cc Sir Adrian!
CAD-02199

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30 June 1992

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

Dear Mr. Peace,

Draft Cadbury Report - Comments

I am enclosing my comments on the Draft Report of the Committee on the Financial Aspects of Corporate Governance (the Cadbury Committee).

I would be grateful if you would kindly arrange for these comments to be considered by the Committee.

Yours sincerely,

Tim Knowles

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30 June 1992

DRAFT REPORT OF THE COMMITTEE ON FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

COMMENTS BY TIM KNOWLES

1. General:

   a. Listed companies will be required to state whether they are complying with the Code of Best Practice (paragraph 1.3). It is to be expected that most of the largest companies will comply with the spirit as well as the letter of the Code. However, compliance with both the letter and the spirit of the Code by many medium size and small listed companies will require major changes in attitude by directors, auditors and institutional shareholders. Please refer to comments 2(a), 4(a) and 5(b) below.

   b. The terms of reference of the Committee are not restricted to consideration of matters related to listed companies but the recommendations are directed only at those companies (paragraph 1.3). Paragraph 3.1 merely expresses encouragement to other companies to aim at meeting the requirements of the Code of Best Practice. Some of the least desirable practices in corporate governance are to be found in non-listed public companies, particularly companies which have issued shares to the public under the Business Expansion Scheme. It is suggested that consideration should be given to the means by which those non-listed public companies could be obliged to comply with reasonable standards of corporate governance.

2. Non-Executive Directors:

   a. The board membership and structure of many medium size and small listed companies (and some of the larger ones) is currently inappropriate to provide the independent contributions to adequate standards of corporate governance required of suitable non-executive directors. Many current non-executive directors have been appointed for reasons (e.g. high profile individual with valuable business connections; retired executive director of the company; experience of the industry concerned; marketing or operational expertise; or merely a friend of the Chairman) not directly associated with the requirements of responsible corporate governance (see comment 2(b) below). These non-executive directors frequently make a positive and valuable contribution to the leadership of the company concerned (paragraph 4.7). However, they do not necessarily have the experience and expertise to fulfil the responsibilities of corporate governance envisaged by the Draft Report, particularly in respect of membership of an effective audit committee (paragraph 4.30).

b. The executive directors of many companies (usually the ones in greatest need of improved corporate governance) will not take the initiative in the appointment of suitable independent non-executive directors as they will perceive such appointments as a threat to their freedom. The proposal for a nomination committee (paragraph 4.24) will not be of initial value in those many companies which do not at present have a core of appropriate non-executive directors. There is a need for institutional shareholders to take a strong active role in securing the necessary appointments of suitable individuals (see comment 5(b) below).

c. Whereas the time commitment of non-executive directors appointed for various reasons other than corporate governance (see comment 2(a) above) may not be much more than that required to read the papers for and attend a monthly meeting of the board, the Chairman and members of the audit and remuneration committees require a far greater time commitment as well as considerable expertise and relevant experience in order to discharge their responsibilities fully and effectively. The respective time commitments should be reflected in the maximum number of appointments held by the individuals concerned and in their fees (paragraph 4.10).

d. The articles of association of many companies provide for remuneration of directors under three headings, namely, fees, special remuneration and executive directors' emoluments. The first two categories are applicable to non-executive directors. The maximum fees (either for any individual or in aggregate) are frequently prescribed in the articles or fixed by ordinary resolution of the company in general meeting under relevant provisions in the articles. The distinction between fees and special remuneration appears to be a 'grey area' in legal opinion. Some companies pay sums to non-executive directors substantially in excess of the maximum permitted fees and attribute such excess to special remuneration for carrying out duties such as membership of committees or as a director of one or more subsidiaries. Where significant amounts of special remuneration are paid to non-executive directors, they cease to have the independence which is necessary (paragraph 4.9). It is suggested that all remuneration of this nature should be categorised as fees and that special remuneration should be payable only in the most exceptional circumstances and should be separately disclosed in the annual accounts.

e. Section 318 of the Companies Act 1985 requires a director's contract of service which cannot be determined within twelve months without payment of compensation to be available for inspection. Section 5, chapter 2, paragraph 43 of the Stock Exchange Yellow Book extends this obligation, 'inter alia', to include a statement in the annual report concerning any such contract of a director seeking re-election at the forthcoming annual general meeting of the company. However, these provisions do not apply to contracts for services provided by non-executive directors. It is suggested that the legislation and continuing obligations should be amended to ensure that all such contracts with directors must be disclosed.

3. Reporting Practice:

a. Section 242 of the Companies Act 1985 requires a public company to deliver its accounts to the Companies Registry within seven months after the end of the accounting reference period. Taking account of the period of notice required for the annual general meeting, this period is broadly equivalent to the requirement in section 5, chapter 2, paragraph 20 of the Stock Exchange Yellow Book that a listed company must issue its annual report and accounts to shareholders within six months of the end of the financial period. It is suggested that these periods are much too long for shareholders and the market to wait in order to be able to assess the financial position of the company. There is a tendency to delay as long as possible when a company is in financial difficulties or has bad news to report. If a public company is unable to issue its annual report and accounts within four months of the end of its financial period, it is probable that there are serious defects in its organisation and/or accounting records. It is suggested that the statutory period to deliver accounts should be reduced to five months and the obligation of listed companies to issue the annual report and accounts should be reduced to four months. Provision could be made for dispensation to be granted only in exceptional circumstances by the Secretary of State and the Stock Exchange, respectively.

b. Section 5, chapter 2, paragraph 24 of the Stock Exchange Yellow Book requires a listed company to issue a half-yearly report (paragraph 4.45). It is suggested that this obligation should be extended by legislation to all public companies except those which are a wholly-owned subsidiary of another public company or whose only shareholders are directors of the company (there may be other appropriate exceptions).

4. Auditing

a. Paragraph 5.1 describes the importance of objectivity and effectiveness in the audit. Paragraph 5.3 explains the main problems in achieving that objectivity as a result of the framework in which auditors operate. Paragraphs 5.10 and 5.11 reject the suggestion that auditors should not provide other services to their audit clients. A major problem of the current framework is that auditors frequently are not only unable to stand firm against a particular accounting treatment (paragraph 5.3) but take a positive role in advising their client on presentational techniques to show the company's figures in the most flattering light (paragraph 4.38). The legal requirement or accounting standard in such cases may be followed to the letter but the spirit is avoided. It is suggested that auditors should have a professional duty to shareholders to advocate to their client due adherence to the spirit as well as the letter of disclosure requirements under legislation, Stock Exchange regulations and accounting standards. They should not assist the client in avoidance of the spirit of such requirements. In any case of material failure to secure what they regard as appropriate treatment, it should be the duty of the auditors to report the relevant facts and figures to shareholders.

b. It is suggested that, in the present environment and internal structure of some very large audit firms, the significance of fees for audit and non-audit work paid by a company to its auditors should be viewed not only in the United Kingdom and worldwide context of the audit firm (paragraph 5.11) but also in the context of the importance to the individual partner, local office and/or profit centre of that firm.

c. The auditors should have a responsibility to report to shareholders where, during the course of the audit, it has been found that payments have been made or other transactions have been undertaken by the directors (particularly those in their own favour or in which they have an interest) beyond their powers under the articles of association and such payments or transactions have neither been identified as such in the accounts nor reversed prior to the signature of the audit report.

5. Shareholders:

a. Paragraph 6.8 endorses the statement published in December 1991 by the Institutional Shareholders' Committee on the Responsibilities of Institutional Shareholders in the UK. Section 2 of that statement encourages direct contact by institutional shareholders with the board of a company in which the institution has invested. Section 3 of the statement encourages the registration of votes by the institutional shareholder in support of the board other than in exceptional circumstances. This method of operation has probably been found to work well in most cases of the larger listed companies where institutional shareholders take a close interest in the company and, where deemed necessary, exert appropriate influence for changes (e.g. British Aerospace PLC and British Petroleum PLC). Other recent major corporate disasters, which have attracted considerable publicity, suggest that the process is not always effective with the larger companies.

b. The role of the institutional shareholders referred to at comment 5(a) above, which may be regarded as satisfactory in the case of most large companies, does not operate satisfactorily in the many medium size and small listed companies. Institutional shareholders frequently own in aggregate 80% or more of the voting capital in such companies. However, these shares are usually held by numerous institutions and the value of the holding of any one institution rarely represents more than an insignificant proportion of the investments of that institution. Consequently, the institutions appear to take little direct interest in the company and decisions to buy or sell the shares are often taken on short-term considerations not necessarily directly related to the performance of the company. Contact with the management of the such companies is usually limited to occasional City lunches where representatives of a few institutional shareholders meet some of the management for an hour or so. Individual institutional shareholders appear to give very little attention to the detail of annual reports and accounts of those companies or, if they do so, they rarely question management on unsatisfactory features and/or apparent defects in standards of corporate governance. Even though the performance and/or standards of a company may be seriously unsatisfactory, the main institutional shareholders, in conformity with the recommendation of the Institutional Shareholders' Committee and usually 'rounded up' by the company's City advisers, duly register their proxies in support of the board. They are rarely represented at the annual or any extraordinary general meeting.

c. Where institutional shareholders have acted on the basis described at comment 5(b) above, individual (i.e. non-institutional) shareholders (some of whom may have a substantial holding in personal terms) in medium size and small listed companies are powerless to secure accountability from an unsatisfactory board. The Chairman, with the security of the proxy votes, can brush aside legitimate concerns expressed and questions asked by individual shareholders at the annual general meeting (paragraph 6.4) or in correspondence. As the institutional shareholders are not represented at the annual general meeting, they are not aware of the legitimate concerns of individual shareholders. It is also difficult for individual shareholders to make contact with major institutional shareholders due to the widespread use by institutions of nominee companies in whose names the shares are registered. Even where serious defects are drawn to the attention of major institutional shareholders in a company, little is achieved by the individual shareholders due to the underlying attitude of the institutions described in comment 5(b) above. Vigilant individual shareholders (paragraph 7.2) can achieve little without the active support of the major institutional shareholders in a company.

d. It is recognised that, with the large number of separate investments held by each of the many institutions, it is neither practicable nor economic for each institution to monitor closely the performance of each medium size and small company in which it owns shares or to analyse in detail the annual report and accounts and other formal documents issued by each such company. In order to overcome the serious problems of accountability in those companies described in comments 5(b) and 5(c) above, it is suggested that the Institutional Shareholders' Committee should consider setting up a central organisation (or commissioning a commercial organisation) which would be responsible for monitoring each medium size and small listed company and analysing the annual reports and accounts and other formal documents issued by each such company. Questions could be taken up directly by the central organisation with the individual company. Reports would be sent by the central organisation to those institutions which held an investment in the company or which had requested receipt of reports on the company concerned. The organisation would also provide a point of contact with institutional shareholders for any individual shareholder who was concerned about a company. The cost of the organisation could be funded by the institutions by either subscriptions or fees for reports received or a combination of both. It is believed that the cost of such an organisation would be minimal in relation to the vast sums invested collectively by the institutions in those companies. The service should provide considerable benefit to the institutions and the value of such benefit should outweigh the costs incurred. Institutions holding a significant proportion (say, 1% or more) of the voting capital should be encouraged to take positive action with companies where a report revealed any unsatisfactory situation. The existence of arrangements along the lines suggested and the resulting active interest by institutional shareholders would create the necessary pressure on boards to meet acceptable standards. It is believed that the analysis of individual companies carried out by brokers is for other objectives and would be inadequate for the purposes described above. A representative of the central organisation would also attend the annual and any extraordinary general meeting of the company and would provide a report of the meeting to the relevant institutional shareholders.

e. A procedure for written questions at annual general meetings has been proposed (paragraph 6.5). There is a period of over three weeks between the issue of the annual report and accounts and the date of the meeting. It is suggested that this proposal might be strengthened if there were a statutory obligation (or, failing this, an obligation imposed by the Stock Exchange on listed companies) on companies to circulate not less than one week before the meeting to all holders of 1% or more of the voting capital, any shareholder who had registered a request for a copy, the central organisation referred to at comment 5(d) above and (in the case of a listed company) the Stock Exchange a full copy of all written questions received not less than two weeks before the date of the meeting and the company's response (which could be a refusal to answer or an inadequate response from which recipients would draw their own conclusions) to each such question. The company should also be obliged to make the written questions and answers (possibly including late written questions received up to three working days before the meeting) available to all shareholders attending the meeting from one hour before the commencement of the meeting.

f. Adoption of arrangements along the lines proposed at comments 5(d) and 5(e) above would provide individual shareholders with an audience among the institutional shareholders and, thus, enable them to play a meaningful part in the process of governance of their company, which is one of the responsibilities and objectives noted in paragraph 7.5.