GOVERNANCE

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The board's strategic succession imperative

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Helen Pitcher, Chairman, Advanced Boardroom Excellence

Materiality – a new era of transparency and scrutiny

'Crucially the new audit report disclosure means that investors and all other stakeholders will be able to make comparisons with levels at other similar companies in similar sectors. If it proves that levels which might be expected to be similar vary significantly then it should raise questions and prompt audit committees to seek justifications.'

Lawrence Reed, Senior Adviser, Independent Audit

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News

Public disclosure of a company's ultimate owners

The Department for Business, Innovation and Skills (BIS) has published a response to its consultation on enhancing the transparency of UK company ownership and increasing trust in UK business. New rules will be introduced to require public disclosure of those who have a beneficial interest in 25 per cent or more of a UK company or limited liability partnership (LLP) and the use of corporate directors will be banned in most cases. Controversial proposals to require registration of those who control nominee directors will not be taken forward, nor will the proposal to introduce a primary duty for bank directors to promote financial stability over the interests of shareholders.

Beneficial ownership register

Companies will be required to maintain and keep open for public inspection a register of beneficial owners. This information will also need to be filed at Companies House once a year. Companies will be given powers to obtain the required information and beneficial owners will also be obliged to disclose their interests in a company to that company, a beneficial owner being any individual who has an interest in more than 25 per cent of the shares or voting rights, or who otherwise exercises control over the management. This includes joint holdings. Where such a beneficial owner is a trust, it will usually be the trustees whose identity must be disclosed, unless someone else, such as a settlor of the trust, exercises effective control over the trust's activities.

The requirement will apply to all UK companies (including companies limited by guarantee) and LLPs, however companies which have securities listed on a regulated market and comply with disclosure requirements will be exempt.

It will be possible to make an application to Companies House to stop beneficial ownership information being publicly disclosed in exceptional circumstances. This is likely to be in line with the existing regime for addresses not to be disclosed where there is a serious risk of violence or intimidation.

Corporate directors

The use of one company as a director of another company will be prohibited, with specific exceptions: exceptions currently being considered include group structures including large private or listed companies, which commonly use corporate directors, and charities.

Nominee directors

Proposed measures aimed at reducing 'opaque control' of companies, including the registration of nominee directors and those who control them and making it a criminal offence for a director to take formal legal steps to divest his/her powers, are not being taken forward, as they have been considered unworkable in practice.

However, BIS intends to:

- increase awareness of directors' duties and liabilities; as part of this, Companies House will send a letter to all new directors with information outlining these duties and liabilities;
- amend the directors' disqualification rules to ensure any misfeasance or breach of duty is taken into account when considering if someone is unfit to be a director; and
- consider explicit application of directors' statutory duties to shadow directors; views on other ways to increase the accountability of those who control directors are invited.

Disqualification of directors

There will be a broader, more generic, list of factors to be considered when determining if someone is unfit to be a director, including culpability and materiality of past conduct, track record, misconduct overseas and breach of sectoral regulation as well as general directors' duties.

The time limit for instituting disqualification proceedings will be increased from two to three years of the earliest insolvency event.

Compensation of creditors

There will be a new power to apply for a compensation order against a disqualified director where creditors have suffered identifiable losses from their misconduct. In addition, liquidators and administrators will be able to assign claims against miscreant directors to increase the chances of action being taken against them.

Bearer shares

Seldom used, except by a number of small companies, 'share warrants to bearer', where the owner of shares is listed in a company's register of members as the bearer of a warrant, will be abolished.

A set period of time will be provided for existing bearer shareholders to surrender their shares for conversion to registered shares. After the period set for surrender, companies with bearer shares remaining will be required to apply to court for an order cancelling those shares.

Next steps

Legislation will be needed to implement these changes as soon as Parliamentary time allows and BIS intends to place a statutory duty on the Secretary of State to publish a review of the efficacy and proportionality of the registry within three years of implementation. Careful consideration will also be given to communication and transitional arrangements, particularly for existing companies.

To see the Government's response paper go to: https://www.gov.uk/government/consultations/company-ownership-transparency-and-trust-discussion-paper

News

Proposed revisions to the UK Corporate Governance Code

The FRC is consulting on proposed changes to the UK Corporate Governance Code which, if implemented, will apply to reporting years beginning on or after 1 October 2014. This consultation follows earlier consultations on directors' remuneration (October 2013) and risk management, internal control and the going concern basis of accounting (November 2013).

Proposed changes

The key changes proposed include the following:

- greater emphasis be placed on ensuring that remuneration policies are designed with the long-term success of the company in mind, and that the lead responsibility for doing so rests with the remuneration committee;
- companies should put in place arrangements that will enable them to recover or withhold variable pay when appropriate to do so, and should consider appropriate vesting and holding periods for deferred remuneration;
- when publishing AGM results companies should explain how they intend to engage with shareholders when a significant percentage of them have voted against any resolution;
- the schedule to the Code dealing with the design of performance-related remuneration for executive directors is updated to encourage companies to give further consideration to the arrangements they have in place for deferred remuneration, such as vesting and holding periods for shares;
- a requirement for ex-directors to continue to hold shares. In order to comply, executive directors' service contracts will probably need to be amended to prohibit directors from disposing of their shares for a specified period after they leave. Executives may want to negotiate over exceptional circumstances when disposals should be permitted;
- companies should state in their financial statements whether they consider it appropriate to adopt the going concern basis of accounting and identify any material uncertainties to their ability to continue to do so;
- companies should robustly assess their principal risks and explain how they are being managed and mitigated;
- companies should state whether they believe they will be able to continue in operation and meet their liabilities taking account of their current position and principal risks, and specify the period covered by this statement and why they consider it appropriate; and
- companies should monitor their risk management and internal control systems and, at least annually, carry out a review of their effectiveness and report on that review in the annual report.

The FRC is also consulting on extracts from its proposed merged guidance on risk and going concern which is intended to help companies to apply the proposed revised Code. The full guidance will be published at the same time as the revised Code.

Following the decision of the Competition Commission (now the Competition and Markets Authority) to delay finalising its proposed Orders to implement the findings of its review of competition in the market for audit services in FTSE 350 companies, the FRC has decided to defer consideration of whether to make any changes to the section of the Code dealing with the audit committee and appointment of the external auditor until the Code is next reviewed; currently scheduled to be in 2016.

Finally, the consultation also seeks views on whether there would be benefits in allowing companies to publish some or all of the information currently contained in the corporate governance report on a website rather than in the annual report and accounts. Any resulting proposals would also be considered as part of the review scheduled for 2016.

Implementation

Subject to the outcome of the consultation the proposed changes will apply to financial years beginning on or after 1 October 2014.

There may be a case for early adoption, particularly as none of the proposals seem likely to be inconsistent with any policy reports already approved by shareholders. Most companies have been introducing claw-back arrangements into their share plans and, even if not, these provisions generally do not need shareholder approval to be introduced. In practice, the proposed changes are unlikely to make much difference to most companies' remuneration arrangements because of existing guidelines and new remuneration report requirements. However, because companies each year have to check compliance with the Code, any change to the Code needs to be taken into account in the annual report exercise.

Comments on the questions set out in the consultation document are requested by 27 June 2014. Responses should be sent by email to codereview@frc.org.uk or in writing to: Catherine Woods, Financial Reporting Council, Fifth Floor, Aldwych House, 71–91 Aldwych, London WC2B 4HN.

For the full Consultation document go to: https://frc.org.uk/Our-Work/Publications/Corporate-Governance/Proposed-Revisions-to-the-UK-Corporate-Governance.aspx

International

Bigger shareholder say over executive pay

The European Commission (EC) has recently published a package of proposed reforms to company law and corporate governance practice, including provisions designed to give shareholders more influence on executive pay. The proposed changes are designed to support longer-term financing for European Union (EU) economies and reflect the evolution of best practice so as to build greater long-term shareholder engagement and to develop stronger bonds between companies and their shareholders.

These reforms will impact both on listed companies across the EU, who will have to seek shareholder approval on pay for their top executives, and the fund managers who control the voting rights for significant holdings in such companies.

Key issues the proposals seek to address are as follows:

- Insufficient engagement of institutional investors and asset managers.
- Insufficient link between pay and performance of directors.
- Lack of shareholder oversight on related party transactions.
- Inadequate transparency of proxy advisors.
- Difficult and costly exercise of rights flowing from securities for investors.

Say on pay

The EC has proposed giving shareholders in listed companies across Europe the ability to reject directors' pay deals, in line with rules introduced recently in some EU States including Belgium and Sweden. Companies would be required to present their pay policies in a clear and comparable fashion and to put to a vote of their shareholders a remuneration policy which included a maximum cap on remuneration. For new recruits, the company would be able to deviate from the maximum, but only subject to prior or ex post approval by the shareholders.

The remuneration policy approved by shareholders would explain how the pay and employment conditions of employees of the company were taken into account when setting the policy or directors' remuneration by explaining the ratio between the average remuneration of directors and the average remuneration of full-time employees of the company other than directors and why this ratio is considered appropriate.

Transparency

The EC wants institutional investors, who hold around 23 per cent of all shares in Europe, and asset managers, who often invest on their behalf, to be more transparent in their dealings. Institutional investors would have to provide details regarding attendance at votes and meetings with management. It is hoped that more transparency would encourage them to take a more active role. The EC's proposal also imposes requirements for greater transparency by proxy agents, who advise institutional shareholders on how to vote at shareholder meetings. The EC is keen that proxy agents, who have recently developed their own code of conduct, explain better how they reach their conclusions.

Other changes

Under the proposals:

- the 10,000 listed companies would have to publish clear and comparable information on their remuneration policy for executives and seek shareholder backing for it every three years;
- the policy on pay should explain how it contributes to the long-term interests of the company. It should also say why the ratio or difference in pay between directors and full-time staff is appropriate, though it does not set a fixed ratio;
- shareholders would have the right to vote annually on the company's report on pay packages for directors, but it would be up to Member States to decide what happens if the report is rejected;
- institutional investors and asset managers would also have to show how they take into account the long-term interests of the people whose money they invest in companies, including the reasons behind their investment strategy;
- asset managers who typically hold a stock for eight months would not be forced to vote in company meetings but would have to explain if they did not;
- other changes include making it easier for a firm to find out who its shareholders are; and
- proxy advisors, or firms that give investors advice on how to vote in annual meetings, would also have to disclose certain information about how they prepared their guidance.

The proposals will be submitted to the Council and the European Parliament for their consideration and final adoption. Once adopted, implementation of the new Directive will be left to EU Member States. Currently, EU countries differ dramatically in their approach to say on pay: it is hoped that the EC's proposals will create a more level playing field.

For more information go to: http://europa.eu/rapid/press-release_MEMO-14-275_en.htm

Global News

Improving corporate governance

'The focus on making boards more gender representative has skewed the debate away from how we can get more people with a diversity of appropriate skills and experience onto boards,' according to a recent report from Policy Exchange.

The report, *Board Rules: Improving Corporate Governance*, suggests that instead of executive search firms expanding shortlists to include more women, attention should be on including people with different skills and experiences to those traditionally head-hunted. Engaging shareholders is another necessary step according to the report which suggests that shareholders should make up the majority of people on the committee responsible for appointing board members to improve performance, diversity and accountability of UK companies.

Summary of recommendations

- Investor representatives should be appointed to the Nominations Committee (NomCo). There should also be a blanket ban preventing chief executives sitting on the NomCo, while chairmen of companies should not be allowed to also chair the body responsible for appointing board members.
- Non-executive director (non-exec) recruitment should become more professional and standardised, including psychometric testing as routine which will ensure a mix of personalities on the board. Executive Search Firms should have a target for searching for people outside the corporate mainstream, ensuring that those with the right skills and experience are no longer over-looked.
- There should be more emphasis on diversity of skills, rather than gender diversity. Annual reports should contain a short statement on what skills and experience each non-exec brings to the board, rather than focusing on how many women have been appointed.
- Guidelines should be established on standard practice in board evaluations to ensure a more standardised and rigorous approach to evaluations. Non-executive director pay should be built into, and form an automatic part of, a board's external evaluation and the FRC should publish, annually, average pay levels across the FTSE 100, 250 and 350, as well as across industry sectors, to increase transparency.
- Board meetings should become more focused, with time split between the supervision of management and strategy. Board packs must be concise and provide non-execs with both a detailed and a holistic view of the business. The board should be able to reject a board pack and postpone the board meeting until they are satisfied with the pack provided. The NomCo should review the board minutes to ensure that both the strategy and management review are given equal weighting.

The solutions recommended in the report involve UK boards being strengthened with increasingly professional non-execs, appointed through a more transparent nominations process that involves investors and being held to an ever higher standard of duty of care. By encouraging the owners of companies to take more responsibility, the UK corporate governance framework will be strengthened.

To see the full report go to: http://www.policyexchange.org.uk/publications/category/item/board-rules-improving-corporate-governance

Corporate reporting in a digital world

The Financial Reporting Lab (the Lab) is undertaking a long-term project looking at how companies are, and may, use digital media to report externally to investors.

The project will look at how companies use websites, videos, apps, social media platforms, blogs, etc in their corporate reporting communications to investors (including annual and interim reporting), and how investors use what is produced in this way. It is expected there will be three broad areas of scope, each seeking to answer fundamental questions.

Digital Present: Corporate reporting through digital media

- How are companies currently using digital media in external corporate reporting?
- How are investors using the digital media reporting produced by companies?
- What approaches to digital media might provide the most benefit to investors?
- Where should companies focus their attention?

Digital Challenges: Barriers to the use of digital media in corporate reporting

- What barriers are there for companies and investors in making the most of digital media for external corporate reporting?
- How would the regulatory regime need to change to support companies and investors in the use of digital media?

Digital Future: Making the most of the digital opportunity

- How might companies use digital media and technology for external corporate reporting in the future?
- How will investors use technology to consume information in the future?

The Lab plans to undertake the project over the next 18 months with the first area being explored in the next few months. The Lab will publish a report highlighting findings and observations on approaches to reporting that are currently considered to be most effective: the first of these is expected towards the end of 2014.

Further information on the Lab and its activities can be found at: http://frc.org.uk/Our-Work/Codes-Standards/Financial-Reporting-Lab.aspx

Feature

The board's strategic succession imperative

Helen Pitcher argues that succession planning needs to be broader than simply board level appointments and should include identifying the talent pipeline within.

As boards start to look at a future beyond the immediate battering and buffering of the past five years, a key strategic underpinning of the organisation's endurance is being rediscovered.

A spotlight is turning from an all-consuming focus on financial stability and reputational risk to succession planning and a longevity beyond the cohort of the existing CEO and their executive team. This is inextricably linked to the board's level of insight into its talent pipeline – the future life blood of the company, central to the organisation's continuity.

This strategic succession risk is now coming to the fore, with a drive to strengthen the depth in the talent pipeline below the board. This is in turn linked to a greater focus on the diversity of thinking and organisational flexibility foreshadowed by the emerging leadership agenda, based on increased collaborative leadership and an all-encompassing information network revolution.

Boards are increasingly recognising their primacy in taking this long-term view and their possession of the strategic 'clout' to alter and temper career flows within the organisation. A recent survey showed that males starting out their careers are now 4.5 times as likely as women to make it to the executive suite in their careers, despite almost equal numbers at entry. (30% Club, 19 March 2014). A further study released in America by Stanford, IED and the Conference Board (12 March 2014) identified that 'directors have little line of sight of senior executives a rung or two down the ladder'.

Until recently, many boards had a tendency to focus only on the key posts of CEO and CFO succession and in some cases CRO (Financial Services) and CTO (Technology Organisations). Succession below these levels being allocated a small amount of board time, with the HRD presenting on the Group Talent and Succession plan, often a dry mechanical exercise, and executive directors being asked their opinions on individuals based on performance evaluation, balanced score cards etc, which are notorious for rater bias, in all but hard financial performance terms and with the inevitable focus on the short-term.

Many CEOs express the view that succession below the key board roles is a matter for the executive not the board, yet succession needs a 20-year horizon not the limited three- to five-year horizon that spans a typical CEO's tenure. Interestingly, organisations that have focused in depth on such matters have had long-standing CEO's, stellar performance and a clear and deeper focus on their talent, providing both formal development, stretch assignments and exposure to the board. Diageo's DLPP (Diageo Leadership Programme) a year-long intensive modular development and coaching programme, which has run for many years, owned and delivered by key members of the board and senior executives, is an exemplar of this type of long-term approach, as is BT's 20:20 programme which is owned and sponsored by the Chairman.

The Regulators too have now turned their focus on the need for boards to increase their insight into the succession pipeline of the organisation with its centrality to the longevity, future continuity and prosperity of the organisation.

The board should be challenging the HRD to come up with a creative, dynamic, effective and economic succession process. This should go beyond the sterile default option of, 'Not sure of internal candidates so let's benchmark and look at the external market', well known as 'the grass is always greener strategy'. This typically indicates a lack of engagement and real in-depth involvement with the board.

A decade of available research also indicates that 'Insiders' can be more successful, with a well-positioned insider often being better suited to the increasing demands and 'short-termism' of the CEO role. Where they are appropriately developed, internal candidates can take a fresh view, unencumbered by the emotional baggage of long tenure and be able to leverage their knowledge about the company's people, suppliers, customers and values to rapidly deliver the organisation's future goals (Joseph Bower in *The CEO Within*).

A recent HBR study also highlighted that boards spend too much time with their eyes focused in the rear view mirror rather than looking forward towards desired horizons. Succession Planning is clearly a key forward looking process that requires all the board's collective engagement. Achieving this requires artful orchestration by the chairman as boards move forward, delicately balancing and handling executive egos and sensitivities, challenging whether the talent has the capability to deliver future strategic goals and ensuring key processes are in place to achieve stretch, development, appropriate remuneration and retention of this talent.

Helen Pitcher is Chairman of Advanced Boardroom Excellence Ltd. www.abexcellence.com

Feature

Materiality – a new era of transparency and scrutiny

Lawrence Reed considers new audit report disclosure requirements which call for more transparency from external auditors as to how they go about setting levels of materiality.

Materiality levels are fundamental to planning and executing external audits but have, in the past, been considered by many to be a bit of a 'dark art'. Independent Audit has long called for greater transparency of information about how materiality levels are set and revised by external auditors and, because of the new audit report disclosure requirements[1], combined with a recent Thematic Review[2] by the Financial Reporting Council (FRC), we are now entering a new era which we believe will give users of the accounts a better understanding of the level of comfort that an audit brings.

There may well be some raised eyebrows when materiality levels are first disclosed because the levels are significant in the context of stock market forecasts. We believe some justifications will prove challenging. In addition, the initial round of disclosures will allow, for the first time, benchmarking between similar companies and promote a more informed debate between audit committees, management, investors and other stakeholders.

The auditing standard dealing with materiality[3] gives the auditor a lot of flexibility and makes it clear that the auditor's determination of materiality is a matter of 'professional judgement'. In conducting an audit the overall objectives of the auditor are to 'obtain reasonable assurances about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error'. It is perhaps not surprising then that the FRC chose the topic of materiality for its first Thematic Review. The Review has been sent to FTSE 350 Audit Committee Chairmen with encouragement to consider the content of the report. There were six key findings, outlined below, which show there is some way to go in the communication by auditors of how materiality levels are arrived at and the consistency of approaches. For audit committees, and those that support them, the FRC takes the opportunity to confirm their role in determining and applying materiality to be significant.

Six key FRC findings in relation to materiality

1. Five of the six firms who audit the FTSE 350 have changed their materiality guidance which would either lead to higher materiality levels or the impact of materiality assessments being reduced.

2. Some firms (though the firms are not identified) have higher permitted acceptable materiality ranges than others. The FRC notes that this may result in less audit work being performed at some firms than at others for companies with a similar size and risk profile. In fact, for certain sectors, this is a strong implication and one which the new audit report disclosures will alert investors to.

3. All six firms have templates for setting overall materiality and 'clearly trivial' limits, though individual auditors did not always explain and justify their judgements in completing the templates. We believe audit committees in particular should want now to see robust justifications.

4. In the majority of cases, materiality levels were the maximum permitted by the firm's guidance. In an unusually cutting comment, the FRC makes an important note that, 'such an approach is not consistent with appropriate exercise of individual judgement as required'.

5. Auditors did not always appropriately consider revising materiality based on forecasts when performance was significantly worse than forecast. So, if this continues into the era of disclosure, we may see materiality levels that might be alarmingly high for some investors in the context of performance.

6. There were instances noted where auditors had not reported all errors above the reporting threshold and cases where errors were recorded at a higher level than the reporting threshold advised to the audit committee. Alarmingly in one instance there was no reporting of materiality levels to the audit committee.

The FRC's clarion call is for auditors to 'review their internal guidance in the light of the areas requiring improvement identified in the report, including in particular how the needs and expectations of users of financial statements are assessed and taken into account in determining materiality levels'.

The growing importance of the audit committee role

Ultimately the setting of materiality levels is still a matter of professional judgement for the auditor. However, the FRC is clear: 'audit committees play a highly important role in safeguarding the quality of audit and should actively engage with their auditors in relation to the determination and application of materiality'.

The FRC has summarised the matters which audit committees should focus on and which may enhance their oversight of the audit process. Audit committees should now seek to fully understand the mechanics of an audit and how materiality plays a part.

This will include:

- the basis for the materiality levels set
- how materiality levels are expected to affect the level of audit work
- the benchmarks used by their auditors in determining materiality
- the reasons for and the effect of any increase in materiality levels and the likely impact on the level of audit work (which interestingly includes whether the auditors believe that the needs and expectations of users of the financial statements have changed)
- how materiality levels affect the extent of audit work in significant areas
- how the auditors determine materiality at group and component levels
- whether materiality levels should have been adjusted in the light of significant events arising near the year end and/or actual results are worse than forecast
- why any misstatements have not been corrected by management
- whether disclosure and omissions reported by the auditors have arisen through error or a specific management judgement and whether the inclusion of such disclosures is likely to provide material information to users.

In addition, audit committees should obtain confirmation from their auditors that changes made to the materiality levels and misstatement reporting threshold have been reported to them.

These enhanced responsibilities will undoubtedly have an impact on audit committees' year-end timetables and should be considered and discussed with the auditors at an early stage.

Independent Audit comment

Materiality is a very sensitive area for investors and other users of accounts because it has a huge impact on the scope and extent of audit work performed.

The FRC's Thematic Review timing is crucial as auditors now have to disclose (for listed companies) how they applied the concept of materiality in their audit reports. With the first sets of new-style audit reports appearing, we believe this may cause a few surprises and stimulate greater debate.

The two most hard hitting comments by the FRC reflect our own experiences in audit effectiveness reviews and revolve around communication issues. There is a call for auditors to 'demonstrate the consideration of risk in setting performance materiality and avoid, as a default, simply setting this at the highest level allowed under their firm's guidance'. The implication here is that there may have been a temptation to push performance materiality to the maximum allowed under a firm's guidance without fully demonstrating the consideration of risk. The FRC further comments on an area that Independent Audit has highlighted in the past: that auditors should improve 'the quality and accuracy of their reporting of materiality levels to audit committees and ensure that all uncorrected misstatements above the reporting threshold are collated and reported'.

The FRC's review has highlighted the fact that, because setting materiality is a matter for auditor judgement, the levels will vary across firms. Crucially the new audit report disclosure means that investors and all other stakeholders will be able to make comparisons with levels at other similar companies in similar sectors. If it proves that levels which might be expected to be similar vary significantly then it should raise questions and prompt audit committees to seek justifications.

All stakeholders should welcome this new era of greater transparency and scrutiny which will further de-mystify one of the fundamental elements in planning and executing external audits.

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[1] ISA (UK and Ireland) 700 revised June 2013 – covering auditor's reports for entities subject to the Corporate Governance Code.

[2] FRC 'Audit Quality Thematic Review – Materiality' December 2013.

[3] ISA (UK and Ireland) 320 'Materiality in Planning and Performing and Audit'.

Feature

Tone from the Top

An extract from a White paper produced by **Sharon Constançon** based on the latest in Genius Methods' Corporate Governance Panel Debate series which brought together a wide range of experts to gain a better understanding of the role of the chairman.

What is expected of a chairman over and above what the text books cover? The debate, held in February this year, covered setting the tone, ethics and culture, of doing the right thing, handling difficult situations, communicating with the media and stakeholders and being forward-thinking; delivering strategic thinking and vision within the culture, being the eyes on the horizon and ears to the ground on behalf of the executive team and mentoring the CEO through the minefield of day-to-day challenges.

Our esteemed team defined the following characteristics that would embed an appropriate 'Tone from the Top':

- Values, ethics, commitment
- Skills, experience, knowledge of the industry
- Communication, chairing competence, listener
- Respect of others, earns respect, respects regulation
- Vision, see horizon, strategic thinker
- Alert to risks, senses unknown, sees opportunities
- Mentor, supporter, decision-maker
- Leader by example, visible, company agenda first
- Media savvy, digital & IT, changing external world

A personal experience

David Jackson, Company Secretary of BP and formerly the General Council and Company Secretary of Powergen summarised key 'Tone from the Top' learnings of his career to date.

David noted that he had seen the leadership changing from a combined chairman and CEO, CEO style predominating, supported by combined general council and company secretary (CoSec) roles to today's model. Good governance requires that the leadership role is split between the chairman leading the board and setting the tone, with the CEO leading the organisation and the CoSec being the guardian of good governance.

The role of general council and CoSec has also split; the CoSec governance agenda is the key driver and the role is focused to support to the non-executive chairman.

David has worked with many chairmen and the 'tones' have varied from legal, compliance, political, performance to ethical, strategic, safety and transparency.

In David's view, the true leadership qualities are shown in the face of a crisis and true culture change can only readily occur with a high degree of turnover on the board; a change of one non-exec, unless it is the chairman, has little opportunity of making a real impact.

Chairmen and non-execs need to be media savvy and in tune with social media and public expectations. For example, BP responded well on the ground to Macondo but did not handle the PR response correctly – the reputational damage has been huge and the share price has not yet fully recovered. Additionally there are risks faced when heads are down coping in that the world continues to move on and change and board behaviour can quickly be out of sync with current best practice.

Another change experienced in David's time and correlated in other FTSE companies, particularly the financial services sector, is the mirroring of board committees at management level; providing direct line reporting, focus on the detail, the strategic vision and all risks.

Planned succession can create inertia in the last chapter of tenure and sudden change in a chairman can leave the board rudderless. Chairmen need to be wise to human traits and to avoid inertia, lack of direction and therefore risks to the organisation, Nominations Committees need to be ready to start recruiting immediately.

In summation David stated that chairmen and non-execs are more accountable to shareholders today than ever before, needing to engage in the detailed conversation.

Culture and values

Bob Garratt a governance consultant questioned 'where does the definition of values start, transfer and end between the chairman and the CEO'?

The phrase 'Tone from the Top' gained traction after a series of well-documented corporate governance failures which highlighted the need for boards of directors to develop an ethical culture. What impact has this idea had in practice?

Every organisation has a set of values which can be revealed by looking closely at the behaviours and activities demonstrated every day in business. These values exist whether they have been discussed and explicitly agreed or not.

Problems arise when the set of values have either not been considered or constructed at all; or, most often, when they have been set at the board-level and have not been successfully embedded at every level in the organisation.

Uncommunicated values 'remain as mere words on the corporate website, bearing no resemblance to the practices and attitudes lived by on a day-to-day basis' (Grant Thornton, 2012).

'The financial services sector is undergoing a step change where Conduct Risk and Customer Focus are behavioural cultures that have to be embedded, demonstrable and evidenced to be in line with the expectations of the FCA' stated Sharon Constançon who is Chairman of a financial services board Culture and Conduct Committee.

Sharon iterated that the Financial Conduct Authority is forward-looking into the realms of behavioural economics to ensure that the correct cultures to support good customer outcomes are prevalent in our financial services market. Many would state that this is needed but however simple it sounds, it is not an easy transition for management as witnessed by Sharon in her Board Evaluation work.

Barriers to effective leadership and business have been highlighted time and time again; badly managed crises and ineffective leadership. Genius' question is, how can boards best be advised to implement and embed values and ethics throughout their organisations?

The role of the chairman

The role of the chairman is a nigh impossible task that comes with huge expectations and responsibilities. Through crises or changes in CEOs, the chairman must oversee the proper steering of the organisation for its long-term sustainability. These days, chairmen often serve for nine years with CEOs serving usually about five years in the FTSE 150 and less than three years in other organisations. This makes the chairman's role in setting the 'Tone from the Top' a vital one.

> 'It is not just the business you do but the way you do the business that makes such a difference and it is the way that chairmen conduct themselves that sets the example.'
>
> *Sir Roger Carr, Chairman of BAE Systems*

The 'Tone from the Top' is about the values of the organisation over the long-term. Corporate ethos should be transmitted from the chairman, who leads by example, through the board, the executive, management and down into all reaches of the organisation.

The chairman needs to lead a process for setting these values, then for embedding them throughout the organisation, and embody these values in their behaviour.

This key process can be facilitated externally to get the creativity working and in co-operation with the company secretary as 'the traditional custodian of the company conscience'.

However, the chairman is a key representative of the organisation, not only as a leader within the organisation, but also as an outward facing position to the rest of the world and the values must be represented and evident in all of the chairman's activities and actions.

Long-term versus short-term

One key issue for the chairman and board as a whole is balancing long-term values with investor demand for short-term success. It is a challenge for a CEO to drive the short-term success, deliver on strategic direction, appropriately incentivise delivery while at the same time fully encompassing the long-term values, culture and ethics defined by the board.

Peter Montagnon, Associate Director of the Institute of Business Ethics, suggests that 'we need to revisit the question of what corporations are actually here for. The idea that corporations exist to increase shareholder value alone, isn't considered to be the full picture anymore'.

Peter's view is that there are a wide variety of competing interests at stake within a corporation and value setting is an attempt to reconcile as many of these as possible to guide the organisation in the right direction.

Incentive schemes, remuneration, expectations of delivery, performance KPI focus, what is measured, personal agendas, competitor behaviour, stakeholder expectations are all at risk of creating counter intuitive behaviour to the culture desired by the board.

David Jackson observed that 'we all seem to agree on the "what", the question is "how"?'

The conversation honed in on resources needed for the 'how': knowledge, process and delivery. The need to turn outside for this resource will depend on the organisation, the type of resource and what is being addressed.

Risk needs to move from silos and a development of a risk culture that at board level is not about operational risk and risk prevention but about entrepreneurial risk leadership espoused by the Code and 'looking forward to the horizon' (*McKinsey*).

Boards are operating in an extremely complex space and changes in the corporate governance environment are rapidly evolving. Fresh thinking is required as organisations will need

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to be creative and innovative in how they communicate and embed the 'Tone from the Top'.

Giving values and ethics real meaning and clout are of the utmost importance in today's corporate governance environment and it is up to each chairman to take the initiative and show true leadership in setting the 'Tone from the Top'.

Sharon Constançon is CEO of Genius Methods. This is an extract from the White paper she has prepared. The full White paper can be found in the resources section of the Governance website at www.governance.co.uk and on the Genius Methods website at www.geniusmethods.com

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