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Dear Ms Cole

### The Cadbury Report

You may recall that we spoke some three weeks ago on the text of the above report. I also spoke, at your suggestion, to Margaret Brewster at Pro Ned. You mentioned that you were recording comments which may lead, in due course, to amendments to the Report. I promised to write and set out the conclusion of those conversations and that is the purpose of this letter. (The delay in writing is due to an intervening holiday which I mentioned when we spoke).

The Institute has supported the recommendations of the Cadbury Committee and contributed through comments at the discussion stage. The Council of the Institute (of which I am a member) has established a committee to prepare comments on discussion documents issued by the accounting bodies and other standard setting organisations. As a member of that committee, it is my responsibility to prepare draft comments for consideration by the committee and, after discussion, to finalise the Institute's submission. I should emphasise that I am not writing with any new comments of the committee but simply to clarify some aspects of the Report which could be misinterpreted.

The main points we discussed were the use and meaning of the terms **executive** and **non-executive** particularly in relation to the chairman of a board. Where the label **executive/non-executive** is applied to a director who is not the chairman then the position is clear and the introduction of the further qualification of **independent** is also clear. Thus there are two types of non-executive director - those who are independent and those who are not.

In the case of the chairman, it is not so clear. The Report rightly emphasises the special role the chairman plays. However, the Report does not describe chairmen as either executive or non-executive. No such distinction is made.

The penultimate sentence of paragraph 4.11 contains the requirement for boards to include a minimum of three non-executive directors "**one of whom may be the chairman provided he or she is not also its executive head**". Although my personal view is that the text is reasonably clear, there is the possibility of confusion.

I think that there are two areas of possible confusion where the text could be modified to minimise any doubt.

First, the requirement that the chairman should not be the "executive head" (if he/she is to count towards the requirement for three non-executives): if, as I understand it, the term "executive head" is not intended to mean anything different to the terms "chief executive" or "managing director" then it would be preferable to avoid it and use either of the latter terms.

This would help minimise any confusion arising from the different perceptions of the role of chairman. As we discussed, some chairmen describe themselves as executive while others prefer non-executive. A third category use neither term. This is the essence of the second point.

There is a danger that the wording in paragraph 4.11 (see bold extract above) might be misinterpreted as meaning that the chairman qualifies as one of the three non-executive directors required by the Report **only if he/she is a non-executive chairman**. This would therefore exclude those chairmen describing themselves as "executive" and possibly also those describing themselves as neither "executive" nor "non-executive". Some of the chairmen excluded in this way might also satisfy the criteria of "independence" and should certainly count towards the required number of non-executive directors.

At your suggestion, I spoke to Margaret Brewster at Pro Ned and sought their views on the correct description of chairmen. Ms Brewster told me that Pro Ned does not recognise the terms "executive" or "non-executive" as applying to chairmen. Instead, Pro Ned distinguish between full-time and part-time chairmen. This reflects the special role of the chairman. I think that this could usefully be included in any revision of the Report.

Ms Brewster's view on whether a chairman would count towards the minimum number of non-executive directors was that eligibility depended only on whether the chairman in question was independent. Thus, if the chairman satisfied the criteria as being independent, then he/she would count towards the minimum requirement. This coincided with your own interpretation.

Paragraph 4.11 could perhaps be amended to reflect this by specifying the required structure of each board in the following terms:

Where the chairman is not "independent"

there should be a minimum of three other directors each of which is non-executive and of whom at least two are "independent".

Where the chairman is "independent"

there should be a minimum of two other directors each of which is non-executive and of whom at least one is "independent".

However, although the above wording clarifies the position in relation to paragraph 4.11, the same point arises elsewhere. The phrase "**non-executive directors**" is used in other parts of the Report. For example,

- i) paragraph 4.15 makes recommendations as to the appointment of **non-executive directors**;

- ii) paragraph 4.35 recommends that membership of the audit committee be confined to **non-executive directors**;
- iii) paragraph 4.42 recommends that the remuneration committee be chaired by a **non-executive director**.

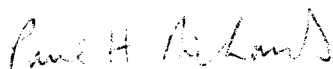
In each case, it cannot be intended that the references to **non-executive directors** should exclude independent chairmen. Some additional clarification to the text would therefore be helpful.

There are a number of alternatives: i) a reference to independent chairman could be included wherever there is a reference to non-executive directors: ii) a new term could be introduced such as "qualifying director" which could be defined as including both non-executive directors and, where relevant, an independent chairman (although the use of a further label is to be avoided if possible); or iii) the text could include, at an early stage (eg in paragraph 4.11) a statement that references to "**non-executive directors**" is intended to include the chairman where the chairman is also "**independent**". This last suggestion would obviate the need for the wording proposed for paragraph 4.11 above.

I am sorry this letter is rather long. However, chairmen are continuing to describe themselves in a variety of ways and the Cadbury Report could help rationalise practice in this area by reinforcing the lead of Pro Ned.

Please let me know if you disagree with any of the above (my office number is 071 621 1770). I am copying this letter to Margaret Brewster at Pro Ned.

Yours sincerely



**Paul H Richards**

**cc Margaret Brewster, Pro Ned**

**cc George Dennis, Chairman, IIMR Accounting and Investment Analysis Committee**

**cc Paul Hewitt, Assistant Secretary, IIMR.**