Ethics and Corporate Governance: The Issues Raised by the Cadbury Report in the United Kingdom

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ABSTRACT. In the late 1980s there was a series of sensational business scandals in the United Kingdom. There was particular public outrage at the plundering of pension funds by Robert Maxwell, at the failure of auditors to expose the impending bankruptcy of the Bank of Credit and Commerce International, and at the apparently undeserved high pay raises received by senior business executives. The City of London responded by creating a special committee to examine the financial aspects of corporate governance. This paper describes the resulting Code of Best Practice produced by the Cadbury Committee. To reduce the power of executive directors in the boardroom the Code recommends a greater role for non-executive directors, changes in board operations, and a more active role for auditors. The paper reviews the various published reactions to the Cadbury Report, and concludes that the Code is unlikely to halt the incidence of business scandals in the United Kingdom.

Introduction

In the United Kingdom the issue of corporate governance has come under intense scrutiny in the last three years. In response to a variety of ethical scandals in business, an eminent panel of experts was convened to examine the workings of boards of directors, and the relationship between auditors, boards, executives and shareholders. The committee was chaired by the industrialist Sir Adrian Cadbury. The report of the Cadbury Committee, as it became to be known, has generated public discussion of the most suitable means of controlling the activities of company directors and executives so as to ensure ethical conduct.

This paper summarises the succession of scandals that occurred around the time of the creation of the Committee, and describes the main highlights of the Cadbury Report, which proposes a "Code of Best Practice" for companies. Cadbury's Code suggests a bigger role for non-executive directors on corporate boards, various changes in board operations, and a more active role for auditors. The concluding sections of the paper address the variety of public criticisms leveled at Cadbury's proposals, particularly the feebleness of the Code's proposed enforcement mechanism.

The recent history of scandals in the City of London

In the latter half of the 1980s, a succession of business scandals drew escalating criticism of the apparent lack of controls on business conduct in the United Kingdom. Questions were raised about the potency of the existing system of self-regulation of publicly-quoted companies listed on the London Stock Exchange, and about the ability of the police to identify and prosecute the perpetrators of well-concealed frauds within large firms.

The police had responded to earlier criticism by consolidating a number of investigative teams to create the Serious Fraud Office (SFO), a unit specialising in the detection of large-scale

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corporate fraud. Despite the existence of the SFO, the spate of major frauds continued, and the SFO incurred great costs and met with only minor success in prosecuting these cases.

At one end of the spectrum were cases of simple fraud, as with the investment firms Barlow Clowes and Brent Walker, where savers' funds were stolen by the founding chief executives of the firms. In the case of the conglomerate Polly Peck, corporate funds were siphoned into offshore companies owned by the CEO and founder, Asil Nadir. His subsequent escape from Britain to Turkish-held Cyprus while on bail was a major embarrassment – "the Serious Fraud Office, Britain's showpiece of corporate justice, has been humiliated" (Brummer, 1993a).

A more complex and notorious case involved the theft of over $1 billion in employee pension funds by the business mogul Robert Maxwell. These funds were used to support his ailing business empire. The Maxwell case was the most dramatic of the cases involving abuse of power by the founder of a large public firm who acted as Chief Executive while simultaneously chairing the board.

Some other scandals involved stock manipulation. In the Blue Arrow affair, senior executives of the merchant bank County Natwest were accused of inflating the success of a rights issue of Blue Arrow shares by selling shares in non-arm's-length transactions. In the Guinness scandal a number of eminent business leaders were jailed for their part in a conspiracy to inflate the value of Guinness shares during the controversial takeover battle for Distillers. This transaction was Britain's largest-ever takeover at the time.

The spectacular collapse of the Bank of Credit and Commerce International (BCCI) sharpened the debate over the role of auditors in the detection of fraud and in affirming the going-concern basis of the audited firm. Shortly before the bank collapsed it had released its latest annual report in the United Kingdom, which gave no clue to its impending bankruptcy via massive fraud. The financial statements in BCCI's annual report were signed off by the auditors with no qualifications. As with some other failures, investors had perceived the absence of a warning from the auditors to be a validation of good corporate health, contradicting street rumours of malaise within BCCI.

Further public distress at behaviour within the business community was spurred by the payment of high salaries and bonuses to some chief executives and directors, often in firms whose current performance was deteriorating. There was the strong impression that CEOs were dictating their own pay rates, and that their rewards were determined more by greed than by any objective measure of performance.

The Cadbury Committee itself describes which scandals were dominant in stimulating the public's desire for the repair of the sorry state of British business ethics: "It is, however, the continuing concern about standards of financial reporting and accountability, heightened by BCCI, Maxwell and the controversy over directors' pay, which has kept corporate governance in the public eye." (Cadbury Report, 1992: p. 9)

There was an obvious need for mechanisms to deter and detect fraud, and to empower board members and auditors so to counter the power held by individuals such as Robert Maxwell.

The corporate governance problems experienced in the UK

Publicly quoted companies in the United Kingdom operate under the classic governance structure shown in figure 1. The shareholders elect a board of directors and a chairperson who manages the board's affairs. The board appoints a chief executive officer who is responsible for the day-to-day management of the firm's business activities. The directors provide an annual report to the shareholders on the firm's financial performance. The directors' report is validated by external auditors, appointed by the shareholders on the recommendation of the board. There is a formal annual meeting of shareholders during which financial results are presented, directors are elected and auditors are appointed.

The business scandals of the 1980s drew attention to the fact that self-interested directors could manipulate the operations of the classic governance structure for their own gain at the expense

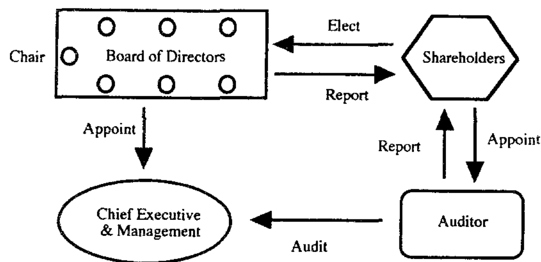

Fig. 1. The classic corporate governance structure.

of shareholders and other fiscal stakeholders. There were a variety of distortions that could take place which had the effect of concentrating power in the boardroom: –

- One individual can become appointed to act as both Chairperson and CEO. The combination of the roles of chair and chief executive in one person clearly subverts the logic of the board operating as a separate monitor of executive activities. This defect in the classic governance structure has long been noted and lamented (see, for example, Lorsch and MacIver, 1989: pp. 184–7; Gillies, 1992: p.65).
- The board controls the nomination of the slate of directors for election by the shareholders. There is obvious potential for corruption in this process, as a CEO can effect the nomination of directors who may further the board's interests rather than the shareholders'. There are three ways in which this can be effected:
  1. The nomination of inside directors who are allied to the CEO. The UK system (unlike the US) does not require outside directors on corporate boards, and relies on the self-discipline of executive directors.
  2. The election of outside (non-executive) directors who are allies of the CEO or who are financially dependent on the firm in some way. In the United Kingdom this is where the "old boy" network is considered to operate in its classic form.
  3. The re-appointment of existing directors for further terms of office. In the absence of a mechanism to ensure the rotation of directors it is possible for a board to become entrenched.
- The pay and incentives for the CEO and other senior executives are decided by the board. If the selection of the board has been biased toward management's interests, then there is a clear opportunity for the payment of excessive remuneration.
- As with the nomination of directors, the board controls the nomination of an auditor for appointment by the shareholders. This raises an obvious conflict of interest in that a powerful CEO can effectively choose the auditor who is then supposed to express an independent opinion on the performance of the firm under the CEO's management. There may be an implicit threat to drop the services of an auditor who expresses an interpretation of accounting standards that is not favoured by management.
- The CEO can monopolize the flow of information to the board, and thus dictate the agenda of the board. At the extreme, the CEO has been able to authorise expenditures without board approval. The absence of another conduit of information flow between the firm and the shareholders as represented by the board has enabled some unscrupulous CEOs to defraud shareholders.

It can be seen that corporate directors are able, if they are so motivated, to manipulate the classic governance structure in a variety of ways so as to promote their own ends. When we add in other elements of human fallibility we have the full recipe for the recent history of corporate abuses in the United Kingdom: "The view of many in the financial press . . . (is that) . . . company failure can be rooted in a combination of malfeasance, stupidity and directors' self interest, aided and abetted by auditors who fail to curb the wildest excesses." (Bain, 1992)

An articulate summary of the corporate governance problem in the United Kingdom was provided in the following editorial in the Economist:

> In principle, shareholders have two main controls over managers: the company's board and the company's auditors. The board is supposed to look after their interests; non-executive directors, especially, are expected to do so. Auditors are supposed to tell shareholders whether a company's account of itself is broadly correct. Neither control is working properly. Boards are dominated by the company's bosses; non-executive directors, though approved by shareholders, are nominated by the chief executives they are meant to moni-

> tor. Auditors, too, are far closer to a company's managers, who supply the information they need, than to shareholders; other sorts of lucrative work, such as management consultancy and tax planning, may hang on the auditors' relationship with managers. (Economist, 1992a)

In addition to the fear of lack of independence of auditors, there was an underlying public ignorance of the role of auditors anyway, which resulted in a public expectation of auditors' capabilities which exceeded their actual statutory duties. This so-called "expectations gap" produced demands for improvements in the scope of auditing so as to conform to public expectations. (Cadbury Report, 1992: p. 40; Humphrey *et al.*, 1993)

The faults in the classic governance structure that were to be addressed by the Cadbury Committee were relatively simple to identify. The nature of these faults appeared to call for radical remedies, and the prognostications of the Committee were eagerly anticipated.

The "Code of Best Practice" proposed by Cadbury

The Cadbury Committee was established in May 1991 by the Financial Reporting Council,[1] the London Stock Exchange, and the accountancy profession.[2] The Cadbury Report was released on December 1st, 1992. The Committee's own summary of their findings is reproduced in Appendix 1. This summary consists of a preamble, followed by the Cadbury "Code of Best Practice", followed by referenced notes on the Code which comprise further recommendations on good practice, but which are not part of the Code itself. (Readers should familiarize themselves with the contents of Appendix 1 before continuing with the remainder of the paper. Readers wishing to review the related literature on corporate governance and accountability should see Keasey and Wright (1993) and Salbu (1993).)

The Code of Best Practice is a short, 19 paragraph description of how firms should conduct their governance practices. Table 1 summarises

TABLE 1
Main recommendations of the Cadbury Report

Governance Issue	Cadbury Code Recommendation
Separate CEO and Chairperson	Recommended but not compulsory
Nomination of Directors	Formal board process via nomination committee dominated by outside directors
Outside Directors	Minimum of 3 non-executive directors
Independence of Directors	Majority of non-executives to be independent
Rotation of Directors	Directors to be appointed for specified terms with non-automatic reappointment
Pay and Bonuses	Annual Report to reveal disaggregated director's pay; remuneration committee of board to be dominated by outside directors
Independence of the Auditor	Audit committee of the board to be formed, comprised exclusively of outside directors
Flow of information to the Board	Board to have a formal schedule of decisions; directors to have paid access to outside advice
Greater Scope of Auditing	Auditors to review compliance to the Code, including directors' statements on going-concern and on internal audit effectiveness

the chief recommendations of the Code in relation to the various governance faults that were detailed above.

The main elements of the Cadbury Code recommendations are described in fuller detail below:

Separation of the Role of CEO and Chairperson. The Code advocates a division of responsibilities at the head of a company, but falls short of insisting on a total separation of the two roles: "Where the chairman[3] is also the chief executive, it is essential that there should be a strong and independent element on the board with a recognised senior member" (Code 1.2). The Report is tentative in elaborating any formal means of recognition of this "senior member" : ". . . board members should look to a senior non-executive director, who might be the deputy chairman, as the person to whom they should address any concerns about the combined office of chairman/chief executive and its consequences for the effectiveness of the board". (Cadbury Report: p. 20, para. 4.5)

Nomination of Directors. The Code proposes formality in the selection of outside directors: "Non-executive directors should be selected through a formal process and their nomination should be a matter for the board as a whole." (Code 2.4) An additional note states that "the Committee regards it as good practice for a nomination committee to carry out the selection process and to make proposals to the board. A nomination committee should have a majority of non-executive directors on it and be chaired either by the chairman or a non-executive director." (Note 7)[4]

The Need for Outside Directors. The Code recommends that a board should have a minimum of 3 non-executive directors. There is no constraint on the number of other directors, and hence there is no set ratio of non-executive to executive directors. The Code recommends the creation of remuneration and audit committees, which would be comprised wholly or mainly of non-executive directors. (Code 3.3 & 4.3)

The Independence of Outside Directors. Code 2.2 states that the majority of non-executive directors "be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment, apart from their fees and share holding." At least 2 of the minimum of 3 non-executive directors should be classed as independent.

Rotation of Directors. The Code states that the service contracts of executive directors should not exceed three years without shareholders' approval. (Code 3.1) With regard to outside directors, the Code says they "should be appointed for specified terms and reappointment should not be automatic". (Code (2.4)

Pay and Bonuses. The Code asks for a full and clear annual disclosure of directors' pay, including pension contributions and stock options, and requires separate disclosures of salary and performance-related pay, with an explanation to be provided on the measurement of performance. (Code 3.2) The pay of executive directors is to be decided by a remuneration committee made up wholly or mainly of executive directors. (Code 3.3)

Nomination and Independence of the Auditor. The Code does not prescribe the process of selection and appointment of an auditor. To promote the independence of the auditor from executive management, the Code says that "the board should establish an audit committee of at least 3 non-executive directors". (Code 4.3) To expose possible conflicts of interest for auditors the fees paid to audit firms for non-audit work should be fully disclosed in the Annual Report. (Cadbury Report p. 39, para. 5.11)

Flow of Information to the Board. The Code states that "the board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is in its hands". (Code 1.4 – the matters to be placed before the board are described in Note 2.) This measure constrains the CEO's authority to formulate and execute strategy. Additional safeguards include the provision of outside advice to directors at company expense. (Code 1.5 & 1.6)

Expanding the Scope of Auditing. Note 14 states that the auditors must review the company's statement of compliance with the Code of Best Practice in so far as it relates to paragraphs 1.4, 1.5, 2.3, 2.4, 3.1 to 3.3, and 4.3 to 4.6 of the Code. Auditors will not only comment on additional financial matters such as the new going-concern statement by directors (Code 4.6), but will also address organizational issues such as the effectiveness of internal control systems (Code 4.5) and the administrative implementation of the Cadbury Code.

Criticism of the Cadbury Code

The final recommendations of the Cadbury Committee were fairly well received by industry, particularly because of the elimination of some of the proposals that had appeared in the draft version of the Cadbury Report issued in May 1992.[5] There remained some sceptics from industry however:

> The Cadbury Report is a disappointment. It is a political document designed to provide a convenient whitewash for some embarrassing failures by a number of people and institutions in an area that has become known as corporate governance, and is so removed from reality that it can only be the predictable weight of establishment acceptance that has muted criticism. (Corrin, 1993)

The editors of a special corporate governance issue of *Accounting and Business Research* summarised the academic response to Cadbury: ". . . although the Cadbury Report has much to commend it, there are a number of dimensions of corporate accountability and governance that have not been addressed." (Keasey and Wright, 1993) The financial press did not give wholehearted praise to the Cadbury Report either. The remainder of this paper describes those aspects of the Report that were seen to be controversial.

Enforcement of the Code of Best Practice

The underlying philosophy of enforcement of the Cadbury Code is essentially one of voluntary compliance, widely regarded as an attempt to maintain a system of self-regulation in the face of the threat of legislated control: "The Cadbury Report represents a watershed in the development of corporate governance in Britain, a deliberate test of the effectiveness of voluntary regulation and of British corporate democracy." (Stiles and Taylor, 1993)

To enforce the Code the London Stock Exchange will require each listed firm to issue an annual statement of compliance. This will identify and explain any areas of non-compliance with the Cadbury Code. It is theoretically possible for a firm to issue a compliance statement in which it details its reasons for not complying with any element of the Cadbury Code. The motivation for full compliance is assumed to be the fear of public exposure and criticism of firms that deviate from the Code.

> The real worry lies in the code's enforcement, or lack thereof. The London Stock Exchange will require listed companies to state in their accounts whether they are observing the code. This is weaker than requiring companies to observe it. And Sir Andrew Hugh Smith, the exchange's chairman, makes it weaker still when he says that delisting is not an appropriate sanction for refuseniks. Instead he promises 'public censure'. (Economist, 1992b)[6]

Much criticism has been directed at the Code's lack of teeth (e.g. Finch, 1992, Osman, 1992). Did the Committee yield to industry pressure and duck the task of imposing discipline on boardroom behaviour? One commentator from the right-of-center Sunday Times is scathing in his review:

> The Cadbury Report is a typically British compromise: well-meaning, reasonable, intelligent and worthless. It is based on the age-old British myth that capitalists are mild-mannered animals capable of learning good behaviour if only they go to the right schools.
>
> In fact, as Joseph Schumpeter, the Austrian economist, pointed out half a century ago, capitalists are predators who render their benefits to society through a process that is both creative and destructive. Such people need to be put inside a strictly policed legal system if they are not to abuse their power and wealth.
>
> Following Guinness, Maxwell, Polly Peck, Barlow Clowes and BCCI, it is little short of laughable that anybody could propose a voluntary code of good conduct as a solution to vast abuses of corporate power. Yet that is what the great and good assembled by Sir Adrian Cadbury came up with. (Cassidy, 1992)

An idea of just how strong some individuals feel the sanctions should be against delinquent behaviour in the boardroom is given by this letter from one of the directors actually involved in the Maxwell affair:

> As a former director within the Maxwell empire who must admit to taking the shilling gladly (for a while, at least) may I be permitted one observation about the pension scandal?
>
> If the fate facing the directors for not standing up to Maxwell had been worse than the prospect of his wrath or the sack then much of what occurred would have been avoided.
>
> Directors have legal and moral obligations to shareholders, employees, and suppliers. Until officeholders are made through the imposition of the severest penalties (such as the confiscation of assets) to understand that power and responsibility must go hand-in-hand there will always be the risk that the desire for the trappings of power will overwhelm the requirements of responsibility.
>
> The flea goes where the dog wishes; if it doesn't fancy the prospect, it should jump off. Staying is eloquent testimony of satisfaction. (Phillips, 1992)

The Cadbury Code seems impotent in comparison to radical ideas such as the threat of confiscation of directors' assets as a means of keeping them responsible. Are draconian penalties at the hand of the law needed to ensure good behaviour in the boardroom? One journalist cites recent history to reject this idea:

> The notion of self-regulation in the financial services industry has become a bit of a joke. The British seem to favour the idea, yet it has done little for the likes of Maxwell pensioners and Barlow Clowes investors. But before we become too carried away with the idea that any regulation is useless unless underpinned by law, bear this in mind: Peter Clowes did break the law; so did Robert Maxwell. The threat of being imprisoned didn't stop them. (Laurance, 1992)

There is thus debate over the effectiveness of stern enforcement and rigid rules in determining corporate behaviour. "Some commentators see the solution as providing more legislation or a plethora of new, often complex, accounting standards. The truth is that corporate governance is more about commitment than compliance. The real solution resides with the board which must lift its integrity and raise its standards and its performance." (Bain, 1992)

The Cadbury Report resists statutory regulation because it fears that legislation will impose minimum requirements which will encourage compliance with the letter rather than the spirit of the law. (p. 12, para 1.10) It remains to be seen if the reliance on integrity and honour in the following of the Cadbury Code of Best Practice will be effective or not. Neil Hamilton, the UK Government's Minister of Corporate Affairs, recognizes this as the critical aspect of the Code: "The controversy over the Cadbury Report was not so much whether any ingredients were missing from its recipe for the financial aspects of good corporate governance but whether a stronger remedy was needed on corporate governance generally." (quoted in Cowe, 1992)

He goes on to threaten that evidence of failure in the enforcement of the Code would provoke the Government to resort to law: "If a sufficiently strong case for further action across the whole field of corporate governance were to emerge, the Government would not be true to its past record if it did not take action." (quoted in Cowe, 1992)

The journalist who quotes the minister expresses his own doubts about the momentum for reform created by the Cadbury Committee's trust in voluntary compliance: "The worry is that without legal backing, current concerns for companies' social responsibilities will melt like snow in spring when the next boom begins to gather pace." (Cowe, 1992)

A "Maxwell-proof" system of corporate governance

Allied to the issue of enforcement is the question of the degree to which the reforms of the Cadbury Committee are sufficient to prevent the re-occurrence of a Robert Maxwell-type fraud. Are the structural mechanisms proposed by Cadbury (e.g. prescribed board agenda, independent outside directors, audit committee, directors' report on internal controls, etc.) sufficient to prevent future abuses of corporate power by an intimidating greedy boss?

To many, the Code seemed inadequate at first sight: "Where was the magic bullet that would rid the world of future Robert Maxwells?" (Martin, 1992) There was scepticism about the Report's claim that "had a Code such as ours been in existence in the past, we believe that a

number of the recent examples of unexpected company failure and cases of fraud would have received attention earlier." (Cadbury Report: p. 12, para. 1.9)

The most damning evidence against the credibility of the Code's structural reforms has come in the form of the persistence of scandals in firms which apparently conform to some of the Cadbury norms. Outside directors failed to curb managerial excesses at British Airways (Levin, 1993, Leppard and Rufford, 1993) and at Barclays Bank (Brummer, 1993a). Six outside directors and an audit committee failed to detect the financial fiasco at the Queens Moat House hotel chain which led to a write-down of $1.5 billion soon after the auditors had given the firm a clean bill of health. (Brummer, 1993b)

On the other hand, is there any workable system of regulation that can guarantee the absence of scandals? A reluctant conclusion drawn by some commentators is that it is next to impossible to design a practical set of governance rules that would be certain of constraining the most extreme examples of managerial deviance: "Maxwell-proofing the UK would probably require such a high level of oversight and scrutiny that the financial system would buckle under the strain." (Martin, 1992)

The UK Minister of Corporate Affairs warns of the high cost of a Maxwell-proof governance structure: "I hate to think that because of one Robert Maxwell all other company directors are going to have to assume disproportionate responsibilities. We have to think how much of an inhibition on the wealth creating process is a system of regulation which imposes relatively high costs for relatively small benefits." (quoted in Jack, 1992)

The Cadbury Committee admits this difficulty when it confesses that it cannot devise a solution to the very problem of fraud that it was created to solve: "It must be recognised that no system of control can eliminate the risk of fraud without so shackling companies as to impede their ability to compete in the market place." (Cadbury Report: p. 12, para. 1.9)

Even recognising the hardness of the task of creating an impregnable set of rules, there remains the question of the strength of the Cadbury Code as a whole. There is little doubt that the Code lies at the weaker end of the continuum of possible measures of prevention of a future Maxwell-like fraud.

External directors

A key aspect of the Cadbury Code is the reliance on independent outside directors to provide a check on internal management, both in the main boardroom and via majority membership of the audit, remuneration and nomination committees. Cadbury's fixation on outside directors as the cure for scandals has been questioned:

> The whole report is like a script for a 'soap' where the non-executive director is cast as a saint, the auditor is a tarnished guardian angel, and the executive director is a villain. Yet such a notion has no basis in reality or research. Every single corporate scandal that gave rise to the need for the report in the first place was riddled with non-executive directors. They served no useful purpose then and saved nobody's money: so why should they now? Why are they the panacea for all future ills? What strange reasoning pillories the executive director but exonerates and elevates to sainthood the non-executive? (Corrin, 1993)

In the UK, the outside director has generally been regarded as insignificant in the governance process, no more than a mere window dressing chosen to enhance the image of the firm. The following list of pejorative descriptions reflects the view that outside directors are useful for display purposes only:

"decorations on a Christmas tree"	(Sunday Times, 1993)
"maraschino cherries"	(Park, 1992)
"the parsley on fish"	(Gillies, 1992)
"management's 'pet rocks' "	(Economist, 1992a)

The Cadbury Committee's vision demands radical changes in the role of the non-executive director, changes which have a number of implications. At the most mundane level, the Code recommends a minimum of three non-executives for each of the boards of the 6 000 firms listed on the London Stock Exchange, suggesting a

minimum of 18 000 outside director positions. Even allowing for individuals holding multiple appointments there are questions as to the stock of available candidates in the United Kingdom, especially given the criterion of independence. Are there enough people qualified to take on the new role demanded by Cadbury?

The future availability of non-executive directors may also be affected by Cadbury's recommendation of 3 year maximum contracts for outside directors. In addition, more outside directors will be needed because a director's ability to hold multiple appointments will be curtailed by the demands of the Code: "The non-executives need to be independent, competent and have the time available to professionally discharge their true duties. I believe this will probably mean a doubling of time allocated per company to the non-executive director which will need to be reflected in higher fees and a reduced number of directorships." (Bain, 1992)

The skills required of outside directors and the demands on their time may imply the evolution of a new kind of professional – the independent full-time outside director: "It is my view that for anyone to conscientiously carry out Cadbury would require the minimum of a degree allied to a professional qualification plus full-time commitment." (Corrin, 1993)

If a new species of professional outside director does evolve because of the demands of the Code, then they may be subject to a conflict of interest: "(The contradiction is that) . . . you can't be a non-executive if you feel it's an amateur status, and you shouldn't do the job if you need the money. The non-executive's fee represents the fundamental conflict of interest which is untouched by the Cadbury Code. Unless non-executives are independently wealthy they may at any time be reluctant to bite the hand that feeds them." (Park, 1992)

One final aspect of controversy about non-executives relates to Cadbury's assumption that the objectivity of the board's non-executive committees, such as the remuneration committee, can be achieved by insisting that the majority of non-executive directors are independent of management. Forbes and Watson (1993) cite a variety of studies which question the ability of non-executives to retain their independence. These doubts are reinforced by empirical research which shows that chief executives receive *higher* pay in firms which operate a remuneration committee, and not the reverse. (Main and Johnston, 1993)

The net results is that Cadbury's reliance on non-executives as the predominant element of control on corporate conduct has been questioned:

> If the Cadbury Committee proposals regarding the greater roles of non-executive directors and remuneration committees are to be realised, then a more fundamental reform of the process of nomination and appointment of non-executive directors will need to be instituted. . . . We believe that the Cadbury proposals are unlikely to have much impact upon either the setting of managerial remuneration or the central problem of corporate governance: how to improve the ability and incentives of shareholders to motivate, monitor, control and, if necessary, remove incompetent management. (Forbes and Watson, 1993)

The new tasks for auditors

The Cadbury Code creates an expanded role for auditors by requiring a review of a firm's statement of compliance in so far as it relates to 11 of the 19 items in the Code. Although the Report states that these items can be "objectively verified", it is uncertain if it is possible to completely define a standardised approach to the review of these items of compliance:

Code 1.4	Prescribed agenda for the board
Code 1.5	Procedure for directors to access outside advice
Code 2.3	Appointment of non-executive directors
Code 2.4	Nomination and selection of non-executive directors
Code 3.1	Length of directors' service contracts
Code 3.2	Disclosure of directors' pay
Code 3.3	Operation of the remuneration committee
Code 4.3	Operation of the audit committee
Code 4.4	Directors' statement of responsibility for the accounts
Code 4.5	Directors' report on the effectiveness of internal controls
Code 4.6	Directors' going concern statement

When the vagueness of some elements of the Cadbury Code is also taken into account (e.g. the degree to which items addressed in the notes to the Code do or do not define proper conduct), then there is scope for conflict between the auditor and the board on the interpretation of the Code. The first 9 of these 11 items are relatively uncontroversial, although they do represent the extension of auditing into matters unrelated to financial reporting.

The last 2 items, in which the auditor will comment on internal controls and on the going-concern statement, are of greater moment. Cadbury introduced these recommendations so as to involve auditors in the detection of fraud, and to ensure the broadcasting of a warning if the survival of the firm was in doubt. Auditors are understandably reluctant to embrace these new initiatives, not the least because of the potential for the extension of the legal liability during a period when auditors are suffering a "litigation explosion". (Humphrey *et al.*, 1993) Any increase in third party liability is predicted to result in a severe restriction on the availability of auditing services. (O'Sullivan, 1993)

Widespread debate on these issues has been limited though, for two reasons. First, the Cadbury Report has deferred the implementation of all elements of the Code that involve auditors, awaiting the formulation of standards by the UK's Auditing Practices Board (APB). This deferral is both general, in that standards need to be defined for the overall review of the statement of compliance (para. 3.9, p. 17), and also specific, in that particular standards need to be defined for the internal controls statement (para. 5.16, p. 41) and for the going-concern statement (para. 5.22, p. 43). The process of defining all of these standards could be contentious, and may produce further delays in implementation.

The second reason for the muted response to Cadbury on auditing was the immediately prior publication of the far more radical critique of auditing contained in the APB's draft report on "The Future Development of Auditing". (Auditing Practices Board, 1992) The APB report did not fight shy of recommendating legislation to bring about change, and stimulated a degree of debate that has overshadowed the response to Cadbury's meeker remedies. The net result is that the accounting profession is currently in a state of flux in the United Kingdom, and it is difficult to forecast if the process of formulation of the Cadbury Code's auditing standards will strengthen or weaken the Code.

The mandate of the Cadbury Committee

The final area of controversy relates to various aspects of the Cadbury Committee's mandate. With regard to size, for example, the Report makes no distinction between large and small listed firms, although it does allow that small firms may initially be unable to comply with all elements of the Code. (para. 3.15, p. 19)

The Report has been criticized for demanding that small companies conform to corporate governance standards designed to cure a pattern of deviant behaviour observable in only the largest of firms. The costs of compliance are proportionately more for small firms, and may even deter some from seeking a public share offering: ". . . the costs of forming an audit committee among the smaller listed companies, which are likely to have a higher level of directors' ownership and fewer non-executive directors, may well act as a disincentive to being listed." (Collier, 1993) A parallel argument to allow for size-dependent standards has been made in the current debate over the reform of auditing. (Snyder and Woolf, 1993)

From an applied ethics perspective, perhaps the greatest failing of the Cadbury Committee lies in the limitation of its mandate, as reflected by the title of the Report – "The Financial Aspects of Corporate Governance". The Report is silent on non-financial aspects of governance, except for one paragraph which suggests that ethical standards are needed primarily to guide the actions of employees rather than boardroom members: "It is important that all employees should know what standards of conduct are expected of them. We regard it as good practice for boards of directors to draw up codes of ethics or statements of business practice and to publish them both internally and externally." (para. 4.29, p. 26)

The emphasis of the Cadbury Code is on

financial accountability, and on the interests of shareholders alone: ". . . the Report can be seen as accepting that existing governance is largely adequate and that management is only accountable to shareholders." (Keasey and Wright, 1993)

It is regrettable that the fraud component of many of the ethical scandals of the late 1980s should have so narrowed the perspective of managerial accountability that Cadbury was able to concentrate on fiscal accountability alone. In Britain there were other simultaneous scandalous examples of the abdication of directorial responsibility, most notably the Zeebrugge Car Ferry Disaster and the King's Cross London Transport Fire, which highlighted the need for a broader approach to the definition of accountability within the corporate governance framework. (Boyd, 1992a, b & c)

The Cadbury Report itself makes scant reference to interest groups other than shareholders, indeed the word "stakeholder" does not itself appear in the Report. By contrast, most financial journalists and academics who have reviewed the Cadbury Report do use the word, and do comment on the duty that company directors owe to a wider public. The widespread conclusion is that the Cadbury Code represents a mere tinkering with the formal structures that surround corporate governance so as to ensure a higher probability of the transmission of true information to shareholders. This may be meritorious, but it will not guarantee that boards will fulfill their social obligations:

> . . . simply splitting the role of chairman and chief-executive and adding non-executive or independent directors will not change delinquent behaviour in Britain's boardrooms. That requires a new boardroom culture, a greater sensitivity to shareholders and a willingness to listen and respond to other stakeholders: in other words, a fresh value system. (Brummer, 1993c)

If the solution lies in an all-encompassing change in boardroom values then it is regrettable that the energies invested in Cadbury's corporate governance review process should have been confined just to the narrow issue of financial accountability to shareholders. An opportunity for the revision of overall boardroom accountability has been missed.

Irrelevant of the limitations of Cadbury's mandate, the question remains as to the best means of effecting cultural change in the boardroom, and in particular the role of the law in promoting responsible conduct. Most analysts are sceptical about the Cadbury Code of Best Conduct as an effective model for ethical corporate governance. The results of the Cadbury experiment in the United Kingdom will thus be followed with great interest over the next few years.

Notes

[1] "The Financial Reporting Council was set up in 1990 to establish and support two bodies under its aegis, the Accounting Standards Board and the Financial Reporting Review Panel, and to promote good financial reporting generally. The three bodies draw their funding broadly equally from the accountancy profession, the City, and the Government." (Cadbury Report, 1992: p. 63)

[2] The 12 member committee adopted these terms of reference:

> "To consider the following issues in relation to financial reporting and accountability and to make recommendations on good practice:
> (a) the responsibilities of executive and non-executive directors for reviewing and reporting on performance to shareholders, and other financially interested parties;
> (b) the case for audit committees of the board, including their composition and role;
> (c) the principal responsibilities of auditors and the extent and value of the audit;
> (d) the links between shareholders, boards and auditors;
> (e) any other relevant matters" (Cadbury Report, 1992: p. 61)

[3] All direct quotations from the Cadbury Report reproduce the gender specific language utilised throughout the Report.

[4] Given that the Cadbury Report states that these Notes to the Code do not form part of the actual Code itself, it is conceivable that a firm could fail to use a nomination committee and yet still claim to be in compliance with the Code if it uses some other

formal process. As with many other aspects of the Code of Best Practice detailed in the "non-Code" Notes rather than in the Code itself, there is immense scope for future argument about the definition of compliance with the Cadbury Code.

[5] The Committee eliminated a requirement that the non-executive directors who chair the audit and remuneration committees be present at the Annual Meeting to answer shareholders' questions about their committees. This form of accountability to shareholders was felt to be too close to a two-tier model of corporate governance, in which the actions of a decision-making board are scrutinised by a board of outside overseers ("the doers" versus "the checkers").

[6] Most press commentary on the Cadbury Report was in response to the release of the draft Report in May 1992. Hence some quotations in this paper predate the release of the final Cadbury Report.

Appendix 1

The Financial Aspects of Corporate Governance – The Code of Best Practice

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Preamble

1. The Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession to address the financial aspects of corporate governance.
2. The Committee issued a draft report for public comment on 27 May 1992. Its final report, taking account of submissions made during the consultation period and incorporating a Code of Best Practice, was published on 1 December 1992. This extract from the report sets out the text of the Code . . . (and ancillary Notes, which are) . . . further recommendations on good practice drawn from the body of the report.
3. The Committee's central recommendation is that the boards of all listed companies registered in the United Kingdom should comply with the Code. The Committee encourages as many other companies as possible to aim at meeting its requirements.
4. The Committee also recommends:
   (a) that listed companies reporting in respect of years ending after June 1993 should make a statement in their report and accounts about their compliance with the Code and identify and give reasons for any areas of non-compliance;
   (b) that companies' statements of compliance should be reviewed by auditors before publication. The review by the auditors should cover only those parts of the compliance statement which relate to the provisions of the Code where compliance can be objectively verified (see Note 14 below).
5. The publication of a statement of compliance, reviewed by the auditors, is to be made a continuing obligation of listing by the London Stock Exchange.
6. The Committee recommends that its sponsors, convened by the Financial Reporting Council, should appoint a new committee by the end of June 1995 to examine how far compliance with the code has progressed, how far its other recommendations have been implemented, and whether the Codes need updating. In the meantime the present Committee will remain responsible for reviewing the implementation of its proposals.
7. The Committee has made clear that the Code is to be followed by individuals and boards in the light of their own particular circumstances. They are responsible for ensuring that their actions meet the spirit of the Code and in interpreting it they should give precedence to substance over form.
8. The Committee recognises that smaller listed companies may initially have difficulty in complying with some aspects of the Code. The boards of smaller listed companies who cannot, for the time being, comply with parts of the Code should note

that they may instead give their reasons for non-compliance. The Committee believes, however, that full compliance will bring benefits to the boards of such companies and that it should be their objective to ensure that the benefits are achieved. In particular, the appointment of appropriate non-executive directors should make a positive contribution to the development of their businesses.

The Code of Best Practice

1. *Board of directors*

1.1. The board should meet regularly, retain full and effective control over the company and monitor the executive management.
1.2. There should be a clearly accepted division or responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong independent element on the board, with a recognised senior member.
1.3. The board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions. (note 1)
1.4. The board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands. (note 2)
1.5. There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense. (note 3)
1.6. All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are followed and that applicable rules and regulations are complied with. Any question of the removal of the company secretary should be a matter for the board as a whole.

2. *Non-executive directors*

2.1 Non-executive directors should bring an independent judgment to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.
2.2. The majority should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment, apart from their fees and shareholdings. Their fees should reflect the time which they commit to the company. (note 4 and 5)
2.3. Non-executive directors should be appointed for specified terms and reappointment should not be automatic. (note 6)
2.4. Non-executive directors should be selected through a formal process and their nomination should be a matter for the board as a whole. (note 7)

3. *Executive directors*

3.1. Directors' service contracts should not exceed three years without shareholders' approval. (note 8)
3.2. There should be full and clear disclosure of directors' total emoluments and those of the chairman and highest paid UK director, including pension contributions and stock options. Separate figures should be given for salary and performance-related elements and the basis on which performance is measured should be explained.
3.3. Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors. (note 9)

4. *Reporting and controls*

4.1. It is the board's duty to present a balanced and understandable assessment of the company's position. (note 10)
4.2. The board should ensure that an objective

and professional relationship is maintained with the auditors.

4.3. The board should establish an audit committee of at least 3 non-executive directors with written terms of reference which deal clearly with its authority and duties. (note 11)

4.4. The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities. (note 12)

4.5. The directors must report on the effectiveness of their internal system of financial control. (note 13)

4.6. The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary. (note 13)

Notes

These notes include further recommendations on good practice. They do not form part of the Code.

[1] To meet the Committee's recommendations on the composition of sub-committees of the board, boards will require a minimum of three non-executive directors, one of whom may be the chairman of the company provided he or she is not also its executive head. Additionally, two of the three non-executive directors should be independent in the terms set out in paragraph 2.2 of the Code.

[2] A schedule of matters specifically reserved for decision by the full board should be given to the directors on appointment and should be kept up to date. The Committee envisages that the schedule would at least include:

(a) acquisition and disposal of assets of the company or its subsidiaries that are material to the company;
(b) investments, capital projects, authority levels, treasury policies and risk management policies.

The board should lay down rules to determine materiality for any transaction, and should establish clearly which transactions require multiple board signatures. The board should also agree the procedures to be followed when, exceptionally, decisions are required between board meetings.

[3] The agreed procedure should be laid down formally, for example in a Board Resolution, in the Articles, or in the Letter of Appointment.

[4] It is for the board to decide in particular cases whether this definition of independence is met. Information about the relevant interest of directors should be disclosed in the Directors' Report.

[5] The Committee regards it as good practice for non-executive directors not to participate in share option schemes and for their service as non-executive directors not to be pensionable by the company, in order to safeguard their independent position.

[6] The Letter of Appointment for non-executive directors should set out their duties, term of office, remuneration, and its review.

[7] The Committee regards it as good practice for a nomination committee to carry out the selection process and to make proposals to the board. A nomination committee should have a majority of non-executive directors on it and be chaired either by the chairman or a non-executive director.

[8] The Committee does not intend that this provision should apply to existing contracts before they become due for renewal.

[9] Membership of the remuneration committee should be set out in the Directors' Report and its chairman should be available to answer questions on remuneration principles and practice at the Annual General Meeting.

[10] The report and accounts should contain a coherent narrative, supported by the figures, of the company's performance and prospects. Balance requires that setbacks should be dealt with as well as successes. The need for the report to be readily understood emphasises that words are as important as figures.

[11] The Committee's recommendations on audit committees are as follows:

(a) They should be formally constituted as sub-committees of the main board to whom they are answerable and to whom they should report regularly; they should be given written terms of reference which deal adequately with their membership, authority and duties.
(b) There should be a minimum of three members. Membership should be confined to the non-executive directors of the company and a majority of the non-executives serving on the committee should be independent of the company, as defined in paragraph 2.2 of the Code.
(c) The external auditor and, where an internal audit function exists, the head of internal audit should normally attend committee meetings, as should the finance director. Other board members should also have the right to attend.

(d) The audit committee should have a discussion with the auditors at least once a year, without executive board members present, to ensure that there are no unresolved issues of concern.
(e) The audit committee should have explicit authority to investigate any matters within its terms of reference, the resources which it needs to do so, and full access to information. The committee should be able to obtain outside professional advice and if necessary to invite outsiders with relevant experience to attend meetings.
(f) Membership of the committee should be disclosed in the annual report and the chairman of the committee should be available to answer questions about its work at the Annual General Meeting. Specimen terms of reference for an audit committee, including a list of the most commonly performed duties, are set out in the Committee's full report.

[12] The statement of directors' responsibilities should cover the following points:

- the legal requirement for directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company (or group) as at the end of the financial year and of the profit and loss for that period;
- the responsibility of the directors for maintaining adequate accounting records, for safeguarding the assets of the company (or group), and for preventing and detecting fraud and other irregularities;
- confirmation that suitable accounting policies, consistently applied and supported by reasonable and prudent judgments and estimates, have been used in the preparation of the financial statements;
- confirmation that applicable accounting standards have been followed, subject to any material departures disclosed and explained in the notes to the accounts. (This does not obviate the need for a formal statement in the notes to the accounts disclosing whether the accounts have been prepared in accordance with applicable accounting standards.)

The statement should be placed immediately before the auditors' report which in future will include a separate statement (currently being developed by the Auditing Practices Board) on the responsibility of the auditors for expressing an opinion on the accounts.

[13] The Committee notes that companies will not be able to comply with paragraphs 4.5 and 4.6 of the Code until the necessary guidance for companies has been developed as recommended in the Committee's report.

[14] The company's statement of compliance should be reviewed by the auditors in so far as it relates to paragraphs 1.4, 1.5, 2.3, 2.4, 3.1 to 3.3, and 4.3 to 4.6 of the Code.

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