, consistently applied and supported by reasonable and prudent judgements and estimates, have been used in the preparation of the financial statements;
 - (d) confirmation that applicable accounting standards have been followed, subject to any material departures disclosed and explained in the notes to the accounts.

- 3 Boards may also wish to use the above statement as a vehicle for reporting that they have maintained an effective system of internal control, and that the business is a going concern, with supporting assumptions or qualifications as necessary, once the necessary guidance on these subjects has been developed (see paragraphs 5.16 and 5.22 of the main report).

DIRECTOR'S RESPONSIBILITY STATEMENT

4

statement in the notes to the accounts disclosing whether the accounts have been prepared in accordance with applicable accounting standards.

AUDIT COMMITTEES

APPENDIX 4

- 1 In the main body of the report the Committee recommends that all listed companies which have not already done so should establish an audit committee, and places great emphasis on the importance of properly constituted audit committees in raising standards of corporate governance.
- 2 Many UK companies already have an audit committee, and a recent research study ('Audit Committees in the United Kingdom', published by the ICAEW, April 1992) has found a steady growth in their number. Audit Committees are now established in 53% of the top 250 industrial firms in the Times 1000, and the figure rises to 66% if unlisted companies and foreign subsidiaries are excluded from the calculation. Most major UK listed financial institutions have also formed an audit committee.
- 3 Audit Committees are well established in the United States, where they have been a listing requirement of the New York Stock Exchange since 1978. A 1989 study revealed that 97% of major corporations had them. In Canada, they are a legal requirement.
- 4 If they operate effectively, audit committees can bring significant benefits. In particular, they have the potential to:
 - (a) improve the quality of financial reporting, by reviewing the financial statements on behalf of the Board;
 - (b) create a climate of discipline and control which will reduce the opportunity for fraud;
 - (c) enable the non-executive directors to contribute an independent judgement and play a positive role;
 - (d) help the finance director., by providing a forum in which he can raise issues of concern, and which he can use to get things done which might otherwise be difficult;
 - (e) strengthen the position of the external auditor, by providing a channel of communication and forum for issues of concern;
 - (f) provide a framework within which the external auditor can assert his independence in the event of a dispute with management;

AUDIT COMMITTEES

for the board to decide in individual cases whether this definition is met.

- (c) The external auditor and, where an internal audit function exists, the head of internal audit should normally attend audit committee meetings, as should the finance director. Other board members should also have the right to attend.
- (d) The committee should have a discussion with the auditors, at least once a year, without executive board members present, to ensure that there are no unresolved issues of concern.
- (e) The audit committee should have explicit authority to investigate any matters within its terms of reference, the resources which it needs to do so, and full access to information. The committee should be able to obtain outside professional advice and if necessary to invite outsiders with relevant experience to attend meetings.
- (f) Membership of the committee should be disclosed in the annual report and the chairman of the committee should be available to answer questions about its work at the Annual General Meeting.

7 Specimen terms of reference for an audit committee, compiled from the many examples that are available, are annexed. They are intended simply as a guide for companies who will wish to adapt and build on them to suit their own circumstances. They will particularly need tailoring for group rather than single company audit committees. The list of duties in the annex reflects the most commonly performed duties in the UK and the US but no single set of duties has emerged as standard practice.

8 There are many excellent publications on audit committees. The Committee's objective is not to rewrite them but to secure the widespread adoption of best practice. For further discussion of the duties and functioning of audit committees, readers are referred in particular to:

AUDIT COMMITTEES

- **Chapter 3 of the Report by the Institute of Chartered Accountants of Scotland 'entitled 'Corporate Governance – Directors' Responsibilities for Financial Statements', February 1992**
- **Guidance booklets produced by individual firms of accountants**
- **Chapter 2, section IV of the Report of the National Commission on Fraudulent Financial Reporting (the Treadway Commission), USA, October 1987**
- **'Audit Committees in the United Kingdom' by P. Collier, published by the Institute of Chartered Accountants of England and Wales, April 1992.**

AUDIT COMMITTEES

ANNEX

Specimen Terms of Reference for an Audit Committee

FOR GUIDANCE ONLY

Constitution

- 1 The Board hereby resolves to establish a Committee of the Board to be known as the Audit Committee.

Membership

- 2 The Committee shall be appointed by the Board from amongst the Non-Executive Directors of the Company and shall consist of not less than three members. A quorum shall be two members.
- 3 The Chairman of the Committee shall be appointed by the Board.

Attendance at meetings

- 4 The Finance Director, the Head of Internal Audit, and a representative of the external auditors shall normally attend meetings. Other Board members shall also have the right of attendance. However, at least once a year the Committee shall meet with the external auditors without executive Board members present.
- 5 The Company Secretary shall be the Secretary, of the Committee.

Frequency of meetings

- 6 Meetings shall be held not less than twice a year. The external auditors may request a meeting if they consider that one is necessary.

Authority

- 7 The Committee is authorised by the Board to **investigate** any activity within its terms of reference. It is authorised to seek any information it requires from any employee and all employees are directed to co-operate with any request made by the Committee.

- 8 The Committee is authorised by the Board to obtain outside legal or other independent professional advice and to secure the attendance of outsiders with relevant experience and expertise if it considers this necessary.

Duties

- 9 The duties of the Committee shall be:
- (a) to consider the appointment of the external auditor, the audit fee, and any questions of resignation or dismissal;
 - (b) to discuss with the external auditor before the audit commences the nature and scope of the audit, and ensure co-ordination where more than one audit firm is involved;
 - (c) to review the half-year and annual financial statements before submission to the Board, focusing particularly on:
 - (i) any changes in accounting policies and practices
 - (ii) major judgemental areas
 - (iii) significant adjustments resulting from the audit
 - (iv) the going concern assumption
 - (v) compliance with accounting standards
 - (vi) compliance with stock exchange and legal requirements.
 - (d) to discuss problems and reservations arising from the interim and final audits, and any matters the auditor may wish to discuss (in the absence of management where necessary);
 - (e) to review the external auditor's management letter and management's response;
 - (f) to review the Company's statement on internal control systems prior to endorsement by the Board;
 - (g) (where an internal audit function exists) to review the internal audit programme, ensure co-ordination between the internal and external auditors, and ensure that the internal audit function is adequately resourced and has appropriate standing within the Company;

AUDIT COMMITTEES

- (h) to consider the major findings of internal investigations and management's response;
- (i) to consider other topics, as defined by the board.

Reporting procedures

- 10 The Secretary shall circulate the minutes of meetings of the Committee to all members of the Board.

APPENDIX 5

- 1 This appendix summarises the main statutory responsibilities of directors and auditors relating to the accounts and audit, as background to the recommendation in the Code of Best Practice that directors should explain their responsibility for preparing the accounts alongside a statement by the auditors about their reporting responsibilities. It also summarises current requirements on internal control, going concern, and fraud, as background to the recommendations on these issues in the report.

The statutory responsibilities of directors and auditors

- 2 The statutory responsibilities of directors and auditors relating to accounts and audit are laid down in Part VII (sections 221 to 262) of the Companies Act 1985. Among the main provisions are the following:

(i) directors

221.-(1) Every company shall keep accounting records which are sufficient to show and explain the company's transactions and are such as to –

- (a) disclose with reasonable accuracy, at any time, the financial position of the company at that time, and
- (b) enable the directors to ensure that any balance sheet and profit and loss account prepared under this Part complies with the requirements of this Act.

226.-(1) The directors of every company shall prepare for each financial year of the company –

- (a) a balance sheet as at the last day of the year, and
- (b) a profit and loss account

(2) The balance sheet shall give a true and fair view of the state of affairs of the company as at the end of the financial year; and the profit and loss account shall give a true and fair view of the profit or loss of the company for the financial year.

227.-(1) If at the end of a financial year a company is a parent company the directors shall, as well as preparing individual accounts for the year, prepare group accounts.

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234.-(I) The directors of a company shall for each financial year prepare a report –

(a) containing a fair review of the development of the business of the company and its subsidiary undertakings during the financial year and of their position at the end of it, . . .

(3) The report shall also comply with Schedule 7 as regards the disclosure of matters mentioned there.

(ii) auditors

235.-(1) A company's auditors shall make a report to the company's members on all annual accounts of the company...

(2) The auditors' report shall state whether in the auditors' opinion the annual accounts have been properly prepared in accordance with this Act, and in particular whether a true and fair view is given –

(a) in the case of an individual balance sheet, of the state of affairs of the company as at the end of the financial year

(b) in the case of an individual profit and loss account, of the profit or loss of the company for the financial year

(c) in the case of group accounts, of the state of affairs as at the end of the financial year, and the profit or loss for the financial year, of the undertakings included in the consolidation as a whole, so far as concerns members of the company.

(3) The auditors shall consider whether the information given in the directors' report for the financial year for which the annual accounts are prepared is consistent with those accounts; and if they are of the opinion that it is not they shall state that fact in their report.

237.-(1) A company's auditors shall, in preparing their report, carry out such investigations as will enable them to form an opinion as to –

(a) whether proper accounting records have been kept by the company and proper returns adequate for their audit have been received from branches not visited by them, and

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(b) whether the company's individual accounts are in agreement with the accounting records and returns.

(3) If the auditors fail to obtain all the information and explanations which, to the best of their knowledge and belief, are necessary for the purposes of the audit, they shall state that fact in their report.

Current requirements on Internal Control

3 Under s.221 of the Companies Act directors are required to maintain adequate accounting records to enable them to disclose with reasonable accuracy, at any time, the financial position of the company and in order to meet this responsibility they must in practice maintain some form of control system over the company's process of financial management. However, there is no explicit requirement in company law for them to maintain an effective system of internal control.

4 Auditors in turn, as part of their usual audit procedures, will consider how far they can rely on the company's internal control systems in carrying out their audit of the financial statements. As a normal part of their audit procedures the auditors thus evaluate the internal control systems and, if they plan to rely on them in reaching their audit opinion, they will test the operation of those systems. As a by-product of this auditors will usually comment to management on their findings in what is commonly known as the management letter. However, there is at present no Companies Act requirement for auditors to report on the adequacy of internal control systems.

Current requirements on Going Concern

5 Schedule 4 of the Companies Act 1985 requires accounts to be prepared on the presumption that the company is a going concern. The going concern concept is defined in accounting standards (SSAP 2) as the assumption that 'the enterprise will continue in operation for the foreseeable future. This means in particular that the profit and loss account and the balance sheet assume no intention or necessity to liquidate or curtail significantly the scale of operation.' The SSAP does not define 'foreseeable future' but auditing guidance states 'while the foreseeable future must be judged in relation to specific circumstances, it should normally extend to a minimum of six months

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following the date of the audit report or one year after the balance sheet date whichever period ends on the later date.'

- 6 Whilst the requirement for directors to prepare financial statements giving a true and fair view creates a presumption that they will satisfy themselves that the company is not in financial difficulties and that the going concern basis is appropriate, there is no explicit obligation in company law that they should do so. There is similarly no requirement in law for the directors to report to shareholders that they have satisfied themselves about the going concern basis or the adequacy of financial resources.
- 7 Auditors in turn, whilst obliged by auditing guidance 'to be satisfied that the going concern basis is appropriate', are not obliged to perform any procedures specifically designed to identify any indications that the going concern basis may be no longer valid.

Current requirements on Fraud

- 8 Auditing guidance makes clear that the prime responsibility for preventing and detecting fraud rests with management, as part of its fiduciary responsibility for protecting the assets of the company. It goes on to state that the auditor's responsibility is 'properly to plan, perform and evaluate his audit work so as to have a reasonable expectation of detecting material misstatements in the financial statements'. It points out, however, that even a properly designed and executed audit may not detect material fraud involving forgery or collusion, and that the auditor's report, based as it is on the concept of reasonable assurance, does not constitute a guarantee that the financial statements are free of misstatement.
- 9 So far as reporting fraud is concerned, the present legal position is that confidentiality is an implied term of an auditor's contract, and there is a public interest in maintaining confidential client relationships. Normally, therefore, it is the auditor's duty to report fraud to senior management. However, there is also a public interest in fraud being dealt with expeditiously and this may entail disclosing matters to a proper authority. An auditor who discloses in such circumstances without malice is protected from the risk of breach of confidence or defamation. In recent years the legislation applying to the special,

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regulated sectors (banks, building societies, insurance and investment business) has been amended so as to remove any obstacles there might be to an auditor reporting directly to the relevant regulator reasonable suspicion of fraud, or other matters relevant to the regulator's functions. The legislation also gives the Government powers to specify circumstances in which information is to be communicated to the regulators, as an alternative to rules or guidance by the professional bodies. In fact the accountancy profession has developed auditing guidelines for each of the special sectors and the Government has not exercised its powers up to now. However, in his report on the BCCI affair, Lord Justice Bingham recommended that auditors of banks should be placed under a statutory duty to report relevant matters to the Bank of England. The Government has announced that it accepts the recommendation and intends to impose a similar duty on auditors to inform the regulators in the other regulated sectors. For the generality of companies, the profession has also developed guidance which encourages the auditor to report fraud to the proper authorities where he no longer has confidence that management itself will deal adequately with the matter.

APPENDIX 6

Outline of the case

- 1 Caparo Industries plc owned shares in a public company, Fidelity plc, whose accounts for the year ended 31 March 1984 showed profits far short of the predicted figure which resulted in a dramatic drop in the quoted share price. After receipt of the audited accounts for the year ended 31 March 1984 Caparo purchased more shares in Fidelity and later that year made a successful takeover bid for the company. Following the takeover, Caparo brought an action against the auditors of the company, alleging that Fidelity's accounts were inaccurate and misleading in that they showed a pre-tax profit of £1.2m when in fact there had been a loss of over £0.4m, that the auditors had been negligent in auditing the accounts, that Caparo had purchased further shares and made their takeover bid in reliance on the audited accounts, that they had thereby suffered loss, and that the auditors owed them a duty of care to prevent that loss either as potential bidders for Fidelity because they ought to have foreseen that the 1984 results made Fidelity vulnerable to a takeover bid from one quarter or another, or as an existing shareholder of Fidelity interested in buying more shares.
- 2 The case went to the House of Lords which held that the auditors did not owe Caparo a duty of care to prevent the loss suffered in consequence of purchasing additional shares, either as potential investors or as existing shareholders (Caparo *Industries plc v. Dickman and others* [1990]1 All ER 568).

Basis for the decision

- 3 In broad terms, the House of Lords considered the issues on the following basis:
 - (a) If A makes a negligent statement, he may (independently of any' contractual or fiduciary relationship) be liable to B if B relies on that statement and thereby suffers loss, provided A is under duty of care to B to avoid or prevent that loss.

- (b) Such a duty of care will exist where a three-pronged test of foreseeability, proximity, and fairness is satisfied:
- (i) **foreseeability:** when making the statement, A should reasonably have foreseen that B might suffer that loss if the statement proved to be wrong;
 - (ii) **proximity:** there must, in relation to the statement, be a sufficient relationship between A and B. Such a relationship will exist if, at the time he made the statement, A knew:
 - that the statement would be communicated to B, either as an individual or as a member of an identifiable class;
 - that the statement would be so communicated specifically in connection with a particular transaction, or transactions of a particular kind; and
 - that B would be very likely to rely on it in deciding whether or not to enter into that transaction or a transaction of that kind;
 - (iii) **fairness:** the Court must consider it to be fair, just and reasonable that the law should impose the specified duty of care on A for the benefit of B.
- (c) In suggesting this three-pronged test, the House of Lords nevertheless recognised that there would often be an overlap between the three elements, that the elements themselves were ‘labels’ rather than precisely applicable definitions, and that there was a necessary element of pragmatism in applying the test to any given set of circumstances.
- (d) So far as concerns audited accounts, whilst it cannot fairly be said that the purpose of the statutory provisions as to publication is solely to assist members and debenture holders to an informed supervision and appraisal of the stewardship of the company’s directors, that is nevertheless the original, central and primary purpose of these provisions.

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on the accounts to buy shares in the company when to do so would give rise to an unlimited liability on the part of the auditor. Nor could a relationship of proximity be deduced between an auditor and an individual shareholder in the company in relation to further purchases of shares in the company by that shareholder, since an individual shareholder stood in no different position from any other investing member of the public to whom the auditor owed no duty, and the auditors' statutory duty to prepare accounts was owed to the body of shareholders as whole, to enable them as a body to exercise informed control of the company and not to enable individual shareholders to buy shares with a view to profit.

Principles established

- 5 The case has established that in the absence of special features, auditors are not regarded as owing a duty of care to prevent loss to anyone relying on their report except (a) the company, and (b) the shareholders as a body. In the absence of special features, no duty of care is owed in particular to individual shareholders, subscribers to new shares, purchasers or intended purchasers of shares from third parties including those conducting takeover bids, bankers or other lenders to the company, or persons doing business with the company.

Arguments for and against extending auditors' duty of care

- 6 Some of the arguments that have been expressed for and against extending auditors' duty of care to individual shareholders, purchasers of shares, and possibly other third parties are as follows.

Arguments for extension

- (a) Third parties, to the knowledge of all, in fact rely to a considerable extent on the integrity of the audited accounts – if legal liability is not imposed there is an allegedly justified expectation gap.
- (b) Professional men are paid – they should therefore be accountable in a wide sense.
- (c) The auditors' liability to the company may provide an effective remedy where the auditors have negligently failed to discover fraud or theft from the company –

but in general not where, for example, the directors have been overvaluing assets or otherwise inflating profits. In any case, the company's loss may be less than that suffered in aggregate by the shareholders.

- (d) The case is bad publicity for the accounting profession and has prompted the perception that, for example:
 - (i) auditors are answerable to no-one;
 - (ii) the requirement for the auditors to exercise due care and skill has been lessened;
 - (iii) having accounts audited is of little or no benefit.

Arguments against extension

- (a) To hold the auditors liable to all and sundry for any purpose for which they may choose to rely on the auditors' statement would result, in the classic words of Cardozo CJ, in 'liability in an indeterminate amount for an indeterminate time to an indeterminate class'.
- (b) Quite apart from the difficulty of defining the extent of liability, there would be endless problems in determining where liability was due to reliance on audited accounts and where not.
- (c) The principal purpose of the statutory provisions for audit and the publication of the accounts is to assist shareholders and debenture holders collectively in monitoring the stewardship of the directors – there is no basis for assuming that the legislature had a secondary purpose to provide protection for the public at large and investors in particular.
- (d) The potential magnitude of the liability is out of all proportion to the size of the audit fee.
- (e) The primary responsibility for producing true and fair accounts lies with the directors – and it would be unfair if, in practice, the auditors (and their insurers) had to foot the bill on their own, or substantially on their own.
- (f) It is, in practice, difficult for auditors to obtain adequate insurance cover.
- (g) The third parties have themselves paid nothing to the auditors – why should they be able to call the auditors to account?

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- (h) The scope and cost of audit work might rapidly become uneconomic if wide-scope liability to all users of accounts were accepted.

The Committee's view

- 7 The Committee recognises that the House of Lords judgment involved a careful and complex balancing of interests – not just those of users of accounts and auditors, but more generally the interests of professional people and those who suffer loss as a result of professional negligence, and the public interest in having a viable and fair system. The principal practical concerns which lay behind the conclusions reached by the House of Lords included the size of auditors' potential liabilities, the difficulties in defining wider liability in any fair yet realistic way, and the likely difficulties in establishing whether third party losses were due to reliance on the accounts. Bearing in mind the wide range of users of accounts, the Committee is unable to see a practical and equitable way in which the House of Lords could have broadened the boundaries of auditors' legal duty of care without giving rise to a liability that was indeterminate in scope, time and amount, nor does it consider that the decision should be altered by statutory intervention at the present time.

Possible ways of extending duty of care without creating open-ended liability

- 8 If, notwithstanding the Committee's recommendation, it were decided to change the principles laid down by *Caparo*, it would be necessary to amend the law by statute to impose a liability on auditors to compensate accounts users in general, or specified classes of user such as investors, who suffer loss by relying on negligently audited accounts. Those proposing such a change have suggested as a quid pro quo that auditors' liability should be proportionate only, or that it should be limited. There are, however, serious objections in both cases:
- (a) **Proportionate liability only:** it is proposed that the law should be changed so that those who together cause damage should not, as at present, each be liable for the whole of the loss, but should each only assume a reasonable proportion of the loss. However, there are considerable technical difficulties in this proposition,

not least because not all the potential defendants may be before the court. The proposition would also need to be considered in relation to the law as a whole, and there is no particular reason for singling out the auditors for special treatment. It should in any event be recognised that even with liability limited to a proportion of the claimant's loss, the amount payable by the auditors could still put them out of business.

- (b) Limited liability: it is proposed that the law should be changed to permit auditors to limit their liabilities by contract with the relevant company. Apart from any practical problems in reaching agreement with the company, there is a fundamental legal problem in establishing a basis on which an auditor might found a limitation of his liability to those with whom he has no contractual tie. Another possibility would be to impose a statutory 'cap' on an auditor's liability, either fixed for all auditors or related to variables such as the size of audit fee or the size of audit firm. However this suggestion would be an unsatisfactory compromise. When the cap operated it would prevent plaintiffs from recovering the full loss suffered, whilst if the auditors faced more claims in relation to one year than their insurance provided cover for, they might still be put out of business and not all the successful plaintiffs would be able to recover the amount of the cap.

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APPENDIX 7

The Committee is grateful to the following for submitting comments on its draft report:

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The Committee is also grateful to all those who provided assistance at earlier stages of its work. A full list of names was published in the Committee's draft report.

Relevant published statements

The following published documents were among those drawn to the Committee's attention:

Chartered Institute of Management Accountants: 'Corporate Reporting -The Management Interface' (1990); 'Non-Executive Directors -Their Value to Management' (1992); 'A Framework for Internal Control' (1992)

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