



SECURITIES AND INVESTMENTS BOARD

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N Peace Esq
Secretary
Committee on Financial Aspects
of Corporate Governance
PO Box 433
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31 July 1992

Don M. Peace,

THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE: THE CADBURY REPORT

The Securities and Investments Board (SIB) has considered the proposals set out in the Draft Report published by the Cadbury Committee on the Financial Aspects of Corporate Governance and has concluded that it does not wish to comment in detail on these proposals generally at this stage.

SIB's interest in corporate governance stems mainly from a general desire for a 'clean and efficient' marketplace in which investors can carry on their business with confidence. SIB also places particular emphasis on the need for effective and independent audit.

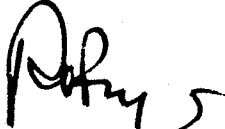
Auditors play a significant role in the regulation of investment businesses in the UK. SIB and the SROs take comfort from the independent assurance which auditors give them as to the financial condition of firms, in particular the maintenance of required levels of capital, and compliance with specific rules and regulations in relation to client money and customers' investments.

In view of the reliance which the regulators place on the involvement of auditors in the monitoring of investment businesses, SIB takes a keen interest in developments which take place in the areas of accounting and auditing. SIB welcomed the setting up of the Financial Reporting Council and the associated Accounting Standards Board and applauds the action which they have taken so far. SIB also welcomed the introduction of the Recognised Supervisory Body regime; but considers that it is too early to make any judgement as to the effect this will have in terms of improving standards of auditing. SIB and the SROs will watch with interest to see how this new system develops and will continue to refer cases of what they consider to be sub-standard audit work to the relevant body.

Finally, SIB welcomes the approach taken so far by the Auditing Practices Board and its intentions for the future. Again SIB will watch developments with interest. SIB recently made a submission to the Auditing Practices Board on its views for the future of auditing practice. This summarises SIB's concerns in relation to auditors and audit and includes suggestions as to where changes might be made in the future. A copy of this submission is attached for your information.

We look forward to seeing the final report of the Cadbury Committee later this year.

Yours sincerely,



R H F CROFT

Executive Director and
Chief Operating Officer

Enclosure



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W C C Morrisson Esq
Chairman
The Auditing Practices Board
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22 June 1992

Our ref: JDO/AJS/L4480705

Dear Mr Morrisson

FUTURE AUDITING PRACTICE

This is SIB's response to your letter of 17 March inviting comment on the present and future of auditing practice.

We have explained to you in earlier correspondence that it has not been possible to arrive at a formal Board response within your original deadline, but we understand that it is still of value to you to receive this letter now.

SIB has every reason to promote and support good auditing.

Where we can rely on audit, our own regulation can build on it in an elegant and economic fashion: where audit is an unstable element in the foundations, our own work is condemned to be both more expensive and less secure.

This importance to us of audit is seen most obviously in relation to investment business firms themselves. We and our fellow regulators under the Financial Services Act have accordingly specified a number of special reports or other requirements which we look for from auditors of investment business firms: we have also attached importance - and continue to do so - to the development and promotion of guidance from APB specifically applicable to investment business auditors.

On a wider front, the objective of promoting confidence in investment markets, products and services gives us a strong interest in the quality of audit, not merely of investment businesses themselves but in relation to all companies whose securities are dealt in on the Stock Exchange or otherwise within the FSA-regulated world.

This reference to companies generally prompts the observation that audit is never, in one sense, in the front-line. Directors, managers, trustees are the front-line - responsible both to run the business in question and present a report and accounts on that: audit is separate and subsequent, to provide independent assurance about the statements made by those directors or others with front-line responsibilities. The primary function of the auditor is to form and express an opinion.

From these perspectives, we have welcomed recent developments - such as the establishment of a statutory regime with Recognised Supervisory Bodies and the renewed attention to your own Board's role. We believe, however, that the scale of improvement which is desirable is substantial, calls for greater remedial effort than the profession appears yet to contemplate, and deserves - at least in relation to listed companies - a more radical approach than has so far been proposed.

The perceptions or beliefs which underline these comments and the attached Notes are that:

- too many auditors forget (or never knew) that the key purpose of auditing is to arrive at, and express, an opinion - and an opinion which is sustainable, independent and competent at that;
- where there are audit shortcomings, the professional bodies and leaders who find themselves in the middle between critics and auditors consistently come across as outward-facing defendants fighting to ward off attacks on auditors: they should surely better be seen as a mobile and alert patrol, poised to pounce on any auditor who simultaneously lets down himself, his professional colleagues and investors or the wider public by expressing an opinion which is incompetent, non-independent or otherwise unsustainable.

It is offensive for users of audited accounts to hear that the expectation gap should be closed wholly by reducing expectations.

Equally, we recognise the risk that as demanding users we may seem to expect a quality of audit which, if achievable at all, will only be attained at unacceptable cost: our answers are:

- that a substantial improvement should be available from redirecting rather than increasing resources: a change in stance on the part of professional bodies and leaders and a renewed emphasis on the basic "opinion" nature of audit do not necessarily involve unacceptable costs;
- that a large present cost (and dis-incentive to an adequate supply of future auditors) arises from potential unlimited financial liability for audit shortcomings: we want good auditing even more than we may sometimes want financial redress, and we are willing therefore to see questions of liability re-addressed;

Yours sincerely

Jeremy Orme

Jeremy Orme
Group Director
Compliance and Enforcement

FUTURE AUDITING PRACTICE

TODAY'S REALITY

Eroded reputation

1. The profession is in ill repute. Disquiet or distrust on the part of interested parties other than management is such that the perception alone is a real problem: it is, for example, difficult for a regulatory body such as SIB to promote a satisfactory regulatory regime other than by building an audit as a reliable pre-existing assurance - but perceptions such as those set out below have at present sadly eroded such reliance.
2. Too many audits of listed plcs and other companies with fiduciary responsibilities are seen as not at present satisfying the primary purpose of an audit. This is to provide independent assurance about statements made by directors and others in charge of businesses, companies, trust funds, etc. Recently, too many statements about which auditors have given assurance are turning out not to have warranted their assurance.
3. There is no confidence that, where there are apparent failures there will be either redress for losses, discipline for negligence or lessons learned for the future.
4. Redress for losses is, post-Caparo, a disaster area - the law has been found not to protect large classes of losers and yet at the same time auditors face dangerously high insurance and litigation costs. No-one is satisfied and audit firms present the unattractive spectacle of seeking yet further to distance themselves from their apparent responsibilities.
5. To accept such distancing is doubly difficult for losers, given the apparent lack of discipline and learning of lessons. The stance taken by the professional bodies (and their leaders) seems to be one of defensively facing the

shareholders, creditors, bankers, beneficiaries, regulators and others who have been let down. The message we hear is: "the auditor is doing his best: do not expect too much". Auditors accordingly appear to continue to graze contentedly behind these defensive walls erected by their protectors.

6. There is no real competition on audit quality between firms of auditors. Market forces are operating to drive down price (and hence audit resource) while maximising service to management (which is at least non-identical with audit and can be in serious conflict).

Conflicts of Interest

7. Conflicts of interest are intensified where a firm provides significant services other than auditing for audit clients.
8. Conflicts of interest also arise within the accountancy bodies which are both trade associations for and regulators of the profession.

Investigation and discipline

9. The professional bodies have not given the impression of using investigation and discipline vigorously and pro-actively to protect and promote high standards of auditing.
10. The resources devoted to monitoring auditors under the new supervisory regime appear to be limited.

Independence

11. Notwithstanding the clear statutory position, the practical reality is that auditors are effectively appointed by, and have their remuneration settled by, the very management on whose statements and reports the audit opinion is to be given.
12. Companies often retain the same auditor year upon year.

TOMORROW'S VISION

13. Robust auditing:

- auditors never to lose sight of their "opinion" role;
- auditors always able to sustain their opinions as having been formed after alert consideration with professional competence.

14. Independence:

- real and visible independence of auditors from management;
- a presumption against combining audit and non-audit services to the same client;
- competition in audit quality.

15. Strong professional leadership:-

- clear and persistent messages how good auditing differs from bad, and that bad auditing is unacceptable.

MAKING THE CHANGES

Better define management and audit responsibilities

16. The directors' report should state the nature and adequacy of decision-taking and internal controls procedures.
17. The directors' report should explicitly commit the directors to a "going concern" view.
18. Audit reports to be expanded to express opinions on these extra directors' statements.
19. Audit reports to include a statement about work done on which audit opinions are based.

Re-examine financial liability

20. Questions as to who is entitled to place what kind of reliance on the auditors' opinion and to whom auditors owe a duty of care must be re-examined - without any objective that auditors must be exposed to unlimited liability for all losses arising out of audited entities.

Independence

21. Consideration should be given to whether auditors of listed companies and those with fiduciary responsibilities should be appointed subject to prior approval and subsequent quality control checks by an outside agency. Perhaps something along the lines of the Audit Commission.
22. Non-audit services to audit clients not to exceed a certain limit by relation to size or value of audit.

Investigation and discipline

23. Increase supervisory resources.
24. Discipline to be prompt - and result in substantial and public consequences where findings are adverse.