Catherine Horton
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28 February 2018

Sent by email to codereview@frc.org.uk

Dear Ms Horton,

Response to the FRC Corporate governance consultation

Introduction and summary recommendations

This response to the FRC Corporate governance consultation on its proposed new Code of Corporate Governance (the Code) and Guidance on Board Effectiveness (the Guidance) is a joint response by seven academic and governance specialists. Many of our responses are influenced by recent events at Carillion plc and our comments in relation to this particular company are stated in the "Discussion" attached to this submission.

The recent failure of Carillion plc has highlighted problems in the way corporate governance, financial reporting and auditing are practised. Unless these problems are addressed they threaten to undermine trust in these important institutions and in capital markets generally.

What is of particular concern is the fact that many of the issues highlighted are reminiscent of some of the corporate behaviour which led to the establishment of an investigation of the Financial Aspects of Corporate Governance by the Cadbury Committee in 1991 and 1992 . Thus one may ask what 25 years of corporate governance development has achieved . Against the above background, we make a number of summary recommendations summarised as follows:

1. The FRC should conduct a critical review of how a company which appeared to be fully compliant with the Corporate Governance Code actually had dysfunctional governance. In particular the FRC should determine:
    a. what was wrong with the board's assessment of its own effectiveness,
    b. what was wrong with its assessment and management of risk,
    c. what was wrong with its assessment of viability and going concern, and
    d. whether it is appropriate for investors and other users of annual reports to rely to any extent on company governance reports when making decisions;
2. The FRC should take a view as to whether Carillion's 2016 Annual Report is a fair, balanced and understandable assessment of the company's position and prospects. If the conclusion is that the annual report did not, the FRC should consider whether there are any systemic reasons for this. If so, these reasons would apply to other annual reports. The suggested FRC review should include consideration of assessments of going concern and viability, critical accounting judgements, goodwill valuation/impairment and risk identification/management;

3. The FRC should determine whether the external audit complied with all relevant auditing standards and, assuming it did, whether there is a systemic problem with auditing standards and/or practices in relation to the areas referred to in 2 above;
4. Shareholder approval should be obtained whenever a change is made to the board remuneration policy; and
5. The FRC and or the Department for Business, Energy and Industrial Strategy should consider whether existing sanctions for the non-adherence to sound and proper board governance, corporate reporting and auditing practice are adequate and appropriate. Further, are they being effectively used? Should further powers be necessary in this aspect?

The Carillion affair raises issues of such concern that we believe the document under consultation in addition to comments needs a comprehensive revision prior to a new consultation. Events have overtaken the code, and imply that it no longer meets the needs of government, business or the regulator.

As stated, the attached 'Discussion' expands upon our thinking. We also attach an Addendum from Professor Bob Garratt which gives a more personal perspective from him on the same issues. We would be happy to expand on our comments if you would like to contact us. Please contact either Professor Bob Garratt, or Professor Paul Moxey, at their email addresses provided below.

Yours sincerely,

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DISCUSSION

The proposed new Code and Guidance should be seen as a measured response to address governance problems highlighted by the failure of BHS and more general concerns held in 2017 about executive pay and corporate culture.

The failure of Carillion revealed what may be more fundamental fault lines in the UK approach to corporate governance and to international financial reporting and auditing standards. The collapse requires the FRC to re-evaluate its approach to corporate governance and to corporate reporting and auditing. This response therefore does not comment on the detailed changes to the Code and Guidance: instead we try to highlight the issues and make suggestions.

Unlike many recent governance scandals where problems with corporate culture, or excessive optimism have occurred, these do not seem to have been obvious problems at Carillion. Assuming the board was being honest in its communications with shareholders and in evidence given to the Parliamentary Work and Pensions Committee, the problem instead seems to have been one of a board which thought wrongly it was doing a good job and which did not know what should have known. Carillion has also highlighted that the conventional approach to risk management is flawed and that more attention must be given to corporate foresight.

We suggest that the FRC do not issue the proposed new code until completing a more thorough review which takes into account what can be learned from Carillion.

The lessons from Carillion

Although final conclusions about exactly what happened must wait for the conclusion of the various enquiries, a picture is emerging which must cause grave concern for everyone interested in governance, corporate reporting and auditing. We can see from Carillion's published reports, and the evidence taken by the Parliamentary Work and Pensions Committee up to the date of this letter, that either:

(i) the published reports were misleading and the evidence that the directors gave to the Committee was disingenuous or

(ii) something is seriously wrong with financial reporting, auditing and corporate governance as it is practised in the UK

or (iii) a combination of (i) and (ii).

The annual report 2016

The 2016 Carillion Annual Report published in March 2017 painted a rosy picture of the company and its prospects. It gave little, if any, warning that the company was about to fail. On the contrary, the report suggested:

- a values-driven, profitable, well-run company with a strong order book;
- revenue growth and a track record of performance;
- a highly effective board;

- a highly skilled and committed workforce and generally a company that was on top of the few challenges it faced;
- unused borrowing facilities of c£750m;
- the audit committee and KPMG, the external auditor, had reviewed accounting policies for revenue recognition, valuation of long term contacts and the valuation of goodwill and were satisfied;
- the audit committee was satisfied the financial statements were fair balanced and understandable;
- the company complied fully with the 2014 UK Corporate Governance Code
- the audit committee was satisfied the financial statements were fair balanced and understandable; and
- the report said Carillion complied fully with the 2014 UK Corporate Governance Code and the report certainly gives the impression of a company with both good governance and a strong commitment to good governance together with a focus on values, openness and culture.

The detailed disclosures on risk suggested:

- that risks were well known and managed and showed the existence of strong internal controls including on long term contracts;
- the board was satisfied the company would be viable and able to continue in operation and meet its liabilities as they fell due over the next three years;

The annual report certainly gave the impression of a company with both good governance and a strong commitment to good governance together with a focus on values, openness and culture.

The July trading update and half year accounts issued in September 2017

In July the half-year trading update created, or tried to create, the impression the board had things under control. The trading update failed to say in words that the balance sheet net assets had become net liabilities and just referred vaguely to 'an expected contract provision of £845m at 30 June 2017'.

Even the half-year report published in September 2017 failed to highlight and explain that net assets had gone from positive £727m to negative net liabilities of £405m. The half-year balance sheet showed net liability of £405m but its significance was not discussed and the report once again suggested the board had things under control. Certainly they did not provide any explicit statement that the company was about to go bust but did emphasise its strong positions in its core markets. Its conclusion suggests the new leadership team fully understood the Group’s challenges, and had 'a route map to significantly improving the balance sheet, risk profile and performance of the business'. It said 'progress to date is positive' but 'transformation of the business, including a radical change in culture, will take three to five years'. It reaffirmed the Group’s strengths, including its 'strong brand and history, reputation for quality and delivery, and the commitment of its people.' It said the 'outlook for the Group is underpinned by a sizeable order book'.

The half year report also confirmed justification for the 'going concern' basis of accounting stating that the Board had 'undertaken a rigorous assessment of the forecast assumptions that support the going concern basis, taking into account the Group's existing debt levels, the financial forecasts, the committed funding and liquidity position and the strategies available to the business on working capital management and disposals'. The Board also said it 'applies sensitivity analysis to these forecasts to assess the impact of potential risks and opportunities in order to provide additional comfort on the level of headroom against available bank facilities' and confirmed the Group was 'compliant with its covenants at 30 June 2017 and is forecast to be in compliance with covenants as at 31 December 2017 and 30 June 2018.'

Comment

In the testimony to the Parliamentary Work and Pensions Committee on 6 February the former Carillion directors seemed to think they had been doing a good job: the board generally met once a month where there was a lot of challenge; they had the right information; the controls were good and the accounting policies were not aggressive although the finance director at the time of the collapse referred to 'a <u>slightly</u> more aggressive trading of the contracts' than she had previously experienced. The ex-directors gave the impression of having been surprised the company collapsed.

It is not possible to reconcile the picture presented by the 2016 Annual Report (including the audit report), the July trading update or the half-year accounts and the testimony of the former directors with what actually happened. If the board had been effective, had understood and managed the risks, had made appropriate judgements on accounting policies and revenue recognition, had asked the right questions and insisted in getting answers, Carillion would either not have failed or the accounts would have presented a very different picture and shareholders warned much earlier.

The Corporate Governance Code as a whole

Carillion claimed to be fully compliant with the 2014 Code. The 2016 Annual Report suggests that this was the case and that the board took good governance very seriously both in terms of compliance and in terms of good governance performance. The failure of Carillion regardless suggests either that something important is missing from our approach to governance or that good governance is ineffective in preserving shareholder value.

Risk Management and Corporate Foresight

The board of Carillion would seem to have been deficient in corporate foresight. The present Corporate Governance Code and FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting ought to have ensured that the board had assurance that all the risks which could severely affect the business model were known, understood and managed. Failing that, the guidance should have ensured sufficient disclosure to shareholders of a problem. The 2016 Annual Report suggests the board and the company were doing all the right things:

> 'The Directors confirm that they have carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity'.

The Report also claimed the company would be viable over the next 3 years:

> 'The Board has tested the outputs from this plan against the potential impacts from the Group's key strategic risks both individually and in unison. On the basis of both reasonably probable and more extreme downside scenarios, the Directors believe that they have a reasonable expectation that the Company will be able to continue in operation and meet its liabilities as they fall due over the three-year period of their assessment.'

The Parliamentary inquiry should question how the board could conclude as late as September 2017 that the company was still a going concern and could remain within its banking facilities at least until June 2018.

We question whether the current guidance does enough to ensure proper corporate foresight or whether other boards can be equally comfortable that matters are under control when in fact the opposite may be true.

Recommendation

- It is clear that boards must do more to look into the future, consider various scenarios, be clearer about what can damage the business model and by how much, and actively plan for meeting those challenges. The FRC should ensure that disclosures about going concern and viability are informative and can be relied upon. They should not be allowed to create false assurance

Board Effectiveness

The board of Carillion had an externally facilitated effectiveness review which concluded 'the Directors continue to be 'highly effective'. It said

> 'The Senior Independent Non-Executive Director led the evaluation of the Chairman's effectiveness. At the December 2016 Board meeting, the Directors reviewed the results of the evaluation, which confirmed that the Board, each of its Committees and the Directors continue to be highly effective.'

There is nothing so far to suggest that the review undertaken by Carillion was materially different from what is undertaken in other companies or that the review process was materially defective.

In testimony, highly reminiscent of the accounts given by former directors to the Parliamentary Committee which investigated the failure of HBOS, the Carillion directors who gave evidence seemed to think they had been doing a good job and seemed to have been taken by surprise when the company failed. The board should have been aware in March that its financial survival depended on Carillion being paid for its work in progress. It seems extraordinary that the board did not realise the game was up after the 2017 half year accounts showed negative assets of £405m (or £1,996m if balance sheet goodwill is excluded). By July the board must have known they were trading while insolvent which theoretically is a criminal offence yet both the profits warning in July and the half yearly accounts published in September 2017 try to give the impression the board is on top of the situation and, thanks to strong fundamentals, everything will turn out OK.

With hindsight it is clear the board was not highly effective. We must therefore question whether board evaluations are fit for purpose. The proposed Guidance on Board Effectiveness looks unlikely to help boards address the problems highlighted by Carillion.

Recommendation

- The efficacy of board evaluation should be reassessed. Shareholders should be given guidance on what reliance, if any, to place on disclosures in annual reports about board evaluation.

Subsidiary governance

The evidence given by the ex-directors hints that the group head office may have relied too much on the management, including financial control, at its subsidiaries. The UK Code, like earlier versions, is totally silent on the question of the role of boards of holding companies in relation to the boards of subsidiaries. It is silent on the governance of subsidiaries in general. It should not be acceptable for a main board director to avoid responsibility by saying s/he thought the subsidiary was doing, or not doing, something.

Recommendation

- The UK Code should cover a main board's role in relation to subsidiary governance.

Accountability

The present system of governance means that in practice individual board members are not held to account when things go wrong. Board members can shelter behind a veil of collective responsibility, which unfortunately means no one is ever held responsible.

It seems necessary to have both a carrot and a stick. If directors are held properly to account, it should ensure others perform their duties better.

Annual Reports - Fair, balanced and understandable?

The 2016 Carillion Annual report and half-yearly statement gave what turns out to have been a misleading picture of the company's health, the risks and the sensitivity to accounting policies and judgements.

The Audit Committee stated that at its February 2017 meeting it 'reviewed the Group's Annual Report and Accounts and recommended them to the Board as representing a fair, balanced and understandable assessment of the Group's position'. In the light of what happened it is difficult for any informed observer to agree with this conclusion.

If the accounts were 'fair and balanced' according to financial reporting standards, the standards must change.

Recommendations

- Boards should be made to present the bad as well as the good in the annual report, in particular at the front of the report i.e. the strategic report.

- Consideration should be given to giving further guidance to boards on the meaning of fair, balanced and understandable.
- Consideration should also be given to requiring disclosure of the confidence levels in accounting judgements and the sensitivity to such judgements. Presently users of accounts are told about certain judgements but given no information on how these judgements might affect the income statement or balance sheet.
- There should be disclosure of the board's level of confidence about, for example, the valuation of long-term work in progress and the recovery of debts. If the board thinks there is a 60% chance of that 50% of a debt will not be paid then this would disclosed[1].

Borrowing facilities

The 2016 Annual Report said Carillion had borrowing facilities of £1.5bn. This meant unused borrowing facilities of around £750m implying plenty of headroom for the group to borrow further. This may have reassured some investors about the company's financial health. It would seem that in practice these facilities could not be used when Carillion needed them. The annual report would therefore seem to have provided false comfort to shareholders such as Kiltearn Partners LLP which owned 10% of the shares and, according to its evidence given to the Parliamentary Inquiry on 2 February 2018, relied on the accuracy of the 2016 Annual Report. Fuller disclosure should have been given about the factors which could have limited use of the borrowing facilities.

Recommendation

- Annual reports should include more granular information about factors which could limit the use of borrowing facilities.

Directors' pay

The 2016 Carillion Annual report made contradictory statements about malus and clawback. Page 69 stated:

> '− A clawback provision is operated that gives the Remuneration Committee the right to recover all elements of bonus.
>
> − A malus provision is operated that gives the Remuneration Committee the right to reduce any deferred bonus awards which have not yet vested in relation to circumstances of corporate failure, which may have occurred at any time before malus is operated.'

While page 78 stated:

> 'Malus' or 'clawback' may be applied if: (1) the results for the year in respect of which the award was made (or, in the case of a LEAP award, for a year in the performance period) have been misstated, resulting in a restatement of the Company's accounts (other than where the

[1] For further information on this, see Confidence Accounting A Proposal http://www.zyen.com/PDF/Confidence%20Accounting1.pdf.

restatement is due to a change in accounting standards, policies or practices adopted by the Company); or (2) the participant is guilty of gross misconduct'.

The latter statement has been referred to in the media. The key difference is that the words 'corporate failure' are missing on page 78. It is not clear from the Annual Report which statement takes priority. It would seem, however, that the remuneration policy changed sometime between the publication of the 2015 and 2016 annual reports. At present shareholders should vote upon a company's remuneration policy once every three years - not when a change is propsed.

Recommendation

- There would seem to be a strong case for requiring the approval of shareholders each year the policy is changed.

External audit

The external auditor, KMPG, seemed satisfied with all aspects of the 2016 Annual Report. The audit report says they specifically considered the risks associated with recognition of contract revenue, margin, and related receivables and liabilities. They also considered the goodwill valuation of c£1.5bn.

It is hard to understand how the external auditor could have seemed so comfortable with the annual report. If they had concerns, they were not communicated to shareholders. We should also question the effectiveness of audit quality.

Recommendation

- The FRC is investigating the external audit. We suggest that, as well as considering whether the audit complied with auditing standards, the review should also consider whether the audit met the standards which shareholders and society might reasonably have expected of it.

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ADENDDUM
SOME DEEPER THOUGHTS ON REFRAMING THE UK'S CORPORATE GOVERNANCE OVERSIGHT AND REGULATORY SYSTEM

Context

The many current negative news items concerning the ineffectiveness of the present UK Corporate Governance system display only too vividly its weaknesses and the contempt in which the majority of UK citizens hold it. Issues like Carillion and BHS, Oxfam and Save the Children, Grenfell Tower, Network Rail and the fast rising costs of the Financial Conduct Authority all highlight that the flawed current assumptions on which 'UK Corporate Governance' is based:

- That Corporate Governance really only applies to listed companies

- That Corporate Governance is the professional province of the accountants

- That the only effective regulatory and oversight tool is a Code of Conduct

These assumptions do not fulfil the nation's current or future needs. A total rethink at national level is now needed; and the present well-intentioned attempts to modify the FRC Corporate Governance Code are destined to failure.

This paper is not a lone voice but reflects many others. After 5 years research for my new book *Stop The Rot: Reframing Governance For Directors and Politicians,* and the hundreds of interviews in boardrooms around the world, we are faced with a paradox. On the one hand 'UK Corporate Governance' (in the form of the versions of the FRC CG Code) is frequently quoted as 'the best in the world'. Sir Adrian Cadbury's 1992 report seems to have become the world default position for this. On the other hand increasingly disillusioned public stakeholders are saying that the current system is not fit for purpose as it fails to deal with some 95% of our organisations that are not listed companies. Confirmation of this can be found by looking at the statements from so many recent Parliamentary select committees and public enquiries where the standard phrase 'but the real issue behind the problems was the lack of effective corporate governance in the organisation' is seen so often. This may be comfortable current coinage but it does not resolve the issue. It does not go any further to argue what should be done about this or, critically, which organisation should have national oversight for ensuring effective corporate governance.

Ironically, the need for a complete rethink was made to me just before his death in May 2015 by Sir Adrian Cadbury in a private letter (we had worked together on such issues since the mid-1980s). He was discouraged by the way UK and international corporate governance had declined into a box ticking and risk-avoiding culture. He insisted that we must return to the entrepreneurial, risk-taking corporate culture in which the board was sovereign. He regretted that from the start the Cadbury Report had the title 'On The Financial Aspects of Corporate Governance' as he felt that this had constrained and positioned wrongly the importance of national corporate governance as a social and political force beyond mere accountancy. He encouraged me strongly to continue his task.

Reframing UK Corporate Governance At National Level

To progress out of the current weak and ineffective non-system I assert that at a minimum we must reframe our thinking and behaviours about effective corporate governance to encompass the following broad statements:

- Corporate Governance is a social good across *all* registered national organisations – private, public and not-for-profit
- Therefore, a national system of CG oversight and regulation must be created beyond the restrictions of Accountancy.
- Future national CG must burst the restrictive boundaries of directors-only thinking to include the rights and duties of directors, but also the rights and duties of Owners, Regulators and Legislators under a system of Public Oversight.
- The Basis of any future national CG Code must be founded on two simple action-based assessments for boards:
  - that the board has continuous oversight and responsibility for resolving the classic board dilemma of 'how do we drive our organisation forward whilst keeping it under prudent control?'
  - that the nation ensures that the Seven General Duties of A Director in the Companies Act 2006 apply to all organisations registered in the UK – private, public and not-for-profit. Particular reference will be made to assessing those Duties relating to ensuring the future success of the business, independence of thought, and the deployment of care, skill and diligence in board decisions.

The Future Role for the FRC in UK Corporate Governance

I make the following proposals:

- That Corporate Governance is removed from the Accountancy-focused current FRC
- That a UK Corporate Governance Reporting Council (UKCGRC) be established immediately
- That the new UKCGRC be given the right to debar directors in any registered organisation for unlawful activities and for conduct detrimental to the interests of their owners and stakeholders
- That Parliamentary oversight be established to reframe laws and codes where necessary to allow the effective running of the UKCGRC
- That Parliament creates a select Committee of Corporate Governance
- That Parliament creates a Standing Commission on Corporate Governance thereby allowing continuous learning between Directors, Owners, Stakeholders, Regulators and Legislators to improve the effectiveness of UK Corporate Governance for the good of the nation.

Bob Garratt,

London,

26 February 2018