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Sir Adrian Cadbury
Chairman
Committee on the Financial Aspects of
Corporate Governance
Moorgate Place
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Ref S/932/057

Dear Sir Adrian

ABI Submission on Draft Report

I have pleasure in enclosing ABI's comments on your Committee's draft report which I hope you will find helpful.

It is perhaps disappointing that there are some who clearly feel that the recommendations undermine the concept of the unitary board, and it might be helpful if the final report emphasised rather more forcefully the support for the unitary board.

Yours sincerely



I L Rushton
Chairman

Enclosure

ABI SUBMISSION ON DRAFT REPORT FROM THE COMMITTEE ON FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (THE CADBURY COMMITTEE)

1. INTRODUCTION

ABI welcomes the draft report of the Committee and fully supports the Committee's objective in seeking further to raise the standards of corporate governance, with particular emphasis on promoting good standards of financial corporate governance. ABI further supports fully the proposal that the Listing Agreement should require companies to make a statement demonstrating their compliance with "The Code of Best Practice". This should encourage improved dialogue between companies and their shareholders.

2. GENERAL COMMENTS

ABI welcomes the emphasis on compliance with a voluntary Code of best practice rather than a statutory Code. The former should encourage greater consistency with the spirit rather than just the letter; the latter is only likely to impose minimum standards. The framework of the Code with accompanying recommendations should enable responsible shareholders to identify deficiencies more readily and take appropriate action at an early stage.

If the Code is to be effective companies must be willing to observe its spirit, and shareholders must be willing to raise non-compliance with company boards.

It is also noted that it is proposed that the Stock Exchange will require a compliance statement as one of its continuing listing obligations. Any sanctions the Stock Exchange may apply should be confined to a qualified listing and not a suspension of listing, as this last course would positively disadvantage shareholders.

The Committee recognises that smaller listed companies may initially have difficulty in complying with some aspects of the Code, and no time limit is placed on them providing a statement of compliance. However, in some instances it may be particularly important that such companies make every effort to comply with some particular provisions of the Code, and they should be expected to explain what steps they are taking to observe them.

ABI questions the claim which is sometimes made, that the Code would be difficult for many companies to implement because of a shortage of suitable non-executive directors. It is known that many major companies are willing to see their executives take such appointments and the problem seems to be a perception that non-executive directors need to be prestigious personalities rather than, for example, the very able executive directors of subsidiaries or divisions of major companies.

Emphasis is placed on the requirement for listed companies to make a statement of compliance with the Code, but it is equally important that all companies should observe the Code, and thought should be given to how it might be applied to those that are not listed. For example, the Accounting Standards Board might consider requiring such a statement in the directors' report and accounts.

3. DETAILED COMMENTS

Paragraph numbers refer to paragraph numbers in the Report.

Code of Best Practice

- 3.7 We support fully the concept that the listing agreement of the London Stock Exchange should require companies to make a statement of compliance with the Code but would suggest that where a company fails to comply with the Code or there is some significant omission from the

Code, any sanction which might be envisaged by the Stock Exchange should be limited to a qualification to the listing and that suspension of listing should only be applied as a last resort in such circumstances. The most effective sanctions that can be applied are those available to shareholders and it is felt to be a matter for shareholders to decide whether the standards of corporate governance in a particular company are falling short of what is desired.

Compliance

- 3.16 It is noted that smaller listed companies may initially have difficulty in complying with some aspects of the Code and the Committee suggests simply that it should be "their aim to achieve compliance as quickly as possible". It is suggested that the report should be strengthened by recommending that such companies should explain what steps they are taking to observe the provisions of the Code.

The Board

- 4.3 ABI fully supports the concept that all directors are equally responsible for the board's actions and decisions, and the concept of the unitary board. It is suggested, therefore, that the provision which states that "if the chairman is an executive director, a senior non-executive director should be appointed to take the lead....." should be amended to suggest that a senior non-executive director should normally be appointed to the office of deputy chairman in such an instance. The intention of the provision is fully recognised but it is felt that, as presently expressed, it could be divisive.

Non-executive Directors

- 4.7 ABI fully recognises that the calibre of non-executive directors is important in setting and maintaining standards of corporate governance and suggests that this paragraph be amended to require that brief biographical details of non-executive directors are made available to shareholders when the director in question is submitted for election or re-election. The same should also apply, however, to executive directors.
- 4.9 In some cases it may be very difficult to ensure that the majority of non-executive directors are "free of any business or financial connection" and a qualification as to materiality would be appropriate.
- 4.10 It is suggested that as a matter of good practice non-executive directors should not participate in share option schemes: it is fundamental that the independence of non-executive directors is not impaired. For this reason the Code should include an additional provision that, other than in exceptional circumstances, non-executive directors should not participate in share option or other performance related rewards unless prior approval had been obtained from shareholders in general meeting and that they should not be significantly dependent on any pension arrangement provided by the company; further, if for special reasons it is deemed appropriate for certain non-executive directors to participate in such arrangements, the details should be fully disclosed.
- 4.12 ABI welcomes the recommendation that non-executive directors should be entitled to seek legal or financial advice in the furtherance of their duties through an agreed procedure and strongly supports the formalisation of such arrangements. It is particularly important that the arrangements are formalised through the Articles so that all shareholders may be aware that the arrangements are in place. Similar facilities should be available to individual executive directors.
- 4.13 It is important that non-executive directors are selected by formal process. ABI therefore supports the recommendation that such appointments should be made by a nomination committee which will carry out the selection and make proposals not only to the board but, where appropriate, to shareholders as well.
- 4.14 ABI supports the recommendation that non-executive directors should be appointed for specified terms and that reappointment should not be automatic. It is strongly suggested that

the report should further recommend that all directors should be subject to retirement by rotation with one-third submitting themselves for re-election annually.

Board Structures & Procedures

- 4.20 ABI welcomes the recommendation that boards should have a formal schedule of matters reserved to them for their collective decision. This will ensure that control of the company remains firmly in their hands as a safeguard against misjudgments and possible illegal practices.

One of the first indications of problems developing in a company's financial structure is when alterations are required in bank borrowing arrangements; paragraph 4.20(ii) should be amended to include "any alterations to the bank borrowing facilities and any material changes thereto."

Nomination Committees

- 4.24 ABI welcomes the suggestion that all appointments should be made through a nomination committee. However, the suggestion that such a committee should be responsible for proposing to the board, in the first instance, any new appointments, whether of executive or non-executive directors should be amended to reflect the fact that the nomination committee is of importance principally in the appointment of non-executive directors.

Audit Committees

- 4.29/ 4.34 ABI has long supported the concept of audit committees and remuneration committees, and welcomes the relevant recommendations in the report. However, while the chairman of the audit or remuneration committee should be available and prepared to answer questions relating to the responsibilities of those committees, it could be divisive to require them to be responsible for answering questions about their work at AGMs. In practice, it would be for the Chairman to refer relevant questions to the chairmen of such committees, and the Report should be amended accordingly.

Board Remuneration

- 4.32 ABI fully supports the Committee's view that openness is the overriding principle in respect of boardroom remuneration. Many of the misunderstandings in recent years have occurred because the basis of such remuneration has not been properly explained. However, shareholders should be concerned not only about past payments but also about future ones, and the report should be amended to emphasise the need to disclose not only the criteria by which past performance has been measured but also any predetermined basis for future performance-related payments.

Financial Reports - Reporting Practice

- 4.47 The recommendation that balance sheet information should be included in the interim report is welcomed as is the requirement that the interim report should be reviewed by the auditors but that a full audit should not necessarily be required. However, we should be clear about what information would be included in the interim report under this recommendation, as it is imperative that the auditors who have reviewed the interim report should discuss their findings with the Audit Committee.

Also, companies in businesses which require specialised valuations of assets or liabilities for their balance sheets should not be required to incur the excessive cost of revising such valuations for interim reports.

Pensions Governance

- 4.51 The governance of pensions and security of company pension funds is being reviewed elsewhere and ABI will contribute to that review. However, the Cadbury Report should consider the eligibility of directors as trustees of self-administered schemes. ABI recommends that all self-administered schemes should have at least one independent trustee, for example, a

non-executive director. Where the rôle of Chairman and Chief Executive of a company is combined, that person should not be eligible to be Chairman of the trustees of that company's self-administered pension scheme.

AUDITING

Ways to increase the effectiveness and value of the audit

- 5.18/ ABI welcomes the suggestion that directors should satisfy themselves by the preparation of adequate cash-flow forecasts, etc., that the company is, at the time of the preparation of accounts and indeed their adoption, a going concern. ABI supports, therefore, the recommendation under provision 5.23 that the directors should state in their report that the business is a going concern with a supporting report by the auditors on this statement.

However, the accountancy profession, in conjunction with representatives of preparers and users of accounts, should develop guidance for companies and auditors as to the information to be contained in such a statement. In the absence of very clear guidelines which are fully understood and properly applied, the limitations of such a statement at any given point of time, and the desire not to damage the company's financial credibility, would call its value into question.

- 5.28 The recommendation that the Government should consider introducing legislation to extend to auditors of all companies the statutory protection already available to auditors in the regulated sector is welcomed, as many of the problems which have developed in recent corporate collapses might have been averted if auditors had felt free to communicate their concerns to relevant parties. This clearly is a highly sensitive area but the present inconsistencies and inhibitions cannot be conducive to good corporate governance or the successful handling of situations where highly relevant information may be withheld.

Auditors' Liability

- 5.31 There has been considerable discussion of the Caparo judgment and the clarification in the conclusions reached by the House of Lords which has avoided giving rise "to a liability in an indeterminate amount for an indeterminate time to an indeterminate class." Concern still remains, however, at the implications, at least for individual shareholders who are on the register of a company when reports and accounts are adopted on the basis of an auditor's report. Further consideration should be given to the position of such shareholders who may individually have suffered some loss or disadvantage but in circumstances where the shareholders as a class are either unable or no longer in a position to take action as a class.

THE SHAREHOLDERS

"The Code of Best Practice"

- 2.2 ABI welcomes the concept of a limited number of specific provisions in the Code of Best Practice, supported by what in effect amount to practice notes incorporated in the body of the report. ABI has already recommended that non-executive directors should only be granted options or participate in pension arrangements in very exceptional circumstances, and then only if the details are fully disclosed: provision 2.2 should be amended accordingly.
- 2.5 The concept of a nomination committee is also welcomed and it is suggested that paragraph 2.5 be amended to require that "non-executive directors should be selected through a formal process, e.g. a nomination committee, and that their appointment should be a matter for the board as a whole and for shareholders".
- 4.7 ABI supports the concept of audit and remuneration committees and is wholly supportive of the UK concept of a unitary board. It is suggested, therefore, that paragraph 4.7 should be amended to require that the Chairman of the audit and remuneration committees should be

available and prepared to answer questions at the AGM but it is important that questions are in general directed through the Chair.

4. **CONCLUSION**

ABI supports fully the approach adopted by the Committee of a Code of Best Practice with the onus placed on boards of companies to account for their observation of the provisions of the Code and on shareholders to question any areas they identify as of concern. It is important that a reasonable period should be allowed to elapse before any review of the Code and its effectiveness in improving standards of communication and governance. The success of the Accounting Standards Board in improving the quality and consistency of accounts will be crucial in the process.

It is important, therefore, that any such review should be carried out by those concerned, e.g., representatives of companies, shareholders and accountants, etc., and that if consistency with good practice is to continue to develop, the burden of unnecessary regulation is avoided.

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