

7/12/91

Arthur Andersen & Co.

Law does not reflect reality  
But joint & several liability

Review Monitor procedures.  
Cos must gauge what's happening  
Audit office review consultations

Should we let sleeping dogs lie? But minds now directed at issues.  
Range of issues over auditing.  
Need to tie together "what to do" & liability.

Limit liabilities by contract. Proportion of fees as in Germany

Recognition of stakeholders' broad interest. Effect mgt. reaction to reports  
resp. — effect disclosure, not rec. duty.

Non-exec., active concept.

Essence of bd. is checks & balances.

Imperfections in financial reporting should be recognised.  
Snapshot, value of business, judgements involved.  
Standards for large & small cos.

Fewer options, greater sanctions: Sanctions make a difference.  
Progress has been made. Self-regulation must be given a chance.  
Give it every chance.

Internal control system probably requires expanded stat. regmt beyond  
keeping proper books of a/c. U.S. profession worked with business.

Hundred Gp. SEC, FRC. evolve standards.

Long-term relationship  
audit.

Interim reporting, balance sheet, cash flow.  
Speed of reporting in info systems.

Climate is changing  
emgt. expected

Going concern

- a) 1987 split considered b) same in US. c) No evidence that countries undermines auditing independence. d) clients want it, advice from Rose who understand the business.

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Our Ref ae/3372Y

Your Ref

*Sir Adrian*

*I will acknowledge*

*N 8111*

7 November 1991.

Sir Adrian Cadbury,  
Chairman,  
Committee on Corporate Governance,  
P O Box 433,  
Moorgate Place,  
London,  
EC2P 2BJ.

Dear Sir Adrian,

We are aware of the approach which you are taking to the collection of evidence on the subject of the role and responsibilities of auditors and financial reporting - that is, the collection of evidence from a limited number of sources and the subsequent publication of your ideas for comment.

Nevertheless, we feel we should write to you at this stage as there are a few important issues where our own views may be at variance with other submissions you are receiving from the accounting profession. Our comments at this stage are confined to these issues.

## Purpose of Annual Accounts

We urge you to address what we consider to be the major issue surrounding financial statements - namely their purpose and the role of the auditor.

Under statute, the preparation of financial statements and their audit is part of the process whereby shareholders hold management accountable for their stewardship. The House of Lords in the Caparo case confirmed the position that, under company law, financial statements are prepared and audited to enable the shareholders, as a body, to exercise their rights as shareholders to control the company.

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In this respect the law disregards the fact that users of accounts include many other current and prospective users. In our view the narrow, legal view of accounts is not in accord with the expectations of the business world.

The "public interest" in accounts should be debated and we hope that the outcome of the debate will be a clear recognition that, besides shareholders, there are many other users of accounts ("stakeholders") who also have an interest in their accuracy.

While the public interest in this context is not easily defined, we believe that it embraces all the current and prospective users of financial statements; including not only shareholders, but also employees, customers, suppliers, banks and other providers of funds. Further it may include the many regulatory, governmental and quasi-governmental bodies that have relationships with companies.

Role of the Auditor

*Board*  
*responsibility* In our view, the accounting profession should be prepared to recognise the broader public interest in accounts and that its current "duty of care" does not reflect the reasonable expectations of society. Indeed, we believe that the profession will not survive in its current form unless it recognises and responds to the "public interest" role that is now expected of it.

However, it is unrealistic to expect the accounting profession to accept this broad role when, under current rules, such a role could lead to financial disaster for a firm found wanting in its opinion. It is therefore necessary to address the shortcomings in the present legal process whereby the auditor can be asked to bear the total loss suffered by a litigant with no contributions or sharing by other parties involved.

It is not easy to see all the steps that would be required but we would like to see a debate which would embrace consideration of:

- o The joint and several liability of auditors. While we recognise that liability depends on difficult questions of causation, it is a fact that when only one of several parties causing the same damage is sued, that party can be held liable for the whole damage, although he may have been only partly to blame.
- o A change in the law so that the courts would have power to apportion damages amongst all those responsible. While we recognise the considerable difficulty of apportioning blame to those who have not been sued and are not therefore before the court, the inequities that can arise from the present position are even more considerable.

- o A change in law, whereby the auditor would be able to limit his liability. While most professionals and organisations - lawyers, surveyors, actuaries and businesses - are generally free to limit their liabilities by contract, the law specifically denies the auditor this right. The law should be changed to permit the auditor to limit his liability, with the approval of shareholders in general meeting, and this should be recorded at the Registrar of Companies for all to know. As a practical matter, competition would ensure that the limit would be set at a realistic but manageable level - probably a multiple of the audit fee.

#### The Board of Directors

Our proposal to widen the role of the auditor leads on to another question and that is the structure of the board of directors of a company.

We believe that all the stakeholders referred to above have an interest not only in audited accounts but also in all the operations of a company. We believe that recent developments in the formation of companies is moving towards a two-tier system.

The lower tier comprises management and has responsibility for the day-to-day running of a company. Key members of management will meet regularly to formalise their decisions.

The upper tier is the board of directors. At present, boards comprises both executive and non-executive directors. Under our view, this level would comprise only non-executives together with, perhaps, the chief executive or chairman of a company. The individuals on this board would comprise representatives of all the stakeholders. We would see representatives of this board providing those who would serve on the audit and compensation committees of the Board.

Clearly, there needs to be a mechanism for ensuring that appropriate individuals are appointed to the board. We presume that there would need to be some form of nominating committee which would itself comprise individuals elected by representative groups of the stakeholders.

#### Form and Content of Financial Reporting

##### - Limitations of conventional financial statements

The Auditing Practices Board has recently moved to expand the auditor's report to clarify the respective responsibilities of directors and auditors. This leaves the issue of the inherent limitations of financial statements to be covered elsewhere.

The understanding of financial statements would be greatly helped by the development of guidance on the interpretation and limitations of financial statements. The inherent limitations of financial statements might be covered in the section of the financial statements dealing with disclosure of accounting policies.

The description of financial statements we envisage would include the inevitable lack of precision in accounting information, the subjectivity of most accounting determinations, the "instant in time" nature of the information presented, the fact that the most complete financial statements can only portray a partial picture of the real economic resources of the business, the fact that financial statements do not endeavour to portray the total value of the business and the artificiality of splitting operations into discreet reporting periods.

- Management's discussion and analysis

We welcome the growing view that "management discussion and analysis" should be a prescribed part of our financial reporting practices.

While it should be relatively straightforward to reach agreement on the content of such analyses with respect to the past and current position of companies, we note that there is already resistance to any discussion of prospective information. While the Companies Act calls for commentary on "future developments" in the directors' report, few companies really respond to this requirement. Experience in the US distinguishes between currently known trends, events and uncertainties that are reasonably expected to have a material effect in the future and "other forward-looking disclosures" involving anticipating new trends, events or uncertainties.

We urge that currently known trends, events and uncertainties that might affect the future be included in any recommended code of practice and that a recommendation be made for guidelines be developed for the disclosure of more forward-looking information.

- Critical business facts, risks and uncertainties

Current reporting practices convey little regular information on critical business facts, risks and uncertainties. While analysts and other sophisticated users are generally well aware of such factors, ordinary shareholders are not. Such disclosures would embrace not only industry, product and geographic information but also information on such matters as

↑ Interest  
Co's

sales to major customers, order backlog data, industry exposures, foreign exchange exposures, restrictions on cash balances, information on bank facilities and in certain circumstances, banking covenants.

#### Interim Financial Reporting

Interim financial reporting practices require urgent review. In our view, the information is so scant and the timing in many cases so poor that the majority of investors can have no real current basis for investment decisions.

again  
interim  
Listed companies should move to quarterly profit and loss reporting. Most listed companies already have accounting systems that would permit such reporting and where such systems are lacking, the need for quarterly reporting would prompt the necessary improvements.

The present situation whereby shareholders are provided with only an annual view of the economic resources and liabilities underlying their investments and have no current information on such critical balance sheet amounts as cash, borrowings, stocks and capital investments is highly unsatisfactory. The need for interim balance sheet information seems overwhelming. It should be provided at the half-year and eventually on a quarterly basis.

#### The Timing of Financial Reporting Generally

The usefulness of financial information is affected by not only how often it is presented and its content but also when it is available. The most comprehensive financial statements available many months after the year-end are inevitably less useful than more timely financial statements.

The annual financial statements and interim statements of listed companies should be published much sooner. The present Stock Exchange requirement of six months for listed companies is too long. We believe a three month period for the publication of both annual and interim financial statements would improve the usefulness of information considerably with little cost to most companies.

There is an urgent need to develop accounting standards for interim reporting. The guidance for interim reporting is already well developed in certain other countries and could be implemented quickly.

#### Going Concern

While we are concerned that users of financial statements should not regard an unqualified auditor's report as an endorsement of the continuity of the business, there is a view that an unqualified report carries such a warranty. While the profession should seek to dispel this unreasonable expectation, we believe it could also take a more positive stance in this area.

While many businesses fail by becoming engulfed by some sudden turn of business events such as the collapse of current trading or the liquidation of a major debtor, in many cases the signs of impending business failure will be apparent over a much longer period.

While current professional guidance recommends steps for the auditor to take up when the going concern assumption is called into question, it is lacking in providing for the consideration of the appropriateness of the going concern assumption on all audits. We believe that the APB should require in all audits the consideration of whether the going concern assumption is valid and develop appropriate guidelines.

Requirements of Adequate Internal Control

There is growing demand for a requirement that listed companies maintain a proper system of internal control and that directors publicly state their satisfaction with the system to shareholders. We strongly support this view and believe that the requirement should also embrace an adequate information system.

Before such a requirement could be implemented, agreement would need to be reached on what constitutes "an adequate information system and a proper system of internal control". While this is a difficult topic, US experience suggests that it is possible to develop quite comprehensive guidelines in this area. We should move quickly to develop our own standards and guidance.

While we would not favour the unnecessary involvement of Government in accounting and auditing, we believe that a voluntary code in this area would be unlikely to work. We already have some experience of the statutory requirement for proper systems of control in the financial sector and we suggest specific legislation covering this issue. The legislative requirement would need to be framed in quite general terms, leaving the details to be developed by the profession.

The statutory requirement should provide not only for the maintenance of proper systems but for the directors' confirmation as part of the financial statements that they are satisfied with the systems.

A requirement for the auditor to "endorse" management's opinion on the company's control environment would serve to focus management's attention on the importance of the issue, provide structure to management's assessment process and bring into play the auditor's special expertise in this area.

If you have any questions, please let us know.

Yours sincerely,

*R J Chapman*

R J Chapman  
Managing Partner

*Self-regulation*

Corporate Governance. 8/11/80 exercise function in AGM

Coparo says auditors are duty to ↑

1) Value of annual independent audit

No satisfactory next step to Coparo

2) Duty of care defined by Coparo being

3) Function of audit

Mgt. letter

Role & responsibilities of auditors

Jan/Feb. document on what would be helpful over Road. ISC.

ISC. umbrella grp. mid-70's. Not individ. co's.. problem. General matters N/A/ unless

NAPP. 1/4 ABI 1/4 Unit/invest trust 1/4 Bankers 1/4 (BMBA) ABI own debt & more active

Perf. measurement, Advertg perf. Statistics.

Disclosure, getting things into open.

Pension Funds have external mgt. between beneficial owners & operators.  
Trustee brief. Policy on voting shld be known.

Automatic voting in firms, worse than not voting. Vote when it counts.  
At least has meant with a policy & decision

1/4% hldg. Vote. Mgt. vote for mgt. unless — then to ~~send~~ sub/other trustees

L. & G. vote indexed funds. Home analysts follow many stocks & vote even <sup>to index</sup>  
Low cost — mkt. neutral.

U.S. ag. voting right has value & ∴ shld be used. Anti ~~take~~ - class shares.  
& ∴ shld enpt. voting right.

Co need to communicate & visit.

House of Fraser 1981. Setting cttee for guidance. Audit cttee route in to corp. govt.