

CAD-02225

COMMITTEE
ON
THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

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1st June, 1992

Sir Ron Dearing, CB,
Chairman,
Financial Reporting Council,
Holborn Hall,
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Dear Sir Ron,

Thank you for your letter of 19th May enclosing a letter from Geoffrey Wilson. I have copied it to Sir Adrian, and will log it as the first consultation response.

Yours sincerely

Nigel

Nigel Peace
Secretary

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CHAIRMAN

7th May 1992

Sir Ronald Dearing CB
Chairman
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Gen Ron,

CADBURY COMMITTEE

Many thanks for your letter of the 28th April and for giving the FRC a confidential preview of this most important report. I have studied this with great interest and would like to congratulate you and the Committee on an excellent and balanced handling of many difficult issues. I much look forward to the discussion at our next meeting on 26th May but in the meantime some immediate reactions may, as you suggest, be helpful. I would like, if I may, to couple these with a response to your note of the 24th April about the ASB discussion paper "Operating and Financial Review" since the two subjects are so closely inter-related.

In general I find myself sympathetic to the bulk of the Committee's conclusions and recommendations which is hardly surprising given the calibre and balance of its membership and the fact that many of the recommendations codify what is already widely accepted as best practice. There are, however, some general points which give me some concern and there are also a few detailed points which may be worth mentioning.

The general concerns are as follows -

1. There is always a tendency for the majority of innocents to pay the price of the few guilty so not surprisingly there are echoes of some of the recent major company failures underlying parts of the report. I believe that on the whole the Committee has kept a fair balance though there are some aspects such as statements on the going concern basis and on the adequacy of funds which it might be argued could be over-reaction.
2. There is some risk that the continuing work of the ASB taken together with the Cadbury recommendations may result in a lesser clarity of financial statements and an increased amount of verbiage. The ASB has quite rightly called for greater disclosure

and less concentration on single measures (such as EPS) and while there is no realistic alternative, the price that will have to be paid is that financial statements will become less easy for laymen to understand. It would, I think, be a pity if at the same time annual reports became over-cluttered with too many statements of how the company discharges its responsibilities to all and sundry. It is so easy for such statements to become filled with platitudes and for readers then simply to ignore them.

In particular I have some reservations about the value of statements on corporate governance which have already been included by companies as distinguished as ICI, Grand Met and Natwest and I wonder whether in paragraph 3.8 on page 6, the phrase "...many companies will wish to go beyond" might be reworded "... some companies will wish..."

By the same token I would be sorry to see the operating and financial review proposed by ASB follow too slavishly the American Management Discussion and Analysis pattern since in this country the tradition of economy in the use of words is probably better established.

I fully support the first part dealing with a commentary on the operating results but it is in the two remaining areas, namely the review of financial needs and resources and commentary on shareholders return and value, that the dangers of many words with little meaning are perhaps greatest. I hope I am not over-playing this concern but one has to remember that these proposals come on top of existing requirements to disclose practice in relation to health and safety, the environment, employee participation etc. and I wonder how much research has been done to establish how many people read those.

3. Our position as a tiny island strongly influenced by US practice and unable to influence our major partners in the EEC as much as we would wish continues to cause me concern both in relation to the work of the ASB and the Cadbury recommendations. Accordingly I would very much welcome the input which you indicate David Tweedie would like to give to the FRC on the subject of the developing international accounting regime. Unless we can make progress in that direction to obtain more equality in disclosure, then much of the value of all this work will be lost and our competitive position may be harmed by lack of equality of information.
4. The sections in the Cadbury report on institutional shareholders and influence (paragraphs 6.6 and 6.12) were in my view a little light on substance in comparison with the remainder of the report. In particular, in paragraph 6.8 there is reference to the need for contact at "senior executive level" but there is no reference to any contact with non-executives. Since the non-executives or independent directors are arguably the shareholders main representatives on the board that relationship is critical but is hardly explored in the report.

Turning now to a few detailed comments -

- a) In paragraph 4.9 I believe the Committee is right to avoid a firm statement that the roles of the chairman and chief executive must be separate since as we all know the issues are not quite as black and white as that. But as a result it is not quite clear what is meant by "a clearly accepted division of responsibilities" and where the role is combined, it is not quite clear what the Committee are suggesting except that the non-executives should be strong.
- b) The suggestion that non-executives should be paid for additional responsibilities such as the chairmanship of board committees makes sense and is, I believe, already the case or being considered by a number of companies.
- c) In paragraph 4.17, it is stated that non-executives tend to lose some of their independent edge the longer they remain on a board. While the case for specified periods of appointment is a good one that statement does not necessarily follow and in my experience some stronger characters become more independent as the years go by !
- d) There is I believe some sense in combining the nomination and remuneration committees into one and it might be sensible to include a reference to this possibility in the report. The nomination tasks are likely by their nature to be fairly infrequent and we have found here, for example, that the combination of these two roles into one committee works well.

The suggestion in paragraph 4.25 is that the nomination committee should be chaired either by the chairman or a non-executive director whereas in the case of the remuneration and audit committee it is suggested that it should be a non-executive. For the sake of clarity, I suggest that in the case of the audit and remuneration committees, it should also be made clear that it may be chaired by the chairman if he is non-executive.

- e) The recommendations on audit committees from 4.28 onwards seem very sensible but I would stress the point in paragraph 4.19 that the FD should have the right of access to the committee. It is also important that the audit committee should report regularly to the board since otherwise there is some danger of it becoming a law unto itself as has I believe occasionally happened in the US. The draft terms of reference in the appendix show the minutes of that committee as being tabled for the board and I believe this should also be a recommendation - otherwise there could be a situation where the chief executive is unaware of what the audit committee is doing.
- f) In paragraph 4.46 the wording suggests that only interim balance sheets should be reviewed by the auditors whereas clearly the intention as shown on page 43 is that it is the interim report as a whole. While I personally have some reservations about the added cost burden of a full interim review and this is perhaps another example of a specific Maxwell tail wagging the whole dog, paragraph 4.46 should be consistent with page 43.

- g) I am glad to see that the Committee has shied away from the rotation of auditors which would be too expensive and disruptive.
- h) It is unfortunate that there seems no reasonable way round the restrictive conclusion of the Caparo case but that seems unavoidable.

I hope these comments are some help and much look forward to the discussion on 26th May.

Yours,



G H WILSON