Coopers & Lybrand

# Implementing the recommendations of the Cadbury Committee

*A survey: June 1993*

CORPORATE GOVERNANCE

# Implementing the recommendations of the Cadbury Committee

# I Introduction

- In-depth interviews based around a questionnaire were conducted with a sample of FT top 200 companies.

- The interviews were conducted or questionnaires completed during the period April to June 1993.

- In total, 30 companies were surveyed, representing a response rate of approximately 50%. The respondents were:

| | |
|---|---|
| • Chairmen | 11 |
| • Company secretaries | 14 |
| • Chief executive officer | 1 |
| • Deputy chairman | 1 |
| • Other directors | 3 |
| | 30 |

# I Introduction (continued)

- Respondents represent the following sectors:

| | |
|---|---|
| Manufacturing/Industrial | 11 |
| Utilities | 6 |
| Banks/Financial Services | 6 |
| Insurance | 3 |
| Retail | 3 |
| Other | 1 |
| | 30 |

## II Overview and compliance

- The Cadbury report has been well received:

  - All respondents, except for one, have a generally favourable attitude to the Cadbury Report.

  - That one, a large international group, expressed concern that the report was too 'parochial'. The recommendations provide only one model for governance based on the UK approach which does not necessarily fit with international commitments.

  - Three other respondents experienced some difficulty in matching compliance with Cadbury to their international commitments to major overseas shareholders although their attitude was still generally favourable.

## II Overview and compliance (continued)

- The majority of companies (83%) intend to comply with the Code in full by June 1993. Reasons for non-compliance are:

  - Two companies had a combined chairman/chief executive but had not formally recognised a senior non-executive director.

  - Two companies felt that it was inappropriate to appoint non-executive directors for a specified term. Some of the non-executives concerned were either chairmen of major subsidiaries or were appointed by a substantial shareholder (and may not therefore be considered to be independent).

  - One company had no non-executive directors; it does secure independent involvement in many of the functions normally fulfilled by non-executives but not through individuals having formal director status.

  - One company was considering not complying with the requirement for directors to report on internal control and going concern.

  - One company did not have an agreed procedure for directors to take independent professional advice although stated that it does happen in practice.

## III Areas of general agreement

- There was general agreement on the majority of the recommendations of the Cadbury report.

- Most respondents either agreed or agreed strongly that:

  - The board should have an **audit committee** with written terms of reference (100%)

  - **Service contracts** should not run for terms exceeding three years without shareholder approval (93%).

  - The board should have a formal **schedule of matters** reserved for its decision (92%).

## III Areas of general agreement (continued)

- The Code should apply to **all listed companies** (89%)
    - three respondents felt, however, that some exemption should be given to small companies.
- Directors should be able to take **independent professional advice** at the expense of the company (86%).
- **Non-executive directors** should be appointed for specified terms (85%).

## III Areas of general agreement (continued)

- Two recommendations of the Cadbury report on which there was less widespread agreement were:

  - The directors should report annually on the effectiveness of **internal control:** 59% agree or agree strongly, 29% indifferent, 12% disagree (none strongly).

  - The directors should report annually that the company is a **going concern**: 52% agree or agree strongly, 26% indifferent, 22% disagree (none strongly).

## III Areas of general agreement (continued)

- The majority of companies (83%) agree that it is useful for the **audit committee to meet with the external auditors** at least once a year without executive directors being present.

- Reasons for disagreement include:

    - Process creates tension.

    - Auditors should be willing to express their views in front of executives.

    - The auditor should be able to have access to non-executive directors without the artificial formality of a meeting.

## III Areas of general agreement (continued)

- The majority of companies (76%) agree that the **chairman of the audit committee** should be available at the AGM to answer questions.

- Reasons for disagreement include:

  - It is the company chairman's job to run the AGM.

  - All directors are available at the meeting to answer questions.

  - The recommendation attributes too great an emphasis to only one of many committees of the board. Other board committees have equally important responsibilities yet are not singled out in this way.

## IV Steps being taken to ensure compliance

- All but one of the companies has made or intends to make changes to comply with the Code.

- Recently privatised utilities tended to make less changes. Governance arrangements established for recent privatisation were more likely already to reflect recent thinking.

- The majority of companies (90%) have given a senior official responsibility to ensure compliance with the Code. This has generally been the company secretary alone (69%) or the company secretary with the chairman and/or one other director (19%).

## IV Steps being taken to ensure compliance (continued)

- The most common changes being made are:

  - Adoption of a formal procedure for directors to take independent professional advice at the expense of the company (75%)

  - Adoption of a formal schedule of matters reserved for board decision (57%)

  - Adoption of a specified term of office for non-executive directors (50%)

  - Separation of the roles of chairman and chief executive (25%)

  - Establishment of:

    - nomination committee 30%
    - remuneration committee 25%
    - audit committee 21%

  - Appointment of further non-executive directors 21%

- Three companies noted that some changes were not as a direct result of Cadbury.

## IV Steps being taken to ensure compliance (continued)

- Of those adopting a procedure for directors to take **independent professional advice**:
  - 77% have done so by resolution of the board
  - 36% have included the procedure in the director's letter of appointment
  - 95% require that an individual (usually the chairman or company secretary) be consulted or advised before taking advice. Two companies permit advice up to £2,500 or £5,000 without prior notification/approval of the chairman
  - 73% put no explicit limits on the nature or cost of advice. Where limits are set they specify a monetary amount (eg £25,000 or £50,000) or the nature of advice.

## IV Steps being taken to ensure compliance (continued)

- Items in the **schedule of matters reserved to the board** include:

| | |
|---|---|
| • acquisition and disposal of major assets | 100% |
| • approval of published financial statements | 100% |
| • approval of business strategy | 96% |
| • nomination of directors | 93% |
| • approval of budgets | 85% |
| • treasury policy | 70% |
| • appointment of senior management | 52% |
| • risk management policy | 44% |

## IV Steps being taken to ensure compliance (continued)

- Many companies have also issued, or plan to issue the following to management:
  - Authority limits for transactions — 93%
  - Schedule of matters reserved for the board — 78%
  - Code of ethics or business practice — 43%

- Steps still to be taken:
  - 21% of the respondents indicated that they are awaiting guidance from the accounting profession before deciding what steps they will need to take to report on internal control and going concern.
  - A minority (46%) of boards periodically review their own effectiveness in directing and controlling the business despite the fact that compliance with the Cadbury Code requires boards to 'retain full and effective control over the company'.

## V The role of the Chairman and Chief Executive Officer

- Views were widely divergent

  - Some respondents (22%) felt that Cadbury should have concluded that the roles should **never** be combined: 'the roles are very different as well as acting as counter-balances'; 'even times of crisis do not justify combining'.

  - Others (17%) felt that Cadbury was too dogmatic: 'horses for courses'; 'strength of the non-executives is crucial in restricting concentration of power'; 'the Cadbury remedy is not the only answer'.

  - The majority (61%) agreed with the Cadbury approach. One comment was that it may not be appropriate for smaller companies.

- However, in 30% of the companies surveyed, the chairman is also the chief executive.

  - Where this is the case, in most instances (67%) a senior non-executive director has been formally recognised, nearly always by appointment as a deputy chairman.

## VI Non-executive directors

- Respondents identified the following as the main contribution of their non-executives:
  - displaying independence and expertise
  - ensuring that the company has a viable strategy and keeps to it
  - bringing an international dimension into the decision-making process
  - bringing experience from a variety of industries, the City, regulatory bodies etc
  - introducing external contacts to the board
  - stimulating, encouraging or, if appropriate, restraining management
  - viewing the presentation of data from an outsider's perspective
  - assisting in the development of succession plans
  - in certain situations, such as in take-overs, representing the shareholders without the influence of having to protect their own positions.

## VI Non-executive directors (continued)

- Of the companies surveyed 93% have three or more non-executive directors.

- One respondent suggested that a **majority** of non-executive directors on the board and all its committees is desirable to ensure compliance with company policies etc.

- Only one company had articles which required the attendance of a single non-executive director to form a quorum of the board.

- A number of chairmen felt that the board should not be loaded with retired executives who, while bringing experience, do not bring independence and new ideas. One suggested they may bring out of date biases and prejudices.

- Some respondents foresee problems in finding suitable candidates who will be able to fill the role of non-executive director once the requirement to report compliance with the Code becomes obligatory. It was pointed out that non-executive directors must be people who are respected by the board.

- A number of companies expressed concern over the independence of non-executives who 'represent' a major shareholder.

## VI Non-executive directors (continued)

- A majority (54%) of companies use external advisers during the process of appointing non-executive directors.

- Terms of office:

  - Non-executives appointed for fixed terms 64%

  - Of these, their terms are for:

| | |
|---|---|
| 3 years | 67% |
| 4 years | 5% |
| 5 years | 28% |

  - Number of terms of office non-executives may serve:

| | |
|---|---|
| two terms | 21% |
| three terms | 3% |
| no maximum | 62% |
| up to a maximum age | 14% |

## VII Executive directors

- Only 59% of the companies surveyed encourage their executive directors to accept appointments as non-executive directors on the boards of other companies.

    - Reasons given for not doing so include:

        - directors should devote all of their time to the company

        - some, particularly the banks, perceive a conflict of interests if directors serve on the boards of possible clients.

## VII Executive directors (continued)

- Most companies (88%) compare internal candidates for executive appointments with those available outside the company. One company stated that it does not do so for product, as distinct from functional, management roles.

- 36% of companies have executive directors on their remuneration committees.

- Most companies (86%) take professional advice when setting the remuneration of executive directors.

- Only 61% of companies surveyed have formal systems for monitoring the performance of executive directors. Where they do, most such reviews are used to determine awards under incentive schemes

- Only 7% of companies have formal arrangements for training executive directors.

- Executive director terms of office:

| | |
|---|---|
| • 1 year or less | 14% |
| • 2 years | 13% |
| • 3 years | 73% |

## VIII Interim reporting

- Most respondents agree with the Cadbury recommendations that:
    - interim reports should include balance sheet information (74%)
    - should be reviewed (but not audited) by the external auditors (79%).
- However, many respondents (32%) had not yet finally decided the format of their next interim reports.
- Among those which had made a full or tentative decision, companies proposed to publish:

| | |
|---|---|
| • a full balance sheet | 48% |
| • selected balance sheet information | 39% |
| • cashflow information | 30% |
| • none of the above | 9% |

- One company pointed out that interim figures could become more extensive than the summary annual financial statements sent to a majority of their shareholders.
- 72% plan to have their auditors review the next interim report.

## IX Audit committees and internal audit

- All audit committees in the sample are (or will be) responsible for:
  - review of external audit findings
  - overall review of the effectiveness of internal controls

- Most audit committees are (or will be) responsible for:

| | |
|---|---|
| • review of annual financial statements | 90% |
| • review of interim financial statements | 83% |
| • review of effectiveness of internal audit | 79% |
| • review of findings of internal audit | 79% |

- A small but significant number of companies (17%) do not have internal audit functions.

## X Internal control

- Most respondents (59%) agreed that the directors should report annually on the effectiveness of internal control. 12% disagreed and 29% were indifferent to the recommendation.

- There was some uncertainty in this area. 17% of respondents replied that they were awaiting the decision of the accounting profession to give guidelines on what such a report should comprise.

- On scope, the twenty-three respondents expressing a view, felt that it would be appropriate for directors to report on:

| | |
|---|---|
| • adequacy of overall control environment | 91% |
| • reliability of controls over financial records | 61% |
| • compliance with relevant laws and regulations | 48% |
| • adequacy of management information systems | 43% |
| • adequacy of controls against fraud | 43% |
| • treasury and risk management policies | 43% |
| • adherence to management policy | 26% |

## X Internal control (continued)

- Directors expect to rely on the following to satisfy themselves on internal control effectiveness:
  - existing internal and external audit work — 92%
  - discussion with external auditors — 84%
  - representations from divisional or finance managers — 32%
  - internal review of controls — 24%

## X Internal control (continued)

- Some of the concerns expressed in relation to reporting on internal control were:

    - 'It is essential that the board address these controls but it is not necessary for the board to report publicly.'
    - 'Any reporting is likely to be stereo-typed and of minimal value.'
    - 'The audit committee considers controls but is concerned not to blunder into technical production areas beyond its expertise.'

- A number of financial sector companies had particular concerns:

    - 'The requirement should recognise existing regulatory reporting requirements.'
    - 'It is not conceivable that a board will go public with an adverse statement.'
    - 'The more inadequate the situation, the less likely directors would be to publish an adverse report (from ignorance or incompetence).'
    - 'There is a risk of becoming very nit-picking. If a company has responded to forty-five out of fifty control issues raised in the last five years, this is probably good going.'

## XI Going concern

- Most (52%) of respondents agreed that the directors should report annually that the company is a going concern. 22% disagreed and 26% were indifferent.
  - A number of chairmen replied that by approving the financial statements in which items such as stocks were valued on a going concern basis they were reporting that their companies were going concerns.
- Amongst the twenty-one respondents expressing a view, directors expect to rely on the following to satisfy themselves that the business is a going concern:

| | |
|---|---|
| • review profit and cashflow forecasts | 81% |
| • review business reports from divisional managers | 57% |
| • confirm adequate borrowing facilities in place | 52% |
| • other | 14% |

## XII Will Cadbury work?

- Practically everyone felt that the Code would not have helped prevent the recent spate of large scale cases of fraud and corporate mismanagement. Nevertheless there was a feeling that 'they are desirable disciplines anyway'.

- Reports by the DTI during the 1950s, 1960s and 1970s had pointed to the same lessons.

- Some chairmen identified a risk where companies have grown from an entrepreneur's own company and 'gone public' yet are still run as private companies.

- One respondent felt there was a need for assessing the 'fit & proper' status of prospective board appointees.

- A number of respondents expressed concern that no person or body has been established to enforce compliance.

## XII Will Cadbury work?

- As one respondent put it:

  **'Codes will not catch rogues!'**