ACTION	**For Information**
TOPIC	**Cadbury Code**
ABSTRACT	**Monitoring Service - Statements of Compliance by Companies**
ENQUIRIES	**Paul Emerton Direct Line 071-216 7678 Fax 071-696 8979** **Michael McKersie Direct Line 071-216 7659 Fax 071-696 8979**

To All Investment Managers

8 April 1994

Ref S/932/057

Dear Member

Cadbury Code - Top 500 Companies

As you may know, companies reporting in respect of financial years ending after 30 June 1993 are required to state in their annual Report and Accounts whether or not they have complied, since 30 June 1993, with the Cadbury Code. Companies must specify areas or periods of non-compliance and give reasons.

The Association is undertaking a qualitative review of each of the top 500 company's statement of compliance, or otherwise, and will be making regular two monthly reports to members. Where serious weaknesses in compliance arise, such as for example too few independent non-executive directors, the matter is discussed first with the leading shareholders - in practice 2 or 3 Offices. A course of action is then decided upon which may or may not involve representation by ABI directly. So far, out of the 52 companies examined, 10 have generated this kind of interest. A brief summary of these cases, together with additional information concerning adherence to the Code, is attached. Urgent cases or non-compliance which call for action at an AGM will be dealt with through the weekly Share Monitoring Report so that member will be fully informed when lodging their proxies..

The Association is also co-operating with the Cadbury Committee in building a database of information about compliance with the Code for the purposes of any subsequent review. If you require any further information, please contact either Paul Emerton or Michael McKersie.

Yours faithfully

R D Regan
Head of Investment Affairs
Secretary Investment Committee

Enclosure

[C022202A.INV.RDR]

Association of British Insurers
51 Gresham Street London EC2V 7HQ Tel: 071-600 3333 Fax: 071-696 8999

TOP 250 COMPANIES - 23 CASES (MARCH 1994)

Companies stating reasons for non-compliance	4
Chairman/CE combined but,	9
without strong and independent element of NEDs on the Board	2*
Nomination Committee for selection of NEDs	13
Remuneration Committee consisting wholly or mainly NEDs	22
Audit Committee with at least 3 members confined to NEDs	19
Audit Committee of 2 NEDs if they only have two	2
Any directors not subject to periodic re-election	10

* leading shareholders have been contacted and the matter discussed in one case. The other company reported fairly early in the period and has other serious omissions but has promised a full review when the 1994 Report and Accounts are delivered.

[N042202A*INV.RDR]

TOP 500 COMPANIES - 52 CASES (MARCH 1994) - FIGURES IN BRACKETS EXCLUDE INVESTMENT TRUSTS

Companies stating reasons for non-compliance	14	(12)
Chairman/CE combined but,	14	(14)
without strong and independent element of NEDs on the Board	6	(6)
Nomination Committee for selection of NEDs	20	(20)
Remuneration Committee consisting wholly or mainly NEDs	42	(38)
Audit Committee with at least 3 members confined to NEDs	38	(32)
Audit Committee of 2 NEDs if they only have two	5	(5)
Any directors not subject to periodic re-election	22	(22)

Summary of cases with serious weaknesses			**ACTION**
1	Too few independent NEDs	7	representations made/being kept under review
2	Audit Committee - not properly constituted	1	"
3	Audit Committee - not property constituted and Remuneration Committee - not property constituted	1	"
4	1 and 3 above	1	company promises full review in 1994 Report
		10	

[N042202A*INV.RDR]

COMMITTEE
ON
THE FINANCIAL ASPECTS
OF CORPORATE GOVERNANCE

c/o The London Stock Exchange
London EC2N 1HP
Tel: 071-797 4575
Fax: 071-410 6822

25 March 1994

Sir Adrian Cadbury
Rising Sun House
Baker's Lane
Knowle
Solihull
West Midlands B93 8PT

Dear Sir Adrian

LIABILITY OF NON-EXECUTIVE DIRECTORS

I have at last been able to obtain a copy of Sir Owen Green's Pall Mall Lecture, and enclose a copy herewith. The remarks on the liability of non-executive directors as reported in the Financial Times are to be found on pages 15-16. I have spoken to a contact at Coopers and Lybrand's corporate governance unit. They have already consulted a barrister on this and are of the view that Sir Owen is mistaken in his view that the liability of non-executive directors who sit on audit, remuneration or other committees has increased. They have not seen this view proposed, or substantiated, elsewhere. While you are on holiday, I will canvass other views, for example from Mark Sheldon, and report to you further.

With best wishes

Brian.

1) Didn't think of this – envisage.

2) Up to Rem. Drs. interest.

3) Structural ? review.

PALL MALL LECTURE

24 FEBRUARY, 1994

Corporate Governance - Great Expectations

Speech by

Sir Owen Green

former Chairman of BTR

SUMMARY

Corporate Governance - Great Expectations
Pall Mall Lecture - Feburary 1994

The corporate environment is one of ceaseless change.

Its problems in Governance change little in nature but much in size and impact. They include:

- Growth in size and international nature of corporations.
- Widening separation of management from shareholding.
- Lack of distinction between the serenity of a professional auditing function and the frenetics of the world of accounting.
- Perceived inadequacies in the administration of laws governing the corporate world.

The disparate interests of the players - shareholders, employees, bankers, related traders and the community - are mutual only in terms of the integrity and competence of the undertaking.

International comparisons of systems of Governance produce no single signpost. Their individuality relates to local influences and each is evidentially as randomly imperfect as that of the UK.

Cadbury overstates the specific responsibilities and understates the potential legal consequences of non-executive directorship.

The role of Auditor should be strengthened and his independence fortified by adequate professional and commercial protection. This will release the non-executive director from his Cadburian watchdog role and restore him to one of constructive contribution to a unitary board's activities.

Codes of conduct aimed to prevent the worst performance are likely to inhibit the best performance in a competitive world. Long live the old unitary concept, its administrative simplicity, its structural homogeneity and its legal convenience.

CORPORATE GOVERNANCE - GREAT EXPECTATIONS

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- Bankers
- Related Traders
- The Community
- The Shareholder

INTERNATIONAL COMPARISONS OF GOVERNANCE
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- USA
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THE UK REVISIONISTS
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- The Board's Responsibilities
- The Chairman
- Remuneration
- The Auditor
- Governance or Over-governance

CONCLUSIONS

CORPORATE GOVERNANCE - GREAT EXPECTATIONS

INTRODUCTION

The concept of corporate governance has been enlarging for more than a century. It has now attained the status of a regime and the busy-ness of an industry. It's growth can be associated with the failure of our law-making system to cope with the pace of corporate development. That development, in size, in complexity and in economic influence, continues as the boundaries of our trading world vanish, the opportunities for investment increase and the aggregation of funds accelerates.

Corporate growth, particularly in size and complexity, demanded greater expertise in management than that provided by a lifetime dedication of a founding father. His commitment was superseded by the career interest of the professional manager. Thus the distinction between ownership and managerial control became inevitable. With a similar result, but for different reasons, the pattern of share ownership also changed from that by individuals to that by institutions. Thus developed a further distinction, that of the professional fund manager, the institution - and his client, the ultimate investor, who might be an individual, a pensioner, an insurance policy holder etc.

The growth of corporate governance as an 'ism' spurred the identification of other interested parties in addition to shareholders. Stakeholders as they are sometimes called, include employees, bankers, lenders, suppliers, customers. Such a variety of interests inevitably entails a broad diversity of particular aims, objectives and expectations.

Small shareholders may require security, regular dividends and some growth. Fund managers may require anything from short term high performance recovery stocks to long term capital growth performance. The employee will seek security of employment and the opportunity for improvement. The banker prefers a client who "works" his account. The supplier seeks a stable relationship with a paying customer and the community seek a good contributor to its well-being.

A design capable of governing the attainment of each of these separate objectives might have taxed the Athenians, even a B School professor. The experienced and pragmatic corporate practitioner realises that the ultimate requirement from any such design is that it does not impede the pursuit of profitability, without which any and all the other interests become substantially irrelevant.

It follows that any system of corporate governance must have as it's basis a recognition of that imperative corporate aim - profitability.

THE CORPORATE ENVIRONMENT

The Austrian economist Joseph Schumpeter provided what I believe to be the best description of a world of advancing living standards. He described it as being dependant on genuine market economies - a specification now accepted by all major economic groups, even including, to a growing extent, that most cautious of advancing nations - China. Schumpeter viewed our world as an open economy forever growing under a process of structural change rather than in static equilibrium. That process of structural change is brought about by creative destruction which through innovation obsolesces existing equipment and processes and their cost. That is to be contrasted with the static circular-flow characteristics of the old command economies.

The introduction of the concept of limited liability was perhaps the greatest single contribution made to the health of that process. That concept enabled, even encouraged, the recruitment of funds on the scale necessary to meet those requirements of a dynamic, thrusting, albeit risk-strewn world. But it protected the investor from the unlimited risks of partnership or of sole trading.

The new funds collected in the process were used for specific purposes to be pursued by entrepreneurs or by professional managers. A distinction between their roles as the drivers of the enterprise and their responsibility for governance does not seem to have been too important in earlier times. The use of non-executive directors was more related to their money-drawing power and their PR potential.

As and when shortcomings appeared in the system additional legislation was framed. Nevertheless law breaking was not unknown and corporate scandals occurred, perhaps more often than in recent years!

THE PROBLEM

Corporate failures are due to market conditions, incompetence, lack of integrity or misconduct. Market conditions are usually beyond the influence of individual corporations. Incompetence and lack of integrity may flourish in conditions of looseness in accounting practices and surveillance. Misconduct is an intolerable cause for which the law must provide the sanction and the punishment. Although the frequency of corporate failure through misconduct may not have grown over the years, its consequences have spread more widely and affected more investors than in earlier times for a variety of reasons.

A main reason relates to growth in all forms of personal savings, particularly in the form of pensions, house ownership and wider share participation, which have been fuelled by successive governments in the UK for political or budgetary reasons. Substantial tax reliefs have been provided to encourage those savings and much advantage has been taken of them. A large part of those funds has been placed through stockmarkets into corporate enterprises and the number and spread of investors, direct and indirect, has greatly increased.

There has been an explosion of mega-force proportions in the size of the world of finance. The Money Illusion has ballooned and there are now more illusionists, to match the ever-growing supply of the gullible. The old idea that 2 + 2 could only equal 4 has long been obsolesced, synergy is the name of the game and fortunes are made, sometimes lost, on paper-structured innovations.

On economic grounds and for other sound reasons, the need to dismantle the corporate state required a shift in society's attitudes. The return to self-dependence and the 'feel-good' factor of personal wealth, through geared homeownership and, the pursuit of material values involved other changes, some of them unintentional. There is little doubt for example that moral standards were affected and the corporate world has not been immune from those changes.

Accounting problems have spread like a plague. Amongst them the desire to produce a universal definition of profit, the determination of values and the monetising of assets, fixed or floating - sometimes twice over - have done little to ease the tasks or aid the standing of the auditing profession.

To the extent that these problems have a legal or technical base they should be dealt with by legal or technical attention. There is much work being undertaken in the field of accounting in the development of standards and for the requirement for explanatory notes in published material, but one wonders whether this campaign for knowledge and statistical 'corrections' is not too important to leave to the generals.

The lack of success in law enforcement is a matter of general concern which is said now to be receiving government attention. Any inadequacy of law itself should be remedied by law. In the environment of the 1990's the current resort to the production of Codes may have attractions but like any quick-paste job they are unlikely to stand the test of time.

How much better would it be if our efforts were to be directed towards identifying the criminal, as they do in the USA , rather than to the rolling out of more coded regulations which burden the innocent and do little to turn the intent of the wrongdoer.

THE PARTIES

I have referred to several parties involved in corporate sector activity which claim, and in some instances need safeguards. What are their expectations from corporate governance and how reasonable are they?

The generic expression for some of these parties is 'stakeholders'. That word takes us beyond current legal definition - rather like the use of the word "owner" to describe a shareholder.

Employees

However, 'stakeholders' does seem to be an appropriate description for employees for their very livelihood depends on their employment with the enterprise. Indeed it is argued that employees by virtue of their length of service and by the relative inflexibility of their connection, i.e. their job. may have made a greater investment than that of the shareholders, in the business. They may also be regarded as having a greater interest in the future of the business for those same reasons.

The German system of governance, the two-tier board, gives some recognition to the employee's status, and has developed from their post-World War II consensus approach to all forms of government. No other major country appears to provide, statutorily, for employee participation in corporate governance. It is to be noted, however, that in the UK, it is not uncommon for employees to have representation on the boards of company pension funds. The importance and sensitivity of pensions schemes and the contributory nature of their funding from employees should indeed entitle them to representation on the relevant Board. Additionally I believe the benefit of this particular window of representation is much underrated in the area of communication.

Pension matters apart, one detects little support from management or labour for the notion of separate employee representation on governing boards. Since his role is wholly executive - doing things - the employee's contribution to and participation in governance should be embraced in and through the executive route. Rather than underplaying the importance of the workforce, that view further emphasises another aspect of the vital role of management executives as members of the Board.

Bankers

Bankers and lenders are quite well provided for in law and through the terms and conditions of their relationships. They write their own rules governing their relations with the client. Any failure in this regard must be largely of their own making.

Related Traders

Customers, clients and suppliers normally have contractual relationships which, for customers at least, usually insure against loss through the inadequate conduct of their suppliers. One is aware, however, of recurring complaints such as late settlement of debts and the misuse of monopoly purchasing power particularly as these affect small suppliers. Although such complaints are often specious, there may be something further to consider in the light of reasonable expectations in these matters. It is to be noted that the government have once more agreed to examine this question.

The Community

The reasonable requirements of the community are mainly satisfied through legislation embracing acceptable levels of adequacy of behaviour. Basic manufacturing standards relating to health, hygiene, environment (noise, smell, effluent) do require regulations. Such considerations apart, the community should have no greater position in relation to the governance of corporations than it has in the conduct of an individual. Arguably less. For the individual is nationally and locally enfranchised. The corporation has no similar franchise despite its proportionately larger contribution at state and local level to the coffers of the community. Why should 'No taxation without representation' fail to apply to the artificial legal person - the Company.

Clearly, each of these parties or stakeholders, to some degree, affects and is affected by corporate behaviour. But the view that this is great enough to require specific recognition by the corporation, much less to be a required inclusion in aims and objective statements is arguable.

In Milton Friedman's words, "broadening the scope of management concerns is a fundamentally subversive doctrine that could thoroughly undermine the very foundations of our free society".

Another US view - a legal one - is that a business should have as its objective the conduct of business activity with a view to enhancing corporate profit and shareholder gain. An expansion of these objectives, however sociologically appealing, will inevitably reduce the concentration of management from its primary purpose.

As Martin Lipton puts it, "management is ill-equipped to deal with questions of a general public interest which would blur the efficient conduct of a focused operation". And so say many of us.

The Shareholder

The most important of these stakeholders, in law, in life and in fact, is the shareholder. Jonathan Charkham, a member of the Cadbury Committee, agrees that under UK legislation the shareholders are technically supreme. The Board which they alone elect is accountable to them. That relationship has clarity and simplicity.

What then are the expectations of the shareholder clothed in his technical supremacy. He is commonly regarded as the owner of the Company. Since that view is the one on which Cadbury relies for the implementation of its "market-based regulation" to turn its proposals into action, the concept merits some discussion.

Charles Handy suggests that we should look at our shareholders more as other countries do, as financiers rather than owners. To satisfy them then becomes a requirement, not a purpose. To reverse this view, he says, runs the risk of confusing means with ends. Shareholders do not have the balancing responsibilities of ownership. He suggests that investing institutions must become guardians, neither owners nor traders. The last exclusion - as traders - I do not share. Nor do the institutions.

Martin Lipton maintains that the modern public corporation is not private property like other private property. Rather it is the central productive (I prefer wealth-creating) element of the economies of the USA and the UK at least. He argues that the rules of corporate ownership and governance must take account of many more interests than do the rules governing less complex property. I agree with his distinction but not his reasons.

To the question - "Where then does ownership of the enterprise reside?" - my suggestion is that it is indeed with the equity shareholders but only as an indivisible collective group. Their ownership is analogous to that of a freeholder landlord whose lease is held by the Board and whose rent is determined in the form of dividends. Separately the investor may also profit from changes in the market value of his investment as determined by market forces.

A further example of recognition of the collective and indivisible nature of shareholders relationship with the company is provided in the House of Lords ruling in the Caparo case and as set out in the Cadbury report. In that case it was found that the auditors' duty of care is owed to the body of shareholders as a whole but not to shareholders as individuals.

Notwithstanding these issues of ownership, what are the shareholders expectations? His individual requirements will relate to the nature of the investment but his underlying universal expectation will be of a company governed with integrity and competence - the twin towers of an enduring business structure.

To the extent that stakeholders can be protected by law, then society's obligation lies in that direction. Equity investment holds its own risks and these are well publicised in the "health warnings" liberally displayed in promotional literature.

Codes of Conduct may save parliamentary time but they have neither the craftsmanship of parliamentary lawyers nor the authority which is created through the scrutiny of experienced legislators.

But the law must be enforced. Were Maxwell, BCCI, Polly Peck, Queens Moat et all to have been regarded as operating within the relevant regulations until their last moments? There is a widely held impression that the judiciary regard fraud and other financial offences as having an abstract quality as expressed by the view of insider trading as a victimless crime. A legion of disadvantaged shareholders, pensioners and creditors think otherwise. Perhaps a touch of the Judge Jeffries or, and more relevantly, a Lord Shawcross might restore balance.

INTERNATIONAL COMPARISONS OF GOVERNANCE

What can our system of corporate governance learn from those adopted by other major world economies? There appear to be some marked differences and little likelihood of early convergence (with the ominous exception of the European Union) due to the differing local requirements of the law, of politics and of custom and practice.

Europe

The German model of a two-tier board is, one suspects, the guiding light of those responsible for UK regulatory development. For that reason the concept of a Supervisory board and a second tier Executive board is worth further examination.. The model was proposed for the UK by the Bullock Committee years ago, and rejected.

Historically, German industry was financed mainly by the banking system. Unusually, when compared with US and UK custom, this finance was provided initially as equity. Without the availability of a charge on assets which a lending bank would normally seek, the German banks sought some direct control over the funds resulting from their equity subscription. That desire was reinforced by the bank proxy custom under which the banks require or shareholders offer their proxies for shareholdings held by banks as nominees.

The banks recognised that they could not manage the businesses underlying their investments and membership of the Supervisory tier board afforded an ideal solution. A solution, I would add, that is often more of form than of substance.

In passing, the conflicts of interest which would arise in US or UK banks, if this model was mirrored, would be huge.

The emergent Supervisory Board, typically with significant bank representation but including worker members, and the Executive Board composed equally of management and labour, also reflected the understandable post-war German commitment to co-determination.

Sir Adrian Cadbury is reported recently to envisage an ultimate convergence between the European and the Anglo Saxon models of governance. Based on the history of the European Community legislation, the power of the Franco-German axis and the whole thrust of Cadbury it is not difficult to envisage who will be expected to do the converging

Other European board structures - French and Italian - reflect the importance of family or state holdings, leaving little scope for protection of other shareholder interest. There is movement, however in State owned industries in France towards co-determination on German lines. It will be interesting to study the development of French corporate governance as their programme of privatisation proceeds.

U S A

The USA appears to have been the most concerned with the development of governance, and may continue to be so. That is hardly surprising, bearing in mind that it is the most imaginative and litigious of communities on the one hand, and it holds the fiercest concern for so-called democratic principles on the other. It claims to hold world leadership of the Unitary Board concept - but in practice its use of a two-tier type structure is evident in many large corporations. It is difficult to believe that the Executive Committee of management in US corporations do not determine most significant issues including those of Governance for formal endorsement by the Board where necessary. This modus operandi is also not uncommon to larger companies in the UK and Germany. Indeed the Articles of Association of many of the largest UK companies permit management board authority involving the widest of discretion.

<u>Japan</u>

The typical Japanese board is very different and perhaps least likely to change. The few outside directors probably come from the web of interconnected associate companies - Keiretsu. The Japanese system believes in the concentration of power in the President/Chief Executive and his operating committee. This reflects their regard for executive strength, for continuity, for long-termism and for the cult of seniority-based experience. This is the nation which alone continues the distinguished tradition under which the most senior officer accepts responsibility for failure. One recalls the head of Japan Airlines visiting and apologising to each family bereaved as a result of an airliner disaster, then giving his resignation. We can no longer expect that behaviour of our political leaders, nor do our industrialists appear to regard this as other than a quaint but obsolete recognition of the honourable dimension in responsibility.

It will be seen that there is not too much international coincidence of view as to the structure of board governance.

THE UK REVISIONISTS

The most recent developments in UK Corporate Governance have been codified in the Cadbury Report of December 1992.

Some Legal Considerations

There was an attempt in 1988 to pass a Bill dealing with Audit Committees through Parliament. That Bill sought to define the term "independent" directors. The Bill passed through all of its Commons stage in one sitting but it was subsequently rejected in the Upper House. Perhaps it was with that precedent in mind that other avenues were sought to provide that which was thought to be too difficult of conventional legislation.

Alterations to or extension of the structure of limited liability companies and the responsibilities of its directors and officers should require to be made through legislation properly drawn up and debated in Parliament before enforcement.

It is important to recognise that Cadbury does not have the force of law but it will have legal consequences. Our company law concepts and our bases of liability stem from the fundamental premise of a unitary board. The consequence of an endeavour to obtain a "half way house" between unitary and two tier boards must create legal confusion. In the event that the courts are involved in any issues of governance they will take the Code as representing the reasonable requirements of directors. One questions whether non-executive directors appreciate that their personal liability may have been substantially increased. Their basic duty of care and skill would formerly have been governed by the concept of <u>subjective</u> reasonableness as determined by their personal background and experience. Executive directors owe a more onerous duty to be judged by objective reasonableness, irrespective of their personal abilities. The strength of this distinction may have been diluted, perhaps extinguished, in the case of members of audit, remuneration and nomination committees whose personal liability may have been increased.

With that potentially enlarged exposure in mind the increased minimum requirement for non-executive directors will only be met with difficulty. This may be so, particularly in the case of less well-regarded companies where there is of course the greatest need. The plight of small company boards over the proportional requirement in numbers has already yielded the possibility of some modification.

The Board's Responsibilities

Corporate governance has been defined by Cadbury as the system by which companies are directed and controlled.

Within this system, the shareholder's role is to appoint (I think they mean "elect") the directors, appoint the auditors and satisfy themselves that an appropriate governance structure is in place.

Cadbury believes that the Board's responsibilities include:

1. Setting the Company's strategic aims.

I wonder how many senior executives of successful growth- achieving companies, even of the largest, would honestly subscribe to that view. Who better to assess short, middle and long term market requirements and asset deployment of the business than those executives steeped in the knowledge of the products and their markets. Board review and endorsement of strategy -

yes. but the idea of non-executives making significant contributions to strategy is not very realistic. As an analogy one recalls the eminent contributions to the strategies of war made by von Clauswitz, Liddle Hart, De Gaulle and Guderian, all men steeped in the technology of their subject. In contrast the contributions to strategy by Churchill and his cabinets and Hitler and his political posse have not been well-regarded by historians.

2. Providing the leadership to put them into effect.

The selection of the Chief Executive and a review of the appointment of his lieutenants is a reasonable expectation of the Board. To extend this requirement further may well interfere with the chemistry of the reaction of the Chief Executive with his men, a process in which the Board would be an inappropriate catalyst.

3. Supervising the management of the business.

This takes the Board close to participation in executive affairs, weakening its ability to preserve the important distinction of management accountability.

4. Reporting to shareholders on their stewardship.

On this subject, Cadbury is to be supported in its recommendations on shareholder communication, particularly with regard to the AGM. Whilst Institutions may feel that not to be an ideal forum for their participation by their attendance, it is often the only opportunity for smaller shareholders publicly to air their views. More should be made of that forum and it is to the credit of some companies with large share registers that they arrange annual opportunities for shareholder questions at venues geographically accessible to their members.

The Chairman

Whilst describing the Chairman's role as "crucial", Cadbury wavered on its separation from that of the Chief Executive. That was a mistake, although it is encouraging to note that, in larger companies at least, the two roles are increasingly recognised as separate and distinct yet compatible.

The general expectation of a Chairman's role is of one who holds the ring, ensures the orderly conduct of a meeting, assisted by the Secretary (an under-emphasised functionary) who takes account of and summarises views and, where necessary, declaring the result of votes.

It is difficult to imagine this being done impartially by the Chief Executive Officer and it is also an unnecessary requirement of him. It would be preferable that there is a mandatory separation of roles in any company having outside shareholding interests.

In smaller companies a local lawyer should prove a good chairman and he would have the added advantage of familiarity with the general requirements of corporate law and of formal meetings. Those who decry this proposition may have an excessively broad view of the executive functions of the Board, a view shared by some academics and non-practitioners and from which Cadbury is not totally exempt.

Remuneration

The Cadbury recommendations on Board Remuneration recognise a problem which has, in the eyes of the general public, grown rapidly in recent years. It is in this aspect of Governance that companies are providing the less attractive features of free markets in which liberty is not licence - a self-discipline of which we need to be constantly reminded.

It is, unfortunately, not rare for there to be at least three elements of compensation. The basic salary recognises the task as described being properly executed. The bonus or performance related pay is an additional reward for doing the same thing but surpassing the requirement. The third element, the share option, will usually represent the reward for the value of the corporate effort over the longer term. That value is normally related to the increase in the share price and the individual's share is usually related to his salary level.

My belief is that the bonus is a hangover from pre share option days. But the combination of the two represents a double-dip into the barrel of available incentive monies. It must be divisive, inflationary and, for as long as it is available, greed promoting. There is little proof of its effectiveness in relation to management performance.

But these items do not amount to the sum of the packages. Frequently these include the pension adjustment - met by the company; termination provisions - often indiscriminate as to entitlement, and signing-on fees reducing the status of top executives to that of professional footballers.

As a first measure for moderation a requirement for total disclosure of all benefits of the highest paid group of executives on the lines of the US SEC compensation tables would identify the true size of these packages.

The Cadbury suggestion of remuneration committees of non-executive directors is demonstrably not a solution, nor is the likelihood of concern or intervention by institutional shareholders who are often and perhaps properly more concerned with the resultant bottom line. Passing the problem to the AGM seems impracticable, nor does moderation appear to be achievable by legislation or through taxation.

But there remain several bodies of influence who might be shamed into disapproving the practice and the persons involved in excessive remuneration packages. That disapproval could be shown, each in its own way, by Government departments, the Honours committee, the IoD and the CBI in their Councils, by the media and by society itself in a demonstrable lack of regard for that over-indulgence.

The Auditor

The Report states that the auditors' role is to provide the shareholders with an external and objective check on the director's financial statements which form the basis of the reporting system. This area is clearly regarded by Cadbury as complex, controversial and requiring much consideration. The evidence is in the devotion of 20 out of the 72 pages of the report proper to these matters.

Cadbury further defines the role of auditors as that of providing the shareholders with an external and objective check on the Directors' financial statements. It then adds that the framework in which auditors operate is not well designed to provide objectivity because

a) Accounting standards, currently, allow too much scope for presentation and Auditors can't stand firm against its client's choice of accounting treatment if that is within permitted standards.

Why, in that event, might auditors wish to "stand firm"? If their objection is strong enough why would they not seek to add a rider to their report? Why are there so many bodies currently engaged in producing new standards, often additional and usually controversial? Who are seeking these innovations? Is it the shareholders in whose interests, mainly if not exclusively, these standards exist? Cadbury observes that the shareholders (and others) need a coherent narrative, supported by figures, of the company's performance and prospects. We can all subscribe to that. But have we not arrived at a point at which the average investor - even the average analyst - is bemused by a growing complex of figures accompanied by ever lengthening notes couched in professional language, supported by a Chairman's report, a Chief Executives report, a Finance Director's statement, an Environmental report and now a Corporate Governance statement?

b) "Auditors have to work closely with management and will wish to have a constructive relationship with their clients".

It is indeed sad to read words the barely concealed meaning of which infer that auditors are hired by managements whose wishes are to be taken as instructions, provided they do not breach the broad and versatile accounting standards.

Another feature of the poor framework for objectivity expressed by Cadbury reads "To the extent however that audit firms compete on price and on meeting the needs of their clients" (this must mean the management) "this may be at the expense of meeting the needs of the shareholders".

These reflections offered by twelve good men and true indicate the level of general regard to which the auditing profession has fallen. Detracting not at all from the problem of the 'expectations gap', albeit a shrinking gap - between what audits do achieve and what they are thought to or should achieve - it is surely unacceptable that the reputation of a profession of the first rank only 30 years ago should have become so controversial. The recently retired senior partner of KPMG Peat Marwick was reported in the Financial Times as believing that, in the past, clients treated the auditor with more respect as a feared and independent character, invariably calling him "Mr". I can recall a few other names but they all conveyed that feeling of awe.

Shareholders should expect their Company's auditors (not the management's auditors) to challenge the management views where the auditors principles are involved and to reject those views where they encourage or condone management bias against shareholder interests. It is difficult to excuse any reluctance on the part of auditors to stand for those principles on which their right to professional respect is based. Their clients are the companies, not the managers. Their re-appointment is not within the gift of the managers but of the shareholders acting as a body, in Annual General Meeting. What additional protection do they need to ensure their status and their independence of management?. Whatever it is, let them have it.

A depth review of the auditing profession is well overdue. The risk of confusion of the role of auditor with those of management consultants et al must be eliminated. Secure the auditor's independence by requiring any change to be made by a special or extraordinary resolution of the company. Consider limitation of his liability in certain circumstances. Restore his role as professional watchdog (but not bloodhound), releasing non-Executive Directors to more constructive purposes.

Corporate Governance or Over-governance

My first impression of the draft Cadbury report was that it was long on accountability but short on drive and efficiency. The final version altered that view a little. It is fair to say that the Committee's purpose was to review those aspects of corporate governance specifically related to financial reporting and accountability. In doing so it has raised the hopes of those who suffered from or were otherwise interested in, and I quote from the preface, "BCCI, Maxwell and the controversy over directors' pay".

Many people might take the view that the spectacular corporate failures of recent years, rare as they have been, were more due to the neglect of requirements of commercial, corporate or common law or inadequacy of due diligence. The Cadbury recommendations will not eliminate those hazards or shortcomings. Indeed, 1993 witnessed more dramatic setbacks or failures and an increase in the controversy on directors pay.

Against these views it should be recognised that the talent which can identify, achieve, or introduce wealth-creating innovation is rare. It is what most of us would regard as enterprising. It is that same spirit which sees the glass as half full, never half empty. The measure is identical but the interpretation is crucially different. Our establishments often seem too easily to develop the "half empty" syndrome. Fear of failure, which has often been a strong and successful motivator, can also lead to reactionary behaviour which fosters regulatory inhibitions which are then presented as safeguards. There is danger in an over-emphasis on monitoring; on non-executive directors' independence from the business of the corporation; on controls over decision making activities of companies. When coupled with the clearly reduced status of executives on the governing boards, such requirements must blunt the competitive edge and deflect the entrepreneurial drive which characterises participation, let alone success, in a free market.

The current thrust of the regulations on corporate governance is towards the distinction of the roles of executive and non-executive or "independent" director. It will lead to a distinction of purpose and, sooner or later, of behaviour.

The emphasis on the special role of the non-executive director has by definition to be on non-executive matters. In stressing his independent judgement, his appointment for a specific term, his requirement to review the performance of the Board and the Executive, Cadbury casts his role as chiefly that of a watchdog.

One only has to read the media reaction to corporate failures of recent years and months to accept that the general expectation of these appointments is as watchdogs and it will be the most human of consequences that the watchdog role will be predominant.

That there should be at least three "watchdogs" on each Board renders more and more remote the idea of a thrusting, innovative, creative group of people ensuring that their organisation is equipped to meet the challenge of Schumpeter's open economy.

Cadbury (I) indicates issues to be considered by son of Cadbury, its successor body. Some of these issues, for example the disclosure of directors' remuneration, may not be regarded as contentious. Much effort might be saved if the US proposals in this and other regards were adopted. But the fading reality of a unitary board will be further diluted by continuing emphasis on the distinctive roles of non-executives in governance. In that event the introduction, de facto, of the upper tier Teutonic shield of the Great and the Good will not be long delayed. What an irony it would be if the behaviour of non-executive directors' under the influence of some of the Cadbury proposals succeeds in persuading executives of the advantage of such a change.

CONCLUSION

In this submission I have described the corporate environment in terms of ceaseless change. Its universe contains a galaxy of investment opportunities - some as transitory as a comet, others as permanent as Mother earth.

The problems presented by this dynamic state reflect the differing requirements of the parties involved. The natural diversity of these requirements are such that the lightest of regulation must affect the expectations of one as it protects the expectations of another. Codes of conduct aimed to prevent the worst performance are likely to exclude the best performance.

International comparisons of governance systems reflect local differences in laws, politics, customs and practice. They are manifestly no more effective than the old UK model.

The potential legal liabilities of non-Executive Directors have increased and they are not well understood.

The distinctive role of auditor should be re-established, thus releasing the non-Executive Director from the role of Cadburian collegiate watchdog to more constructive ends.

As a pre-Cadbury practitioner, I have yet to learn of any system of control of a corporation which will be an improvement on the old unitary concept, its administrative simplicity, its structural homogeneity and its legal convenience.

Long may it endure.

CFACG(94)2nd Meeting

COMMITTEE ON THE FINANCIAL ASPECTS

OF CORPORATE GOVERNANCE

The next meeting of the Committee will be held in Committee Room No 2, 23rd Floor, London Stock Exchange, London EC2, on Thursday 19 May at 4.00 pm.

Agenda

1. Apologies for absence.

2. Minutes of previous meeting held on 23 February 1994, already circulated.

3. Independent Majority on Boards - paper by the Chairman attached - CFACG(94)1.

4. Internal Control - presentation of Report on the Exposure of Draft Guidance to Directors on Internal Control by the Chairman of the Working Party (Paul Rutteman). Copy of the Report and briefing note (CFACG(94)2) attached.

5. Monitoring Compliance with the Code of Best Practice - verbal update on progress by the Chairman of the Monitoring Sub-Committee. — Info. coming thro'. — 176 analysed.
Controlling S/holdr - issue. > 30%.

6. Any other business.

7. Date of next meeting - 3.00 pm Wednesday 14 September 1994 at the London Stock Exchange. Full analysis. Size.

a) Small co's compliance
b) Ability & quality of neds.
c). Remuneration
d). Role of S/holdrs. AGM.

Gina Cole
Secretary
12 May 1994

COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

Independent Majority on Boards

1. A query about the application of the Code has been raised with me concerning 2.2. This states that the majority of non-executive directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement.

2. As I recall, we arrived at this through our recommendation that audit committees should be made up of a minimum of three non-executive directors, the majority of whom should be independent.

3. Up to now 2.2 has raised no questions because, with a normal board, meeting the audit committee recommendation establishes a majority of independent directors among the non-executive directors on the board as a whole.

4. The board in question is that of a consortium. It is unusual in that it has nine non-executive directors, of whom four are clearly independent while five are from the bodies which make up the consortium. These five are also suppliers, in some cases very large suppliers.

5. This would appear to fall foul of 2.2, although it was not a situation which we envisaged or discussed. My first thought is that provided the five take no part in any decisions related to the interest of their own companies as suppliers and that their interests are disclosed in the Directors' Report, it would be possible for the board to regard them as independent in all other respects, though the judgement would have to be theirs.

6. We say in 4.12, "It is for the board to decide in particular cases whether this definition (of independence) is met. Information about the relevant interests of directors should be disclosed in the Directors' Report".

7. I would appreciate advice at our next meeting on how to respond to this query and whether any thought needs to be given by us or by our successors to the wording of the Code in the light of it, bearing in mind the criteria set out in section 4.11 of our Report where our concern was that their should be a sufficiency in number and calibre to carry significant weight in the board's decisions. The text reads -

"Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct. **We recommend** that the calibre and number of non-executive directors on a board should be such that their views will carry significant weight in the board's decisions. To meet our recommendations on the composition of sub-committees of the board, all boards will require a minimum of three non-executive directors, one of whom may be the chairman or the company provided he or she is not also its executive head. Additionally, two of the three should be independent in the terms set out in the next paragraph".

Sir Adrian Cadbury
May 1994

REPORT OF THE WORKING GROUP ON INTERNAL CONTROL TO THE CADBURY COMMITTEE ON THE EXPOSURE OF DRAFT GUIDANCE TO DIRECTORS ON 'INTERNAL CONTROL AND FINANCIAL REPORTING'

INTRODUCTION

1. The Working Group wishes to report the results of its exposure of draft guidance on the Cadbury Code's requirements on internal control as they affect the directors of listed companies. It seeks clarification and support on certain unresolved issues and agreement on a deadline for the publication of authoritative guidance.

2. The Working Group was formed to respond to the Cadbury Committee's request for:

   (a) *'a great deal of detailed work'* to develop its proposals,

   (b) *'a set of criteria for assessing effectiveness'* and

   (c) *'guidance for companies on the form in which directors should report.'*

3. The Working Group published draft guidance in October 1993 with a deadline for comment of 28 February 1994. It has received close on 100 responses, (see appendix), nearly all of which come from the directors and auditors whose working practices will be most affected by the implementation of the Cadbury Code. It is perhaps unfortunate that there has been very little response from groups representing the shareholders or creditors who might be considered its main beneficiaries. Copies of the responses have been passed to the Committee's Secretary and some of the most significant responses representing groups of companies are noted in the text.

4. The Working Group hopes to issue another exposure draft by the end of the summer and to complete guidance in time for implementation for accounting periods beginning on or after 1 January 1995. The Working Group however has no authority of its own and, to achieve these deadlines, needs the Committee to:

   (a) clarify certain requirements of its Code which are causing practical problems and

   (b) advise on other issues arising from its experience to date and its expectations for the future.

ISSUES WHERE THE COMMITTEE IS ASKED TO CLARIFY ITS REQUIREMENTS

Paragraph 4.5 'The directors should report on the effectiveness of the company's system of internal control'.

Issue 1. The Cadbury Code refers to a report on *'effectiveness'* rather than *'responsibility'*. Most respondents accept the need for directors to make some statement on internal control but many consider paragraph 4.2's requirement for a public report on the effectiveness of the company's system of internal control too onerous. Such respondents include the CBI, the Association of British Insurers, the British Bankers Association, The Group of Scottish Finance Directors, ICAEW, Coopers & Lybrand, Ernst & Young, KPMG, Price Waterhouse and Touche Ross.

Issue 2. The Cadbury Code refers to *'internal control'* rather than *'internal financial control'*. Although most respondents agree with the Working Group's suggestion that directors should only be required to report on financial controls, an important minority observe that the Committee's original draft requirement referred to *'internal financial control'* and that the subsequent deletion of the word *'financial'* demonstrates a conscious decision to require a comprehensive report. Respondents in favour of this approach include the Institute of Internal Auditors, ACCA, Coopers & Lybrand, Ernst & Young and Price Waterhouse. It is worth remembering here however that some of these respondents are against public reporting in the first place.

Issue 3. The Cadbury Code makes no distinction between large and small listed companies. Some respondents however perceive that, despite operating what they consider to be an effective system of controls, they may not be able to meet all the individual control criteria. We understand that the Committee is already considering in conjunction with CISCO how its code should be interpreted by smaller companies.

Issue 4. A number of respondents believe that the draft guidance is too detailed and that the Working Group should restrict itself to a brief statement of principles. Others suggest that the more detailed guidance should be relegated to a separate volume. In addition to many individual plcs, such respondents include CBI, 100 Group, CIMA, Coopers & Lybrand, Ernst & Young, KPMG, Price Waterhouse and Touche Ross. The distinction between the need for principles and the need for guidance is one which the Working Group believes can only be made by the Cadbury Committee.

5. **Issue 1. Effectiveness v responsibility**

Responses generally demonstrate directors' perception that:

(a) the public expression of an opinion on effectiveness may increase public expectations in a complex area and directors' vulnerability to criticism and litigation should serious weaknesses subsequently come to light.

(b) reporting a weakness, especially one which has subsequently been corrected, may unjustifiably affect confidence in the company and may not therefore be in the shareholders' interest. It may also breach obligations to insurers.

(c) the procedures necessary to support a public statement as opposed to an implied responsibility may involve significant extra costs within the company, let alone the costs of any review to be performed by auditors.

Some respondents suggest that the Committee's purposes might be better served by changing paragraph 4.2's requirement from a report on <u>effectiveness</u> to a statement of <u>responsibility</u> backed by a <u>description of the process</u> by which directors seek to fulfil their responsibility.

There is clearly a balance to be struck between accountability and cost but such a compromise, although a considerable step forward, would not prevent some companies with weaker systems from emphasising the positive aspects while remaining silent on any weaknesses, thereby making it difficult for any reader of the statement to assess the overall position.

6. **Issue 2. Internal control v internal financial control**

Definitions of internal control cover not only reliable financial information and reporting but effective and efficient operations and compliance with laws and regulations. While directors are clearly responsible for all these aspects, our respondents are overwhelmingly in favour of limiting the remit of the Code and any consequent public reporting to the financial aspects. Auditors also point out that the subjectivity involved in expressing opinions in such areas as efficiency and value for money would make any review they performed much more difficult and would add very little value for considerable extra cost. This view is shared by the majority of the Working Group which supports a requirement for reporting on internal financial controls with guidance for directors on how to provide additional paragraphs expanding this coverage into other areas of internal control should they so wish.

Nonetheless, several respondents note the difficulty of isolating financial controls from other controls and the Institute of Internal Auditors has drawn our attention to the original draft of the Committee's requirement. This specified that the directors' report was to cover *'financial'* controls and the IIA point out that the deletion of the word *'financial'* in this and several other places in the main body of the report may indicate the Cadbury Committee's deliberate decision to require public reporting of the whole range of internal control.

This issue can only be clarified by the Committee itself.

7. **Issue 3. Smaller listed companies**

The draft guidance illustrates how smaller companies might meet its criteria for effective control and accepts that the controls used by smaller companies may be less formal than those necessary for larger companies. Many respondents however believe that the additional monitoring may impose disproportionate extra costs. We understand that the Cadbury Committee is already negotiating with representatives of smaller listed companies and it will obviously be necessary for the Working Group to adjust its approach to any agreement made.

8. **Issue 4. Guidance v principles**

The issue of guidance v principles is only relevant should issue 1 *'Effectiveness v responsibility'* be decided in favour of *'Effectiveness'*.

Most respondents comment on the length of the draft guidance, (although its 57 page format compares with the 300 pages of its US equivalent and includes 26 pages of detachable illustrative appendices).

While the Working Group will respond to this criticism by producing its final *'set of criteria for assessing effectiveness'* in a format similar in length to the Cadbury Code itself, it observes that a document of this length can only contain statements of principle, it cannot provide practical guidance or impose any restraint on the type of board the Cadbury Code is designed to restrain.

In practice, the Cadbury Code is supplemented by the full report, a much larger document which includes illustrative guidance in the form of specimen terms of reference for an audit committee. The length and detail of any supplementary guidance offered on internal control is something on which the Working Group wishes to seek guidance from the Cadbury Committee.

In considering the appropriate length for guidance the Committee may wish to consider the following factors which underlie the length of the current draft.

(a) The distinction between *'material'* and *'immaterial'* **risks** is more important than the distinction between what some respondents refer to as *'high'* and *'low'* level controls. Non - executive directors serving on audit committees should be aware of the main risks and how those risks are controlled even if they have delegated the day to day operations to a lower level.

(b) The modular format of the draft guidance and its appendices offers directors various levels of detail at which to work and delegate.

For the non - executive director this risk-based approach and key questions are more flexible than any high level/low level divide and perhaps represent the most potent and immediately relevant part of the guidance. The most detailed level is pitched at the key questions which senior external auditors ask in assessing the effectiveness of a particular system. These key questions would in practice be supported by detailed questions rejected by the Working Group as too specific but whose number can be gauged from the third volume of the COSO report.

If the Cadbury Committee considers that the statement of criteria require any supplementary guidance the Working Group can provide:

(a) a separate section or perhaps a separate volume, with some 20 pages of discussion drawn from chapters 1-6 of the draft guidance. The danger of such a supplement however will be that it may only reformat similar publications already produced by ICAS and CIMA.

(b) a more extended manual of illustrative good practice which would include the material mentioned in (a) and also the key questions of the appendices.

ISSUES WHICH THE WORKING GROUP CAN RESOLVE WITHOUT FURTHER COMMITMENT FROM THE CADBURY COMMITTEE BUT ON WHICH IT WOULD WELCOME ADVICE

9. Issue 5. Reportable Weaknesses

Although most correspondents recognise that any requirement to report on effectiveness implies some explanation of situations where control is found to be ineffective, respondents consider it *'unrealistic'* to expect directors to report weaknesses which have not already resulted in losses or uncertainties in the financial statements themselves. The Working Group intends to accept this view and believes that this change would relieve much of the concern that directors express over litigation.

10. Issue 6. Period v point in time reporting

The great majority of respondents accept that any public report on internal control is a stewardship report and should therefore cover the same period as that covered in the financial statements. Although this is a different conclusion than that reached in the US and might therefore inconvenience multi-nationals, it appears consistent with UK law and the thrust of the Cadbury Code. Opponents of this view include ICAEW, Touche Ross, Manweb and the National Westminster Bank.

11. Issue 7. Prescription v voluntary compliance

Some respondents are concerned that the guidance would be perceived as prescriptive. The perception of prescription must be rebutted, not only since the guidance is in respect of a voluntary code and is designed around the directors' own judgement of material risks in particular situations but also because the intention to prescribe is specifically denied in the text. The guidance is illustrative and the pressure applied to individual companies is only the pressure implicit in any public statement of good practice. Such pressure is an essential feature of voluntary codes.

APPENDIX

LIST OF RESPONSES

Working Group sponsors

Cadbury Committee

Accounting Professional Bodies

Chartered Institute of Management Accountants
Chartered Association of Certified Accountants
Auditing Practices Board
Institute of Chartered Accountants of Scotland
ICAEW
Financial Reporting and Auditing Group
BCAB
Faculty of Information Technology

Interest Groups

Association of British Insurers
British Bankers Association
British Merchant Banking and Securities Houses Association
Building Societies Association
Confederation of British Industry
Group of Scottish Finance Directors
Institute of Internal Auditors
Institute of Investment Management and Research
Law Society
Midlands Industry Group of Finance Directors
100 Group of finance directors

Auditing firms

Arthur Andersen
BDO Binder Hamlyn
Coopers & Lybrand
Ernst & Young
Grant Thornton
KPMG Peat Marwick
" " " " (results of Birmingham seminar)
Pannell Kerr Forster
Price Waterhouse
Robson Rhodes
Stoy Hayward
Touche Ross

Government Institutions
- The Post Office
- The Bank of England

Building Societies
- Halifax Building Society

Listed companies
- Argos
- Arjo Wiggins Appleton
- BAT Industries
- Boots company
- British Alcan
- British Gas
- British Telecom
- Cable & Wireless
- Coats Viyella
- Crest Packaging
- Croda International plc
- Enterprise Oil
- Eurotherm
- Glaxo
- Grand Metropolitan
- Hambro Countrywide
- Hambros plc
- CE Heath
- ICI plc
- Johnson Matthey
- Kingfisher
- Land Securities
- Logica
- London Transport
- Manweb
- Marks & Spencer
- Marley
- National Grid
- National Westminster Bank
- Norweb
- RTZ
- Reckitt & Colman
- Royal Bank of Scotland
- Sainsbury's
- Sedgewick Group
- SmithKline Beecham
- Standard Life
- Sun Alliance
- Tesco plc
- TI Group
- TT Group

Unilever
United Newspapers
Weir group plc
Wickes
Widney
Williams
Wimpey (George)
Wolseley plc
Zeneca

Analysts and training establishments
Kingdom Management Training
Oxley Fitzpatrick
RJM Business Analysts

Individuals
Esculier
JA Morton

CFACG(94)2

COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

Internal Control

1. Background

1.1 Paragraph 4.5 of the Code of Best Practice advises that "The directors should report on the effectiveness of the company's system of internal control.". The recommendation on how this should be taken forward is contained in paragraph 5.16 of the Report which says:-

> "... and **we recommend** that the accountancy profession, in conjunction with representatives of preparers of accounts, should take the lead in:-
>
> (a) developing a set of criteria for assessing effectiveness;
>
> (b) developing guidance for companies on the form in which directors should report; and
>
> (c) developing guidance for auditors on relevant audit procedures and the form in which auditors should report.".

1.2 The Working Group's draft guidance was issued in October 1993, for comment by end February 1994. The Chairman of the Working Group, Paul Rutteman, wrote to Sir Adrian on 14 April (copy attached at Annex 1) and suggested an early meeting to discuss the way forward. an invitation was extended for him to attend the next Committee meeting which has been accepted. It is likely that Mr Rutteman will be accompanied by the Secretary to the Working Group, Richard Chinn, and two other members. He has been asked to join the meeting at 4.30pm.

2. Comments made to the Committee prior to publication of the Report and Code

2.1 I thought it might be useful for Committee members to remind themselves of the comments made by interested parties on the subject of internal control, both prior to the publication of the draft report in May 1992, and after its publication.

3. Prior to Publication of the Draft Report

3.1 **Price Waterhouse** - Stock Exchange to require listed companies to maintain appropriate and effective systems of internal controls and it should issue guidance on the features of good systems for various business sectors. Directors to state in financial statements whether appropriate and effective system is in place. Auditors to report whether directors had reasonable basis for this statement.

3.2 **Arthur Andersen** -companies to maintain proper systems of internal control and directors to publicly state their satisfaction with the system to shareholders - also to include an adequate information system. Need for specific legislation - suggest that voluntary system wouldn't work. Requirement for the auditor to "endorse" management's opinion.

3.3 **Coopers & Lybrand** - standards on internal control to be set. Directors to report in annual report that they are satisfied that adequate internal controls exist and auditors required to report on this statement.

3.4 **CBI** - support for the Committee's proposals in principle - including comment on internal financial controls and going concern - "We shall offer views on the profession's ideas for giving them effect.".

3.5 **IOD** - against statutory intervention, but nothing specific mentioned internal control.

3.6 **Chartered Institute of Management Accountants** - statutory requirement for quoted companies to have adequate internal control. Financial statements to contain a statement to this effect. Auditors to make a statement as far as internal control statement relates to the financial statements which they have audited. Quoted companies to have audit committees.

3.7 **FRAG** -annual financial statements of quoted companies should contain a statement on the adequacy of internal controls, on which the auditors should report their opinion.

3.8 **ICAS** - ICAS Working Party recommendations on Directors Responsibilities for Financial Statements. Annexes 5 and 6 of that Report are attached to this paper for information at Annex 2..

4. Comments Received in response to the publication of the Draft Report in May 1992.

ACCOUNTANTS/ACCOUNTANCY BODIES

4.1 The ICAEW reported that they had set up a working group in conjunction with the ICAS and the 100 Group of Finance Directors to provide guidance on reporting by company boards on internal control. The APB also stated that the Board would form a working party to bring forward proposals for an auditing standard on reports by auditors on the directors; statement on the effectiveness of internal control systems. The project to be co-ordinated with the work of the ICAEW-led working party.

4.2 The ICAS welcomed the recommendations. They commented "No one model of internal control can apply to all companies. We therefore suggest that the directors; report should reflect what actually happens in the company rather than having a standard imposed applicable to all companies. Also the cost/benefit analysis as to the appropriate system of internal control must be tailored to suit the company.".

4.3 CIMA argued that the Report's treatment of internal control and internal audit was inadequate and that it was inconsistent in the use of the terms "internal control" and "internal financial control". They pointed out that much work was being done to establish a framework for internal control and that the Report should take this into account.

4.4 Arthur Andersen endorsed the recommendations. "So that there can be no doubt as to their breadth, we suggest that a definition of internal financial control be included so as to emphasise that it embraces not only the safeguarding of assets but also addresses the management information needed to control the business.". Arthur Andersen would have liked to see legislative backing for the recommendations.

4.5 BDO Binder Hamlyn commented "We firmly believe that this proposal is not capable of implementation in the short term and would encourage further research and consultation on this issue.".

4.6 Clark Whitehill commented "Although the report hopes that the accountancy profession and others will draw up criteria for assessing effective systems of internal control, we fear that the result will nevertheless be the declaration of a bland statement which will soon become meaningless.".

4.7 Coopers & Lybrand supported the recommendation, subject to reservations about auditors liability, and Ernst & Young also supported the recommendations in principle, and agreed that auditors should report on the directors' statement. Grant

Thornton were in agreement that legislation should only be considered in the light of experience.

4.8 Kidsons Impey suggested the report should have given a clearer indication of what constituted financial controls and what constituted non-financial controls. Neville Russell commented "A report by the directors would be very useful but it would represent a fundamental change in the nature of an audit for auditors to report positively on the internal controls. This change and its consequent difficulties and expense should not be underestimated.". Stoy Hayward supported the recommendations, while Touche Ross recommended research into the levels of cost. "The final report should recognise fully the probable extent of the burden, not least in respect of smaller listed companies.".

SHAREHOLDERS

4.9 The Institute of Investment Management and Research commented that they would like to see users of accounts included among those who should be involved in the follow-up work on developing guidance on internal control.

(Notably no specific comments on internal control from PIRC, NAPF, ABI, BMBA, Postel, IFMA, AITC, or other fund managers who commented on other aspects of the draft report.)

COMPANIES

4.10 The CBI supported the proposals on internal control in principle, but argued that the provision should not stand as part of the Code until the detailed guidance had been agreed. The IOD also supported in principle while noting that the application of the proposals in practice would require very careful consideration.

4.11 Sir Colin Corness (Redland) suggested that "internal financial control" should have read "financial control", and Sir Owen Green believed that "This is another fussy and superfluous proposal.". Julian Sheffield of Norcross said it would be difficult to imagine any company saying anything other than "We believe our internal financial controls are adequate", a view support by Sir Alick Rankin. Brixton Estate thought that the adequacy of internal control should be left to the audit committee.

4.12 BP commented that the report took it for granted that readers shared a common understanding of what internal control was. "In reality there are widely different perceptions of what it means". BP stressed that internal control has wider applications than the area of financial recording and reporting. The Midlands Industry Group of Finance Directors opposed the recommendations on the grounds that internal control is a management issue, not an issue of corporate governance.

5. <u>Guidance on Criteria of Control issued by the Chartered Accountants of Canada.</u>

5.1 Committee members might be interested to read the above guidance, which is attached at Annex 3.

Gina Cole
12 May 1994

ANNEX 1.

The Working Group on 'Internal Control'
PO Box 433, Moorgate Place, London EC2P 2BJ
Telephone 071 920 8461

14 April 1994

RNC/LG

Sir Adrian Cadbury
Chairman
The Committee on The Financial Aspects of Corporate Governance
The London Stock Exchange
EC2N 1HP

Dear Sir Adrian

RESPONSES TO DRAFT GUIDANCE TO DIRECTORS ON INTERNAL CONTROL

The period for comment on this draft guidance ended on 28 February. The Working Group has received over 100 responses and therefore has a clear impression of how its suggestions are perceived.

Nearly all the responses have come from the directors and auditors whose working practices will be most affected by the implementation of the Cadbury Code. We have received no responses from groups representing the shareholders or creditors who might be considered its main beneficiaries.

While there is general support for some kind of statement on internal control, a number of respondents have expressed concern as to the exact form this statement should take. Much of this concern relates not to the draft guidance but to the Code itself. I should appreciate an early opportunity to meet and to discuss with you the best way forward.

The Code requires the directors to report on the effectiveness of the system of internal control and the key issues relating to the Code requirements are as follows:

(1) The need for a report on the **<u>effectiveness</u>** of the system of internal control

(2) Whether weaknesses in the system should be reported publicly, and

(3) Whether 'internal control' should be considered in its broader meaning (to include the efficiency and effectiveness of operations) or in the narrow context of financial controls.

1. **Reporting on effectiveness**

While most directors appear willing to attest their **responsibility** for the company's system of internal control and to describe the steps they have taken to fulfil that responsibility, some are concerned that any public expression of an opinion on the **effectiveness** of the system would increase their vulnerability to criticism and litigation should serious weaknesses subsequently come to light.

2. **Reporting weaknesses in systems**

A number of respondents suggest that to expect directors to qualify such an opinion for weaknesses which have not resulted in losses already reported in the financial statements is not only unrealistic but might affect confidence in the company to the detriment of the shareholders' interest. It might also breach obligations to insurers.

3. **Internal control v Internal Financial Control**

Considerable uncertainty is expressed as to whether the Code requires the directors statement to cover **all** internal controls including those involved with efficiency, legality and value for money, or to limit itself to aspects involving the safeguarding of assets, the control of liabilities, the maintenance of reliable records and the preparation of true and fair financial statements. Internal auditors would prefer the wider interpretation, although most directors favour the latter option. External auditors would clearly prefer to restrict their own review to the latter option.

If these basic issues can be resolved, the Working Group believes that practical guidance may be developed for periods beginning 1st January 1995.

Yours Sincerely

Paul Rutteman

Chairman
Internal Control Working Group

ANNEX 2.

ANNEX 5

A SUGGESTED FRAMEWORK FOR INTERNAL CONTROL

(referred to in paragraph 8 of Chapter 2)

Paragraph 6 of Chapter 2 referred to a number of components of control. There are various ways in which internal control can be considered but we think it helpful that our recommendations should be accompanied by guidance concerning one framework which would provide the means of achieving the recommended objectives. The basic framework may appear purely theoretical but we consider this is the clearest way to present the suggested components and should enable them to be incorporated into a business's system of internal control as appropriate. It is neither relevant nor necessary for us to attempt to provide a detailed implementation manual and only example procedures are illustrated - see Annex 6.

Inevitably, the needs of each individual entity will shape the way in which a suitable internal control system is developed. Approaches other than our suggested framework exist, such as those used by building societies and banks. Extensive literature is available which may assist some companies to adopt such approaches.

The question of suitable systems is not a new one and the accountancy profession has considerable experience of providing advice to directors on the selection or development of systems relevant to the needs of their business.

Components of control

Our framework identifies eleven components of control, namely: (1) integrity (2) ethical values (3) competence (4) the control environment (5) communication (6) establishing objectives (7) risk assessment (8) information systems (9) managing change (10) control procedures and (11) monitoring.

It may be helpful to group the components under the following headings:

QUALITY AND COMMITMENT OF PERSONNEL AND EFFECTIVE COMMUNICATION

(1) integrity
(2) ethical values
(3) competence
(4) the control environment
(5) communication

CLARITY OF RESPONSIBILITIES AND ISSUES

(6) establishing objectives
(7) information systems

The extent to which categories (8) and (9) are addressed will vary from company to company depending on individual circumstances. This will be needs driven rather than resource driven ie the size of company will not necessarily be a decisive factor in selecting appropriate procedures.

(8) risk assessment
(9) managing change

PROCEDURES

(10) control procedures
(11) monitoring

Noted below are the components we have identified in our framework of internal control, together with the criteria for effective control for each component.

Component	Criteria for effective control
QUALITY AND COMMITMENT OF PERSONNEL AND EFFECTIVE COMMUNICATION	
(1) Integrity	Calibre of the staff and the effectiveness of the selection process
(2) Ethical values	Value standards of the organisation
(3) Competence	Staff are both selected and trained appropriately
(4) Control environment	Commitment of senior and middle management to a rigorous and disciplined application of the other components
(5) Communication	There is prompt, effective transmission throughout the business entity of relevant information concerning achievement of appropriate objectives. Also that instances of information channels being blocked are identified quickly and the matter rectified.
CLARITY OF RESPONSIBILITIES AND ISSUES	
(6) Objectives	There is clarity as to each member of management's authority and responsibility and objectives for the relevant trading period. It follows that there should be clarity as to the interrelationship of each person's roles with others in the organisation.
(7) Information systems	There is a clear and appropriate definition of information needs at the relevant levels and groups within the business. Information requirements are identified therefrom and systems are put in place to provide the needed information in a timely and accurate way.
(8) Risk assessment/ opportunities	This has three aspects: - risk from external events which would undermine the business's ability to function eg dependence on one customer or supplier - risk from change in the market place which the company supplies (clearly such changes may also present significant opportunities but it is not the purpose of this paper to address these) - internal risks related to inappropriate handling of transactions and operations such that the company's trading position is significantly affected.

(9) Managing change	Changes affecting the entity's ability to achieve its objectives are identified for management to respond to (keeping the business on the rails). Where management introduces changed objectives or priorities (changing the rails), that these are reflected promptly and effectively within the control environment.
(10) Control procedures	Control procedures are in place to identify non-adherence to policy and to address risks related to achievement of objectives.
(11) Monitoring	All the above aspects of the control environment are kept under regular review and policies and procedures are modified as needed. Where internal audit exists, it will be a powerful tool to assist management in discharging that responsibility.

An example application of the suggested framework for internal control is given in Annex 6.

ANNEX 6

AN EXAMPLE APPLICATION OF THE SUGGESTED FRAMEWORK FOR INTERNAL CONTROL

(referred to in paragraph 8 of Chapter 2)

We suggested in Chapter 2 that there should be an explicit requirement for large companies to maintain internal control systems over their financial information sufficient to provide reasonable assurance that at least nine specific points were satisfied. In Annex 5, we set out a possible framework for achieving effective control.

In this Annex, we draw together the requirement and the framework for control by giving an example of procedures which could be used to implement effective control in relation to one of the detailed points to be satisfied. For clarity, we have deliberately kept the example simple.

The example being illustrated is as follows:

Requirement (a)

All the company's transactions and other accounting information which should have been recorded have been recorded.

Example

The company's cash receipts system.

Potential error

Cash misappropriated by employee and subsequently concealed by falsifying bank reconciliation.

QUALITY AND COMMITMENT OF PERSONNEL AND EFFECTIVE COMMUNICATION

INTEGRITY

1. Does the staff recruitment process assess the integrity of the individual?

2. Is the necessity for continuing staff integrity communicated effectively throughout the enterprise, both in words and deeds?

3. Does management act promptly and fairly to take disciplinary action if a lack of integrity is discovered?

ETHICAL VALUES

The Board of Directors provides direction, guidance and oversight. By selecting management, the Board has a major role in defining what it expects in respect of ethical values and can confirm its expectations through its oversight role.

4. Does a code of conduct exist?

5. Is the code comprehensive, addressing eg conflicts of interest, illegal or other improper payments, insider trading?

6. Does the Board challenge management as well as itself on ethical issues?

7. Do conditions, such as extreme incentives or temptations, exist that can unnecessarily and unfairly test people's adherence to ethical values?

COMPETENCE

8. Has management determined the knowledge and skills needed to perform particular jobs?

9. Are these levels of skill and knowledge determinants in the employee selection process?

10. Is staff performance monitored and are training needs identified on a structured basis?

CONTROL ENVIRONMENT

11. Is a commitment to the other components of internal control communicated effectively throughout the organisation, both in deeds and words?

12. Will the organisational structure foster adherence to the components of internal control?

13. Are Board/audit committee members effective - impartial, objective, capable, inquisitive, have a working knowledge of the company's activities and environment and do they commit the time necessary to fulfil their Board/audit committee responsibilities?

COMMUNICATION

14. Differences in control accounts/bank reconciliations are notified to superiors.

15. External communications relating to complaints are notified to superiors.

CLARITY OF RESPONSIBILITIES AND ISSUES

OBJECTIVES

16. Adequacy of the definition of responsibilities and an understanding by those concerned of their responsibilities.

17. Knowledge where appropriate within the company of these responsibilities.

18. The existence of an appropriate organisational structure to facilitate the information flows necessary to achieve objectives.

19. Segregation of duties

20. Authorisation and approval

INFORMATION SYSTEMS

21. The existence of an appropriate organisational structure to facilitate the information flows necessary to achieve objectives.

22. Assessing whether it is appropriate to build in materiality criteria.

23. The means of ensuring the integrity of data contained within information systems.

24. The means of ensuring that changes to operating systems and programmes, and access to data within the system, are secure.

25. The maintenance of adequate reference manuals specifying the systems.

The extent to which risk assessment will be addressed will vary from company to company depending on individual circumstances. This will be needs driven rather than resource driven ie the size of company will not necessarily be a decisive factor in selecting appropriate procedures.

RISK ASSESSMENT

26. Are risks identified through formal processes eg assessing the impact and controllability of risks?

27. Do senior managers review risk assessments in their areas of responsibility?

28. Does management determine the estimated amount of loss, and the probability or likelihood of the risk occurring?

The extent to which managing change will be addressed will also vary from company to company depending on individual circumstances. This will be needs driven rather than resource driven ie the size of company will not necessarily be a decisive factor in selecting appropriate procedures.

MANAGING CHANGE

29. Adequate procedures are in place to allow changes such as in key management responsibilities or critical external factors eg exchange rates, customer information, to be made efficiently and effectively.

PROCEDURES

CONTROL PROCEDURES

30. Differences in control accounts/bank reconciliations and other anomalies are investigated by appropriate personnel and corrective action is taken.

31. Adequate physical control maintained over funds held.

MONITORING

32. Appropriate personnel to review exception reports etc and to decide whether policies and procedures require modification. Where internal audit exists, it will be a powerful tool to assist management in discharging that responsibility.

ANNEX 3

Purpose

5.01 The guidance issued by the Criteria of Control Committee is intended to be of use to several parties:

- To managers and other people throughout an organization who are accountable for implementing and maintaining control in an organization or part of an organization, because their 'being in control' is fundamental to their achieving operating objectives;

- To a board of directors participating in, and conducting its oversight responsibility for the effectiveness of, control in an organization;

- To those who are asked or who wish to provide reports on the effectiveness of control in their organization;

- To auditors who are asked to provide assurance on the reliability of assertions about the effectiveness of control.

5.02 The Committee's charge and long-term intention is to promulgate "criteria of control" - that is, definitive standards against which control systems can be measured. These guidelines are issued in the expectation that, after due process of exposure and comment, they will form the basis for generally accepted criteria of control.

5.03 These guidelines provide a benchmark against which an organization's control processes can be evaluated. The Committee intends to develop related guidance on topics such as control evaluation (addressed by way of example only in Exhibit X on page 30); management reporting on control within the organization; management and board reporting external to the organization; and auditors' provision of assurance concerning such management and board reports.

5.04 This guidance is applicable to all kinds of organizations in both the public and private sectors, and is applicable equally to a whole organization and to a part of an organization (such as a division, group or individual). The specific details and the formality with which control is applied will vary, depending on factors such as the size, structure and type of an organization.

5.05 Significant changes are taking place in many organizations. These include the restructuring of work to eliminate levels of management; reducing the size of the workforce by giving more responsibility to front-line employees; and utilizing information technology to streamline approval procedures. These and other changes are leading many organizations to place more emphasis on informal controls (such as shared vision and values), based on two key assumptions:

- that people will do the best job that the organization's systems allow; and
- that people have the capacity and willingness to exercise self-control.

This guidance has been developed to be equally applicable to such organizations and therefore takes into account recent evolution in the practice and theory of control.

The Nature of Control

5.06 Control involves the coordination of activities toward the achievement of objectives. This can be achieved through having good information and being able to make use of it at the right time and at the most appropriate level in the organization. Control creates the conditions for people to exercise their judgement and creativity, while managing the risk of inappropriate actions. Control gives people the flexibility to address change while establishing procedures to cope with known risks. This understanding of control is very different from the connotations it sometimes carries: a set of rules imposed from above, an unwelcome constraint on people's ability to get on with their work.

5.07 Definition: Control consists of dynamic, integrated processes, effected by an organization's board of directors (or its equivalent[1]), management and all other staff, designed to provide reasonable assurance regarding the achievement of the following general categories of objectives:

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1 The governing body of a government or not-for-profit entity may be called by a different name. In a unit within an organization, the equivalent to the board of directors is the senior management or other leadership group.

- Effectiveness and efficiency of operations

  - addresses an organization's basic business objectives, including performance and profitability goals and the safeguarding and efficient use of resources. This includes the safeguarding of the company's assets from inappropriate use or loss and ensuring that liabilities are identified and controlled.

- Reliability of financial and management reporting

  - addresses the maintaining of proper accounting records , the reliability of financial information used within the organization and for publication to third parties. This includes the protection of records against two main types of fraud: the concealing of theft and the distortion of results.

- Compliance with applicable laws and regulations and internal policies

  - addresses the responsibility for ensuring that operations are conducted in accordance with legal and regulatory obligations and internal policies.

5.08 The fundamental concepts included in this definition are:

- Control consists of a number of integrated processes. It is a means to an end, not an end in itself. It is a series of interconnected actions and events that are directed at helping to achieve objectives.

- Control is effected by people at every level of the organization. People are responsible for designing, implementing, sustaining and maintaining the control processes.

- Control processes are dynamic. Organizations operate in constantly changing environments both externally (e.g. customers, suppliers, regulation, etc.) and internally (e.g. people, operating processes, priorities, etc.). The control processes must be mutually supportive and integrated, and also change and adapt if they are to continue to be effective.

- Control can be expected to provide only reasonable assurance, not absolute assurance. Absolute assurance is not possible due to inherent limitations of, and choices made in, any control process, discussed more fully below.

- Control is geared to the achievement of the organization's objectives in one or more separate but overlapping categories. For example, objectives relating to effectiveness of operations may include requirements for management reporting and regulatory compliance.

5.09 An organization's control processes exist for the fundamental reason that they help the organization meet, or measure its progress in meeting, its objectives. Control processes should, therefore, be built into rather than built onto the organization's operating activities. In a practical sense, this means that when changes are contemplated to any aspect of an organization's operations, the control processes should be considered and adjusted, if necessary, simultaneously with the operating change. In some cases, the control processes may be so integral to the operating activities that it is difficult to clearly separate the two.

5.10 Given the complex nature of control, the Committee is especially concerned to avoid prescribing or condoning a set of detailed, prescriptive control procedures. Such detailed prescription can only add to the management burden and, if poorly applied, will provide only a documentary facade of control that is not indicative of the actual effectiveness of control in the organization. Instead, the Committee sets out high-level guidance that management at all levels in an organization can use to develop, assess and change its own control processes.

Control frameworks

5.11 A control framework is a way of looking at an organization so that important aspects of control and important relationships between them are apparent. Thus a control framework helps people to understand what is happening and to predict and prepare for what is likely to happen next. Several themes are relevant to any control framework. Examples of such themes are values, policies, needs of interested parties, accountability, authority, responsibility, objectives, risk assessment and acceptance, planning, skills and capabilities, reward systems, information, control activities, monitoring and measuring, learning and changing, mission and vision, personal responsibility, decision processes, trust and coordination.

5.12 Any control framework will tend to emphasize some aspects and relationships more than others. Accordingly, while an organization may adopt a single framework, the use of multiple frameworks can provide additional insights into control.

5.13 The guidelines set out herein provide practical guidance for designing and assessing control in most organizations today. The guidelines draw on the U.S. publication 'Internal Control - Integrated Framework'[2] They are representative of the current state of the art of management control as applied in practice and as discussed in management and control literature. They draw on past developments, and are subject to future evolution.

5.14 No one framework will be perfectly suited to all organizations, and these guidelines will need to be creatively interpreted and applied. An organization will need to create a coherent framework or frameworks suited to its particular circumstances. Appendix 4 gives examples of interpretive frameworks for these guidelines.

5.15 The committee intends to continue to study the evolution of approaches to management control. Additional publications or amendments to these guidelines may result.

What Control Processes Can Do

5.16 Control processes can help an organization achieve its objectives, mitigate risk and prevent loss or misuse of resources. They can help ensure reliable financial and management reporting. They can help ensure that the organization complies with laws, regulations and internal policies, avoiding damage to its reputation and other consequences. In sum, control can help an organization get to where it wants to go.

What Control Processes Cannot Do

5.17 It is equally important to be clear on two things that control processes cannot do. They cannot provide absolute assurance regarding the achievement of objectives, no matter how well they are designed and operated. And they cannot ensure that actions and decisions taken are correct, especially with hindsight.

2 Committee of Sponsoring Organizations of the Treadway Commission, New Jersey, 1992. It is the intention and belief of the Committee that organizations whose control systems follow its guidelines will also be in compliance with the COSO framework. A comparison between the control framework outlined in this statement and the framework provided by COSO is provided in Appendix 2.

5.18 There are two basic reasons why absolute assurance is not possible.

- First, there are inherent limitations in any control process. These include the realities that human judgment in decision making can be faulty, that breakdowns can occur because of human failures such as simple error or mistake, that control procedures can be circumvented by collusion of two or more people and that management has the ability to override the control process. Control processes can help minimize the occurrence of such errors and breakdowns but cannot provide absolute assurance that they will not occur.

- Second, cost/benefit considerations can and should be taken into account when designing control processes and specific control activities in an organization. The costs of control processes must be balanced against the risks they are designed to manage. Accordingly, design decisions involve explicit and implicit acceptance of some degree of risk, resulting in outcomes or actions which cannot be predicted with absolute assurance.

5.19 Control processes cannot prevent the occurrence of strategic and operational decisions which are, in retrospect, incorrect. However, they can work to help ensure that an environment and an information-gathering process exists to provide appropriate, reliable information to those responsible for decision-making and monitoring. The decision whether to act and, if so, what action to take, then depends on individuals (both management and other staff). Control processes follow and report on the results of actions taken, or decisions not to act, through the chain of responsibility in the organization. Subsequent action may be taken based on the information provided by the control processes.

Participants in Control

5.20 People at all levels of an organization participate in control. The actions of senior management and the board of directors or its equivalent are key in setting the tone for the organization as a whole. Through their decisions and actions, they implicitly and explicitly influence the type of decisions and actions which will occur throughout the organization. While control processes cannot prevent faulty decisions, the environment established by the actions of people in positions of authority will influence the direction of decisions when choices are available.

5.21 The board of directors or its equivalent has several roles in control. Decisions taken or confirmed at this level as well as other board activities, such as approving senior management appointments, influence the control environment by helping set the tone of the organization as a whole. The board also has an oversight responsibility for control, usually carried out by receiving, reviewing and questioning representations from management and, in some cases, regulators and external auditors. In addition, at their discretion, the board may initiate inquiries into areas of particular concern.

5.22 The responsibility for control will flow through the organization in conjunction with an individual or team's accountabilities. Ideally, the responsibility for control is made explicit, but it may not be, especially in areas where it may not be thought of as separate from the operating activity. For example, a plant manager may have production and efficiency targets that he or she is accountable for achieving. Effective control processes will help the plant manager ensure that the goals are achieved, but the control responsibility may not be explicitly stated, because it is deemed to be implicit in the operating responsibility.

5.23 While management is a participant in control, they also are accountable for it and therefore need to assess its overall functioning. Depending on the size and nature of the organization, this assessment can be made by management itself, an independent third party or by a specific function within the organization. On-going information (or lack of it) from the control processes will also provide indications of where they may be not functioning as expected and trigger an assessment of them and related processes. For example, if management expects to receive information about customer service levels in a certain department and no information is received or it is found not to be available, they may initiate a review of information gathering and reporting processes in the area.

Control Components

5.24 The framework used in this guidance groups control guidelines into four components. The components are broadly defined as follows:

- Control environment - provides the context for effective control in the organization.

- Objectives & Risks - addresses objective setting, risk assessment and planning.

- Control Activities - provides reasonable assurance that individual actions that are required to meet objectives are carried out as expected by designing and selecting appropriate control procedures, considering objectives, risks and cost/benefit trade-offs.

- Monitoring & Change - enables management to assess whether the organization is operating as desired in terms of achieving objectives, identifying opportunities or problems and assessing environmental changes that may, in turn, require reevaluating objectives, risk assessments, policies, activities or the monitoring process itself.

5.25 The components and guidelines can and should be applied throughout the organization. For example, the control environment can be considered for the organization as a whole or for a particular division, department, business process, work group or team or even for an individual. Similarly, key risks can be identified both for the organization as a whole as well as for an individual operating unit.

5.26 The control components apply for all three categories of objectives. The control processes within the control components, when operating together, are the means by which the organization achieves reasonable assurance of objectives being satisfied. For example, to help ensure efficient and effective operations, the organization needs to set objectives, identify and assess risks and adjust processes appropriately for them, undertake specific activities to guide and control operating processes and monitor the results against objectives, all in an environment that will affect the types of decisions made and actions taken.

5.27 Control processes are inter-related. They cannot be designed or evaluated in isolation from each other or from operating activities. The dynamic interrelationships among operating activities and control processes cause the specific control processes to vary from one organization to another.

Summary of guidelines

5.28 The following is a summary of the control guidelines set out with explanatory material in the balance of this document.

A. Control Environment

A1 Shared principles of integrity and ethical values should be established, endorsed by the board of directors, or its equivalent, communicated and practiced throughout the organization.

A2 Policies designed to support the achievement of the organization's objectives and management of its risks should be established, communicated and practiced so that people understand expectations and the scope of their freedom to act.

A3 Human resource policies and practices should be established which are consistent with the organization's principles of integrity and ethical values and with the achievement of its objectives.

A4 Authority, responsibility and accountability should be clearly defined and consistent with the organization's objectives so that decisions are made by the appropriate people.

A5 People in an organization should have the necessary knowledge, skills and tools to support the achievement of the organization's objectives.

A6 Communication processes should support the organization's values and the achievement of its objectives.

A7 The control environment as a whole should support an atmosphere of mutual trust between people in the organization.

B. Objectives and Risks

B1 Objectives should be established and communicated.

B2 Significant internal and external risks faced by the organization in the achievement of its objectives should be identified.

B3 Plans should be established and communicated to guide efforts in achieving the organization's objectives.

B4 Objectives and related plans should include measurable performance targets and indicators.

B5 Objectives should be reviewed in light of operating performance and changes in the business environment.

C. Control Activities

C1 Control activities should be designed as an integral part of business activities.

C2 The decisions and actions of different parts of the organization should be coordinated.

C3 The appropriateness of the design and the effectiveness of the operation of control activities should be assessed periodically with the results of the assessment reported to those responsible for the control activities.

C4 Control activities should be reviewed, and changed if necessary, when objectives, risks, policies or processes change.

D. Monitoring and Change

D1 The external environment should be monitored to obtain information which may signal a need to reevaluate the organization's objectives.

D2 The internal environment should be monitored to assess whether changes are required to objectives, policies and/or activities.

D3 The organization's assumptions, inherent in its assessment of risk, the development of objectives and plans, the design of its control processes and in its monitoring of the environment, should be periodically challenged.

D4 Performance should be monitored against the targets and indicators identified in the organization's objectives and plans.

D5 Sufficient and pertinent information should be identified, captured and communicated in a timely manner to enable people to perform their assigned responsibilities.

D6 Information needs and related systems should be reassessed as objectives change or as reporting deficiencies are identified.

D7 Follow-up procedures should be established and performed to ensure appropriate change or action occurs.

D8 The organization should periodically assess the performance of its control processes as a whole in managing risk to the desired level.

A. Control Environment

The control environment sets the tone of an organization, influencing the control consciousness of its people. A culture and values that support good control are the foundation for all other components of control.

A1 Shared principles of integrity and ethical values should be established, endorsed by the board of directors, or its equivalent, communicated and practiced throughout the organization.

5.29 All control rests ultimately on the exercise of individual self-control. Consistency between organizational values and people's own values is conducive to people accepting personal responsibility for their decisions and actions. It also encourages employees to assume individual and collective responsibility for the continuous improvement of the reliability of control processes. The action required will "feel like the right thing to do."

5.30 Principles of integrity and ethical values form the basis for how activities are conducted. Together with an understanding of mission and vision, they constitute the basic identity out of which an individual, group, organization or board will operate. Values contribute to control by underpinning policies and procedures and providing a guide to decision and action.

5.31 The values, preferences, operating philosophy and management style of the senior management and the board of directors, or equivalent, greatly influence the organization's objectives and policies, and the design and operation of control activities and monitoring processes. Principles of integrity and ethical values encompass their attitudes and behaviour towards such issues as:

- compliance with laws, regulations, rules and corporate policy;
- respect for the privacy of client, organization and employee information;
- potential conflicts of interest;
- fair treatment of and respect for individuals;
- relations with parties external to the organization, e.g. shareholders, customers, suppliers, etc.
- integrity of transactions and records; and
- appropriateness of accounting policies.

Managers' attitudes and behaviour towards these issues throughout the organization also influence the behaviour of people within their respective areas of responsibility.