

in Adrian : copy for retention.

I will reply

from: Lord Chilver
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acknowledged

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Nigel
24/10

Thanks
Adrian

16 October 1991

CAD-02247

Mr Nigel Peace
Secretary to the
Cadbury Committee on
The Financial Aspects
of Corporate Governance
P O Box 433
Moorgate Place
LONDON EC2P 2BJ

Dear Mr Peace,

**THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE:
SUBMISSION FROM THE INNOVATION ADVISORY BOARD**

I am writing to you in my capacity as Chairman of the Innovation Advisory Board on the financial aspects of corporate governance, as requested in your letter of 22 August 1991.

The IAB is a group of independent people, advising DTI on matters of innovation policy. The IAB is not a formal part of DTI.

The IAB believes that innovation is at the heart of all successful internationally competitive companies, and therefore innovation policy should be a primary concern of the boards of all companies. However, the issue of corporate governance has ramifications that go far wider than the terms of reference of the Innovation Advisory Board, and therefore we have confined our comments largely to those aspects relating specifically to the process of innovative investment by UK industry.

The principal areas of interest for the IAB are indeed those issues mentioned in your letter, namely on communication between companies and their shareholders, and on reporting of intangible investments. Both these subjects were referred to in Chapter 3 of the IAB's Action Programme, "Promoting Innovation and Long Termism", which we published last October. A copy of this chapter is annexed to this letter.

On the specific issue of communication, however, you will no doubt be aware of our recently published Innovation Plans Handbook (copy enclosed) which gives guidance to companies and their investors about best practice in this communication process.

We would hope that the methodology set out in this handbook, which has been developed in conjunction with the financial and industrial communities, will come to be regarded as a benchmark for improved communication between companies and their shareholders. It draws attention to the importance of other aspects of company performance that are essentially non-financial in character, but that should be considered in assessing the true worth of a company.

As far as non-executive directors are concerned, we have suggested that NEDs have a real rôle in guiding company management, especially as far as longer term, innovative investment is concerned; we believe the financial community should give greater recognition to this than they appear to do at present.

To quote from the Innovation Plans Handbook:

"For all companies, and particularly those investing heavily in innovation, investors should also examine the structure of the board to make sure that checks and balances are in place.

Do the non-executive directors

- understand innovation?
- monitor the innovation effort?
- check whether the management is running into trouble?"

Turning to the issue of performance measurement, the Innovation Advisory Board feels that too much emphasis is placed on purely financial measures. The IAB welcomes the work being done by CIMA and others on performance measurement in the manufacturing sector using non-financial criteria, although it is too early to say whether this work will lead to a methodology which can be accepted widely by industry and the financial community.

On the financial side, the IAB welcomes the initiative of the Accounting Standards Board on accounting for intangible investments, and is likely to be involved in their investigation of how this might be achieved. While the IAB recognises that certain forms of intangible expenditure are more easily quantified than others, it is hoped that the ASB will press for the disclosure of other intangible investments (or "revenue investments" to coin the ASB term) following the precedent set by the revised SSAP13 for R&D. This would give recognition of the value of such investments in enhancing the future value of companies even though they may not appear on the balance sheet.

Indeed, the recently published R&D Scoreboard (reprint enclosed) has already attracted attention to the value of systematic reporting of such expenditure. The example set by the R&D Scoreboard could well be followed for other forms of intangible expenditure, such as education and training.

We hope that this letter and attachments give your committee an indication of how the IAB stands on corporate governance. We are ready to make more detailed input on specific points, for example, by helping to identify relevant non-financial measures of performance to augment existing financial reporting procedures.

Yours sincerely,



Lord Chilver
Chairman, Innovation Advisory Board

ACTIONS ON CORPORATE

MANAGEMENT/SHAREHOLDER RELATIONSHIPS

General Objectives

3.1 To identify adjustments in management/shareholder relationships that would give management more confidence to undertake investment in innovation, and encourage shareholders to become more involved in the long-term future of their companies.

Specific Actions

3.2 (a) in takeover proposals, encourage the placing of more emphasis on the bidder producing a detailed and convincing statement on the long-term commercial justification for the proposed takeover (already required under the Takeover Code), and on subsequent discussion of such justification by shareholders in target companies, and by shareholders in the bidding companies in the case of "larger" takeovers (Class I under Stock Exchange rules).

(b) advise on mechanisms enabling institutional shareholders to play more coherent roles in the oversight of company managers, with such shareholders in return providing more stability in their support to company management, for example through:—

- the appointment of non-executive directors to company Boards in sufficient strength to influence both management strategies and the make-up of management teams as necessary;
- arrangements between key institutional shareholders to secure the appointment of non-executive directors of their choice;
- such key shareholders then continuing to act as a group, thus providing the possibility of more consistent support to company management in backing innovation plans initially, and through any difficult periods, and in takeover situations.

Background

(a) Takeover practices

3.3 The Board has already expressed its concern (1) that the threat of contested takeover may be a significant deterrent to innovative investment. For many large companies the high increases in profitability in the late 1980s (around 10% a year in real terms) appear to have resulted in even more dramatic increases in dividend payments (16% a year), with R&D levels remaining relatively static. Studies and surveys show:

- UK dividend pay-out ratios two or even three times higher than in West Germany, with the contested takeover suggested as a factor (2);
- there is “quite substantial empirical evidence that the recent growth in dividend payments has been strongly associated with the boom in takeover bids” (3);
- companies reporting that they have cut back on their innovation plans in order to meet City expectations on profits and dividends (4).

3.4 The Board recognise that the contested takeover can still be an important discipline for company efficiency although they do note that contested takeovers are rare in the rest of Europe and are now strongly debated in the USA. The Board’s proposals are within the existing takeover policy framework; yet they are intended to make contested takeovers more “deliberate”. Their aim would be to encourage shareholders to give full consideration to the long-term view, and thereby giving management more assurance that the merits of long-term investment would be taken more fully into account in takeover situations.

(b) Use of Non-Executive Directors

3.5 The characteristic make-up of share-holdings in UK companies, widely dispersed amongst institutional and other shareholders, results in a very arms-length position of UK shareholders vis-a-vis company management. Such positioning is a considerable disadvantage as it means that:—

- UK shareholders generally do not (and probably cannot) play the involved and supportive roles including the backing of innovative investment, attributed to banking and industrial shareholders in Germany and Japan;
- such shareholders may instead be encouraged to use their holdings as trading counters rather than long-term holdings, with company management then being more cautious over innovation plans;
- such shareholders are also not playing particularly effective roles in monitoring the efficiency of company managements.

3.6 The Association of British Insurers (ABI) have made a considerable advance by setting out the merits of appointing non-executive directors, and the expectations of institutional shareholders concerning the characteristics and duties of such directors (5). The ABI will shortly be concluding its discussions with other organisations and its eventual proposals should then become accepted practice. The CBI are also considering corporate governance issues.

3.7 The IAB welcomes these steps, and also the suggestions for closer shareholders' involvement being discussed in such forums as the Institutional Shareholders Committee. The IAB proposals envisage a "quid pro quo" between key institutional shareholders and company management, with such shareholders acting as a group and exercising more managerial control through their selected non-executive directors, and with the company management in return having the possibility of more consistent support from its owners.

3.8 One possible problem could be finding sufficient numbers of suitable non-executive directors to fulfil such new roles. In the IAB's view it is important that the non-executive directors have the industrial and commercial capabilities to contribute positively in the oversight of company managers. In practice such appointments probably can only be made by using senior managers or directors in other industrial and commercial companies (and banks and other bodies as appropriate).

3.9 The use of non-executive directors could also make good any short-fall in management discipline arising from the procedures of contested takeovers becoming more deliberate. Indeed non-executive directors could act more promptly and flexibly to correct managerial under-performance.

3.10 Providing shareholders with such controls should be an acceptable price for management to pay if shareholders were thereby drawn into longer-term relationships with their companies. The principal task would appear to lie in getting the institutional shareholders to act together as a group, or as a small number of groups.

3.11 Further consideration of such specific changes in management/shareholder relationships should be given when the CBI and ABI have completed their consultations and have finalised their reports in November.

References

- (1) "Innovation: City Attitudes and Practices", IAB, June 1990.
- (2) "Banks and Securities Markets: Corporate Financing in Germany and the UK", Mayer and Alexander, CEPR, June 1990.
- (3) "Company Profitability and Finance", Bank of England Quarterly Bulletin, August 1990.
- (4) "Attitudes to R&D and the application of technology", PA Consulting Group, January 1990.
- (5) "The Role and Duties of Directors — A Discussion Paper", Association of British Insurers, June 1990.