CAD-02447

ERNST & YOUNG

■ Chartered Accountants
Rolls House
7 Rolls Buildings
Fetter Lane
London EC4A 1NH

■ Phone: 071-928 2000
Telex: 888604
Fax: 071-405 2147
LDE 213 CDE 777

Nigel Peace
Secretary
Committee on the
Financial Aspects of Corporate Governance
P O Box 433
Moorgate Place
LONDON
EC2P 2BJ

7 August 1992

DCL/kvg

Direct line
071–928 2000

Dear Sir

We welcome the opportunity to comment on the draft report of the Committee on the Financial Aspects of Corporate Governance (the Committee).

We strongly support the Committee's aim of defining a clear framework for corporate governance and accountability. However, whilst we would like to believe that the Code of Best Practice and other recommendations by the Committee will lead to significant strengthening by companies of control over their businesses and of their public accountability, we are doubtful that this will prove to be the case.

The Code of Best Practice

The Code of Best Practice is a combination of objective rules (regarding such matters as the maximum duration of directors' service contracts) and desired qualitative attributes of directors and boards (such as the requirement for the board to retain full and effective control over the company). In respect of many of the qualitative attributes in the Code, little or no objective operational criteria or characteristics are discussed in the draft report. Rather, the Committee calls for individuals to ensure that their actions meet the spirit of the Code and to give precedence to substance over form in interpreting it. The success of the Code in raising standards of corporate governance will therefore depend very largely on the actions of individual directors and the collective actions of boards of directors. In our view, the largely self-regulatory regime proposed by the Committee is unlikely to overcome concerns about the working of the corporate system to which the Committee refers. Further, we do not share the Committee's view that, had such a Code been in existence in the past, a number of the recent examples of unexpected company failures and cases of fraud would have received attention earlier and might have been avoided.

Few would take issue with the proposition that financial corporate governance should be characterised by openness, integrity and accountability. However, those responsible for governing companies face the harsh realities of the market place and the need to maintain their companies' standing in the financial markets. There will inevitably be occasions when economic self-interest will, in the absence of effective enforcement mechanisms, inevitably predominate over openness, integrity or accountability. We do not believe that an appeal to

■ A list of partners' names is available for inspection at the above address.
Authorised by The Institute of Chartered Accountants in England and Wales to carry on investment business.

directors to follow the principles on which the Code is based will be persuasive. Directors and boards that have not thus far felt the need to abide by the principles of openness, integrity and accountability are unlikely to feel driven to do so now in order to win support for their strategies or to assist the efficient operation of capital markets. Nor, in our view, is the prospect of greater regulation likely to be a major deterrent to those who tend to comply with the letter rather than the spirit of rules.

We are in favour of greater discussion by companies in their annual reports and accounts of the effectiveness of their mechanisms and processes relating to financial corporate governance. The Committee's proposed requirement that companies publish a statement of compliance in their annual report and accounts would cause directors to reflect on their standards of corporate governance and . However, in view of the qualitative attributes in the Code, statements of compliance would, inevitably, be highly subjective and therefore open to interpretation. We believe that, to be relevant and reliable, such statements would need to be based on relatively objective criteria and should discuss how in practice the company's mechanisms and processes actually meet the criteria.

Whilst we believe that auditors should respond positively to the changing needs and expectations of users of annual reports and accounts, we do not believe that it is practicable for auditors to report on the overall quality of their clients' standards of corporate governance by reference to general precepts. Auditors would have the very same difficulty in providing the objectivity expected of them that, as the Committee points out, arises from accounting standards and practice which sometimes allow boards too much scope for presenting facts in a variety of ways.

• Board of directors

Subject to our comments below concerning the concept of monitoring the executive management, we agree with the thrust of the proposals in the Code relating to the board. However, we are disappointed that the Committee held back from proposing that the roles of chairman and chief executive should always be separate.

• Non-executive directors

We support the Committee's view that the number and calibre of independent non-executive directors on company boards should be such that their views carry significant weight in the board's decisions. However, although the Committee emphasises the need for non-executive directors to bring independent judgement to bear on issues and calls for a majority of non-executives on a board to be independent, it does not explicitly acknowledge that a number of current non-executive directors actually owe their appointment to their business connections with the company. We believe that the thrust of the Committee's recommendations should be towards independent directors rather than towards non-executive directors.

In addition to the characteristics of independent directors described in the draft report, we believe that the shareholdings of independent directors should be no more than nominal.

The Committee places great emphasis on the control function of non-executive directors as a basis for securing good standards of financial corporate governance. We acknowledge the important contribution which non-executive directors can and should make in this direction but believe that the Committee's expectations of non-executive directors are unrealistic. We also believe that certain aspects of the role which the Committee proposes for non-executive directors are inimical to the concept of the unitary board.

It is generally the case that the best-qualified non-executive directors will serve only on boards which are dedicated to good corporate governance. Moreover, companies which have the greatest need to improve their standards of governance are likely to be reluctant to seek non-executives of real calibre who are prepared to devote sufficient time to the company's affairs to play the monitoring role envisaged by the Committee.

In addition and paradoxically, the Committee's emphasis on the control function of non-executive directors may actually discourage candidates with the appropriate skills and experience from serving on the boards of any but the best-run companies. Although the Committee avers that all directors are equally responsible for the board's actions and decisions, it assigns to the non-executive directors the role of monitoring the board. There will be a real danger that non-executive directors of companies which claim to comply with the Code but which subsequently experience difficulties through major fraud, management misjudgement or incompetence, could be accused of negligence based on failure to discharge the responsibilities assigned to them in the Code.

It appears to us that the role the Committee envisages for non-executive directors is ultimately inconsistent with the concept of a unitary board and that the Committee's recommendations reflect this inconsistency. For example, on the one hand the Committee suggests that the non-executive directors are in the best position to monitor the performance of the board. Since the board includes the non-executives, whose responsibilities as directors in law are the same as those of the executive directors, this involves monitoring their own decisions. In the Code itself, this role is described in terms of the board monitoring "the executive management". Since the board includes the executive directors, this would seem to require the executive directors to monitor themselves.

The Committee recommends that non-executive directors should be entitled to take independent professional advice at the company's expense, and regards it as "good practice" for all new board appointments to be proposed by a nomination committee which has a majority of non-executive directors on it. Although such measures might be necessary to counter the behaviour of unscrupulous executive directors in extreme cases, they could in other cases generate division within boards and could even result in the passing of control over the board to non-executive directors.

The Committee's proposals would create a two-tier board within the legal structure of a unitary board. We do not regard this as tenable. If non-executive directors are to assume the responsibilities proposed by the Committee, it will be necessary to bring the law into line with these responsibilities and the implications of this need to be considered.

• Executive directors

We support the proposals in the Code which relate to executive directors, although we see no reason why disclosure of emoluments of the highest paid director should should be restricted to the highest paid UK director. The draft report states that complete disclosure should be made of directors' present and future benefits, including stock options and similar rights, and we support the need for such full disclosure. However, the Committee's specific recommendations, as embodied in the Code, appear to fall short of this.

• Controls and reporting

We support the proposals in the Code which relate to controls and reporting.

The Committee makes a number of recommendations regarding audit committees. We support the proposal that all listed companies should establish effective audit committees. However, this proposal provides a good example of the challenge facing many companies in implementing the Committee's recommendations in spirit as well as in form. The quality of audit committees today is extremely variable. This may in part be because audit committees can only be as effective as the board, and more particularly the chairman, chief executive or finance director, allow them to be. However, serving on an effective audit committee is a demanding task. Many current members of audit committees lack either the expertise, the independence of mind or the commitment required to enable audit committees to bring about greater accountability by companies and help restore confidence in financial reporting.

In relation to audit committees as to the other responsibilities it attributes to non-executive directors, one of the fundamental issues which the Committee implicitly raises and which needs to be considered is whether adequate numbers of suitably qualified, energetic and conscientious candidates are available for appointment as non-executive directors. We very much doubt that adequate men and women of such calibre are available and it is not clear to us on what basis the Committee feels justified in assuming that the situation will change sufficiently so as to make its recommendations practicable.

In relation to the remuneration committee, we believe that the committee should consist of independent non-executive directors.

Other recommendations

• Financial reports

The purpose of annual reports and accounts is to report on stewardship. In our view, the Operating and Financial Review to which the Committee makes reference should not be "essentially forward-looking". Such an approach would encourage the use of projections and forecasts which are inherently uncertain. Rather, companies should be required to discuss their past performance and current position, including known trends, events and uncertainties that are reasonably expected to have a material effect, in a manner similar to that required by the US Securities and Exchange Commission.

The Committee discusses at length the quality of financial reporting. However, the usefulness of financial information is determined not only by its quality but also by its timeliness. In our view, the periods currently allowed by the Stock Exchange for the issue of annual accounts and interim reports are too generous and should be reduced from six and four months respectively to three months in both cases.

• Interim reports

We agree with the Committee's recommendation that interim reports should include balance sheet information and should be subject to limited review by the auditors, but consider that cash flow information should also be included in interim reports.

In view of the importance the Committee attaches to the publication of relevant information to the market and to parity of information among shareholders, together with its encouragement to companies to improve the transparency of their activities, we are surprised that it rejected quarterly reporting. We accept the argument that quarterly reporting would increase costs but do not find compelling the suggestion that shareholder bodies accept the present position of reporting by boards. The shareholder bodies to which the Committee refers are likely to reflect the views of institutional shareholders who, as the Committee acknowledges, are in a position to keep in touch with the boards of companies in which they have invested in a way which is not feasible for the individual shareholder. Quarterly reporting would help to meet several of the criteria which the Committee regards as important. In particular, it would reduce the ability of companies to manipulate market expectations and could improve the level of confidence in financial reporting by improving the transparency of the activities of companies.

• Enhancing the perceived objectivity of the audit

We support the Committee's recommendations that fees paid to audit firms for non-audit work should be fully disclosed, and that the accountancy profession should draw up guidelines on the rotation of audit partners.

• Enhancing the effectiveness of the audit

We support in principle the Committee's recommendations for enhancing the effectiveness of audit, and in particular that auditors should report on the directors' statements concerning the effectiveness of their internal controls and the fact that the business is a going concern.

We regard it as unfortunate that the Committee has attributed the "expectation gap" entirely to the lack of understanding of the nature and extent of the auditor's role. In relation to financial reports the Committee states that "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 position could be reported....". However, the Committee does not refer to the widespread misconceptions about the nature, purpose and inherent limitations of accounts which, in our view, lie at the heart of the expectation gap. We believe that the distinction between the financial reporting expectation

gap and the audit expectation gap needs to be clearly made in order to make sensible judgements as to the way in which their various elements should be addressed - and, importantly, by whom they should be addressed. We comment further on this latter aspect below.

- Auditors' liability

In our view, it is highly desirable that the auditing profession shows itself willing and able to adapt to the changing needs and expectations of which the Committee's draft report is a reflection. At the same time, as in any business or profession, auditors must weigh the risks involved. Unfortunately, the Caparo judgement has given rise to major misconceptions regarding the duties of auditors and, as a consequence, about the reliability of audited accounts. As the Committee says, the decision in Caparo does not justify assertions that the auditor's duty to use skill and care has been lessened. Such assertions fail to recognise that the auditing profession continues to be faced by huge liability claims, which can exceed the level of cover available in the commercial insurance market, leaving the assets of audit firms and the personal assets of every partner vulnerable.

The accounting profession has always accepted that those with valid claims against professional advisers who have breached their duty should be able to obtain compensation for loss, and we would not wish to suggest that this should not be the case. However, it is the fact that auditors have some of the characteristics of regulators but do not have the immunity from liability claims that regulators typically have. Moreover, in practice, often because other potential defendants such as individual directors or companies that have failed do not have adequate resources, auditors are called upon to meet the whole liability for extremely large sums far beyond the extent of their degree of responsibility for the loss suffered by the plaintiff. In the face of the increasing tendency of those who believe they have suffered loss to seek financial recompense through the courts, these factors have resulted in an escalation of claims against auditors out of all proportion to the degree of responsibility.

In this situation, auditors have been reluctant to expand their responsibilities. Indeed, they have felt driven progressively to insert more caveats and to resort to negative rather than positive assurance in their reporting principally out of fear of subsequent litigation.

This is not a healthy state of affairs. We strongly support the extension of the scope of audit in the direction recommended by the Committee and further still as the needs and expectations of users of information evolve. However, this must be accompanied by a change in the law which results in a more equitable approach to risk and liability.

- Endorsement of work by others

The Committee concludes its recommendations by endorsing the work of the Financial Reporting Council, the Accounting Standards Board, the Financial Reporting Review Panel, the Auditing Practices Board and the Institutional Shareholders' Committee.

Accountability to shareholders

We note that the Committee was unable to make any specific recommendations regarding mechanisms or processes, such as shareholder committees, to strengthen the accountability of boards of directors to shareholders. We assume that the absence of any such recommendations reflects the views put to the Committee by institutional investors. In our view, the failure to find new and effective mechanisms for strengthening the accountability of boards of directors to shareholders, and the apparent absence of any strong determination by shareholder bodies to support such mechanisms, points to an inability to graft on to the present system of accountability enforcement mechanisms which will meet today's public expectations.

The expectation gap

In our view, the primary responsibilty for closing the expectation gap and for providing the framework for raising standards of corporate governance and financial reporting lies with the Department of Trade and Industry, the Financial Reporting Council and the Stock Exchange. The Auditing Practices Board has a vital role to play in improving the level of confidence in auditing but this can only take place against the background of improved accounting and reporting standards.

Whilst we agree with the Committee that the endeavours of these bodies to improve the environment for corporate governance should be encouraged, we believe that there is a critical need for more coordinated and concerted action on the part of regulatory bodies.

More fundamentally, however, we are doubtful whether self-regulation can provide the robust and responsive framework necessary in today's business environment. We believe that the present regime, of government-sponsored self-regulation by various discrete bodies which appear to have little or no meaningful contact with each other, and to reach decisions almost entirely on the basis of consensus among the regulated, is failing to meet public expectations. While this situation continues, we do not believe that the Committee's endeavours will bear fruit. Moreover, failure to implement a more effective regulatory regime in the UK now may well deprive the UK of the ability to influence future proposals which, we believe, will emerge from the European Commission for a European Securities and Exchange Commission.

Should you wish to discuss the contents of this letter, please contact Richard Findlater or David Lindsell at the above address.

Yours faithfully

Ernst & Young