Chapter 7 revision notes

Corporate governance

Corporate governance code of practice

During the 1980s and 1990s there was huge concern within the business community following the financial scandals surrounding BCCI, Polly Peck and Robert Maxwell's companies. Such concern was seen in a lack of confidence in financial reporting, and in shareholders and others being unable to rely on auditors to provide the necessary safeguards for their reliance on company annual reports.

The main factors underlying the lack of confidence in financial reporting were:

- loose accounting standards, which allowed considerable latitude (an example has been the treatment of extraordinary items and exceptional items in financial reporting)
- lack of a clear framework to ensure directors were able to continuously review business controls
- competitive pressure within companies and on auditors, making it difficult for auditors to maintain independence from demanding boards
- lack of apparent accountability regarding directors remuneration and compensation for loss of office

The Cadbury Committee defined corporate governance as 'the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting'.

The framework for establishing good corporate governance and accountability has been established in a Combined Code of Practice, developed from the work of the Cadbury, Greenbury, and Hampel Committees.

The underlying principles of the Code are:

- openness
- integrity
- accountabilit

The audit and the role of auditors

There is a statutory requirement for the audit of the accounts of limited companies, except for smaller limited companies.

It is the responsibility of the shareholders to elect suitably qualified, independent auditors, to whom they are responsible.

The external auditors are not part of the company but are responsible to the shareholders, with the main duty of objectively reporting to shareholders and others as to whether, in their opinion, the financial statements show a true and fair view, and comply with statutory, regulatory and accounting standard requirements. Such an opinion is an unqualified opinion.

The report of the auditors is usually very short and additionally includes:

- reference to the director's responsibility for preparation of the annual report and accounts
- reference to the responsibility as auditors being established by:
    - UK statute
    - the Auditing Practices Board (APB)
    - the Listing Rules of the Financial Services Authority
    - the accountancy profession's ethical guidance

The auditors are required to explain the basis of the audit, and report if in their opinion:

- the directors' report is not consistent with the accounts
- the company has not kept proper accounting records

- they have not received all the information and explanations required for the audit
- information specified by law, or the Listing Rules regarding directors' remuneration and transactions with the company, are not disclosed
- company policies appropriate and consistently applied and adequately disclosed
- all information and explanations considered necessary to provide sufficient evidence to give reasonable assurance that the accounts are free from material misstatement
- the overall presentation of information in the accounts is adequate

In addition to their reporting on the financial statement of the company, the auditors reports now include a statement of the company's corporate governance compliance with the seven provisions of the Combined Code of Practice. This review is in accordance with guidelines issued by the Auditing Practices Board.

The audit and the perceived role of auditors has been the subject of much criticism over the years. The responsibility of the auditors does not include guarantees that:

- the financial statements are correct
- the company will not fail
- there has been no fraud

Companies increasingly face a greater diversity and level of risk:

- financial risk
- commercial risk
- operational risk

and the increasing possibility of failure is very real. Although the financial statements of companies are based on the going concern concept, the directors and auditors cannot realistically give any assurance that those businesses will not fail.

Fraud is perhaps something on which auditors may arguably be expected to give an opinion. This is not something that is currently required from an external audit. It is something for which an internal audit department may be responsible. In the same way, external auditors could be requested to report on the adequacy or otherwise of systems of internal control.

Directors' responsibilities

Directors of limited companies have a specific responsibility to shareholders, and general responsibilities to all stakeholders and the community, for the management and conduct of companies. (Note the continued activities of pressure groups such as Greenpeace and the Friends of the Earth).

Directors' duties are mainly embodied in the:

- Companies Act 1985
- Insolvency Act 1986
- Company Directors Disqualification Act 1986
- Health & Safety at Work Act 1974
- Financial Services Act 1986

and there is the potential for legal action on corporate manslaughter.

In addition, it should be noted that further statutory provisions giving rise to vicarious liability of directors for corporate offences are included in Acts of Parliament, which currently number well over two hundred!

Directors can be:

- forced to pay a company's losses
- fined
- prevented from running businesses
- imprisoned

Non-executive directors are legally expected to know as much as executive directors about what is going on in the company. Ignorance is not a defence. Directors must be aware of what's going on and have knowledge of the law relating to their duties and responsibilities. Fundamentally, directors must:

- use their common sense
- be careful in what they do
- look after shareholders
- look after creditors
- look after employees

Directors of limited companies have a fiduciary duty to act in the best interests of the company, and a duty of care to all stakeholders and to the community at large, particularly with regard to the Companies Acts 1985/1989, Health & Safety at Work Act 1974, Financial Services Act 1986, and Insolvency Act 1986.

Corporate manslaughter

Up until 1999 there had only been five prosecutions in the UK for corporate manslaughter, resulting in two convictions. The risk for directors is therefore remote, but nonetheless it should not be ignored.

Other responsibilities

Directors do not owe a direct duty to shareholders, but to the company itself. Directors have no contractual or fiduciary duty to outsiders and are generally not liable unless they have acted in breach of their authority. Directors must have regard to the interests of employees but this is enforceable against directors only by the company and not by the employees.

Insolvency

A company becomes insolvent when it is unable to pay creditors' debts in full after realisation of all the assets of the business. The penalties imposed on directors of companies continuing to trade, whilst insolvent, may be disqualification and personal liability.

The Insolvency Act 1986 provides guidance on matters to be considered by liquidators and receivers in the reports, which they are required to prepare on the conduct of directors. These matters include:

- breaches of fiduciary and other duties to the compan
- misapplication or retention of monies or other property of the compan
- causing the company to enter into transactions which defrauded the creditors
- failure to keep proper accounting and statutory records
- failure to make annual returns to the Registrar of Companies and prepare and file annual accounts

Wrongful trading

A major innovation of the Insolvency Act 1986 was to create the statutory tort (civil wrong) of wrongful trading. It occurs where a director knows or ought to have known before the commencement of winding up that there was no reasonable prospect of the company avoiding insolvency and he/she does not take ever step to minimise loss to creditors.

The implications for directors for wrongful trading may be to contribute to the assets of the business, and disqualification from further involvement in corporate management for a specified period.

A director will not be liable for wrongful trading is he/she can show that from the relevant time he/she 'took every step with a view to minimising the potential loss to the company's creditors as (assuming him/her to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he/she ought to have taken'.

Fraudulent trading

Fraudulent trading is an offence committed by persons who are knowingly party to the continuance of company trading in circumstances where creditors are defrauded or for other fraudulent purposes. Generally, this means that the company incurs more debts at a time when it is known that those debts will not be met.

The implications for directors for fraudulent trading may be to contribute to the assets of the business without limit, disqualification, and possible criminal and civil penalties.

Disqualification of directors

The implications of the Company Directors (Disqualification) Act 1986 apply not only to compan directors, and over 50% of the provisions relate to any persons.

Disqualification means that a person cannot be, for a specified period of time, a director or manager of any company without the permission of the courts. Disqualification is governed under the Company Directors (Disqualification) Act 1986.

Summary of directors' obligations and responsibilities

The following is a checklist of directors' obligations and responsibilities:

- both executive and non-executive directors must act with care, look after the finances and act within their powers, and look after employees

- directors are responsible for keeping proper books and presenting shareholders with accounts, and failure to do so can result in disqualification
- directors should understand the accounts and be able to interpret them
- the board of directors is responsible for filing accounts with the company registrar and must also notif changes to the board of directors and changes to the registered address
- shareholders must appoint auditors
- the directors are responsible for calling and holding annual general meetings, and ensuring minutes of all meetings are appropriately recorded
- directors are responsible for ensuring that the company complies with its memorandum and articles of association
- if a company continues to trade whilst technically insolvent and goes into receivership a director may personally be forced to contribute to repaying creditors
- a director trading fraudulently is liable to be called on for money
- any director who knew or ought to have known that insolvency was unavoidable without minimising loss to the creditors becomes liable
- directors can be disqualified for paying themselves too much
- inadequate attention paid to the financial affairs of the company can result in disqualification

Actions to ensure compliance

Directors of limited companies, in addition to taking out individual professional liability insurance, must ensure that they clearly understand their obligations and responsibilities.

Directors of companies need to be aware of the dividing line between the commission of a criminal offence and the commission of technical offences of the Companies Act. Directors should take the necessary actions to ensure compliance with their obligations and responsibilities, and to protect themselves against possible non-compliance:

- directors may delegate their responsibilities within or outside the company and in such circumstances they must ensure that the work is being done by competent, able and honest people
- directors of small companies in particular should get professional help to ensure compliance with statutory responsibilities
- directors must ensure that they are kept fully informed about the affairs of the company by having regular meetings and recording minutes and material decisions
- directors should ensure they have service contracts that cover the company's duties, rights, obligations, and directors' benefits
- directors must ensure that detailed, timely management accounts are prepared, and, if necessary, professional help sought to provide for example monthly reporting systems and assistance with interpretation of information produced and actions required

All directors must clearly understand their obligations and responsibilities, closely watch company performance, and take immediate, appropriate action as necessary, to ensure compliance and minimise their exposure to personal risk.