

CFACG(92)14

COMMITTEE ON THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

RESPONSES TO THE DRAFT REPORT; NOTE BY THE CHAIRMAN

I attach a note by the Chairman to steer discussion at the Committee's forthcoming meeting. In case it should help the conduct of the meeting, I have added an annex which tabulates the points made in his note and cross-references them to the relevant paragraphs of the Committee's draft report.

Nigel Peace
Secretary
10 September 1992

RESPONSES TO DRAFT REPORT

There is now a considerably greater degree of public interest in the issues covered by our Report than when the Committee was set up. Some doubts were expressed at our first meeting as to whether we would have anything significant to say! The Report has unexpectedly become the centre of press attention and this has ensured a level of response to the invitation to comment beyond our expectations.

The first question this raises is how to treat the weight of comment we have received, which Nigel Peace has done such an outstanding job of summarising. To do it full justice would mean, in my view, re-considering our terms of reference and taking several more months over re-drafting. Cost and our reliance on Nigel Peace apart, this would not meet the expectations of those who are looking to the Committee for guidance and who are already (CBI letter) acting on our draft proposals. I suggest, therefore, that we should stick to our original timetable as best we can and simply address the key criticisms, while leaving the form and as far as possible the length of the Report as it is.

We should consider acknowledging the extent and value of the comments which have been submitted and possibly add that they will form part of the input to our successor body. I would be prepared to do some work on them after we have published the final report. We cannot take full account of the thought which has gone into the best of them in one or two meetings. One comment was to the effect that submissions should be encouraged to continue to come in.

Next comes the question of what changes to make. Some of the criticisms cancel each other out, although we need to take some note of the standing of their various proponents. There is no reason for us to make a change simply because of criticism, but there are one or two points where all of us have probably had second thoughts and we need to build as

much support as we can for those recommendations we regard as of prime importance.

The last background point I would make is that we have been urged to make a firm statement about who will take the work on from us and we probably need to be clear how queries on the implementation of our Report are to be dealt with, between now and May 1994.

Turning now to the issues which I suggest we have to address, there are some which apply to our approach to the Report as a whole.

TONE

We are said to be "long on accountability and short on drive and efficiency" and to take a negative view of governance. The former criticism derives directly from our remit, but do we need to spell out the message in 1.1 and 1.2 more clearly? Are there any additions that we need to make to show that we understand the importance of competitive efficiency and believe that basically control and efficiency go together?

DIVIDING THE BOARD

This is the most common criticism and is related to the role we propose for ned's, allied to the absence of positive statements on the role of executive directors. An affirmation of our support for the unitary board early in the Report would help to restore the balance, as would an underlining of the equal responsibility of all directors for the board's conduct. We may also need to emphasise that what is proposed is an allocation of responsibilities within the board and that the board as a whole remains responsible for final decisions.

There are specific words like "monitor", which have been picked up and there is the proposal for an appointed leader.

Do we stay with these? Minor changes like giving all directors the right to outside advice are no problem.

I accept that there is a fundamental issue here and that there could come a point when logic would point to a two-tier board. I do not believe we are at that point yet, (although those who advocate distinct legal duties for ned's would pass it), and that the unity of boards need not be undermined by our proposals, given a competent chairman.

MAXWELL

We recognised that our recommendations would be subject to the Maxwell test. Do we stand by 1.7? Mumford, for example, claims that Maxwell would have signed off as complying with the Code and that neither his directors nor the auditors could have challenged his action credibly. The problem is that to say that a statutory code might be no more effective in extreme cases is weak. What is needed is a Code, backed by vigilant shareholders and an investigative Press.

ENFORCEMENT

This is one of the issues on which there is a divide. There has also been some degree of misunderstanding, for example over the threat of delisting. The majority view leans towards the inadequate sanction argument, in spite of CBI not wanting a listing obligation. The good will comply, the wicked will ignore. Should we strengthen enforcement and if so how?

Now to move to specific sections of the Report.

THE CODE

It is suggested that the Code should stand on its own and should set down principles, leaving boards to work out their own means of compliance. The detailed provisions should be subordinated to the Code's aims. Only verifiable statements should be audited and the Code should be divided accordingly.

The concept of a Code of Best (Good?) Practice has wide support, the argument is over wording and specific proposals in it. How do we react?

The question of small companies is inevitably raised. The arguments for leaving matters as they are include:- all listed companies should accept the same obligations, where to draw the line and the ability of small firms to give adequate reasons for areas of non-compliance.

There is a general question of costs and benefits. It is possible for a company not to comply on cost/benefit grounds and carry its shareholders with it. The difficulty with making disproportionate cost the basis of exception is that the Code begins to lose certainty. Auditing costs for interims a particular target.

Lastly under this heading, comes the date of application. There are arguments for delay, for bringing all the provisions in at the same time and for going right ahead with, for example, audit committees. Is the year-end still feasible?

THE BOARD

There are a number of points under board structure, including too much emphasis on structure rather than behaviour and that we are too rigid. The "ned" leader proposal has been attacked as undermining the chairman's position, as has the notion of committee chairmen answering at the AGM. Then there are those who favour splitting the two top posts. On committees, it is argued that executive directors should not be barred. Boards should register what they delegate rather than the powers they retain.

A good deal of comment on directors' contracts and pay. Suggested that best practice is three years fixed or one year rolling, and that the pay of all directors should be

published. All directors should come up for election at least every three years.

On "ned's" there are those who advocate only independent ones should be appointed and that the definition of "independent" should be more closely defined and made tighter or looser according to choice. There are those who would like guidance on the number of "ned's" (this is done by PRO NED) and indeed on board size. Comments on where will they come from and that we are expecting too much from them. There is independent support for strengthening the role of "ned's" in the research recently carried out by The Stock Exchange and PRO NED, which suggests that we would be right to stand by our approach in general.

Our position on nomination committees is not clear, are we saying that it is a matter for the whole board, preferably through a nomination committee?

There are views on the make-up and duties of audit committees and we should emphasise that they are committees of the board. Would we accept the board acting as an audit committee; presumably they would then have to give as detailed consideration to audit matters as a committee would? I think we should support the need for internal audit and refer to their function in relation to the external auditors.

On internal control and going concern, there is considerable caution and a plea to await accounting guidance. Comment on the difference between internal control and internal financial control.

AUDITORS

The view of the non-accountants is that the auditors have been let off too lightly. It is suggested that they should be readier to resign, if they do not approve of accounting methods or receive no board support when they suspect fraud. Caparo judgment may be right in law, but needs amending. Some

auditors prepared to accept wider liability in exchange for a cap.

SHAREHOLDERS

This is the section where we had least to offer and the CBI have asked us to support the use of votes and the publication of voting policies and to encourage shareholder communications. Provisions of Code directed solely at boards, but should include shareholders.

Shareholders should be able to vote on directors' pay as a package and the Companies Act should be altered to make it possible in practice for shareholders to put forward resolutions. Written questions at the AGM (an idea already taken up by one board) should not preclude questions from the floor and there should be the chance to meet directors informally.

A certain level of shareholder backing should be required for directors coming up for election.

Reports and accounts should come out more promptly.

It would be helpful if we could draw on some of these ideas to strengthen the shareholder section.

THE FUTURE

Advice to our successors? Should we give any indication as to what the next steps in the field of corporate governance might be? Should the follow-up enquiry have wider terms of reference and be staffed differently? Should there be a review of company law as proposed by the Law Society?

Should trends in corporate governance in Europe be reviewed, if only to avoid taking steps which might cause conflict later, if and when there is some degree of convergence?

The Code should be seen as a living document (The Law Society).

Adrian Cadbury

9/9/92.

TABLE OF POINTS FOR DISCUSSION

- 1 How to deal with the weight of comment received?
- 2 Who will take the work on from the Committee, and how are queries to be dealt with up to May 1994?
- 3 Tone of the report.
- 4 Criticism that the proposals will divide the report:
 - a) affirm support for unitary board and underline equal responsibility of all directors for the board's conduct?
 - b) consider minor changes, eg to the following:
 - statement that NEDs are in best position 'to monitor the performance of the board and that of the chief executive' (4.3)
 - proposal that NEDs should have an appointed leader (4.6, Code 1.2)
 - limiting to NEDs the procedure for taking independent advice (4.12, Code 2.4)
 - proposal that Committee chairmen should answer questions at AGM (4.29, 4.34, Code 4.7)
- 5 Maxwell. Do we stand by 1.7?
- 6 Enforcement. Should we strengthen enforcement and if so how? CBI's opposition to a listing obligation.
- 7 The Code:
 - a) Should stand-alone version be prepared (see separate paper)?

- b) Should those elements where compliance can be verified be separated from the others, to assist auditing?
- c) Should new provisions be added, addressed to shareholders (see 27 below)?
- d) Other reaction to consultation comments?
- 8 Endorsement by auditors (3.10) - APB's suggestion that statement of compliance should be considered and endorsed by audit committee.
- 9 Small companies (3.16).
- 10 Cost/benefit concerns (especially relating to increased audit costs eg in respect of interim reports).
- 11 Date of application (3.7). Is proposed start date (year-ends on or after 31 December 1992) too soon?

The Board

- 12 More emphasis on behaviour needed, less on structure?
- 13 Combined roles of chairman and chief executive - some support for splitting. (4.6, Code 1.2)
- 14 Board committees (nomination, audit, remuneration) - should executive directors be allowed? (4.24, 4.29, 4.34)
- 15 Formal schedule of matters reserved to board for decision - turn round so as to recommend that boards should define what they expressly delegate, rather than what they retain? Or expand guidance on what schedule should contain? (4.19, 4.20, Code 1.4)
- 16 Directors' contracts. Consider
- a) proposal that all directors should come up for re-election at least every three years (4.14, Code 2.3)

- b) proposal that best practice on service contracts is three years' fixed on one year rolling. (4.33, Code 3.1)
- 17 Disclosure of directors' pay (4.32, Code 3.2). See separate paper.
- 18 Non-executive directors:
- a) Is general approach right, despite scepticism that there are enough candidates of the right quality?
 - b) Clarify definition of independence? (4.9, 4.10, Code 2.2)
 - c) Provide guidance on minimum number of NEDs? (Not covered in draft report, but recommendations on audit committees require minimum of 3 NEDs, 2 of whom must be independent.)
- 19 Nomination committees (4.13, 4.24, Code 2.5). Need to clarify. Is Committee saying that nomination is a matter for the whole board, preferably through a nomination committee?
- 20 Audit committees (4.29, Code 4.1). Need to emphasise they are committees of the board.
- 21 Need for internal audit (4.31). (See separate paper.)
- 22 Internal control (4.26, Code 4.2). Do we mean internal control or, more narrowly, internal financial control? Caution expressed about increasing audit costs but comments on balance support the recommendation.
- 23 Going concern (5.23, Code 4.6). Considerable caution and a plea to await accounting guidance.
- 24 Pensions governance (4.51). Better to omit?

Auditors

- 25 Should auditors be readier to resign?
- 26 Auditors' liability (5.31).

Shareholders

27 How to strengthen the section on shareholders (section 6)?

Suggestions include:

- a) Addressing the Code also to shareholders, and including in it the recommendations that institutions should publish their voting policy and should make positive use of voting rights.
- b) Allowing shareholders to vote on directors' pay (see separate paper).
- c) Making it easier for shareholders to table resolutions at AGMs (see separate paper).
- d) Requiring a certain level of shareholder backing for directors coming up for election.
- e) Prompter publication of report and accounts.

28 Written questions at AGMs (6.4).

29 Shareholder communications (6.9 to 6.11).

30 The future?

Other main sections of report not touched on above

31 Interim Reports (4.47). A wide range of comments received.

32 Disclosure on non-audit fees (5.11). Comment from accountancy firms is muted.

33 Rotation of auditors (5.12). Support from big accountancy firms but reservations from some smaller ones.

34 Fraud (5.24 to 5.28).