

**Building Societies Commission**

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Sir Adrian Cadbury
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3 September 1993

Dear Sir Adrian,

CORPORATE GOVERNANCE - BUILDING SOCIETIES COMMISSION

When we met at the Institute of Management lunch last month I mentioned that the Building Societies Commission intends shortly to issue guidance on Corporate Governance for building societies. We propose first to circulate a draft prudential note on the subject for consultation with building societies and other interested parties. A copy of the draft note, which has of course not yet been issued, is enclosed.

As you will see, we have drawn on your Committee's Code of Best Practice, and have obtained permission from the Business Development Manager of the publishers (who I understand presently hold copyright in the Code) to reproduce it.

We have also found it helpful, in many places in the draft note, to draw on the explanations and reasoning in the Committee's Report, in several places using substantially similar wording. I am writing, therefore, to let you know what we are proposing in order to obtain any necessary copyright consents and to ask if you would be content for us to include a suitable acknowledgement in the opening paragraph of the note. If you are content with this solution, and you will see that we have included a suggested form of words (sidelined here), we would issue the draft in this form. If you would like a different acknowledgment or would yourself like to put in some wording over your own signature when we go to final publication we should, of course, be delighted.

Sir Adrian Cadbury

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3 September 1993

We should be very happy to know how you would like us to proceed. I am going on leave to Greece tonight but if Gina Cole could be in touch with Pat Gevers here with any comments or wishes you or the Committee may have, then I should be most grateful. Alternatively, my Deputy Chairman, Harry Walsh, is in charge until my return if you wish to be in touch with him. I apologise for asking but it would be very helpful if we could have a quick answer as societies now expect the draft.

Within the next few days, Pat Gevers here, who has previously been in touch with Gina Cole on the copyright question, will approach her to obtain the necessary permission.

Yours sincerely,

Rosalind Gilmore

Rosalind Gilmore

CONSULTATION DRAFT

BUILDING SOCIETIES ACT 1986

PRUDENTIAL NOTE 1993/

BOARDS AND MANAGEMENT

Interest in corporate governance over the last few years resulted in the publication in December 1992 of the Cadbury Report on the Financial Aspects of Corporate Governance and associated Code of Best Practice. The Cadbury Code was developed for listed companies, and the Commission has therefore prepared this note for societies based on the Code. The note includes in a number of places explanations which have been drawn from the Cadbury Report, as well as best practices drawn from the Cadbury Code of Best Practice. The Commission is grateful [to the Cadbury Committee and Professional Publishing Limited] for permission to do so. Part I of the Note contains a Code of Best Practice closely based on Cadbury which sets out the practices which the Commission considers are important for good corporate governance. Part II explains the practices included in the Code and includes further recommendations. The Commission considers these recommendations useful although not essential or appropriate in all circumstances. Whilst mindful of the differences in size and activities of societies, the Commission recommends that the Code of Best Practice should be adopted by all societies. The board of a society will be asked to provide a policy statement about the society's compliance with the Commission's Code of Best Practice to the Commission annually before the annual review meeting each year, commencing for annual review meetings to be held in 1994. The Commission also strongly recommends the directors of a society to inform their members about their society's compliance with the Commission's Code in the annual report and accounts for their society commencing with financial years ending after 30 June 1994.

PART I: CODE OF BEST PRACTICE FOR BUILDING SOCIETIES

A. Introduction

Building society boards and management will be aware of the legal provisions about direction and management contained in the Building Societies Act 1986 and the general law relating to directors' duties. The legal framework allows for variation in approach, but there are some practices the Commission considers are important to ensure good corporate governance in a mutual. A code of these best practices is set out below together with cross references to the relevant explanatory paragraphs in Part II of this prudential note.

B. The Code

The Board

1. The chairman of a building society should be independent of any executive position with the society [paragraph 7].
2. A board should have a succession plan to replace the chairman well before he or she is due to retire [paragraph 8].
3. A board should develop a board composition plan that is suitable for it to direct all of the society's activities [paragraph 16].
4. A comfortable working majority of directors on a board should be non-executive [paragraph 18].
5. Any society should have at least one executive director on the board [paragraph 19].
6. The chief executive should be a member of the board [paragraph 20].

Non-executive directors

7. A board should have an agreed procedure for the identification and recruitment of potential non-executive directors [paragraph 25].
8. A non-executive director should bring independence of judgement to bear on the issues a board considers [paragraph 26].
9. A non-executive director should serve for a specified initial term after which the board should review whether to recommend re-election [paragraph 27].

Executive directors and other executives

10. (i) An executive's service contract for a fixed term should not exceed 3 years; and
(ii) in the case of any other service contract for an executive the period of notice which the society has to give to terminate the contract should not exceed 1 year [paragraph 29]. (1)
11. A board should have plans for succession to key executive posts [paragraph 31].

Board procedures

12. A board should have a remuneration committee to make recommendations to the board about the pay of executive directors [paragraph 32].
13. A board should establish an audit committee of non-executive directors consisting of at least 3 members [paragraph 34].
14. It is a board's responsibility to ensure that an objective and professional relationship is maintained with the external auditors [paragraph 35].

15. A board should have a procedure that enables individual directors to obtain independent professional advice at the society's expense for the furtherance of their duties [paragraph 36].
16. Each director should have access to the advice and services of the secretary and any separately appointed compliance officer(s) [paragraph 37].
17. A board should have specific procedures for the consideration of loan applications by directors or persons connected with them [paragraph 39].
18. If a director or any member of his or her immediate family (2) participates in a share option scheme that director should not be allowed to participate in any discussion or vote on any transaction (such as sale of the subsidiary) under which that director or family member would benefit financially [paragraph 40].

Reporting

18. A board has a duty to present a balanced and understandable assessment of the society's position to the members [paragraph 41].
19. Directors should explain their responsibility for preparing the accounts next to a statement by the external auditors about their reporting responsibilities [paragraph 43].

Notes: (1) This applies to any contract made or renewed after the date of issue of this consultation draft prudential note.

(2) As defined in paragraph 3A(2) of Schedule 9 to the Building Societies (Accounts and Related Provisions) Regulations 1992 (inserted by [the Building Societies (Accounts and Related Provisions)(Amendment) Regulations 1993]).

PART II: PRUDENTIAL GUIDANCE ON BOARDS AND MANAGEMENT

A. INTRODUCTION

Over the last few years, both here and in the United States, there has been a growing interest in corporate governance which led to several suggested codes of conduct or principles appropriate to public limited companies. In the United Kingdom, the Cadbury Report on the Financial Aspects of Corporate Governance (1) includes a Code of Best Practice. The Cadbury Report and Code are focused on the requirements for listed companies and cover the way company boards set financial policy and oversee its implementation and the way in which they report on the activities and progress of their companies to shareholders.

2. There are, however, significant differences between building societies and listed companies. Building societies have no equivalent to the influential role of the institutional equity shareholder. Building societies are mutual organisations, the boards and management of which have to exercise a special degree of care in respect of the money placed with their societies by investors, compared with the duty which the boards of public companies owe to their shareholders. Investors in societies are like depositors in banks rather than shareholders in companies and generally expect to withdraw at least the original nominal value of their investments in full. The building society industry is part of a regulated sector and is subject to different statutory requirements from companies (the Building Societies Act 1986 ("the Act") and its related statutory instruments) as well as to prudential guidance and supervision.

(1) Report of the Committee on the Financial Aspects of Corporate Governance. 1 December 1992.

3. The Cadbury Report was designed to contribute positively to the promotion of good corporate governance in the United Kingdom and although the Cadbury Code of Best Practice was not developed for building societies (reflected in the fact that the London Stock Exchange does not require building societies with listed securities to publish statements about their compliance with the Cadbury Code) many of the best practices in the Code can be applied to building societies. The Commission is pleased to note that societies already practice many of the major recommendations.

4. Since the Cadbury Report was not focused on the requirements for building societies, the Commission is providing guidance on corporate governance tailored to their structure, and which covers not only financial matters and reporting to members, but also takes into account certain broader issues applicable to mutuals such as the rights of members. The following sections are designed to provide societies with that guidance, and focus on the role and responsibilities of the chairman, a number of issues relating to non-executive and executive directors under the broad headings of board composition and board procedures, together with a brief section on reporting requirements.

5. The responsibilities of boards and management fall into three categories:

Legal requirements: these are the responsibilities contained in the Act and the general law relating to directors' duties. Boards and management will be aware of the legal provisions with which they are required to comply. The legal requirements allow for considerable variation in approach by societies to board and management issues. The Commission recognises the need for such variety, since societies of different asset sizes and natures will operate in different ways. However, there are some practices which the Commission considers are important for societies to adopt and these form the second category of responsibilities.

Recommended best practices: these are the practices which in the Commission's view are important to good corporate governance and to protect the interests of members. These practices are distinguished in bold in the text and are set out in Part I in the form of a Code of Best Practice. The board of a society will be asked to provide the Commission with a policy statement about the society's compliance with

the Commission's Code of Best Practice before the annual review meeting each year commencing with annual review meetings to be held in 1994. The Commission strongly recommends that, commencing for societies with financial years ending after 30 June 1994, the directors of a society adopt the practice of stating in the society's annual reports and accounts whether it complies with the Commission's Code of Best Practice and of identifying and giving reasons for any areas of non-compliance;

Desirable practices: these are the practices which might usefully be adopted by societies but which the Commission recognises may not be essential or appropriate in all circumstances.

B. THE ROLE AND RESPONSIBILITIES OF THE BUILDING SOCIETY CHAIRMAN

6. The chairman of any institution has a key role to play in the direction and management of that institution. In a building society the role arguably carries greater responsibilities than for the generality of companies because of the special degree of care described in paragraph 2 above which the board is required to exercise. In addition, building societies today operate in a different environment from that of a decade ago and now face greater competition for their retail and mortgage products. Competition itself has led to more innovation and decreasing lead-in times for the launch of new products, with the consequent need for greater understanding and control of the risks being taken. The challenge of greater competition in core activities and the scope for diversification of activities allowed to societies under the Act have resulted in increased responsibilities for building society chairmen and other non-executive directors.

Separation of functions of chairman and executives

7. The Commission considers that **the chairman of a building society should be independent of any executive position with the society** (for example the chairman should not at the same time be the chief executive) and is pleased to note that this practice has been adopted by all authorised societies. This practice ensures the vital division between non-executive and executive responsibility at the head of each building society is maintained to

provide a system of checks and balances, with no individual having exclusive or over-concentrated power.

Succession planning for chairman

8. The current demands on the time of a building society chairman are necessarily quite heavy, sometimes requiring the chairman's presence at a society for 2 to 3 days each week. The director chosen to be chairman must not only be competent to fill the role but must also have sufficient time to devote to the society's affairs. The chairman of a society is a key figure who may not be replaced easily. For this reason, the Commission considers that **a board should have a succession plan to replace the chairman well before he or she is due to retire.** In many cases, the deputy or vice-chairman will be the "heir" designated to succeed the chairman in the normal course of events or in an emergency. In such cases, the deputy or vice-chairman will usually have worked closely with the chairman for a sufficient period and should be able to take over with little or no disruption to the smooth running of the business. In other cases the board will need to include in the plan the means by which the designated successor will get the necessary experience to allow smooth progression from one chairman to another.

9. In the past, some societies' approach to succession was based on automatic annual rotation of the chair. The Commission notes that this practice is being abandoned. In view of the responsibilities of a chairman outlined above, it is clear that one year is not sufficient time for a chairman to be fully effective. However, the Commission has no objection in principle to the rotation of the chair for a reasonable term of years, provided directors meet the necessary time and competence criteria. But a director should not feel obliged to take on the chairmanship just because it is that director's "turn". A three year term (or two years in the case of long-serving directors) would appear to be the minimum to allow sufficient continuity for the board to act effectively.

Role and responsibilities

10. It would not be appropriate to provide an exhaustive description here of the chairman's role and responsibilities, but since the chairman has a critical role in ensuring the

effective working of the board the following paragraphs set out some of the key elements affecting board performance.

11. The board of a building society must have the capacity to take a balanced and objective view of the current performance of the business and of the society's future plans and strategy. The board must assess the risks facing the society, arising from its continuing business strategy and from specific proposals. The chairman is responsible for ensuring that the board does not accept management's views without fully considering all the arguments before it judges the issues. Two of the elements that need to be in place to ensure that the board can do this effectively, good management information and relevant expertise, are dealt with in paragraphs 13 and 15 below. It is for the chairman to ensure that those elements are in place and are used effectively. It is also important that the compliance aspects of proposals are explained to and understood by the board (see paragraph 37 below re compliance officers).

12. There are two other aspects for which the chairman has particular responsibility as part of the decision-making process. The chairman needs to ensure that before the board reaches its decisions individual directors have a fair opportunity to express their views and that after discussion the board is broadly united on the decisions reached.

13. A board cannot make informed decisions, which can be implemented effectively, unless it has access to good management information, in good time. Directors need to be briefed properly to be fully effective. The quality and timeliness of management information are more important than quantity - management should provide well focused briefing with clearly presented financial data to give the board a picture of current business performance and trends, as well as for specific projects. It is primarily the chairman's responsibility to call the attention of the management to any inadequacies in the arrangements for the briefing of the board, including arrangements for the regular review of the information provided.

14. There are three aspects of planning that, in the Commission's view, are primarily the responsibility of the chairman. These are:

succession for the chairman (see paragraphs 8 and 9 above): the chairman's

responsibility for succession planning includes ensuring that the board has an established approach to succession; has succession plans for emergencies; identifies a successor well before the chairman's expected retirement; and reviews established plans in the light of any major changes in circumstances;

board composition (see paragraphs 15 to 19 below): the responsibility for ensuring that a board composition plan is developed rests with the chairman; it is also a matter for him or her to decide how the plan should be established (ie whether it needs a formal approach or can be informally established);

management succession (see paragraph 31 below): the chairman also has responsibility for ensuring that the board establishes procedures for succession to key executive posts.

C. BOARD COMPOSITION

Board composition plan

15. The criteria of prudent management in section 45 of the Act include the requirement that direction and management of a society should be carried out by a sufficient number of persons who are fit and proper (see paragraph 24 below) with prudence, integrity and adequate professional skills. This has clear implications for board composition as well as management skills: the directors of any society collectively need to have a range of skills and experience that reflect the society's main activities. If the board has a well-developed understanding of those activities it will be able to control and direct them more effectively. The Commission is pleased to note that building societies generally already have a good spread of skills and experience on their boards with which to direct the traditional core business activities. It is equally important for societies to have the skills to control non-core activities, if these form a significant part of the business. A board should have within it at least one member with the relevant professional expertise to direct that activity. For example: a society doing a significant amount of commercial lending should have a non-executive director with some experience of commercial lending; and a society with a large and active treasury operation that has adopted the limited approach to the management of

structural risk would need a non-executive director with some understanding of treasury activities. The Commission expects the board of any society considering undertaking a major new activity to ensure that the board has or obtains the necessary level of understanding to direct that activity effectively.

16. The Commission considers that **a board should develop a board composition plan that is suitable for it to direct all of the society's activities.** The composition plan can be helpful in establishing gaps in board expertise and can focus the search for future recruits to fill them. The plan should be reviewed regularly against the requirements in the society's corporate plan. A board will need to keep in mind that the election of directors is a matter for members to vote on, and that members have the right under the society's rules to nominate candidates. It may therefore be desirable to explain the succession plan (see paragraphs 8 and 9 above) and criteria composition to the members.

17. The board will also need a good spread of ages - to facilitate future succession planning - see paragraphs 8 and 9 above.

Ratio of non-executive directors to executive directors

18. It is the non-executive directors on a board who, because they are independent, are particularly well placed to take an objective view of proposals put forward by management and therefore to safeguard the members' interests. The best interests of members may not always immediately be apparent, but the existence of an independent majority of non-executives on a board is likely to mean that in practice these interests are protected and conflicts of interest are avoided. The Commission considers that **a comfortable working majority of directors on a board should be non-executive.** The appropriate "ratio" for a board will differ according to its size and nature and the Commission will take this into consideration during its continuing supervision of societies.

19. The Commission also recognises that smaller societies may not have as many executives with appropriate responsibilities for appointment to the board as directors as larger societies. The Commission does not consider that such societies need to recruit additional executives for this purpose, but the Commission considers that **any society should have at**

least one executive director on the board.

The chief executive

20. The appointment of a chief executive, like that of the chairman, is a specific requirement of the Act and like the chairman, the chief executive of a building society has a key role to play. The approach and influence of the chief executive should have enormous effect on the running, and thus the success (or otherwise), of the society. A chief executive's knowledge of the management of a society should be very valuable to its board. The changes in the building society industry over the last decade, including the greater scope of activities allowed under the 1986 Act and the increased regulatory requirements mean that the skills and activities of the chief executives of even the smallest societies should, in the Commission's view, be sufficient to meet the requirements for appointment to the board, if not immediately on appointment as chief executive, then shortly thereafter. The Commission considers that **the chief executive should be a member of the board.**

21. A board will need to consider very carefully whether a retired chief or other executive should remain as a board member. Although such an arrangement may have advantages - eg of continuity in the short term, if the new chief executive has been appointed from outside the industry, or in smaller societies where the necessary specialist abilities would otherwise be lacking - succession and composition planning should help to avoid such needs arising. In the Commission's view the disadvantages will outweigh such considerations in most cases. It is, therefore, very important that both the society's chairman and the new chief executive feel comfortable with the approach taken by the board.

The finance director

22. Financial management is important in any business - and particularly so in financial institutions such as building societies which deal with the investments of, and loans to, their members. The role of the finance manager is critical to the institution, for monitoring, compliance and future plans and initiatives, as well as to the supervisory authority, which may well use him or her as a primary point of contact. In the smallest societies, the chief executive may well undertake, or have very close involvement with financial management.

In the largest societies (and this is already the case for most of the top twenty building societies) the executive responsible for finance will be a director. It will be a matter for the board of a society where practice is in between to decide whether it is appropriate to recommend to members the election of a head of finance to the board or otherwise to ensure that the key requirements of the role are adequately filled in their society at board level and the board is appropriately apprised on financial matters.

Membership of subsidiary boards

23. The Commission's guidance on relationships with associated bodies is set out in Prudential Note 1990/2. Paragraph 15 of that note deals with membership by non-executive directors of subsidiary boards. The Commission has reviewed the terms of that paragraph and the Commission's current view is that where the professional skills and background experience of a non-executive director of a society may make that person a valuable member of the board of the society's subsidiary, it would be sensible for that person to join the board and in the appropriate circumstances assume the chairmanship. This paragraph modifies Prudential Note 1990/2 in that respect. Accountability of the subsidiary chief executive to the group chief executive must, however, be preserved.

D. BOARD PROCEDURES

Fit and proper criteria

24. Although the 6th criterion of prudent management in section 45 of the Act sets out the requirement that direction and management should be carried out by persons who are "fit and proper", the Act does not define "fit and proper". Boards will no doubt have their own ideas as to what qualities they look for when considering the appointment of new directors or managers and whether the "fit and proper" criteria are fulfilled and they will be aware of the sort of issues to which the Commission has regard through the questions in the personal questionnaires that must be completed (and submitted to the Commission) by all new directors and senior officers. However, it may be helpful to boards to set out the considerations the Commission has used in the past. A list of those considerations is at Annex A.

Identification of potential non-executive directors

25. The Commission considers that a board should have an agreed procedure for the **identification and recruitment of potential non-executive directors** (including steps to ensure that the fit and proper criteria are met). Some societies have already established this practice but where this is not the case, it is suggested that the chairman should take the necessary steps to develop agreed procedures and ensure that all directors are aware of them. Again a board will need to keep in mind that the election of directors is ultimately a matter for the members.

26. One of the criteria which a board will need to apply in identifying a candidate for a position as a non-executive director is the ability to exercise independence of judgement. The Commission considers that **a non-executive director should bring independence of judgement to bear on the issues a board considers**. Therefore, in establishing the benefits to be paid for the services of its non-executive directors a board will want to strike a balance between recognising the value of the contributions they make and not undermining their independence. In this context the Commission considers that pension schemes for non-executive directors should be avoided and a board should instead ensure that the fees its non-executive directors receive adequately reward those services. A director's business relationships with a society are discussed in paragraph 38 below.

Terms of appointment of non-executive directors

27. It seems likely that the building society industry will continue to face major new challenges to core and new business in the future. A building society board needs to have the flexibility to meet those challenges and, if necessary, to make changes to the composition of the board to deal effectively with them. In addition to the need for flexibility it is important that non-executive directors should maintain their independent role in the assessment of the society's performance and proposals; this may be diminished after remaining (and expecting to remain) on a board for a long period of time. The Commission also recognises that the special nature of building societies means that past experience of the industry is particularly valuable and that too rapid a turnover of directors could also have adverse effects on a society. The Commission therefore considers it to be important for

boards not to give non-executive directors the expectation that they will remain on the board - automatically standing for re-election every 3 years - until the retirement age under the society's rules. The Commission considers that **a non-executive director should serve for a specified initial term after which the board should review whether to recommend re-election.** Boards may wish to move towards the practice of issuing letters to non-executive directors setting out any special roles, initial term of office, remuneration, and review.

Appointment of executives

28. Many societies have made the appointments of their senior executives subject to the terms of formal service contracts. The practice as to the type and length of existing contracts and re-appointment terms varies from society to society, but there is some evidence that a trend is developing towards contracts for long fixed terms or with long notice periods which the Commission considers undesirable.

29. If a board considers it is necessary to offer a formal contract, the board should consider very carefully the terms of the contract it will offer to a prospective senior executive (or the terms of a contract being renewed for an existing executive). The terms agreed should reflect a reasonable balance between the need to attract or retain an executive of the requisite calibre and the board's ability to make any necessary change and the associated costs of so doing. In particular, a board should ensure that the period of notice the society must give if it wishes to terminate the contract is not excessive. The Commission therefore considers that:

- (i) **an executive's service contract for a fixed term should not exceed 3 years; and**
- (ii) **in the case of any other service contract for an executive the period of notice which the society has to give to terminate the contract should not exceed 1 year.**

This applies to any contract made or renewed after the date of issue of this consultation draft prudential note.

30. In the Commission's view the performance of a senior executive should be appraised annually by the appropriate board committee regardless of the existence of a formal service contract.

Executive succession planning

31. The loss of a senior executive can have a significant impact on the smooth running of a society. The Commission considers that a **board should have plans for succession to key executive posts** - in particular for the chief executive's post. Such plans do not have to identify named individuals to take over each post but should establish how the board intends the posts to be covered both in emergencies and in the normal course of events. In this context such a plan might also cover the career development of existing staff and should take into account the need to comply with legislation against discrimination and to promote equal opportunities. The succession plan should be reviewed regularly and with regard to future demands on resources as forecast by the corporate plan.

Remuneration committees

32. The Commission considers that a **board should have a remuneration committee to make recommendations to the board about the pay of executive directors**. The membership of the committee is for the board to determine (and could include every member of the board) but, in the Commission's view only non-executive directors should be able to determine the chief executive's remuneration.

Audit committees

33. The Commission's guidance on the issues societies need to address if their systems are to satisfy the 5th criterion of prudent management in section 45 of the Act - the maintenance of requisite accounting records and systems of control and inspection - are set out in Prudential Note 1987/4 on Systems. Section 7 of that prudential note includes guidance about audit committees. The Commission considers, however, that more detailed guidance about audit committees is necessary and the following paragraph supersedes the guidance about the constitution of an audit committee set out in paragraph 7.1 of Prudential

Note 1987/4.

34. The Commission considers that **a board should establish an audit committee of non-executive directors consisting of at least 3 members.** Executive directors should therefore not be members of the committee. Because of the nature of his or her other duties it is not expected that the chairman would normally be a member, but if the board chairman is a committee member, he or she should not chair the committee. The internal auditor and, if appropriate, the finance director should normally attend at least part of the meetings, but neither should be members of the committee. The external auditors should have direct access to the committee, with or without executives being present, and should attend some meetings particularly those where matters such as the year end accounts or systems are being discussed. A list of matters on which a committee might advise is included in para 7.1 of Prudential Note 1987/4.

Relationship with external auditors

35. It is important for the relationship between a society and its external auditors to be maintained on a professional and objective basis and this is reflected in the requirements of the Act and in the accountancy profession's ethical guidance. The Cadbury Report explained shareholders' requirements for companies which are that auditors will work with and not against the management whose financial statements they are auditing, but in so doing their professional skills should be applied impartially and a critical detachment and consciousness of the accountability to those who formally appoint them should be maintained. The Commission considers that these requirements apply equally to building societies and that the external auditors and the society have a responsibility for maintaining such a relationship. In the Commission's view **it is a board's responsibility to ensure that an objective and professional relationship is maintained with the external auditors.** The Commission considers that this should be one of the audit committee's duties on behalf of the board and the committee should ensure that the auditors are able to put their views in the event of any difference of opinion with management.

Independent professional advice

36. The Commission considers that a board should have a procedure that enables individual directors to obtain independent professional advice at the society's expense for the furtherance of their duties. It is considered that use of any such procedure would be likely to be infrequent. However, the Commission would expect a board to give serious consideration to any reasonable request for independent advice, and, if such a request were to be refused, to have very sound reasons for doing so.

Access to secretary and compliance officer

37. The Commission considers that each director should have access to the advice and services of the secretary and any separately appointed compliance officer(s). These are key roles within a building society. The secretary has a similar role to a company secretary in ensuring board procedures are followed and regularly reviewed and in providing guidance on the board's responsibilities and how they should be discharged. The secretary's appointment, removal and role are covered in the Act and the BSA's model rules. The Commission also suggests in paragraph 7.2 of Prudential Note 1987/4 that a society should consider appointing a compliance officer at board or senior management level (eg the secretary) to advise the board on compliance with existing and prospective legislation.

Ensuring independence

38. The Act recognises that there may be legitimate business relationships between directors (and other officers) and societies. It places certain limitations on specified financial transactions, requires directors to disclose their interests in any existing or proposed contracts, and requires the reporting of dealings which are permitted (paragraph 39 sets out the Commission's views on procedures relating to loans to directors). In addition the rules of societies provide that a director cannot vote in relation to a contract in which he or she has an interest. The Commission considers that a board should also ensure that any relationship with a business connected with a director (or other officer) of a society is carefully limited, to avoid over-dependence by either party, and should be conducted at arm's

length. This is particularly important for non-executive directors because their independence is essential to ensure the control and direction of the society in the members' best interests at all times.

Loans to directors

39. The limitations in section 65 of the Act include restrictions on the loans which a society can make to directors or persons connected with them. The provisions of that section are such that it would be inappropriate for a society simply to follow its usual loan procedures when a loan application is made by a director or a person connected with a director of that society. In the Commission's view it is not appropriate for the responsibility for the approval of such loans to rest with staff members, even if, but for the a loan being to a director or a director-connected person, the loan would be within staff mandates. The Commission considers that **a board should have specific procedures for the consideration of loan applications by directors or persons connected with them.** The procedures should require a thorough review of the proposed terms of loans before they are authorised, including the obtaining of legal advice, if necessary, to ensure that the making of the loans is permitted by the Act. Procedures should also be designed to ensure that any such transactions are conducted at "arms length".

Share option schemes

40. The Commission's views on profit participation, including share option schemes in subsidiary companies which are open to directors or other officers, are set out in paragraphs 16 to 20 of Prudential Note 1990/2. The Commission considers that **if a director or any member of his or her immediate family participates in a share option scheme that director should not be allowed to participate in any discussion or vote on any transaction (such as sale of the subsidiary) under which that director or family member would benefit financially.** Promotion of any such transaction should be limited to non-executive directors with no financial interest in the outcome.

E. REPORTING REQUIREMENTS

41. All authorised societies report to their members annually through the annual report and accounts (which include the directors' report and annual business statement) and the summary financial statement. The legal requirements as to the form and content of the annual report and accounts and summary financial statement are set out in the Act and the Accounts and Related Provisions Regulations made under it. In addition, societies with listed securities publish half yearly interim reports in accordance with the requirements of the London Stock Exchange. In the annual report and accounts the directors' report must include a review of the development of the society's business during the financial year and of its position at the end of it, which the Act requires to be "fair", that is to say balanced and objective. The Accounts and Related Provisions Regulations also require the directors to express an opinion as to likely developments. The Cadbury Committee pointed out the need for the narrative on performance and prospects in companies' accounts, supported by the figures, to be readily understandable and balanced - that is setbacks should be reported as well as successes. The Commission agrees with this view and therefore considers that **a board has a duty to present a balanced and understandable assessment of the society's position to the members.**

42. The Commission considers that the members of a society should be provided with comprehensive disclosure in the annual business statement of the interests of directors and other officers. The Commission has therefore extended reporting requirements in [the Building Societies (Accounts and Related Provisions)(Amendment) Regulations 1993] in relation to:

- (a) the term and notice periods of service contracts;
- (b) the emoluments band in the notes to the accounts;
- (c) any appearance in the registers of loans and income of related businesses;
- (d) pension arrangements for non-executive directors;

- (e) pension arrangements for executive directors and other officers if they differ from the staff pension scheme;
- (f) outstanding options to subscribe for share or debentures of associated bodies.

43. The Cadbury Committee recommended that, as a first step to narrowing the gap between the public's perception, and the reality, of the external auditors' role, the responsibilities of directors and auditors for preparing and reporting on financial statements should be made clear. The Commission is of the same view and therefore considers that **directors should explain their responsibility for preparing the accounts next to a statement by the external auditors about their reporting responsibilities.** Suggested wording for a statement of responsibilities by directors is at Annex B.

44. The Auditing Practices Board's Statement of Auditing Standards 600 ("SAS 600"), "Auditors' Report on Financial Statements", which applies in respect of audits of financial statements for financial periods ending on or after 30 September 1993, includes a provision that auditors should distinguish between their responsibilities and those of the directors and that if the directors do not include an adequate description of directors' responsibilities, the auditors' report should do so. It should not be necessary for the external auditors of building societies which comply with the Commission's Code of Best Practice to include a description of the directors responsibilities in their reports.

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