



House of Commons

Trade and Industry Committee

The White Paper on Modernising Company Law

Sixth Report of Session 2002–03



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appendices*

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The Trade and Industry Committee

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Committee staff

The current staff of the Committee are Elizabeth Flood (Clerk), David Lees (Second Clerk), Philip Larkin (Committee Specialist), Clare Genis (Committee Assistant) and Rowena Macdonald (Secretary).

Contacts

All correspondence should be addressed to the Clerk of the Trade and Industry Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5777; the Committee's email address is tradeindcom@parliament.uk

Footnotes

In the footnotes of this Report, references to oral evidence are indicated by 'Q' followed by the question number. References to written evidence are indicated in the form 'Ev' followed by the page number.

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Summary

We welcome the comprehensive review of company law that has taken place over the last five years, and particularly the decisions to draft new legislation with the small company primarily in mind and with additional requirements for larger companies where necessary; to simplify and codify the main principles of company law; and to establish mechanisms to enhance transparency and promote good corporate governance.

We approve of the Government's approach to the definition of directors' duties; and we welcome the recommendations of the Higgs Report, believing that they will strengthen scrutiny of management decisions with a view to the long-term health of the company.

We believe that, for the Government's proposals to succeed in improving corporate governance, there will need to be more positive engagement between investors—especially large institutional investors—and the companies in which they hold shares. While agreeing that it is desirable for investors to exercise their power of “voice” rather than “exit”, we are doubtful whether many investors have the time, money or capacity to be as active as would be necessary.

We support the proposed requirement for the largest companies to produce Operating and Financial Reviews, on the grounds that these, too, will increase transparency and provide improved insight into the company's operations and prospects. We welcome the extensive review of the rules to ensure independence of auditors and to restore confidence in company reporting and accounting mechanisms. We believe that the Government's proposals achieve a reasonable balance between statutory requirements and regulation by independent bodies; but we recommend that legislation in some areas should not be ruled out if looser forms of regulation fail.

We are concerned at the delay in the Government's production of a Companies Bill and request that the Government now provides a date for publishing it.

1 Introduction

1. The last significant review of company law in the UK took place more than forty years ago. Since then, relevant statute and case law have changed, and there have been major developments in recognised ‘best practice’ in corporate governance,¹ with the result that it is now difficult and time consuming for directors and other interested parties to discover exactly what the law relating to companies is. As a result, in 1998 the then Secretary of State for Trade and Industry decided that there should be a comprehensive review of company law. The Review was conducted by a Steering Group comprising experts from law, commerce, accountancy and academia, with the support of a broadly based Consultative Group, and it published its final report in July 2001. The Government responded to the Review Group’s proposals in a White Paper, *Modernising Company Law*, in July 2002.²

2. We decided to hold an inquiry into some of the themes covered in the White Paper. However, the Company Law Review was only one government initiative of several in the broad area of company law. In particular, the Higgs Review of the Role and Effectiveness of Non-Executive Directors was running concurrently. Mr Higgs reported in January 2003 and, given the centrality of the area it covered to the corporate governance themes addressed in the White Paper, we decided to include his proposals within the remit of the inquiry as well.³

3. During the course of the inquiry we took oral evidence from the Trades Union Congress (TUC); the Institute of Chartered Accountants of England and Wales (ICAEW); the Law Society of England and Wales; the Investment Managers’ Association (IMA); the Quoted Companies Alliance (QCA); the Institute of Directors (IoD); the Corporate Social Responsibility Coalition (CORE); the Confederation of British Industry (CBI); and Mr Derek Higgs. In addition we received written submissions from 16 different organisations. We are grateful to all those who contributed evidence to the inquiry.

1 As recommended by a series of reviews set up in response to financial scandals in the late 1980s and early 1990s. The reviews started with the *Cadbury Report* in 1992, followed by the *Rutteman Report* of 1994, the *Greenbury Report* of 1995, the *Hampel Report* of 1998 (which was the basis of the existing “Combined Code” referred to elsewhere in our Report) and the *Turnbull Report* of 1999. For more details on these, see Ev 18-19

2 Cm 5553. The White Paper is in two volumes, with the consultative document in Volume I and draft clauses of the proposed Companies Bill in Volume II. We refer to it simply as ‘the White Paper’ throughout this Report, and, except where otherwise indicated, all references are to Volume I.

3 *The Review of the Role and Effectiveness of Non-Executive Directors*, DTI (January 2003), referred to hereafter as ‘the Higgs Review’.

2 Background

4. The existing framework of company law in the UK was established in the nineteenth century. It has since been added to with case law, EC directives and statutes that were reactions to particular concerns or corporate scandals. The result is a complicated and confusing agglomeration of law with no overall coherence or consistency, which is little understood by those who are required to act in accordance with it, and which, it is feared, has become a source of competitive disadvantage.⁴

“Too much of British company law frustrates, inhibits, restricts and undermines ... significant parts are outmoded or have become redundant, and they are enshrined in law that is often unnecessarily complicated and inaccessible”.⁵

When the Company Law Review was initiated in 1998, the Review Group was charged with providing a framework of company law that encouraged competitiveness as well as improving accountability.⁶

5. The Company Law Review process has been wide-ranging and extensive. It began with the publication of a consultative paper.⁷ The Review Group’s first major publication was produced in February 1999 and set out its early work and areas for subsequent investigation.⁸ This was followed by three detailed consultation papers in October 1999 on *Company General Meetings and Shareholder Communication*, *Company Formation and Maintenance*, and *Reforming the Law Concerning Overseas Companies*.⁹ There were two further major publications¹⁰ before the final report in July 2001. Each paper has been subject to widespread consultation. The extent of consultation undertaken has been impressive and the review process as a whole has been commended to us.¹¹

6. A significant component of the Review has been concerned with simplifying company law covering small companies. The current company law framework was conceived with large companies in mind and a complicated series of exemptions has been used to modify the regime for small companies. The approach adopted in the Review and the White Paper is to set out a minimum necessary level of legislation for the small company with extra layers added for larger firms. This approach was supported in evidence to us and we welcome it.

7. This was not, however, an aspect of the Company Law Review or White Paper upon which we dwelt at length. Instead we focussed on the more controversial proposals for establishing minimum standards for corporate governance. It is in this area, as seen in the continuing debate between enthusiasts of enlightened shareholder value (ESV) and of pluralism for instance, that the most significant disagreements have occurred.

4 White Paper, p 3

5 Company Law Review Steering Group, *Modern Company Law: For a Competitive Economy - Final Report*, Volume I, DTI (June 2001), p ix, referred to hereafter as ‘Review Group Final Report’

6 Company Law Review Consultative Meeting Note for Record, 21 July 1998, www.dti.gov.uk

7 *Modern Company Law: For a Competitive Economy*, DTI (March 1998)

8 Company Law Review Steering Group, *Modern Company Law: For a Competitive Economy - The Strategic Framework*, DTI (February 1999)

9 Company Law Review Steering Group, DTI (October 1999)

10 Company Law Review Steering Group, *Modern Company Law: For a Competitive Economy - Developing the Framework*, DTI (March 2000); and *Modern Company Law: For a Competitive Economy - Completing the Structure*, DTI (November 2000)

11 Qq 79 (Law Society) and 272 (CBI)

8. In this Report we examine a variety of distinct areas—directors’ duties; the role of non-executive directors; company reporting and auditing; and the role of institutional investors under the new proposals. However, though these issues appear disparate, when viewed through the lens of corporate governance there is considerable overlap, and proposals in one can have significant implications in the others. We have also addressed a number of small but significant proposals for change in areas such as publication of infringements of company law, the availability of directors’ and shareholders’ addresses, as well as the general question of how in future company law should be kept up to date.

9. Finally, the Government’s Company Law White Paper is not in itself the end of the consultation process. Whilst setting out much in the way of potential reforms, the White Paper is far from being a complete, legislative proposal and significant areas remain to be finalised before a draft bill is brought forward.

3 The Role of Directors

Directors' duties

10. One of the areas where the accumulation of case law had become confusing was that of the duties of company directors. The Company Law Review Steering Group concluded that the law on this matter had become unclear both for the directors themselves and for those trying to hold them to account. Furthermore, the Review Group expressed the opinion that the law ought to be revised to bring it into line with existing best practice, encouraging directors to look beyond maximising short term returns to institutional shareholders towards the longer term and to recognise the roles that relationships with other stakeholders, such as employees, suppliers, customers and others affected by the company's commercial activities, play in the success of the company.¹²

11. The Review did not set out detailed specifications concerning how directors should conduct their everyday activities; these were properly a matter for each company to determine and should continue to be set out in the contracts of employment of the individual directors. Instead, the aim was to provide a generic statement of duties, sufficiently broadly defined to be applicable to directors of companies of every size.

12. In early Review documents the debate about how to approach defining directors' duties produced two distinct positions. They were labelled 'Enlightened Shareholder Value' (ESV) and 'Pluralist'.

13. The ESV approach towards defining directors' duties maintained that the primary duty of a company director was to maximise value for the company's shareholders. However, it added that other relationships were significant in this and therefore needed to be taken into account when judging how to carry out this duty. The interests of employees, customers, suppliers, and local residents, as well as the environmental impact of the company's activities and its good standing in the eyes of the public, all had to be considered when judging what was in the interests of shareholders.

14. Such an approach would require no fundamental change to existing company law, which obliges directors to act in the interests of members of the company; and therefore any revision of the law along ESV lines would consist of codification rather than significant reform.

15. The pluralist approach to defining directors' duties would require a more fundamental change in company law. Where the ESV approach would have directors consider the impact on other stakeholders of their attempts to produce shareholder value, the pluralist approach would force directors to consider the interests of stakeholders in their own right. Shareholders would become merely one of a number of parties whose interests the directors would weigh against each other when making decisions.

16. The Review Group ultimately rejected the pluralist approach, considering that it would confuse the issue of directors' duties, giving directors little in the way of guidance in decision-making. It also ran the risk of creating a litigious climate for business where

12 Review Group Final Report, para 3.11

those parties who felt they had not been treated as they would have liked by a company's directors sought recompense through the courts.¹³

17. The White Paper has drawn on the ESV approach of the Review Group's final report and has largely adopted its proposed statement of draft duties,¹⁴ the relevant section of which states:

“A director of a company must in any given case —
 act in the way he decides, in good faith, would be the most likely to promote the success of the company for the benefit of its members as a whole ...; and
 in deciding what would be most likely to promote that success, take account in good faith of all the material factors that it is practicable in the circumstances for him to identify.

“Notes

(1) In this paragraph, ‘the material factors’ means —

the likely consequences (short and long term) of the actions open to the director, so far as a person of care and skill would consider them; and
 all such other factors as a person of care and skill would consider relevant, including such matters in Note (2) as he would consider so.

(2) Those matters are —

1. the company's need to foster its business relationships, including those with its employees and suppliers and the customers for its products or services;
2. its need to have regard to the impact of its operations on the communities affected and on the environment;
3. its need to maintain a reputation for high standards of business conduct;
4. its need to achieve outcomes that are fair as between its members.”¹⁵

The majority of the evidence we received was generally supportive of both the ESV approach towards defining directors' duties contained in the White Paper and to the draft statement of directors' duties it suggests.¹⁶

18. The pluralist approach did, however, retain some strong advocates who did not consider the ESV approach to provide a sufficiently robust framework to guarantee that the interests of those other than shareholders would be properly taken into account in the company decision-making process. Supporters of the pluralist approach¹⁷ argued that in order to achieve adequate recognition of the interests of other stakeholders, it was

13 Company Law Review Steering Group, *Modern Company Law: For a Competitive Economy - Developing the Framework*, DTI (March 2000), paras 3.30–3.31

14 Apart from the section on duties to creditors which is discussed in paras 23–25 below

15 White Paper, Volume II, Schedule 2, p 112-113

16 For example, Ev 1 (Association of British Insurers ('ABI')), Ev 4 (Centre for Tomorrow's Company) and Ev 26 (Institute of Chartered Secretaries and Administrators (ICSA))

17 Chiefly the TUC and CORE

necessary to oblige directors to consider these interests independently of the interests of shareholders. It was also suggested that broadening the range of groups to whom directors owed a duty would ‘dilute’ the pressure on companies from institutional investors to provide short term returns and would thus improve long term economic performance.

19. There was disagreement even amongst its advocates about how pluralism might best be implemented. The approach initially favoured by the TUC would have seen representatives of the various stakeholder groups included in the company’s decision-making process.¹⁸ This was part of a larger agenda of company reform that implicitly seemed to challenge the unitary board model, the standard UK single board comprising both executive and non-executive directors.¹⁹ The Corporate Social Responsibility Coalition (CORE) supported the introduction of a ‘duty of care’ along the lines of that encapsulated in existing Health and Safety legislation, where there was not necessarily direct input from the stakeholders into decisions of company boards but the company, and the directors, remained responsible for the impact of their activities on other stakeholders and were forced to consider them fully.²⁰

20. In practice, however, even the advocates of pluralism felt that the ESV approach represented progress on existing company law and the TUC acknowledged that, if the ESV approach was implemented sufficiently robustly, the practical differences between it and the pluralist approach would be small.²¹ Nevertheless, the underlying principles of ESV and pluralism are not the same and the debate between the advocates of each position represents a fundamental disagreement about the purpose of company law. Those supporting ESV do so basically because they believe that company law exists to promote the long-term success of companies which, in their view, requires the management of companies to have regard to factors such as goodwill that involve interest groups other than shareholders. The pluralists, on the other hand, while also believing that companies will benefit from taking account of wider interest groups, regard company law as an instrument for forcing companies to behave in particular ways—for example, requiring companies to follow good environmental, employment and social practice.²²

21. Our witnesses differed in their interpretation of the White Paper’s draft statute. Some saw it as a simple restatement of the duty of directors to maximise shareholder value.²³ Others saw it as “putting the company not the shareholders or other stakeholders at the heart of the [corporate governance] process”.²⁴ Whilst these are not necessarily incompatible statements, they do indicate a divergence over the degree of change that might be expected. This is further highlighted by the TUC’s observation that the difference between the two models of director’s duties might be small, depending on how seriously the relationships with groups other than shareholders were taken.²⁵ Overall, then, there is considerable scope for interpretation and it is therefore hard to anticipate the impact of the legislation as currently drafted. It does seem that those seeking an increased input into company decision making by a broader range of stakeholders may be disappointed.

18 Q 23 (TUC)

19 Elsewhere in Europe the standard board model requires companies to have two boards, one comprising executive directors who manage the company and a second comprising representatives of the various stakeholder groups who ensure that the management board is acting in their broader interests.

20 Q 256 (CORE)

21 Q 9 (TUC)

22 See, for example, CORE’s complaint that the list of directors’ duties contained no requirement “to minimise, wherever practical, the social and environmental impacts of a company’s activities”: Ev 9.

23 Qq 273-276 (CBI)

24 Ev 4 (Centre for Tomorrow’s Company)

25 Q 9 (TUC)

However, whilst their direct input might be minimal, under the White Paper's proposals there is an onus on directors to take such stakeholders' interests into account and to consider the impact of their decisions on other interested parties as well as shareholders.²⁶

22. We consider that the aim of the law should be to provide a framework to promote the long term health of companies, taking into account both the interests of shareholders and broader corporate social and environmental responsibilities. The specific duties of care required of companies to their employees and society at large will normally best be set out in other legislation, covering areas such as health and safety, environmental and employment law. However, the proposed statement of directors' duties in the White Paper does represent a step forward as, for the first time, it explicitly recognises that good managers will have regard to a broader range of considerations than value to shareholders, which on its own may lead to short-termism. The White Paper's formulation leaves the responsibility to make decisions about the company's future where it should be—on the directors, not on the courts.

Duties to creditors

23. A notable area of divergence between the Review Group and the White Paper is over directors' duties to creditors. The Review Group recommended the inclusion of a statement of duty of directors towards creditors in the case of insolvency. This would hold the directors financially liable if, once insolvency was imminent, they failed to take all reasonable steps to minimise the loss to the company's creditors.²⁷ This statement was largely derived from existing insolvency law and so did not amount to new law in itself. The White Paper rejected this recommendation on the grounds that it conflated company law and insolvency law.²⁸

24. The Review Group also raised the possibility of—though reached no conclusion on—introducing a duty to act in creditors' interests, jointly with shareholders', where insolvency was not necessarily imminent but was a possibility. This proposal was rejected in the White Paper on the grounds that any decision about the point at which insolvency was a possibility rather than imminent would necessarily be an extremely finely balanced one. The risk was that directors, fearing personal financial liability, would opt for insolvency at the first hint of trouble. The White Paper claimed that such a measure would discourage risk-taking by directors and run counter to the 'rescue culture' the Government favours (and which is the main theme of the Enterprise Act 2002). The White Paper does raise the possibility of including creditors in the list of stakeholders but reaches no firm conclusion.²⁹

25. We see no need to include a duty to creditors in the statement of directors' duties. This statement is intended to lay out a broad, generic set of obligations and not a detailed list of the legislation which directors might be required to adhere to under certain circumstances. The duties owed to creditors are derived not from company law but from insolvency law. In the same way that the statement of directors' duties does not include the detailed obligations they are under which derive from health and safety legislation, environmental legislation or employment legislation, neither need it include obligations under insolvency law. Changes to these obligations are not ruled out but they

26 See Qq 81-83 (Law Society) and 199 (IoD)

27 Review Group Final Report, paras 3.8–3.14

28 Para 3.13. The ABI is of the same view (Ev 1), but the ICSA agrees with the Review Group (Ev 26).

29 Para 3.14

should be addressed through the reform of—in this case—insolvency law rather than company law.

4 Non-Executive Directors

26. The issue of the non-executive director ('NED') is not directly addressed in the White Paper but has been investigated separately in the Higgs Review. Furthermore, the recommendations arising from the review will be incorporated into a revised Combined Code, not the proposed Companies Bill. However, the centrality of NEDs to the corporate governance themes addressed by the White Paper, as well as the timing of the publication of the Higgs Review's final report, has prompted us to consider their role here.

27. It is a fundamental principle of the unitary board that there is no legal distinction between executive and non-executive directors. Most of the evidence given to us was strongly in favour of maintaining the unitary board principle and there was little support for moves away from it.³⁰ Any reform of the role of NEDs would, therefore, need to be within the parameters set by the unitary board principle.

28. Mr Higgs has said that his proposals should be seen within the context of the unitary board and are merely aimed at formalising the role of the NEDs and their relationship with the executive directors rather than bringing about fundamental change:

“[The report's proposals are] about rigour; it is about getting away from casualness; it is about getting the right people working in the right way, in the right framework, to improve ... the rigour with which people contribute to the boardroom; and an understanding of the areas in which respectively they can most effectively contribute which is very much at the heart of this. It is about tightening up what has, in the past on occasions, been unsatisfactorily sloppy.”³¹

29. The Higgs Review has generated a very large amount of press coverage in the short time since its publication. Much of this has been unfavourable and has centred around comments from a number of high profile company chairmen and directors dismissing its proposals as overly prescriptive and inflexible given the wide variety of companies that would be affected by the proposals. The report deliberately seeks to avoid such an accusation by adopting a 'comply or explain' approach—the proposals should be adhered to but, if they are not seen as appropriate, the reasons for this and their rejection can be explained. This 'comply or explain' principle is the basis of the well-established Combined Code which sets out the corporate governance requirements for listed companies.³²

30. There are two related but distinct functions that NEDs are required to fulfil on company boards. First, they play a mentoring role, bringing experience, expertise and access to networks of contacts that the board might otherwise lack. Secondly they have a monitoring or scrutiny role. Their relative autonomy from the company's day-to-day activities should give them the independence to ensure that the proper corporate governance procedures are being met. Whilst the mentoring role remains important, especially amongst smaller companies who may not have the depth of experience amongst their executive directors that a larger company would be expected to have, the scrutiny role has increased in significance in recent years. This is a trend that continues in the recommendations made in the Higgs Report. The report recognises the dual function of NEDs but its proposals are largely aimed at ensuring that the scrutiny role is fulfilled. To

30 Ev 4 (Tomorrow's Company), Ev 19 (ICAEW), Ev 26 and 27 (ICSA)

31 Q 305

32 *The Combined Code: Principles of Good Governance and Code of Best Practice*, Financial Services Authority (May 2000)

this end, Mr Higgs has put forward measures to ensure the independence of NEDs and hence their capacity to hold to account the company management and to put their point of view.³³

Criteria for appointing NEDs

31. Because of the increased emphasis on the scrutiny or monitoring role that NEDs play, concerns have been expressed that the pool from which they are drawn is too small and that the informal networks through which they are frequently appointed encourage cronyism. The results of this are twofold. First, that too many individuals hold too many NED posts simultaneously and so are incapable of devoting sufficient time to them; and secondly, that a nominally independent NED may in fact not be very independent at all. The onus on NEDs to ensure good corporate governance requires that they devote sufficient time to the company to perform this function adequately. Given that many NEDs hold several non-executive posts simultaneously, there is a limit to how much time they can devote to each of these. Furthermore, much of the evidence that we received called for a *mandatory* limit to be placed on the number of non-executive posts that could be held simultaneously.³⁴ The alternative suggested was that potential NED appointees should disclose their existing commitments and the extent of their availability to the board's nominations committee.³⁵ It is the latter approach that Higgs has adopted.

32. A broad consensus emerged in our inquiry that it was impossible for anyone to hold more than five or six non-executive posts concurrently and carry them out properly. Mr Higgs justified his decision not to set a mandatory limit by suggesting that the focus should not be on numbers but on the need to fulfil the NED's duties properly.³⁶ This position was supported by other witnesses who suggested that, because the circumstances of individual NEDs varied so widely, there was nothing to be gained from setting down a mandatory limit: some might hold important and demanding jobs and would be unable to find the time to fulfil one or two non-executive posts; other NEDs might have retired and so could spare the time to hold more.³⁷

33. The emphasis on fulfilling the duties of NED rather than setting down mandatory limits on their commitments is in keeping with the general approach adopted throughout the Higgs Review and we broadly support this approach. As Mr Higgs said in his evidence to us, it is important to avoid being distracted by arguments about numbers and to focus on the important principle that underlies them.³⁸ That said, however, there is a risk that the absence of a mandatory limit will be regarded as *carte blanche* to continue as before by those with multiple non-executive directorships. **It is important that the flexibility built into the Higgs proposals is not abused and this will need to be monitored carefully by the Financial Services Authority as guardian of the Combined Code, and by the Department of Trade and Industry. We are confident that such monitoring will take place, given the concerns about multiple directorships expressed to us by key interest groups (such as the IMA) and the welcome given to the Higgs proposals by bodies such as the ABI and the National Association for Pension Funds.**

33 NEDs can be either independent or non-independent when judged by the criteria for independence set out in the Higgs Review (see below, para 34). Given the focus on the scrutiny role of NEDs, the Higgs Review's proposals are aimed solely at independent NEDs. References to NEDs here are to independent NEDs unless otherwise stated.

34 Qq 35 (TUC) and 228 (IoD). Tomorrow's Company suggested a limit of four: Ev 4

35 Qq 67 (ICAEW), 290-291 (CBI) and Ev 27 (ICSA) — though the ICSA also suggested that best practice should be a limit of no more than three or four NED positions.

36 Qq 331-332

37 Q 66 and Ev 19 (ICAEW), and Q 291(CBI)

38 Q 331 (Mr Higgs)

34. The issue of independence of NEDs was also addressed in the evidence. One set of witnesses painted a picture of a small number of company directors all holding non-executive positions on each others' boards.³⁹ The Higgs Review proposes two strategies to reduce this perceived incestuousness. First it lays out a stricter definition of 'independence' than that currently contained in the Combined Code. The Higgs proposals would prevent anyone who has had close business or personal links with the company or its senior personnel or advisers, represents one of the major shareholders or has served on the board for more than ten years from being considered an independent NED.⁴⁰ The second approach is to widen the pool from which NEDs are drawn. Whilst it was conceded that there was a wider body of people from whom NEDs could be recruited,⁴¹ some witnesses still maintained that the breadth of experience gained in the relevant industry that was required to successfully contribute to a company board meant that the number of potential appointees would inevitably remain limited.⁴²

35. Two possible solutions to this emerged in the course of our inquiry, both of which are also proposed by the Higgs Review. First, it was suggested that senior executives below board level in large companies—the so-called 'marzipan layer'—might gain useful experience from holding a non-executive post with a smaller company and could make a valuable contribution to its running.⁴³ The second proposal was that by focussing on the generic skills a NED requires—judgement, management skills, analytical skills, and probity—a significant number of potential NED appointments could be found with backgrounds in sectors other than commerce. This would mean that the pool from which NEDs are drawn could be extended to those with backgrounds in the public sector, academia, law, large charities or politics, for instance. Some witnesses were sceptical about the extent to which those lacking business experience could contribute constructively to running a company.⁴⁴ **We believe that there is scope for recruiting NEDs from outside the usual, narrow pool. Some could be found among younger business people with direct commercial experience, others among those with still relevant but broader experience.** Fears about such people's lack of relevant industrial expertise are overplayed: NEDs from outside the business world would be supplementing rather than replacing the existing pool of NEDs and whilst they may lack commercial experience they would clearly have a range of other skills and expertise that would allow them to make constructive contributions to the boards they joined. **In fact, it might be that the introduction of those with backgrounds different from those of the existing, thoroughly homogeneous pool of NEDs could introduce fresh thinking and an element of dynamism to company boards.**

36. Fears that NEDs drawn from a wider pool might lack commercial experience could, to some extent, be addressed through the provision of training. The Higgs report recommends the introduction of induction programmes for new NEDs (regardless of their background) which would give a thorough introduction to the company.⁴⁵ It seems that something as basic as this is still relatively unusual and such provision as there is, is frequently at the request of the new NEDs themselves rather than being standard practice.

39 Q 171 (QCA)

40 Higgs Review, p 37

41 For example, by the ICSA (Ev 26) and the Institute of Directors (see press release dated 20 January 2003, "IoD welcomes broad thrust of Higgs recommendations").

42 Qq 145-147 (IMA)

43 Q 224 (IoD) and Ev 26 (ICSA)

44 Q 146 (IMA); the ICAEW also sounded a warning note (Appendix 13).

45 Echoed by, for example, the ICSA: Ev 28

37. Beyond this, the Higgs Review points to a growing desire among NEDs for more systematic provision of other training. But the Review also notes the limited availability of courses aimed exclusively at NEDs (and, indeed, there appears to be a shortage of training provision for directors as a whole). There is a need for broader, developmental training of directors in general. Mr Higgs recommends a change in “entrenched boardroom culture”: “Companies should acknowledge that to run an effective board they need to provide resources for developing and refreshing the knowledge and skills of their directors”.⁴⁶

38. Without going so far as some of our witnesses—who considered that it should be a requirement for at least a minimum number of directors per listed company to have Chartered Director status⁴⁷ **we think that it is important that attitudes towards training of directors change. Relevant experience is clearly fundamental for directors but their professional development should not stop merely because they have reached board level. However, this attitudinal change can only be realised if training provision is available. The Institute of Directors now runs a chartered directors programme, but this is the exception and directors' training (as opposed to training in management, for instance) remains scarce.**⁴⁸ We hope that the Higgs Review can act as a stimulus to both the provision and take-up of training for all directors.

Special roles for NEDs

39. The Higgs Review also makes some more specific recommendations about the role of NEDs on company boards. In the main it is these proposals that have generated the greatest controversy and the most hostile response in the media.

40. One of these contentious proposals is for NEDs to comprise 50% of company boards. The fear has been that companies will have to add significant numbers of NEDs to their boards to fulfil this criterion (the implicit assumption being that chairmen are prepared to meet the terms of the proposals through adding NEDs to the board rather than removing executive or non-independent NEDs). The cost of this proposal is viewed by critics as a burden and there is a fear that it will lead to overly-large and unwieldy boards. Opponents of the proposals also object to the measures relating to the role of NEDs on the board's principal committees.⁴⁹ The Higgs Review proposes that remuneration committees and audit committees should comprise at least three people, all of whom should be independent NEDs.⁵⁰ The nomination committee should comprise a majority of NEDs, which could include the chairman of the board; but the chairman should not also be the chair of the nominations committee.⁵¹ Nobody should sit on all three of the principal committees.⁵²

41. In addition to the predominant role on the board's committees, the Higgs Review proposes that the independent NEDs should meet as a group at least once a year as a matter of routine. This meeting would be chaired by a Senior Independent Director (SID). The primary role of the SID would be to act as an alternative point of contact for investors who, for whatever reason, did not wish to liaise with the chairman. To this end the SID would

46 Higgs Review, paras 11.13–11.14; see also the views of Ernst & Young: Ev 15

47 Ev 4 (Tomorrow's Company)

48 Qq 219-220 (IoD)

49 The audit committee, the nomination committee and the remuneration committee

50 Higgs Review, para 13.11 and p 60

51 Higgs Review, para 10.9

52 Higgs Review, para 13.2

be required to keep fully informed of investor concerns and, with this in mind, to periodically attend the regular meetings between management and major investors.⁵³

42. For its detractors, the collective impact of these measures would be to undermine the position of chairman. The chairman would, through not chairing the nominations committee, lose the ability to shape the board. The meetings of NEDs would, it is alleged, compromise the unitary board principle, and the SID would, by liaising with the shareholders, undermine the chairman's position at the apex of the company.

43. However, the hostile response from business leaders to many of these measures seems to us excessive. The fears about the need to recruit vast numbers of NEDs to comply with the Higgs proposals that they should comprise more than 50% of the board, the whole of the audit and remuneration committees and the majority of the nominations committee, and that no NED should sit on all three committees, also seem misplaced. Mr Higgs pointed out that companies would require a minimum of four NEDs—a figure already met or exceeded by the majority of the FTSE 350.⁵⁴

44. Much of the concern about the proposal for a Senior Independent Director⁵⁵ would appear to stem from a misunderstanding of the role that the review envisages for it. The Higgs Review makes it quite clear that the SID should not routinely establish lines of communication with investors in order to bypass the chairman. This function is aimed at maintaining a dialogue between the board and investors during a crisis if the normal lines of communication have broken down. This necessarily involves the SID keeping abreast of the views of shareholders through attending meetings with them. But the report makes clear that the role is essentially a passive one, a point reiterated by Mr Higgs in his evidence to us.⁵⁶ It should also be noted that many companies already nominate SIDs. Presumably those that choose not to are free to do so under the 'comply or explain' principle adopted throughout.

45. We also considered whether the requirement for the independent NEDs to meet annually would undermine the unitary board principle. Mr Higgs pointed out that, at the moment, a decision by NEDs to meet would be taken as a sign of crisis. If it became a mandatory requirement for the NEDs to meet, no such inference could be made.⁵⁷ Furthermore, given the day-to-day contact between the executive directors, it seems to us entirely legitimate that the NEDs should be able to meet to discuss company matters. However, it could be argued that the exclusion of an independent non-executive chairman from such a meeting—as proposed by the Higgs Report—would be divisive.

46. The proposals that the audit and remuneration committees should comprise independent NEDs seem sensible in the light of recent history⁵⁸—and, indeed, the Combined Code already requires listed companies to have an audit committee composed entirely of NEDs, a majority of whom should be independent. However, we note the concern that the prohibition on the chairman chairing the nominations committee might be a step too far. Opponents argue that the chairman is ultimately responsible for the actions of the board and so it is reasonable that he/she should be able to exert some control over appointments to it. They accept that concerns about cronyism are legitimate but hope that

53 Higgs Review, paras 7.5 and 15.15

54 Q 316

55 Expressed, for example, in the IoD press notice cited above (footnote 41) and Ev 28 (ICSA).

56 Qq 341 and 347

57 Qq 338-340

58 The key role of the NEDs on these committees is recognised, for example, by the ICAEW (Ev 20) and ICSA (Ev 27).

transparency and proper appointments procedures would overcome this. We did not consider this proposal, so have no recommendation to make on it. We merely note that there are some signs that it may be revised.⁵⁹

47. We recognise that the Higgs proposals could have different implications for larger and smaller fully listed companies. In order to comply with the provision that boards should have a majority of NEDs, smaller listed companies may not be so willing to appoint senior managers to the board. This could lead to a situation, as is currently common in the US, where the only Executive Directors are the CEO and the FD. We consider the wider representation of the Executive Directors on the Board to be a particular benefit to companies and therefore suggest that the situation is kept closely under review by the Government. We would be concerned if the effect of the Higgs proposals was to encourage smaller listed companies to relist on the AIM⁶⁰ where overall it would be shareholders' protections that would be diminished.

48. It has been suggested that the Higgs proposals will result in NEDs having to commit more time to their work and that remuneration will need to increase accordingly.⁶¹ The Higgs Review suggestions for increasing the supply of NEDs would help to alleviate the problem. But for the most part Higgs is not proposing much that is not already adopted as best practice by many companies. Given this, it is hard to see how the time commitment of those NEDs who have already been doing their jobs thoroughly will increase significantly. There must be concerns about whether those who feel they cannot meet the time commitments were fulfilling the duties required of them.

49. We welcome the Higgs Review. The proposals are modest but can contribute to good corporate governance standards in the UK, whilst the 'comply or explain' principle ensures that they should be flexible enough to avoid being seen as overly prescriptive. Interpretation is important, however, and the boards of companies must approach the proposals in an objective and sensible fashion in order to adopt those suitable to them and adapt those that need to be 'tweaked'. Similarly, though, failure to comply should not be taken as a negative sign by investors, providing it is accompanied by an adequate explanation that shows how governance standards are not compromised by the decision. It is important that the proposals are not interpreted so flexibly that they lack substance, nor so rigidly that they become a straitjacket.

59 'Higgs qualifies boardroom proposals', *Financial Times*, March 14 2003, p 6

60 Alternative Investment Market

61 Ev 28 (ICSA), Ev 38 (KPMG), Ev 42-43, para 1.6–1.16 (PCGWorldwide Limited)

5 Reporting and Auditing

Operating and Financial Review

50. Only a partial view of a company can be gleaned from its accounts. The accounts provide information on the company's past performance and can give no indication of its future strategy, the risks and opportunities it is likely to face, the way in which it manages its relationships with its stakeholders, or the manner in which it deals with social and environmental matters. At present, companies have the option, as part of their financial reporting and publishing of accounts, to produce an Operating and Financial Review ("OFR"), a narrative report covering the main factors underlying the company's performance and which is intended to give a broader view of the company's operations than the purely financial reports. Comparatively few companies have actually produced such reports, despite Government support for voluntarism evidenced by, for example, the Prime Minister's call in autumn 2000 for the FTSE 350 companies to produce reports on their environmental policies and activities. The White Paper therefore proposes that "economically significant" companies be required to publish an OFR.⁶²

51. The White Paper emphasises that "companies are increasingly reliant on intangible assets such as the skills and knowledge of their employees, their business relationships and their reputation. Information about future plans, opportunities, risks and strategies is just as important to users of financial reports as a historical review of performance."⁶³ It places the requirement in the context of the broader statutory definition of directors' duties proposed elsewhere in the White Paper,⁶⁴ and therefore proposes that the OFR should include information on "relationships with employees, customers and suppliers and the company's impact on the wider community" as well as "the company's impact on the environment".⁶⁵

52. Other interested parties have expressed different motives for requiring wider reporting and accountability: increasing public concerns about the environment; well-publicised difficulties with sudden large lay-offs of staff; public perceptions that — in particular "big" — business is indifferent to its effects on local communities and does not play an active role in supporting wider society; and a feeling that in general crude short-term profit-seeking appears to dominate company thinking at the expense of employees, customers and suppliers. The White Paper notes some of these motives, and says that the Government believes that the new requirement to report would be "a major contribution to both corporate social responsibility and sustainable development issues".⁶⁶

53. However, the Government does not intend to prescribe the content of OFRs: "It will, of course, be for directors to decide precisely what information is material to their particular business."⁶⁷ Rules for the compilation of OFRs will be drawn up by a new body set up under the proposed Companies Act, the Standards Board, and preliminary guidance for directors is being compiled by an independent group of experts. Moreover, although the White Paper makes it clear that company auditors will be required to report on the OFR,

62 Para 4.29 of the *White Paper* refers to "economically significant" companies; the draft clauses annexed to the White Paper use the term "major companies" (defined in clauses 77 and 78). We have preferred the former description.

63 *White Paper*, para 4.30

64 Discussed in paras 17–22 above.

65 *White Paper*, para 4.31

66 *Ibid.*, para 4.32

67 *Ibid.*, para 4.33

the auditors' report will be concerned only with the adequacy of the process of preparing an OFR and not its content, unless the content is "inconsistent with the financial statements or other information they are aware of as a result of the audit".⁶⁸

54. Reaction to the White Paper proposals has been mixed, with questions raised in particular over whether more companies should be made subject to the OFR regime; whether too much discretion is being left to directors as to what they put in OFRs; what value OFRs will have, given the lack of any independent check on their accuracy; and what, if any, redress there will be (and for whom) if OFRs are inaccurate.

Potential users of OFRs

55. The question of who is intended to be the user of an OFR overlaps with that of what an OFR should contain. The White Paper mainly emphasises the benefit to the members of a company (ie its shareholders or other owners), but, as already mentioned, the Government thinks that the information given in the OFR will also be of value to a wider cross-section of stakeholders because it will help to promote Corporate Social Responsibility and other desirable ends.⁶⁹

56. The witnesses from the ICAEW summed up the benefits to be gained from an OFR. The existing model for company accounts was many years out of date as it looked only backwards in time, failing to take into account less tangible factors, and therefore not recording the full value of the company to either its owners or other stakeholders. The OFR, on the other hand, was more forward looking, dealing with areas that drive share value such as cash flow and relations with important groups like employees, customers and suppliers.⁷⁰ The ICAEW did not attempt to put a value on such intangible factors, but CORE did: CORE said that it was generally accepted that factors such as these and having good social and environmental policies made up about 70% of a company's value, while its physical stock and property and cash in the bank comprised only 30%.⁷¹

57. Our witnesses put forward a variety of views as to the potential audience for an OFR. All agreed that it would be a useful source of information for shareholders: the IMA saw it as replacing the Chairman's statement in giving some needed colour to the historical results and a steer about future trading conditions.⁷² Both the IMA and the Institute of Directors felt that the OFR offered an opportunity to give briefer but better, more focussed information to shareholders than was possible with the current trend to increasingly glossy and expensive but essentially uninformative company reports.⁷³ The CBI suggested that some institutional investors were already assessing companies on whether they complied with best practice in the areas of social and environmental policies and stakeholder relationships; the OFR, they implied, would encourage this trend.⁷⁴

58. The witnesses from CORE suggested other groups that might find OFRs useful: Non-Governmental Organisations campaigning on particular environmental or social issues, local residents worried about aspects of company policy, the Socially Responsible

68 *Ibid.*, para 4.40

69 *Ibid.*, paras 4.31 and 4.32

70 Qq 46 and 51, and Ev 20-21; see also Ev 27 (ICSA)

71 Q 263; see also Ev 2 (ABI), Ev 3 and 4-5 (Tomorrow's Company)

72 Q 131. See also Qq 157 (QCA) and 263 (CORE), Ev 2 (ABI), Ev 14 (Ernst & Young), Ev 21 (ICAEW)

73 Qq 133-35 (IMA), 205-06 (IoD). CORE agreed: see Q 266

74 Qq 278-79

Investment industry and their customers, and company employees.⁷⁵ CORE insisted that there were already examples where the mere publication of information had shamed companies into improving their environmental or other performance.⁷⁶ However, in CORE's view, the usefulness of OFRs was likely to be limited by companies' taking a narrow interpretation of the information they were required to give. CORE noted that the draft clauses appended to the White Paper described the objective of the OFR as:

“Providing such information as will permit the members of the company ... to make an informed assessment of—

the company's operations;

its financial position; and

its future business strategies and prospects.”⁷⁷

CORE considered this definition to be too centred on the company itself, ignoring, for example, the effect of the company's policies on the environment and on other interested parties. The result, CORE feared, would be that in practice OFRs would be useful only to shareholders concerned about the value of companies.⁷⁸

Content of OFRs

59. The proposed content of OFRs was also the subject of debate. The White Paper distinguishes between the compulsory content of the OFR and other matters which would have to be included in the OFR if the company's directors thought that they were necessary to enable readers to reach an informed opinion of the company's performance and prospects. The compulsory, or “core”, elements are: a statement of the company's business; a “fair review of performance” during the financial year and of the company's position at the end of the year; and “a fair projection of the prospects for the company's business and of events which will, or are likely to, substantially affect that business”.⁷⁹ The White Paper also lists — while making it clear that the list is not exhaustive — “other matters” which the directors may decide are “material” to their particular business⁸⁰ and therefore should be reported on in the OFR. These “other matters” are:

the management structure of the company;

information on the purchase and sale of shares by members of the company;

the company's employment policies;

the company's policies on “environmental issues relevant to the company”;

the company's policies on social and community issues “relevant to the company”;

the company's performance in carrying out its employment, environmental and social and community policies;

75 Q 263; see also Ev 5 (Tomorrow's Company), Ev 47-48 (Work Foundation)

76 Qq 259-60. CORE cited the example of the Toxic Release Inventory in the USA: after the publication of this, emissions were reduced by more than 40%.

77 Draft Clause 73(3)

78 Q 261

79 Draft Clause 74(2)

80 This phrase is used in para 4.33 of the White Paper.

any other matters “which affect, or may affect, the company’s reputation.”⁸¹

60. As already mentioned, the Government does not intend to lay down more detailed requirements for OFRs in statute, on the grounds that a degree of flexibility will ensure that directors have to think carefully about the content of an OFR. This—the Government hopes—will encourage directors to integrate environmental, social and employment factors into their consideration of company policy as a whole: in the jargon, to “embed” such areas in all their policy decisions rather than leaving them in a Corporate Social Responsibility ghetto. Flexibility in refining the contents of an OFR would also enable the more forward-looking companies to set high standards by developing good practice.⁸² While it would be for the Standards Board to produce rules on the content of and procedures to be followed in compiling an OFR, the Government anticipated the legislation by setting up a group of experts to produce the essential guidance for directors on how to assess whether an issue was material to the company and therefore must be included in the OFR.

61. While in general agreeing with the proposed balance between the use of statute and more flexible Standards Board rules in specifying the content of OFRs, our witnesses disagreed sharply about the proposed distinction between the core subjects and other matters, which some commentators have summarised as a division between mandatory and discretionary subjects.⁸³ However, as many of our witnesses conceded, the draft clauses do not actually leave it to the discretion of directors as to whether they report on, for example, environmental and social issues: if these were material to an assessment of the company’s position and prospects, directors would have to report upon them.⁸⁴ The disagreement instead focussed on how seriously directors would take reporting on issues other than the core matters, and in particular whether they would treat such matters in a superficial manner, listing token information against a set of headings.

62. The TUC was disappointed that reporting on stakeholder relations—in particular relations with employees and employment policies—was not to be mandatory.⁸⁵ The trades union witnesses said that they did not imagine that many companies would ignore employment issues altogether in the OFR, but they feared that the “materiality” test could seriously affect the quality of such reporting, and would send a negative signal to directors about the importance of relations with employees.⁸⁶ CORE went further, arguing for reporting on social and environmental policies and performance to be mandatory; for stakeholders to have a right to participate in the reporting process (though they did not make it clear quite how this should be achieved); and for directors to be given a specific duty to ensure that the reporting process was carried out properly.⁸⁷ CORE also disliked the way in which the list of “other matters” was phrased, suggesting that, if a company had no social or environmental policies that affected the company, then the directors were perfectly entitled to decide that they were not required to report on social or environmental issues at all.⁸⁸

81 Draft Clause 75(2)

82 Ev 2 (ABI), Ev 5 (Tomorrow’s Company), Ev 10-11 (CORE), and Ev 46-47 (Work Foundation)

83 Ev 38 (KPMG)

84 Q 277 (CBI); see also the views of CORE: Q 261

85 So was Tomorrow’s Company: Ev 5

86 Qq 1 and 27

87 Q 251. The TUC also suggested that OFRs would be more robust if linked more strongly to the list of directors’ duties: Q 27

88 Q 261

63. We explored whether such reporting requirements would be too expensive for companies, and would require judgments by directors on matters that were difficult or even impossible to quantify. Both the TUC and CORE were firmly of the view that environmental and social issues were not “too vague” to be reported on in an objective fashion.⁸⁹ The TUC thought that it was the responsibility of the Standards Board to frame rules to ensure that OFRs did provide a reasonable qualitative assessment of social and environmental policies and achievements. Moreover, it was a mistake to believe that these issues were by definition incapable of objective analysis. Different standards and indicators against which companies could measure themselves already existed or were being developed: for example, the International Labour Organisation’s standards for employee conditions. CORE and the Work Foundation pointed out that companies in some other European countries were already required to produce reports similar to the proposed OFR, in particular in relation to environmental issues, but there were moves towards statutory reporting on social policies too.⁹⁰ Both sets of witnesses concluded that reports on such issues could be informative and need not degenerate into a box-ticking exercise.⁹¹

64. On the question of expense, CORE said that experience among companies that already produced environmental reports showed that such reports could cost anything between £30,000 and £60,000. However, this did not take into account the efficiency gains often made by companies as a result of the detailed environmental studies needed to draft such reports.⁹² CORE cited the example of the Co-operative Bank, from whom we sought further evidence. The Bank told us that their social and environmental report, which was acknowledged by many to be exemplary, cost less than £200,000 per year, which, though a considerable sum, needed to be set against the large amounts paid by other companies for production of their “glossy” accompaniments to their annual financial statements. The publicity—much of it positive—generated by the Bank’s first such report had been estimated to be worth more than £900,000 of equivalent advertising value. It was also the Bank’s view that, although many companies preferred to hide “bad news”, “communicating poor performance makes any good performance all the more believable”.⁹³

65. The witnesses representing businesses were generally content with the White Paper proposals, including the distinction between core and other subjects. The Law Society’s main concern was that it should be clear exactly what directors should report on.⁹⁴ The ICAEW said that, while supporting the concept of reporting on social and environmental issues, this should not be pressed so far or so fast that it became incompatible with the focus on the directors’ legal duty, which was to the company. Both they and other witnesses felt that the concept of “materiality” was vital in this, as anything more prescriptive could lead directors to take a rather sterile, “box ticking” approach to the OFR. Some suggested that such an approach could even lead companies to set up compliance units, thus undermining the intention of such reporting, which was to spread consciousness

89 See also Ev 47 (Work Foundation)

90 Qq 29 (TUC), 256 and 266 (CORE) and Ev 47 (Work Foundation). We note in this context that AccountAbility, a London-based accounting institute, has recently launched the AA1000 standard to ensure the credibility of environmental and social reporting: see ‘Non-financial standard launch’, *Financial Times*, 26 March 2003, p 12.

91 Qq 29 (TUC) and 262 (CORE)

92 Q 265

93 Ev 71

94 Q 102

of the importance of stakeholder relations and other intangible assets throughout the company.⁹⁵

66. We asked whether, as framed in the White Paper, OFRs would require companies to publish information that might help their competitors. The ICAEW drew our attention to the fact that companies had to give much more extensive and detailed information to stock markets in the form of their company prospectus than they were required to provide in their annual accounts. Companies now accepted that they could provide fuller information in their annual report and accounts without revealing anything that would damage their competitiveness.⁹⁶

67. We were also concerned about how auditors would approach the task of auditing an OFR containing broadly qualitative rather than quantitative information. We noted that the TUC believed that auditors should be required to check not only the veracity of the contents of the report but also that all relevant information had been included. This would seem to place wider responsibilities on the auditors than the Government intends: the White Paper describes the process of auditing an OFR as essentially concerned with the adequacy of the process of preparation, not on its detailed content; though auditors would also have the duty of reporting on whether the OFR complied with “applicable rules” (that is, those produced by the Standards Board, which are expected to cover content as well as process) and whether the OFR was inconsistent with the financial statement “or other information they are aware of as a result of the audit”. The ICAEW acknowledged that the White Paper proposals for reporting on environmental and social issues were rather “tortuous”, but expressed no concerns about difficulties in auditing an OFR. The President of the ICAEW said that he would expect an OFR to indicate clearly the “big risks and the big opportunities” specific to that particular company, rather than having pages of generic information common to many companies.⁹⁷

68. There seems to be a discrepancy between what the advocates of greater Corporate Social Responsibility want from the auditing of OFRs and what auditors—and the Government—expect. Given the limitations on auditor responsibility even in respect of financial information (underlined by recent corporate difficulties and scandals), it would be unrealistic to expect auditors to assume greater responsibility for information that is qualitative and even less easy to verify than financial reports.

69. The proposed OFR would be a marked improvement on current minimum reporting standards. It would help to give a much more rounded, clearer view of both past operations and future prospects of companies. It would be of benefit not only to shareholders and potential investors in companies, but also to all those concerned with wider aspects of company behaviour, whether as employees, local residents, or as interest groups involved in environmental/social issues or general corporate governance.

70. We believe that in practice directors will not be able to get away with assuming that environmental and social concerns are not relevant to their company and can be passed over without comment; we think that, in this area too, companies will be expected by investors and bodies like PIRC⁹⁸ to “comply or explain”. We would also

95 Qq 46 (ICAEW), 131 (IMA), 156 (QCA), 202-04 (IoD), 277 (CBI), and Ev 5 (Tomorrow's Company)

96 Qq 49 and 50

97 Q 51

98 Pensions Investment Research Consultants Ltd

be concerned if the effect of these proposals concerning the production of an OFR were to support a ‘box ticking’ attitude amongst companies. We recognise the concerns expressed by some witnesses over whether the division into “core” and “other” matters would in effect downgrade the latter, but we consider that there will be pressure (from investors and others) for companies to raise their standards of reporting to those set by the pioneers in this area. In this context, we agree with the view expressed by the TUC that company law alone cannot be expected to change corporate culture: without active shareholders and other interest groups, unwilling or incapable directors would be able to nullify the effects even of statutory obligations.⁹⁹

Types of companies required to produce an OFR

71. The White Paper defines those companies that will be required to publish OFRs as:

public companies which are not a subsidiary of another company incorporated in a European Economic Area state and which meet two or more of the following conditions:

the company’s turnover is at least £50 million in the financial year in question;

the company has a balance sheet total of at least £25 million at the end of the financial year in question;

the average number of the company’s employees is at least 500 in the financial year in question.

private companies which are not a subsidiary of another company incorporated in a European Economic Area state and which meet two or more of the following conditions:

the company’s turnover is at least £500 million in the financial year in question;

the company has a balance sheet total of at least £250 million at the end of the financial year in question;

the average number of the company’s employees is at least 5000 in the financial year in question.

In other words, the thresholds for private companies are set consistently at ten times that for public companies.

72. The White Paper estimates that these size criteria will affect approximately 1,000 companies or groups (less than 0.1% of registered companies), with an aggregate turnover of about £1,000 billion and covering a quarter of corporate economic activity in the UK.¹⁰⁰

73. Most of those who gave evidence to us thought that the threshold for publishing an OFR was about right: it was limited to those companies whose annual reports were actually of interest to major shareholders or which were large enough, even though private companies, to have some of the characteristics of a listed company; and the production of an OFR should not be unduly burdensome for a company this size.¹⁰¹ On the other hand,

99 Qq 1 and 25

100 Para 4.37

101 Qq 52-54, 56 and 57 (ICAEW), 130 (IMA) and 159 (QCA)

some of the representatives of smaller quoted companies warned that they believed the Government's Regulatory Impact Assessment under-estimated the burden of producing an OFR on such companies.¹⁰² The witnesses from the TUC said that they would like to see the requirement extended to a very wide range of companies, but were happy for it to be phased in, starting with the biggest companies first.¹⁰³

74. The only witnesses not broadly content with the proposed thresholds were those represented by CORE. CORE suggested only one threshold, a turnover of £5 million, which it said would comprise only 2.5% of companies, but would cover 85% of economic activity in Britain. The witnesses pointed out that this was the threshold in existing legislation in relation to certain accounting and auditing requirements, so, when companies reached the £5 million threshold, the OFR would simply be part of the wider reporting responsibilities laid on them.¹⁰⁴

75. While we recognise the potential benefits of producing OFRs—for the companies themselves, as well as for investors and wider interest groups—we are aware that to date there has been little private sector experience of them in the UK,¹⁰⁵ and a number of companies (especially those within the FTSE 350 but outside the FTSE 100) are clearly anxious about what an OFR will be expected to contain, and the cost and difficulty of producing one. So on balance we prefer the gradualist approach advocated by the TUC (and possibly intended by the Government), so that the details of what is required can be worked out with the largest companies and then the key aspects extended to smaller companies. We are therefore content with the thresholds proposed in the White Paper.

Sanctions for breaches of accounting standards

76. The White Paper discusses the question of sanctions for breaches of accounting standards. At present, the Secretary of State or the Financial Reporting Review Panel¹⁰⁶ may apply to the courts for an order requiring the directors of a company to prepare revised annual accounts if the accounts are in breach of the law; but for any other documents required by statute (such as the present directors' report), there is no mechanism for administrative enforcement, and enforcement relies only on criminal prosecution. There have been very few such prosecutions.¹⁰⁷

77. While the Government does not intend to make any change to the current regime of criminal sanctions for failure to prepare and distribute the various reports required by law, the White Paper concludes that administrative measures are more suited than criminal sanctions to the enforcement of requirements that “may often contain an element of judgment (for example as to whether accounts comply with Standards Board rules; whether the process for compiling the OFR was adequate; whether the reasons given for non-compliance with the Combined Code are sound)”. The White Paper also suggests that administrative enforcement is likely to be more effective in encouraging improved disclosure.¹⁰⁸ There has also been some suggestion that the imposition of a tougher form

102 Q 158 (QCA)

103 Q 28

104 Q 264

105 In contrast, within the public sector departments are now required to produce an OFR with their annual resource accounts, using a standard template.

106 One of the bodies with delegated powers to enforce company law.

107 White Paper, para 5.19

108 White Paper, paras 5.23 and 5.18 -5.20; a point underlined by Ev 14 (Ernst & Young)

of punishment would lead to demands that the requirements for accounts and the duties laid upon auditors be made far more specific, thus undermining the UK principle-based approach to accounting standards. The Government therefore proposes to extend the current administrative enforcement procedure for annual accounts to the entire range of reporting documents.¹⁰⁹ An exception to this is the proposal to introduce criminal sanctions for the offence of intent to mislead or deceive an auditor.¹¹⁰

78. We asked the ICAEW whether its membership was broadly content with the proposed balance between criminal penalties and administrative measures for enforcing disclosure. The ICAEW felt that it drew a necessary distinction between people who did their job honestly and got it wrong (whether directors or auditors) and people who were “knowingly and recklessly going out to mislead and ultimately to defraud”.¹¹¹ The accountants also said that there had been difficulties in the past in prosecuting managers and others who had wilfully misled auditors, and that it would be very useful to have the proposed clear offence of misleading auditors.¹¹²

79. We agree that the effect of the law should be to encourage companies to make the proper disclosure rather than merely to punish directors for failing to do this. We note that the current—criminal—sanctions have been little used. We therefore concur with the Government that administrative measures should be more effective in achieving disclosure. We also support the proposal to introduce a clear criminal offence of intent to mislead or deceive the auditors.

109 The financial statements, summary statement, OFR, directors' remuneration report and the supplementary statement. For a description of all these documents, see the White Paper, paras 4.8–4.14, 4.43, 3.21–3.22 and 4.15–4.17

110 Company Law Review, para 8.119 and White Paper, para 4.47

111 Q 74; see also Ev 14 (Ernst & Young) and Ev 41 (Law Society)

112 Qq 76 and 73; see also Ev 2 (ABI)

6 Auditors and Audit Committees

80. While the review of Company Law was taking place, events such as the scandals over Enron and other companies, and the financial difficulties faced by, for example, Marconi, brought into prominence the role of external auditors. Many commentators raised questions about such issues as whether firms which had acted for years as auditors of particular companies could be said to be truly independent of those companies; whether auditors who gained a large share of their income from a company or who also offered (far more lucrative) non-audit services to the companies they audited could be independent; and whether the dearth of large international accounting firms reduced competition to such an extent that, again, it was impossible to ensure independence.

81. The White Paper did not cover issues concerning the independence of auditors, pointing out that these were being dealt with by the Government's Co-ordinating Group on Audit and Accounting Issues ('the Co-ordinating Group'). That Group produced its interim report in July 2002, shortly after the White Paper appeared, and, as a result of its preliminary findings, two further reviews were set up. The Secretary of State for Trade and Industry initiated a review by her Department into the regulation of the accountancy profession, in particular the organisation by the Accountancy Foundation of the various aspects of self-regulation;¹¹³ and the Financial Reporting Council appointed a group chaired by Sir Robert Smith to draw up guidance for audit committees.¹¹⁴ The Co-ordinating Group published its final report on 29 January 2003.¹¹⁵

82. Also in July 2002, the Treasury Committee published a Report on *The Financial Regulation of Public Limited Companies*, its reaction to Enron and the other recent accounting scandals, which considered aspects of auditor independence.¹¹⁶ This Report was recently the subject of a debate in Westminster Hall.¹¹⁷

83. We do not intend to examine in detail all the areas covered so comprehensively by these different reviews, but a number of important issues discussed by them are relevant to our inquiry into what changes ought to be made to company law. The chief of these issues are:

whether there are any types of non-audit work that are incompatible with auditor independence—and, if so, whether there should be a statutory prohibition of such work or whether the profession should be left to regulate itself;

whether there should be a requirement for companies to change their audit firm regularly, and, if so, at what intervals; or whether it would be sufficient simply to change the personnel working on the audit while retaining the same audit company;

what other measures should be taken to discourage too cosy a relationship between auditors and client companies;

113 This reported in January 2003: *Review of the Regulatory Regime of the Accountancy Profession: Report to the Secretary of State for Trade and Industry*, URN 03/589, published on 29 January 2003 at www.dti.gov.uk

114 Whose report was published in January 2003 as *Audit Committees: Combined Code Guidance*, available at www.frc.org.uk/publications

115 *Final Report to the Secretary of State and Chancellor of the Exchequer*, URN 03/567, at www.dti.gov.uk This is referred to hereafter as 'Final Report of Co-ordinating Group'.

116 Sixth Report of Session 2001-02 (HC 758)

117 HC Deb, 13 March 2003, cols 137WH-174WH

the effect on confidence of the lack of competition among big accounting companies; and the role of audit committees in ensuring auditor independence from the clients' perspective.

Ensuring auditor independence

Competition

84. One of the major problems faced by anyone trying to restore confidence post-Enron in the system of auditing of big companies is the small number of accounting firms (currently four¹¹⁸) that are capable of auditing complex multinational companies. Even while clearing the merger of the remnants of Andersens with other accountancy firms in various European countries, the European Commission left open the question of whether or not the reduction from five to four main players led to “a situation of oligopolistic dominance”.¹¹⁹ These accountancy firms have also been important providers of non-audit services to big companies in such areas as the installation of IT systems, valuation services, tax advice, and management consultation. This has led to the appearance, if not the fact, of too close a relationship between auditors and clients, which undermines confidence in auditor objectivity.

85. There have been suggestions that the ‘Big Four’ accountancy firms should be broken up to increase competition. The ICAEW explained to us why this might not work. First, as mentioned above, only big firms had the international reach themselves to audit major multinational companies (and none of the next tier of accountancy firms was willing to take up the challenge of trying to audit such companies); and secondly, smaller companies formed from the break-up might well be forced by lack of expert personnel to specialise in certain sectors of industry, so more accountancy firms would not necessarily increase the competition to provide auditing services to individual companies.¹²⁰ We are aware that the Office of Fair Trading has concluded that, although the market for auditing and accountancy is highly concentrated, this is a global problem and that it is difficult to see what action at a national level could solve it.¹²¹ The Government has found these arguments persuasive to date, though the Co-ordinating Group has welcomed the Office of Fair Trading’s commitment to keep the situation under review.¹²²

86. On the other hand, witnesses both from the ICAEW and representing the second tier of listed companies believed that far too much prestige was attached to being audited by one of the ‘Big Four’. Mr Mackay of the QCA suggested that one of the reasons for the dominance of the Big Four was that institutional investors put pressure on companies by subtly making it clear that they would not consider investing in companies that were not audited by one of the Big Four.¹²³ The ICAEW was of the view that a number of smaller accountancy firms had enough expertise to audit any companies other than the largest multinationals.¹²⁴ Some observers have suggested that, following recent scandals and difficulties, there is now less prestige in being audited by one of the biggest accounting firms. **We believe that such an audit for many companies was always a status symbol**

118 Following the collapse of Andersens as a result of its part in the Enron scandal.

119 Case No COMP/M2810 – Deloitte & Touche/Andersen (UK), 01/07/2002

120 Q 77

121 Office of Fair Trading Press Notice of 22 November 2002 and attached statement.

122 Final Report, para 6.5

123 Q 180

124 Q 77

rather than a sign of extra quality, as a number of accountancy firms are equally well qualified to audit most companies. We also think that greater competition in the market for accounting services would promote auditor independence and give a good basis for investor confidence. We therefore hope that institutional investors will not revert to putting pressure on smaller companies on the basis of mere prestige; such an action would contradict many of their efforts in other areas to increase transparency, accountability and effective corporate governance overall.

Non-audit work

87. Both Mr Mackay and the ICAEW thought that a key to improving competition among accountancy firms was restricting the right of auditors to carry out non-audit work. Mr Mackay believed that restrictions would lead to the break-up of firms into auditing and non-auditing companies; the ICAEW suggested that, if there were restrictions on the same firm undertaking the external audit and non-auditing work, then the Big Four between them would not be able to provide all the services needed by large companies, so smaller accountancy and other firms would have an opportunity to provide non-audit work, and competition would improve.¹²⁵ There have been suggestions that companies may, for the sake of appearance, be more reluctant to employ their auditors for non-audit services.¹²⁶ **Certainly, we see a change in the balance between audit and non-audit work as being vital to guarantee auditor independence.**

88. On the subject of judging what types of non-audit work were suitable, the ICAEW took the view that focussing on the independence of auditors was not necessarily helpful; what was really needed was auditor objectivity. Objectivity was defined by two fundamental principles: auditors could not audit their own work; and auditors could not carry out quasi management responsibilities for the company being audited. If certain actions were clearly in breach of one of these principles, and no changes to the actions could bring them into line with the principles, then those acts should be prohibited. The interpretation of these principles had recently been tightened up by the profession's regulatory bodies, the ICAEW witnesses said. They gave as an example the fact that it had been concluded that there was an unavoidable conflict of interest if parts of an auditing firm were responsible for large IT installations which affected integral parts of a company's internal financial control systems.¹²⁷ However, the profession did not favour, for example, a complete ban on non-audit work by auditors as there were cases where such non-audit work did not present a major conflict of interest and, indeed, might be better done by a firm with an auditor's insight into the business, aims, ethos and organisation of the client than by an outside body.¹²⁸ The CBI gave an example of an area of work which auditors were better placed than others to do: the conduct of due diligence on a company that their client was considering buying.¹²⁹ Other witnesses, however, thought that there should be a ban on auditors providing certain types of non-audit services, and felt misgivings about whether self-regulation in this area would work.¹³⁰

89. We also had conflicting evidence about whether audit was used as a loss leader, with the resulting danger that auditors' independence would be compromised by their reliance on the continuance of their non-audit work with companies. A witness from the QCA said

125 Qq 185 (QCA) and 77 (ICAEW)

126 See Final Report of Co-ordinating Group, para 1.31

127 Q 58

128 Ev 14 (Ernst & Young), Ev 22-23 (ICAEW), Ev 26 (ICSA) and Ev 38 (KPMG)

129 Q 280

130 Q 185 (QCA)

that companies had had experience of accounting firms using audit in this way; he felt that there should be a ban on certain types of non-audit services even if this resulted in the cost of audit rising.¹³¹ The witnesses from the CBI, however, said that in their experience audit committees were well aware of what was the appropriate fee for an audit and could therefore detect if audit was being used as a “loss leader”.¹³²

90. Although the evidence is necessarily anecdotal, it seems to us that there is a danger of audit services being used as a loss leader, not least because the lack of competition for auditing big and especially multinational companies¹³³ must make it very difficult for even the most conscientious audit committee to determine a true market rate for the job. It therefore seems appropriate to limit the types of non-audit services provided by auditors.

91. We do not think there should be a ban on all types of non-audit work by auditors: some tasks could be carried out by auditors without undermining their independence, and potentially more efficiently than by bodies without the inside knowledge of company operations gained by auditors. We consider that the two principles described by the ICAEW¹³⁴ are the key tests to determine whether or not non-audit work should be banned.

92. We note the view of the Co-ordinating Group that, despite the measures taken by the accountancy profession since July 2002 to tighten and clarify the requirements for the provision of non-audit services, further strengthening was required, in particular in connection with the provision of internal audit services, and clarification was needed on the supply of valuation services, taxation services and IT and financial information technology systems.¹³⁵ We did not take evidence on the exact types of non-audit work that are considered to present particular difficulties in ensuring auditor independence, though we are aware that **particular concerns have been expressed about the supply of expensive IT systems, especially financial control systems; and it seems to us obvious on first principles that external auditors should not also be involved in the provision of internal audit systems. We would therefore recommend a strengthening of the requirements in these areas. Beyond this, we are content that the details of the requirements should be filled in by experts.**

93. This leaves open the question of whether the ban on certain types of non-audit work should be statutory, determined by an independent regulator or applied by self-regulation. In considering this, we are mindful of the general principle behind the current review of company law, that it should be focussed on what is required of small companies first. Although there have been difficulties with the auditing of some small companies, it is the larger, mainly listed, companies that have been the main cause of concern. There are many accountancy firms that can deal with auditing anything but the largest companies, so there is no oligopoly in this part of the market. Moreover, in respect of smaller client companies the provision of non-audit services is less lucrative to auditors, so the small accountancy firms that deal with such companies are less likely to be in a position to make their auditing services a loss leader. At the same time, small companies do not have many options when it comes to obtaining advice on, for example, their tax affairs, and their auditors would be an obvious source of professional help. It would therefore be wrong to

131 Qq 181 and 186

132 Q 281

133 Discussed in more detail in paras 84–86 above

134 And which are endorsed by the Co-ordinating Group: Final Report, paras 1.35–1.36

135 *Ibid*, paras 1.41–1.48

impose statutory requirements about auditors that would affect companies of all sizes; and, even if one excluded smaller companies who are subject to a lighter auditing regime under company law, this cut off point would not necessarily coincide with the division between companies where problems of auditor independence may arise and companies where there are unlikely to be such problems. Statute appears to be a rather inflexible way of addressing the issue of banning or restricting certain types of non-audit work.

94. On the other hand, public confidence in self-regulation of professions is low and is likely to continue to be so, even though the approach taken by the accountancy profession towards regulating conflicts of interest seems to us to have been sound. We welcome the conclusion by the Government's review of the regulatory framework of the accountancy profession—endorsed by the Co-ordinating Group—that there should be an independent body to set standards for the accountancy profession.¹³⁶ **For reasons of flexibility and maintaining a light-handed approach to regulation, we conclude that it should be the responsibility of an independent body to set standards to uphold the independence of auditors. If such regulation seems to be failing, however, we believe that the Government should re-consider whether it is necessary to impose statutory restrictions on certain types of non-audit work by auditors.**

95. In cases where there is no regulatory bar on auditors undertaking work, then audit committees should have a clear responsibility to determine whether, in the particular circumstances of their company, the auditors should be awarded such contracts.¹³⁷

Rotation of audit firms

96. Other options to promote auditor independence have also been under discussion, the principal one being whether it should be compulsory for companies to change their auditing firm, or to require re-tendering for audit work, after a certain period, or whether it would be sufficient simply to enforce a regular change of key audit personnel. The ICAEW was opposed to compulsory rotation of audit firms, on the grounds that the highest risk of audit failure occurs in the first two years after new auditors have been appointed, because the new firm is unfamiliar with the risks attaching to that particular client.¹³⁸ Some representatives from companies, however, felt that compulsory change of firms was vital to preventing an unhealthy close relationship between auditor and client.¹³⁹ Another argument against rotation of companies was that, where the client was involved in a specialist business, there were likely to be so few accountants who had experience of such business that in practice the appointment of a new auditing firm would probably be accompanied by the re-employment en masse of the old audit team by the new auditing firm. The QCA was not worried by this prospect: it was not the people doing the groundwork of the audit who needed to be changed regularly but the more senior, policy-formulating personnel; and senior personnel were such a close-knit group that moving team leaders would be insufficient, and only a change of auditing firm would do.¹⁴⁰

97. In contrast, the ICAEW argued that it was not organisations but individuals that built up relationships, and that the recent changes to the accountancy profession's rules (to reduce the timeframe for rotation of key personnel from seven to five years, and to extend

¹³⁶ Review of the Regulatory Regime of the Accountancy Profession. Chapter 4 (in particular para 4.21); Co-ordinating Group Final Report, para 1.71.

¹³⁷ For further discussion on the role of audit committees in ensuring auditor independence, see paras 103–106 below.

¹³⁸ Qq 58-60 and Ev 23; see also Ev 2 (ABI), Ev 14 (Ernst & Young) and Ev 39-40 (KPMG)

¹³⁹ Qq 179 and 182 (QCA)

¹⁴⁰ Qq 182-84

the key personnel covered from just the lead audit partner to everyone involved in making significant audit judgments) would be effective in preventing the sort of relationship that would impair auditor impartiality.¹⁴¹

98. The ICAEW and QCA did agree on one area of audit/client relationships: the QCA approved of the rule enforcing a two year cooling-off period before an auditor could join a client company. The rule was intended to take into account the sort of difficulties that would be faced by auditors trying to audit the work of a former colleague, and especially of a former boss.¹⁴²

99. We note that the Co-ordinating Group has concluded that the arguments against compulsory audit firm rotation outweigh those in favour; and we are also aware that the Office of Fair Trading has expressed the opinion that such mandatory rotation could reduce competition.¹⁴³ These bodies were less opposed to the idea of compulsory re-tendering for audit work, but the Co-ordinating Group feared that such a requirement could result in companies “going through the motions”, and at worst might encourage uneconomic pricing of audit services by audit firms, with the possible result of a decline in audit standards.¹⁴⁴ The Co-ordinating Group believed that the provisions for rotation of personnel and for greater responsibility for audit committees in ensuring auditor independence, plus requirements for greater transparency by audit firms themselves,¹⁴⁵ provided sufficient assurance that inappropriately close relationships would not build up between auditor and client.

100. We welcome the recent changes to the rules on rotation of audit personnel and on the two year “cooling off” period for auditors. However, we are not confident that by themselves they will be sufficient to restore confidence in the independence of auditors.

101. We agree with the Co-ordinating Group that compulsory re-tendering could simply be an expensive but unproductive exercise. This option depends on the vigilance and independence of the company’s audit committee to be effective; but, with a vigilant and independent audit committee, it is not necessary.

102. We are less inclined than the Co-ordinating Group and ICAEW to worry about an increased likelihood of audit failure in the first two years of a new company’s tenure: after all, if (as both the ICAEW and Co-ordinating Group predict) audit teams simply swap from the old to the new audit firm, then there will not be a loss of knowledge and understanding of the client with mandatory circulation of firms. More convincing to us are the arguments about the difficulty of finding a new audit firm that does not have a conflict of interest over the provision of non-audit services, especially in the present uncompetitive state of the market. We therefore do not recommend mandatory rotation of audit firms. However, we do not think that it should be ruled out altogether: if the other measures taken both to increase the scrutiny of auditors by independent directors, and to encourage greater competition among audit firms, prove insufficient to restore confidence in the objectivity of external auditors, then compulsory circulation of audit firms should be re-considered.

141 Q 58; see also Ev 14 (Ernst & Young)

142 Qq 62 (ICAEW) and 187 and 188 (QCA); see also Ev 14 (Ernst & Young)

143 Final Report of Co-ordinating Group, paras 1.23–1.30 and (for the OFT’s view) 6.4; Ev 23 (ICAEW) and Ev 40 (KPMG)

144 Final Report of Co-ordinating Group, para 1.30

145 Not discussed by us, but see *ibid.*, paras 1.62–1.66, 1.69–1.70, 1.72 and Chapters 5 and 6

Audit Committees

103. We have already mentioned the debate over the role of Non-Executive Directors in relation to audit committees of companies.¹⁴⁶ The White Paper on Company Law makes no reference to audit committees, but the general tenor of company law reform is to increase transparency and the accountability of company boards to shareholders, and—for the reasons set out below—audit committees are central to this.

104. Our witnesses suggested that the audit committee had a number of key roles to play. The first was as the main point of contact between board and auditors: for the auditors, the committee should represent “the best practical proxy to the shareholders”, and for the Non-Executive Directors it should be the channel of information independent from the executive directors because it originated with the auditors, who were “out and about” in the company and therefore had more opportunities for examining the day-to-day running of the company than Non-Executive Directors.¹⁴⁷ The other key role of audit committees was seen to be in ensuring the independence of auditors. The ICAEW went so far as to assert that proper scrutiny by audit committees would be more effective in ensuring auditor independence than requirements for the rotation of audit companies,¹⁴⁸ as audit committees met the auditors frequently to discuss their work, and not just every five years (for the purpose of appointment or re-appointment). The CBI to a large extent agreed with the ICAEW on the desirability of relying on the audit committee to ensure auditor independence rather than introducing regulations to limit what auditors could do.¹⁴⁹

105. The only change recommended by the ICAEW to promote proper supervision of auditors by audit committees was for it to become absolutely standard for such committees to make a detailed report to both the full board and the shareholders setting out not just the committee’s recommendation about the appointment of auditors but also such matters as why the committee was satisfied that the auditors’ independence had been maintained and what the committee’s policy was on the provision of non-audit services.¹⁵⁰

106. Several of these areas were discussed in the Higgs report,¹⁵¹ and a key issue that we had to consider was whether audit committees would be able to fulfil their functions unless they were composed of non-executive directors. There was agreement among our witnesses that the audit committee should be composed of Non-Executive Directors, and that certainly a majority—and possibly even all—of them should be independent.¹⁵²

107. We agree that audit committees have a vital role to play in corporate governance, and that they should be the main channel of communication between auditors and shareholders via the full board. In order to be “the best practical proxy to the shareholders” for the auditors, such committees should be composed of non-executive directors who are not compromised by having had too close a relationship with the management of the company in the past, who are highly analytical, tough-minded and at least some of whom have had recent financial experience. So that the shareholders are kept as fully informed as possible, such committees should also make a full report to both board and shareholders on how they have exercised their

146 See paras 40, 43 and 46 above

147 Qq 62 (ICAEW) and 288 (CBI), Ev 2 (ABI), Ev 15 (Ernst & Young), Ev 21 (ICAEW)

148 Ev 24. On rotation, see para 96 above

149 Q 280; see also Ev 2 (ABI), Ev 15-16 (Ernst & Young) and Ev 38 (KPMG)

150 Qq 60 and 63 and Ev 20 and 23; see also Ev 15-16 (Ernst & Young), Ev 26 (ICSA) and Ev 38 (KPMG)

151 Higgs Review, paras 13.4–13.7

152 Qq 3 and 31 (TUC), 62 (ICAEW), 175 (QCA) and 235 (IoD), and Ev 15 (Ernst & Young)

function of scrutinising the auditors. In this context, it also makes sense for the chairman of the audit committee to attend the AGM to answer questions from the shareholders, as already provided for in the Combined Code. Finally, it is important for the members of the audit committee to be fully briefed about their special role, and companies should, where necessary, provide specific training for members of the audit committee to enable them properly to scrutinise external audit and internal control and risk management.

7 Institutional Investors

108. The White Paper's assumption that good corporate governance equates with enlightened shareholder value clearly puts the onus for maintaining standards of corporate governance on the shareholders. From clarifying directors' duties to the increasing role for NEDs and the OFR, the emphasis in the White Paper is on increasing transparency and accountability to the shareholders. Shareholders have two sorts of influence in relation to companies: they can seek to change the way the company is run by argument and voting ('voice'), or they can simply sever their connection with the company by selling their shares ('exit'). Of the different sorts of shareholder, institutional investors—for the reasons set out below¹⁵³—have the most influence. The role of institutional investors was not the primary focus of the Company Law White Paper; this was covered by the Myners Review in 2001.¹⁵⁴ However, the fundamental role that institutional investors are expected to play in ensuring good corporate governance under the approach proposed by the Company Law White Paper persuaded us that this important issue required our consideration.

109. The proportion of shares held by institutional investors has increased dramatically over the recent decades as insurance and pension funds have swelled. Institutional investors have steadily increased the percentage of UK equity they hold from 30.3% in 1963 to 51.9% in 1999.¹⁵⁵ The equity held by institutional investors is heavily concentrated amongst the largest public companies, with their involvement diminishing outside the FTSE 250.¹⁵⁶

110. Given this development, the institutional investors are by far and away the most significant group of shareholders, especially amongst the largest and most complex companies. Their influence is further compounded by the advent of paperless settlements such as CREST, which grant fiduciary investors nominal ownership rights whilst the original owner is reduced to beneficiary status. This type of settlement has meant that many individuals who own shares are increasingly unlikely to take any active interest in the running of the companies in which they hold shares. The White Paper notes that the Government is considering reforms to the current arrangements under which such beneficiary shareholders no longer receive company information and lose the right to speak at company meetings.¹⁵⁷ However, whilst welcome, these measures are unlikely to counter the practical restraints on individual shareholder involvement. Few will have the time or expertise to fully exercise their right of 'voice' (whilst the fiduciary investors will retain the right to 'exit' by trading the shares). Furthermore, they will also, as individuals, lack the critical mass to put meaningful pressure on the company board. There might be scope for the trustees of pension funds to exert a greater pressure on their agents—some trade unions have taken small steps in this direction¹⁵⁸—but this will be limited in scope for the foreseeable future. As the Myners Review showed, trustees lack the expertise, time or resources to be able to carry out this role in any sort of systematic fashion, nor are there any internal mechanisms giving them a mandate to act in this way.¹⁵⁹ This means that,

153 See below paras 109–110

154 *Myners Review of Institutional Investment: Final Report*, HM Treasury (March 2001) referred to hereafter as 'the Myners Review'

155 Myners Review, table 1.1

156 Q 162 (QCA)

157 White Paper, paras 2.40–2.41

158 Qq 2-5 (TUC)

159 Myners Review, appendix A

under the Enlightened Shareholder Value approach adopted in the White Paper, the onus for ensuring good corporate governance amongst the most significant companies inevitably lies with the institutional investors.¹⁶⁰

111. This fact is made clear in both the final report of the Company Law Review Steering Group and, albeit briefly, the White Paper. The Review Group's final report notes that:

“[t]he vast majority of major public companies are controlled by institutional investors, fund managers, insurance companies and other discretionary investors managing portfolios of shares on behalf of savers and, via pension fund trustees, on behalf of pensioners and future pensioners. Our proposals on transparency and the controlling powers of shareholders are fundamentally dependent on the responsible, diligent and active exercise of their powers by these fiduciary investors.”¹⁶¹

112. If institutional investors are to play the role of ensuring good corporate governance that the White Paper places on them, then a change in their 'traditional' attitude towards the companies in their portfolios would appear to be needed. It requires institutional investors to actively engage with the companies in which they hold equity and, wherever possible, to utilise their powers of 'voice' rather than 'exit'. This contrasts with the often-expressed view that institutional investors take a short-termist approach towards their investments which has an unsettling effect on companies: “The investment institutions predicated to play a larger role in corporate governance appear to have one overriding aim; to increase the worth of their holdings, almost at any price and in the shortest possible timescale”¹⁶². This may mean (as one of our witnesses suggested) that such investors concentrate on areas such as the composition and functioning of the board, but only with the aim of improving the company's financial performance, not with a view to its long-term health.¹⁶³ The Myners Review observes that fund managers are encouraged to cling as closely as possible to stock market indices by peer group benchmarks and that the vagueness of the timescales over which they are to be assessed tends to encourage short-termism.¹⁶⁴ Furthermore, as margins are pared back, there is an increase in the use of tracker funds in which trading is, for the most part, carried out by computer programmes designed to mirror as closely as possible the performance of the market as a whole. Clearly, then, the environment is not conducive to active engagement with companies even where this could produce good returns.

113. There are, however, some signs that the institutional investors realise that there should be a change. The Institutional Shareholders Committee (ISC) recently published a statement of principles regarding their engagement with the companies in which they invest.¹⁶⁵ This states that signatories to the document (which comprise, via the various trade associations, the majority of the institutional investors) undertake to produce a clear, public statement of policy on monitoring the performance of companies. In doing this, institutional shareholders will try to satisfy themselves that a company's board structure, including sub-committees, is effective, with NEDs playing an adequate role, with a view to identifying problems at an early stage and thus minimising any potential loss. The statement also requires signatories to include in their statement of policy details of the

160 Q 141 (IMA)

161 The Review Group Final Report, para 3.52

162 Ev 44-45, paras 3.1–3.7 (PCGWorldwide Limited)

163 Q 297 (CBI)

164 Myners Review, p 2

165 Printed as Ev 34-36

circumstances under which they are likely to intervene and the form that intervention is liable to take.

114. The professed aims of the ISC statement are, according to the deputy chairman of one of the signatory organisations, to put in place “some process around the whole shareholder activism debate” and to create a climate where “it is no longer defensible for somebody to say ‘I do not like the company’ and sell the shares”. It will, he predicted, “drive significant further engagement by institutional investors with the companies in which they are investing”.¹⁶⁶

115. Some of our witnesses suggested that the tendency of investors to short-termism was exaggerated by critics anyway. Unsurprisingly, witnesses from the IMA took this view;¹⁶⁷ but significantly some of those from the CBI said that, although institutional investors were worried about short-term performance themselves, in practice they did not pressurise company directors to concentrate only on immediate share value whilst neglecting the long term benefits from, for example, R&D: they expected directors to run businesses for the long-term.¹⁶⁸ Other witnesses concluded that although the concentration on short-term performance was a problem, institutional investors could do something to counteract this.¹⁶⁹ A witness from the CBI noted that the establishment of compliance departments by some institutional investors was a sign that they were taking the good corporate governance of companies seriously—and it was the compliance departments and not the fund managers who wielded the votes at companies’ AGMs.¹⁷⁰

116. The constructive engagement of institutional investors with companies is a welcome development. However, there are limits to the extent that the shareholders can be expected to remedy failings in corporate governance.

117. Should an institutional investor become too involved with the company in which they hold equity they run the risk of becoming an insider and thus prevented from trading in the shares of that company.¹⁷¹ This should not prevent institutional investors from monitoring a company’s performance or corporate governance structure but will act as a deterrent to any further involvement in most cases. And without a deeper involvement there is clearly a limit to the extent to which institutional shareholders can be expected to ensure that fraud and mismanagement are ruled out, although by ensuring proper procedures and an adequate board structure are in place they can make such practices more difficult.

118. A further constraint would appear to be that of resources. In a climate where margins are being cut back and cost-cutting amongst institutional investors and fund management houses is rife, there is a very clear limit to the increase in resources which managers are going to devote to corporate governance issues. The ISC statement, while encouraging greater engagement by institutional investors with companies, emphasises that the resources devoted to this task should be commensurate with the benefits to their clients/customers: “The duty of institutional shareholders and agents is to the end beneficiaries and not to the wider public”.¹⁷² A representative of the Investment Managers’ Association noted that the pressure to increase monitoring of corporate governance issues was “a hell of a burden financially” and that “there is a concern in many

166 Q 136 (IMA: Mr Tomlinson, Chief Executive of Barclays Global Investors)

167 Qq 123-124

168 Q 301

169 Q 125 (IMA)

170 Q 298

171 Ev 14 (Ernst & Young)

172 Ev 35

institutions that they do not have the resources to do it”.¹⁷³ The cost of constant corporate governance monitoring has led to fears of ‘free-riding’ by some investors on the efforts of those that are willing to carry out the scrutiny of companies.

119. If institutional investors consistently take the steps necessary to satisfy themselves that the companies they are investing in are run to their satisfaction, then this will act as a spur to better minimum standards of corporate governance. The indications, from developments such as the statement of principles from the ISC, that this scrutiny of companies is being integrated into the daily operations of the institutional investors will certainly help maintain these standards. However, there is a danger that too much is expected of the institutional investors. For the most part, they have little involvement with the companies in which they invest. In spite of the ISC statement of principles, ‘exit’ (trade) rather than ‘voice’ (engagement) will remain the norm for institutional investors. This is compounded by the general ‘herd’ mentality identified by the Myners Review and specifically by developments such as tracker funds which will reinforce it.¹⁷⁴ It is also worth bearing in mind that, in so far as the systematic scrutiny of companies’ corporate governance is confined to the institutional investors, given the concentration of such investors amongst the largest public companies, this scrutiny will be limited to the companies in or near the FTSE 250 index.

120. Ultimately, the primary concern of institutional investors is to maximise the returns on their investments. Whilst this may bring with it some pressure on companies hoping to attract funds from institutional investors to ensure that they have adequate corporate governance systems in place, there is a limit to the extent to which the institutional investors are willing or able to police the probity of the UK’s companies.

173 Q 143 [Mr Watson]; also Ev 27 (ICSA)

174 Myners Review, p 2

8 Revising Company Law in the Future

121. As we have already pointed out, the Company Law Review which started its work in 1998 was the first comprehensive examination of this area since the Jenkins Committee Report in 1962. There is a widespread feeling that this is too long a gap, especially in view of the rapid changes to business, and the difficulties presented by the fact that more and more of company regulation is set in an international context, whether through EU legislation or through adherence to, for example, International Accountancy Standards. The net result has been that company law is now complex, much of it is in language incomprehensible to many directors, shareholders and other interested parties, and it needs to be simplified and updated.¹⁷⁵ While praising the way that the review process has been conducted over the past five years, there was a general feeling among our witnesses that they did not wish to wait 35 years before another massive review took place.¹⁷⁶ In harmony with this view, the White Paper proposes that, in order to make it easier to keep company law up to date, detailed provisions currently set down in primary legislation should instead be able to be amended by means of secondary legislation,¹⁷⁷ or be devolved to independent rule-making bodies.¹⁷⁸

122. In its response to the Company Law Review Steering Group, the Law Society identified other reasons why it preferred the updating of company law by means of secondary legislation: the technicality of much of the legislation which, it felt, was too great for most Members and even Ministers to grasp (leading to misunderstandings and unfortunate amendments); a lack of confidence that Parliament will give thorough, detailed scrutiny to bills; the problems of overcrowded and short parliamentary timetables; the inadequacy of public consultation, especially during Parliamentary consideration of primary legislation but even sometimes before the introduction of bills (compared with secondary legislation where, it said, public consultation was usually adequate); and the inaccessibility and lack of specialist knowledge of Parliamentary Counsel, who draft primary legislation, as compared with the Departmental lawyers who play a greater role in drafting secondary legislation.¹⁷⁹

123. The procedures for updating Company Law proposed in the White Paper may be more responsive and rapid than the current process, but their effect could be that company law and regulation would become less and less subject to detailed consideration by Parliament. Even where powers are delegated to Ministers rather than to other bodies, current procedures for considering most types of secondary legislation give little opportunity for detailed examination of proposals and it is impossible for Parliament to amend secondary legislation: it has to be accepted or rejected in full.

124. Some of our witnesses also thought that the use of secondary legislation ran the risk of reducing the certainty of company law (by, for example, differences in the wording between the statements of principle in the primary legislation and the detailed secondary legislation). This risk has repercussions wider than in the UK: according to the Law Society, the certainty provided by British company law to date has been the principal

175 Qq 79 (Law Society), 121 (IMA), 150 (QCA), 195-6 (IoD) and 272 (CBI)

176 See, for example, Q 79 (Law Society)

177 Secondary legislation, whether in the form of Statutory Instruments or other types of regulation, is subordinate legislation made by a Minister to whom such a power has been expressly delegated by an Act of Parliament.

178 White Paper, Chapter 5

179 Response produced by the Law Society's Committee on Company Law to the Company Law Review, paras 3.2–3.3 and 11; also Q 88

reason why British law is the law of first choice for a considerable amount of world trade.¹⁸⁰ However, the Law Society suggested to us that any problems with the certainty of the law could be reduced by publishing all the necessary secondary legislation at the same time as the Companies Bill. This would also have the advantage of making it easier to judge whether it was appropriate to delegate powers in each of the proposed areas.¹⁸¹

125. The Law Society raised doubts about the desirability of using non-statutory codes to “flesh out” rather than simply to explain the law. These concerns were based on experience with a number of corporate governance codes which, according to the Law Society, have been uncertain in their meaning and where no one body has taken responsibility for giving guidance on their interpretation.¹⁸²

126. We understand the reasons why all those involved in the recent major review of company law would want to find a better and easier way of updating such law in the future.¹⁸³ While not agreeing in full with the Law Society’s criticism of the primary legislation process, we recognise that it can be cumbersome and that constraints on parliamentary time mean that there are often delays in introducing much needed Bills. We do, however, have concerns that a reaction to the existing system may result in the delegation of too many or too significant powers, thus reducing accountability. **We therefore recommend that, when the Companies Bill is eventually drafted in full, particular attention be paid to whether powers are being delegated appropriately, whether to Ministers or to other bodies; and we consider that, to assist in this, all proposed secondary legislation should be published at the same time as the primary legislation. We also recommend that any changes in the exercise of the most significant powers be subject to the Regulatory Reform Order procedure, which ensures both wide publication and more detailed parliamentary scrutiny than other forms of secondary legislation.**

127. We note the Law Society’s concerns about the use of non-statutory codes. The line between “fleshing out” and explaining the law is difficult to draw; but we think that in two major areas of corporate governance (directors’ duties and measures to ensure auditor independence) the Government is proposing the right balance between statute and regulation by independent bodies. The clear identification of the bodies responsible for drawing up such codes (whether the proposed Standards Board or the independent body to regulate the accountancy profession) should remove any confusion about who is responsible for giving guidance on the interpretation of the codes. We also believe that the codes will be policed effectively because of the increased activism on the part of investors. In fact, a number of individuals and organisations have objected to the Higgs Report explicitly on the grounds that investors and others will be too strict in requiring adherence to its proposals, so there may be a danger that the current climate of caution will lead to excessive compliance with codes of conduct. And, as we have already suggested in other contexts, there is always the possibility of using statute if the more flexible forms of regulation do not work.

180 *Ibid.*, paras 12.4 and 12.2

181 Qq 88 and 89

182 Response to Company Law Review, para 12.5

183 See, for example, the views of the ICAEW: Ev 25

9 Other Issues of Principle

Directors' home addresses

128. We also considered a number of smaller issues that still raised questions of principle in relation to corporate governance. These were: whether the law allowing company directors' home addresses to remain confidential should be extended to all directors, not just those at risk from attack by extremists; and the linked question of the continuance of the current right to inspect and obtain copies of companies' registers of members (which has been abused, for example by some direct marketing organisations); and whether companies should be required to disclose convictions of the companies themselves, their directors and other officers for breaches of Companies Act requirements—and, if so, what form the disclosure should take.

129. It has been a principle of company law that the names and addresses of company directors ought to be registered and publicly available so that not only the regulatory authorities but also anyone with a financial or other legitimate interest in a company can discover who the directors are and contact them. Problems with the availability of this information have arisen chiefly in relation to cases like Huntingdon Life Sciences, where extreme animal rights organisations have organised campaigns of intimidation not only against the directors and employees of the company but also against those people's families, the shareholders, the company's insurers and financial backers, and so on. The Government has recently introduced new provisions to exempt directors considered at risk from the requirements about making their home addresses publicly available.¹⁸⁴ (Their home addresses are still supplied to Companies House but are kept on a separate register which is not open to the public.) The question considered in the White Paper was whether such protection should be extended to all directors, not least because of doubts about whether directors would realise that they were "at risk" in time. However, the Government indicated that it would prefer to leave any further amendment until it was clear whether the "at risk" provisions were working effectively.¹⁸⁵

130. Several of our witnesses were of the view that the protection of the new provisions should be extended to all directors. They felt that, provided that directors' home addresses were registered at Companies House and that there was a requirement to notify Companies House of any change of address, the central principle of public accountability would be maintained.¹⁸⁶ The Law Society pointed out, however, that a practical problem reduced the protection given to directors by removing their home addresses from the public register: although Companies House could make such a change in respect of companies of which these people were currently directors, it was impossible for Companies House to amend the records of companies of which they were formerly directors.¹⁸⁷

131. We sympathise with those who fear that directors' families may be made the target of extremist campaigning groups; but we are also aware that many people have concerns about unscrupulous company directors who operate on the edge of legality, and the fact that home addresses are on a public register provides some extra assistance in tracking down these people.¹⁸⁸ We hesitate to recommend a further

¹⁸⁴ In the Criminal Justice and Police Act 2001

¹⁸⁵ White Paper, para 6.10

¹⁸⁶ Qq 107 (Law Society) and 238 (IoD)

¹⁸⁷ Q 107

¹⁸⁸ The ABI and Ernst & Young are of a similar view: Ev 2 and Ev 15 respectively.

breach of the principle of transparency, not least because it is not yet clear whether the recent legislation will be effective. We therefore agree with the Government that the situation should be kept under review.

Register of shareholders

132. Public access to shareholder lists—a requirement of current company law—is intended to provide openness and accountability by, for example, allowing shareholders to circulate draft resolutions to other members. Though for some shareholders there are risks of targeting by extremists, for most the chief annoyance from current arrangements has been the abuse of public access by direct mail companies for commercial purposes.¹⁸⁹ There is general agreement that such information should not be used for commercial purposes, but the Company Law Review and the Government have differed on how best to protect it. The Government's preferred option (set out in the White Paper) is to give companies the right to ask the courts for relief from the obligation to supply copies of their registers of members if the companies consider that the registers are to be used for “inappropriate purposes”.¹⁹⁰ The Company Law Review recommended that the information in the register should be used only for purposes connected with the company itself, and that anyone using the register for an unauthorised purpose should be liable to account to the company for any profits arising from that use.¹⁹¹ The Government considered that the Review's approach would be less effective than allowing companies to refuse to supply the information in the first place.

133. The Law Society told us that it would be very difficult to draft a legal definition that would differentiate between someone who wanted the shareholder information for a legitimate, company-related purpose and someone who wanted it for an illegitimate purpose. The Institute of Directors accepted this, but still believed that such information should not be available commercially.¹⁹² We agree. The sort of information on shareholders' registers would, in other circumstances, be subject to the provisions of Data Protection law and shareholders would have the option as to whether they wanted their names and addresses revealed to, for example, direct mailing organisations. **We accept that there are valid reasons for maintaining public access to such registers;¹⁹³ and we agree with the Government that it would be more effective to allow companies to refuse to provide copies of the register than to give them the right to try to recover any financial gain from illegitimate use of the information. We consider that, with the general background of data protection and human rights legislation, the courts will be able in practice to distinguish between appropriate and inappropriate use of information. We are concerned that it should be as cheap and easy as possible for companies to apply to the courts in such cases, and urge the Government to bear cost in mind when drafting these provisions.**

134. We are aware that similar problems of protecting individuals from harassment arise in relation to other information provided by shareholders and companies, especially the Register of Charges at Companies House and information provided by individual shareholders wishing to take advantage of nominee services. **We recommend that the**

189 White Paper, paras 6.11–6.13

190 *Ibid.*, para 6.15

191 Para 6.14–Para 11.44

192 Qq 108-12 (Law Society) and 240 (IoD)

193 Ernst & Young agrees: Ev 15

Government explore what other types of information might be open to abuse, and take these into account in the legislation.

Disclosure of convictions by companies

135. One of the problems addressed by the review process was the fact that, because of the piecemeal way in which company law has developed over the last 40 years, there are inconsistencies in the sanctions prescribed for various offences, whether criminal, civil and administrative penalties or other civil consequences. Having formulated a coherent approach, the Company Law Review proposed that companies should be required to disclose convictions of the companies themselves, their directors and other officers for criminal breaches of Companies Act requirements. (The White Paper reports that there were 1,597 such convictions in 2000–01, mostly for failure to deliver accounts or annual returns to Companies House, but a few for more serious offences such as fraudulent trading.¹⁹⁴) The disclosure should be made in companies' supplementary statements, as part of the annual reporting and accounting process. The Company Law Review team was of the opinion that such disclosure would deter potential wrongdoers, and thus encourage compliance.¹⁹⁵

136. The White Paper seeks views on whether such disclosure would be a deterrent, and how it could be made. The Government thinks that to require disclosure in the supplementary statement would be both difficult and expensive to enforce. Instead, it has put forward the option of a public register of convictions, similar to that on the HSE's website for health and safety offences.¹⁹⁶

137. Our witnesses were uniformly of the view that companies should be required to disclose such convictions: it would be useful information for potential investors and would tend to promote good corporate governance.¹⁹⁷ Some thought that disclosure should go further, to breaches of wildlife protection or pollution law, or major human rights infringements.¹⁹⁸ They also expressed concern over whether a requirement to reveal convictions in company reports would be sufficient: some witnesses suggested that the companies that failed to deliver their accounts to Companies House were likely also to fail to disclose convictions in their annual reports, thus compounding the offence. The solution would be to have a central Companies House register, which would be updated automatically on conviction, and perhaps with a time limit so that spent convictions were removed after a period.¹⁹⁹

138. We consider that it would be in harmony with the other proposed alterations to company law to increase transparency by requiring disclosure of convictions for breach of company law. We agree that, to ensure fairness, there should be a central register, but we see no reason why in addition companies should not be required to disclose such breaches themselves. Under the proposals on the provision of information in company reports and accounts,²⁰⁰ any failure by companies to make such disclosure would not be a further criminal offence but could be corrected by administrative measures. As for convictions under other legislation, these should be

¹⁹⁴ Para 6.24

¹⁹⁵ Para 15.34

¹⁹⁶ White Paper, para 6.24

¹⁹⁷ Q 192 (QCA); see also Qq 117 (Law Society), 246 (IoD) and 268 (CORE), and Ev 2 (ABI)

¹⁹⁸ Q 268 (CORE)

¹⁹⁹ Qq 192-93 (QCA), 246-49 (IoD), Ev 10 (CORE) and Ev 15 (Ernst & Young)

²⁰⁰ See paras 76-79 above

disclosed in the OFR, if the company was large enough to be required to make one; and the provisions for audit of the OFR should be sufficient to deter any company reluctant to reveal this information in the OFR.

Conclusions and recommendations

Directors' duties

1. We consider that the aim of the law should be to provide a framework to promote the long term health of companies, taking into account both the interests of shareholders and broader corporate social and environmental responsibilities. The specific duties of care required of companies to their employees and society at large will normally best be set out in other legislation, covering areas such as health and safety, environmental and employment law. However, the proposed statement of directors' duties in the White Paper does represent a step forward as, for the first time, it explicitly recognises that good managers will have regard to a broader range of considerations than value to shareholders, which on its own may lead to short-termism. The White Paper's formulation leaves the responsibility to make decisions about the company's future where it should be—on the directors, not on the courts (Paragraph 22).
2. We see no need to include a duty to creditors in the statement of directors' duties. This statement is intended to lay out a broad, generic set of obligations and not a detailed list of the legislation which directors might be required to adhere to under certain circumstances (Paragraph 25).

Higgs Review

3. We welcome the Higgs Review. The proposals are modest but can contribute to good corporate governance standards in the UK, whilst the 'comply or explain' principle ensures that they should be flexible enough to avoid being seen as overly prescriptive. Interpretation is important, however, and the boards of companies must approach the proposals in an objective and sensible fashion in order to adopt those suitable to them and adapt those that need to be 'tweaked'. Similarly, though, failure to comply should not be taken as a negative sign by investors, providing it is accompanied by an adequate explanation that shows how governance standards are not compromised by the decision. It is important that the proposals are not interpreted so flexibly that they lack substance, nor so rigidly that they become a straitjacket (Paragraph 49).

Non-Executive Directors: multiple directorships

4. The emphasis on fulfilling the duties of NED rather than setting down mandatory limits on their commitments is in keeping with the general approach adopted throughout the Higgs Review and we broadly support this approach. But, it is important that the flexibility built into the Higgs proposals is not abused and this will need to be monitored carefully by the Financial Services Authority as guardian of the Combined Code, and by the Department of Trade and Industry. We are confident that such monitoring will take place, given the concerns about multiple directorships expressed to us by key interest groups (such as the IMA) and the welcome given to the Higgs proposals by bodies such as the ABI and the National Association for Pension Funds (Paragraph 33).
5. It has been suggested that the Higgs proposals will result in NEDs having to commit more time to their work and that remuneration will need to increase accordingly.

The Higgs Review suggestions for increasing the supply of NEDs would help to alleviate the problem. But for the most part Higgs is not proposing much that is not already adopted as best practice by many companies. Given this, it is hard to see how the time commitment of those NEDs who have already been doing their jobs thoroughly will increase significantly. There must be concerns about whether those who feel they cannot meet the time commitments were fulfilling the duties required of them (Paragraph 48).

Non-Executive Directors: recruitment

6. We believe that there is scope for recruiting NEDs from outside the usual, narrow pool. Some could be found among younger business people with direct commercial experience, others among those with still relevant but broader experience. In fact, it might be that the introduction of those with backgrounds different from those of the existing, thoroughly homogeneous pool of NEDs could introduce fresh thinking and an element of dynamism to company boards (Paragraph 35).

Directors: training

7. It is important that attitudes towards training of directors change. Relevant experience is clearly fundamental for directors but their professional development should not stop merely because they have reached board level. However, this attitudinal change can only be realised if training provision is available. The Institute of Directors now runs a chartered directors programme, but this is the exception and directors' training (as opposed to training in management, for instance) remains scarce. We hope that the Higgs Review can act as a stimulus to both the provision and take-up of training for all directors (Paragraph 38).

Effect of Higgs proposals on company boards

8. We recognise that the Higgs proposals could have different implications for larger and smaller fully listed companies. In order to comply with the provision that boards should have a majority of NEDs, smaller listed companies may not be so willing to appoint senior managers to the board. We consider the wider representation of the Executive Directors on the Board to be a particular benefit to companies and therefore suggest that the situation is kept closely under review by the Government. We would be concerned if the effect of the Higgs proposals was to encourage smaller listed companies to relist on the AIM where overall it would be shareholders' protections that would be diminished (Paragraph 47).

Reporting by companies

(a) Environmental and social reporting

9. The proposed Operating and Financial Review (OFR) would be a marked improvement on current minimum reporting standards. It would help to give a much more rounded, clearer view of both past operations and future prospects of companies. It would be of benefit not only to shareholders and potential investors in companies, but also to all those concerned with wider aspects of company behaviour, whether as employees, local residents, or as interest groups involved in environmental/social issues or general corporate governance (Paragraph 69).

10. We believe that in practice directors will not be able to get away with assuming that environmental and social concerns are not relevant to their company and can be passed over without comment; we think that, in this area too, companies will be expected by investors and monitoring groups to “comply or explain”. We would also be concerned if the effect of these proposals concerning the production of an OFR were to support a ‘box ticking’ attitude amongst companies. We recognise the concerns expressed by some witnesses over whether the division into “core” and “other” matters would in effect downgrade the latter, but we consider that there will be pressure (from investors and others) for companies to raise their standards of reporting to those set by the pioneers in this area. In this context, we agree with the view expressed by the TUC that company law alone cannot be expected to change corporate culture: without active shareholders and other interest groups, unwilling or incapable directors would be able to nullify the effects even of statutory obligations (Paragraph 70).
11. There seems to be a discrepancy between what the advocates of greater Corporate Social Responsibility want from the auditing of OFRs and what auditors—and the Government—expect. Given the limitations on auditor responsibility even in respect of financial information, it would be unrealistic to expect auditors to assume greater responsibility for information that is qualitative and even less easy to verify than financial reports (Paragraph 68).

(b) Which companies should be required to produce OFRs

12. To date there has been little private sector experience of the production of OFRs in the UK, and a number of companies are clearly anxious about what an OFR will be expected to contain, and the cost and difficulty of producing one. So on balance we prefer a gradualist approach, so that the details of what is required can be worked out with the largest companies and then the key aspects extended to smaller companies. We are therefore content with the thresholds for production of OFRs proposed in the White Paper (Paragraph 75).

Penalties for failure to comply with reporting requirements

13. We agree that the effect of the law should be to encourage companies to make the proper disclosure in their annual report and accounts rather than merely to punish directors for failing to do this. We note that the current—criminal—sanctions have been little used. We therefore concur with the Government that administrative measures should be more effective in achieving disclosure. We also support the proposal to introduce a clear criminal offence of intent to mislead or deceive the auditors (Paragraph 79).

Audit by the ‘Big Four’ Accountancy Firms

14. We believe that such an audit for many companies was always a status symbol rather than a sign of extra quality, as a number of accountancy firms are equally well qualified to audit most companies. We also think that greater competition in the market for accounting services would promote auditor independence and give a good basis for investor confidence. We therefore hope that institutional investors will not revert to putting pressure on smaller companies to use only one of the ‘Big Four’ companies on the basis of mere prestige; such an action would contradict many of

their efforts in other areas to increase transparency, accountability and effective corporate governance overall (Paragraph 86).

Provision of non-audit services by auditors

15. Although the evidence is necessarily anecdotal, it seems to us that there is a danger of audit services being used as a loss leader, not least because the lack of competition for auditing big and especially multinational companies must make it very difficult for even the most conscientious audit committee to determine a true market rate for the job. It therefore seems appropriate to limit the types of non-audit services provided by auditors (Paragraph 90).
16. We do not think there should be a ban on all types of non-audit work by auditors: some tasks could be carried out by auditors without undermining their independence, and potentially more efficiently than by bodies without the inside knowledge of company operations gained by auditors. We consider that the two principles described by the ICAEW **are the key tests to determine whether or not non-audit work should be banned** (Paragraph 91).
17. However, particular concerns have been expressed about the supply of expensive IT systems, especially financial control systems; and it seems to us obvious on first principles that external auditors should not also be involved in the provision of internal audit systems. We would therefore recommend a strengthening of the requirements in these areas. Beyond this, we are content that the details of the requirements should be filled in by experts (Paragraph 92).

Regulation of auditors

18. For reasons of flexibility and maintaining a light-handed approach to regulation, we conclude that it should be the responsibility of an independent body to set standards to uphold the independence of auditors. If such regulation seems to be failing, however, we believe that the Government should re-consider whether it is necessary to impose statutory restrictions on certain types of non-audit work by auditors (Paragraph 94).

Rotation of auditors

19. We welcome the recent changes to the rules on rotation of audit personnel and on the two year “cooling off” period for auditors. However, we are not confident that by themselves they will be sufficient to restore confidence in the independence of auditors (Paragraph 100).
20. We agree with the Co-ordinating Group that compulsory re-tendering could simply be an expensive but unproductive exercise. This option depends on the vigilance and independence of the company’s audit committee to be effective; but, with a vigilant and independent audit committee, it is not necessary (Paragraph 101).
21. We are less inclined than some of our witnesses to worry about an increased likelihood of audit failure in the first two years of a new company’s tenure. More convincing to us are the arguments about the difficulty of finding a new audit firm that does not have a conflict of interest over the provision of non-audit services, especially in the present uncompetitive state of the market. We therefore do not recommend mandatory rotation of audit firms. However, we do not think that it

should be ruled out altogether: if the other measures taken both to increase the scrutiny of auditors by independent directors, and to encourage greater competition among audit firms, prove insufficient to restore confidence in the objectivity of external auditors, then compulsory circulation of audit firms should be re-considered (Paragraph 102).

Audit committees

22. We agree that audit committees have a vital role to play in corporate governance, and that they should be the main channel of communication between auditors and shareholders via the full board. In order to be “the best practical proxy to the shareholders” for the auditors, such committees should be composed of non-executive directors who are not compromised by having had too close a relationship with the management of the company in the past, who are highly analytical, tough-minded and at least some of whom have had recent financial experience. So that the shareholders are kept as fully informed as possible, such committees should also make a full report to both board and shareholders on how they have exercised their function of scrutinising the auditors. In this context, it also makes sense for the chairman of the audit committee to attend the AGM to answer questions from the shareholders, as already provided for in the Combined Code. Finally, it is important for the members of the audit committee to be fully briefed about their special role, and companies should, where necessary, provide specific training for members of the audit committee to enable them properly to scrutinise external audit and internal control and risk management (Paragraph 107).

Institutional investors

23. Ultimately, the primary concern of institutional investors is to maximise the returns on their investments. Whilst this may bring with it some pressure on companies hoping to attract funds from institutional investors to ensure that they have adequate corporate governance systems in place, there is a limit to the extent to which the institutional investors are willing or able to police the probity of the UK’s companies (Paragraph 120).

Revising Company Law in future

24. We recommend that, when the Companies Bill is eventually drafted in full, particular attention be paid to whether powers are being delegated appropriately, whether to Ministers or to other bodies; and we consider that, to assist in this, all proposed secondary legislation should be published at the same time as the primary legislation. We also recommend that any changes in the exercise of the most significant powers be subject to the Regulatory Reform Order procedure, which ensures both wide publication and more detailed parliamentary scrutiny than other forms of secondary legislation (Paragraph 126).

Public availability of directors’ home addresses

25. We sympathise with those who fear that directors’ families may be made the target of extremist campaigning groups; but we are also aware that many people have concerns about unscrupulous company directors who operate on the edge of legality, and the fact that home addresses are on a public register provides some extra assistance in tracking down these people. We hesitate to recommend a further breach

of the principle of transparency, not least because it is not yet clear whether the recent legislation to protect ‘at risk’ directors will be effective. We therefore agree with the Government that the situation should be kept under review (Paragraph 131).

Misuse of registers of shareholders

26. There are valid reasons for maintaining public access to registers of shareholders; and we agree with the Government that it would be more effective to allow companies to refuse to provide copies of the register than to give them the right to try to recover any financial gain from illegitimate use of the information. We consider that, with the general background of data protection and human rights legislation, the courts will be able in practice to distinguish between appropriate and inappropriate use of information. We are concerned that it should be as cheap and easy as possible for companies to apply to the courts in such cases, and urge the Government to bear cost in mind when drafting these provisions (Paragraph 133).

Disclosure of convictions by companies

27. We consider that it would be in harmony with the other proposed alterations to company law to increase transparency by requiring disclosure of convictions for breach of company law. We agree that, to ensure fairness, there should be a central register, but we see no reason why in addition companies should not be required to disclose such breaches themselves. Under the proposals on the provision of information in company reports and accounts, any failure by companies to make such disclosure would not be a further criminal offence but could be corrected by administrative measures (Paragraph 138).

List of Abbreviations used in the Report

AIM	Alternative Investment Market
CORE	Corporate Social Responsibility Coalition
ESV	Enlightened Shareholder Value
ICAEW	Institute of Chartered Accountants of England and Wales
IMA	Investment Managers' Association
ISC	Institutional Shareholders' Committee
NED	Independent Non-Executive Director
OFR	Operating and Financial Review
QCA	Quoted Companies Alliance
SID	Senior Independent Director

Formal Minutes

Tuesday 1 April 2003

Members present:

Mr Martin O'Neill, in the Chair

Mr Henry Bellingham
Mr Richard Burden
Mr Jonathan Djanogly
Dr Ashok Kumar

Mr Andrew Lansley
Mrs Jackie Lawrence
Linda Perham
Sir Robert Smith

The Committee deliberated.

Draft Report (The White Paper on Modernising Company Law), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 138 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Sixth Report of the Committee to the House.

Ordered, That the provisions of Standing Order No. 134 (Select Committees (reports)) be applied to the Report.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House.

[Adjourned till Tuesday 7 May at Four o'clock

List of Witnesses

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Mr David Coats and Ms Janet Williamson, Trades Union Congress	Ev 1
Mr Peter Wyman and Mr Roger Davis, Institute of Chartered Accountants of England and Wales	Ev 8
Ms Harriet Creamer and Ms Vanessa Knapp, Law Society	Ev 16
Tuesday 29 October 2002 afternoon	
Mr Lindsay Tomlinson, Mr Tony Watson and Mr Richard Saunders, Investment Management Association	Ev 22
Thursday 31 October 2002 morning	
Ms Linda Crow and Mr Tom Mackay, Quoted Companies Alliance	Ev 27
Ms Patricia Peter, Institute of Directors	Ev 33
Thursday 31 October 2002 afternoon	
Mr Martyn Williams, Mr Peter Frankental and Ms Deborah Doane, CORE	Ev 40
Mr John Weston, Mr Roger Myddelton and Mr Clive Edrupt, Confederation of British Industry	Ev 46
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Mr Derek Higgs and Ms Anne Willcocks	Ev 53

List of written evidence

1	Association of British Insurers	Ev 65
2	Tomorrow's Company	Ev 67
3	Co-operative Bank	Ev 70
4	CORE	Ev 71
5	Ernst and Young	Ev 77
6	Institute of Chartered Accountants in England and Wales	Ev 81
7	Institute of Chartered Secretaries and Administrators	Ev 90
8	Institutional Shareholders' Committee	Ev 98
9	KPMG	Ev 101
10	Law Society	Ev 105
11	PCG Worldwide Limited	Ev 105
12	The Work Foundation	Ev 110