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Sent: 05 October 2009 15:30
To: Chris Hodge
Cc: roger.stear@ethicability.org
Subject: FRC review of Combined Code - response letter

Submitted on behalf of

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BEHAVIOURAL ASPECTS OF GOOD GOVERNANCE

1. Introduction

We write to provide further comments and evidence in response to the FRC's progress report and second consultation in respect of its review of the effectiveness of the Combined Code. This submission is being made jointly between David Phillips, Senior Corporate Reporting Partner in PricewaterhouseCoopers LLP and Professor Roger Steare of Cass Business School and is focused exclusively on the critical issue of corporate behaviour and the tone from the top. Importantly, the FRC in its progress report, highlights the fact that the "quality of corporate governance ultimately depends on behaviour not process". Unfortunately, when it comes to regulation, there is a tendency for the solution to be presented in terms of additional process which, as we have experienced, can, more often than not, result in mindless box ticking and unthinking compliance with the form of what is being requested, but little substance around the behavioural change sought.

The behavioural aspect of business is something in which Cass Business School has taken a particular interest over recent times, particularly through the work of Professor Roger Steare. This was brought to public attention through his book on business ethics and his "ethicability®" Moral DNA Report¹. Auditors also have significant interest in this issue, since they recognise that the integrity, honesty and the style of management adopted are critical to an auditor's assessment of a company and its sustainability. Some believe that this issue is the most critical in the audit process, but despite this, there is arguably insufficient routine and structured effort committed to this critical area, through auditor training and core audit processes. Clearly auditors are required to consider management culture and behaviour during the acceptance and continuance process and the assessment of the internal control environment, but the impact lacks the sophistication modern business auditing should demand. Arguably, a substantial element of audit time should be devoted to this area, extending, as it does, from the tone at the top, the effectiveness of the board, the impact on the overall culture and behaviour of the organisation and finally how the finance function is positioned in the overall running of the business. But here again, processes that demand more box ticking do not help; it's the professional experience and judgement of the auditor that is needed to identify problems and courage that's needed to intervene when the situation demands. Furthermore, it is worth noting at this

junction that a clean audit opinion relates to the truth and fairness of the financial statements; it does not necessarily indicate that the auditor agrees with: the way a company is being led; the tone from the top; and the management style and culture and behaviours that lie behind the delivery of the reported results on which the auditor gives his opinion.

2. Why understanding character and behaviour is fundamental

It is worth reminding ourselves that a corporation only exists as a "person" in law. In every other perspective, a corporation is a human community whose collective behaviour is a function of the behaviours of all its individual members including employees, customers, suppliers, local communities and investors - who are themselves both individual as well as corporate. The governance responsibility of the board and the senior executive team for the human behaviour of a corporation, is ultimately driven by the character and behaviour of the members of the board and the executive. This is why the Walker Review July 2009 Consultation Paper rightly refers to "character and judgement" throughout; and why the FRC's own July 2009 Progress Report refers to board "behaviour". We welcome these references to character, judgement and behaviour, but we also recommend that these are given greater prominence and attention going forward.

The selection and development of executives by corporations is already strongly supported by a range of assessment tools and techniques. In his research study Good to Great,² Professor Jim Collins, formerly of Stanford University Business School, has identified several character traits as characteristic of the best and most successful business leaders in over 1,400 corporations over the preceding 30 years. These traits are the moral virtues of "humility", "self-discipline" and "fierce resolve". More recently, Professor Steare has analysed the character traits of over 600 senior executives, including Board members, within financial services firms. His published research³ has clearly demonstrated that self-discipline is the weakest character trait amongst this group. It should be noted that self-discipline is the moral virtue that tempers greed.

Character, judgement and behaviour are connected stages in a process. Character or integrity, is the sum total of all of our moral values and informs the behaviour of trusted adults. Good collective judgements and decisions are made when we consider not only legal rules and obligations (which should be regarded as the "letter" of the law), but also how our values (the "spirit" of the law) help us to decide fair and reasonable outcomes for all stakeholders. We must also acknowledge that this process will vary according to the situational context faced by boards. As a consequence, it is critically important not only that the behaviours of organisations are better understood, but that there are processes in place to monitor the environments in which they operate, particularly to identify those situations when rational human behaviour is most challenged.

Against this behavioural background, we make the following observations and recommendations for how the UK's governance model can be developed and enhanced in the future.

• Enhancing the UK's "Soft Law" governance system

It is critical that in developing the UK's governance model we remain committed to a principles-based system which treats adults like adults and not as children. We do however believe that the current

system could be strengthened by:

1. the establishment of a chairman's group under the sponsorship of the FRC to act as a forum for the exchange of views, knowledge and best practice in the areas of board effectiveness, remuneration and reporting. This suggestion recognises the critical "lynch pin" role that chairman play in the whole governance process and its effectiveness. Furthermore, this group could also be tasked with encouraging leadership development programmes in the UK to put a serious emphasis on the components of effective governance, at least as much as is currently focused on commercial knowledge and management theory;
2. the establishment of a mechanism to provide the timely monitoring of the business environment in order to highlight to boards situations of increased risk, leading to environments where failures in governance may be more likely to occur (e.g. economic cycle, industry profiles, company profiles, significant transactions, poor financial performance...);
3. removal by the FRC of specific code requirements when it is clear that the desired shift in behaviour has occurred and has been verified.

• Character and behaviour

Furthermore, we believe the system can be further strengthened if work is undertaken to increase boards' understanding and awareness of the character and behavioural mix that is more likely to support an effective governance environment. In particular we suggest that the FRC should:

1. conduct research and encourage market experimentation around the use of tools and techniques that can be used to assess the character and behavioural profile of directors and boards; and
2. consider ways in which boards and individual directors can develop a conscious, diligent and verifiable collective decision-making process, that captures the essence of what is meant by the FRC in its references to "character" and "behaviour" throughout its July 2009 consultation document.

• Remuneration – exposing the behavioural impacts

One important aspect that has emerged through the banking crisis is the critical inter-relationship between: remuneration and incentive structures; organisational and individual behaviours; and the level of risk appetite assumed by the organisation. Much discussion has revolved around the need to focus more attention on remuneration, particularly bonuses, and ideas have been proposed in relation to how behaviour can be moderated to ensure that excessive risk taking is avoided and that decisions are made in the longer term interest of the organisation as a whole.

In determining what can be done to shine a light on this critical area, we believe that prescriptive measures are unlikely to be beneficial. We do however believe that as part of the annual remuneration report, the board should explain how the structure of the remuneration system is intended to impact the behaviours in the organisation and its approach to risk. In this regard boards should be required to explain what if anything they do to assess whether these board expectations are operating on the

ground.

- **External reporting – exposing culture, values and behaviours**

In a similar vein to the point made above, it may also be beneficial for boards to explain the behavioural tone which is established in the way it engages with shareholders and the management team and in the actions it takes. This can be seen as a statement of “who we are” and “what we stand for”. In this context, boards may wish to explain what management style and behavioural norms they encourage and what behaviours they will not tolerate. Here an understanding of the actions and penalties that have been put in place to deal with such exceptions could provide added impact.

- **Shareholder engagement – exposing the things that matter**

Finally, the FRC’s progress report rightly recognised that shareholder engagement with companies is critical to the functioning of the whole governance model. Similarly, good oversight is not all about process, but is also about the behaviours of investors in the situations that matter. Here the FRC may wish to consider commissioning research to throw more light on what “good shareholder behaviour” looks like, recognising that there is no single “correct” model, and use its position to promote the findings of this work with institutional shareholders and chairmen.

Footnotes:

¹ “Who’s doing the right thing? ethicability® Moral DNA Report 2008” by Professor Roger Steare and Pavlos Stamboulides

² “Good to Great”, Jim Collins, Random House, 2001

³ “ethicability®”, Roger Steare, Roger Steare Consulting Limited, 2009

Kind regards

Yours faithfully

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| David Phillips PricewaterhouseCoopers LLP | Professor Roger Steare Cass Business School |

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