Financial Reporting Council

Sir Winfried Bischoff

Chairman, Financial Reporting Council

Business of Trust

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17:00 – 19:00

Good evening,

I am pleased to be here to support The Lord Mayor, Charles Bowman's 'Business of Trust' agenda. We hear a lot about trust these days. Sadly, because in some areas it is in short supply. Business falls into this category although there has paradoxically recently been some recovery, admittedly from a low base, of trust in financial services. I fully support the Lord Mayor's excellent initiative. Trust was something the FRC addressed in its report on Corporate Culture and the Role of Boards in 2016 on which I will comment more later.

Strong corporate governance and audit quality are essential to good decision taking in business, maintaining public and investor confidence in the integrity of business, and in particular, building trust in the reporting of company performance. However, over recent years, we have seen failings in governance, reporting and audit which not surprisingly have led to a loss of public respect, and ultimately, trust in business.

Trust is very important. I personally believe that to regain trust, we in business probably need to focus also on building respect. That means finding ways to reconnect the public at large, the media and politicians with the good that business does. That includes the social benefits, not just of wages and tax paid, not just of services, goods and jobs provided, but of the deeply underlying personal satisfaction of being employed and contributing to society.

The twists and turns over the last year or so, accompanied by the result of the Brexit referendum, have ushered in a new political and economic narrative. Alongside this, and following some high-profile cases of misconduct, there is a perception that business is not delivering for all.

Codes put forward principles that make bad behaviour less likely to occur; and public reporting makes it harder to conceal. But, by itself, a code does not prevent inappropriate behaviour, strategies or decisions. Only people, particularly the leaders within a business, can do that.

Over the years, the FRC has taken many steps to encourage improvements in confidence in the way companies are governed. This summer we will publish a new UK Corporate Governance Code to help business continue to deliver on expectation of investors, the public and the economy. Our consultation on proposals for the new Code generated over 270 responses, which far exceeds previous consultations and illustrates the interest in restoring trust in business.

The proposals for the new Code received a positive response. In particular, the streamlined structure and clearer language, the focus on the application of the Principles, the broadening of the Board’s responsibilities to include wider stakeholders in addition to shareholders, and the focus on diversity are welcomed. So, I am pleased to say was our aim to shorten – or to use our phrase, sharpen - the Code.

So, what are our proposals and do they go far enough to restore trust in business?

First, there is a clear message to companies that they must live up to the requirement in the Companies Act 2006, that is their Boards must have due regard to the interests of stakeholders not just shareholders.

Directors need to understand the impact of the company on its employees, on consumers, on the environment and on wider society. Without that understanding public trust in the business is put at risk and in consequence the long-term interests of shareholders are actually undermined. The new Code will ask companies to report on those wider stakeholder issues.

Second, remuneration policies. This is on a number of fronts: perceptions of rewards for failure; rewards that incentivise short-term, often poor, business decisions; and rewards that simply represent an inequitable share of resources that could be committed to growth or returned to the stakeholders.

The new Code attempts to deal with these aspects by calling on companies:

- To be more specific about their response to significant shareholder opposition on any resolution, including those on executive pay policies and awards;
- To give remuneration committees broader responsibility for overseeing how remuneration and workforce policies align with strategic objectives and support long-term success, and notably to consider discretion in exceptional circumstances;
- To undertake engagement with the workforce to explain how executive remuneration aligns with wider company pay;

- To extend recommended minimum vesting and post-vesting holding periods for executive share awards from 3 years to 5 years; and
- To ensure the views of the workforce are considered more carefully by the board.

Third is the issue of Culture.

Culture in business is a key ingredient in delivering long-term sustainable performance. When there is a healthy culture, the systems, the procedures, and the overall functioning and mutual support of an organisation exist in harmony. This brings enhanced integrity, respect, long-term success and ultimately trust.

For this reason, we at the FRC led a coalition of parties that produced a report on "Corporate Culture and the Role of Boards" in 2016.

As one of the five coalition partners of that report, CIMA, our co-hosts this evening, were instrumental in stressing that values and value creation need to be aligned. We all are grateful for CIMA's initiative thinking on its business model framework.

Very importantly, that framework emphasises the need to integrate the governance and operations of the business. Too often, corporate crises have revealed a disconnect here – rather than a clear line of sight of the key issues and metrics that deliver value. The framework also suggests that boards consider how they share the value they have created through dividends, taxation, reinvestment and incentives. Poor decision making in these areas all too easily undermines trust.

CIMA will soon be publishing the final version of the business model framework and developing the ‘Trust Lens’ to enable boards to put these important ideas into practice.

Following the completion of the Culture Project, the FRC established a Stakeholder Advisory Panel, of which Charles Tilley is a member, of a broad range of stakeholder representatives. The diversity of this panel enables us to focus on the needs of society in pursuit of our mission to promote transparency and integrity in business.

Our research found that in order to establish an appropriate culture, a board must define the purpose and values of the company. It involves establishing a company specific corporate culture, asking questions and making choices: how to align values and purpose to the company’s strategy; how to integrate new leaders into that culture, particularly at times of merger or acquisition; how to maintain a healthy governance under pressure; how to decide whether different parts of the business should operate different cultures, and how actively and transparently to communicate values, purpose and behaviours in order for shareholders to support, and for society to acknowledge the benefits generated by responsible companies.

Once a good culture is in place, it must not stop there. The ongoing success of the company is rooted in diversity and succession planning. A Board must determine the balance of skills, background and experience required by the senior executives and non-executive directors.

Boards as a whole need thoughtfully to consider also the links between diversity, strategy and business values. Diversity avoids the danger of group think.

That naturally brings me to the subject of long-term thinking.

Culture and values, by their very nature encourage long-term thinking.

By contrast budgets, quarterly reporting and financial plans, though necessary, are essentially short-term.

When speaking about the long-term I can do no better than to recommend to all of you the article by Professors Joe Bower and Lynn Paine in the Harvard Business Review of May-June 2017. They argue cogently and refreshingly that in managing for the long term it is the company's health and not shareholders' wealth that must be management's priority. The assumption that boards and management are the agents of shareholders is wrong, they argue. Rather their duty legally is to the company. Of course, shareholders are an integral part of the company and its purpose and values, but only one part. Employees, customers, suppliers, the community and even the environment also play a part and have a stake. As you might imagine this highly influential thought piece has led to debate and controversy in the United States, not least amongst the new class of activist shareholders! But its sentiments are echoed by Larry Fink of BlackRock and others such as Vanguard.

One of the observations in our Culture Report was the role of the Board in establishing, not only the right behaviours but also the right incentives and disincentives. In doing so, the Board must be credible in the eyes of shareholders but also of employees. Employees are expected to display the right behaviour, but the Board should similarly set the standards for the senior management. That in turn means careful thought has to be given to how culture is measured and reported.

Of course it is true that corporate culture is intangible. But it can be measured through conduct and outcomes, and much information is already available to the Board to do so. Health and safety reports, environmental assessments, customer satisfaction data, employee turnover, diversity initiatives, exit interviews, whistleblower incidents and responses, conduct self-assessments and employee engagement surveys are all good examples. It is what you choose to measure and how you analyse and interpret it that is important. At the same time culture is company specific and there is no one–size–fits-all. The indicators selected for assessment should therefore be tailored to each company's circumstances.

To conclude, despite the challenges I've outlined UK business remains in a good position globally, and our professional firms are of the highest calibre. But, we must not stand still. We need to work together so that business in the UK regains respect, integrity and trust by delivering fair outcomes over the long term for all investors and for wider society as a whole.

Thank you for listening.