CAD-01171

From Sir Simon Hornby
Chairman

30 July 1991

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Sir Adrian Cadbury
Committee on Corporate Governance
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Dear Adrian,

You wrote to me on 21 June about giving evidence to your committee. I am sorry that I have taken so long to reply to it, listing the headings which I feel we would like to discuss with you if you consider it would be helpful. However, I do know that you will be having a lot of evidence and will understand if you feel you have not got time to talk to me and Kevin Hawkins, the Corporate Affairs Director of W H Smith.

I list below the headings which we would like to discuss. These are not listed in any order of priority:

1. The responsibilities of the shareholder as owner. How is the shareholder as owner best kept informed. Should there be a differentiation between information given to large institutional shareholders and small individual shareholders.

2. The independence of the auditor. The role of the audit committee. Disclosure of information. Materiality.

3. The stockbroker's analyst. The power of the analyst in pushing the stockbroker's salesman to churn shares in order to earn commission.

4. The annual report and interim report. What information should be given.

There are of course other matters of corporate governance which could be discussed but I note from your letter that you have been specifically asked to look at the financial aspects and therefore I have omited other headings which broaden the subject.

Yours ever, Simon.

W H Smith Group PLC Registered number 471941 England
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Sir Adrian.

RECORD OF MEETING WITH SIR SIMON HORNBY ON 30 OCTOBER 1991

Present:

Sir Simon Hornby, Chairman, W H Smith
Kevin Hawkins, Corporate Affairs Director, W H Smith
Sir Adrian Cadbury
Nigel Peace

Sir Simon said that one of the problems of corporate governance was to get shareholders to think of themselves as owners. He (and his Managing and Finance Directors) made many one-to-one presentations to the company's institutional shareholders, and his first question was always whether they regarded themselves as owners. Invariably the answer was equivocal, qualified by reference to their duties to their clients, that they were judged on their annual results, and so forth. To be fair, some of the company's biggest shareholders had stayed with the company for many years (eg the Prudential and Standard Life which held 11% between them). Others however, such as Mercury Asset Management, simply did not consider themselves as owners. If they were dissatisfied with the company's management they would not discuss improvements but would simply sell up and buy into another company. They would only consider collective action with other institutions if there was a crisis. When the problems were short of crisis proportions they preferred quietly to sell because it was so much less trouble.

2 Sir Adrian commented that individual institutions were unwilling to take the lead in organising collective action because of the fear that other institutions would gain a free ride and the consequent difficulty of justifying the administrative expense to those whose money they were investing. However the institutions could in effect only sell to each other and he believed that they would therefore be justified in pooling their effort.

3 Sir Simon continued that if he was to have a fruitful conversation with major shareholders he had to tell them more than he should. They would be interested for example in the company's strategy, what was happening in the various divisions, and the good news as well as the bad. He was prepared to tell major shareholders the bad news. Occasionally it might lead them to sell

but usually they were very supportive. He was not however prepared to tell the world. He believed that such one to one meetings should be recognised as healthy because they informed the owners about the state of the business, and that the DTI would be doing a great disservice if it sought to stop them.

4 Sir Simon commented that the shareholders he met were the investment managers. He contrasted them favourably with analysts whom he said he felt strongly against. Analysts had a distorting effect on financial reporting - finance directors massaged the figures for their benefit. He believed that analysts should be met only as a group. They were brokers and interested essentially in maximising stock turnover because that was how they earned their commission. It might be better if the basis on which they earned commission was changed to increases in the capital value of the fund.

5 He continued that there was no hope of shareholders being properly informed if the board itself was not properly informed. Information flows to the board would be very much less good if there was a majority of executive directors and an executive chairman, because they might not want bad news to be revealed. So the first step was a properly constituted board, with a majority of non-executive directors (who should complain if they were dissatisfied with the information they received) and a chairman was not responsible for managing any part of the business. Indeed this was a very strong argument for splitting the roles of chairman and chief executive, because an important task of the chairman was to ensure that the Board was receiving proper disclosure. At W H Smith divisional presentations were a regular feature of board meetings and he found these helped the flow of information.

6 Sir Simon said that he had been the first non-executive director at Pearson. It had taken time to change the culture but the effect was now visible. (He added that he agreed with Dennis Stevenson that non-executives should be properly paid.)

7 Sir Simon said that one-to-one meetings with shareholders were of great value as a channel for disclosing bad news. One had to think very carefully about public announcements of bad news, both as regards materiality of the information and timing, otherwise one would be at the mercy of the media. It would not for example be in the interests of shareholders to issue a press notice saying that prospects looked bleak. Even comment about rectification of past mistakes (eg disposal of a recent acquisition) needed careful

judgement about timing. In fact W H Smith was carrying out a rigorous analysis of all its acquisitiions in the last six years, but the analysis would be internal, not in public. Mr Hawkins added that annual reports were largely retrospective. Responsible companies would not seek to ignore bad news or play it down unduly (for example, the effect of a cyclical downturn, or a strategic error over a new acquisition), but the construction put on the news was a question of judgement and the choice of words was important.

8 Sir Simon said that another area of very great concern was the failure of auditors to tell the truth. Finance directors had auditors in their pockets, because auditors were too afraid of losing the account. There were some appalling accounting practices, for example in the field of acquisition accounting. Auditors should report to the audit committee, not to the finance director, and the chairman of the audit committee should be paid more than the standard non-executive fee in recognition of the extra work he should be expected to do. Would it also help if auditors had to be changed every five years? Sir Adrian said that the route of the problem was the pressure on the company to publish the results that the City expected. Auditors buckled under because the standards allowed room for interpretation. They had to be strengthened. He did not believe that compulsory rotation was desirable but it was the responsibility of boards and auditors to ensure that their relationship remained sound, and occasional changes of personnel could certainly help to this effect.

9 Sir Simon said that companies were afraid to let too much bad news out and tried to mask it. In his own company there was a recent example where a business had been sold for a very modest profit. The gain had been included in the profit and loss account and not disclosed on the grounds that it was immaterial. The result however had been to make the next year's profits look very flat. A strong audit committee manned by strong non-executives was needed to ensure that this sort of detail was disclosed.

N D P

4 November 1991