

COMMITTEE
ON
THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

PO Box 433
Moorgate Place
London EC2P 2BJ
Tel: 071-628 7060 ext 2565
Fax: 071-628 1874

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Harrogate

CAD-01287

COVER SHEET

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To: Sir Adrian

Date: 22/6/92

Address:

Fax No.:

From: Nigel Pease

Subject: REVISED Q&A BRIEF

I cleared the answer to Q19 with Mike Sandland. His line was very much the same as Sir Andrew Hugh Smith's: he cannot anticipate the reaction of institutions during the consultation period but he would have no reason to suppose it would not be very favourable. (He also made the point - that when it comes to keeping up pressure on individual companies, it will be down to individual institutions.)

Regards,

Nigel.

LAUNCH OF DRAFT REPORT: QUESTION AND ANSWER BRIEFING

1 The Committee is unrepresentative

From the time the Committee was set up, we have been open to representations from all interested parties. A further period of consultation follows publication of the draft report. The members of the Committee are not representatives. Although some belong to organisations which will have the primary responsibility for turning our proposals into action, they were chosen because of the individual contribution with they could make to the Committee's work.

2 No major company on the Committee

Committee includes the Chairman of the Institute of Directors, the former Chairman of the CBI Companies Committee, and the Finance Director of SmithKline Beecham. The Chairman headed Cadbury Schweppes for two decades and retains several non-executive directorships. Sir Christopher Hogg (Reuters and Courtaulds) has acted as an adviser to the Committee.

3 No small shareholder representative on the Committee

Committee has paid careful attention to interests of ordinary shareholders (see eg 6.5) and will welcome their views during the consultation period. Institutional shareholders (who are represented on the Committee) largely hold shares on behalf of individuals and not correct to assume a wide divergence between their interests and those of ordinary shareholders.

4 The basis of the conclusions: there is insufficient evidence to support the proposals

Have sought to produce concise report but it is based on evidence from wide range of sources - getting on for 100 contributors are listed in Appendix 6.

5 The proposals are 'anti business': disclosure requirements will disadvantage companies internationally

Good corporate governance will strengthen companies not weaken them. Specifically on disclosure, we say boards should aim for highest level of disclosure consonant with not damaging their competitive position. Many matters on which we recommend disclosure - eg directors' pay, audit fees, internal control systems - have no direct bearing on competitiveness. (Do not in any case accept that there is a correlation between disclosure and disadvantage.)

6 Proposals will stifle initiative

Important not to stifle initiative. However, given the importance of companies in society, essential that there is a balance of power and authority at the head of a company, such that no one individual has unfettered powers of decision.

7 The mechanisms being set up are too bureaucratic

On the contrary, they are extremely light-handed. The requirement is simply for an annual statement in the report and accounts. The system permits great flexibility. However - bearing in mind the considerable public concern - if companies do not back the Code in spirit then regulation in some areas may be inevitable (1.8).

8 The proposals favour large shareholders/disadvantage small shareholders

No question of favouring any particular category of shareholder. We make point of encouraging boards to experiment with ways of improving their links with all their shareholders (6.5).

It is a fact of life that institutional shareholders are able to keep in touch with companies in a way that is not feasible for the individual shareholder. We stress however that any significant statements about the company must be made publicly and so be equally available to all shareholders.

9 The proposals favour auditors: the Committee has been captured by the accountants

Only two members of the Committee are practicing auditors. Wholly unreasonable to suggest that the other ten members - all very senior figures - did other than consider the arguments on their merits.

Committee is absolutely clear that responsibility for the financial statements, and for reporting on the company's position, rests with the directors. That does not equate with 'capture' by the profession.

10 Proposals will increase the cost of the audit

Committee believes that there **should** be an extension of the audit which will increase its value to users of accounts and bring it closer into line with public expectations (5.15). Some increase in audit costs may result from the proposals but clearly those charged with taking them forward must keep value for money considerations uppermost in their minds.

11 The Caparo decision has not been challenged

The Committee discussed fully and the report writes the case up in some detail (Appendix 4). The House of Lords had to achieve a delicate balancing of interests and we are unable to see how a different balance could have been drawn without exposing auditors in effect to an indeterminate liability. The result would almost certainly be that audits would become much more expensive, either because insurance premiums went up or more extensive audit checks were undertaken. Do not believe increasing audit costs to support wider liability would be advantageous. Some have proposed that a balance could be maintained by introducing limited or proportionate liability for auditors, but do not regard this as feasible for reasons set out in the report.

Caparo does not mean that auditors cannot be sued - witness the major suits against the auditors of BCCI, Polly Peck, and Barlow Clowes. Auditors still owe a duty of care to the company, and the shareholders as a body.

12 There is insufficient attention to stamping out fraud and other illegal acts

The Committee addresses these issues carefully at 5.24ff. Do not believe that imposing on auditors a duty to detect material fraud would provide a guarantee, because the auditor would simply not be able to deliver. It would significantly increase audit costs, however.

An effective and independent-minded audit committee is an essential safeguard where there is a suspicion of fraud. We also recommend that the Government should extend statutory protection to the auditor against being sued by his client where he reports reasonable suspicion of fraud to an appropriate authority, eg for breach of duty to maintain a confidential client relationship, or defamation.

13 The auditing disciplinary mechanism is inadequate

Undesirable practices, such as low-balling, opinion shopping and predatory pricing, have not been addressed

Regulation of auditors should be shifted to an independent organisation

It is essential for the profession's public image and standing that it should deal effectively with professional conduct issues and that it should uphold professional standards. The Committee has not however regarded it as part of its remit to address these issues specifically. (It is understood that the Joint Ethics Committee will soon be producing guidance for the profession on low-balling and opinion shopping.)

14 The report will drive companies away from London listing

No grounds for this view. The listing requirement will apply only to UK-registered companies. Clearly the Code is not appropriate in the case for example of continental companies with a two-tier board structure. (The City's interest is best served by having a well-regulated market.)

15 An establishment whitewash

Of course reject. There has been no attempt to sweep any issue under the carpet. We have produced a substantial package of proposals and they will stand or fall on their merits. A question of balance: some may think we have not gone far enough, others that we have been too prescriptive. Hope the balance is right.

16 The proposals are unrealistic:

- there are not enough non-executive directors around
- good non-executives cannot spare the time that the duties require
- the threshold for compliance is too low

PRO NED has on its register about 750 individuals who would be interested in serving as non-executive directors. They are carefully screened by PRONED and regarded as competent and capable. Against these figures PRO NED receive only 100 requests a year from companies who are looking for NEDs. Clearly therefore there are plenty of good quality candidates available.

The demands now being made on NEDs are significant and duties should be clearly agreed before an appointment is accepted.

The Committee recognises (3.16) that smaller listed companies may take longer before they achieve full compliance with the Code, but we have no doubt that all companies whose shares are publicly traded should aim to comply.

17 The proposals are unenforceable

Clearly delisting would be an inappropriate sanction, but the London Stock Exchange has the weapon of publicity and it would propose to draw public attention to cases of inadequate disclosure. Progress will be monitored and if it is inadequate then the Government may in due course wish to consider the possibility of regulation.

18 Will the Stock Exchange definitely deliver a listing requirement?

(Wording to be cleared with Stock Exchange)

Strictly a question for the Stock Exchange. However the Chairman of the Stock Exchange is a member of the Committee and we have every confidence regarding his intention that the Stock Exchange should introduce a listing requirement.

19 Will the institutions deliver their support?

Strictly a question for the institutions. However the ISC - whose Chairman is a member of the Committee and which represents the overwhelming majority of institutional shareholders in the UK - has produced a very clear policy statement which we warmly support. We very much hope that the institutions will deliver their support in line with that policy statement.

20 Committee has made up its mind and will not be receptive to comments during the consultation exercise

Committee will certainly give favourable consideration to changes if they would be a real improvement or would secure broader support for the package.

21 Committee is not robust enough on split of Chairman and Chief Executive

Code makes quite clear that there must be a division of responsibilities at the head of a company. We do allow flexibility in how this is achieved, but where the posts of chairman and chief executive are combined it must be justified by the presence of a strong independent element on the board.

NDP

22 May 1992

CADBURY COMMITTEE
REPORT

QUESTIONS AND ANSWERS

1. **Why does not the report deal with ethical questions for auditors such as low-balling and opinion shopping?**

These subjects are already being dealt with by the Chartered Accountants Joint Ethics Committee. After wide consultation, now complete, the Committee will soon be producing guidance for the profession which will help protect the public interest.

2. **The report mentions that if fraud detection were to be stepped up, the additional cost might not be justifiable. Do you agree with this?**

There are certain kinds of fraud which are extremely hard to detect and it is doubtful whether any amount of extra audit work would increase the possibility of bringing them to light. These tend to be in the area of senior management fraud where coercion and collusion may be involved. The balance of advantage is not in favour of incurring significant extra cost in order to detect more minor fraud.

The Cadbury report, rightly, lays greater emphasis on fraud prevention with its recommendations for closer review of management action through the use of independent non-executive directors and audit committees, and for public reporting on the state of listed companies' internal controls.

3. **The Cadbury Committee is not persuaded that the imposition of a statutory duty (as opposed to a right) to report fraud to the regulatory authorities would make any practical difference. Do you agree?**

A right, rather than a duty, has existed in the regulated areas of banks, building societies, investment and insurance services for some time and all the evidence seems to show that it works well. A change to the law of this type would have no more than symbolic effect. However, Cadbury's proposal that the right to report fraud (without creating difficulties in relation to the duty of client confidentiality) should be extended more widely into the non-regulated area is welcome.

4. **The Cadbury report seems to sidestep the issue of the provision of non-audit services, such as management consultancy, by auditors. Independence and the integrity of the audit is the issue here. There is no evidence to show that this has been compromised. The Institute agrees with the Cadbury Committee in supporting the principle of disclosure of fees paid to audit firms for non-audit work.**

5. **Are the Cadbury recommendations going to be followed in practice?**

We believe that companies will feel obliged to do their best to conform with the code of practice as soon as possible. The committee has proposed a rapid rate of progress in complying with the code and has taken a sensible and practical approach, given that some of the recommendations will not be capable of being implemented immediately.

6. **Do you believe that the concepts of internal controls and going concern reporting are sound?**
The Council of the Institute has not yet pronounced on these concepts but will of course do so. We have set up working groups to examine the practicalities of these matters already, in anticipation that they will receive general acceptance.
7. **The Cadbury report places a high premium on the provision and use of suitable non-executive directors. This would seem to require an additional supply. Where are they going to come from?**
Non-executive directors of listed companies who are also suitable members for audit committees need to have more than a passing acquaintance with financial reporting and auditing matters. It may well be that there are a number of chartered accountants with the right qualifications for these posts.
8. **The Cadbury report does not appear to deal with abuses in pension funds.**
This is a large subject in itself and a number of bodies, including this Institute, is examining ways of improving the security of pension funds. It may well be that a number of Cadbury's recommendations for better corporate governance can be applied in the pension fund environment.
9. **Do you consider that the use of cash flow statements in interim reports should be adopted at an early stage or that there are good reasons to postpone this until the post-implementation review of Cadbury's proposals, as the report suggests?**
The Cadbury report recommends the use of summarised balance sheet information in interim statements. Cash flow statements are of more or less equal significance to users and it would be a good thing if companies were to take a lead in voluntarily publishing these with their interim results, even ahead of the post-implementation review.
10. **The code is directed at listed companies, but as many other companies as possible are encouraged to aim at meeting its requirements. Surely there are very many smaller non-listed companies which would find it difficult, if not impossible, to comply?**
Yes, this is true. However there is a number of sizeable companies which are not listed but which have "public-interest" characteristics, both in the public and private sector. One may expect that these would wish to comply with the code.
11. **The Cadbury report expects that auditors will review companies' statements of compliance with the code. How can they do this when some of the code's requirements would not appear to be capable of external attestation, eg. the requirement that non-executive directors should bring an independent judgement to bear on business issues?**
The Auditing Practices Board has been asked to produce guidance for auditors on their review of compliance. It is too early to say how the Board will deal with this particular problem, but obviously it will consider carefully scope and feasibility issues before providing guidance.