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From
Sir Brian Corby
President

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Sir Adrian

Some helpful paragraphs (eg 16, 17, & 26).

Paras 20 & 21 suggest that our Code may be a bit less voluntary than the CBI would wish.

Nigel 20/3

12 March 1992

Sir Adrian Cadbury
Committee on Corporate Governance
P O Box 433
Moorgate Place
London
EC2P 2BJ

Dear Adrian

I am enclosing a paper giving preliminary evidence to your Committee and hope that it will be useful.

Much of what we say will be well known to you, though some of our positions on the role of audit are more recent and take note of the proposals coming forward from the various accountancy bodies. You will also see that we have identified a number of corporate governance issues related to pension funds. We have set up a Steering Group on the whole pensions question which I shall chair.

We look forward to seeing your Committee's consultative document, on which we shall gather views as widely as we can.

If the Secretary to your Committee, Nigel Peace, has any points on our evidence, could he please contact Graham Mason or Clive Edrupt here.

Yrs.

Brian

Sir Brian Corby

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MEMORANDUM FOR SIR ADRIAN CADBURY

CBI VIEWS ON THE

FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

1 We hope that this evidence to the Cadbury Committee will be useful to its deliberations and look forward to offering comment on its consultation paper later this year.

2 Although the Committee is examining the financial aspects of corporate governance, we believe that it will not interpret the scope of its enquiry narrowly, because financial performance over the longer term measures the success of a business in fulfilling its economic and social purpose, and that in turn depends on a successful blending of the main ingredients of corporate governance: the composition of the board, its manner of operation, and the way its discharges its duty of accountability to the owners of the enterprise, notably through explanation of business policies and clear and useful financial reporting.

3 Enquiries into corporate governance are not new. In 1973 the CBI published its view of the key issues of the time in "The Responsibilities of the British Public Company" (the Watkinson Report). The climate of opinion was then quite different. Questions were being raised about companies' accountability to their workpeople through worker representation on the board, or their responsiveness to the nation's economic objectives, a strand of opinion which later resulted in proposals for planning agreements between businesses and the Government.

4 Over the last decade these questions have largely disappeared from the public agenda and there is wide acceptance of the notion that a successful business offering a good return to its owners over the longer term will also discharge its obligations to its other stakeholders: its workpeople, customers, suppliers and the community in which it functions.

5 Corporate governance is now at the forefront of discussion for quite other reasons. The main focus of enquiry now centres on the relationships between company boards and shareholders; and the stimulus for this enquiry has two causes: the high level of takeover activity in the mid to late 80s led to the sentiment amongst many directors and managers that institutional investors did not adopt a longer term perspective towards the businesses in which they held shares; and more recently a number of large corporate failures in the wake of the recession has provoked questions about checks and balances in boards dominated by strong personalities, as well as the effectiveness of financial reporting.

6 Our search for remedies has led us to the conclusion that answers are not to be found in attempts to transpose to the UK the financial and company structures of successful economies such as Germany and Japan, which base their performances on consistently high levels of investment made in a longer term perspective. Their systems derive from different histories and business cultures. What we do need is to embody the attitudes which work well elsewhere in the UK framework. This was the reason the President of the CBI, Sir Brian Corby, set up a Steering Group on Long-Termism and Corporate Governance, which brings together leading representatives of City institutions and industry.

7 In pursuing this aim, much of the Steering Group's activity has been given over to discussion of statements of best practice issued by the Institutional Shareholders' Committee (ISC) on the role and duties of directors, the responsibilities of institutional shareholders and the conduct of communications, including financial reporting, between boards and the owners of the business. Many of these concerns, of course, touch upon the role of the private investor whom the CBI has been seeking to encourage through the work of its Wider Share Ownership Task Force and latterly through the Wider Share Ownership Council.

8 The centrepiece of this evidence is made up of a summary of the CBI's response to the various statements issued by the Institutional Shareholders' Committee. But before entering into the substance, we wish to make one general point about the place of codes of practice in tackling issues of this kind. It applies with even greater force to the use of legislation. Statements of best practice are valuable as guidance because they codify the operating assumptions of the institutions; but on matters such as the composition of boards or the formation of board committees they should not be used as a template to be imposed on every listed company. There are many examples of successful businesses which have performed well over many years in meeting their obligations to their various stakeholders but which have board structures other than those which the ISC advocates.

9 We now address in turn the role and responsibilities of directors, institutional investors, and the key issues of communications between them. For the sake of convenience, we have in some instances expressed our views in the form of a comment on the ISC's statements.

THE ROLE AND DUTIES OF DIRECTORS

10 We strongly support the principle that directors of a company, both individually and collectively, must be directly accountable to shareholders. This requirement for each director to accept personal responsibility for the conduct of the business as a whole encourages the board to function as a team and adopt policies designed to achieve a sustained long-term good performance for their company. Whilst the legal duty and functioning as board member promotes a wider field of vision than that needed for management of a division or function within a company, it cannot be assumed that such a change occurs overnight. For this reason, the CBI has joined with the Institute of Directors in developing an induction course for new directors to acquaint them with their legal duties and the key elements of corporate governance.

11 There is strong pressure from the European Commission (for example, through the draft 5th Company Law Directive and proposals for a European Company Statute) for the UK to adopt the two-tier board system used in various forms by the Dutch and Germans and some Scandinavian countries on the assumption that this is superior to the well-tried single-tier unitary boards used in the majority of industrial nations. It is worth noting that North America, most Commonwealth and continental European countries, as well as Japan, use the single-tier system. We accept that in Germany and the Netherlands the two-tier board system can work well. But their banking and trade unions relationships and patterns of share ownership are different from those in the UK; and the contribution these make to the success of their board structures should not be under-estimated. In particular, the universal financing banks tend to exert strong influence in the supervisory boards responsible for overseeing longer term planning. Being committed to the company's strategic policies and with a close knowledge of the business, the banks may be particularly supportive when the company encounters difficulties.

12 In their own different setting, CBI members remain committed to the UK's concept of the unitary board and do not feel that the imposition of a two-tier system or a system in which some directors have a supervisory role over the activities of the other directors, as contemplated by the draft EC legislation, would lead to better performance. We believe that a single-tier structure with no legal or formal distinction between the role and duties of executive and non-executive directors makes it clear where responsibilities lie: with the board both collectively and individually. However, we see no reason why a company should not be free to decide to adopt a variant of the two-tier system, if it feels that the composition of its board and its manner of operation lends themselves to such a development. This could be appropriate for a company with substantial interests in countries where a two-tier structure is mandatory.

13 The CBI emphasises the important role that can be played in the proper and effective stewardship of a company by non-executive independent directors, both on the board of directors itself and by serving on board committees such as audit and remuneration committees where they exist.

THE RESPONSIBILITIES OF INSTITUTIONAL SHAREHOLDERS

14 The need to examine the responsibilities of institutional shareholders arises because of the marked shift in the patterns of ownership of UK listed equities. Over the last thirty years the relative holdings of institutions and individuals have been reversed:

TABLE: Ownership of UK Listed Equities

	1963	%	1989
Institutions	29.2		60
Individuals	53.8		20

Virtually no quoted company can now increase its capital or make a major acquisition or disposal against the wishes of a small number of institutions. A system of board accountability designed for a majority of private shareholders must now be adapted to accommodate this pattern of ownership.

15 Whilst they recognise that institutions have a fiduciary duty to beneficiaries which may dictate whether they hold or sell a particular share, CBI considers that the influence of institutional investors should be matched by a sense of ownership which looks to the successful performance of the business over the longer term. Because in some cases the institutions cannot readily dispose of large holdings in the market, this acts as reinforcement of the view of some investors that they must see themselves as owners and codify the way in which they exercise this responsibility. For this reason the CBI welcomes the initiative of the ISC in publishing a statement on this theme in December 1991. Whilst not agreeing with all of its conclusions, we accept its general thrust and consider it is a useful contribution to the debate.

16 The CBI supports the principle that institutional shareholders should encourage regular, systematic contact at senior executive level to have an exchange of views and information on business philosophy, performance, and quality of management. It is only on rare occasions and with prior notice that an institutional shareholder will be ready to become an insider and refrain from dealing. For the rest, great care must be taken that price-sensitive information is only released by public

announcement and not in private conversations between company executives and institutional investors. It is the view of experienced company boards that important relationships of this kind can be managed within the framework of the current Insider Trading Act. Changes to the UK law as a result of the EC Directive must be enacted in a way that does not render them difficult or virtually impossible, as is said to have happened in Ireland following the Companies Act 1990.

17 For its part, the CBI believes that all shareholders must continue to be involved in the dialogue between a company and its owners. We recognise that institutional shareholders must take a leading role in this because of their major holdings and professional expertise. Yet consideration needs to be given to the means of improving communications with private shareholders. Many employers have improved their communications with their employees, in terms of frequency, style and content. It is less obvious that companies have paid the same attention to their private shareholders. This is one of the topics that will no doubt also be addressed by the Wider Share Ownership Council.

18 In the past the major institutions have been reluctant to be seen influencing the management of companies and have not attended general meetings or sent in proxy votes. They have based this stance on a strict interpretation of their role as investors of other people's money. As it was not - and often is not - practicable to consult the beneficiary owners in the time available, some felt they lacked the authority to vote one way or another. If they had doubts about a company's policies or about its future performance for other reasons, they exercised their mandate by selling the shares. The major institutions have realised for some time that this was taking a limited view of their responsibilities. Accordingly, the ISC statement encourages the use of voting rights positively unless institutions have good reason for doing otherwise. It also suggests that the board should be told in advance of the reasons for voting against a motion.

19 CBI welcomes these statements. It is clearly right that the institutions should understand the business in which they are invested but stand aside from involvement in the management. They have neither the capability to do so nor the wish to become shadow directors because of the liabilities to which they would be exposed. However, their concern for the performance of the business leads them to an interest in the composition of the board. As noted, the CBI believes that the key issue is the existence of checks and balances relevant to the particular business. The appointment of non-executive directors of good calibre can be an important element in providing independent thinking and broader horizons to decisions. But the composition of the board should be determined by the criteria of quality and the right blend in the team rather than by a formula which lays down a quota of outside directors.

20 The CBI notes that the ISC supports the appointment of Compensation and Audit Committees. Many companies find that such Committees are valuable. But the decision to form them should be a matter for individual boards and tailored to the operation of the business. Where Compensation Committees are established, we endorse the proposition that they should be made up wholly or largely of non-executive directors, so that the determination of rewards for executive directors and senior management is independent and seen to be so.

21 One consideration should be kept firmly in mind in examining the proposals now coming forward for the creation of various committees of the board, either as a legal requirement or as a matter of prescription by institutional investors. They gradually lead to the conclusion that two classes of director are being created, one of which supervises and monitors the other. This undermines the concept of the unitary board and leads toward the two-tier system to which, as noted, we are opposed in its mandatory form.

22 The CBI fully supports the institutional investors' encouragement of companies to disclose in their annual report the principles upon which directors' remuneration is determined, so that they are fully understood by shareholders. The key principle to be observed throughout the company, in our view, is that pay should be related to performance. We do not, however, think, it necessary for the details of individual directors' service contracts to be disclosed in the same way. Such information is in any case available for inspection at the company's offices during the period between the posting of the notice of a shareholders' general meeting and meeting itself.

AUDITORS' RESPONSIBILITIES AND LIABILITIES

23 Of late there has been considerable debate about the responsibilities and liabilities of auditors as a result of major corporate failures of which there was no warning in most cases. The difficulties arise from two sources: an unrealistic notion of what the auditor can examine and verify; and a confusion which stems from the fact that he is carrying out a public duty, defined in statute, on the basis of a private contract.

24 In carrying out his duties under the Companies Act and Stock Exchange requirements the auditor determines that proper books of account are kept and samples transactions to see that the record is supported by evidence. Although he can inspect accounting systems to see whether they can reveal fraud, he cannot realistically be put under a duty to detect it or other illegal acts. Still less can the auditor be expected to act as a public watchdog bound to report frauds or other illegal acts directly to the competent authorities without consulting the directors, who collectively have the responsibility for preparing the accounts. There are matters of evidence, confidentiality, and defamation which constrain what auditors may do.

25 It has been suggested that the auditor's role should be extended to checking on internal controls, auditing management discussion and analysis in the annual report, or certifying accounts on the basis that a concern will continue in business for the year ahead. If there is to be a legislative change to his role, it should only be after the fullest debate. For the moment, we would simply make the point that the responsibilities companies properly bear in seeking quotations have to be tempered with some thought of cost and benefit. Some large groups already pay £5 million in audit fees; and an extension of the auditor's role would clearly add to these costs.

26 The same consideration must also apply in the debate on the scope of the auditor's liability. In the recent Caparo case, the House of Lords held that the auditor owed a duty of care to the shareholders of a company as a class and to no other, save when he was put on notice that another would rely on the audited accounts. It seems to us that this is a reasonable definition of the ambit of the auditor's liability. To exceed it would lead to greater confusion about the role of the auditor and add to the size of fees paid by companies, since the premium for professional indemnity cover would rise beyond existing high levels.

27 The CBI believes that a statement of the auditor's responsibilities in the audit report (with a similar one for directors in the directors' report) would be a modest step forward in removing some of the public confusion about his role and responsibilities. We have expressed our support for the draft proposal on these lines put forward by the Auditing Practices Board.

28 There is a view that the performance of the auditor may be affected if he becomes too close to the board of his client company. The CBI does not share this opinion. Provision for the regular change of auditors (rotation) would more likely result in a less reliable service being given to shareholders, since the evidence is that most audit failures occur in the first year after the appointment of a new auditor.

29 Nor do the CBI believe that an auditor should be debarred from offering consultancy services to his client company. Insight into a company's business through the audit often leads to well-tailored and fruitful advice. It would be wrong to end the possibility of such relationship, when there are improved safeguards against undue influence being exercised against an auditor to alter his judgement, notably through legal suit, professional disciplinary action and the Financial Reporting Review Panel.

30 The CBI is aware of contrary points of view. The Audit Commission, whose founding Chairman was a former senior partner in a leading accountancy firm, insists on regular rotation of audit appointments and debars auditors from undertaking consulting work for their clients. The Committee may wish to consult the Commission on whether the predicted advantages (or disadvantages) of its approach have materialised.

ACCOUNTING STANDARDS

31 CBI believes that the Companies Act 1989 drew the right line between the law and professional regulation in setting accounting standards. As was correctly forecast when the Government brought forward the legislation, the law is not flexible or quick enough to deal with the accounting treatment of new commercial practices.

32 The operation of new framework for financial reporting so far promises to give companies and the investment community a system of regulation which deals rapidly with questionable accounting practices and takes note of commercial realities in the proposals for standards which are brought forward. It is imperative that important changes to accounting standards are only made after full consultation with all those with a stake in the integrity and usefulness of published company accounts and heed the principles being established in the International Accounting Standards Committee (IASC).

33 Equally, the drive for greater disclosure must be tempered by a proper balancing of the cost of assembling data against the benefit to users of new information. The Accounting Standards Board's proposals must also recognise that disclosure by UK companies already exceeds that required and practised in some major industrial countries in the EC and elsewhere. We support the work of the IASC and the securities markets regulators grouped in the International Organisation of Securities Commissions (IOSCO) leading to better standards of disclosure and the mutual recognition of accounts. However, it is important that UK businesses should not be put at a competitive disadvantage. The study commissioned by the DTI into takeovers in the EC made it clear that there was a distinct contrast between the open financial market and level of disclosure in the UK compared with other Member States.

34 The Committee may wish to give some attention to the role, purpose and content of accounts and of the directors' report and the audit report. The CBI is presently giving consideration to the possible adoption in the UK, in some form, of a system similar to the United States Securities and Exchange Commission requirement for management discussion and analysis.

PENSION FUND MANAGEMENT ISSUES

35 Corporate governance issues arise in relation to pension fund management. Issues as to the legal status, ownership and control of pension funds, the powers, duties, responsibilities and qualifications of pension fund trustees, the respective interests and board representation of pensioners and employees on the one hand and the company on the other, the need to avoid conflicts of interest in the management of the fund, and the extent of the employer company participation in the fund management have recently been shown to require examination.

36 Although it may be argued that the existing law as to the trustees' fiduciary duty is adequate, publicised cases indicate that conflicts of interest can and do arise to the detriment of the trust's beneficiaries, the pensioners and employees. Although abuses by the dishonest cannot be eliminated, a review of pensions law and practice is needed. Such a review might consider questions such as the following:

- what should proper and adequate qualifications be for trustees;
- whether the appointment of custodian or independent trustees would help to avoid conflicts and abuses;
- whether a compensation or insurance fund should be compulsory;
- whether the movement of pension fund assets should be controlled;
- whether restrictions on what investments a fund can make should be laid down;
- whether supervision and regulation of fund management and adherence to trust deeds should be tightened.

37 The CBI will be reviewing its position on some of these questions and believes that the Cadbury Committee may also wish to consider them.

* * *

38 As will be evident from the thrust of this preliminary evidence, CBI believes that further intrusion of the law into matters of corporate governance is unwelcome, unnecessary, and thus change, where needed, should be based on persuasion, the spread of best practice and self regulation. We hope that this memorandum will contribute to this end.

March 1992