

cc Sir Adrian

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Azh'd.

N10/7

7 July 1992

Nigel Peace,
Secretary,
Committee on the Financial Aspects of Corporate Governance,
P O Box 433,
Moorgate Place,
London
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Dear Mr. Peace,

I have some observations on the Drafty Report issued 27 May which I hope are constructive and of use, and these are set out in the enclosure with this letter.

Yours sincerely,



T J Grove

COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

Draft Report issued 27 May 1992

Comments

The committee's Terms of Reference was a single matter - considering certain issues in relation to financial reporting and accountability and to make recommendations on good practice. The issues as listed were (in my words):

1. the review and reporting of performance (not the accountability for performance)
2. board audit committees (not shareholder audit committees)
3. auditors role and value of their work (not the total control systems needed to ensure the reliability of financial systems and the reports based on these and within that the role of auditors as part of the control process)
4. links between shareholders, board and auditors
5. other matters

The need for the committee and the report is explained by

a sufficient lack of good effective financial corporate governance - whatever this implies (1.2, 1.6 and 1.7) (what has everybody been doing?)

need to bring greater clarity to the **responsibilities** of directors, shareholders and auditors (1.5) (although I would have believed this to be clear, but perhaps clarity equals re - definition?)

strengthening the control of listed companies over their businesses and their public accountability (1.4) (whatever this is)

to provide a Code more effective than legislation (1.8) (rather presumptuous and unlikely ever to be sufficient)

Some of my comments are implied above. However, to look at the report again, I would add:

1. The whole flavour of the report leaves a strong impression that it has been written with the best interest of Boards of Directors (and not necessarily of investors) in mind ; and without adequate emphasis on how the Board can defend any future charge that its duty of accountability has been fulfilled. At one point (6.9) there is even reference to a two tier public shareholder relationship which gives rise to concerns not addressed adequately in the report.

2. There are a number of comments that are either woolly in the extreme and which are contradictory. The wording in places is such that a less than clear and precise meaning comes through.
3. The well publicised two class Board membership is hardly supportable and the links proposed with shareholders leave them with little power over a Board determined to retain its powers.
4. The report and incidentally the latest draft on the audit report, adds nothing to the debate on how better to communicate the results of an audit - except to say that a longer report might be useful.
5. Objectives are stated as principles - the overriding principle in respect of Board remuneration is openness - so diverting away from the point that should receive attention.

A synopsis of my views on two main Sections follows.

The Board

The selection of Directors is a shareholder duty being one of the responsibilities of ownership referred to in 3.4.

The recommendations in no way develops this basic point. By effectively creating the concept of internal watchdogs wearing the coats of directors, the recommendations leave it to the Chairman/Board to effectively approve the selection of Directors. They go on of all things to contemplate training (4.15 and 4.16) those selected on merit (4.13).

The selection of board members is surely not the job of the Chairman? (4.24) especially if he is to be advised by those he has approved for appointment.

The Chairman's role is so crucial in the concepts expounded as to call into question whether or not the report should have recommended the re - affirmation at each AGM of the appointee.

On structure and financial responsibilities the report gives the impression by the mere mention of "committees" (4.17) and "designated responsibility of a main board director" (4.18), that Finance is the last thing that the Board wants to be concerned about. This is reinforced by lack of any reference to the need for total board commitment and involvement in the financial implications of policy and strategy.

The concept that the statements suggested in 4.22 can do more than support a contention that the responsibilities have been fulfilled must be questioned. There is no need to have the two. If institutional shareholders do not know what an audit is, then how can they assume the roles they have? And if the purpose is to safeguard the interests of the individual minority shareholder it is surely an ineffective step?

Auditing

5.2 appears to show a problem when there is reference to the bench mark for auditing to be against "strict accounting standards" when in essence the work is based on acceptable auditing standards. It is not the accounting standards (again covered in 5.8) but the lack of a full and open approach to audit reporting that is the problem. The Committee have in no way addressed the very real problem an auditor will face if he strongly opposes a point in a major PLC's accounts and the lack of a secure channel for exposure and resolution of this free from Board pressure on his livelihood. Why not in 5.11 allow the shareholders a direct insight into the audit and related fee arrangements? And what need is there for a relationship with management built on "trust and experience" referred to in 5.12?

Also

- 5.3
- I cannot agree that an auditor is unable to stand firm against an inappropriate accounting treatment.
 - the Committee cannot see a practicable way of enabling a direct link with shareholders. Why not an Audit Committee of shareholders? In 5.26 there is an illustration of one argument for such committee.
 - Why should there be any acceptance of a drop in standards from price competition?
- 5.4 The Caparo judgement may need to be tested further; but surely the Institutional investors by their very nature are holding themselves out to the persons whose money they deal in as having the expertise to do so and this must include an understanding of how companies are managed and results presented and reported upon?
- 5.14 The expanded report as suggested will add nothing to the shareholders need for assurance on the job done; and 5.16 is a gateway to more "fogging up".

The report does not develop for example the potential to have positive statements made by directors that there has been compliance with the Companies Act (e.g. CA1985 Section 393, Part X, Section 221).

There is to my mind a clear conflict between Paras 4.34 and 4.36 of the Report. There is no sure way to be certain of the correct remuneration for Directors, but to limit those having the task to Directors surely cannot be the correct long term answer?

Summary

I do not believe that the conclusions of the report make any significant contribution to better corporate governance.

I also come to the conclusion that, for meaningful progress to be achieved, the links between shareholders and directors through the selection and appointment processes, shareholder supervision direct and via appointed auditors must be changed by legislation.

Terence J. Grove

London 7 July 1992