

IN CONFIDENCENOTE OF MEETING WITH MR. JONATHAN CHARKHAM, BANK OF ENGLAND ON  
WEDNESDAY, 19TH JUNE, 1991

Present: Jonathan Charkham  
Sir Adrian Cadbury  
Nigel Peace

1. Mr. Charkham said that he saw the Committee's fundamental concern as being the passage of information. It was information that held all the parties in the system (including shareholders, creditors, and employees) together. The purpose of accounts needed to be seen in this light - they gave a measure of the performance of the business and told shareholders what their stake was worth. They were a means of putting numerically what people would normally say in words.
2. The first question which arose was who should supply the information. On this the Companies Acts were clear and correct - the responsibility lay with Boards of Directors. He believed it was extremely important that Boards should feel that they, and not their auditors, were responsible for the figures. Audit Committees should exist to help Boards, not the auditors, get the figures right.
3. Mr. Charkham continued that auditors tended to be too close to their clients. In practice they were part of the production team for the figures. He believed that as companies were responsible for the figures they should have stronger internal teams to prepare them. The role of the external audit should only be to check. In fact he doubted the logic of having an external audit once a year. Once every 2½ years or so might be adequate, provided there was (say) an external Audit Commission able to require more frequent and in-depth audits in cases of concern. An early in-depth investigation might have helped in the case of Polly Peck, for example.
4. The next question was the form in which information should best be conveyed. Mr. Charkham said that the problem with reports and accounts at present was that they threw figures at shareholders. He wanted the document to tell a story in words, illustrated not led by the figures. A

good example he had seen recently was of a company which had made an unsuccessful investment in BSB. The figures had been honestly disclosed and there had been no attempt to conceal, but what the reader could not do was put together the story - why the investment had been made, what stood to be lost, whether any prospect of success remained, etc.. The primacy of words needed to be reasserted, and they should be contained in a single statement by the Board, not the usual three, as at present. Such an approach would also enable important information which at present was often lost in Notes to the Accounts (e.g. exceptional items) to go instead in the narrative statement.

5. Mr. Charkham suggested a photographic metaphor: accounts were of necessity a snapshot, but the snapshot needed to be set in the context of the movie - i.e. what had gone before and what the outlook was.
6. Mr. Charkham continued that he thought users wanted to know the following information from the report:
  - (i) what the business did, including a breakdown by product and market;
  - (ii) who the people were, including details of the background and responsibilities of those running the business, and information about human resources policies and strategies;
  - (iii) plans and strategies for the future, including statements on investment and R & D;
  - (iv) an account of stewardship in the past year - i.e. performance.

The narrative should refer to figures in the accounts, and Notes to the Accounts, as appropriate.

7. Mr. Charkham said that the ICAS's work on "Making Corporate Reports Valuable" was excellent but it still put the figures first, which was the wrong way round. (He undertook to let Sir Adrian have a copy of his letter to the ICAS on the MCRV report.)

8. Asked how he would effect change, Mr. Charkham said that (assuming his ideas found favour with the Committee) it would be unrealistic to expect the institutional shareholders to enforce them - the most that could be expected was a cheer from the sidelines. Similarly, the Stock Exchange would be unlikely to want to use the sanction of delisting. So ultimately it would be for DTI to establish the regulatory framework by statutory means. He believed that it was a proper role for Government to establish what was in effect the price for limited liability.
9. Mr. Charkham reiterated the advantages of externalising the audit - it would help put responsibility back with the Board; it would reduce auditors' fears of being sued, because people would no longer have incorrect expectations about their function; and it might also help uncover fraud by the Board if there was a system of external audits at irregular intervals with the possibility of more frequent in-depth investigations.
10. On the question of directors' pay, Mr. Charkham said that it was extremely difficult to devise a fair system. All the mechanisms had drawbacks - share option schemes were too dependent on the vagaries of the market; Earnings per Share could be manipulated in the short term; and external comparisons were exceptionally hard to conduct. There was also the problem of time lags - i.e. that profits could be down by the time that bonuses were paid. He did not have the answer - it had to be a balance of external and internal relativities and capacity to pay. He agreed with Sir Adrian however that there was no reason why shareholders should not be given full information on how pay and bonuses were calculated. One possibility worth considering was whether shareholders should be asked to approve in advance either the method or the amount of remuneration. It was worth noting that the SEC in the US had always held that directors' remuneration was not a matter for shareholders' resolution, but was now understood to be changing its mind. Mr. Charkham said that it would also be worth considering whether Boards should be required to consider directors' pay as a proper agenda item, and to record decisions formally in the minutes. He was concerned by evidence of directors' pay being discussed in cabals, taken under Any Other Business, and then not minuted. It was very difficult for Non-Executives

to challenge decisions subsequently.

11. Sir Adrian said that he would be very grateful for any help Mr. Charkham could provide in defining the Committee's remit - i.e. in defining what was meant by the "financial aspects of corporate governance" - in advance of a general discussion at the first meeting. Mr. Charkham suggested the phrase meant "the role of accounts and information in the running of companies", but would consider the request further.

NDP/PJS

25th June, 1991