a Sir Adrian

CAD-02211

COMMITTEE
ON
THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

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24th June, 1992

G. H. Fryer, Esq., FCA,
The Old Oak Barn,
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Surrey, KT15 3DU.

Dear Gavin,

Thank you very much for your letter of 17th June, which I have copied to Sir Adrian Cadbury.

I was very interested to read your perspective, and your points will certainly be taken into consideration when the Committee digests the consultation response. I will let you know if there are any points we would wish to discuss further.

Yours sincerely,

Nigel Peace

Nigel Peace
Secretary

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Nigel Peace Esq
Secretary
Committee on Financial
Aspects of Corporate
Governance.
Moorgate Place, EC2

17th June 1992

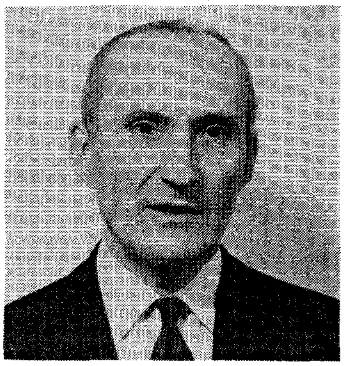
Dear Mr. Peace,

I submit my views on aspects of the Cadbury Report.

I recently retired from employment of The London Stock Exchange. I am now an independent consultant. For many years I have taken a close interest in aspects of Corporate Governance. I enclose a leaflet to tell you a little more of my background, and to explain why I write on my own letter-heading.

Yours sincerely,

Gavin Fryer.



Gavin Fryer was educated at Marlborough College. He qualified in 1960 and became a Fellow of the Institute of Chartered Accountants in England and Wales.
Throughout his twenty-five year career at the London Stock Exchange he took a key rôle in developing standards of regulation applied to issuers of securities. He took charge of this work in 1978 and was Director of Listing at the Exchange until his retirement.

He held responsibility for comprehensive reviews of London's listing rules, with special attention to the implementation of European Community directives and establishment of the Unlisted Securities Market in 1980, widely regarded as a model for junior securities markets. He has considerable knowledge of requirements for listing applied in countries outside the U.K. and great experience of negotiations on many aspects of compliance with listing rules. He has negotiated with senior representatives of listed companies and their advisers, the U.K. government, professional organisations in the fields of law, accountancy, company secretaries, securities houses, chartered surveyors and mining consultants.

He is recognised in these fields through communication with all U.K. and overseas companies listed in London and through relationships established with many regulatory bodies outside the U.K. He advised both the Hong Kong and Johannesburg Exchanges in the development of their arrangements for regulating issuers.
Gavin Fryer has been influential in the development of U.K. and international accounting standards. He has represented the U.K. securities market, the Federation of Stock Exchanges in the European Community and the Fédération Internationale des Bourses de Valeurs on accounting matters. He has lectured extensively on listing rules in the U.K., Europe, Japan and U.S.A. and in Helsinki and Milan on methods of production of bearer securities. Gavin Fryer has been a witness in public enquiries and investigations by governments in over forty cases.

Gavin Fryer offers:

- guidance and advice to stock exchanges and other regulators whether embryonic or long-established;
- an independent assessment of how issuers of securities can best comply with listing requirements;
- extensive experience of investigations both as witness and enquirer;
- a well-tried problem-solving capacity.

He is Special Adviser to the London Stock Exchange and represents the Exchange internationally on accounting matters. He continues as Editor of the Stock Exchange Official Yearbook.

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17th June 1992

Dear Mr.Peace,

Financial Aspects of Corporate Governance

Draft Report ("the Report")

I am writing to comment to your Committee on several aspects of the Report issued for public comment on 27th May 1992.

I fully support the establishment of the Committee chaired by Sir Adrian Cadbury. The context in which the Committee was set up contains several features which rightly should worry those entrusted with the task of controlling the activities and conduct of directors of public companies. Publication of the Committee's analysis is greatly to be welcomed in encouraging correct identification of steps that ought to be taken to improve the effectiveness of corporate governance.

Discussion in the Report about the principles on which the "Code of Best Practice" is based states at paragraph 3.6 that "if standards of financial reporting and of business conduct or generally are not seen to be raised, a greater reliance on regulation may be inevitable" (my underlining).

Again, at paragraph 3.14 about a framework for standards that will encourage and support good governance, the Report states that "raising standards of corporate governance cannot be achieved by structures and rules alone" and again, ".... what counts is the way they are put to use."

The Committee believes that it is necessary to review the adoption and effectiveness of the recommended Code of Best Practice after it has been in force for two years. I support this view.

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My reading over 25 years of published reports by inspectors appointed by the DTI under the Companies Acts and other inspectors investigating calamitous events of public importance suggest that the draft Code of Best Practice should be widened. A great many of those reports into the affairs of companies concluded that the structure of organisation, and lines of accountability and responsibility left much to be desired. A chief cause for concern was that a single key personality was able to exercise far too much autonomy, and even exerted power over board members and executives by inducing a sense of fear, or fright. The point is reflected in paragraph 4.6 of the Report. The other type of report may be illustrated by the following:

Fennel report on King's Cross London underground fire;
Sheen report on Zeebrugge ferry;
Taylor report on Hillsborough stadium;
Hidden report on Clapham Junction railway accident.

These reports were, inter alia, about "management of risk". What these reports brought to the public's attention were ill-defined structures and unclear chain of command within the relevant company or authority. The consequences, unhappily, were that instructions were not clear and concise, were not properly conveyed if they were conveyed at all, or were misunderstood or were not acted upon. Further the roles and duties of senior personnel were often not defined with clarity and efficiency. The reverse can also be perceived, namely, that if command structures can lead to working practices slipping to unacceptable and dangerous standards through lack of adequate discipline, so also can head-strong directors act with little or no interference and outside the disciplines of proper management or boardroom control. These reports demonstrate in many ways why proper structures and controls are needed to act as a brake upon those entrusted with stewardship of the funds or safety of interests of third parties. Thus regular reviews of chain of command, delegation of power and responsibility, exercise of authority and misuse of autonomy should be specified by the senior source of authority within a company.

I strongly believe that it is not only attention to financial controls, accountability and governance that is needed. Indeed, review of and report on the consequences of the actions of management responsible for financial aspects is in many cases too late. By that time the non-executive directors and any other investigators are looking at the consequences of past action. Previously they should have been confident that appropriate opportunities were taken to carry out necessary reviews of exercise of authority before a course of action was embarked upon. An example of this is the specific need for properly

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convened meetings of directors, whether of the full board or in committee, with pre-circulation of relevant papers. Another is the control applied under the London Stock Exchange's Model Code governing director's transactions in securities, before any of the directors acquire or dispose of securities of their company. Such a standard of conduct ought also to be applied to the most senior members of the company's executive. Material contracts proposed to be entered into on behalf of a company should be submitted to the board of directors or a specially designated committee of the board that includes the company secretary. The Report states at paragraph 4.20 that the Committee envisage that the full board should decide on material acquisition or disposal of group assets, and significant investments, borrowing facilities, loans and repayments thereof. There is a third set of matters on which the power of decision should be reserved to the full board. I have in mind unusual proposals, transactions or arrangements not in the well-understood ordinary course of business previously undertaken by the company.

The audit committee, it seems to me, would be a suitable source of control over the establishment of a proper working management structure. Management should propose a structure in which a number of features ought to be incorporated. The audit committee could then review that structure particularly from the chairman's level through the board to senior management level. Such review should extend to establishment of appropriate checks on exercise of authority at each level, the need for instructions that ought to be given and the clarity thereof, accountability, recognition and acceptance of responsibility, and recording of action taken or response received or relevant consequences. These procedures should be regularly reviewed for their relevance, necessity, need for change and how changes are communicated and acknowledged by those upon whom ultimate responsibility within the company will rest.

Steps on these lines would benefit the interests of the proprietors of a company as envisaged in paragraph 6.3 of the Report. They would also strengthen the accountability of all directors to their shareholders. Similarly, possibility of fraud by senior management would be reduced and, where the possibility exists, could be subject of informed discussion within the forum of the audit committee. At the time fraud is suspected or identified it should not be necessary to investigate the structure of command and accountability but merely follow through the established procedures to see at what point they broke down.

A further desirable feature of accountability on the part of directors would be for the directors' report contained in the annual report and accounts to include a statement of the strategy currently followed by the company as distinct from a merely bald

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statement of the company's activities. Some groups of companies have at their head a new top holding company with few directors who hold direct responsibility for the principal operating subsidiaries. It is sometimes said that these holding company directors are mainly interested in and involved in developing future strategy. Shareholders may well wonder what that means, whether the existing well-understood business of a company is to change, or highly-leveraged transactions are to take place, even significant re-purchase of the company's shares etc. If the audit committee were to consider public perception of their company and criticise, in a constructive way, the proposed statement on strategy, the investing public would be better informed.

In conclusion, I believe that there is benefit in widening the scope, functions and duties of the Audit Committee to review the matters I have outlined in this letter. Concentration on the financial aspect of corporate governance runs the risk of being too little and, in due course being found to have been too late.

If you wish me to elaborate on any of these points I would be happy to meet you or members of the Committee.

Yours sincerely,

Gavin Fryer