

**PANNELL
KERR
FORSTER**

CHARTERED ACCOUNTANTS

N Peace Esq
Secretary
Committee on Financial Aspects
of Corporate Governance
PO Box 433
Moorgate Place
London EC2P 2BJ

New Garden House
78 Hatton Garden
London EC1N 8JA
Telephone: 071 831 7393
Telex: 295928 PANKER G
Telefax: 071 405 6736
DX 479 Chancery Lane

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Dear Mr Peace

The Cadbury Committee Report

You have invited comments on the draft report of the Committee on the Financial Aspects of Corporate Governance (commonly known as the Cadbury Committee Report). We have accepted that invitation and would start by applauding those responsible for having raised this issue which is one of obviously critical importance to the future well being of the corporate sector. Having said which we believe that in concentrating on the financial aspects of corporate governance before any consideration of the role, duties and responsibilities of the company itself there is a strong danger that the committee has been set the wrong task. It is difficult to see how one can effectively establish a system of governance unless one knows what the purpose of that governance is.

We believe that this is a signal danger in the approach currently being adopted and that until the wider issues are settled the report and the code of practice should be regarded as persuasive rather than mandatory. There seems to us to be four key questions which need to be answered namely:-

1. What is the purpose of a Company?
2. What are the responsibilities of the Company?
3. What is the role of shareholders?
4. In the light of the above, what are the duties and responsibilities of directors and is there a difference in the role between executive and non-executive directors.

Only the last of these is touched upon by the report and even then without examining the fundamental assumptions on which the report's judgements are made.

Having said which and having regard to the limited and one sided nature of their brief, we believe the Committee is to be congratulated upon having raised a number of important issues.

The Code of Best Practice.

We agree that the Code should in principle apply to all listed companies, but we are concerned that smaller companies may have so much difficulty in complying with it in its entirety that its effect may be diluted. Further thought needs to be given to such problems.

Additionally whilst we accept the concept of the Code we are really not clear as to its status and what if any is the effect of non compliance. We believe that this needs to be established before the code in its final version is published.

In paragraph 3.4 the Committee refers to the shareholders' willingness to exercise their responsibility as owners. We are not at all clear that shareholders of a listed company really regard themselves as owners, rather they regard themselves as investors. We believe that this is an important distinction and that the ownership concept in a listed company context is now not really consonant with the facts. The purpose of a stock market is to enable individuals, corporate or otherwise, to have a ready market for their shares and thus to avoid the responsibilities of ownership by simply concentrating on the responsibilities of investment.

With these caveats, we agree entirely with the Committee's emphasis on integrity, openness (within commercial constraints) and the need for standards to be continually raised. We support the need for directors and audit committees of listed companies to confirm compliance with the code, but for auditors to reaffirm that compliance, other than in very general terms needs in our view further work on the guidelines as to how this is to be measured. We shall look forward to commenting on such guidelines once they are established.

The Board.

We understand and accept that there is a need for a division of responsibilities within a board and that no large listed company should be capable of being dominated by one individual but we are concerned about the apparent belief that within a board there should be two leaders. We feel very strongly that the duty of the Board (within the constraints of the law) as a whole is to create wealth for the investors. The Board has, therefore, to work as a team, and not to be put in a position where half the Board's main purpose appears to be to police the activities of the other half. We are concerned that whilst the report makes this point at 4.7, the overall impression of the report, because it deals with controls is one where the vision of the non-executive is that he is there to dismiss the chief executive should this prove necessary rather than provide positive input to the future direction and success of the company. We believe non

executive directors have an important role to play in bringing their broader experience to bear on the board's discussions.

Two further points on the Board seems to us relevant. We note with wry amusement the suggestion made in the press recently that the role of non-executive is now becoming so onerous that there should be a limit to the number of non-executive directorships an individual may take on, which when coupled with the suggestion that such posts should be remunerated at substantial levels goes some way to undermining their ability to demonstrate their independence. We believe that non-executive directors should be entitled to take on as many posts as they can sensibly handle but that their reappointment should depend on the positive support of the executive directors.

Finally, it is clear from one or two recent cases that there is a need for non-executives to have the ability to seek legal advice on their own. Could this not be better handled by an insistence that all directors are covered by some form of legal advice insurance which could be coupled with mandatory Directors and Officers Liability Insurance.

We are not quite so clear as to the merits of directors taking other independent professional advice and would like to see more detail as to what is envisaged and under what procedures.

We agree with the Committee's views on the Training of Directors and Board Structures and Procedures. We would however insist that the question of material guarantees was a matter reserved for the Board.

Audit Committees.

We accept the concept of an Audit Committee but do not believe that it is realistic or sensible to insist on it being all non-executive. Such a stipulation is, in our view, capable of becoming divisive and we would much sooner have a stipulation that a majority of the committee and its Chairman are non-executive.

We also do not believe there is any merit in having a formal meeting once a year without the finance director or other executive director being present but with the external auditors. Reality suggests that this will not achieve anything and that in the normal way an auditor ought to be prepared to raise any issue in the presence of the executives and not be encouraged to do so in their absence. On the few occasions where a significant problem arose where the auditors wished to raise matters privately with non-executives he should, and in practice does, have a right of audience with the senior non-executive director.

We are in two minds as to whether the review of the half year and annual financial statements should be a responsibility of the audit committee prior to submission to the Board. On the one hand, it is important that non-executives have a proper opportunity to raise questions on the accounts and on the other hand this same opportunity needs to be available to the executives

and it is the Board as a whole who are jointly responsible for the figures. On balance, we believe that this responsibility is better reserved for the Board as a whole in a discussion led by the Finance Director and to which the external auditor is invited. The danger that we foresee is that if the audit committee had the review responsibility the Board as a whole will simply rubber stamp the accounts.

We believe that a further duty of the audit committee is to satisfy itself as to the appropriateness of those accounting policies which the company employs and which are of material significance in understanding the company's results.

Board Remuneration.

We wholeheartedly endorse these proposals.

Financial Reports.

We confess to some scepticism as to the financial reporting concept established in 4.41. We applaud the concept but believe that in practice the need to provide such a report will lead to a standardised and uninformative presentation which will tend to stifle innovation and communication rather than encourage it. We hope we are wrong.

We agree entirely that there should be an expansion to the content of interim reports and as an auditor applaud the need for these to be subject to audit review. However, whilst we applaud the concept we are concerned that appropriate guidance is introduced before this recommendation is brought into effect.

Pensions Governance.

As a firm we are committed to the need for a review of this whole area. Recent events have simply underlined this need. We look forward to this being carried out urgently and to assisting in this development.

Auditing.

The essence of the audit process is that it is an independent and critical appraisal carried out by professionally qualified individuals so as to provide independent corroboration of the integrity of the financial information.

Whilst we understand the superficially attractive arguments for quarantining the important point is surely that the client should be able to get the best advice he can from whatever source he wants and not to have artificial business restrictions imposed on him.

Rotation of Auditors.

We have already stated the essence of an audit is the ability to conduct an independent and critical appraisal and we do therefore accept that anything which improves that independence and criticality is beneficial. However, we believe that the approach being adopted by the committee is over simplistic and for the large listed company of the sort to which the report is in reality addressed otiose.

The system of checks and balances envisaged by the introduction of a mandatory audit committee on the one hand, and the audit firm's own internal procedures on the other, provide, we believe, an adequate framework without introducing any mandatory rotational system. To insist on a mandatory change every 7 years brings with it a danger that there will be change for change's sake and a more informal system whereby the audit committee satisfies itself as to the independence and criticality of those involved in its audit seems to be much more sensible.

Going Concern.

Whilst we agree with the Committee's recommendations we do not believe they have advanced the argument very far. One of the fundamental questions must be what is the legal liability of directors in making such a statement and what additional work will need to be done by auditors before they approve such a statement. At present in the case of prospectuses and working capital statements where going concern statements are "made after due and careful consideration" there is the necessity for a considerable volume of expensive work. Auditors will be very happy to carry this out if the business community deems it desirable but there must be a difficulty in introducing a lesser standard of care for annual accounts.

Fraud and other Illegal Acts.

We have no comment to make on these recommendations, nor indeed on the section on Auditors Liability.

Timetable

The Report envisages that the code should come into effect as of 31 December 1992. There is much detailed work which remains to be done and we question whether this timetable is really realistic.

The Shareholders.

As we have already stated, we believe shareholders are more sensibly regarded as investors rather than as owners and should be perfectly entitled to take such action as they deem

appropriate to safeguard their interests, and the Committees recommendations must be interpreted within these constraints.

Finally, we congratulate the Committee on their achievement in raising the debate on the issue addressed but at the same time have a feeling of disappointment that their brief has been so narrowly interpreted. We also confess to feeling that their conclusions lack a certain rigour. Perhaps this was inevitable but then perhaps too is our sense of disappointment.

Yours faithfully



Pannell Kerr Forster