



23 July 1992

Nigel Peace, Esq.,
Secretary,
Committee on the Financial Aspects of
Corporate Governance,
P.O. Box 433,
Moorgate Place,
London EC2P 2BJ.

Dear Nigel,

Draft Report

I enclose the IOD's formal response to the Draft Report issued by the Committee.

One supplementary point which might be worth making is that our comments are made on the basis that the Stock Exchange have agreed that a report on compliance or otherwise with the Code of Best Practice should be a continuation of continued listing.

No doubt, before the final version of the Report is issued, it will be confirmed with the Stock Exchange that they are agreeable to this.

Yours sincerely,

A handwritten signature in cursive script, appearing to read 'Blenyth Jenkins', written in black ink.

Blenyth Jenkins
Director of Corporate Affairs

**COMMITTEE ON THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE**

IOD RESPONSE TO Draft Report

1. IOD Position

The IOD is happy to have been able to contribute to the work of the Committee in producing the Draft Report.

The IOD's response to the terms of the Draft Report should be read within the context of the IOD's posture in relation to corporate governance as a whole, (as opposed to its financial aspects only).

This may be summarised as follows:

(a) The Importance of corporate governance

The IOD regards the subject of corporate governance, by which we mean the effective and ethical performance by a board of directors of its function in relation to the company, its shareholders and other persons or organisations having a legitimate interest in the business of the company, as being of fundamental importance. It is of importance to the economy as a whole, as the operation of a free market economy is dependent on the success of the companies operating within it, which in turn is dependent on the effective performance of their function by the boards of directors of those companies. It is of importance to the operation of the market, as persons investing in a company have legitimate expectations of the board of directors of that company. Finally, it is of importance to the community at large

in that stakeholders in a company other than shareholders are dependent on the effective performance of their function by the directors.

(b) Responsibility

The elements of corporate governance are setting a company's strategic direction, ensuring its implementation, supervising management and providing information regarding the affairs of the company to those entitled to receive it.

The IOD believes that these functions are exclusively a matter for directors. Whilst shareholders and auditors have their role in relation to the running of a company, questions of corporate governance are determined in the boardroom and nowhere else. This applies to the company's accounts, which are the responsibility of the board, and no other party.

Within this context, the IOD is totally committed to the principle of a unitary board, whereby all directors have equal responsibilities to all shareholders. It does not recognise particular categories of directors having particular responsibilities to particular categories of shareholders.

(c) External controls

Whilst the IOD is convinced that the majority of quoted plcs operate in accordance with an effective and ethical system of corporate governance, there have been some recent well publicised corporate failures, manifestly attributable to the absence of such a system, which have aroused legitimate public concern.

Whilst these examples are not typical, they have called in question the controls exercised over boards of directors so as to enforce standards of corporate governance.

Whilst, at law the shareholders, in aggregate, (in this connection, the IOD does not recognise privilege attaching to any particular category of shareholder), are owners

of the company and have the power of appointment and dismissal of both directors and auditors, as a practical matter this in no way enables them to exercise control of the governance of the company, on a day to day basis, in which they hold shares. Whilst bodies representing particular categories of shareholders may issue statements indicating their preferred board structure, and whilst, in isolated instances they may act in concert to enforce such a structure on a particular company, to envisage for example the investment manager of an index linked pension fund participating in the audit process of a company in which the fund holds shares is obviously unrealistic.

(d) Internal controls

In the absence of meaningful external controls, it is for boards of directors themselves to ensure the integrity of the board's operations by structuring themselves in such a way that there is in place a system of checks and balances such as to enable the board to perform one of its major functions, that of monitoring the company's executive, in a manifestly objective manner. Whilst the presence of such a system of checks and balances is an integral element of effective corporate governance, it should not way be allowed to erode the principle of a unitary board.

The creation of such a system of checks and balances requires the presence on the board of independent, (i.e. not employed by the company and having no significant financial interest in the company other than their fees as directors), non-executive directors with sufficient experience and authority to lend credibility to the proceedings of the board. The IOD's view is that the boards of directors of quoted plcs should have a sufficient number of such independent directors to provide a significant presence in board proceedings and to provide membership of the board committees referred to below.

The contribution to the establishment of an effective control system which independent directors may be expected to make, and disregarding for this purpose their positive contribution to the strategic direction of the company, and, in this connection the IOD regards the potential of such positive contribution as far

outweighing the monitoring role, lie in two areas. First in relation to the proceedings of the board as a whole, by providing an objective element in exercising the board's function of monitoring the executive. Second, as members, and in a majority, of committees of the board established in areas where executive directors have a perceived self-interest. These are audit, remuneration and nomination and, in this connection, the IOD does not subscribe to the view that such committees in any way derogate from the authority or responsibility of the board as a whole. The function of such committees is to assist the board in the performance of its responsibilities by ensuring that, prior to consideration by the board, the areas concerned are subjected to objective and detailed appraisal in a manner not practicable at meetings of the board as a whole.

In addition to the controls involved in board composition, a further necessary control is in relation to board leadership. The leader of the board (the chairman) and the leader of the executive (the chief executive) perform totally different functions, and the combination of both roles in a single individual gives rise to an obvious potential conflict of interest.

(e) Statutory or Regulatory Enforcement

Whilst the IOD is convinced that the presence of the controls just referred to is an essential factor in the integrity of the corporate governance of any company, it does not believe that the desired results can be achieved by the application of a mechanistic formula. It does not therefore believe that legislation or regulation to impose the necessary system of checks and balances would be effective, as the spirit of such legislation or regulation could too easily be circumvented. To be effective they are dependent on acceptance by directors of their value as being best practice in the direction of companies. To this end, the IOD has consistently, over the years, advised its members of the desirability of the principles referred to above.

Having said that, the IOD accepts that public disquiet aroused by failures of major companies will render some form of regulatory enforcement inevitable unless there is, in the relatively short term, evidence of a general acceptance of these principals.

(f) Other elements of corporate governance

Best practice, in this connection, is not limited to matters of board structure but includes recognition by directors of the necessity for openness, for directing their company in an ethical manner and of the key requirement for training in their role as directors. Directors must accept that their activities are the subject of legitimate public interest and should therefore seek to act as role models. Therefore in matters such as, for example, directors' remuneration they should ensure that this is set at levels capable of being justified to shareholders, employees and the media and that the fullest possible explanation is given of the basis on which such remuneration has been established.

Finally, and this cannot be too strongly stressed, the monitoring function is one element only of corporate governance, and to concentrate on the accountability element alone is to ignore the positive function of corporate governance in relation to setting the company's strategic direction.

2. Draft Report

Within the context of the principles enunciated above, the IOD's response to the Draft Report is as follows:

A. General

(i) Issues Arising

The Committee's terms of reference limit it to consideration of the financial aspects of corporate governance and were established against a background of what was perceived to be a loss of public confidence in the effectiveness of the audit process.

The Draft Report has therefore to be considered against two benchmarks.

Are the recommendations, if implemented, likely to be such as to restore confidence in the audit process?

Is the cost involved in implementation such as to inhibit the acceptability of the recommendations to those companies required to implement them?

A third issue, not directly raised by the Draft Report, but which the IOD believes to be of crucial importance in the corporate governance debate, is whether, confined as it has been within its terms of reference, the Committee's recommendations, by focusing on a particular aspect of the role of directors, has not succeeded in presenting a distorted view of what that role is in practice.

(ii) Effectiveness

The IOD believes that the core of the report, containing a Code of Best Practice, whilst relating only to the (necessarily) limited remit of the Committee, the requirement that the directors report on compliance and that such report should be a condition of continued listing, will, on implementation, enhance public confidence in the audit process.

The system of internal checks and balances inherent in the Code of Best Practice represent areas of corporate governance which the IOD has consistently advocated over the years and, if implemented, are likely to have ramifications, in relation to public confidence, well beyond the purely financial aspects of corporate governance.

The clearer definition embodied in the Code of Best Practice of the respective roles of the directors and of the auditors in relation to the auditing process is likely to go some way towards reducing the expectation gap.

The proposal contained in the Draft Report that the operation of the Code of Best Practice should be reviewed after a specific period, with a view to establishing what, if any, further measures are required is likely to increase the effectiveness of the Committee's recommendations.

(iii) Cost Implications

The effect of the aggregation of the recommendations contained in the Draft Report in relation an expanded audit function is likely, if implemented, substantially to increase audit costs to a level which in the case of smaller quoted plcs, is likely to be insupportable. This applies to the costs both of internal measures required to be taken under the terms of the Draft Report, and of substantially increased audit fees. The Committee should consider whether, in some at least of the matters concerned which are required, under the terms of the Draft Report to be endorsed by the auditors could, as a practical matter, be more appropriately validated by some form of internal endorsement, such as by the chairman of the audit committee.

(iv) Context

We do not believe that the general tenor of the Report expresses with sufficient clarity our fundamental belief that corporate governance is a matter for directors. This should be prominently featured in the report, as it is absolutely crucial to any discussion of corporate governance. Also, by focusing on the accountability aspect of the director's role it produces a distorted picture by ignoring the more positive aspects of corporate governance. We realise that this is to some extent dictated by the Committee's terms of reference, but believe that reference in the Draft Report to the existence of broader aspects of corporate governance would have gone some way to redress the balance.

The whole tenor of the Draft Report is of directors requiring assistance in how to run companies. This presumption should be reversed. The responsibility for running companies is that of boards of directors. The IOD has always supported the concept

of professionalism of directors, and through its Centre for Director Development actively engages in the promotion and operation of training courses for directors. The purpose of the report can only be to assist them by advising them as to appropriate standards regarding, for example, board structures.

We do not accept the Committee's ownership concept of the role of institutional shareholders. There is no doubt that shareholders have the right to appoint and remove directors, and they should recognise that they have responsibilities over and above completing proxy forms. We welcome their acceptance of such responsibilities.

However, it should be understood that control by shareholders over boards of directors can, at best, be imperfect and that the basic responsibility for corporate governance must reside in the boardroom, and in the effectiveness of boards of directors working under the chairman.

B. Recommendations

The IOD's comments on the recommendations contained in the Draft Report are as follows:

1. The Code of Best Practice

- (a) The IOD supports the concept of a code of best practice many of the provisions of which reflect the advice we have given to our members over a number of years.
- (b) The IOD also welcomes the concept of a statement of compliance and a reviewing process of its operation after a two year period. Whether its introduction in respect of years ending after the end of 1992 is perhaps premature is debatable.

- (c) The question of review by the auditors requires careful thought. Quite apart from the cost factor, the question of practicability arises. The auditors can, for example, scarcely be expected to report on all matters covered by the Code of best Practice. For example, the independent judgment of non-executive directors.
- (d) We agree that all parties concerned with corporate governance should encourage compliance with the code. As a practical matter, whilst the support of institutional shareholders is welcomed, in the nature of things they can only express general support, as opposed to ensuring compliance.

2. Audit Committees

This totally reflects IOD thinking. However, the IOD would be prepared to go further and has recommended, by calling for all listed companies immediately to establish audit committees.

3. Directors' Service Contracts

The IOD supports this recommendation.

4. Interim Reporting

Whilst we support the principle of more meaningful interim reporting, in particular the inclusion of balance sheet information, the form of the review by the auditors requires careful consideration if this is not, in fact, to increase the expectation gap. It seems to us that such review can at best provide negative assurance. If, on the other hand, positive assurance is required, this would amount virtually to a full audit process, thus doubling the annual audit costs.

5. Enhancing the perceived objectivity of the audit

The IOD supports these recommendations.

6. Enhancing the effectiveness of the audit

- (a) Whilst supporting the principle behind reporting on internal financial controls and reporting that the business is a going concern, the application of the principle, in relation to differing types of company, requires the most careful thought. The IOD will be happy to participate in detailed discussions on evolving guidance for companies and auditors in these areas.
- (b) The IOD would similarly support extension of statutory protection in relation to reporting suspicion of fraud, and is prepared to participate in consideration of protection in relation to illegal acts other than fraud.

7. Endorsement of work by others

The IOD supports the work of the bodies referred to in this section. In particular, we support the objectives of the Financial Reporting Council and the Accounting Standards Board. However, without in any way qualifying our support, we would urge these bodies to maintain the primacy of the "true and fair" view. There is an overriding requirement that accounts present a true and fair view and that boards have a duty to ensure that they do, explaining clearly why any accounting standards have not been observed in the circumstances of the particular case. Auditors have a corresponding duty to say whether, in their opinion, the accounts show a true and fair view - again, explaining clearly the reasons in cases where they feel they do not.

C. Code of Best Practice

The IOD's comments on the Code of Best Practice contained in the Draft Report are as follows:

1. The IOD supports the proposed code of practice, many of the components of which are embodied in its own Guidelines for Directors.
2. Points of reservation are as follows:
 - (a) In pursuance of the IOD's policy of openness, we would support the disclosure of the remuneration of all directors.
 - (b) We have expressed above our views on reporting that the business is a going concern. Whilst accepting the desirability of the concern, the practical implications of its implementation, and the cost factors involved, require the most careful consideration.
 - (c) Whilst accepting that there is merit in the chairmen of the audit and remuneration committees being available to answer questions at the Annual General Meeting, their role should be expressed as being "in support of the Chairman", who has, of course, overall responsibility for the conduct of the meeting.