

ARTHUR
ANDERSEN

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Check RSA 18th.

Dear Sir Adrian,

I am enclosing a copy of the summary of the views expressed at the recent Dinner.

Due to the quality and range of views exchanged at our dinner on 30 March 1992, we have decided to arrange another dinner on 18 May to discuss the matter further. The format of the evening will be similar to that of the last dinner with another cross section of the Midlands business community.

We would of course be delighted if you could attend but are fully aware of the demands on your time.

I look forward to hearing from you.

Kind regards.

Yours sincerely,



Chris Holden

Encl

Nigel

Add to circulation list.

Adrian

cch/ked/4629L

*CADBURY COMMITTEE ON CORPORATE
GOVERNANCE*

DINNER - 30 MARCH 1992

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Super audit

- Would it be appropriate for the law to incorporate the right of non-executive directors to insist upon the performance of a "super audit"? A "super audit" would not be a regular occurrence but could be required, by the non-executive directors, at certain watersheds in a company's history.
- A super audit would be considerably more expensive than a regular audit and could cost (say) three times as much.
- Would a "super audit" not lead to the auditors taking on the responsibilities of the directors? What would be the responsibility of the executive directors under these circumstances?
- Should all audits be "super audits"? Is it not appropriate to give more responsibility to the auditors?
- What exactly would a "super audit" give you? It may still not lead to the detection of fraud.
- The idea of moving away from one uniform standard of audit is very difficult. An audit has to be adequate in terms of both duty of care and in fulfilling a duty to the shareholders.
- One solution may be contracted out financial management, whereby the accounting function is out sourced. The provider of the service (say, the division of a major accounting firm) would take responsibility for the preparation of the management accounts and could take responsibility for the detection of fraud.

Financial statements prepared in this way could continue to be subjected to independent audit. However, over time (and subject to the necessary changes in the relevant legislation), the requirement of an independent audit for such financial statements could be removed. The financial management function contracted out to a suitable independent accounting firm would provide a continuous guarantee of the integrity of the financial statements, thus obviating the need for an audit.

Non-executive directors

- Non-executive directors are the key to good corporate governance. The problem is that most non-executive directors are no good. Too many non-executives are professionals (ie. accountants, solicitors, merchant bankers, etc.) and not enough are individuals with experience of running businesses.
- It is too easy to become a non-executive director and methods need to be found to make it more difficult.
- Non-executive directors should have experience of the business. The problem with too many non-executive directors is that a large amount of time has to be spent in bringing them up-to-date with the business.
- Non-executive directors should not be seen as a panacea for all problems. All the directors are responsible for the company. Are we not asking non-executive directors to take on too much responsibility?

- There is an advantage in having non-executive directors without relevant industry experience. These individuals can add to and complement the knowledge of the executive directors.
- A lot of the issues relating to corporate governance would be dealt with by good non-executive directors working within a strong structure which would allow them to discharge their responsibilities. Such a structure should include clearly defining the responsibility of the audit committee and the remuneration committee. The chief executive officer should not be chairman of either committee.

It is also important to have a critical mass of non-executive directors. A good rule of thumb may be two executive directors to each non-executive. However, a critical mass of at least three non-executives is essential if they are to adequately discharge their responsibilities with respect to the audit committee and the remuneration committee.

- There is currently a great emphasis on the role of non-executive directors when things go wrong. Is it likely this emphasis will continue when the current recession ends?
- It is believed that this issue will not go away when good times return.

Too often in the past, non-executive directors have been drawn from the old boy network. Merchant banks have often used the role as a method by which past debts can be repaid.

Should there be a process through which non-executive directors are selected which would give chairmen choice when selecting their non-executives?

It is important to provide a structure to allow non-executive directors to fulfil their responsibilities.

- Would it not be appropriate to change the term "non-executive director" to either "independent director" or, as in the US, "outside director"?
- Should industry encourage non-executives to have regular contact with their companies and to become involved in decisions relating to board structure, business strategy and business performance?
- The attitude of the chairman to non-executives is central to the role these individuals can fulfil. If the chairman does not facilitate the role of the non-executive, the latter becomes powerless.
- Attempting to police a board of executive directors is worthless. If people do not want to be policed, they will not be. The real problem is not the quality of non-executive directors (which is poor) but the quality of executive directors.

Executive directors must be qualified. It is unreasonable that an executive director in one industry can then either launch a takeover or be appointed as an executive director in another industry without any relevant experience.

It is important to police what we have got rather than to change the current position.

Institutions

- Where does the responsibility for the inadequacy of the audit process lie? Is it with the shareholders/institutions who do not want to get involved as they are too afraid of being seen as quasi-directors?
- Institutional shareholders should be encouraged to become more involved with the business. However, in fairness to institutional shareholders, British companies are not good at keeping the City informed.

The quality of City analysts is not good.

- A number of institutional shareholders, when asked to meet with management subsequent to the announcement of the company's final results, declined.
- Many of the institutions see themselves as investors, not as owners. Rather than getting involved to resolve issues, they simply sell their shares.

Do institutions complain that they are not adequately informed?

- No. The institutions have historically wanted to stand back. However, they are now keen to become more involved. There is a growing pressure on institutional investors not to be entirely passive.
- The Germans are horrified at the willingness of British companies to pay dividends out of reserves. Recently, one or two institutional investors have applied pressure with the objective of maintaining the dividend despite poor current year results.
- The United States is much quicker to cut the dividend and the remuneration of directors should the financial performance of the business deteriorate.
- Would greater institutional involvement in the management of businesses be beneficial, given the investment community's preoccupation with short term results?
- Institutional shareholders do not appear interested in training.
- The institutions are not concerned about corporate governance, only about profitability.

The analysts are not good enough.

Is the management of a business not the responsibility of the professional executive directors?

- The only way to change the attitude of the institutions is to give them more responsibility.

The institutions do not want to become involved in management, but they do wish to exercise influence over the compositions of boards and the number of non-executive directors.

- The institutions need to exert pressure to force companies to appoint strong non-executives who will ensure compliance with the regulations and recommendations.

Rotation of auditors and non-executives

- Would it be sensible to require the rotation of audit firms every 4/5 years. It may also be appropriate for non-executive directors to have a specific period of office.
- If auditors and non-executive directors are to change on a regular basis, there is a danger they will be removed just when they are beginning to understand the business.
- There is an argument that auditors actually understand the business faster than the directors give them credit for and, consequently, rotation would not significantly impact their understanding of the business.

Acquisition accounting

- Accounting standards should be strengthened to enable the reader of financial statements to understand the impact of acquisition accounting.
- Currently, it is too easy to justify acquisitions by manipulating financial results. It should be made more difficult to justify acquisitions in this way.
- It should not be possible to justify takeovers by accounting techniques.

Audit committees

- One proposal is for the whole board to form the audit committee. Once the auditors leave the room, there is a forum for the non-executive directors to question the executive directors.
- The most effective audit committees are those which exclude executive directors.

Looking at high profile companies which have suffered dramatic collapses, it is often true they were dominated by an autocratic individual. Independent checks are required to prevent one individual from having excessive influence over a company.

Responsibility of directors and auditors

- Currently, the responsibility of the auditors is limited. Therefore, should something be done to redress the balance of responsibility between the directors and the auditors?
- The current position, with respect to the responsibility of directors and auditors, should be clarified. Directors should be required to state their responsibilities in the directors' report, followed by a statement from the auditors setting out their responsibilities.

Factions on boards

- There is a danger that boards can become corrupted by individuals who represent certain factions. These individuals are not members of the team and do not have the interests of the business at heart. Their primary objective is purely to represent their faction.
- It may be appropriate to remind such individuals that, in accordance with the Companies Act 1985, directors have a responsibility to the company as a whole and not to any individual or group.

The management letter

- Auditors make recommendations in the management letter regarding internal controls and business issues. However, these recommendations are only circulated within the company. It may be appropriate for management letter comments to be publicised.
- Would it be appropriate for the management letter to be in a statutory form?

Other matters raised

- The problem with all of these proposals is that they would not stop the determined fraudster.
- With respect to directors' pay, we are the only country in Europe that requires publication of this information. Surely, if we were to stop publicising the information, the criticisms levelled at directors in this area would stop.
- Is there a danger that we will become over regulated and that decent management will be penalised.
- All companies should be required to have an internal audit department which should be responsible to the non-executives.

Points communicated subsequent to the dinner

- Accounts should be more user friendly in order that the shareholders fully understand the behavioural pattern of the business.

In addressing the above, perhaps statements should be made and certified by an audit committee regarding the adequacy of the internal systems and controls for the day to day running of the business.

- It would be useful to test the benefits, coupled with the burdens, of a statement being made in the accounts with regard to the adequacy of the working capital requirements of the business (and the availability of such capital) for the coming twelve months.

Reference should be made to the burdens that could fall upon a company arising out of off-balance sheet items.