

## 6 ACCOUNTABILITY AND AUDIT

### I Introduction

6.1 The Cadbury committee considered the case for audit committee of the board, including their composition and role; the principal responsibilities of auditors and the extent and value of the audit; and the links between shareholders, boards and auditors. Most of Cadbury's recommendations were well received a number have been acted on by the accountancy profession, the Auditing Practices Board and the Accounting Standards Board. Our remit does not require us to review in detail the work of these bodies in implementing the Cadbury recommendations. We therefore comment selectively.

6.2 The primary responsibility for good corporate governance rests with the directors. The statutory role of the auditors is to provide the shareholders with independent and objective assurance on the reliability of the financial statements and of certain other information provided by the company. This is a vital role; it justifies the special position of the auditors under the Companies Act. But auditors do not have an executive role in corporate governance. If the directors fall short of high standards of corporate governance the auditors may be able to identify the deficiency; they cannot make it good.

### II The Audit Committee

6.3 The Cadbury committee recommended that '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' (code 4.3). They also recommended that a majority of the non-executive directors on the committee should be independent of management (report, 4.35(b)). Larger companies have implemented the recommendations almost universally, and we believe that the results have been beneficial. Audit committees have strengthened the independence of

**the auditors by giving them an effective link to the board; and the explicit remit of the audit committee has strengthened its members in questioning the executive directors.**

- 6.4 **We recognise that smaller companies may find it difficult to recruit a sufficient number of non-executive directors to meet Cadbury's preferred composition of the audit committee. We recommend shareholders to examine such cases carefully on their merits. But we do not favour relaxing the guidelines on this point by size of company.**

### III The External Auditors

#### A The Role of the Auditors in Corporate Governance

- 6.5 **The basic statutory duty of the auditors is to report to the shareholders on whether the company's annual accounts are properly prepared and give a true and fair view; and on whether the directors' report is consistent with the accounts.**
- 6.6 **Following publication of the Cadbury and Greenbury reports, the Listing Rules now require the auditors to review the directors' statement on 'going concern' certain aspects of the directors' statements of compliance with the Cadbury code and certain elements of the report of the remuneration committee. The Listing Rules also require directors to agree with the auditors the content of preliminary announcement of financial results. Finally, auditors are required by auditing standards to review other financial and non-financial information in the annual report and to report on any inconsistencies between these and the statutory financial statements; and to report privately to the directors observations on internal control resulting from the audit.**

- 6.7 **These are extensive responsibilities; they require auditors to demonstrate their financial expertise and skills of objective enquiry, analysis and report. Directors often also request auditors to provide additional verification, and the scope of this is evolving, for example in the context of half year reports. Here, we share the reservations of others that to require public verification for its own sake might detract from the directors' sense of responsibility. We therefore recommend neither any additional prescribed requirements nor the removal of any existing requirements for auditor verification of governance or publicly reported information.**

### **B Auditor Independence**

- 6.8 **Everyone concerned accepts the principle that auditors must be objective and thus remain independent from company managements. Statutory provisions, auditing standards and professional guidance all aim to ensure that this principle is applied in practice. We are confident that those concerned will keep these safeguards under close scrutiny and will bring in any improvements which are necessary. Our own impression is that audit firms have very strong commercial reasons for preserving an unblemished reputation for independence. But there may be a temptation to compromise on independence where an audit firm depends for a significant proportion of its income on a single audit client. We suggest that the bodies concerned should examine whether, in the existing professional guidance, the 10% limit of total income from one listed or other public interest client should be reduced.**
- 6.9 **The audit committee is an essential safeguard of auditor independence and objectivity; we suggest that it should keep under review the overall financial relationship between the company and the auditors. In particular, the audit committee should have a key role where the auditors also supply a substantial volume of non-audit**

**services to the client. We suggest that the committee should keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity with value for money.**

### IV Internal Controls

**6.10 Cadbury recommended that 'the directors should report on the effectiveness of the company's system of internal control' (code, 4.5) and that this report should be reviewed by the auditors (code, footnote). This left open the questions to whom the auditors should report, and whether their findings were to be made public. Cadbury also recommended the accountancy profession to take the lead in developing criteria for assessing effectiveness and in developing guidance both for directors and auditors to assist in reporting on internal control (report, 5.16). The accountancy profession established a working group to develop criteria for assessing effectiveness, and guidance for directors on reporting; this group reported in December 1994. The Auditing Practices Board took on the task of developing guidance for auditors, and issued a discussion paper in April 1995.**

**6.11 The word 'effectiveness' has proved difficult both for directors and auditors in the context of public reporting. It can imply that controls can offer absolute assurance against misstatement or loss; in fact no system of control is proof against human error or deliberate override. There has also been concern that directors or auditors who confirmed the effectiveness of a company's control system may be exposed to legal liability if unintentional misstatement or loss of any kind is found to have occurred. The report of the working group therefore recommended that the directors' statement should acknowledge the board's responsibility for the internal financial control system, but explain that such a system could provide only reasonable assurance against material misstatement or loss; should describe the key procedures established in order to provide effective financial**

controls; and should confirm that the directors had reviewed the system's effectiveness. Directors were also encouraged, but not required to state their opinion on the effectiveness of their system of internal financial control. Relatively few companies have done this.

- 6.12 It has been suggested that point 4.5 of the Cadbury code should be amended to read 'The directors should report on the company's system of internal control' — i.e. dropping the word 'effectiveness'. This would not require any change to the minimum requirements of the working group's guidance — the directors would still need to review the system's effectiveness. This would recognise what is happening in practice and seems eminently sensible. We believe that auditors should not be required to report publicly on directors' statements, but that they can contribute more effectively by reporting to directors privately. This would enable a more effective dialogue to take place; and allow best practice to continue evolve in the scope and nature of such reports, rather than externally prescribing them.

- 6.13 The working group's guidance refers to internal financial control, defined as internal controls over the safeguarding of assets, the maintenance of proper accounting records and the reliability of financial information used within the business or for publication. But the guidance also encouraged directors to review and report on all aspects of internal control, including controls to ensure effective and efficient operations and compliance with laws and regulations. We accept that it can be difficult in practice to distinguish financial from other controls; and we believe that it is important for directors and management to consider all aspects of control. We are not concerned only with the financial aspect of governance and we fully endorse the Cadbury comment that internal control is a key aspect of efficient management. Directors should therefore maintain and review controls addressing all relevant control objectives. These should include

business risk assessment and response, financial management, compliance with laws and regulations and the safeguarding of assets, including minimising the risk of fraud.

6.14 Cadbury regarded it as good practice for companies to set up an internal audit function to help discharge these responsibilities but did not refer to this in the code. We see no need for a hard and fast rule here. But we suggest that companies and particularly audit committees, should review from time to time the need for a separate internal audit function. The work of the external auditors, important though it is, will not necessarily cover the full scope of the controls.

6.15 Directors and management must always have the main responsibility for an effective system of controls. The right control environment and 'tone from the top' is an important element of this.

### v Accounting Standards

6.16 Accounting principle and the content of financial statements are regulated both by the law and by accounting standards. The Cadbury committee drew attention to weaknesses which then existed in financial reporting and endorsed the objectives of the then newly established Financial Reporting Council and the Accounting Standards Board in setting reporting standards. Cadbury also welcomed the actions of the Financial Reporting Review Panel in monitoring compliance. These bodies are making good progress. We note that there are now moves towards the international harmonisation of accounting standards. However we do not consider that our remit requires us to review these areas, in which the accounting authorities are closely involved.

## VI Going Concern

- 6.17 Cadbury recommended 'that the directors should state in the report and accounts that the business is a going concern, with supporting assumptions or qualifications as necessary; that the auditors should report on this statement; that the accounting profession ... should take the lead in developing guidance for companies and auditors, and that the question of legislation should be decided in the light of experience (report, 5.22). Guidance was developed by a working group set up by the accountancy profession and issued in November 1994. We understand that directors in preparing 'going concern' statements and auditors in reporting on them have found the guidance satisfactory, and we see no need for legislation.
- 6.18 It has been put to us that accounting standards already require directors either to prepare accounts on a going concern basis or to explain any alternative basis which they consider appropriate; a separate 'going concern' statement is therefore strictly unnecessary. There may be some logic in this, but the present requirement obliges directors to focus on whether the company is properly regarded as a going concern; we would not wish to recommend the removal of the requirement and thus to risk downgrading the importance of 'going concern'. Economic conditions in the UK are currently favourable but in the event of a downturn the requirement for a public statement in respect of going concern will play an important part in maintaining good corporate governance practices.

## VII Auditors' Liability

- 6.19 In this report we do not propose any change in the role of auditors or their public reporting responsibilities. We feel that best practice should be allowed to develop and evolve. It is clear, however, that while boards often seek greater reassurance about controls and other matters, auditors feel inhibited in going beyond their present

**functions because of concerns about the present law on professional liability .We consider that account should be taken of these concerns by those setting professional standards and when decisions on changes in the relevant law are taken.**