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Nigel Peace
Secretary
Committee on the Financial Aspects of Corporate Governance
P.O. Box 433
Moorgate Place
LONDON EC2P 2BJ

Dear Mr. Peace

I enclose my comments on the Cadbury committee's draft report.

Yours sincerely

A handwritten signature in cursive script that reads "Catherine Gowthorpe".

Catherine Gowthorpe

Senior Lecturer

COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

Comments on the draft report

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Note 1: Throughout this reply the Committee is addressed in the second person plural.

Note 2: References in parentheses are listed on page 16.

1. INTRODUCTORY COMMENTS

1.1 Public confidence in the business community has been badly dented by some recent spectacular cases of business failure and corporate fraud. Concern has been expressed in a number of quarters at what are perceived by many to be excessive pay increases awarded by certain company directors to themselves. Your investigation into, and report upon, corporate governance are therefore most timely.

1.2 My first comment relates to a statement made on page 5 of the report, namely, that "The basic system of corporate governance in the UK is sound". This is an ambitious statement which does not appear to be supported by evidence at any point in the report. Such a statement must, unless validated by extensive research, be a matter of opinion only. In any case public and investor confidence may be severely affected by reports of only a small number of cases of poor corporate governance and the proposition that the majority of companies are soundly constituted and sensibly run may be, however unfairly, ignored.

1.3 The whole report is based upon the one confident assertion that the system is basically sound. This assumption is, of course, convenient as it avoids the necessity of considering radical changes. The series of proposals which you have put forward will demand very little in the way of radical action from most companies. I will, in the course of this reply to your report, make some comments upon the detailed recommendations, but all that I have to say must be viewed in the light of my considerable doubt that your fundamental assumption on the soundness of corporate governance stands up to scrutiny.

1.4 My comments will principally relate to the recommendations you have made in sections 4 and 5 of your report.

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2. THE BOARD

2.1 The report emphasises the key role of directors. Para 4.3 starts "...all directors are equally responsible for the board's action and decisions". At no point is it made clear to whom they should be responsible. In law, of course, the position is clear; directors have a responsibility to the shareholders who appoint them, and to the company which employs them. I feel that your committee could have provided an ideal forum for discussion of more fundamental questions such as:

- * Which interest groups should companies serve?
- * Are companies responsible only or mainly to their shareholders?
- * To whom should directors be responsible?

Earlier in the report at para 2.6 there is a hint of a wider responsibility: "Although the reports of directors are addressed to the shareholders, they are important to a wider audience.." It is a pity that the report did not develop this idea further, and look beyond the relationship of directors and shareholders. UK companies are often accused of an inability to see beyond short-term goals, and indeed a short-termist approach on the part of directors is entirely understandable when their performance is judged mainly by whether or not they have produced a high eps and an increased dividend for the shareholders. We urgently need to address the problem of the pursuit of short-term goals at the expense of clear and beneficial long-term strategies. There is unlikely to be a genuine challenge to the short-termist approach unless the formal responsibilities of directors are considerably widened to include broader social responsibilities. If directors are encouraged to take account of the broader implications for other interest groups when making decisions then the corporate sector is more likely to produce decisions which act ultimately in the best interests of society and the economy as a whole.

2.2 Non-executive directors

The report dwells at length upon the role of the non-executive director in improving corporate governance; it is worth, therefore, commenting in detail upon those of your recommendations designed to enhance the position of the non-executive. The report includes a number of observations upon

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the qualities of a non-executive; a key quality referred to more than once is "independence of judgement". Independence is a quality of mind which may be absent in individuals who on the face of it would seem best qualified to provide it. The converse may also be true. However, it would seem sensible to provide some ground rules for determining who is eligible to serve in this important capacity, and so it is encouraging to see in the report some guidelines being set as to acceptable modes of remuneration. I agree therefore with your view, expressed in paras 4.10, that non-executives should not participate in share option schemes, and that their service should be non-pensionable. I note with interest, though, that you do not go so far as to recommend this approach, but merely "regard it as good practice". I wonder why you felt unable to go so far as to recommend this?

2.3 Financial interests of non-executive directors

Also, I take issue with your recommendation in para 4.9:

"We recommend, therefore, that the majority of non-executives on a board should be independent and free of any business or financial connection with the company apart from their fees, *or their shareholding*" (my italics)

I do not dispute your view that non-executive directors should receive adequate payment for their services, but I am concerned about the threat to independence which a shareholding poses. External auditors are specifically precluded by professional ethics rules from holding any shares in a client company:

"A member's objectivity may be threatened or appear to be threatened where he or she holds a beneficial investment in the shares or other forms of investment in a company upon which the practice reports" (1). Such shareholdings are clearly seen as a threat to independence.

I think there is a grave risk that the independence of non-executive directors would be similarly threatened if they held shares in the company. A shareholding to my mind is a "business or financial connection with the company".

The difficulty here, as elsewhere in your recommendations lies in the ambiguous position of non-executive directors. The report, as you point

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out in para. 4.6 emphasises the control function of non-executive directors, but you also point out that their primary role should be one of contributing to the leadership of the company. These roles may often conflict, and it is probably unrealistic in many practical circumstances to expect individuals to alternate between them.

2.4 Separation of the roles of chief executive and chairman

I think it is correct to say that the role of chairman should be separated from that of the chief executive. Your recommendation in para. 4.6 is, however, too timid. It allows any chief executive who so wishes to take on the role of chairman as well without breaking the Code of Best Practice. If you believe that the roles should be separate then I think you should make that recommendation, and not water it down to the point where it becomes largely meaningless. The recommendation should ideally go even further; a non-executive chairman, and indeed any non-executive, is likely to be more effective and have greater independence if he has not been employed in an executive capacity within the company. A similar view is expressed in the Institutional Shareholders' Committee publication on the role of directors (2).

2.5 Selection of non-executive directors

Selection of non-executive directors poses another set of problems. The validity of practically all your recommendations hinges upon the quality of the non-executive directors. The report has a great deal to say about selection procedures and how formal processes should be set up within a company to ensure that the procedure reinforces independence. It is interesting that the report makes it clear that the board is responsible in fact, if not strictly in law, for appointing directors. There is no reference in paras 4.13 and 4.14 to the role of shareholders; it is assumed, and stated, that the responsibility to appoint is that of the board.

A pressing question, which the report does not fully examine is this: where are all these good quality independent non-executive directors to come from? The supply will need to be increased by a considerable margin. Some companies, in order to comply with the code of practice, will be appointing non-execs for the first time; others may need to appoint more.

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Sir Adrian Cadbury has been quoted as saying that the days of multiple directorships are over, and if this were to be the case then a number of companies would be looking for new non-executives.

It is interesting in this context to look at the PRO NED publications. PRO NED keeps a register of people who are interested in taking on non-executive directorships. The organisation's publicity material states the following criteria for applicants:

"Those people with an interest in joining the register need to be able to demonstrate an all round business experience and a first class track record, preferably gained as a result of serving on the board of a publicly quoted company. New entrants are not normally accepted below the age of 45 or above the age of 60".

Although your report is not so precise as this, it seems likely that these are the criteria which it had in mind; not only were the PRO NED publications consulted, but also of course, Sir Adrian Cadbury as the Chairman of PRO NED, would be likely to endorse their recommendations.

However, there is surely a danger in restricting the pool of talent quite so much. Surely applicants with commensurate experience in other fields should be not only considered but also actively encouraged? Arguably, directors of other plcs may not in fact bring a sufficiently open mind to the problems they confront as non-executive directors of other companies. There is, I think, a good case to be made for companies considering applicants from non-traditional sources. PRO NED's criteria would tend to encourage the perpetuation of a certain type of individual, who cannot reasonably be said to represent a range of shades of opinion. Widening the criteria to allow in non-traditional applicants would of course constitute a relatively high risk policy. The risks might be as follows:

- * Such individuals might not have the appropriate level of knowledge of business affairs
- * They might be reluctant to become involved in conflicts relating, say, to financial statements presentation
- * The prestige of the position might make them reluctant to take any course of action which might endanger it

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These risks could be overcome by appropriate training of suitable individuals.

2.6 Ethical standards

Para 4.23 deals very briefly with point of great importance; the ethical approach of the business. If corporate governance is to be based in the UK largely upon a voluntary code of practice, it becomes particularly important that directors should be clear as to their ethical responsibilities. The price of failure to adopt high ethical standards may be very high indeed; the costs to investors, employees and society in general may have to be met for many years. A timely warning has been delivered recently in a US context (3):

"If directors fail to respond, it is clear that....governments...will legislate ethics at the expense of corporate freedom and common sense. If boards fail to become more active on ethical issues it's possible the present system of corporate governance itself will be altered by an enraged public. The corporation may lose control of director selection".

This warning, I think, should be heeded in the UK too. Effective corporate governance must have at its heart an ethical approach to business dealings. Establishing this approach throughout companies will not be easy; it involves a massive change in culture; a revolution in thinking which is hard to envisage in a UK context. I think your report should examine the whole question of business ethics much more thoroughly, and should suggest ways in which companies could improve their ethical standards. Your emphasis in para 4.23 is all wrong; you suggest by this wording that only employees need to be instructed in ethical standards, whereas in fact the process must start at the top with the board itself. Ethical approaches to decision-making must permeate the whole of a corporation's culture.

2.7 Audit committees

The recommendations you make on the subject of audit committees are sensible and include many good features. However, the success or failure of the committee rests entirely upon the quality of its non-executive

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directors, and so all the doubts I have already expressed about the quality of such directors are directly relevant here. The trend towards having an audit committee is well-established, albeit fairly recently, in the UK. It is probably too early to say whether or not these committees can make a significant contribution to improvements in corporate governance.

2.8 Internal audit

Your report has been the target of criticism from the Institute of Internal Auditors, on the grounds that insufficient prominence is given to the role of the internal auditor in continuous, as opposed to intermittent, monitoring of internal controls. Your report largely ignores the potentially very useful resource of internal audit. Other models of terms of reference for an audit committee would place greater emphasis on the liaison with internal audit, e.g. March and Powell 1989(4)

2.9 Board Remuneration

In para 4.32 you state that the overriding principle in respect of directors remuneration is that of openness. I would dispute this statement, and suggest instead that fairness might reasonably be considered the most significant principle in respect of board remuneration. Directors are entitled to be remunerated in a fair and equitable manner, having regard to performance and to market conditions. There has been much protest in recent times as to the large pay increases awarded to certain directors; protest has come from shareholders, employees, the press and certain sections of the political establishment. Whilst, relatively speaking, the issue of board remuneration may be regarded as a minor consideration in the improvement of corporate governance, it carries a high profile. A report in The Guardian (24.6.92) highlights this point:

"Boots and Reed International fuelled the controversy over top directors' pay when they revealed huge increases yesterday in the rewards for their chief executives. The presence on Boots' board of Reed chairman Peter Davis will also add to criticisms that there is a cosy club of non-executive directors who approve each other's pay."

Rightly or wrongly, this represents a common public perception of board remuneration. Your recommendations in this area, I suggest, are unlikely

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to result in any significant change in this perception.

You suggest in para. 4.32 that the principle of openness demands that "shareholders are entitled to a complete disclosure and explanation of directors' present and future benefits...". I quite agree with this statement, and therefore find it curious that your recommendation fails to achieve "complete disclosure and explanation." If full disclosure is to be achieved then the remuneration of each director, split into salary and performance-related elements, should be stated in the accounts. Elsewhere in the report you have recommended amendment to the Companies Acts; the amendment required in this case would be fairly straightforward.

2.10 The Board - Conclusions

I commented above (para 2.3) on the potential conflict of interest which exists for non-executive directors between their leadership role, which you see as primary, and their function as monitors of the chief executive and of board performance in general. I think that the two roles are ultimately irreconcilable, and that if an effective control over executive board members' activities is to be operated a means must be found of separating leadership and control. Eventually this may mean implementing a two tier board structure modelled, perhaps, upon one of the European examples. Some commentators have suggested, since the publication of the draft report, that the committee should take its approach to the logical conclusion and recommend a two tier board structure. I hope that you will consider this suggestion fully in the course of producing the final version of your report.

Your report could have, and in my opinion should have, explored much more fully issues relating to directors' responsibilities for corporate ethics, and to the role of internal audit in improving corporate governance.

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3. AUDITING

3.1 Non-audit services

You have considered, and briefly stated in para. 5.10, some of the persuasive arguments in favour of prohibiting auditing firms from providing other services to their clients. One problem in reaching a balanced judgement on this question arises from the paucity of information produced by audit firms. If audit firms were required to produce information on profitability on a segmental basis, it might be possible to ascertain to what extent audits are being used in general terms as "loss leaders". Until and unless it is possible to ascertain the extent of cross subsidy within audit firms it is difficult to judge whether or not audit is a genuinely profitable activity. One possible argument against prohibition of provision of other services is that firms of accountants might tend to withdraw from the auditing market, and thus reduce consumer choice even further than it has already been reduced. For this reason amongst many others audit firms should be required, notwithstanding their status as partnerships, to publish the same degree of detailed financial information as do limited companies.

The arguments for prohibition of other services are convincing, and I hope that you will reconsider the matter.

3.2 Disclosure of fees for non-audit work

Company law was amended in 1991 to require a company to disclose by way of note to its accounts the remuneration of its auditors for non-audit work carried out during the year (5). I am unclear as to what your recommendation in para. 5.11 intends to add to this statutory requirement.

3.3 Rotation of auditor partners

This recommendation is uncontroversial in the sense that it is already being actively considered by the ICAEW and by the major auditing firms. Its adoption may have some positive benefit in the case of those audits where the audit partner's independence is in some degree compromised,

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because of long association with a company. However, it has been correctly pointed out from within the profession that rotation of audit partners tends to occur naturally in any case. The peer review procedures which are typically adopted in major auditing firms should in any event be capable of identifying and rectifying those instances where an audit partner has allowed his independence to be compromised. Your recommendation, then, is unremarkable in substance, and tends to obscure the absence of more radical proposals.

3.4 Auditors' responsibility in relation to the reporting of fraud

You provide a very fair assessment (paras. 5.24 to 5.27) of the difficulties faced by the external auditor with respect to the detection of fraud. It would be unrealistic to place upon auditors the responsibility of detecting all material fraud, even though the imposition of this responsibility would apparently contribute to closing the expectations gap. The external auditor operates under severe time constraints imposed by economic pressures. Such pressures will not be abated whilst the function of external audit continues to be fulfilled by private sector firms. A very surprising omission from your discussion of fraud detection is the consideration of the contribution which may be made by internal audit to fraud detection. Internal auditors are far more likely in most circumstances to detect material fraud; they are also better placed to prevent its occurrence in the first place. If, however, they are to perform this function effectively they must be guaranteed as much independence as possible. Your committee could do much to strengthen their independence by fully recognising their importance, and by recommending means of improving their status and lines of communication within companies. Representation as of right on the audit committee would help to provide such improvement.

Your recommendation in para.5.28 would provide external auditors with statutory protection against an action for breach of duty if they report fraud to appropriate investigatory authorities. This recommendation will strengthen the position of the external auditor and is to be welcomed.

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3.5 Other illegal acts

There is certainly a difficulty in ascribing a wider role to **external** auditors which requires them to detect illegal acts by clients. It would be unreasonable to expect the requisite degree of expertise. However, it is not at all unreasonable to expect **internal** auditors to have extensive experience of legal requirements in the particular industry in which they are employed. This is another area where you appear not to have even considered the very valuable contribution which can be made by a properly constituted internal audit function.

3.6 Auditors' liability

Appendix 4 succeeds in summarising very succinctly the facts of the Caparo case and the issues which it raised. The problem of auditors' liability is not one which you could very well have avoided in the course of a considered discussion of the expectations gap; however, it is a problem of such magnitude and significance that it might well be considered to merit a completely separate investigation. Your conclusion is, essentially, to let the matter rest in its present extremely unsatisfactory state. I contend, however, that this supine solution is against the best interests of all parties, including firms of external auditors themselves. Defence against liability claims in court is not an activity which occupies a great part of audit firms' resources, because so few cases ever reach court. In consequence, the body of case law is not replenished with sufficient frequency to allow a confident prediction of the outcome of liability claims. Auditors must, therefore, devote considerable and expensive efforts to arriving at out-of-court settlements, and attempting to minimise adverse publicity and the damage to the firm's reputation.

Shareholders and other parties interested in annual reports have, partly as a result of the Caparo decision, been left in considerable doubt as to the value and reliability of published financial statements and the audit report they carry. Unless the problem of auditors' liability is resolved doubt and uncertainty will persist.

If it is beyond the scope of your committee to fully consider and deal

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with this matter I think that you must at least suggest some mechanism for doing so.

3.7 Auditing - conclusions

The problems relating to auditors' objectivity which you identify in para. 5.3 could be tackled by means of adopting far more radical solutions than you have apparently considered - as you are no doubt well aware. Many of the remedies you do discuss are already in the process of implementation by the professional and regulatory bodies, and so Section 5 of your report proves upon close examination to be offering very little in the way of innovative measures.

I hope that you will consider the following matters before finalising your report:

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Internal audit

- * Improving the status and independence of internal auditors within companies;
- * Strengthening lines of communication between internal auditors and audit committees;
- * Recognising the contribution which can be made to improvements in fraud detection and prevention by internal audit

Separation of audit and non-audit services

- * Reconsider the question of "quarantining" audit from other services
- * Clarify your recommendation in para. 5.11

Auditors' liability

- * Reconsider the implications of the Caparo case and suggest a mechanism for clarifying, and redefining if necessary, the limitations of auditors' responsibility.

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4. LEGISLATION OR SELF-REGULATION?

4.1 Your report has been much criticised in the press for its failure to base recommendations for improvements in corporate governance upon new legislation. For example:

"Following Guinness, Maxwell, Polly Peck, Barlow Clowes and BCCI, it is little short of laughable that anybody could propose a voluntary code of good conduct as a solution to vast abuses of corporate power."(6)

It is easy to overlook the fact that in some of the examples cited above laws were breached. Those individuals or companies which would break a voluntary code of conduct would not necessarily stop short at breaking the law. Some of the cases recently brought by the Serious Fraud Office have proven that, even where legislation exists, it can be extraordinarily difficult, and expensive, to gain a conviction. The difficulties seem often to lie as much in the process of obtaining justice as in the laws themselves.

On the other hand, it is difficult to envisage a company being delisted for failing to comply with the Code of Best Practice. It is more likely that the threat of adverse publicity would deter companies from too flagrantly breaching the code, and it remains to be seen how potent a threat that is in practice.

On balance I feel that it is desirable, where possible, to avoid legislation. Where measures are implemented by means of legislation it is all too easy for companies to obey the letter but not the spirit of the law. Generally, I concur with Professor Brown's view:

"Increased regulation would be a major expense and inconvenience for the "good and well behaved" companies; and the system would still be all too easy to manipulate by those who set out to be deliberately "bad"."(7)

However, such a view of the legislation/self-regulation debate is sustainable only where conscientious efforts are made to ensure that self-regulation does not become an excuse for inactivity. Your report should be seen as only the beginning of a lengthy and possibly permanent process which will involve frequent review of progress and compliance. If

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legislative methods prove to be the only means of ensuring compliance they must be used.

5. CONCLUSION

5.1 In my reply I have concentrated mainly upon areas where I wish to offer some criticism, and where I feel sufficiently well-informed to comment. In general I believe that you deserve commendation for having undertaken the project, and also for the clear English in which your report is written.

5.2 My principal criticisms of the report relate to the following points:

- * Failure to address the conceptual questions underlying corporate governance, examples of which I have listed in 2.1 above.
- * Non-executive directors. I believe that the control or supervisory function which you envisage for non-executive directors is incompatible with their role in providing strategic leadership for their companies. You have not addressed this problem, principally, I suspect, because the logical solution to it (i.e. the separation of boards of directors into two distinct parts) is perceived as unpalatable.
- * Attributes of non-executive directors. Your recommendations do not provide sufficiently for genuinely independent non-executives, nor do they address the problem of how to recruit and train individuals from non-traditional sources.
- * Ethical issues. Your report looks only very briefly at ethical matters. An examination of ethical implications must surely lie at the heart of any attempt to improve corporate governance.
- * Internal audit. Your report fails almost completely to recognise the valuable resource of internal audit.
- * Auditors' liability. Although the report provides an excellent summary of the issues raised by the Caparo case, it ultimately avoids offering any solution to a perennial problem.

I hope that this reply will prove useful to you in your deliberations, and I wish you success in your endeavours.

Catherine Gammage

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