

30 January 1991

CORPORATE GOVERNANCE AND ACCOUNTABILITY

BACKGROUND

1 There is little included within the legislation covering commercial activity in the UK which helps ensure that companies are managed honestly and competently within an effective framework of corporate governance and accountability. The Companies Acts require companies to maintain accounting records that are sufficient to show and explain a company's transactions, and to produce true and fair accounts of the company's results and financial position. The concepts implicit in corporate governance, such as management controls and other internal controls are generally not covered. There are, of course, exceptions. For businesses in specific industry sectors, such as those covered by the Building Societies Act 1986, directors' statutory responsibilities have been considerably extended. Common law also imposes additional obligations over and above those included in legislation. The overall picture is patchy and incomplete.

2 At the same time, there is widespread confusion about the role of the auditor. Many people expect from the audit something far different from that which is required by statute - the so called expectation gap. This is particularly so in relation to the role of the auditor with respect to fraud, management efficiency and the prevention of insolvency. As a result, the value of the audit is increasingly doubted and the usefulness of company accounts, both to investors and other stakeholders in companies, has been called into question. The interrelationship between the auditor's responsibilities and those of a company's directors is particularly misunderstood.

OBJECTIVES

3 Against the above background, there is an urgent need to codify the responsibilities of those involved in corporate governance and to describe what best practice should be. To help secure proper administration of companies and fair stewardship, directors and senior management need to have unambiguous reference points for guidance. While there will still be business failures, and while the attitudes, abilities and perceptions of management can never be legislated for, sensible guidance will at least minimise the risks. What can reasonably be expected of a company's auditor also needs to be clarified and, as far as possible, the legal position made clear.

4 The best way to progress this is for a committee to be established to report on corporate governance and accountability, and to draft a Code of Practice. Such a committee should particularly consider and report on how best to secure proper administration of companies and fair stewardship; the scope of reporting to shareholders and other stakeholders; the role of executive directors, non-executive directors and large shareholders; and the role and conduct of audit.

5 The remainder of this paper identifies the main issues to be considered by such a committee and the material which could be covered.

ISSUES

Who is responsible for corporate governance

6 It is important to identify those who should be involved in the framework of corporate governance, i.e. who is responsible. In law, most responsibility for corporate governance rests with the board of directors but as well as a company's executive directors, other levels of senior management will also have an important role. Any guidance has to address the variety of interlocking mechanisms which should exist in any large company to ensure that different levels of management know and meet their responsibilities. Non-executive directors, large shareholders, the Audit Committee and the auditors themselves are also part of the framework. In particular companies and industry sectors there will be others.

Current legal environment

7 As far as directors are concerned there is no single statute which defines their obligations. Instead, there are specific requirements placed on directors in relation to certain activities, for example, maintaining accounting records. Other than in specific industry sectors, for example those covered by the Building Societies Act 1986, the Banking Act 1987 and the Financial Services Act 1986, there is little legislation which deals with the duties of directors with respect to corporate governance or how they should discharge such duties. However, the industry specific legislation which exists provides a useful source of material for guidance. Other features of directors' responsibilities derive from common law, for example, the duty of care which directors owe and their fiduciary duties.

8 The responsibilities of auditors derive from a mixture of statute, common law and professional regulation.

EC and other countries requirements

9 The draft EC Fifth Directive and associated draft "Vredeling" Directive merit consideration. They deal with issues relating to directors duties and their enforcement, and the extent of non-executive director involvement on boards.

10 It is also relevant to research and consider the duties and responsibilities of directors and auditors which currently exist in other countries, especially in Europe, Japan and the USA.

Existing guidance material

11 There already exists a considerable amount of guidance material dealing with corporate governance and, in particular, the rights and duties of directors and auditors. However, little is available which explains the interrelationship between these two groups.

12 There have been four main sources of comment on corporate governance:

- (a) Discussion papers issued by professional bodies and regulatory bodies.
- (b) Seminars and surveys of opinion.
- (c) Statements made by individual public companies and audit firms.
- (d) media observations.

The role and responsibilities of directors

13 Against the background of the current responsibilities imposed on directors by law, an analysis is required of where further guidance is needed. This would include, for example, the need for guidance on establishing and operating a robust and reliable system of internal control, financial and otherwise, as well as guidance on the role which can be played by internal audit, an audit committee and non-executive directors.

The role of auditors

14 The statutory function of auditors is relatively clear. What causes confusion is the belief of some users of accounts and other interested parties that the auditor's role goes further. Consideration needs to be given to identifying where users of accounts are looking for assurance from auditors, and why. Four matters which it seems reasonable to assume users are looking for are that:-

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

15 Consideration needs to be given to the implications of this on what auditors should do and what additional information, if any, they should be reporting on. Progress is unlikely to be made on this until there is a clearer view of what directors' responsibilities are in these areas.

Accountability

16 Consideration needs to be given to the accountability of those involved in the framework of corporate governance, in particular who is accountable to whom and what method and form of reporting is needed to provide comfort that responsibilities are being properly met. This would include, therefore, consideration of whether directors should report annually on their systems of internal control, on the preparation of budgets, on a company's "going concern" and so on.

RECOMMENDATIONS

17 It seems likely that specific recommendations could be made in the following areas:-

- Who has a role to play in corporate governance.
- The responsibilities of directors:
 - to formalise their strategy, and to have in place a process for preparing business plans and budgets;
 - to establish adequate systems of control (financial and otherwise);
 - to measure performance;
 - to report to shareholders;
 - in relation to illegal acts;
 - in relation to their own personal interests.
- The role of internal audit.
- The role of an Audit Committee.
- The role of non-executive directors and the extent of non-executive director involvement on boards of directors.
- The exercise of rights of ownership by large shareholders.
- In relation to auditors:
 - their role and responsibilities;
 - scope and form of report;
 - appointment, remuneration and replacement.

Corporate governance and accountability

Some publications

LAW

Statutes

Companies Acts 1985/89

Banking Act 1987 (esp. Schedule 3)

Building Societies Act 1986

Insolvency Act 1986

Financial Services Act 1986

Company Directors Disqualification Act 1986

Case law (not a comprehensive list)

Re City Equitable Fire Insurance Co Ltd (1925)

Dorchester Finance Co Ltd and Another v Stebbing and others
(1989) - see Accy Nov. 1989 page 49

Caparo Industries vs Fidelity Directors

PROFESSIONAL AND OTHER BODIES

The Commission on Auditors' Responsibilities
(Cohen Commission) (USA)

The House Subcommittee on Oversight and Investigations
(John Dingell) (USA) - no report produced yet

Code of Recommended Practice on Non-Executive Directors
(PRO NED) (June 1990)

Report of the National Commission on
Fraudulent Financial Reporting
(Treadway) (Oct 1987) (USA)

Report of the Commission to Study the Public's
Expectation of Audits
(CICA) (Jun 1988) (Canada)

The Role and Duties of Directors: A discussion paper
(ABI) (Jun 1990)

Corporate Governance and the Market for Companies:
Aspects of the Shareholders' Role
(Bank of England, Discussion paper No. 44) (Nov 1990)

COOPERS & LYBRAND DELOITTE GUIDANCE

Audit Committees: The Next Steps
(Bancroft Report) (Mar 1990)

The Audit Judgement and its Communication
(Dell Report) (Dec 1987)

Responsibilities of the Auditor (Brian Jenkins, 31 May 1990)
(Founders' lecture to Society of Company and Commercial Accountants)

Becoming a Director?
(Margaret Morris-Marsham) (Due to be published shortly)

The Company Director in Europe: A Guide to
Directors' Duties and Responsibilities in 24 Countries (1986)

The Independent Director - A study of the Non-Executive
Director and of the Audit Committee
(R I Tricker, Tolley) (1978)

OTHER MATERIAL

Legal and General seminar papers (Nov 1990)

CALPERS survey of views on corporate governance in the US top
500 companies

TEXTS RECITING EXISTING DUTIES

Financial and Accounting Responsibilities of Directors
(ICAEW Technical Release No. 723, Oct 1988) (Accountancy, Dec 1988)

Guidelines for Directors
(Institute of Directors) (1990)

The Director's Manual
(Institute of Directors) (1990)

Guides to Boardroom Practice: Directors' Personal Liabilities
(Institute of Directors) (1988)

Non-Executive Directors: A Guide to their
Role, Responsibilities and Appointment
(Lindon - Travers, Director Books)
(reviewed in Accountancy, Dec 1990)

Company Director - Powers, Function and Duties
(CBI, Jordans)

On the Board
(Jeffrey Mills) (Allan and Unwin)

The Company Director and the Law
(John Pranks)(Longman)

The Rights and Duties of Directors
(Touche Ross, Butterworths) (Due out in one month)

Directors' Responsibilities
(Ernst & Young) (1990)

Company Directors' Liabilities, Rights and
Duties
(CCH)

Directors' Personal Liability
(Pennington) (1987)

Insider Dealings and Directors' Liabilities
(Mitchell) (1989)

A Director's Guide: Directors' Duties and Company Law
(McArthur & Barnard) (1990)

Company Director and the Law
(Franks) (1986)

The Responsible Director
(Peter Souster, Howard Tilly & Co, Chartac books) (1986)

Being a Director: A Guide to the Responsibilities and Opportunities
(Winters, British Institute of Management) (1988)