SUBMISSION TO THE TREASURY COMMITTEE'S INQUIRY INTO THE FINANCIAL REGULATION OF PUBLIC LIMITED COMPANIES BY THE CHARTERED INSTITUTE OF MANAGEMENT ACCOUNTANTS (CIMA)

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1. BACKGROUND

1.1 Introduction

1. In February 2002, the Treasury Committee decided to launch an inquiry into the financial regulation of public limited companies. The formal terms of reference are:

   - *To examine, in the light of the Enron collapse, the arrangements for financial regulation of public limited companies in the United Kingdom.*

2. This document constitutes CIMA's written submission. We are pleased that we have been invited to support this with oral evidence.

1.2 CIMA

1. CIMA supports over 57,000 Chartered Management Accountants and 75,000 students. The CIMA qualification is regarded as a leading professional accounting qualification. Chartered Management Accountants are grounded in financial and management accounting, information, financial and business strategy, project management, marketing and human resource management. CIMA enhances the commercial relevance of its qualification by granting membership to the Institute only when a student has recorded a career profile demonstrating three years' relevant experience. Members are expected to observe high ethical standards of professional conduct. Through constant monitoring of the syllabus, we ensure our qualification covers the latest business issues in a rapidly changing marketplace.

1.3 CIMA witnesses

Attending the Treasury Committee on 10th April will be:

- Bruce Epsley - President
- Richard Mallett - Director of Technical Development
- Stathis Gould - Head of Technical Issues

1.4 General comments

1. CIMA has a unique perspective from which to view these issues. As professional accountants, CIMA members are both preparers and users of audited financial statements. Because CIMA members predominantly work in business and cannot practise as auditors, CIMA has an unconflicted view on auditing issues and our evidence is derived from a business perspective.

2. It is essential to understand the reasons for major corporate collapses and to address any weaknesses in order to maintain investor confidence and the efficient functioning of local and global capital markets. As such, there are many stakeholders involved including accountants, investors, creditors, financial analysts, investment banks, credit rating agencies, employees and customers.

3. CIMA suggests that corporate collapses result from a combination of:

   - Poor management and leadership

- Weaknesses in the regulatory, governance and control framework
- Market pressures
- A lack of personal integrity resulting in deliberate fraud. Alternatively, there are situations where executive remuneration and incentive schemes result in executive behaviour that is not in the best interest of the enterprise.

CIMA urges the Treasury Committee to explore all these issues as integral components of the corporate governance debate.

4. Any change required as a result of the inquiry must be implemented in a way that does not overburden or restrict unnecessarily the effective operation of companies and markets.

5. In the wake of a number of corporate failures in the late 1980s and early 1990s, we believe that a relatively robust framework for corporate governance has evolved in the UK and is now delivered through the Combined Code and the associated Turnbull guidance. Despite this, the collapse of Enron shows that now is not the time to be complacent and that there is always room for incremental improvement in the regulatory, governance and control frameworks. Changes, however, need to be carefully considered and provide practical and workable solutions for companies to improve their governance and transparency of financial reporting.

6. It is first and foremost the responsibility of all Directors of a Board to present financial statements that are true and fair. It is also their responsibility to set in place, monitor, and continually improve a framework for corporate governance. Given the relatively robust framework in the UK, CIMA would suggest that the Treasury Committee recommends that the Financial Services Authority (FSA) writes to all Directors of listed companies (possibly through their company secretaries) to remind them of - and reinforce their commitment to - these responsibilities. This should be widely publicised such that the initial onus for integrity is clearly for Directors and the management team.

2. SUMMARY OF CIMA's KEY PROPOSALS

1. The FSA, in conjunction with an appropriate group of relevant stakeholders, should agree a Code of Best Practice for non-executive directors with respect to their:

   - Roles, responsibilities and professionalism
   - Training
   - Need to ensure time to give a high quality and diligent contribution
   - Independence

2. Encourage companies to widen the role of the audit committee to include a review of governance frameworks. This would extend its role from considering financial reporting and internal control principles.

3. The need to reinforce the importance of sound internal management and control systems and the value of internal audit. Business risks need to be systematically evaluated, monitored and managed on a transparent basis.

4. The FSA to write to all directors of listed companies reminding them of their responsibilities (see section 1.4 paragraph 6).

5. The importance of international accounting and auditing standards, based on a principles rather than rules-based approach. It is our view that standards must place the focus on accounting for the substance of a transaction rather than its form.

6. The need to ensure the independence of auditors from their clients.

7. Consideration of the benefits of UK board structures in comparison to those in the US in terms of the role of non-executive directors and the Board structure.

8. Improvement of shareholder-company dialogue albeit balanced against the risks and constraints of selective disclosure.

9. Fraud prevention measures and the need to protect 'whistle blowers'.

10. The need to consider the design of executive remuneration and incentive schemes with emphasis on the key role of the Remuneration Committee.

3. EFFECTIVE MANAGEMENT AND LEADERSHIP

1. The task of leading and managing enterprises is more challenging than ever before in an environment of greater complexity, speed of information flows and demand for improved performance and accountability. It is therefore essential that both managers and executive directors have the relevant and necessary skills, time and experience to manage the type and size of enterprise concerned. CIMA believes that high-quality training is fundamental to effective management and leadership and is a need that has been under-estimated.

2. It is equally important for non-executive directors (NEDs) to have adequate skills and training in order for them to discharge their responsibilities. CIMA believes that a Code of Best Practice should be drawn up by the FSA and a group of relevant stakeholders to address issues such as the selection and training of non-executive directors. Such training should cover more than just an explanation of responsibilities and duties, but should focus on the behavioural and attitudinal aspects of directorship including, for example, the ability to ask searching questions. All training delivered to non-executive directors should conform to the Code.

   The important contribution that NEDs should be making is set out in the OECD guidelines. These stipulate four core areas:

- Playing an effective role in the decision making process with robust questioning and challenging the answers
- Providing an objective view on board and management performance so that if a company is failing to realise its goals, NEDs can require a change of management
- NEDs can intervene wherever there is a risk that the interests of management, company and shareholders diverge e.g. where there is a conflict between short term and long term objectives, particularly in situations where there is a

proposed merger, acquisition or corporate restructure. Also where executive remuneration is discussed
- NEDs can provide investors with an additional assurance that their interests are defended on wider aspects of issues such as financial reporting, remuneration, and nomination.

3. It is also important that NEDs are able to devote enough quality time to the company of which they are a director. CIMA proposes that there are best practice guidelines that warn of the difficulties that arise from an individual accepting an appointment that they cannot commit sufficient time to. Directors should also disclose all their directorships in the annual report and accounts.

4. Independence is a key attribute for non-executive directors. In CIMA's view, what really matters is the possession of an independent frame of mind and the willingness to ask incisive questions. It is important that at least one non-executive director should have a high level of skill and experience in financial matters to enable the effective challenge of decisions and performance. We propose that best practice guidelines should provide examples of where the independence of NEDs may be compromised and conflict of interest could arise as a result.

5. In order to increase confidence and improve quality, information about the skills and training of both management and directors should be disclosed in the annual report and accounts together with information about the time input of non-executive directors.

6. We note that the government is undertaking a review into the role of non-executive directors as announced by the Trade and Industry Secretary on 27 February 2002 and CIMA is proposing to submit its views as appropriate.

4. THE REGULATORY, GOVERNANCE AND CONTROL FRAMEWORK

4.1 General Principles

1. CIMA believes that any regulatory framework that applies to public listed companies needs to reflect the following general principles:

   - The public interest should take precedence over all other concerns;
   - High ethical standards, emphasising values such as integrity, competency, transparency and accountability;
   - Accordance with international standards and/or best practice;
   - Emphasis given to appropriate checks and balances and other robust business processes to minimise and/or manage risks
   - Principles not rules-based standards, which emphasise substance over form and transparency;
   - Does not create unnecessary burdens and complexity;
   - Regulators must have received high-quality training to enable them to execute their responsibilities properly;
   - Independence - both of NEDs and external auditors.

4.2 Corporate Governance

1. It is the responsibility of the Board to lead and control the company. This needs to be emphasised even more than is presently the case.

2. Companies should be encouraged to widen the role of the audit committee to include a review of governance frameworks. This would extend its role from considering financial reporting and internal control principles. We suggest that, in many cases, companies might wish to reconsider the name of this committee. It is CIMA's belief that the connotation for some is that the Audit Committee's role extends to considering arrangements for financial statements and not for other crucial areas it might deal with such as managing business risk. Overall, the responsibility for corporate governance within an organisation should remain with the Board.

3. The Combined Code stipulates that boards need to be balanced and that not less than a third should comprise non-executive directors (of which the majority should be independent). This contrasts with the boards of US companies which typically have a majority of non-executive directors. CIMA suggests that the benefits of current UK practice need to be considered in more detail.

4. For good governance, a company also needs to have robust internal management and control systems. CIMA has also been a long-standing advocate of the value of internal audit and we were very pleased that the Turnbull Report recognised this. Of key importance is that companies ensure that they have the right accounting and finance systems capability so that accurate information is delivered quickly to key decision-makers. This should incorporate appropriate exception reporting.

5. The importance of supplementing financial statements with qualitative and forward-looking information is crucial to facilitating an improved understanding of business performance as well as promoting accountability. We supported proposals in the Company Law Review to introduce a mandatory Operating and Financial Review (OFR) for listed companies as a key part of their annual report. CIMA is undertaking further research on the more detailed requirements of an OFR particularly in respect of non-financial business drivers where CIMA can add value to the debate.

6. There is great value to be had from independent, searching, perceptive analysis of financial statements including the probing for more information where disclosure is lacking or clarification is needed. To do this effectively, key users of financial statements such as fund managers, financial analysts, credit rating analysts and other such commentators must keep themselves appropriately appraised of key developments in financial reporting and disclosure through continuing professional development.

7. CIMA hopes that the Treasury Committee will ensure that proposed recommendations relating to corporate governance are measured and do not undo the considerable progress that has been made in the development of best practice corporate governance principles in the UK over the last decade.

4.3 The Accountancy Profession

1. In view of the recent establishment of the structure for the regulation of the UK accountancy profession, any fundamental change to the framework should be avoided at this stage. A review of the framework by 2005 has already been agreed.

2. Nevertheless, high profile cases damage confidence in the profession and the public interest dimension needs to take precedence over all other concerns. Any pragmatic changes suggested, which have the practical effect of strengthening confidence would have our unequivocal support.

4.4 Accounting and Auditing Standards

1. The Board of Directors has the prime responsibility to ensure that the reporting of the company's performance is transparent, reliable and of high quality.

2. CIMA recognises that robust international accounting (and auditing) standards are crucial to facilitating investor confidence and the healthy functioning of capital markets. CIMA therefore welcomes the move by the European Union to introduce international accounting standards for the majority of EU listed companies by 2005. We would not support any move to European accounting standards. We strongly advocate that the principles-based approach of the UK Accounting Standards Board (ASB) and the International Accounting Standards Board (IASB) is preferable to the more prescriptive approach that exists in the US and which may have been a factor in the Enron collapse. We will continue to contribute to the work of the IASB which is leading the development International Accounting Standards.

4.5 Audit Issues

1. CIMA notes that the Government is undertaking a review of the role of auditors to be conducted by the DTI, FSA and Accountancy Foundation as announced by the Trade and Industry Secretary on 27 February 2002. CIMA will be submitting its views to this review as appropriate.

2. CIMA has established an Audit Review Working Party, comprising senior CIMA members and staff, to determine CIMA's position on auditor independence and associated issues. We envisage that it will make its final report to the CIMA Council in July 2002; in the meantime, we offer the following provisional comments.

3. It is the role of the board - not the auditors - to lead and control the company. Any examination of the roles and responsibilities of auditors needs to bear this in mind. In fact, to be so involved would be totally contrary to the principles of auditor independence.

4. In the post-Enron climate, a key issue for debate has been the independence of auditors from their clients in terms of:

    - the length of time that a firm has been providing the audit service for its client;
    - the deepening of the relationship through the provision of additional non-audit services;
    - the movement of staff from accountancy firms to client companies.

5. It is vital to ensure that an appropriate level of independence is achieved and a number of remedies have been proposed. These all need to be examined carefully. They include:

    - A restriction on the ability of auditors to offer additional services, for example, consultancy. The definition of which services that could be provided by auditors to their clients and those which should be provided separately will need careful consideration.

    - The process for appointing auditors and setting fee levels.

    - Compulsory rotation of auditors. The benefits to be gained from rotating audit firms would have to be weighed carefully against those accruing from the good understanding of the business, which audit firms develop over the course of their professional relationship with the company.

    - Improving the accountability of audit firms, for example, through more transparent disclosure of performance, fee levels and relationships with clients.

4.6 Market Pressures

1. Companies are under considerable pressure to perform and create sustainable shareholder value. There is always a danger that this pressure is so extreme and demanding of "quick results" that the fundamental principles of sound business and governance are overlooked. We would urge the committee to consider the extent to which excessive market pressures were a factor in the Enron collapse and to what extent they are present in the UK context.

2. A key issue here is the role of investors and their relationships with companies. Companies need to have regular and ongoing dialogue with their institutional shareholders. CIMA has undertaken research that identifies the considerable potential of extending the corporate governance role of fund managers (*Financial Institutions and Corporate Governance: A Dynamic Model of Corporate Governance)*. The research based on interviews with over 40 UK fund managers reveals that regular active interaction between fund managers of large institutional investors and company directors takes place when companies are performing well and not just when they are in crisis. The report includes a robust five-stage model of intervention by fund managers, which provides a useful framework for fund managers to consider the circumstances in which they should intervene, the degree of intervention and the approaches that they should adopt. We would be very pleased to make this report available to the Treasury Committee if appropriate.

3. CIMA believes that the Treasury Committee should consider the role of investors and their relationships with companies albeit in the context of the risks and constraints of selective disclosure. It may be useful to consider whether best practice guidelines as currently set out in the Combined Code could be strengthened in this area.

4.7 Assuring Integrity

1. Companies need to have adequate systems for detecting and preventing fraud.

2. The issue of 'whistle blowing' needs particular consideration. In particular, finance directors and risk managers often have to ensure that unpalatable issues are properly addressed by the board and disclosed to shareholders. It is vital that such individuals are properly protected when performing such duties. Without such protection, there is a danger that the integrity of the 'whistle-blower' is compromised through the fear of losing one's job and income.

3. Performance incentives must be designed in such a way as to discourage dishonest or fraudulent behaviour. There are also situations where executive remuneration and incentive schemes result in executive behaviour, while not fraudulent or dishonest, is still not in the best interest of the enterprise. There is a particular need to avoid excessive reward for short-term corporate financial performance that is detrimental to wealth creation over time. The design of executive incentive schemes is a complex area and the Remuneration Committee has a key role to play. The committee might wish to consider this area in more detail.

4. With regard to terms of employment contracts, it is necessary to balance the need to encourage good performance with the need to provide adequate security for 'whistle-blowers'.

5. GENERAL CONCLUSIONS AND REMARKS

1. CIMA is firmly committed to high standards of corporate governance and a reputable, sound accountancy profession that operates in the public interest. Business must be conducted honestly, equitably and with integrity.

2. We would urge the Treasury Committee to consider its review within the context of the global economy. It is vital that any solutions proposed do not damage the ability of UK enterprises to compete successfully in the global market.

3. We await the findings of the Treasury Committee with interest. On behalf of our members, CIMA provides a firm commitment to engage fully with the relevant authorities to ensure that the appropriate regulatory framework for business is developed and enforced in the public interest.