February 2018

GoodCorporation's Response to the Financial Reporting Council's Consultation on Proposed Revisions to the Corporate Governance Code

Introduction

GoodCorporation welcomes the increased focus on corporate culture in the revised Corporate Governance Code (the Code).

In particular, we were encouraged to see the Financial Reporting Council (FRC) carrying forward recommendations from its 2016 report, *Corporate Culture and the Role of Boards*, such as Provision 2 under Section 1, which states that the board should 'monitor and assess' company culture in order 'to satisfy itself that behaviour throughout the business is aligned with the company's values'.[1]

We believe this new provision will go a long way towards helping boards adhere to the revised Code's first principle: 'to promote the long-term sustainable success of the company'.[2]

However, in pursuing this objective, we also believe the Code could go further. The following consultation response will argue that:

1. It is the core ethical behaviours underpinning a company's culture which ultimately safeguard its long-term success

2. These core ethical behaviours can be defined, monitored and assessed by boards in exactly the way the revised Code prescribes

3. Monitoring the alignment between ethical behaviour and company values should be incorporated in to the audit and risk provisions of Section 4

In addition, we also look at meaningful engagement with stakeholders and provide additional recommendations on how that could be enhanced.

Our response will substantiate each of these arguments in turn. As this response therefore relates to the Code's understanding of 'culture' as a whole, and this term is used throughout the revised version, we will be making general comments on the consultation materials, taking care to signpost the principle or provision to which these comments relate, as requested in the consultation document.[3]

[1] Financial Reporting Council, *Proposed Revisions to the UK Corporate Governance Code, Appendix A – Revised UK Corporate Governance Code*, December 2017, Section 1, Provision 2, p. 3

[2] Idem. Section 1, Principle A, p. 3

[3] Financial Reporting Council, *Proposed Revisions to the UK Corporate Governance Code*, December 2017, p. 26

1. It is the core ethical behaviours underpinning a company's culture which ultimately safeguard its long-term success

A company's culture could rightfully include important values such as 'innovation', 'competition' and 'motivation'. While values like these are often central to a company's outward performance, they do little to mitigate a company's risk of internal misconduct and are therefore of less interest to the shareholder.

As recent headlines have shown, it is often the behaviour of a company's staff internally which leads to scandals that bring down its external reputation and, with it, the company's chances of long-term success.

Perhaps one of the most high-profile and striking examples is the Volkswagen 'diesel-gate' scandal, in which Volkswagen diesel engines were fitted with software that could detect when their emissions were being tested and momentarily improve the results.

An analysis of the ethical characteristics behind Volkswagen's culture, published in *Fortune* magazine after the scandal, showed that the company was 'driven by a ruthless, overweening culture' and 'run like an empire, with overwhelming control vested in a few hands, marked by a high-octane mix of ambition and arrogance—and micromanagement—all set against a volatile backdrop of epic family power plays, liaisons, and blood feuds.'[4]

This kind of culture, which 'mandated success at all costs',[5] ultimately cost the company dearly. The Volkswagen share price collapsed once the emissions cheating came to light and remained at roughly half its pre-crisis peak two years later, albeit now recovering.

Companies are thus being held to account, not just for 'what' they achieve, but 'how' they achieve it. The decision-making behind every objective, the 'how' behind the 'what', therefore needs to be supported by a culture which promotes ethical behaviour. Establishing, monitoring and measuring these aspects of company culture specifically will reduce a company's risk of scandal and, ultimately, safeguard its long-term success.

2. The core ethical behaviours underpinning a healthy company culture can be defined monitored and assessed by boards in exactly the way the revised Code prescribes

Building on the conclusions of its 2016 *Corporate Culture* report, the FRC argues in its consultation document that 'in order to establish an appropriate culture', the board must 'consider the type of behaviours it wishes to promote'.[6]

The revised Code builds significantly on the 2016 report in this respect, which asked only that boards set the correct 'tone from the top' and lead by example to ensure good standards of behaviour permeate throughout their organisation.[7]

Provision 2 also requires the board to 'satisfy itself that behaviour throughout the business is aligned with the company's values'. Going on to stipulate that 'where it finds misalignment it should take corrective action',

[4] Geoffrey Smith and Roger Parloff, "Hoaxwagen: How the massive diesel fraud incinerated VW's reputation—and will hobble the company for years to come", *Fortune*, 7 March 2016, available online at http://fortune.com/inside-volkswagen-emissions-scandal/ (accessed 27 October 2017)

[5] Ibid.

[6] Financial Reporting Council, *Proposed Revisions to the UK Corporate Governance Code*, December 2017, Section 1, Paragraph 40, p. 10

[7] Financial Reporting Council, *The UK Corporate Governance Code,* April 2016, p. 2

explaining the board's activities and any action taken in the annual report. We welcome this requirement which we hope will move the dial on company culture reporting.

A recent survey of FTSE 350 board directors found that although 86% of people viewed culture as very important or fundamental to their company's performance, only 12% of organisations provided detailed information on culture in their public filings and annual reports.[8]

The result is an abundance of culture 'buzz-words' in the annual reports of FTSE companies, which often stands in stark contrast, not only to the ethical scandals some of these companies suffer within the same year, but also to their lack of any concrete system for measuring the ethical values that lie beneath their culture.

We welcome the encouragement to monitor and assess but feel that boards should focus their attention on the behaviours that underpin company culture. Not only are behaviours identifiable and measureable, they pervade the company's decision-making from top to bottom, determining everything from executive pay to 'borrowing' of company property. Measuring the ethical behavioural aspects of company culture therefore would provide boards with the most reliable indicator of whether their culture is likely to safeguard or jeopardise the company's chances of 'long-term sustainable success'.[9]

We are also encouraged to see that Provision 3 under Section 1 of the revised Code recommends 'a means for the workforce to raise concerns in confidence'.[10] However, whistleblowing systems like these only come into play when an issue has already arisen. They are not sufficient, in isolation, to enable boards to 'monitor' their company culture as this does not provide a sufficient analysis of the behaviours which may cause issues to arise in the first place.[11]

3. Monitoring the alignment between behaviour and company values could be incorporated in to the audit and risk provisions of Section 4

Section 1 of the consultation states that a poor culture is a significant business risk in itself [12], however culture does not then appear in section 4 on audit, risk and internal control. In our view it would be logical to extend the risk assessment to explicitly cover ethical culture/behaviour as a key part of protecting the shareholders' interests.

4. Assessing the impact of business activities on wider stakeholder groups

Principle C states that the board should ensure effective engagement with shareholders and stakeholders. We believe that this should involve regular reviews and assessments of the impact of the company's activities on various stakeholder groups, taking into consideration issues such as fair pay, health and safety, supplier payment terms, human rights and treating customers fairly. This could be similar to the IFC Performance

[8] See Ernst and Young - *Is your board yet to realise the true value of culture?* 2016, pp. 6 and 21

[9] Financial Reporting Council, Proposed Revisions to the UK Corporate Governance Code, Appendix A – Revised UK Corporate Governance Code, December 2017, Section 1, Principle A, p. 3

[10] Idem. Section 1, Provision 3, p. 3

[11] Idem. Section 1, Provision 2, p. 3

[12] Financial Reporting Council, Proposed Revisions to the UK Corporate Governance Code consultation, December 2017, Section 1 provision 39

Standards model, which enables organisations to assess the impact of their activities on stakeholders and to take due consideration in decision making.

We also feel that there is a strong argument for some form of employee representation at board level and would advocate for advisory panels to enable directors to hear from employees and other key stakeholders. We would also recommend that organisations seek and take account of the interests of its different stakeholder groups. This could be done by independent assessment of stakeholder views, which are measured and benchmarked over time to demonstrate levels of engagement.

Engagement with employees should also consider pay. While the consultation rightly makes reference to the role of incentives and rewards in driving behaviours that support the desired culture, businesses also need to acknowledge the corrosive effect of widening pay gaps. Executive pay in the UK has quadrupled in the last 20 years outstripping both profitability and average pay considerably. We have also seen a decrease in productivity. The consultation rightly advocates for improving the experience of the workforce by developing working practices that engender trust, offering fair rewards and recognition and providing flexible working conditions[13].

We would also argue that in reaching pay decisions businesses need to consider the wages of the executive in conjunction with those on the shop floor to ensure that all staff are rewarded fairly and not just those at the top.

Conclusion

GoodCorporation would therefore recommend that the wording of the revised Corporate Governance Code is amended to show that:

1. In considering the kind of company culture they wish to promote, boards should devote particular attention to the core ethical behaviours they would like to underpin it

2. These core ethical behaviours should be defined, monitored and assessed in a way that draws on the experiences of the company's key stakeholders

3. Doing so should provide clear metrics for boards as they seek to establish a culture which promotes the long-term sustainable success of the company and identifies any cultural risks to the business itself and should be included in the remit of the audit committee

4. Meaningful engagement should involve impact assessment of business activities on different stakeholder groups as well as the use of advisory panels to ensure that directors hear regular feedback from different stakeholder groups

Submitted by GoodCorporation, leading adviser in the field of business ethics and corporate responsibility.

[13] Financial Reporting Council, Proposed Revisions to the UK Corporate Governance Code consultation, December 2017, Section 3 provision 80