ADDRESS BY SIR ADRIAN CADBURY TO PIRC CONFERENCE ON PENSION FUNDS AND CORPORATE GOVERNANCE ON 13 NOVEMBER 1991

## Outline speaking notes

- 1. I was grateful to receive an invitation to attend your conference, and to have the chance to tell you something about the background to our Committee and to get your views/advice on the issues before us.
- 2. The Committee on the Financial Aspects of Corporate Governance is not a title which lends itself to a snappy acronym. It does not have much of a PR ring about it and 'financial aspects' tended, when we were first formed, to be dropped off which led to misunderstandings.
- 3. The full title indicates that the remit is not to redesign boards; it is to recommend ways of improving standards of financial information and systems of financial control. Shareholders, directors and professional accounting advisers are linked by flow of information. This leads on to such questions as what information do shareholders and directors require, and whose responsibility is it to provide that information and vouch for its accuracy?
- 4. Partly because the remit was thought to be wider than it is, expectations as to what we might be able to achieve were exaggerated at the outset. The Times in a leader at the time we were set up, on the theme of directors' pay,

referred to the need for the Committee to "cleanse the Augean stables". Any Herculean pretensions were rapidly brought to earth by Accountancy Age.

- 5. To understand our role we need to go back to who set us up and why. Our three main sponsors are the Financial Reporting Council, the London Stock Exchange and the accounting profession. The DTI provided invaluable help in kind by seconding a secretary to us. The Bank of England provides our meeting place.
- 6. The background to our being set up was widespread concern about the effectiveness and accountability of boards, significantly manifest both here and in the US. Again, in both countries, this raised questions about the rights and duties of shareholders.
- 7. Closer to our remit, there were some major collapses of established companies whose reports and accounts seemed to give no prior warning of the true financial situation (or were so coded as to be unintelligible). What were the directors doing? Where were the auditors? There was confusion about the precise respective responsibilities of directors and auditors and concern that accounting rules allowed too much latitude. The Caparo Case raised difficult questions about to whom auditors owed a duty of care. Chris Swinson, BDO Binder Hamlyn managing partner, wrote recently:

"Only those who are blind and deaf could deny that the state of financial reporting and auditing gives cause for concern".

- 8. Evidence of this general anxiety is to be found in the number of papers addressing corporate governance issues, and the steps taken to strengthen the bodies responsible for accounting/auditing standards. Two papers - ABI 'Role of Institutional Shareholders' and IFMA 'Voting by Institutional Shareholders' - are directly in your field.
- 9. Given the activity on these matters in the US, it will be interesting to see how far and fast the US institutional practices on voting and proxy solicitation spread to the UK.
- 10. So to be more precise about the concerns of our sponsors, the accountancy profession is anxious about the loss of public confidence in the audit role. The Financial Reporting Council is concerned that the auditor does not have enough rocks to stand on in dealing with a demanding board. The regulators want to see roles and responsibilities clarified and a proper system of checks and balances in place.
- 11. Although our remit is limited by the 'Financial Aspects' in our title, it is still a large one. One of our main tasks will be to examine the role and responsibilities of the auditor in the context of corporate governance, and in so doing we shall be examining issues such as audit committees;

the need for strong independent directors to sit on them; and the requirement for effective accounting standards and high standards of company reporting. Furthermore one cannot look at the role of the auditor in isolation. It has to be looked at alongside the corresponding role of the board, and the involvement of shareholders.

12. I'm not sure who coined the phrase 'corporate governance'.

Reading through a speech by the President of the Institute of Chartered Accountants in 1934 on corporate governance themes I noticed that he did not use the term - instead he struggled with 'the machinery concerning public company administration and control'. But in other respects the speech showed that little is new. Then too there had been some spectacular company collapses in the wake of recession, then too there were calls to clarify the duties and responsibilities of directors and auditors. There were also some remarks about shareholders with a familiar ring:

"In an ordinary case the remedy is with the shareholders themselves, as the election of the members of the board lies in their hands. Shareholders do not, however, necessarily possess the information on which they can form a considered judgement. Furthermore the shareholders in public companies are, as a body, extremely apathetic. So long as the affairs of the company in which they are interested prosper, relatively few of them trouble to peruse the directors' reports and accounts with

any care, or to attend the annual meetings, or to ask any questions...

"Are there any means by which the exercise by shareholders of their rights can be made more effective in spite of these unfortunate features...?"

The speech went on to suggest that the answer might lie in the two associations who represented the insurance companies and the investment trusts setting up an organisation to take a more active interest in AGMs; and in shareholders entrusting their voting rights to such an organisation.

13. Clearly the issue of the responsibilities of shareholders towards the companies in which they have invested is of key importance, since institutional shareholders at least have leverage to bring about changes in direction, management and strategy. Leverage is not solely dependent on size, as Anne Simpson made clear. But arguments on whether the interests of those who have entrusted funds to institutions are best served by becoming involved or by leaving that to others are all too familiar to you. The Chairman of the Institutional Shareholders Committee is a member of our Committee and we have papers from ISC and ABI before us. But the bulk of the evidence we have received has been from the accounting profession and companies. We are anxious to have the views of shareholders.

- 14. We are specifically interested returning to our focus on the position of the auditor about whether anything can be done to secure greater shareholder interest and involvement in the effectiveness of the audit. Should for example the composition of audit committees be made subject to shareholders' approval? Should shareholders be able to put forward their own nominees for audit committees? Should a shareholder committee separate from the audit committee be set up to deal with the appointment, remuneration and removal of auditors? The practical difficulties in implementing any of these proposals are clear and we have received arguments to that effect. But any ideas along these lines, as seen from the institutional perspective, would be welcome.
- 15. The Committee hopes to produce a draft report probably in early March and to consult widely on it before publishing a final version in the summer. The report will be addressed to our financial sponsors but I hope that all the organisations represented on the Committee -including the CBI, Institute of Directors, Hundred Group of Finance Directors and Institutional Shareholders Committee will be active in supporting the conclusions. I envisage these probably falling into two categories a statement of best practice, and possibly also specific recommendations addressed to bodies like the accountancy institutes, Stock Exchange, DTI or whoever would be the appropriate implementing body. I would expect to concentrate on principles rather than detail, not duplicate the work of

others, and to rely on self-regulation rather than legislation.

- opinion and consolidate best practice as standard practice.

  A window of change is now opening. Doubts about the way in which the present system of financial accountability is operating are combined with a general willingness to look at how it could be improved. We do have a real opportunity to make an authoritative statement of best practice if the bodies represented on the Committee swing behind it.
- 17. So far as the auditor is concerned, I believe the Committee will see its role as being to help restore confidence in the role of the audit. Part of the solution may very well lie in the direction of audit committees manned by effective independent directors of the required calibre, and an acceptance by boards and auditors that they share a responsibility to ensure that the relationship between them remains professional and objective. The work of the Accounting Standards Board is also crucial.
- 18. So far as the role of boards of directors is concerned, and falls within our remit, there are some very good statements of best practice already in existence and there is a wide measure of consensus. We may be able to draw on them to produce a set of principles and rely on the weight of the Committee to give them added authority.

19. And finally there is the role of the shareholder. As I said earlier, I would be genuinely interested to hear views on how major shareholders in particular can best exercise their responsibilities as proprietors of a company.

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