CAD-02349

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From
Howard Davies
Director-General

CBI

HD/GCM

31 July 1992

Sir Adrian Cadbury
Committee on Corporate Governance
P O Box 433
Moorgate Place
London
EC2P 2BJ

Dear Sir Adrian

The CBI Council approved the enclosed commentary and summary at its meeting on 29 July, so I convey them to you as our formal response to your Committee's draft report. As you know, we have spoken to the press about our reply (though not to the Telegraph separately, as their report on 27 July might imply); and I believe that you had notice that this would be our intention, in case your comment was invited on what we had to say.

Your Committee's draft report has aroused great interest; and, apart from our national Committees, groups based on most of our Regions up and down have given their opinion on it. The recommendations were fully debated and what we say in comment on them is based on a solid consensus; that emerged very clearly at our Council meeting earlier this week.

I suspect that one of the key achievements of your Committee will not be mentioned by the press: that the draft report has caused many companies to look at their structure and practices to see how they compare with the Code. In a good number of cases, beneficial change is already in hand.

We are grateful to you for agreeing to go to some trouble to launch our discussion at Harrogate by which time your final report will have appeared or be near to delivery. We look forward to that.

Yours sincerely

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CA 458 92

DRAFT REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

SUMMARY OF THE CBI RESPONSE

1. The CBI welcomes the Cadbury Committee's draft Report as an important contribution to the debate on corporate governance. A great deal of constructive discussion has been stimulated by the Committee's proposals both amongst CBI members and elsewhere in the business and professional community. We give below the main points of the CBI response (elaborated in the attached commentary) which we offer at this stage of the Committee's enquiry.

2. CBI members accept the need for continuing efforts to improve standards of corporate governance, so that the generality of businesses match the level practised by the best companies. However the means chosen to achieve this end should recognise that not all of the practices advocated will be relevant to the smaller company.

3. Cadbury is right to reject further major intrusion of the law into corporate governance which would introduce rigidity and invite a focus on the letter rather than the spirit of standards. The concept of a Code of Best Practice, by contrast, offers flexibility; and the CBI finds many positive features in the one put forward by the Committee. A good deal of what it says represents what member companies consider to be best practice.

4. We also support the recommendation from the Committee that boards provide a statement of their compliance with the Code in their annual report. We do not, however, support the proposal that the statement of compliance should be a listing obligation as a means of sharpening accountability to shareholders. Where investors wish to intervene with a board, they can invoke the Code and the company's compliance with it according to the particular circumstances. A listing obligation is not necessary for this purpose. Indeed such a requirement could lead to over-elaboration of the Code and proliferating bureaucracy.

5. Moreover, we have serious misgivings about extending the auditor's functions to review of compliance with the Code: on some issues this would take the profession outside its sphere of competence.

6. We support the view of the Committee that non-executive directors have an important role to play in companies. Perhaps because of its terms of reference, the Committee has focused narrowly on their monitoring role. We think this is unfortunate, because it understates the contribution which the non-executives can make to the growth of a business: their different experience brings a fresh eye to problems and the development of strategy. Moreover, the concept of the unitary board is based on all directors being equally responsible for its actions (with equality of access to information); its effectiveness depends on members of the board as a whole working together. In that setting it is for the board to distribute functions to its members; attempts to reserve tasks as a rule to one class of directors will create the danger of opening the way to a two-tier system. For this reason, whilst we would support a recommendation to establish audit committees, we do not believe it should be a requirement for membership to be restricted to non-executive directors.

7. In general, whilst many companies, especially larger ones, will find it useful to establish board committees, the decision to do so should be a matter for individual boards in line with the nature and size of the business.

8. We accept the Committee's view that there must not be an undue concentration of power in one individual on a board, and that where the roles of chairman and chief executive are not separate (especially where the chief operating officer is also the chief executive), there must be appropriate checks and balances through independent directors. Whilst it is helpful that there should be a rallying-point, if there is concern at the working of the board, we find little support for the notion of an appointed leader among the non-executives.

9. We endorse the Committee's recommendations on service contracts and on disclosure of the basis of board remuneration including the performance related element.

10. In principle, we support the Committee's proposals for strengthening the scope and quality of audit work in relation to financial reporting, including comment on internal financial controls and the 'going concern' basis of accounts. We shall offer views on the profession's ideas for giving effect to them.

11. It is clearly proper that users of accounts should have confidence in the objectivity of the auditor, but in deciding whether measures are needed to reinforce it, we ask the Committee to consider that the effectiveness of an audit is enhanced by a close knowledge of the business and stability amongst the audit team. We do

not, therefore, believe that the rotation of the audit partner should be an absolute requirement. Equally, companies find that a close professional knowledge of their affairs is a benefit when seeking other advice from the firm conducting the audit. We would not want to see any restriction on the sources to which companies may turn for advice and believe that a requirement for a firm to declare non-audit fees is sufficient disclosure for users of accounts.

12. The CBI urges the Committee to give more attention to the role of shareholders in its final Report. We believe it should offer guidance on ways of sharpening their responsibilities as owners of the business, for example, through the use of voting rights.

13. The work of the Cadbury Committee has lent fresh impetus within CBI member companies to the process of assessing procedures and making changes in corporate governance. It is important that this should continue and, as the Committee has identified, its Code should be updated to embody new developments and best practice. For this reason the 'ownership' of the Code should be clearly established; and we invite the Committee to make firm arrangements for the review body in its final recommendations.

* * *

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DRAFT REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

CBI RESPONSE

(References to Draft Report and Code paragraphs:)

CODE OF BEST PRACTICE

1. The Code of Best Practice forms the heart of the Committee's recommendations; and we support this approach. However, if the Code is to be a success, we believe it must satisfy the criteria set out in the following three paragraphs.

2. The provisions of the Code must be capable of broad support and compliance by all listed companies and companies generally. The Code should be a statement of the principles of good corporate governance which, as identified by the Committee, should be based upon openness, integrity and accountability, but these principles must be sufficiently flexible to allow for differences in companies' needs and the ways in which boards seek to accommodate them. A manufacturing company will not have the same board and management structure as a financial services business; and a smaller company will not need to follow all the practices of a larger one.

3. The draft Code is inconsistent with the UK structure of a unitary board, whereby all directors, both executive and non-executive, are jointly and collectively responsible for the management and stewardship of a company. We believe that it is wrong for certain functions of the board to be reserved for non-executive directors and that they should be cast primarily in a monitoring or policing role. A formal separation of tasks of this kind opens the way for a continental two-tier structure and undermines the UK concept of boards themselves settling the distribution of functions amongst their members.

4. The Code should offer guidance rather than rigid prescription on how boards manage their affairs. It would surely run counter to the purposes of the Committee if a successful, financially sound and well run business suffered prejudice to its market reputation because it complied with some but not all of the Code's provisions.

5. As presently drafted, it is also not clear, when the Code cross-refers to a paragraph in the draft Report, whether that paragraph is intended to be incorporated in the draft Code. The point is important because the paragraphs in the draft Report often deal with additional recommendations and generally discuss a range of matters which go much wider than the provisions of the Code itself. Whilst a company may support a particular provision of the Code, it may not necessarily accept or feel itself committed to all that is said in the draft Report to which cross-reference is made. If the recommendations and the supporting argument are there to help define the spirit rather than the letter of the Code, that should be made clear.

6. We prefer that the Code should contain no cross-references to the Report or the recommendations. The Code should be able to stand on its own.

Statement of Compliance

7. We support the Committee's proposal that boards should publish a statement of the extent of their company's compliance with the Code in their annual report and accounts.

8. However we do not agree that the making of such a statement should be a Stock Exchange listing obligation, with the sanctions of public warning from the authorities and adverse press comment, should a company fail to make a statement or only offer a wholly inadequate one. For persistent failure to make a statement of compliance, there will presumably be the ultimate sanction of delisting. Delisting is a draconian remedy, especially as shareholders will then be unable to dispose of their shares and the sanction will obviously not bear upon unquoted companies.

(Paras 3.7-3.11)

9. Moreover, if a statement of compliance becomes a Stock Exchange listing obligation, we believe the effect will be to make the Code less capable of flexible change and interpretation. The Code will assume the status of a quasi-legal document; and boards and their professional advisers will seek guidance on the precise form and nature of the statement they are expected to make. Detailed questions about the interpretation of the Code and whether it stands on its own or is to be read with the rest of the Report are bound to arise. We therefore consider that a Stock Exchange listing obligation is not appropriate.

10. We support rather the approach followed by the Institutional Shareholders' Committee in its Statements of Best Practice on the Role and Responsibilities of Directors and on the Responsibilities of Institutional Shareholders. These have been put forward as models of good practice which companies and shareholders should seek to follow, rather than provisions which the addressees are bound to observe. The sanction against the company is adverse public comment and shareholder disapproval. We consider that this is the way in which the Cadbury Code should be taken forward.

11. If the Code takes the form of a statement of the principles of good corporate governance, the compliance statement will be easier to prepare and to understand. We believe that it would be helpful if the Committee in its final Report provided the text of a sample compliance statement by way of illustration and guidance.

12. We do not consider it to be appropriate for the compliance statement to be reviewed by the auditors. The Code is primarily concerned with management and
(Para 3.10) stewardship issues and board structures which auditors have no special competence to assess. Auditors may be qualified to comment on financial questions and matters of fact - e.g. on the existence of non-executive directors and board committees - but there are matters of judgement, as, for example, on the independence of non-executive directors which the auditor is not able to assess. Whilst the auditor would no doubt comment if he felt the compliance statement was patently false or misleading, he cannot be expected to comment with authority on the calibre, qualification and experience of the non-executives. Auditors do not regularly attend board or committee meetings and cannot assess how the board conducts itself.

13. Accordingly, on compliance with the Code, we believe the Committee should restrict itself to a recommendation that boards make a statement in the company's annual report. It will then be for the shareholders and potential investors to decide whether the extent of a company's compliance should be raised with the board and whether to buy, keep or sell the shares.

Start of Compliance

14. More time should be given to boards before they are asked to publish a statement of compliance in their annual report and accounts. The current proposal affects companies with year ends on or after 31 December 1992. However, by then the Committee's final Report will at best only recently have been published. This will give companies right near the end of their accounting period little or no time to consider the document and give effect to its recommendations, particularly if they should materially differ from those in the current draft Report.

15. A later date of, say, 31 December 1993, may be more appropriate. The Committee can still recommend that companies comply with the Code as soon as possible and encourage disclosure of their level of compliance in the meantime.

Review of the Code

16. We support the regular review of the Code in the light of EC or other developments affecting companies. We believe that "ownership" of the Code needs to be clearly established and urge the Cadbury Committee to propose firm arrangements for a review body in its final Report.

(Paras 3.12-3.13)

DETAILED CRITIQUE OF THE CODE OF BEST PRACTICE

THE BOARD

Board Structures and Procedures

(Code 1.1) **The board must meet regularly, retain full and effective control over the company and monitor the executive management.**

17. We agree that boards should meet regularly with due notice of the issues to be discussed and should record their conclusions. It is also vital that minutes are circulated promptly, particularly to those directors unable to be present at the meeting. We oppose the words "monitor the executive management" as imparting a supervisory role inappropriate to a unitary board.

(Code 1.4) **Boards should have a formal schedule of matters reserved to them for decision to ensure that the direction and control of the company is firmly in their hands. (Paragraphs 4.19, 4.20)**

(Paras 4.19 & 20)

18. We would formulate this recommendation in another way. The board is responsible for the direction and control of the company and it is a matter for its members what powers, responsibilities and duties they delegate, not what they retain. Such delegation should be subject to appropriate systems of internal control as with all other aspects of the management of the company. Any list of issues reserved to the board should be only illustrative; and all would have to use their common sense in interpreting it. As noted, a better approach, more consistent with the unitary board, would be to have a list of issues/ decisions expressly delegated.

Combined Roles of Chairman and Chief Executive

(Code 1.2) **There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong independent element on the board, with an appointed leader. (Paragraph 4.6)**

(Para 4.6)

19. We agree that the combination of the roles of chairman and chief executive (especially where he is also the chief operating officer) may represent a strong concentration of power, although the Committee is right to recognise in the proposed Code that company boards may, where appropriate, wish to combine the roles. Companies are now tending to reorganise their structures on this basis as existing incumbents filling dual roles retire. An appropriate part of the checks and balances in companies which combine the two offices would be to have a suitable number of strong independent non-executive directors. On such boards a non-executive director is often appointed deputy chairman. We have no great liking for the term "leader" but support the concept that there should be a rallying point for directors with concerns about the operation of the board, if the chairman has an executive role.

NON-EXECUTIVE DIRECTORS

(Code 1.3) **The calibre and number of non-executive directors should be such that their views carry significant weight in the board's decisions. (Paragraph 4.6)**

(Code 2.1) **Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct. (Paragraph 4.8)**

(Code 2.2) **The majority should be independent and free of any business or financial connection with the company apart from their fees and shareholding. Their fees should reflect the time which they commit to the company. (Paragraphs 4.9, 4.10)**

Comments on Code 1.3, 2.1 and 2.2

We fully support these statements.

20. We agree that non-executive directors are an important part of the board team. Whilst it is the Committee's clear purpose to sustain the concept of the UK unitary board, we believe that the general effect of the draft Report's recommendations and the Code may be to undermine it. We believe that the proper approach is to emphasise that the distribution of responsibilities is a matter for each board. For some board committees it may be appropriate to have a majority of non-executive directors, but specific functions should not be reserved to them *ab initio*.

(Paras 4.7 & 4.8)

21. Whilst PRONED and others say that they have a good supply of people of calibre on their books, senior businessmen are sceptical whether there are enough directors of quality available with the time to spare for the commitment to a non-executive role in another company. We ask the Committee to look again at the question of supply, as its draft Report advocates measures which would add to the demands on the outside director.

22. No one would question the principle that independence of mind needs to be underpinned by independence of means in the remuneration of non-executive directors. It is, however, the view of some CBI member companies (though not all) that the issuing of share options to them as an incentive is compatible with their positive role in developing the longer term strategy of the business. Whatever view boards and shareholders may take of the issue, full disclosure in the annual report and accounts must be a requirement.

(Para 4.10)

(Code 2.4) **There should be an agreed procedure for non-executive directors to take independent professional advice if necessary, at the company's expense. (Paragraph 4.12)**

23. We agree with the proposal that non-executive directors should be entitled to take separate independent advice, if appropriate, at the company's expense and under agreed procedures, and believe this should be extended to every director on the board. The Committee should also give guidance as to what
(Para 4.12) the appropriate procedures should be: costs might be substantial; and where several directors wished to take up such a facility, there would be a need to avoid duplication.

(Code 2.3) **They should be appointed for specified terms and reappointment should not be automatic. (Paragraph 4.14)**

(Code 2.5) **Non-executive directors should be selected through a formal process and their nomination should be a matter for the board as a whole. (Paragraph 4.13)**

24. We support the provision on terms and suggest that all directors, executive and non-executive, should be subject to retirement and re-election by rotation at intervals of not longer than 3 years.
(Para 4.14) We agree with the suggestion in paragraph 4.14 that the letter of appointment for non-executive directors should set out their duties, term of office, remuneration and its review.

25. The nomination of all directors, not just non-executives, should be a matter for the board as a whole and subject to a formal selection process.
(Para 4.13) The Committee appears to leave the use of nomination committees to the discretion of individual boards by
(Para 4.24) not referring to them specifically in the Code. However, in paras 4.13 and 4.24, it speaks of them in terms of approval and prescribes how they might be composed. Uncertainties of this kind become important if the Committee remains of the view that a statement of compliance should be a listing obligation.

EXECUTIVE DIRECTORS

Board Remuneration

(Code 3.1) **Directors' service contracts should not exceed three years without shareholders' approval. (Paragraph 4.33)**

26. We agree with this provision.

(Para 4.14) As noted, we suggest that all directors including executive directors should be subject to retirement and re-election by rotation at intervals of not longer than 3 years.

(Code 3.2) **Directors' total emoluments and those of the chairman and highest paid UK director should be fully disclosed and split into their salary and performance-related elements. The basis on which performance is measured should be explained. (Paragraph 4.32)**

27. The CBI has for some time taken the view that the principles upon which directors' remuneration is determined should be set out in the annual report and
(Para 4.32) accounts. We therefore support the measure of disclosure advocated by the Committee.

Remuneration Committees

(Code 3.3) **Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors. (Paragraph 4.34)**

28. Paragraph 4.34 specifies that a remuneration committee should be established, sets out how it
(Para 4.34) should be composed, lays down that its detail should be disclosed in the annual report, and proposes that its chairman should take questions at the AGM (we take the last point later in the CBI response).

29. Many CBI member companies see the merit in having remuneration committees in order to have formal procedures and independent assessment of the determination of rewards for executive directors.
(Para 4.34) They would accept a recommendation of this kind as a statement of current good practice and judge it right that the CEO should be a member of that committee, since he will have a close knowledge of the performance of executive directors and senior managers.

30. However, we believe that the establishment of such committees should be a matter of choice for boards rather than prescription: smaller companies (and some larger ones) manage their affairs without them, and in a manner which satisfies their shareholders.

CONTROLS AND REPORTING

Audit Committees

Internal Controls

(Code 4.1) **Boards must establish effective audit committees. (Paragraph 4.29)**

31. We would support a recommendation to establish audit committees, but not a mandatory requirement; it must remain a matter of judgement for each company.

(Paras 4.27-31)

32. Whilst many companies see the value of audit committees, as Cadbury reports, there are others who strongly hold the view that there should not be any intermediary between the auditors and the whole board, which has responsibility for preparing the accounts. We believe, therefore, the establishment of an audit committee should be a matter for decision by individual boards rather than absolute prescription, so we cannot support the language of the Code.

33. However, membership of the audit committee should not be restricted to the non-executive directors. Boards will often consider it appropriate that one or more executive directors, in particular, the finance director and perhaps the chief executive, should be members of the audit committee. We do not agree that the latter should only attend by invitation.

34. We agree with Cadbury that both the external auditor and the head of internal audit should be invited to attend meetings of the committee. Both should in any event be entitled to make representations to the committee and have access to the committee chairman.

(Code 4.7) **The chairmen of the audit and remuneration committees should be responsible for answering questions at the Annual General Meeting. (Paragraphs 4.29, 4.34)**

35. The board as a whole is responsible for the stewardship of the company. This position is formally recognised by the chairman normally being the spokesman for all of its members at the AGM. To have certain classes of questions directed as a matter of course to particular members of the board undermines the sense of collective responsibility, in our view. The chairman should be the focal point of questions; and other directors should respond at his invitation.

(Para 4.29)

(Code 4.2) **Directors should report on the effectiveness of their system of internal financial control. (Paragraph 4.26)**

36. In principle, we support this provision of the Code which is a reinforcement of an existing legal
(Para 4.25) requirement. As the Committee notes, there are issues of definition and procedure to be resolved before the provision could be put into effect. It should not stand as part of the Code, until there is agreement on detailed guidance for directors and auditors.

Reporting Practice

(Code 4.4) **It is the board's duty to present a balanced and understandable assessment of their company's position. (Paragraph 4.41)**

37. We consider the Code should be specific in its provisions; Code 4.4 is too general a statement to be helpful and needs to be expanded, particularly if it
(Para 4.41) is to be interpreted by reference to para 4.41 in the
(Paras Report which is incorporated by reference in the
4.45-49) Code.

The recommendations in 4.41 that:

- the report and accounts should contain a coherent narrative, supported by figures, of the company's performance and prospects, on the basis that "words are as important as figures";

- setbacks as well as successes should be dealt with

are all statements that make the Code provision more intelligible. To avoid incorporation by reference these could usefully appear in the Code itself. Indeed, the suggestion in paragraph 4.42 - inclusion of a forward-looking Operating and Financial Review **(OFR)** - and the suggestions and recommendations in paragraphs 4.45-50, (interim reports, balance sheet and cash flow information, an expanded chairman's statement and simplified reports) should form part of any Code, if it is intended that they are to be part of the suggested interpretation of 4.4. We do not now comment separately on all these suggestions but reiterate that the Code must stand alone for companies to know what it is that compliance entails.

38. As to the **OFR** suggestion, we support the adoption in the UK of a practice on the broad lines of the US Securities and Exchange Commission requirements for Management Discussion and Analysis and have
(Para 4.42) considered the recent **OFR** proposals from the Accounting Standards Board. We support the voluntary approach proposed by the Accounting Standards Board rather than the rigidly structured and regulated approach of the SEC requirements.

39. We consider that **quarterly reporting** for all listed companies should not be mandatory. Such reporting tends to focus attention excessively on short-term results and involves additional costs for companies.

(Para 4.47) It also has the effect of extending the "close season" when directors and other insiders cannot deal in a company's shares. Quarterly reporting should be a matter for individual boards.

40. The proposal that **balance sheet information** be included in the half yearly interim report will involve some additional cost as will also the review of such a report by the auditors. Although it may not be a formal audit, the auditors' guidance will be

(Para 4.47) needed on the nature and format of such report. Additional costs must be kept to the minimum at a time when many companies are under intense competitive pressure internationally.

(Code 4.5) The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities. (Paragraph 4.22)

41. We agree that such a statement should be made, as a counterpart to a statement by the auditors of their

(Para 4.22) reporting responsibilities. There should be a provision of the Code to cover the auditors' statement.

Auditing

Quarantining Audit from Other Services

(Code 4.3) Boards should ensure that an objective and professional relationship is maintained with the auditors. (Paragraph 5.7)

42. This is too general a statement. We note that in paragraphs 5.7-5.9 of the Report in support of Code 4.3 the Committee states:

(Paras 5.7-5.9)

- shareholders require auditors to work with management and remain professionally objective;
- maintaining this professional and objective relationship is the responsibility both of boards and auditors;
- an essential first step is the development of effective accounting standards.

- the second step should be the formation by every listed company of an audit committee which gives auditors direct access to the board members.

We believe that the responsibility shared between boards and auditors for the quality of this relationship should be made explicit in the Code.

43. As to the further statement in paragraph 5 of the Report, we are opposed to any restriction being placed on the freedom of auditors to carry out **non-audit services** for their clients. Companies find it (Para 5.10) beneficial and cost-effective through their auditor's knowledge of their business to make use of consultancy and other services. We therefore welcome the fact that the Committee does not make any recommendations to restrict the ability of audit firms to provide such services.

44. We agree that fees for non-audit work should be (Para 5.11) disclosed.

Rotation of Auditors

45. We oppose the mandatory **rotation of audit firms.** We would however support a non-prescriptive recommendation for the regular rotation of audit partners and indeed of audit managers, to ensure (Para 5.12) continued independence. With larger companies using the larger audit firms, there is normally more than one partner involved in any event, so the rotation can be achieved reasonably smoothly. The team should however be kept as stable as possible in order that the audit be carried out effectively, efficiently and at acceptable cost.

Responsibilities of auditors

46. We note that at paragraph 5.14 the Report states: "Auditors' reports should state clearly the auditors' (Para 5.14) responsibilities for reporting on the financial statements, as a counterpart to a statement of directors' responsibilities for preparing the financial statements (paragraph 4.22)".

47. We support this suggestion and consider that it could be reflected as a provision in the Code as is the case with the complementary recommendation as to the statement of directors' responsibility - Code 4.5. This would go some way to redressing the lack of balance in the Code which does not include any provisions for auditors' role in corporate governance.

Going Concern

(Code 4.6) **The directors should state in their report that the business is a going concern, with supporting assumptions or qualifications as necessary. (Paragraph 5.23)**

48. Recent proposals on this have been published by the Auditing Practices Board; and the Accounting Standards Board may also publish proposals on behalf of preparers of accounts. As with the question of internal controls, we consider this provision should be held over until these proposals have been worked out.

(Paras 5.18-23)

Fraud and Other Illegal Acts

49. We do not support the recommendation (para 5.28) that consideration should be given to extending **statutory protection** for auditors under the banking and financial legislation to embrace all auditors generally. Claims against auditors who failed to discover and report fraud, which might be one result of statutory protection, could complicate the issue of responsibility. If auditors suspect fraud and cannot ensure its redress by the Board, the proper step is for them to resign.

(Paras 5.24-28)

OTHER MATTERS

Directors' Training

50. We strongly support the establishment of training programmes for all directors, in particular, as directors' legal duties and responsibilities increase. Both existing and well established directors as well as newly appointed and prospective directors should have such training.

(Para 4.15)
(Para 4.16)

The Shareholders

51. There are no Code provisions on the issue of board communication with shareholders although the Committee considers the question in the Report. Regular communications between institutional and private shareholders and a company should be maintained and material information should be made public and be distributed to all shareholders promptly.

(Paras 4.45-4.50)
(Paras 6.1-6.12)

52. We consider there is room for improvement in the quality and style of communication with, and the involvement of, private shareholders, in the companies in which they invest. Many companies produce magazines, newsletters etc for their employees and this style of communication (and indeed the same communication itself) could be developed to send to private shareholders as well. Companies have made progress in this area but we believe more could be done. Cost is a difficulty, but this would be mitigated if the same publication was appropriate to send to both employees and shareholders. We would welcome any initiatives and ideas the Committee is able to make following responses to its draft Report.

53. The views of PROSHARE would be relevant on whether or not private shareholders would welcome further and swifter information communication to make them participate more actively in the affairs of companies in which they have an investment.

54. We consider that the Code should expressly state that institutional shareholders ought to have a policy on the use of their voting power, either by proxy or by attending AGMs, and should publish their policy. The Code could usefully also incorporate the conclusions set out in paragraph 6.8 of the Report, taken from the Institutional Shareholders' Committee guidelines, on the positive use by institutional investors of their voting rights, which the Committee endorses. This would go some way to redress the balance between the three groups - boards, shareholders and professional advisers - which the Report states in its conclusion have a common interest in corporate governance. This view is not reflected in the provisions of the Code, which are directed solely to boards.

(Para 6.8.2)

(Para 7.5)

Code is addressed to listed co's.

Recs. to a/cts & s/hldrs. no defined class.
no structure for follow-up.

July 1992

CAD-02349

COMMITTEE
ON
THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

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28th July, 1992

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Dear Mr. Mason,

In Mr. Peace's absence, I am writing to thank you for your letter of 27th July, a copy of which I have passed to Sir Adrian Cadbury.

I confirm that your comments will be taken into consideration before the Committee's report is finalised.

Your letter will be put before Mr. Peace on his return next week when he will no doubt reply to the other points raised in your letter.

Yours sincerely,

P. J. Snoad

Pat Snoad
Secretary to Mr. N. D. Peace

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Director General
Howard Davies

Deputy Director-General and Secretary
Maurice Hunt

CONFIDENTIAL

27 July 1992

Mr Nigel Peace
Committee on Corporate Governance
P O Box 433
Moorgate Place
London
EC2P 2BJ

Dear Nigel,

CBI RESPONSE

As promised, I enclose a copy of the draft CBI response which is to be considered by the CBI Council on the morning of Wednesday, 29 July. The text is, of course, subject to amendment, but we thought it would be helpful for Sir Adrian and yourself to see it in advance.

I shall follow up your thought that we should also send a copy to Sir Andrew Hugh Smith in advance. Many thanks for the idea.

We shall be referring to the CBI response, together with other agenda items, at our usual post-Council press conference at 1500 hrs on 29 July. This will be taken by our President and Director-General; and I expect that we shall issue a short press release summarising the key points of our response.

As far as I can recall, Ian Butler is the only member of your Committee who is on the CBI Council. I understand that he will be coming in order to speak in our debate at need.

Finally, may I confirm that I have asked our Conference Unit to arrange a car from London for Sir Adrian on 9 November and a hotel for the night in Harrogate. We can settle the detail nearer the time.

Yours sincerely,

Graham Mason

G C Mason
Director
Company Affairs

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C 45 92 (Summary)

TO THE COUNCIL FOR THE MEETING ON 29 JULY 1992

SUMMARY OF THE CBI RESPONSE TO THE CADBURY COMMITTEE DRAFT REPORT ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

1. The CBI welcomes the Cadbury Committee's draft Report as an important contribution to the debate on corporate governance. A great deal of constructive discussion has been stimulated by the Committee's proposals both amongst CBI members and elsewhere in the business and professional community. We give below the main points of the CBI response (elaborated in the attached commentary) which we offer at this stage of the Committee's enquiry.

2. CBI members accept the need for continuing efforts to improve standards of corporate governance, so that the generality of businesses match the level practised by the best companies. The means chosen to achieve this end should recognise that not all of the practices advocated will be relevant to the smaller company.

3. Cadbury is right to reject further major intrusion of the law into corporate governance which would introduce rigidity and invite a focus on the letter rather than the spirit of standards. The Code put forward by the Committee, by contrast, offers flexibility; and the CBI finds many positive features in it. A good deal of what it says represents what member companies consider to be best practice.

4. We do, however, have major reservations about making a statement of compliance a listing obligation as a way of sharpening accountability to shareholders. This requirement is likely to produce over-elaboration of the Code and proliferating bureaucracy. Where investors intervene with a board, they can invoke the Code as part of their case, using it according to a company's particular circumstances. An obligatory statement of compliance in the annual report is not necessary for this purpose.

5. We support the view of the Committee that non-executive directors have an important role to play in companies. Perhaps because of its terms of reference, the Committee has focused narrowly on their monitoring role. We think this is unfortunate, because it understates the contribution which the non-executives can make to the growth of a business: their different experience brings a fresh eye to problems and the development of strategy. Moreover, the concept of the unitary board is based on all directors being equally responsible for its actions (with equality of access to information); its effectiveness depends on members of the board as a whole working together. In that setting it is for the board to distribute functions to its members; attempts to reserve tasks as a rule to one class of directors will create the danger of opening the way to a two-tier system. For this reason, whilst we support a recommendation to establish audit committees, which we consider should not be mandatory, we do believe the membership should not be restricted to non-executive directors.

6. We accept the Committee's view that there must not be an undue concentration of power on one individual in a board, and that where the roles of chairman and chief executive are not separate (especially where the chief operating officer is also the chief executive), there must be appropriate checks and balances through independent directors. Whilst it is helpful that there should be a rallying-point, if there is concern at the working of the board, we find little support for the notion of an appointed leader among the non-executives.

7. We support the recommendation to identify the performance-related element of directors' remuneration and note that many companies find remuneration committees useful.

8. In principle, we support the Committee's proposals for strengthening the scope and quality of audit work in relation to financial reporting, including comment on internal financial controls and the 'going concern' basis of accounts. We shall offer views on the profession's ideas for giving effect to them. However, we have serious misgivings about extending the auditor's functions to review of compliance with the Code: on some issues this would take the profession outside its sphere of competence.

9. It is clearly proper that users of accounts should have confidence in the objectivity of the auditor, but in deciding whether measures are needed to reinforce it, we ask the Committee to consider that the effectiveness of an audit is enhanced by a close knowledge of the business. We do not, therefore, believe that the rotation of the audit partner should be an absolute requirement. Equally, companies find that a close professional knowledge of their affairs is a benefit when seeking other advice from the firm conducting the audit. We would not want to see any restriction on the sources to which companies may turn for advice and believe that a requirement for a firm to declare non-audit fees is sufficient disclosure for users of accounts.

10. The CBI urges the Committee to give more attention to the role of shareholders in its final Report. We believe it should offer guidance on ways of sharpening their responsibilities as owners of the business, for example, through the use of voting rights.

11. The work of the Cadbury Committee has lent fresh impetus within CBI member companies to the process of assessing procedures and making changes in corporate governance. It is important that this should continue and, as the Committee has identified, its Code should be updated to embody new developments and best practice. For this reason the 'ownership' of the Code should be clearly established; and we invite the Committee to make firm arrangements for the review body in its final recommendations.

* *

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C 45 92

TO THE COUNCIL FOR THE MEETING ON 29 JULY 1992

CBI RESPONSE TO THE CADBURY COMMITTEE DRAFT REPORT ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

(Draft Report and Code paragraphs:)

CODE OF BEST PRACTICE

12. The Code of Best Practice forms the heart of the Committee's recommendations; and we support this approach. If the Code is to be supported and be a success it must satisfy the criteria set out in the following three paragraphs.

13. The provisions of the Code must be capable of broad support and compliance by all listed companies and companies generally. The Code is a statement of the principles of good corporate governance which, as identified by the Committee, should be based upon openness, integrity and accountability, but these principles must be sufficiently flexible to allow for differences in companies' needs. A manufacturing company will not have the same board and management structure as a financial services business; and a smaller company will not need to follow all the practices of a larger one.

14. The draft Code is inconsistent with the UK structure of a unitary board, whereby all directors, both executive and non-executive, are jointly and collectively responsible for the management and stewardship of a company. We believe that it is wrong for certain functions of the board to be reserved for non-executive directors and that they should be cast primarily in a monitoring or policing role. A formal separation of tasks of this kind opens the way for a continental two-tier structure and undermines the UK concept of boards themselves settling the distribution of functions amongst their members.

15. The Code should offer guidance rather than prescription on how boards manage their affairs. It would surely run counter to the purposes of the Committee if a successful, financially sound and well run business suffered prejudice to its market reputation because it complied with some but not all of the Code's provisions.

16. As presently drafted, it is also not clear, when the Code cross-refers to a paragraph in the draft Report, whether that paragraph is intended to be incorporated in the draft Code. The point is important because the paragraphs in the draft Report often deal with additional recommendations and generally discuss a range of matters which go much wider than the provisions of the Code itself. Whilst a company may support a particular provision of the Code, it may not necessarily accept or feel itself committed to all that is said in the draft Report to which cross-reference is made. If the recommendations and the supporting argument are there to help define the spirit rather than the letter of the Code, that should be made clear.

17. We prefer that the Code should contain no cross-references to the Report or the recommendations. The Code should be able to stand on its own.

Statement of Compliance

18. The Committee proposes that a statement of compliance with the Code in the annual report and accounts should be a Stock Exchange listing obligation, with the sanctions of public warning from the authorities and adverse press comment, should a company fail to make a statement or only offer a wholly inadequate one. For persistent failure to make a statement of compliance, there is the ultimate sanction of delisting, when shareholders have had sufficient opportunity to express their disapproval at the AGM and sell their shares. Delisting is a draconian remedy, especially if shareholders are unable to dispose of their shares. If the proposal for an annual statement of compliance is to apply generally, as the Committee hopes, the sanction will obviously not bear upon unquoted companies.

(Paras 3.7-3.11)

19. If a statement of compliance is to become a Stock Exchange listing obligation, we believe that this will have the effect of making the Code itself less capable of flexible change and interpretation. The Code will assume the status of a quasi-legal document; and boards and their professional advisers will seek guidance on the precise form and nature of

the statement they are expected to make. Detailed questions about the interpretation of the Code and whether it stands on its own or is to be read with the rest of the Report are bound to arise. We therefore consider that a Stock Exchange listing obligation is not appropriate.

20. We support rather the approach followed by the Institutional Shareholders' Committee in its Statements of Best Practice on the Role and Responsibilities of Directors and on the Responsibilities of Institutional Shareholders. These have been put forward as models of good practice which companies and shareholders should seek to follow, rather than provisions which the addressees are bound to observe. The sanction against the company is adverse public comment and shareholder disapproval. We consider that this is the way in which the Cadbury Code should be taken forward.

21. If the Code takes the form of a statement of principles, as we propose, the compliance statement will be easier to prepare and to understand. We believe that it would be helpful if the final Report of the Committee gave the text of a sample compliance statement by way of illustration and guidance. The only recommendation of the Committee should be for the directors to make a statement of compliance with the Code in the company's annual report. It will then be for the shareholders and potential investors to decide whether the extent of a company's compliance affects their judgement to buy, keep or sell the shares.

22. We do not consider it to be appropriate for the compliance statement to be reviewed by the auditors. The Code is primarily concerned with management and stewardship issues and board structures which auditors have no special competence to assess. Auditors may be capable and qualified to comment on financial questions and matters of fact - e.g. on the existence of non-executive directors and board committees - but there are matters of judgement, as, for example, on the independence of non-executive directors which the auditor is not able to assess. Whilst the auditor would no doubt comment if he felt the compliance statement was patently false or misleading, he cannot be expected to comment with authority on the calibre, qualification and experience of the non-exeutives. Auditors do not regularly attend board or committee meetings and cannot assess how the board conducts itself.

(Para 3.10)

Start of Compliance

23. More time should be given to boards before they are asked to publish a statement of compliance. The current proposal affects companies with year ends on or after 31 December 1992. However, by then the Committee's final Report will at best only recently have been published. This will give companies right near the end of their accounting period little or no time to consider the document and give effect to its recommendations, should these materially differ from those in the current draft.

24. A later date of, say, 31 December 1993, may be appropriate for the introduction of a statement of compliance. The Committee can still recommend that companies comply with the Code as soon as possible and disclose the level of their compliance in the meantime.

Review of the Code

25. We support the regular review of the Code in the light of EC or other developments affecting companies. We believe that "ownership" of the Code needs to be clearly established and urge the Cadbury Committee to propose firm arrangements for a review body in its final Report.

(Paras 3.12-3.13)

DETAILED CRITIQUE OF THE CODE OF BEST PRACTICE

THE BOARD

Board Structures and Procedures

(Code 1.1) **The board must meet regularly, retain full and effective control over the company and monitor the executive management.**

26. We agree that boards should meet regularly with due notice of the issues to be discussed and should record their conclusions. It is also vital that minutes are circulated promptly, particularly to those directors unable to be present at the meeting. We oppose the words "monitor the executive management" as imparting a supervisory role inappropriate to a unitary board.

(Code 1.4) **Boards should have a formal schedule of matters reserved to them for decision to ensure that the direction and control of the company is firmly in their hands. (Paragraphs 4.19, 4.20)**

27. We would formulate this recommendation in another way. The board is responsible for the direction and control of the company and it is a matter for its members what powers, responsibilities and duties they delegate, not what they retain. Such delegation should be subject to appropriate systems of internal control as with all other aspects of the management of the company. Any list of issues reserved to the board should be only illustrative; and all would have to use their common sense in interpreting it. As noted, a better approach, more consistent with the unitary board, would be to have a list of issues/ decisions expressly delegated.

(Paras 4.19 & 20)

Combined Roles of Chairman and Chief Executive

(Code 1.2) **There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong independent element on the board, with an appointed leader. (Paragraph 4.6)**

28. We agree that the combination of the roles of chairman and chief executive (especially where he is also the chief operating officer) may represent a strong concentration of power, although the Committee is right to recognise in the proposed Code that company boards may, where appropriate, wish to combine the roles. Companies are now tending to reorganise their structures on this basis as existing incumbents filling dual roles retire. An appropriate part of the checks and balances in companies which combine the two offices would be to have a suitable number of strong independent non-executive directors. On such boards a non-executive director is often appointed deputy chairman. We have no great liking for the term "leader" but support the concept that there should be a rallying point for directors with concerns about the operation of the board, if the chairman has an executive role.

(Para 4.6)

NON-EXECUTIVE DIRECTORS

(Code 1.3) **The calibre and number of non-executive directors should be such that their views carry significant weight in the board's decisions. (Paragraph 4.6)**

(Code 2.1) **Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct. (Paragraph 4.8)**

(Code 2.2) **The majority should be independent and free of any business or financial connection with the company apart from their fees and shareholding. Their fees should reflect the time which they commit to the company. (Paragraphs 4.9, 4.10)**

Comments on Code 1.3, 2.1 and 2.2

We fully support these statements.

29. We agree that non-executive directors are an important part of the board team. Whilst it is the Committee's clear purpose to sustain the concept of the UK unitary board, we believe that the general effect of the draft Report's recommendations and the Code may be to undermine it. We believe that the proper approach is to emphasise that the distribution of responsibilities is a matter for each board. For some board committees it may be appropropriate to have a majority of non-executive directors, but specific functions should not be reserved to them *ab initio*.

(Paras 4.7 & 4.8)

30. Whilst PRONED and others say that they have a good supply of people of calibre on their books, senior businessmen are sceptical whether there are enough directors of quality available with the time to spare for the commitment to a non-executive role in another company. We ask the Committee to look again at the question of supply, as its draft Report advocates measures which would add to the demands on the outside director.

31. No one would question the principle that independence of mind needs to be underpinned by independence of means in the remuneration of non-executive directors. We do, however, record the view that the issuing of share options to them as an incentive is compatible with their positive role in developing the longer term strategy of the business. Whatever view boards and shareholders may take of the issue, full disclosure in the annual report and accounts must be a requirement.

(Para 4.10)

(Code 2.4) **There should be an agreed procedure for non-executive directors to take independent professional advice if necessary, at the company's expense. (Paragraph 4.12)**

32. We agree with the proposal that non-executive directors should be entitled to take separate independent advice, if appropriate, at the company's expense and under agreed procedures, and believe this should be extended to every director on the board. The Committee should also give guidance as to what
(Para 4.12) the appropriate procedures should be: costs might be substantial; and where several directors wished to take up such a facility, there would be a need to avoid duplication.

(Code 2.3) They should be appointed for specified terms and reappointment should not be automatic. (Paragraph 4.14)

(Code 2.5) Non-executive directors should be selected through a formal process and their nomination should be a matter for the board as a whole. (Paragraph 4.13)

33. We support the provision on terms and suggest that all directors, executive and non-executive, should be subject to retirement and re-election by rotation at intervals of not longer than 3 years.
(Para 4.14) We agree with the suggestion in paragraph 4.14 that the letter of appointment for non-executive directors should set out their duration, terms of office, remuneration and its review.

34. The nomination of all directors, not just non-executives, should be a matter for the board as a whole and subject to a formal selection process.
(Para 4.13) The Committee leaves the use of nomination committees to the discretion of individual boards by not
(Para 4.24) referring to them specifically in the Code. However in paras 4.13 and 4.24 it speaks of them in terms of approval and prescribes how they might be composed. In circumstances of this kind the nature of disclosure of compliance is important. Companies will want to know what flexibility they have and what is the relationship between the Code and the rest of the Report, if disclosure is to be a listing obligation.

EXECUTIVE DIRECTORS

Board Remuneration

(Code 3.1) Directors' service contracts should not exceed three years without shareholders' approval. (Paragraph 4.33)

35. We agree with this provision.

(Para 4.14) As noted, we suggest that all directors including executive directors should be subject to retirement and re-election by rotation at intervals of not longer than 3 years.

(Code 3.2) Directors' total emoluments and those of the chairman and highest paid UK director should be fully disclosed and split into their salary and performance-related elements. The basis on which performance is measured should be explained. (Paragraph 4.32)

(Para 4.32) 36. The CBI has agreed that the principles upon which directors' remuneration is determined should be set out in the annual report and accounts. We therefore support the measure of disclosure advocated by the Committee.

Remuneration Committees

(Code 3.3) Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors. (Paragraph 4.34)

(Para 4.34) 37. Paragraph 4.34 specifies that a remuneration committee should be established, sets out how it should be composed, lays down that its detail should be dislosed in the annual report, and proposes that its chairman should take questions at the AGM (we take the last point later in the CBI response).

(Para 4.34) 38. Many CBI member companies see the merit in having remuneration committees in order to have formal procedures and independent assessment of the determination of rewards for executive directors. They would accept a recommendation of this kind as a statement of current good practice and judge it right that the CEO should be a member of that committee, since he will have a close knowledge of the performance of executive directors and senior managers. We believe that the establishment of such committees should be a matter of choice for boards rather than prescription: smaller companies (and some larger ones) manage their affairs without them, and in a manner which satisfies their shareholders.

CONTROLS AND REPORTING

Audit Committees

Internal Controls

(Code 4.1) **Boards must establish effective audit committees. (Paragraph 4.29)**

39. We would support a recommendation to establish audit committees, but not a mandatory requirement; it must remain a matter of judgement for each company.

40. Whilst many companies see the value of audit committees, as Cadbury reports, there are others who strongly hold the view that there should not be any intermediary between the auditors and the whole board, which has responsibility for preparing the accounts. We believe, therefore, the establishment of an audit committee should be a matter for decision by individual boards rather than absolute prescription, so we cannot support the language of the Code.

(Paras 4.27-31)

41. However, membership of the audit committee should not be restricted to the non-executive directors. Boards will often consider it appropriate that one or more executive directors, in particular, the finance director and perhaps the chief executive, should be members of the audit committee. We do not agree that the latter should only attend by invitation.

42. We agree with Cadbury that both the external auditor and the head of internal audit should be invited to attend meetings of the committee. Both should in any event be entitled to make representations to the committee and have access to the committee chairman.

(Code 4.7) **The chairmen of the audit and remuneration committees should be responsible for answering questions at the Annual General Meeting. (Paragraphs 4.29, 4.34)**

43. The board as a whole is responsible for the stewardship of the company. This position is formally recognised by the chairman normally being the spokesman for all of its members at the AGM. To have certain classes of questions directed as a matter of course to particular members of the board undermines the sense of collective responsibility, in our view. The chairman should be the focal point of questions; and other directors should respond at his invitation.

(Para 4.29)

(Code 4.2) **Directors should report on the effectiveness of their system of internal financial control. (Paragraph 4.26)**

44. In principle, we support this provision of the Code which is a reinforcement of an existing legal (Para 4.25) requirement. As the Committee notes, there are issues of definition and procedure to be resolved before the provision could be put into effect. It should not stand as part of the Code, until there is agreement on detailed guidance for directors and auditors.

Reporting Practice

(Code 4.4) **It is the board's duty to present a balanced and understandable assessment of their company's position. (Paragraph 4.41)**

45. We consider the Code should be specific in its provisions; Code 4.4 is too general a statement to be helpful and needs to be expanded, particularly if it (Para 4.41) is to be interpreted by reference to para 4.41 in the (Paras 4.45-49) Report which is incorporated by reference in the Code.

The recommendations in 4.41 that:

- the report and accounts should contain a coherent narrative, supported by figures, of the company's performance and prospects, on the basis that "words are as important as figures";

- setbacks as well as successes should be dealt with

are all statements that make the Code provision more intelligible. To avoid incorporation by reference these could usefully appear in the Code itself. Indeed, the suggestion in paragraph 4.42 - inclusion of a forward-looking Operating and Financial Review **(OFR)** - and the suggestions and recommendations in paragraphs 4.45-50, (interim reports, balance sheet and cash flow information, an expanded chairman's statement and simplified reports) should form part of any Code, if it is intended that they are to be part of the suggested interpretation of 4.4. We do not now comment separately on all these suggestions but reiterate that the Code must stand alone for companies to know what it is that compliance entails.

46. As to the **OFR** suggestion, we support the adoption in the UK of a practice on the broad lines of the US SEC requirements for Management Discussion and Analysis

(Para 4.42) and are currently considering the recent proposals from the Accounting Standards Board for an Operating and Financial Review. We generally support the flexible approach proposed by the Accounting Standards Board rather than the rigidly structured approach of the SEC requirements.

47. We consider that **quarterly reporting** for all listed companies should not be mandatory. Such reporting tends to focus attention excessively on short-term results and involves additional costs for companies. (Para 4.47) It also has the effect of extending the "close season" when directors and other insiders cannot deal in a company's shares. Quarterly reporting should be a matter for individual boards.

48. The proposal that **balance sheet information** be included in the half yearly interim report will involve some additional cost as will also the review of such a report by the auditors. Although it may not be a formal audit, the auditors' guidance will be (Para 4.47) needed on the nature and format of such report. Additional costs must be kept to the minimum at a time when many companies are under intense competititive pressure internationally.

(Code 4.5) The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities. (Paragraph 4.22)

49. We agree that such a statement should be made, as a counterpart to a statement by the auditors of their (Para 4.22) reporting responsibilities. There should be a provision of the Code to cover the auditors' statement.

Auditing

Quarantining Audit from Other Services

(Code 4.3) Boards should ensure that an objective and professional relationship is maintained with the auditors. (Paragraph 5.7)

50. This is too general a statement. We note that in paragraphs 5.7-5.9 of the Report in support of Code 4.3 the Committee states:

(Paras 5.7-5.9) - shareholders require auditors to work with management and remain professionally objective;

- maintaining this professional and objective relationship is the responsibility both of boards and auditors;

- an essential first step is the development of effective accounting standards.

- the second step should be the formation by every listed company of an audit committee which gives auditors direct access to the board members.

51. As to the further statement in paragraph 5 of the Report, we are opposed to any restriction being placed on the freedom of auditors to carry out **non-audit services** for their clients. Companies find it beneficial and cost-effective through their auditor's knowledge of their business to make use of consultancy and other services. We therefore welcome the fact that the Committee does not make any recommendations to restrict the ability of audit firms to provide such services.

(Para 5.10)

52. We agree that fees for non-audit work should be disclosed.

(Para 5.11)

Rotation of Auditors

53. We oppose the mandatory **rotation of audit firms.** We would however support a non-prescriptive recommendation for the regular rotation of audit partners and indeed of audit managers, to ensure continued independence. With larger companies using the larger audit firms, there is normally more than one partner involved in any event, so the rotation can be achieved reasonably smoothly. The team should however be kept as stable as possible in order that the audit be carried out effectively, efficiently and at acceptable cost.

(Para 5.12)

Responsibilities of auditors

54. We note that at paragraph 5.14 the Report states: "Auditors' reports should state clearly the auditors' responsibilities for reporting on the financial statements, as a counterpart to a statement of directors' responsibilities for preparing the financial statements (paragraph 4.22)".

(Para 5.14)

55. We support this suggestion and consider that it could be reflected as a provision in the Code as is the case with the complementary recommendation as to the statement of directors' responsibility - Code 4.5. This would go some way to redressing the lack of balance in the Code which does not include any provisions for auditors' role in corporate governance.

Going Concern

(Code 4.6) **The directors should state in their report that the business is a going concern, with supporting assumptions or qualifications as necessary. (Paragraph 5.23)**

56. Recent proposals on this have been published by the Auditing Practices Board; and the Accounting Standards Board may also publish proposals on behalf of preparers of accounts. As with the question of internal controls, we consider this provision should be held over until these proposals have been worked out.

(Paras 5.18-23)

Fraud and Other Illegal Acts

57. We do not support the recommendation (para 5.28) that consideration should be given to extending **statutory protection** for auditors under the banking and financial legislation to embrace all auditors generally. Claims against auditors who failed to discover and report fraud could complicate the issue of responsibility. If auditors suspect fraud and cannot ensure its redress by the Board, the proper step is for them to resign.

(Paras 5.24-28)

OTHER MATTERS

Directors' Training

58. We strongly support the establishment of training programmes for all directors, in particular, as directors' legal duties and responsibilities increase. Both existing and well established directors as well as newly appointed and prospective directors should have such training.

(Para 4.15)
(Para 4.16)

The Shareholders

59. There are no Code provisions on the issue of board communication with shareholders although the Committee considers the question in the Report. Regular communications between institutional and private shareholders and a company should be maintained and material information should be made public and be distributed to all shareholders promptly.

(Paras 4.45-4.50)
(Paras 6.1-6.12)

60. We consider there is room for improvement in the quality and style of communication with, and the involvement of, private shareholders, in the companies in which they invest. Many companies produce magazines, newsletters etc for their employees and this style of communication (and indeed the same communication itself) could be developed to send to private shareholders as well. Companies have made progress in this area but we believe more could be done. Cost is a difficulty, but this would be mitigated if the same publication was appropriate to send to both employees and shareholders. We would welcome any initiatives and ideas the Committee is able to make following responses to its draft Report.

61. The views of PROSHARE would be relevant on whether or not private shareholders would welcome further and swifter information communication to make them participate more actively in the affairs of companies in which they have an investment.

62. We consider that the Code should expressly state that institutional shareholders ought to have a policy on the use of their voting power, either by proxy or by attending AGMs, and should publish their policy. The Code could usefully also incorporate the conclusions set out in paragraph 6.8 of the Report, taken from the Institutional Shareholders' Committee guidelines, on the positive use by institutional investors of their voting rights, which the Committee endorses. This would go some way to redress the balance between the three groups - boards, shareholders and professional advisers - which the Report states in its conclusion have a common interest in corporate governance. This view is not reflected in the provisions of the Code, which are directed solely to boards.

(Para 6.8.2)

(Para 7.5)

July 1992