

PRESS CONFERENCE ON 1 DECEMBER 1992DRAFT OPENING STATEMENT BY SIR ADRIAN CADBURY

Sir Ron Dearing, Fin. Reg. C/Cl.  
 Sir Andrew Hogg Smith, Lon. Stk. Ex.  
 Jim Butler, Senr Partner, KPMG  
 Peter Marwick,

I am supported on the platform by representatives of our sponsors who set up our Committee in May of last year in the wake of concern at the low level of public confidence in financial reporting and auditing.

*In addition,*

I am delighted to have the whole Committee here to support the launch of the Report. We have a strong Committee whose recommendations will carry weight with those to whom our Report is addressed. This is an opportunity for me to thank them, and our hard-working secretary, for the way in which they have all contributed to the Final Report which is very much a team effort. We will all be available to talk to you individually after the conclusion of the formal proceedings.

The central recommendation of the Report - as in the earlier draft - is that the boards of all listed companies registered in the United Kingdom should comply with the Code of Best Practice set out in the report. The Code is to be underpinned by a London Stock Exchange disclosure requirement, whereby companies will be required to state in their annual report whether they are complying with the Code and to give reasons for any areas of non-compliance.

So that people are quite clear about the content of the Code, we have published it as a free-standing document, separate from the full report. It is addressed to companies, and copies are being sent today, along with the full report, to the chairmen of all listed companies. Our recommendations to the accounting profession, shareholders and Government are contained in the full report which also sets out the reasoning behind the Code.

The final version takes account of the considerable weight of informed comment on our draft from well over 200 bodies and individuals. Although there were detailed criticisms, the great majority of respondents have supported the Committee's broad approach and this has given us a clear mandate to proceed.

The case for the Code is that

Boards <sup>have to</sup> ~~must~~ be free to drive their companies forward, but <sup>they have to</sup> exercise that freedom within a framework of effective accountability. Our proposals - in line with our remit - are designed to support that framework. They are not radical or untested but ~~are~~ draw on the experience of successful and respected companies.

The planks on which the Code is based are the need for disclosure and for checks and balances. Disclosure ensures that all those with a legitimate interest in a company have the information which they need in order to exercise their rights and responsibilities towards it. In addition, openness by companies is the basis of public confidence in the corporate system. Checks and balances guard against undue concentrations of power and make certain that all the interests which boards have a duty to consider are properly taken into account.

The Code avoids prescription as far as possible. For example, it does not lay down precisely how the posts at the head of a company should be structured. What it sets out are the governance principles, and leaves companies to decide how to meet them in the light of their own particular circumstances.

The system will not, however, lack teeth. It has to carry conviction to achieve its aims and this is why the Code has to be underpinned by the disclosure requirement. It is not compliance which is subject to the listing rules, however, it is the statement of compliance. Compliance is a matter for shareholders. It can only be so, if the shareholders know precisely where their boards stand in relation to the Code. So the statement of compliance is crucial.

#### Changes to draft report

A number of detailed changes have been made to the Code and <sup>to</sup> the rest of the report, in response to points made by consultees, but they are changes of emphasis and clarification rather than radical revisions. The most frequent criticism has been that the Committee's proposals on non-executive directors, taken as a whole, will undermine the unitary

nature of the UK board system. This is not the Committee's intention. The report now spells out the Committee's support for unitary boards and the collective responsibility of all directors for the governance of the company (paragraphs 1.8 and 4.3). It clarifies the role of non-executive directors within the unitary board (paragraphs 4.4 to 4.6) and the relationship between the board and its audit committee (paragraph 4.36). In addition

- \* the recommendation that there should be a procedure for obtaining independent professional advice now extends to all directors, not just the non-executives (Code 1.5)
- \* the report makes clear that all board members should have the right to attend audit committee meetings (paragraph 4.35c)
- \* the proposal that the chairmen of the audit and remuneration committees should be responsible for answering questions at the AGM, <sup>as being</sup> ~~which was~~ inconsistent with the board's collective responsibility for these functions, <sup>has been dropped.</sup>

I must emphasise however that the main thrust of the report's proposals on non-executive directors <sup>remains exactly as it was in the draft</sup> ~~is undiluted~~. The report and Code now spell out clearly that boards will require a minimum of three non-executive directors (paragraph 4.11 and Code 4.3).

*But they should be ready at an AGM to answer for their duties work, if the Chmn. directs questions to be asked*

Other changes to the draft report in response to consultation comments that I would highlight are as follows:

- \* a clearer definition of 'independence' (paragraph 4.12 and Code 2.2)
- \* greater emphasis on the role of the company secretary (paragraphs 4.25 to 4.27 and Code 1.6)
- \* greater emphasis on the internal audit function as an integral part of a company's system of internal control (paragraph 4.39)
- \* a new recommendation that institutional investors should disclose their policies on the use of their voting rights (paragraph 6.12)

- \* identification of issues for the Committee's successor body to review in greater depth, including the rules for the disclosure of directors' remuneration, and the procedures for putting forward resolutions at general meetings (page 57).

#### Conclusion - role of shareholders

to sum up:

We are looking to shareholders to use their influence as owners to ensure that the companies in which they have invested comply with the Code. Compliance statements present shareholders with a ready-made agenda for their representations to boards. We are, in effect, relying on market forces to turn our recommendations into action.

We believe that it will benefit the market standing of companies to comply with the Code and so it will be to their own advantage to do so. Equally, shareholders will have a direct interest in ensuring that the companies in which they invest comply, for the same reason. We expect compliance, therefore, to be brought about primarily through a combination of the self-interest of boards and shareholder action.

Compliance is however a matter for everyone concerned with corporate governance. We look not only to the financial institutions but also to the wide range of other bodies backing our work to encourage the adoption of our recommendations. We specifically refer, in the Final Report, to the part which the media have to play in drawing attention to governance issues of public or shareholder concern. That is why we are so pleased to have this opportunity of meeting with you and of discussing any issues arising from our report which you may want to raise.

3.14.

## LAUNCH OF COMMITTEE'S DRAFT REPORT

### Key points to get across

1 **Set report in a positive context:** good corporate governance strengthens not weakens companies. Boards must have freedom to drive their companies forward but within a framework of effective accountability and safeguards. Report recognises need to strike balance between entrepreneurial drive and proper safeguards.

2 **Specific nature of Committee's remit:** Committee's remit was limited to financial reporting and accountability. Report looks principally at the reporting and control functions of boards, at the role of auditors, and at the role of shareholders. This in no way implies that other functions of boards (eg leadership) or other governance issues (eg two-tier boards, pension funds, the short termism debate) are unimportant. They were simply outside our remit.

3 **Why Committee was set up:** concern at low level of confidence in financial reporting and auditing. Some unexpected major company failures, and criticism over board accountability over such matters as directors' pay, were the visible signs of a governance system that was not serving companies or their stakeholders as well as it should have. Underlying reasons:

- \* competitive pressures on companies and auditors
- \* loose accounting standards
- \* inadequate financial control systems
- \* confusion over responsibilities
- \* failure of reports and accounts to give intelligible and balanced assessments of the position of companies.

3 **Core content of the report:**

\* At the heart of the recommendations is a **Code of Best Practice** addressed to the boards of all listed companies. It contains 19 concise points which will:

- \* clarify responsibilities
- \* encourage disclosure
- \* tighten standards
- \* strengthen control systems

\* encourage balance of interests on board and constructive challenge

\* Chapter on **auditing**. The report recognises the annual audit as an essential feature of corporate governance. It contains a series of recommendations - most addressed to the accountancy profession - designed to ensure that the audit is objective and effective.

\* Chapter on **shareholders**. The report underlines the importance of a constructive relationship between companies and their major shareholders and warmly welcomes a recent policy statement by the ISC. It also discusses ways in which general meetings could be made more effective in order to strengthen companies' links with their individual shareholders.

5 **Report is not prescriptive:** our approach is directed at establishing best practice and at allowing some flexibility in the way it is implemented. Responsibility for meeting the spirit of the recommendations is put on companies and the bodies to whom they are addressed.

6 **But Code has teeth:** backed by listing requirement on disclosure. Implementation of Code will be monitored. Its terms will be monitored and updated when necessary.

7 **Committee's strength:** wide basis of membership has enabled Committee to draw on good work which has been done in specific fields and to pull together a set of recommendations which would command broad support. Committee's representation includes members of those bodies best placed to take action on its recommendations.

8 **Essential to get broad support:** recommendations need to be taken as a whole and all groups - companies, shareholders, auditors - have a common interest in improved working of the corporate system. Concerted effort required. We look for broad support from all interested parties. Especially look to the institutional shareholders to use their influence to ensure that the companies in which they have invested comply with the Code. If broad support is not forthcoming, will be increasing pressure for legislation and external regulation which will be less effective.

Non-prescription.  
Meet spirit.

## CORPORATE GOVERNANCE

- 1) Issues. effectiveness / clarity. UK/US.  
Why not better run? To whom are cts able, to whom shld. be?
- 2) Break link between shldrs & dtrs. Strongest fam. co. heaviest fragmented shldrs.  
Rise of institutions, lengthening of chain. Hdg. shares as agents. Act on behalf of others, no certainty wthes. Followers (spectators)
- 3) Expec. in U.S. (also UK) takeover seen means of buying mgt. to act in interests of owners. a) those who can make best use of assets control then.  
b) finance by debt disciplines growth/developmt.
- 4) But limits. a) Major upheaval to change mgt. b) Record uninspiring  
c) Control by threat bought inevitable mgt. response.
- 5) Against genl. backgd. searching for more effective linkage between owners/mgt.  
Concern over well-pub. co. failures, no prior warning. Raised ?'s value of  
repl/acs, role of auditors, info. flow. from cts to shldrs, creditors, employees.  
- Dis. remuneration - shldr. frustration. (ability).
- 6) Committee setup rel. narrow focus. - resp. of dis for reviewing / replg.  
on perfor, nature of info. value of audit, links shldrs, dds, auditors.  
Conscious thought cts' engine of econ. & encouragement to entrepren. drive  
to improve internet. compet. posn. Same time those invested capital life in bus.  
req'd acceptable system safeguards. Reg'd balance risktaking & suff. checks to  
retain confide. in self-reg. system.
- 7) Principles behind Otter's proposals: - - No nec. conflict between efficiency & control.  
- need for appropriate checks.  
- need for disclosure: ability & confidence based on openness.  
- need for clarity of resp.: evidence confus in dis / auditors resp.
- 8) Otter took govt. system as is. ∴ gt. may. cts well managed, w/evidence  
wholesale restructuring req'd. Saw need for tightening up system, establishment  
of ~~standards~~ <sup>standards</sup> against which shldrs / empl. / others cd. judge stdg. partic. co. Proposals  
needed to be taken wth measures to firm up hcg. / audtg. stds.

non-exec. dir. whose seniority is recognized  
align. to shareholders, & other stakeholders?

a) Heart of recs. Code Best Practice. - all listed cos reg'd in UK.  
Code based on openness, integrity & accountability.  
Statement of Compliance.

Acceptance of need revise & review - Consult on draft rept. May 94  
new team go over ground again, Allow whd.? when problems? what new issues?

10) Every public co. headed by effective bd. balance inside knowl. o/s. experts.  
All dirs. = resp. for bd's demerits.

(A) Bd). Cmn's resp. to get best out of bd. team see interests served properly balanced.  
Rt. issues raised, all dirs. suff. briefed to discharge resp.

Given primary imp't. of Director Cmn. ~~is not~~ resp. for Wkg. of bd. shld. in  
principle not double up as cexec. (diff. role) as well.

∴ clearly accepted divsn. resps. no one person unfettered power.

(B) c/mn). If Cmn. is cexec essential conc. of power. balanced by strong indept.  
element; some cos <sup>have</sup> recognised need for formal appt. senior non-exec. to ensure  
effectiveness balance maintained.

(C) NEDs) Given remit control concentrated in monitoring role n. ed's. objective o/siders.  
Above essential role in leadership/strategy and fin. aspects (repty. & control)  
well-placed indept. judgement -

- calibre/no. views carry significant wt.
- majority indept.
- nomination resp. bd. as whole (no patronage).
- appointed for specified term, reappt. not automatic

(D) Structure  
& Controls.

- Effective control system
- Effective audit offices.
- Disclosure bd. remunern.

(E) Reports.

- Balanced & understandable assessment
- Fin. repty. shld. be true & fair.
- Highest level disclosure. Competitive positn allows.
- Advrtge. explain factors likely influence fin. program.
- Bal sheet info interim (+ cash flow?).



14) In all this going with gain of fact.

- Effective bd. in control terms likely to be so in bus. terms.  
Certainly bd. not effectively in control of bus. but likely well placed from commercially.
- In interests of shareholders collectively encourage higher stds.  
" " Co's encourage shareholders take long term view & understand what co. attempting to do.
- Regula may seem stupid, former alternative, forming regula raise stds & improve efficiency difficult.  
So much to do with quality e.g. needs, quality of citizenship.

15) Levers of power with shareholders; to which institutions see it as in interests of their clients to press co's respond to aims of Regt. will be main determinant of success.

Look at Regt. as whole + stringency of acq. stds.

- 11) Auditing - Essential part checks & balances.  
 - Ensure <sup>(a)</sup> objectivity & <sup>(b)</sup> effectiveness.  
 a) Tighten standards.  
 b) Encourage competi. on regu. int. price.  
 c) Clarify. resps.

(General)

(a)

Objective relationship. - resp. of auditors/mgrs.  
 - disclosure remuneration non-audit wk.  
 - periodic change audit partners.

(b)

Expand audit coverage to include :-  
 - internal control.  
 - going concern.

## 12) Shareholders

- ~~Impact of~~ Majority shares held by institutions, acting for others.  
 a) Hold shares on behalf of individuals. Common interest individ/institutional shareholders.  
 b) Individual fund can sell, cannot collectively; so incentive to improve.  
 c) Move to indexation, argument for free ride or for interest in saving gen? level.  
 d) Pension/insce. funds interest in long-term growth.

Possibility gr. alignment interests of shareholders & of cos. where share time horizon.  
 Combined interaction by ISE.

- encourage regular contact
- make positive use of voting rights
- make views known on checks & balances.

Make better use oppy. AGMs present to? bds. & for bds. to communicate  
 cor. posn. to shareholders.

## 13) How will this come about :-

- built in statement on compliance.
- new team in 2 yrs. time.
- Imple. of code as agenda for shareholders: gby strengthens shareholders hands  
 keep up great work.

# Principles

## Once.

- a) System is work, resp. must be clear.  
These resp. system must know what is expected from.  
System contain its own
- b) Checks & balances. Power of exec. balanced effective represent  
~~for~~ ~~interests~~ of all the parties direct interest in why & success.  
of co's. Job of ~~clm~~ remind execs. w/ their co.  
Balance not just monitor that mgt. confuse own interests with co's interest  
Also means set high std. for execs. encouraging them to aim high  
Informed
- c) Disclosure. ~~Effective~~ Effective of s. influence one of forces on which  
effectiveness system depends. Then shld's, empl. <sup>regulators</sup> creditors, comm.  
suppliers need to know <sup>what</sup> present state of bus. is & of what plans for  
future. shld's. entitled to know as much as with no endager  
competitive posn. & co's pt. of view gain supt. through openness  
& cert. lose trust how attempted concealment.

267.68

62.50

56.57

32.32

154.02

573.09

In sum — we do not believe implementi proposals impede well-run co., accept costs.

- Key aspect approach (missed by Press is follow up 2 yrs time. <sup>offset</sup> 2 barrels to proposals.
- Advocate of statutory approach, spell out detail of statute show effective.
- Issues will not go away as <sup>when</sup> econ. picks up.

### Principles behind approach.

- Clarify resps. make explicit what was implicit (going concern internal controls)   
 Also resp. for system of govt. know precisely what expected of them   
 (training, receive appropriate).
- System has to contain its own checks/balances.   
 Power of exec. balanced by effective represn other legitimate interests
- Accuracy. Effectiveness of govt. system depends on how in a form, to exert external influence having timely, relevant & accurate info.

Ed. Evershed - s/hdrs are not in eye of main pt. owned of undertaking  
The undertaking is stg. diff from the identity of the s/hdrs.

## U.K. CORPORATE GOVERNANCE

Comments on general issue. 3i. Why concern?

Effectiveness & ability. Why not better run (in genl)? Return achievable?  
Public/pol. agenda.

+ Collapses no warning value a/c. / audits.

Ability formal structure s/hdrs, / dirs / auditors.

Dir's appoint selves, AGM's. s/hdrs no link auditors.

(weakness) Major institutional investors can hold s/hdrs. to a/c. s/hdrs in genl l'd. power.  
Frustration - dir's pay.

.. How bd. members chosen 80% old boy, like with like, complacency lack of challenge.  
Process imp't. start with task, not 'name'.

a). How bring change about b). Expect too much needs. 3). Unitary bd.

Other's terms of refce.

Considering control / reporting functions s/hdrs & role of auditors

Resp. <sup>↑</sup> lies with s/hdrs. Keys. are cl/mn. balanced bd, independent views,  
effective fin. controls, bd structure (audit, rem, non) supts. role of needs.

Repty. principle true & fair. Wholly inappropriate. (present fairly in all mat. respects)

Audit weaknesses. alternative a/c treatments, compet. pressures on Co's &  
auditors. lack of understgy. native extent auditor's role.

CLARIFICATION - Resps. for internal control, going concern, fraud not  
(Caparo) well understood

s/hdrs. - make AGM's more effective, welcome ISC. statement.  
Build long-term relationships.