

IN CONFIDENCE

RECORD OF MEETING WITH SIR RON DEARING, CHAIRMAN
OF THE FINANCIAL REPORTING COUNCIL,
ON 11TH JUNE, 1991

Present: Sir Ron Dearing
Sir Adrian Cadbury
Nigel Peace

The meeting was held to canvass Sir Ron's views on the ground which the Committee might cover.

Role of the non-executive directors

1. Sir Ron suggested that the role of non-executive directors in the following areas might be considered:
 - the appointment of auditors
 - the salary of board members, and long-term succession
 - (possibly) reporting to the board on the performance of the board and of the company.

2. Sir Ron commented that companies did not get value out of their non-executive directors. Too often they were just an authenticating authority. They were not powerful individually and could not match the knowledge of the executive directors. However, they did develop judgements and anxieties which they lacked the opportunity to articulate in a considered way. He therefore wondered whether they should make an annual report to the board - not as outsiders, but as board members deploying their particular experience and independent standpoint in the service of the board in the same way that executives deployed their own professional knowledge as for example finance or marketing directors. He also wondered whether non-executives should have access to the services of a management consultant so as not to be dependent for information on the officers of the company.

3. Sir Ron said that the selection of non-executive directors was handled unprofessionally by too many companies. It was very important to get the distinctive skills necessary to make the board fit for its particular purpose.

4. Sir Ron thought that boards needed at least 3 non-executives if the non-executives were to have sufficient mass when things were going badly. (Sir Adrian commented that he would not count a non-executive Chairman within the three). It might be desirable to establish a normal term for the length of appointments - perhaps 6 years with renewal after 3 years.

Auditors

5. Sir Ron said that auditors were in a fundamentally weak position. If they stood up to clients they risked revenge and dismissal - perhaps not immediately, but after a year or two. There was strong competition between the accountancy firms and loss of a major account was a serious matter. Clients would also go "opinion shopping". So within the accountancy firm the "business view" would tend to prevail over the "technical view".
6. Sir Ron continued that the whole system needed toughening up. Auditors needed to be both frightened and strengthened. One step was the setting up of the Financial Reporting Review Panel. If the Panel successfully challenged the accounts of a large company in Court, and the auditors had not qualified the accounts, they would be reported to the Disciplinary Committee. Another step should be the establishment in each company of an Audit Committee of non-executive directors. The Finance Director and Head of Internal Audit should attend if appropriate but the auditors should be able to meet the non-executive directors alone if they wished.
7. Sir Ron said that he was not inclined to the view that auditors should be appointed for a maximum term, to prevent too cosy a relationship developing. Valuable expertise was built up by the auditor and it was always possible to rotate the audit partner. If fixed terms were to be introduced however then the removal of the auditor before the expiry of the term would be a particularly serious matter. One (tentative) possibility might be for the Audit Committee before taking a decision to co-opt a couple of people from a panel maintained by the Stock Exchange for the purpose.
8. Sir Ron did not have a strong view about whether the same firm should act as both auditor and consultant, although he did feel that audit should

not be a loss leader. One possibility (again tentative) might be to require the audit and consultancy arms of accountancy firms to be separate legal entities.


Annual reports

9. Sir Ron said that he regarded the standard of annual reports as very poor. They were not written from the point of view of helping the shareholders to understand the business, and were more significant for what they omitted than for what they contained. He had been impressed by the Alliance & Leicester's attempt to produce an informative summary for the small shareholder. One possibility might be for such summaries to be subject to a negative audit report (i.e. "this summary is not unfair or unreasonable") - Mr. Roques of Touche Ross had not balked when he had mentioned the idea. However it was very important that full accounts should continue to be available to shareholders on request. Sir Ron added that the "Daily Mail" had been campaigning for accounts that were comprehensible to the small investor.

10. Sir Ron said that he would contribute a note on the need for explanatory prose to accompany the figures in annual reports. More generally, it was noted that the FRC would be producing a report in November on the quality of financial reporting and how it should be developed. This would express concern about Polly Peck and say what reports ought to contain. It would also endorse good practice. The FRC would also be taking a view in due course on whether the balance sheet should be added to half-yearly reports. Sir Ron said that he did not however favour quarterly reporting as in the US.

The Institutional Investors

11. Sir Ron said that it would be well worth seeing the big institutional investors in due course (e.g. Post Office and BT Pension Funds, the Prudential, and so forth). They did not trumpet their power but they were influential and did maintain contacts with Chief Executives.


NDP/PJS

13th June, 1991