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Dear Jonathan,

Thank you for returning the transferring copyright from NEDO to Oxford University Press.


In view of the widespread interest in the interim report of the Cadbury Committee I thought it would be helpful to add the enclosed postscript to my piece for the conference. It is intended to be a fairminded appraisal of the Committee's report. I was wondering if it would be of interest to the Committee which has invited comments on its proposals.

Yours

Nicholas Dilsdale

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To add to if may chris

 10/8/92.

A Postscript on the Draft Report of the Cadbury Committee

by Nicholas Dimsdale

In its Draft Report the Committee on the Financial Aspects of Corporate Governance (1992), known as the Cadbury Committee, reviews many of the problems of corporate governance concentrating upon the composition of boardrooms, the responsibility of non-executive directors and the role of auditors. The Report is primarily concerned with the boardroom and accounting aspect of governance rather than the operation of the capital market and the role of takeovers in disciplining managements. It does however adopt a similar view to this paper on the basic issue which is seen as the need to ensure the accountability of boards of directors to shareholders. The shareholders elect the board who report on their stewardship in financial statements which are subject to external checks through the company's auditors. The Report places particular emphasis on the need for fair and accurate reporting of a company's progress to its shareholders which is the responsibility of the board and is subject to confirmation by its auditors.

The major recommendation of the Report is the defining of a code of best practice for companies. The Committee proposes that all listed companies should comply with the code and that the stock exchange should require the annual report of all listed companies to include a statement about the extent of compliance (Para. 3.7). Should a board not comply with the code's provisions it would have to provide reasons for its behaviour. This essentially voluntary code of practice is preferred to an extensive reform of Company Law. [The Code is set out in the Appendix]

The Committee favours the separation of the offices of chairman and chief executive officer to prevent excessive concentration of power in board rooms. Where the offices are combined, there should be a strong group of non-executive directors with an appointed leader to counterbalance the power of the executive (Para. 4.6). The Committee seeks to promote the power and influence of non-executive directors who should be independent and of high calibre, so that their views will carry weight in board

discussions (Para. 4.8). They should be able to seek independent professional advice at the company's expense. While the principle that all directors are equally responsible for the board's decisions is retained, non-executives are seen as being in the best position to monitor the performance of the company and of the executive directors. The Report does not recognize the potential conflicts of interest which could arise in this situation where non-executives are actively participating in board decision making and also acting as monitors of the board.

Non-executives are to be in a majority on the nominating committee which is responsible for making recommendations for board membership. This provision is intended to ensure that candidates are judged on their merits and not according to their standing with the chief executive. Whether it will suffice to ensure the appointment of truly independent and forceful non-executives remains to be seen. At least the Committee has recognized the danger of having ineffectual non-executive directors as at Polly Peck and the Mirror Group and has made recommendations which are intended to prevent such situations recurring.

Companies are to set up audit committees whose membership should be confined to non-executive directors (Para. 4.29). The function of the audit committee is to advise on the appointment of auditors, to ensure the integrity of the company's financial statements and to discuss with the auditor any problems arising during the course of the audit. The Committee sees the audit committee as playing a major role in improving standards of corporate governance.

Board remuneration is a controversial issue following the recent massive increases in salaries of chief executives and other senior executives in major companies. The Committee proposes that companies should set up remuneration committees consisting wholly or mainly of non-executive directors who should make recommendations to the board on the

pay of executive directors (Para. 4.34). This is despite recent experience in Britain and the U.S. that remuneration committees staffed by non-executive directors do not prevent massive pay increases for executive directors. The Committee recommends that directors' total emoluments and those of the Chairman and highest paid directors should be disclosed in the company's report including a breakdown between salary and performance related pay. It can be argued that Cadbury's recommendations for disclosure in this area do not go far enough. What is needed is a fine breakdown of the remuneration package of the five highest paid directors, giving full details of stock options, as required by the Securities and Exchange Commission. Furthermore, the ability of shareholders at the Annual General Meeting to challenge companies on directors' pay should be increased in contrast to Cadbury's attempt to skirt this issue.

The Report recommends improvements in the reporting of financial information which are to be welcomed. It emphasizes the responsibility of boards to present a balanced and understandable assessment of their company's position (Para. 4.41). It recognizes that because of the varying nature of accounting practices there is scope for uncertainty and even manipulation in the presentation of a company's results. In these circumstances the need for 'true and fair' financial reporting is emphasized. Specific improvements are recommended in that interim reports should include balance sheet information. They should be reviewed by its auditors and discussed with the audit committee. They should also provide information on cash flow, which is needed to assess whether the company is a continuing enterprise (Para 4.4). This is an issue on which directors are to be required to give specific assurances and on which auditors must comment. Following the Maxwell affair the Committee recommends that good corporate governance requires that the control of the company's pension fund should be separated from the rest of the company. This is intended

to safeguard the assets of pension funds whatever the fate of a company (Para. 4.51).

The Report recognizes that there is a conflict of interest between auditors who are appointed by managers and yet are responsible for the interests of shareholders. Accounting practices allow considerable scope for presenting information in a variety of ways which could favour the interests of the management rather than the shareholder. One solution to this problem would be to make the appointment of auditors by shareholders more than a formality and so to strengthen the connection between auditors and shareholders. The Cadbury report rejects this approach and calls for a professional and objective relationship between boards of directors and auditors (Para. 5.7). It puts its faith in a general improvement in accounting standards and in providing the auditors with access to non-executive directors on audit committees.

Auditors may well be tempted to accede to management pressures on auditing issues in order to secure remunerative consulting work. The proposal that auditors should not provide consulting and other services to managements, so called 'quarantining', was rejected by the Committee although it does recommend disclosure of payments by companies to auditors for non-audit work (Para. 5.11). Such a recommendation seems rather feeble in view of the presence of conflicts of interests in this area, which could well not be resolved to the advantage of shareholders.

The Report recommends that there be a regular rotation of partners in auditing firms so that auditors and management do not build up too close a relationship during the course of time (Para. 5.12). It does not go so far as to suggest regular changes in accounting firms but only in personnel.

The Committee has recognized the existence of an 'expectations gap' between what is commonly expected of auditors and what they see themselves as doing (Para. 5.13). Auditors are seen as failing when a company fails or when the management are found to be incompetent and possibly fraudulent.

Cadbury does not question the decision of the House of Lords in the Caparo Case which limits the responsibility of auditors to a duty of care to shareholders in general. This responsibility does not extend to the interests of individual shareholders or of prospective purchasers of the company's stock (Paras. 5.31 - 5.33). It could be argued that this approach is rather restrictive and shelters the auditors. If their responsibilities were more widely defined, they would have a greater incentive to qualify accounts, should they be dissatisfied with either the state of a company's accounts or its internal control systems. More frequent qualifications of accounts by auditors would provide the shareholders and the capital market with valuable information about the difficulties being encountered by companies.

The Report does however recommend a change in legislation which would protect auditors against charges of breach of client confidence if they report cases of suspected fraud to the investigating authorities (Para. 5.28). It could be argued, in the light of recent British experience, that the recommendation should have been stronger making the reporting of such suspicions mandatory.

The Committee naturally wishes to strengthen the accountability of company boards to their shareholders. The chief way of achieving this objective is through securing general compliance with the proposed code of conduct (Para. 6.3). Other suggestions include measures to make Annual General Meetings more effective: written questions may be submitted by shareholders before the meeting and a summary of points raised during the meeting should be circulated to all shareholders (Para. 6.5). Institutional investors should be encouraged to make greater use of their voting rights and to seek contact with companies at a senior executive level. They should take particular interest in boards where there is a concentration of power in the hands of the chief executive and should seek to promote the influence of non-executive directors. In general they

should be encouraged to bring about changes in under-performing companies rather than to dispose of their shares (paras. 6.7 and 6.8).

The emphasis on the role of institutions in improving corporate governance creates a problem of equal treatment of different categories of shareholder. The Committee recognizes that the information available to financial institutions is superior and suggests that significant statements about a company must be made available to all shareholders (Para. 6.9). It also accepts that closer relations with managements can result in institutional investors gaining price sensitive information which makes them insiders (Paras. 6.9 and 6.10). While encouraging discussions between institutions and management, the Report does not go so far as to recommend the formation of shareholders committees and the participation of shareholders in the appointment of directors and auditors. The Report questions whether such bodies could be properly representative of shareholder interests and argues that shareholders should seek to influence boards directly rather than through Committees (Para. 6.2).

The Cadbury Committee has made useful proposals for improving the system of corporate governance in Britain. In some respects its recommendations seem unduly timid. The proposed voluntary code of conduct is lacking in effective sanctions. It will be relatively easy for companies to claim compliance without the provision of an adequate system for evaluating and monitoring the operation of the code. The changes in legislation which are proposed are minor but the voluntary code should, it is proposed, be assessed after two years. Should it fail to bring to an end the more flagrant abuses of executive power, the case for more extensive changes in legislation will have to be reviewed.

Appendix

(1992) Draft Report of the Committee on the Financial Aspects of Corporate Governance.

THE CODE OF BEST PRACTICE

1. Board of Directors

1.1 The board must meet regularly, retain full and effective control over the company and monitor the executive management.

1.2 There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong independent element on the board, with an appointed leader. (Paragraph 4.6)

1.3 The calibre and number of non-executive directors should be such that their views carry significant weight in the board's decisions. (Paragraph 4.8)

1.4 Boards should have a formal schedule of matters reserved to them for decision to ensure that the direction and control of the company is firmly in their hands. (Paragraphs 4.19, 4.20)

2. Non-executive Directors

2.1 Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct. (Paragraph 4.8)

2.2 The majority should be independent and free of any business or financial connection with the company apart from their fees and shareholding. Their fees should reflect the time which they commit to the company. (Paragraphs 4.9, 4.10)

2.3 They should be appointed for specified terms and reappointment should not be automatic. (Paragraph 4.14)

2.4 There should be an agreed procedure for non-executive directors to take independent professional advice if necessary, at the company's

expense. (Paragraph 4.12)

2.5 Non-executive directors should be selected through a formal process and their nomination should be a matter for the board as a whole.

(Paragraph 4.13)

3. Executive Directors

3.1 Directors' service contracts should not exceed three years without shareholders' approval. (Paragraph 4.33)

3.2 Directors' total emoluments and those of the chairman and highest paid UK director should be fully disclosed and split into their salary and performance-related elements. The basis on which performance is measured should be explained. (Paragraph 4.32)

3.3 Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors. (Paragraph 4.34)

4. Controls and Reporting

4.1 Boards must establish effective audit committees. (Paragraph 4.29)

4.2 Directors should report on the effectiveness of their system of internal financial control. (Paragraph 4.26)

4.3 Boards should ensure that an objective and professional relationship is maintained with the auditors. (Paragraph 5.7)

4.4 It is the board's duty to present a balanced and understandable assessment of their company's position. (Paragraph 4.41)

4.5 The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities. (Paragraph 4.22)

4.6 The directors should state in their report that the business is a going concern, with supporting assumptions or qualifications as necessary. (Paragraph 5.23)

4.7 The chairmen of the audit and remuneration committees should be responsible for answering questions at the Annual General Meeting. (Paragraphs 4.29, 4.34)