SIFA STRATEGY

Catherine Horton
Financial Reporting Council
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27 February 2018

Dear Ms Horton,

Thank you for giving us the opportunity to respond to the Proposed Revisions to the UK Corporate Governance Code. We have deliberately kept our responses to areas of the Code where we have particular knowledge and expertise of working with both listed and large private companies.

In summary, we strongly support both the direction and the actions of the proposed revisions. We believe, however that further clarity should be provided in both the Principles and the Provisions that involve culture and broader stakeholder engagement. These are key areas of change for companies to integrate into their governance and management processes.

In terms of culture, it is important that it is understood that culture is both an internal and external influence that can be understood and proactively managed. We invite the Financial Reporting Council to better reflect its clear definition of Culture as outlined in its 2016 report. With reference to stakeholders, too much emphasis has been placed on the workforce, with not enough regard taken to the importance and influence of other stakeholders such as suppliers, customers, regulators, local communities and others. It is important that each company undertakes a test of “materiality” with its full stakeholder universe and includes the interests of wider stakeholders into its decision-making processes. At the moment, many companies will believe that purely including the workforce in some form, will satisfy the governance requirements, when in many cases other external stakeholders can have an equally significant impact on the long-term performance of a business. Best practice must encourage a more active listening role for companies, to build and maintain successful relationships with a wide range of stakeholders.

If required, we are available at your convenience to provide further detail to our responses.

With best regards,

Fergus Wylie
Director and Co-Founder

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Q. Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?

Reference to Stakeholders - Principle C and Provision 3 and 4

When the Proposed Revisions were launched, it was said that the revised Code sets out good practice so that the boards of companies can “undertake effective engagement with wider stakeholders, to improve trust and achieve mutual benefit, and to have regard to wider society”. While we’re in full agreement with this ambition, the current drafting of the Provisions and Principles do not sufficiently encourage meaningful engagement with stakeholders beyond the workforce. Nor do they adequately define which stakeholder groups should be considered as part of “wider stakeholders”.

In its current form, the revisions to the Code places too much emphasis on the workforce stakeholder group and not enough on other, often equally, influential external stakeholders. We note in the FRC’s own excellent report, “Corporate Culture and the role of Boards”, published in 2016, that the FRC defined culture as follows; *“Culture in a corporate context can be defined as a combination of the values, attitudes and behaviours manifested by a company in its operations and relations with its stakeholders. These stakeholders include shareholders, employees, customers, suppliers and the wider community and environment which are affected by a company’s conduct.”* We believe the stakeholder list as given within this definition of culture should be included within the revised Code for clarity.

This is not in any way to diminish the importance of the workforce. However, we believe the omission of specific reference to other stakeholders invites Boards to focus solely on their workforce in their belief this answers the letter of the Code and is the definition of “best practice”. It raises the possibility for the revision to the Corporate Governance Code to fail to adequately encourage Boards to consider their other stakeholders, their “licence to operate” and their broader role in society. We encourage the FRC to consider providing more defined guidelines of which specific stakeholders should be considered. Both Provisions 3 and 4 place a specific emphasis on gathering the views of the workforce, but do not specify which other stakeholders should be engaged with, beyond a general reference to “other stakeholders” in Provision 4.

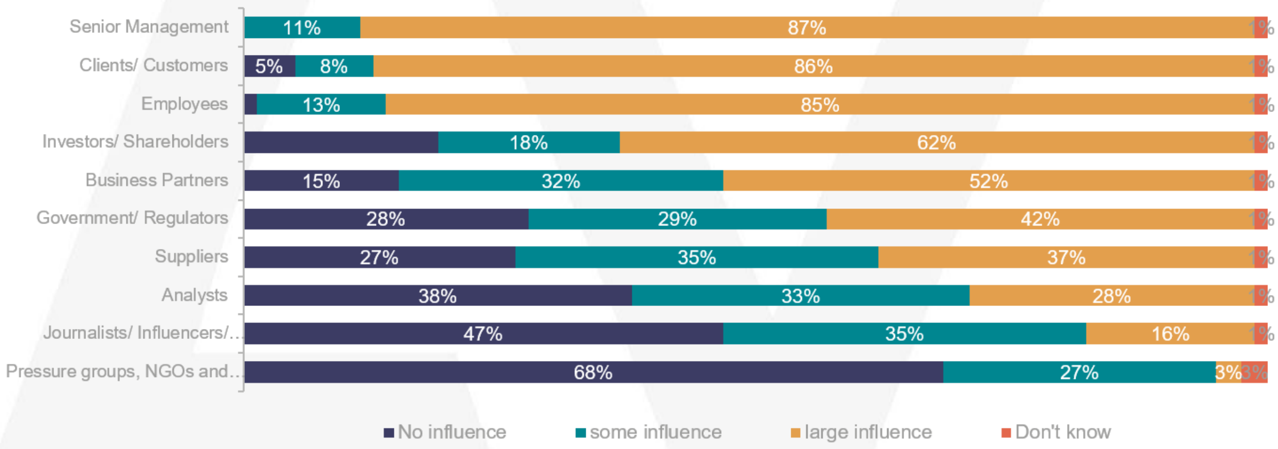
Furthermore, as the revision to the Code recognises that the implementation of the Principles and Provisions must be addressed in its own way by each company, we invite that the Code encourages Boards to engage with, and report on its engagement with, stakeholders which are material to its licence to operate as well as its trust and credibility. Each company should be encouraged to identify its stakeholders and report which stakeholders have a material impact on the long-term performance of their business and how their interests have been accounted for in decision-making. This will encourage dialogue with shareholders as to the validity of materiality, which will be different for each sector and company. It will also encourage each Board to make clear how it engages with these "material" stakeholders and considers them within their decision-making processes as currently invited by the Code.

As an example, should a retailer undertake such a "materiality" test it should identify part or all of its supply chain as a key stakeholder group, among others. We have seen over the last few years a lack of governance with this particular stakeholder group going back to the Bangladesh disasters and the Tesco scandal, but also more recently with the high-profile collapse of Carillion..

To further emphasise the importance and relevance of a multi-stakeholder approach, as is already recognised by the FRC in previous reports and communication around the revisions to the Corporate Governance, we include an excerpt of research conducted by SIFA Strategy in 2017 among senior management of FTSE 350 companies. The research clearly identifies the impact that a diverse range of stakeholders can have on the commercial performance and value of an organisation.

Figure 1.

How much influence do each of the following stakeholder groups have on the commercial performance and value of your organisation?



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Q. Do you have any comments on the revised Guidance?

Reference to Culture – Principles A and D, along with Provisions 2 and 3.

In its current form, the proposed revisions to the Code in relation to "Culture" places too much emphasis on the internal influence of culture as reflected through the workforce specifically and omits the external importance of culture through behaviour and interactions with other stakeholders. While we encourage the emphasis on Boards spending more time engaging with and listening to the interests of the workforce, it is important that other stakeholders are not forgotten in this process.

The clear definition of Culture as outlined in the 2016 report, "Corporate Culture and the role of Boards" (included above), has not been effectively or accurately reflected within the current revisions of the Code. We invite the FRC to reflect this definition into both the Principles and Provisions that refer to Culture, as it correctly identifies the importance of values and behaviours as regards both internal and external stakeholders in how culture can impact a company over the long-term.

Without a clear definition of culture and encouragement to understand it in more detail, the Provisions and Principles aimed at driving businesses to form healthy corporate cultures risk losing their impact. As Sir Win Bischoff said, "building trust in business has to start in the organisation and forming a healthy corporate culture is integral to the credibility of a company". While efforts to build trust may start inside an organisation, external stakeholders can play an equally important role and will have an understanding of what an organisation's culture is and how it is reinforced in corporate behaviour – both of which partly define perceptions of trustworthiness and credibility.

In the current form, without more clarity, the revisions risk enforcing three common misunderstandings of corporate culture. It was interesting that these misunderstandings were also evidenced during the recent Panel discussion held by the FRC in Manchester on 14 February 2018.

1. Culture is a function of the current senior management/ Board

   It is often stated that culture is driven "from the top" and historically shareholders have identified culture through the CEO (as stated by one panellist on 14 February). The current definition also places the onus on the Board to ensure culture is aligned with purpose, strategy and values. While senior management clearly have a significant influence on culture, should they wish to do so, culture is embedded within a company over a much longer period of time than any incumbent CEO or senior management team. This is particularly the case for larger companies and is also evidenced by the average tenure of a CEO of a listed company being around 4 years. It would be short-termist to believe that corporate culture is changed every time a new CEO is appointed. Furthermore, when culture is correctly defined as including the behaviour with external stakeholders, then the influence of the senior management is even less.

As both organisations and investors are being encouraged to take a more long-term approach to strategy, investment and reporting, culture must also be considered as a long-term construct. Boards and investors need to understand that culture is a long-term factor within the DNA of a company. As such it needs to be understood and analysed, rather than judged as a direct manifestation of the current senior management or just as "driven from the top".

2. Culture is an internal function

   We refer again to the FRC definition of culture. This correctly identifies that culture manifests itself beyond the workforce. It is correct that the workforce is a driver of culture and the conduit of an organisation's values and behaviour with its external stakeholders. As such, in understanding culture the workforce is a primary stakeholder but the interpretation and perception of culture from external stakeholders is also extremely important when looking to manage the long-term performance of a company.

3. Culture is intangible and can't be understood, measured or pro-actively managed

   To date, many Non-Executive Directors seem to accept that culture is an intangible asset that can't be analysed within the normal Board reporting frameworks. This is incorrect. Increasing numbers of companies successfully provide insight into culture, reputation, behaviour and stakeholder engagement. In particular, when analysis includes stakeholders beyond the workforce, then the value of such insight is even higher. Effective analysis enables proactive measurement and management of both culture and behaviour, as well as the ability to identify potential areas of risk. The Provisions should be made more clear as to how the Board can consider culture, beyond the general comment of "ensuring that it is aligned with strategy". The FRC and the revised Corporate Governance Code has an opportunity to encourage organisations to take a more long-term approach to managing and understanding culture.