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FINANCIAL REPORTING COUNCIL

Holborn Hall, 100 Gray's Inn Road, London WC1X 8AL Telephone 071 404 8818 Fax 071 404 4497

Chairman: Sir Ron Dearing CB

Deputy Chairmen: Sir Trevor Holdsworth, Sir Andrew Hugh Smith, ~~James~~ Ian Plaistowe

Secretary: Sydney Treadgold

16 July 1992

Nigel Peace Esq
Secretary
Committee on Financial Aspects
Corporate Governance
P O Box 433
Moorgate Place, EC2P 2BJ

Dear Nigel

COMMENTS ON THE CADBURY COMMITTEE REPORT

I enclose two letters from members of the Financial Reporting Council, commenting on the Cadbury Committee Report. You may recall there were two earlier ones which arrived too late to influence the text, and for convenience I enclose those too.

Executive and Non Executive Board Members

Our report has been criticised for dividing the non-executive from the executives. Upto a point this is overdone. Each executive board member is expected to make a distinctive contribution, and collectively to run the company effectively. Similarly the non-executives have individual and collectively distinct contributions to make.

However, picking up Paul Girolami's point (see his letter) that there should be no difference between executive and non-executive board members over the right to obtain legal advice, the same point has been made strongly to me by the Chief Executive of another company (Gary Allen of IMI). I also heard a comment in the same sense from a Company Secretary.

This is just but one aspect of the theme, that in spite of disclaimers we make at the beginning of the Report, in fact we do open up a division between the executives and non-executives in a way that is divisive. It has also been argued to me that in some instances we have got it wrong.

For example, we say that the non-executives are in the best position to appraise



the Chief Executive (section 4.3). But a little reflection suggests that executives see far more of the Chief Executive than the non-executives and arguably are in a much better position to judge his performance. The fact is that both the executive members and the non-executive members have a complementary contribution to make to judgement of the Chief Executive. What distinguishes the non-executives is that they are not at hazard for their livelihood in the same way that an executive member would be if he risked criticising the Chief Executive.

In Section 4.3 we recommend that where the job of Chairman and Chief Executive are combined, one of the non-executives should be an appointed leader - to maintain the balance between the executives and non-executives influence. There is another reference in 4.6. It has been suggested that this again polarises the executives and non-executives into two classes.

You will recall that I was one of those who urged that unless there were a non-executive who was a recognised "ganger", it would be difficult for anxious non-executives, or for that matter anxious executives to have someone to whom they would naturally turn to share their anxiety and who would see it as their role to take soundings if he got the impression that there was real disquiet in the board. Without that there may be individual grumbling, but with no facilities for anxious members to meet together, a situation could deteriorate dangerously and only lead to action when the company was in actual crisis.

In response to those points I propose the following amendments:

Para 4.12

*after "non-executive directors" in line one,
insert "or executive directors";*

Para 4.3

*DELETE "are in the best positive position to monitor,"
INSERT "have an important contribution to make to maintaining";*

Para 4.3

*DELETE "in order to maintain the balance"
INSERT "should have recognised responsibility to advise the Chief Executive and if necessary raise with the Board as a whole, any well based concern that the exercise of the power vested in the combined chairman and chief executive was weakening the effectiveness of the board, or of any of its members".*

Those points reflect concerns made by several commentators but what follows now reflects the views expressed to me by my colleague on the IMI Board, Gary Allen, the Chief Executive. Mr Allen has the advantage of being a qualified accountant and speaking for a company whose accounts have been described by an outside expert commentator as being particularly straight forward and reliable. He will be writing in with his comments to Adrian, but I thought you would find it helpful



for me to give you a foretaste with my gloss on them.

The Auditor Certificate of Compliance with the Code

Mr Allen points out that there are some matters covered by the Code which the auditor is not qualified by his profession to judge; for example, the auditor is not qualified to judge item 1.3 in the Code and how can the auditor judge whether the board as a board has a full and effective control, without being given observer status at board meetings, which is going completely beyond the professional role.

The argument is that the discharge of these responsibilities in the Code and the certification of them should be a matter for the board.

We all agree that the responsibility rests with the board. But the problem of leaving it entirely to the board is that when there is a bad one, the certificate will be given even if the conditions are not properly met, and there will be no sanction if through poor observance things go wrong. Though we may decide therefore to keep an auditors role. it ought to be limited to those matters which an auditor is able through his normal duties and by his professional skills, competent to discharge.

The Interim Report

Section 4.47 deals with the Interim Report and proposes that it should be subject to review by the auditors but not audit. The point argued here is that the auditor would probably need to do almost as much work to satisfy himself in conducting a review as if he were giving an audit certificate.

You may wish to take advice on that, but I note we do not include this recommendation in our Summary of Recommendations.

The Operating of Financial Review

The concern here is with the provision of forward looking information. All boards are likely to be cautious about such information and Mr Allen is concerned that we may be making an unreasonable demand.

Again this is not part of the Code and I have explained to Mr Allen that the Accounting Standards Board is consulting Finance Directors of companies separately on its proposed approach. I further said that the issue is in fact, whether, when the Code comes under review in two years hence, the operating and financial review should form part of it.

Consultancy

In Section 5.11 we propose that the Audit Committee should keep under review the non-audit fees paid to the auditor both in relation to their significance and in



relation to the companies total expenditure on consultancy.

The point here is that a widely diversified company operating internationally with sensible delegated authorities will not know, without a special exercise, what is spent on consultancy. Mr Allen would be comfortable however, if we stuck to the Audit Committee reviewing the balance between what is paid to the auditors for audit and the total sum paid to the partnership in non-audit fees. - - -

I think that is a fair point but again the recommendation does not form part of our Summary of Recommendations.

The Code

As I have suggested in previous correspondence, we need to be clear whether the Code is the Summary and Recommendations or whether it incorporates all the detail to which the Summary cross refers.

I know from our conversation that you have been working on that and had come to the conclusion that only in closely defined areas should it go beyond the Summary as stated. As you know my view on that is that we have to be careful not to go into too much prescriptive detail, for example by incorporating in the Code as how many times a year the Audit Committee should meet.

ENC

A handwritten signature in cursive script, which appears to be 'John Minard', is written across the middle of the page. Below the signature, the number '2' is written in a similar cursive style.

2nd July, 1992

Dear Ron,

The Institute of Chartered Accountants has written to me, as Chairman of its Senate consultative body, for my views on the draft Report on Corporate Governance, and since I am a member of your Council which commissioned the Report I thought I should let you know about my reply which is in the form of general observations rather than a commentary on the specific recommendations taken one by one.

Looking at the terms of reference, I expected that the Committee would review the structure and principles underlying financial reports to shareholders and the roles of boards, audit committee and auditors in that context. It would have provided a firm foundation for corporate accounts on which the ASB could coherently formulate its standards. I think we should re-examine the case for having a thorough-going review of this sort.

The Committee chose, instead, to cover a much wider area and focused on Corporate Governance: "the system by which companies are run". In my view, however, it has taken a highly restricted view of this subject and has confined its attention only to the board, auditors and non-executive directors. Even if the Report were said to address only that part of Corporate Governance concerned with the abuse of executive power, its survey remains too limited. Although the Committee has made a valuable contribution to the debate on a number of very important issues, it has dealt with these issues only in part. I emphasise the narrowness of view not to suggest that we continue the debate on Corporate Governance against a wider perspective, - I do not - but to explain a real weakness which runs through the Report.

It portrays a distorted image of a board's operations. I believe in the unity of the board and the equality of each director, as director. It is not impractical or idealistic to say that the board is most effective when it operates as a team and united in their commitment to the control of the company in an efficient and honest way. The mixture of non-executive and executive directors, with their different management and functional responsibilities, is mutually supportive and corrective and I do not see the need for a "leader" of non-executives, whether formally appointed or not, or for an individual director to act as a counter-balance. The Report, moreover, over-estimates the contributions which auditors and non-executive directors can properly make to the effective running of a company. An example is the suggestion that the auditors should comment on the board's statement of compliance. The Code in many of its recommendations moves outside the financial area and I am not sure whether the auditors are in the best position to comment on the adequacy of corporate action instead of the accuracy and fairness of financial reports. Another example turns on the suggestion that non-executive directors should be entitled to consult professional advisers at the company's expense. This shows the same bias, but is a sensible idea, providing it is extended to all directors and that it is restricted to advice on the individual director's position vis-a-vis the company.

Most of the specific recommendations, however, enshrine principles of good corporate Corporate Governance and are in accordance with the best practice. They should be supported. Many of them, for the reason I outlined above, have a bias in the direction they point, and, they should not, therefore, be enforced rigidly or tightly, and allowances should be made for exceptions if reported in accounts and approved by shareholders.

Yours sincerely,

Paul Girolami

Sir Ron Dearing, CB,
Chairman,
Financial Reporting Council,
Holborn Hall,
100 Gray's Inn Road,
London, WC1X 8AL.

Rowena Mills Associates Ltd

Head Office

P.O. Box 594
London W8 7DE, U.K.

Tel: 44 +(0)71-937 4035
Fax: 44 +(0)71-603 7461

Western Region Office:

Peart Hall, Spaxton,
Bridgwater, Somerset TA5 1DA, U.K.

Tel: 44 +(0)278 671343
Fax: 44 +(0)278 671209

RMA

Sir Ron Dearing,
Chairman,
Financial Reporting Council,
Holborn Hall,
100 Gray's Inn Road,
London.
WC1X 8AL

June 12th, 1992

Dear Ron,

You have asked us if we would drop you a note in respect of the Cadbury Report but I feel that I, probably, as usual, spoke far too much at the Council meeting on May 26th. The principal point I made was that I felt that all companies, regardless of size or listing, should try and comply with the Recommendations.

Cost will, of course, inhibit them to some extent, as it will do the larger companies in respect of, for example, interim audits.

Like most commentators, I think all of us (except those who find it most convenient this way!) have felt that the biggest problem is the lack of any real sanctions to enforce these Recommendations. The other point I raised was in respect of the recommended ratio of non-executive directors but I understand that you had thought long and deep about this without being able to come to any conclusions - perhaps a minimum ratio could be recommended?

4.24 Chairmanship of Nomination Committee

I felt there was an inconsistency in the last sentence insofar as the nomination committee should be chaired "either by the Chairman or non-executive director" because these two would surely have a different stance - one with an interest and the other independent.

4.34 Control of Remuneration

While this is very laudable I think it will be very heavily resented by executive directors that non-executive directors should control their remuneration!

/2

5.11 "Quarantining" of Auditing

While the Committee was not persuaded that audits should be "quarantined" from other services, I do feel strongly that there ought to be such a quarantining. There is no doubt that certainly at the height of the boom the same companies were carrying out both Consultancy and auditing; this could not but have had some influence on the presentation of the audit, and its being in line with the Board's particular requirements.

Kind regards,

Sincerely
Rowena

Rowena Mills
Chairman & Chief Executive

PS. On re-reading I realize this contributes very little!

DELTA**DELTA PLC**1 KINGSWAY
LONDON WC2B 6XF
TELEPHONE 071-836 3535
FAX 071-836 4511
TELEX 27762**CHAIRMAN**

7th May 1992

Subject file

87.

Sir Ronald Dearing CB
Chairman
Financial Reporting Council
Holborn Hall
100 Gray's Inn Road
London WC1X 8AL

Gen Ron,

CADBURY COMMITTEE

Many thanks for your letter of the 28th April and for giving the FRC a confidential preview of this most important report. I have studied this with great interest and would like to congratulate you and the Committee on an excellent and balanced handling of many difficult issues. I much look forward to the discussion at our next meeting on 26th May but in the meantime some immediate reactions may, as you suggest, be helpful. I would like, if I may, to couple these with a response to your note of the 24th April about the ASB discussion paper "Operating and Financial Review" since the two subjects are so closely inter-related.

In general I find myself sympathetic to the bulk of the Committee's conclusions and recommendations which is hardly surprising given the calibre and balance of its membership and the fact that many of the recommendations codify what is already widely accepted as best practice. There are, however, some general points which give me some concern and there are also a few detailed points which may be worth mentioning.

The general concerns are as follows -

1. There is always a tendency for the majority of innocents to pay the price of the few guilty so not surprisingly there are echoes of some of the recent major company failures underlying parts of the report. I believe that on the whole the Committee has kept a fair balance though there are some aspects such as statements on the going concern basis and on the adequacy of funds which it might be argued could be over-reaction.
2. There is some risk that the continuing work of the ASB taken together with the Cadbury recommendations may result in a lesser clarity of financial statements and an increased amount of verbiage. The ASB has quite rightly called for greater disclosure

and less concentration on single measures (such as EPS) and while there is no realistic alternative, the price that will have to be paid is that financial statements will become less easy for laymen to understand. It would, I think, be a pity if at the same time annual reports became over-cluttered with too many statements of how the company discharges its responsibilities to all and sundry. It is so easy for such statements to become filled with platitudes and for readers then simply to ignore them.

In particular I have some reservations about the value of statements on corporate governance which have already been included by companies as distinguished as ICI, Grand Met and Natwest and I wonder whether in paragraph 3.8 on page 6, the phrase "...many companies will wish to go beyond" might be reworded "...some companies will wish..."

By the same token I would be sorry to see the operating and financial review proposed by ASB follow too slavishly the American Management Discussion and Analysis pattern since in this country the tradition of economy in the use of words is probably better established. I fully support the first part dealing with a commentary on the operating results but it is in the two remaining areas, namely the review of financial needs and resources and commentary on shareholders return and value, that the dangers of many words with little meaning are perhaps greatest. I hope I am not over-playing this concern but one has to remember that these proposals come on top of existing requirements to disclose practice in relation to health and safety, the environment, employee participation etc. and I wonder how much research has been done to establish how many people read those.

3. Our position as a tiny island strongly influenced by US practice and unable to influence our major partners in the EEC as much as we would wish continues to cause me concern both in relation to the work of the ASB and the Cadbury recommendations. Accordingly I would very much welcome the input which you indicate David Tweedie would like to give to the FRC on the subject of the developing international accounting regime. Unless we can make progress in that direction to obtain more equality in disclosure, then much of the value of all this work will be lost and our competitive position may be harmed by lack of equality of information.
4. The sections in the Cadbury report on institutional shareholders and influence (paragraphs 6.6 and 6.12) were in my view a little light on substance in comparison with the remainder of the report. In particular, in paragraph 6.8 there is reference to the need for contact at "senior executive level" but there is no reference to any contact with non-executives. Since the non-executives or independent directors are arguably the shareholders main representatives on the board that relationship is critical but is hardly explored in the report.

Turning now to a few detailed comments -

- a) In paragraph 4.9 I believe the Committee is right to avoid a firm statement that the roles of the chairman and chief executive must be separate since as we all know the issues are not quite as black and white as that. But as a result it is not quite clear what is meant by "a clearly accepted division of responsibilities" and where the role is combined, it is not quite clear what the Committee are suggesting, except that the non-executives should be strong.
- b) The suggestion that non-executives should be paid for additional responsibilities such as the chairmanship of board committees makes sense and is, I believe, already the case or being considered by a number of companies.
- c) In paragraph 4.17, it is stated that non-executives tend to lose some of their independent edge the longer they remain on a board. While the case for specified periods of appointment is a good one that statement does not necessarily follow and in my experience some stronger characters become more independent as the years go by !
- d) There is I believe some sense in combining the nomination and remuneration committees into one and it might be sensible to include a reference to this possibility in the report. The nomination tasks are likely by their nature to be fairly infrequent and we have found here, for example, that the combination of these two roles into one committee works well.


The suggestion in paragraph 4.25 is that the nomination committee should be chaired either by the chairman or a non-executive director whereas in the case of the remuneration and audit committee it is suggested that it should be a non-executive. For the sake of clarity, I suggest that in the case of the audit and remuneration committees, it should also be made clear that it may be chaired by the chairman if he is non-executive.

- e) The recommendations on audit committees from 4.28 onwards seem very sensible but I would stress the point in paragraph 4.19 that the FD should have the right of access to the committee. It is also important that the audit committee should report regularly to the board since otherwise there is some danger of it becoming a law unto itself as has I believe occasionally happened in the US. The draft terms of reference in the appendix show the minutes of that committee as being tabled for the board and I believe this should also be a recommendation - otherwise there could be a situation where the chief executive is unaware of what the audit committee is doing.
- f) In paragraph 4.46 the wording suggests that only interim balance sheets should be reviewed by the auditors whereas clearly the intention as shown on page 43 is that it is the interim report as a whole. While I personally have some reservations about the added cost burden of a full interim review and this is perhaps another example of a specific Maxwell tail wagging the whole dog, paragraph 4.46 should be consistent with page 43.

- g) I am glad to see that the Committee has shied away from the rotation of auditors which would be too expensive and disruptive.
- h) It is unfortunate that there seems no reasonable way round the restrictive conclusion of the Caparo case but that seems unavoidable.

I hope these comments are some help and much look forward to the discussion on 26th May.

Yours,



G H WILSON

Sears plc

40 Duke Street London W1A 2HP



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1st May 1992

Sir Ron Dearing
Financial Reporting Council
Holborn Hall
100 Gray's Inn Road
London
WC1X 8AL

Dear Ron,

Thank you for your letter of 28th April enclosing the draft report of the Cadbury Committee. I am very pleased to have this and to note the extent to which the Committee has gone in order to cover so many areas of concern. I think that the document will become a turning point in attitudes towards the need for good corporate governance.

On a few points of detail and to avoid wasting time at our next meeting, I would like to suggest consideration be given to the following:

1. The importance of Audit Committees has been very well covered, but it is still not a "requirement". May I suggest that if a company chooses not to have an Audit Committee then it should state the reasons why and, furthermore, as an absolute minimum, the Auditors should be present at the Board Meetings which consider the Interim Report and the Final Accounts.

*max. of
directors
Members*

2. Whilst I am pleased to see a reference to a suitable term of office being agreed for Non-Executive Directors, I do not see this again referred to under Audit or Remuneration Committees. They are not necessarily on all fours and I suggest that for these two Committees, there should be a short term of office of, say, 3 years which can be renewed for a further 3 years.

Telephone 071 408 1180

Fax 071 408 1027

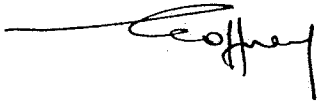
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I think there is a need for freshness amongst the constituent members of these Committees as much, if not more, than we would hope to see in the body of the Non-Executive Directors.

3. My voice in the wilderness regarding the inclusion of balance sheet information at the interim stage has at last been heard and I am pleased to note that at paragraph 4.46, balance sheet information should be included and be reviewed by the Auditors.

With best wishes.

Yours sincerely

A handwritten signature in cursive script, appearing to read "Geoffrey".

Geoffrey Maitland Smith
Chairman