

1 CORPORATE GOVERNANCE

- 1.1 The importance of corporate governance lies in its contribution both to business prosperity and to accountability. In the UK the latter has preoccupied much public debate over the past few years. We would wish to see the balance corrected.

Public companies are now among the most accountable organisations in society. They publish trading results and audited accounts; and they are required to disclose much information about their operations, relationships, remuneration and governance arrangements. We strongly endorse this accountability and we recognise the contribution to it made by the Cadbury and Greenbury committees. But the emphasis on accountability has tended to obscure a board's first responsibility — to enhance the prosperity of the business over time.

- 1.2 Business prosperity cannot be commanded. People, teamwork, leadership, enterprise, experience and skills are what really produce prosperity. There is no single formula to weld these together, and it is dangerous to encourage the belief that rules and regulations about structure will deliver success. Accountability by contrast does require appropriate rules and regulations, in which disclosure is the most important element.

- 1.3 Good governance ensures that constituencies (stakeholders) with a relevant interest in the company's business are fully taken into account.

In addition, good governance can make a significant contribution to the prevention of malpractice and fraud, although it cannot prevent them absolutely.

- 1.4 Corporate structures and governance arrangements vary widely from country to country. They are a product of the local economic and social environment. We have had

the benefit of expert advice on how corporate governance works in practice in the United States and in Germany. We have found no support for the import into the UK of a whole system developed elsewhere. But the underlying issues of management accountability are the same everywhere. There are signs that market developments may lead to convergence, with greater emphasis than before in continental Europe on 'shareholder value'. US and British pension funds and other institutional investors are increasingly investing outside their home territories, and are beginning to exercise their rights as shareholders abroad as they would at home.

- 1.5 The Cadbury committee — a private sector initiative — was a landmark in thinking on corporate governance. Cadbury's recommendations were publicly endorsed in the UK and incorporated in the Listing Rules. The report also struck a chord in many overseas countries; it has provided a yardstick against which standards of corporate governance in other markets are being measured.
- 1.6 Our remit requires us to review the Cadbury code and its implementation to ensure that the original purpose is being achieved. We are also asked to pursue any relevant matters arising from the Greenbury report. But we have an additional task, to look afresh at the roles of directors, shareholders and auditors in corporate governance. We made it clear at the outset that we would keep in mind the need to restrict the regulatory burden on companies, and to substitute principles for detail wherever possible.
- 1.7 We endorse the overwhelming majority of the findings of the two earlier committees. In this report we comment on matters where we take a different view, or which Cadbury and Greenbury did not deal with at all. We do not attempt to record every point of agreement. For example, we do not deal in detail with the role of the company secretary in corporate governance, because that role was fully recognised by the Cadbury committee and we have noth-

ing to add. But we do approach corporate governance from a somewhat different perspective. Both the Cadbury and Greenbury reports were responses to things which were perceived to have gone wrong — corporate failures in the first case, unjustified compensation packages in the privatised utilities in the second. Understandably, both concentrated largely on the prevention of abuse. We are equally concerned with the positive contribution which good corporate governance can make.

- 1.8 It is too soon to reach a considered assessment of the long-term impact of the Cadbury code, but it is generally accepted that implementation of the code's provisions has led to higher standards of governance and greater awareness of their importance.
- 1.9 It is even more difficult to reach a definitive conclusion on Greenbury as only one set of annual reports has been produced under its guidelines. Despite the belief in some quarters to the contrary, Greenbury was not about controlling board remuneration, nor can that ever be done in a free market economy. But it is already clear that Greenbury's primary aim — full disclosure — is being achieved. Indeed, the new corporate governance requirements for the full disclosure of directors' emoluments and for a remuneration committee report have led to a disproportionate part of annual reports being devoted to these subjects.
- 1.10 For the most part the larger listed companies have implemented both codes fully. Smaller companies have also implemented most provisions, but there are some aspects with which they find it harder to comply. We considered carefully whether we should distinguish between the governance standards expected of larger and smaller companies. We concluded that this would be a mistake. Any distinction by size would be arbitrary; more importantly, we consider that high standards of governance are as important for smaller listed companies as for larger

ones. But we would urge those considering the governance arrangements of smaller listed companies to do so with flexibility and a proper regard to individual circumstances.

- 1.11 Good corporate governance is not just a matter of prescribing particular corporate structures and complying with a number of hard and fast rules. There is a need for broad principles. All concerned should then apply these flexibly and with common sense to the varying circumstances of individual companies. This is how the Cadbury and Greenbury committees intended their recommendations to be implemented. It implies on the one hand that companies should be prepared to review and explain their governance policies including any special circumstances which in their view justify departure from generally accepted best practice and on the other hand that shareholders and others should show flexibility in the interpretation of the code and should listen to directors' explanations and judge them on their merits.
- 1.12 Companies' experience of the Cadbury and Greenbury codes has been rather different. Too often they believe that the codes have been treated as sets of prescriptive rules. The shareholders or their advisers would be interested only in whether the letter of the rule had been complied with — yes or no. A 'yes' would receive a tick, hence the expression 'box ticking' for this approach.
- 1.13 Box ticking takes no account of the diversity of circumstances and experience among companies, and within the same company over time. It assumes, for example, that the roles of chairman and chief executive officer should never be combined; and that there is an ideal minimum number of non-executive directors, and an ideal maximum notice period for an executive director. We do not think that there are universally valid answers on such points. We believe, as did the Cadbury committee, that there can be guidelines which will be appropriate in most

cases; but that there will be valid reasons for exceptions. Where practices are approved by the board after due consideration, it is not conducive to good corporate governance for the company's explanations to be rejected out of hand and for its reputation to suffer as a result.

- 1.14 There is another problem with box ticking. It can be seized on as an easier option than the diligent pursuit of corporate governance objectives. It would then not be difficult for lazy or unscrupulous directors — or shareholders — to arrange matters so that the letter of every governance rule was complied with but not the substance. It might even be possible for the next disaster to emerge in a company with, on paper, a 100% record of compliance. The true safeguard for good corporate governance lies in the application of informed and independent judgement by experienced and qualified individuals — executive and non-executive directors, shareholders and auditors.
- 1.15 These conclusions have led us to start from the beginning and consider what is meant by corporate governance. We can accept the Cadbury committee's definition of corporate governance as 'the system by which companies are directed and controlled' (report, paragraph 2.5). It puts the directors of a company at the centre of any discussion on corporate governance, linked to the role of the shareholders, since they appoint the directors. This definition is of course a restrictive one. It excludes many activities **involved in** managing a company which may nevertheless be vital to the success of the business.
- 1.16 Our next step was to consider the aims of those who direct and control companies. The single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders' investment. All boards have this responsibility and their policies, structure, composition and governing processes

should reflect this.

A company must develop relationships relevant to its success. These will depend on the nature of the company's business; but they will include those with employees, customers, suppliers, credit providers, local communities and governments. It is management's responsibility to develop policies which address these matters; in doing so they must have regard to the overriding objective of preserving and enhancing the share holders' investment over time. The board's task is to approve appropriate policies and to monitor the performance of management in implementing them.

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This recognises that the directors' relationship with the shareholders is different in kind from their relationship with the other stakeholder interests. The shareholders elect the directors. As the CBI put it in their evidence to us, the directors as a board are responsible for relations with stakeholders; but they are accountable to the shareholders. This is not simply a technical point. From a practical point of view, to redefine the directors' responsibilities in terms of the stakeholders would mean identifying all the various stakeholder groups; and deciding the nature and extent of the directors' responsibility to each. The result would be that the directors were not effectively accountable to anyone since there would be no clear yardstick for judging their performance. This is a recipe neither for good governance nor for corporate success.

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This does not mean, of course, that directors must run the company exclusively in the short-term interests of today's shareholders. As we explain later, the directors' duty is to shareholders both present and future. The shareholders, many of whose holdings remain largely stable over time, are interested in a company's sustained prosperity. As regards stakeholders, different types of company will have different relationships, and directors can meet their legal duties to shareholders, and can pur-

sue the objective of long term shareholder value successfully, only by developing and sustaining these stakeholder relationships. We believe that shareholders recognise that it is in their interests for companies to do this and — increasingly — to have regard to the broader public acceptability of their conduct.

- 1.19 It is also important to recognise the limitations on shareholder action. Firstly, shareholders themselves are subject to constraints — they range from the smallest individual shareholders who act on their own behalf, to the largest institutional shareholder who invests third party funds, frequently under instruction, and always in a competitive environment. Secondly, shareholders cannot be denied their rights; they must be free to buy or sell as they see fit. Thirdly, shareholders by and large are not experienced business managers and cannot substitute for them. Shareholders however can and should test strategy, performance over time and governance practice, and can and should hold the board accountable provided they do this with integrity.
- 1.20 Having reached broad conclusions on the nature and purpose of corporate governance, we have identified a small number of broad principles — some already identified in the Cadbury and Greenbury reports — which we hope will command general agreement. In doing this we have been mindful that business must have proper regard to its responsibilities and to disclosure; but it is equally important to have structures and principles which allow businesses to flourish and grow. We set out our suggested principles in the next chapter. These principles and what follows on other matters are directed largely at the process of corporate governance, which is our remit.
- 1.21 We believe, however, that it is worth repeating that process can only ever be a means, not an end in itself: it will always be far less important for corporate success and for the avoidance of disaster than having properly informed

directors of the right calibre, bringing openness, thoroughness and objectivity to bear on the carrying out of their roles. It is the board's responsibility to ensure good governance and to account to shareholders for their record in this regard.

The Future

- 1.22 **In the** foreword to our preliminary report we said that, in response to many requests, we intended at the completion of our work to produce a set of principles and code which embraced Cadbury, Greenbury and our work. This intention has received wide support and we shall therefore produce such a document.
- 1.23 We intend to pass the completed document to the London Stock Exchange so that it can sit alongside the Listing Rules. We believe the London Stock Exchange should then issue the document for consultation, together with any proposed changes to the Listing Rules. It is for the London Stock Exchange to determine what changes it wishes to recommend, but this committee certainly **envisages that the current requirement for companies to confirm or otherwise compliance with Cadbury will be superseded by a requirement to make a statement to show how they (i) apply the principles and (ii) comply with the combined code and, in the latter case, to justify any significant variances.**
- 1.24 We do not envisage that the consultation on the new combined principles and code will allow a re-examination of the whole subject but we share the view, widely expressed, that there must be an opportunity to eliminate any ambiguities or to seek clarification. This committee will complete its work with the publication of our final report and the issue to the London Stock Exchange of the combined principles and code, but is prepared to assist the London Stock Exchange during the consultation process.

- 1.25** **The objective of the new principles and code, like those of the Cadbury and Greenbury codes, is not to prescribe corporate behaviour in detail but to secure sufficient disclosure so that investors and others can assess companies' performance and governance practice and respond in an informed way. There is, therefore, in our view no need for a permanent Committee on Corporate Governance. The London Stock Exchange can in future make minor changes to the principles and code.**
- 1.26** **We recognise, however that corporate governance will continue to evolve. We therefore suggest that the Financial Reporting Council (FRC), on which the Chairman of the London Stock Exchange, the President of the CBI and the Chairman of the Consultative Committee of Accountancy Bodies customarily sit as Deputy Chairmen, and which itself includes the Bank of England and the DTI as its sponsors, should keep under review the possible need in the future for further studies of corporate governance.**
- 1.27** **We have consulted with the London Stock Exchange, the FRC and the DTI and the above suggestions have their support. We have reason to believe that they would also receive wide support from the other main bodies involved.**