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your reference

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PC 103

Sir Adrian Cadbury Chairman Committee on the Financial Aspects of Corporate Governance P O Box 433 Moorgate Place London EC2P 2BJ

31 July 1991

[Handwritten signature]

1 Following our discussions on 15 July, I asked a group of senior partners to advise me on what seem to us to be the key issues for the Committee. I hope our initial thoughts will prove helpful to you.

2 The current focus on corporate governance represents a reaction to a small number of failures, of companies or of people. Generally executives are honest, act in good faith and manage their companies as best they can. Non-executive directors and auditors bring to bear valuable outside experience. Management, non-executive directors and auditors work constructively together. In curing the few failures, care should be taken not to sacrifice the environment that leads to the success of the vast majority.

**The roles of non-executive directors and shareholders**

3 In theory, the excesses of managements are curbed if there are enough non-executive directors with experienced maturity of judgement, independence of mind and "guts".

4 However, not all companies have enough non-executives with these qualities. They may often be absent in companies where they are needed most. Legislation would be of limited help: it can dictate the numbers but it cannot ensure the quality and independence. Shareholders can do so - perhaps through greater involvement of institutional shareholders. However, it would need to be ensured that conflicts did not arise between fund managers' influence on a company and their duties to their own institution whose interests may be for the short term.

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5 There may be a need to codify the separate responsibilities of, for example: chairman of the board; chief executive; non-executive director.

#### **Unforeseen company failures**

6 The fashionable criticism of financial reporting is that companies fail financially, but no real hint of vulnerability was given in the previous annual report. We would like to recommend a positive step forward:-

- (a) There should be a formal statement by the directors in the annual report that they have reviewed forward financial information to be satisfied that, so far as they can tell, the business will remain a going concern for at least one year.
- (b) The auditors should report, by exception, on the directors' statement. We envisage a review not dissimilar to that carried out by reporting accountants on working capital forecasts in prospectuses.

#### **Inadequate internal controls**

7 Losses and business failures sometimes occur as a result of lapses or inadequacies in internal controls. We recommend that standards of internal control should be set, with companies expected to comply with those standards. (Much useful material already exists in guidance to auditors, but at present there is no equivalent guidance to company management.)

8 We recommend that, in the annual report, directors should be required to confirm they are satisfied that adequate controls exist and auditors should be required to report on that statement.

#### **Auditor appointment and remuneration**

9 One of the items under the committee's terms of reference is auditor appointment and remuneration. If it is felt that auditors independence needs further buttressing, we urge that the committee looks at a "private sector", and not a "public sector" solution. The latter would tend to lead to bureaucracy, would be inappropriate for private sector companies and, in the long term, a negative influence on the ability of firms to attract talent into auditing.

10 We see no reason to change the fundamental tenet that auditors are appointed by the shareholders. If the committee were to conclude that greater external involvement was required in auditor appointments, the answer would logically be the establishment, for major companies, of shareholder audit committees.

## Conclusion

11 We believe the above represent the main areas where current practice might be improved. Codes of practice would need to be developed, but the committee will no doubt also wish to consider the question of policing. Whether such developments can be left to self-regulation, or whether they will need legislation or similar enforcement, is difficult to forecast. It may depend on the level of acceptance of the committee's recommendations.

12 We look forward to the opportunity to comment on the committee's proposals, before they are finalised. In the meantime, if you would like a further discussion, please let me know.

*G. Gough*

*C. B. Gough*

C B Gough

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Sir Adrian Cadbury  
Committee on The Financial  
Aspects of Corporate Governance  
P O Box 433  
Moorgate Place  
London EC2P 1BJ

12 August 1991

Dear Sir Adrian Cadbury

In Mr Gough's absence on holiday I am writing to thank you for your letter of 9 August. Mr Gough will see your letter on his return to the office at the end of the month.

Yours sincerely

*Susan Dodsworth*

Secretary to  
Mr C B Gough

London Aberdeen Armagh Bangor (N.I.) Belfast Birmingham Blackburn Bournemouth Bristol Cambridge Cardiff Croydon Dungannon Edinburgh Enniskillen Glasgow  
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