Financial Reporting Council

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The not-so-secret path to longevity of business success

Introduction

Good morning everyone! Or should I say g'day?

I am honoured to be here today to give this keynote address, and I want to thank the organisers, the Governance Institute of Australia, and particularly Anji Kurian, for all the excellent arrangements involving my participation in this important conference.

Respect, Trust and Challenge – the title for this conference – resonate with me and my career, both in my executive roles in banking and financial services and in my non-executive appointments.

1. Culture and the importance of trust

We talk, quite rightly, a lot about trust. Somewhat controversially I suspect, I believe that trust needs to be preceded by respect for business and all that business stands for. If business is not respected, then it will not be trusted. But trust is hard to secure.

Next month I will step down, after some five and a half years, as Chairman of the Financial Reporting Council in the UK, the regulator for audit and promoter of governance and stewardship.

That allows me to look back on the changes in attitude, in corporate governance and in stakeholder engagement, as well as more broadly in regulation, over that period.

You will be well aware that in many parts of the world politicians, the public and the media have demanded regulation to be much tougher, and that regulators should be seen to be feared. Australia and the UK are no exception to these sentiments.

I propose to discuss Respect, Trust and Challenge under three headings:

- Culture
- Conduct; and
- Stewardship

I will also want to touch on some associated aspects. Such as remuneration and ESG (environmental, social and governance, factors); the board's important involvement and investment in strategy, and the role audit plays in all of this.

2. Corporate governance and trust

During my time as Chairman of the Financial Reporting Council, we have taken a number of steps to help business regain respect and trust. These include publishing in July 2018 updated Guidance on Board Effectiveness alongside the revised UK Corporate Governance Code.

This was intended to stimulate boards' thinking on how they can carry out their role and improve their effectiveness. If boards are seen to be effective, they will command respect and hopefully also trust. The Code gives best practice advice on how an effective board should manage the conflict between short-term interests and the long-term impact of its decisions, and how to address shareholder and stakeholder interests from the perspective of the long-term sustainable success of the company.

That review of the UK Corporate Governance Code was stimulated in part by concerns that public trust in business is low, and the impression - erroneous in my view - that businesses in general don't take sufficient account of the impact they have on society and the environment. They do, but regrettably not all of them.

This decline in trust can be traced back to the global financial crisis, when banks and other financial institutions appeared to have sacrificed long-term sustainable success in favour of chasing short-term shareholder returns at the cost of growth in the economies of affected countries, their citizens and the taxpayer. This contagion spread across to other sectors, where issues including lack of transparency and the remuneration packages of senior management raised concern, not to say anger. In recent years, even in what is simplistically described as the real economy, a number of corporate failures have significantly affected customers, employees and suppliers. Worse, as far as the public is concerned, senior management and executives have been immune to, and controversially not punished for, the effects of these failures.

The Code emphasises the importance of building trust by forging strong relationships with key stakeholders. Boards should be more transparent about their pay policies and how they link them to company culture and behaviours. The Code also introduces alternatives for engaging with the workforce. Employees should be satisfied that their views have been noted and <u>how</u> they have been dealt with.

3. Culture, Regulation and the Audit Market

The new UK Corporate Governance Code is shorter and sharper than its predecessors, a practical objective I set our management. It places emphasis on Boards taking account of the interests of all key stakeholders.

In doing so it emphasises the importance of long-term value creation and a culture that supports that longer-term vision.

The Code requires Boards to decide what type of behaviours and culture they wish to promote in order to deliver their business strategy. Since behaviours and values must run through the whole organisation, that requires advocacy and monitoring.

Let me here make some comments about audit and its regulation because it touches on culture.

The audit market in the UK, is under particular scrutiny. There are three separate but linked reviews – one completed, one in its final stages, and the third to be completed by December.

Sir Donald Brydon, a former chair of the London Stock Exchange, and chair and director of a number of prominent companies, is undertaking a review into the future of audit and how best to close the expectation gap of what users of company accounts want to <u>see</u> audit do, what the public <u>expects</u> audit to do, and what auditors <u>can</u> do in reality. Opinions on these three areas differ markedly. Secondly, the Competition and Markets Authority, the UK competition regulator, has launched a consultation about how to improve competition in the audit market, or how to deal with the very high concentration in the audit market.

Thirdly and of most relevance to us at the FRC was the review by Sir John Kingman of the FRC itself and of audit regulation. He published his recommendations last December. They included more powers for the FRC as regulator, and for the FRC to transition to a new body called the Audit, Reporting and Governance Authority – ARGA. Sir John recommended that the new Authority should develop a robust market intelligence function to identify emerging risks. Rather than largely look at the immediate past year, it should look forward; it should also promote competition in the market for statutory audit services; and it should help advance innovation and demand continuous quality improvements. The availability and thoughtful use of new technology would be a help in some of these areas.

A number of stakeholders suggested to the Kingman Review that there is a case for introducing in the UK something similar to, the Sarbanes-Oxley (SOX) regime in the US specifically relating to internal controls. I might call it SOX-light. This would provide assurance around internal controls. The pros and cons of such a regime should at least be considered, and then consulted upon, paying special attention to proportionality.

Transparency is another theme in Sir John's review. He recommended more transparency in our annual audit quality and corporate reporting review findings of the largest audit firms in the UK; and a more timely and transparent complaints resolution.

I note with interest that there are some similarities here in Australia in that major reform of the financial sector is coming, following Commissioner Kenneth Hayne's Royal Commission review into misconduct in the banking, superannuation and financial services industry. This envisages changes to the Australian Prudential Regulation Authority, including new powers for the regulator.

Culture was as prominent a theme of Commissioner Hayne's report as it was of Sir John Kingman's report. Commissioner Hayne declared that the responsibility for corporate conduct (and misconduct) lies with the board, and that this must have consequences for the board's role, priorities and accountability. He expressed a clear expectation that the board will challenge management and ensure accountability. This robust challenge, not surprisingly, is already increasingly being required of boards in financial services and is something I strongly endorse. It seems to be working in that industry and deserves applicability more generally.

As a side comment, while auditors are blamed in many quarters for the failure of companies, the prime responsibility must lie with a company's board of directors and its management. Yes, auditors need to be more sceptical and consistent, but theirs is likely to be a contributory rather than prime factor in any corporate failure. Let me hasten to add that this does not excuse auditors' shortcomings!

4. **Culture and its link to success**

The ongoing success of a company and its culture are also rooted in diversity and succession planning. The new Code calls on Boards to take time to consider and understand how diversity and effective succession plans will achieve their strategy and promote long-term value.

When the FRC published its report in 2016 on *Corporate Culture and the Role of Boards*, one of its key findings was that any indicators and measures should be aligned to desired outcomes and should be material to the business.

Employee surveys, exit interviews, whistleblowing reports and their outcomes, net promoter scores, and staff turnover rates are examples of what can be used as benchmarks for the temperature of an organisation when measuring corporate culture. Those data are in fact gathered already and sit in the database of corporations and are not an additional burden. They simply are not made enough use of.

'Overboarding', where directors take on too many roles, length of service, board refreshment, succession planning and diversity are also addressed in the new Code. The chair's length of service should be limited we felt, as did investors to an overwhelming degree. Subject to our 'comply or explain' regime we proposed that the chair's maximum tenure as a director should be the same as that of non-executive directors, that is restricted to nine years. A limited extension was envisaged if, for example, a longer appointment were required to support the company's succession plan and diversity policy. I can tell you that this recommendation, applauded by shareholders, caused more anxiety among chairs than any other!

5. ESG and climate change

Diversity has gained momentum over recent years, but it isn't the only big issue to do so. Climate reporting and environmental, social and governance (ESG) factors have also been the focus of attention.

The FRC's Financial Reporting Lab, a type of experimental and non-judgmental sandbox, which speaks to investors and companies and highlights and promulgates market-led best practice, has recently been looking at the ways in which companies disclose this range of factors. Whether they are called ESG, pre-financial information, wider metrics, non-financial or extra-financial, it is clear that they play an increasingly important role in investor decision-making.

Many investor participants in our recent Lab projects have noted that boards and management gain credibility when they are willing to discuss and disclose what they are doing in the area of ESG. At present investors feel they do not get enough information on how boards decide on their company's sustainability topics. Qualitative information is all well and good, but investors have asked for more data and for an indication of which non-financial metrics are being monitored and managed.

One particular area in which this call has become louder is climate change. It is a defining issue of our time and presents far-reaching primary, secondary and tertiary financial risks. The FRC's expectation in this area is clear - boards should address, and where relevant report on, the effects of climate change.

Reporting should set out how the company has taken into account the resilience of the company's business model, and the risks, uncertainties and viability in both the immediate and longer-term in light of climate change. Also, how the company intends to respond to climate change, and how climate change has been considered in its strategic planning.

The Lab's work on climate change has been underway since last year. We have been anxious in our work to draw on best practice being undertaken internationally. In this context we have been impressed to see some of the activity from Australian regulators, and Australian investors and in the AASB/AuASB statement around climate change and materiality.

6. **Culture and its link to Conduct**

In a world of globalisation and social media, climate change, pollution, working conditions, behavioural issues like sexual harassment and bullying, employee diversity, corruption and aggressive tax strategies are factors which readily destroy the value of brand, reputation and trust. The menu is large but many of these issues are now at the forefront of boards' awareness and, I am happy to observe, are being dealt with much more proactively.

Boards, of course, should regularly challenge the CEO and his executive committee's views. Group-think occasionally does, but should <u>not</u> influence how key decisions are made. Rather, long-term thinking should be the lode-star.

The Code promotes constructive challenge in the boardroom. Successful boards should not be comfortable places all the time. Only through effective debate can issues be resolved. For me in my career, the more memorable moments are at times of conflict and anxiety, when, for example, the company is in trouble and you are having to take a leading role to find solutions; or when you have to take a big strategic decision which may only pay off in the longer term. At times like this hubris and complacency are the enemy! It is natural for board members, including the non-executives, to bathe in the success of their company. While understandable, that can lead to disaster. All chairs, and indeed many directors at some time or the other, have had to fight against these instincts.

7. Remuneration – the elephant in the room

Remuneration and public and shareholder reaction to it are clearly critical areas in many parts of the world. The FRC has used the recent update of the UK Corporate Governance Code to strengthen the role of the remuneration committee. While committees continue to have delegated responsibility for designing and determining remuneration for the board and senior management, they also have a role in advising the board in respect of wider workforce policies on rewards and incentives. That includes advice even on what we might think of as tangential rewards, highlighted recently in the UK, in the debate on the very generous terms and conditions of pensions for the senior management as compared with those for the workforce in general.

Most critically, however, Remuneration Committees should focus on the strategic rationale for executive pay and the links between remuneration, strategy and long-term sustainable success.

They should also work to simplify the structure of the remuneration policy. Simpler structures help reduce the reliance on consultants, and they improve direct communication with shareholders and the workforce.

Where performance-based incentive plans are used, the choice of a range of financial, non-financial and strategic measures can help ensure that targets are aligned with value over the long-term. Metrics need to be reliable and credible to satisfy shareholders, and their purpose should be explained.

8. Strategy – Board responsibility

An effective board defines the company's purpose and then sets a strategy to deliver it, underpinned by the values and behaviours that shape its culture and the way it conducts its business. I know that there is a saying that "Culture eats strategy for breakfast – I disagree. The two are symbiotically intertwined.

A company's purpose is the reason for its existence. The board is responsible for setting and reconfirming it. A well-defined purpose will help companies articulate their business model, and develop their strategy, operating practices and approach to risk. Companies with a clear purpose find it easier to engage with their workforce, gain the support of customers, and the respect of the wider public.

In considering strategy, there are some key attributes to be considered by the company's directors:

- Are we playing an active role in shaping long-term investment plans to underpin delivery of our strategy and value creation?
- What behaviours are required given the financial targets we set?
- How competent is our management to deliver the strategy?
- How does executive remuneration link to our strategy and KPIs?
- Are we thinking long-term or are we simply extending one-year budgets to the medium term?

The challenge that boards face is to balance the competing demands of the company's stakeholders and how best to factor these into setting and maintaining the strategy. Keeping strategy under review of course is essential and I do not argue against the validity of short-term performance. But strategy means long-term and does not mean making short-term changes to satisfy fashion or investor preferences.

9. Stewardship – Investor responsibility

Good governance is essential and can be kept under review through effective investor engagement. To promote such engagement, the FRC has consulted on the UK Stewardship Code. This was world leading when introduced in 2010, but now needs to be refreshed. Investors – those who put up their own money, not those who manage it – should demand high quality stewardship by their fund managers, and managers in turn must respond to that demand.

The new Stewardship Code (which incidentally has not yet been published, but the consultation on which has been largely completed) most significantly demands that fund managers not only explain their <u>policies</u>, but also then report on the <u>outcomes</u> they have achieved. This proposed major change, the disclosure of <u>outcomes</u>, rather than spelling out policies only, will be far-reaching and should allow clients and customers to make better informed and differentiated judgements on the distribution of their fund management mandates.

10. Private/Non-Listed companies

Corporate governance of large private companies has been something the FRC has looked at periodically and with real purpose in the past 12 months. We formed a Coalition group and its study culminated in the launch of the Wates – named after its chairman Sir James Wates - Corporate Governance Principles for Large Private Companies in December 2018. It completed for us a year of significant review of the whole of the UK's corporate governance framework. The Wates Principles are part of that framework and recognise the important economic and social contribution made by larger private companies.

The Coalition Group considered and included some aspects thought to be essential for <u>publicly listed</u> companies, such as the importance of:

- company culture and purpose;
- a diverse board; and
- dialogue with wider stakeholders.

The Wates Principles suggest companies consider their approach to governance and how the Principles can take into account their own particular circumstances. They should not be reluctant to copy what they consider best from publicly-listed companies.

The Principles are not intended to be a burden but an opportunity to showcase what private companies are doing and to demonstrate the vital role they play in our society.

These companies an enormous contribution in terms of turnover, tax and jobs. They do so not just in the UK but in many other countries, including Australia. The Wates Principles happily also create a platform for greater prominence in the overall narrative about a country's openness to business and investment.

Larger Private Companies will begin to report on their governance arrangements from 2020. Before then the FRC will give increased prominence to the Principles to ensure they are successful in achieving the requisite governance in private companies.

This is a long-term project and like the UK Corporate Governance Code for listed companies the Wates Principles for unlisted companies will develop over time. History suggests they will do so successfully. The UK Corporate Governance Code is an excellent precedent. It has been in place since 1992, and has evolved from the initial Cadbury Report into a Code which is now renowned across the world.

Much like in the UK, corporate governance has evolved in Australia since the global financial crisis stimulated by some high-profile corporate failures. Whereas the UK Corporate Governance Code is 'comply or explain', your framework is a mix of prescriptive and voluntary elements.

11. **A regional governance initiative**

In that context, you may be interested in an unusual voluntary, entirely unofficial and not EU-led, development in corporate governance across five European countries with different legal and cultural regiments. At the suggestion of an eminent Italian industrialist, who at the time was chair of the Italian Corporate Governance Commission, five chairs of their countries' corporate governance bodies decided to get together annually to discuss developments in their own countries, compare best practice, and highlight similarities rather than focus on differences. The other countries are France, Germany, the Netherlands and the UK. By the way, the members requested that the UK remain a member of this informal body even after our expected EU exit, a request which I was happy to meet on behalf of the FRC.

I mention this innovative idea because I believe globality, global standards and global business models will increasingly require a global approach to corporate governance by companies and their regulators.

There is more that companies in Asia have in common, than divides them, and I believe an initiative along these lines involving say Australia, Japan, Singapore and Hong Kong as a start might prove productive. The imperative, I believe, is to test the concept initially with just a few – admittedly important – members and then to let momentum decide how far the initiative can go.

Conclusion

So, in conclusion, I come back to the beginning: without respect, you cannot achieve trust. To achieve that, boards must be held to account to challenge senior management and the decisions they make for long-term viability of their company. For this challenge to work, it has to be realised that culture is an important factor of business success.

Thank you for listening and I hope you enjoy the rest of the conference.

I am now happy to answer your questions.