Response from **Professor Carol Adams PhD CA FAICD, Professor of Accounting, Durham University Business School** on the:

UK Financial Reporting Council (FRC) Consultation on Draft Revised Corporate Governance Code and on the current Stewardship Code

21st January 2018

Thank you for the opportunity to respond to the Draft Revised Corporate Governance Code and the Stewardship Code at https://www.frc.org.uk/consultation-list/2017/consulting-on-a-revised-uk-corporate-governance-co.

I have been researching international corporate reporting for around 25 years with a particular focus on the governance, strategy, culture and performance implications of non-financial reporting. I have been involved in the work of the Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC), Climate Disclosure Standards Board (CDSB) and in the AA1000 Standard series through their governance structures and/or technical work.

It is pleasing to see the significant increase in attention given to non-financial reporting over this period not least because qualitative accounting research clearly demonstrates that corporate reporting influences (and is influenced by) both organisations and society. The increased attention to non-financial reporting is of paramount importance in an increasingly globalised business world where the relationship between corporate activities and success on the one hand and the external environment (including social and environmental issues) on the other, is significant.

Research demonstrates that when Boards are involved in the development of corporate reports that take a long-term focus and which recognise that value is more than profit they are cognisant of a wider range of risks and opportunities and set strategy accordingly (see Adams, 2017[1]).

I applaud recognition in your consultation documents of the relevance to business and investors of Sustainable Development Goals and the recommendations of the Financial Stability Board's Task Force on Climate related Financial Disclosure (TCFD). Key global standard setters are providing guidance to companies on responding to the Sustainable Development Goals (SDGs) and make explicit reference to the existence of sustainable development issues in the external environment which pose a risk to a company's ability to create value for shareholders and other stakeholders in the long term (see Adams, 2017b).

Please find below my response to your consultation questions.

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[1] Adams, CA, (2017) Conceptualising the contemporary corporate value creation process, *Accounting Auditing and Accountability Journal* 30 (4) 906-931 http://dx.doi.org/10.1108/AAAJ-04-2016-2529 Also available here

Q1. Do you have any concerns in relation to the proposed Code application date?

It should apply as soon as reasonably possible.

Q2. Do you have any comments on the revised Guidance?

Overall, the proposed changes can be expected to improve the governance of UK companies and hence their performance. Issues concerning the Sustainable Development Goals (SDGs), climate change, longer term focus have also been raised[2] at the IASB Board in connection with the ongoing revision of their *Management Commentary – A Practice Statement*. It is appropriate that they are also explicitly considered in governance and stewardship codes and related guidance.

Q3. Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?

The methods proposed should ensure that employee voices are heard, but there are additional options which would encompass a wider range of stakeholders. Employees are not the only stakeholders that companies should engage with.

Engaging with a wide range of stakeholders ensures that material risks and opportunities are identified. This includes risks and opportunities posed by sustainable development issues (see Q4 below).

A board sub-committee could be charged with oversight of such risks and opportunities and the stakeholder engagement required to identify them. Management often conduct a broad stakeholder engagement to identify material risks and opportunities as part of the process of developing a sustainability report. Board oversight of this stakeholder engagement process (which currently often does not occur – see Adams, 2017[3]) would help ensure such risks and opportunities were considered in developing strategy.

Further, when developing their Board skills matrix, Boards could be encouraged to ensure they have sufficient board level expertise with respect to the governance of climate change and other sustainable development risks.

Q4. Do you consider that we should include more specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance?

Yes, definitely. Sustainable development issues pose risks and opportunities for companies large and small.

Relevant risks for a multinational corporation, for example, might include adequacy of water supply and labour rights in the supply chain. For a medium sized company, opportunities might include, for example, the use of plant and manufactured materials for products traditionally made from leather seen as less environmentally sustainable by a growing number of people.

[2] http://www.ifrs.org/-/media/feature/meetings/2017/november/iasb/wider-corporate-reporting/ap28a-wcr-mcps.pdf

[3] Adams, CA, (2017) Conceptualising the contemporary corporate value creation process, *Accounting Auditing and Accountability Journal* 30 (4) 906-931 http://dx.doi.org/10.1108/AAAJ-04-2016-2529 Also available here

A board sub-committee could be charged with oversight of such risks and opportunities and the stakeholder engagement required to identify them.

An approach to doing this is proposed in: Adams, C A (2017) *The Sustainable Development Goals, integrated thinking and the integrated report*, IIRC and ICAS. ISBN 978-1-909883-41-3. (Download here[4].) A growing number of investors and asset managers are considering how they will respond to the recommendations of the *Task force on Climate-related Financial Disclosures* and the Sustainable Development Goals. Companies that consider these approaches are likely to have access to cheaper capital.

In considering responses to Q4, I urge the FRC to bear in mind that responses may be negative due to a lack of experience with the SDGs and the TCFD recommendations, both published relatively recently. This will change as investors are increasingly considering how they can engage with companies on these matters[5].

Q5. Do you agree that 20 per cent is 'significant' and that an update should be published no later than six months after the vote?

Yes, 20 per cent can signify a shift in opinion against the current perceived wisdom.

Q6. Do you agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years? If not, please provide information relating to the potential costs and other burdens involved.

Yes.

Q7. Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?

I believe it should *not* be longer and there is a case for it to be shorter.

Q8. Do you agree that it is not necessary to provide for a maximum period of tenure?

No. I believe a maximum recommended period of tenure ensures that proposed longer tenures are carefully considered.

Q9. Do you agree that the overall changes proposed in Section 3 of revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

Yes, with respect to women. However, I believe that the Code should require companies to provide data on levels of ethnic diversity at Board level and in their pipelines. The lack of transparency with respect to ethnic diversity makes the issue invisible and therefore the current lack of diversity is not addressed.

[4] http://integratedreporting.org/wp-content/uploads/2017/09/SDGs_integratedthinking_and_integratedreport.pdf
[5] See for example the Annual Integrated Report 2017 of Cbus Superannuation Fund and the work of the Australian Council of Superannuation Investors.

Q10. Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not, please provide information relating to the potential costs and other burdens involved.

Yes. Asking for information on costs and burdens from those against extending the Hampton-Alexander recommendation inappropriately shifts the focus from the benefits which have been identified in a substantial body of academic research as well as the reports published by consultants quoted in your consultation document. The lack of inclusion of women and ethnic minorities in senior positions over the last century has not been due to cost concerns and has ignored economic benefits[6].

Q11. What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relating to the practical implications, potential costs and other burdens involved, and to which companies it should apply.

The Code should encourage companies to provide data on levels of ethnic diversity at Board level and in their pipelines. This should apply to the same companies required to report on gender diversity and be extended beyond the FTSE 350.

The lack of transparency with respect to ethnic diversity makes the issue invisible and therefore it is not addressed. The focus of question 11 on the costs and burdens detracts from the benefits. Apart from better representing employees (as per the arguments behind Q3 above), an ethnically diverse management team and Board will contribute to other forms of diversity, including, for example, the nature of issues considered by the Board and approaches to addressing them.

Q12. Do you agree with retaining the requirements included in the current Code, even though there is some duplication with the Listing Rules, the Disclosure and Transparency Rules or Companies Act?

Yes, omission here would reduce their visibility and signify lower importance.

Q13. Do you support the removal to the Guidance of the requirement currently retained in C.3.3 of the current Code? If not, please give reasons.

Yes, it will still be publicly available.

Q14. Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?

The wording of the remuneration section (Appendix A, section 5) appears to be giving remuneration committees a more management, rather than governance, role. The requirement in para 33 that remuneration committees "should oversee remuneration and workforce policies and practices" could lead to managing whereas "taking these into account when setting the policy for director remuneration" is an appropriate governance role.

The statement in para 39 of Appendix A is unclear: "Notice or contract periods should be one year or less." Suggest omitting 'or contract'.

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[6] See: Adams CA and McPhail K (2004) Reporting and the politics of difference: (non)disclosure on ethnic minorities *Abacus* 40(3): 405–435; and, Adams CA and Harte GF (1998) The Changing portrayal of the employment of women in British banks' and retail companies' corporate annual reports *Accounting, Organizations and Society* 23(8): 781–812. Also available here.

Q15. Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?

I support the provision in Appendix A para 36 that remuneration schemes should promote long-term shareholdings by executive directors that support alignment with long-term shareholder interests. However, the emphasis on such periods being longer than five years should be stronger. Many risks considered (or which should be considered) by executive directors, including climate change and other sustainable development issues, take significantly longer than 5 years to have a material impact on share value and dividends.

Further, a broader range of performance considerations could be considered in light of the increased interest in aspects of performance not measured in financial terms. In addition, the Code could require that executive remuneration is linked to achievement of strategic goals to enable long term value creation. This could include: improvement in culture; reduction of the gender pay gap; improved mechanisms to identify sustainable development risks and opportunities; and, evidence of responses to such risks and opportunities. To help achieve this, as a minimum the questions for remuneration committees in Appendix B page 22 could include: How can executive remuneration reflect achievement of strategy which is designed to support long term value creation (which is not measurable in financial terms?).

***Q16. Do you think the changes proposed will give meaningful impetus to boards in exercising* discretion?**

The boundaries between exercising discretion and managing (as opposed to governance) need more consideration.

UK Stewardship Code Questions

Q17. Should the Stewardship Code be more explicit about the expectations of those investing directly or indirectly and those advising them? Would separate codes or enhanced separate guidance for different categories of the investment chain help drive best practice?

Yes, particularly given the importance of environment, social and governance (ESG) considerations to long term value creation and in addressing sustainable development issues. In any case, it is hard to see how it could do any harm.

Q18. Should the Stewardship Code focus on best practice expectations using a more traditional 'comply or explain' format? If so, are there any areas in which this would not be appropriate? How might we go about determining what best practice is?

Best practice could be determined from a review of the statements of compliance with the Stewardship Code provided by asset owners and asset managers and by reference to published research, including research on leading practices in other countries.

Q19. Are there alternative ways in which the FRC could highlight best practice reporting other than the tiering exercise as it was undertaken in 2016?

I like the idea in para 13 of the consultation document of highlighting some best practice reporting against the Stewardship Code. However, to do this in place of Tiering all reports might mean that some reporters put less effort into reporting (and hence also into following the Stewardship Code). This could be addressed by the suggested 'comply or explain' approach.

An alternative approach would be to work in partnership with another organisation to develop an awards programme which would encourage leadership in reporting practice.

Q20. Are there elements of the revised UK Corporate Governance Code that we should mirror in the Stewardship Code?

The Revised Guidance on Board Effectiveness to accompany the UK Corporate Governance Code includes specific questions for Boards to consider. Specific questions could similarly be included in the Stewardship Code for asset owners and asset managers to consider against each of the principles.

Further, the Stewardship Code could make specific reference to approaches to the recommendations of the Task force on Climate-related Financial Disclosures and the UN SDGs. (See approach recommended in Adams, C A (2017) *The Sustainable Development Goals, integrated thinking and the integrated report*, IIRC and ICAS. ISBN 978-1-909883-41-3.[7]

Q21. How could an investor's role in building a company's long-term success be further encouraged through the Stewardship Code?

By making specific reference to approaches to the recommendations of the Task Force on Climate-related Financial Disclosures and the UN SDGs.

By encouraging engagement with companies on long term strategy and approach to incorporating material risks and opportunities and reporting thereon (for example by following the IIRC's *International <IR> Framework*[8]).

By encouraging engagement with companies on their approach to addressing sustainable development issues and making a contribution to the SDGs. See approach recommended in Adams, C A (2017) *The Sustainable Development Goals, integrated thinking and the integrated report*, IIRC and ICAS. ISBN 978-1-909883-41-30[9].

Q22. Would it be appropriate to incorporate 'wider stakeholders' into the areas of suggested focus for monitoring and engagement by investors? Should the Stewardship Code more explicitly refer to ESG factors and broader social impact? If so, how should these be integrated and are there any specific areas of focus that should be addressed?

An alternative term might be considered to that of ESG which is associated with a focus on risks, rather than risks and opportunities. Suitable terms include 'responsible investment' and 'sustainable

[7] Available at http://integratedreporting.org/wp-content/uploads/2017/09/SDGs-and-the-integrated-report_full17.pdf
[8] Available at http://integratedreporting.org/resource/international-ir-framework/
[9] Available at http://integratedreporting.org/wp-content/uploads/2017/09/SDGs-and-the-integrated-report_full17.pdf

development issues', a term which can be linked to making a positive contribution to the SDGs. Wider stakeholder views need to be considered to ensure material matters are identified.

As noted in my responses to a preceding question, the Stewardship Code could make specific reference to approaches to the recommendations of the Task force on Climate-related Financial Disclosures and the UN SDGs. With respect to the SDGs see approach recommended in Adams, C A (2017) *The Sustainable Development Goals, integrated thinking and the integrated report*, IIRC and ICAS. ISBN 978-1-909883-41-30[10].

Q23. How can the Stewardship Code encourage reporting on the way in which stewardship activities have been carried out? Are there ways in which the FRC or others could encourage this reporting, even if the encouragement falls outside of the Stewardship Code?

Reporting can be encouraged through engagement with asset owners and asset managers and by providing examples of best practice reporting of stewardship activities. Assisting a partner organisation to develop criteria for a reporting awards scheme is another possibility.

In its award winning Annual Integrated Report 2017 Cbus superannuation fund provides an example of how reporting on wider impacts can be incorporated in an integrated report. The report follows the five-step approach articulated in Adams (2017) here.

Q24. How could the Stewardship Code take account of some investors' wider view of responsible investment?

Use the term 'responsible investors' (which includes shareholders) and adopt recommendations made in response to earlier questions.

Q25. Are there elements of international stewardship codes that should be included in the Stewardship Code?

In order to assist compliance with international codes you could provide a summary of key international codes which are covered by following the UK Stewardship Code plus a summary of additional information which would be required to follow other key international codes (or reference to the parts of such codes not covered in the UK Stewardship Code). This might be done in collaboration with relevant code setters.

Q26. What role should independent assurance play in revisions to the Stewardship Code? Are there ways in which independent assurance could be made more useful and effective?

There is a need for improvement in non-financial assurance processes and scope. The FRC could identify ways to contribute to the further development of non-financial assurance practices.

Q28: Should board and executive pipeline diversity be included as an explicit expectation of investor engagement?

Yes, along with climate change disclosures and approach to the SDGs.

[10] See footnote 9 above.

Q29: Should the Stewardship Code explicitly request that investors give consideration to company performance and reporting on adapting to climate change?

Absolutely critical. Climate change has significant long term financial consequences and addressing it underpins the achievement of a number of SDGs. The Stewardship Code should encourage engagement with companies on the recommendations of the Task Force on Climate-related Disclosures.

Q30: Should signatories to the Stewardship Code define the purpose of stewardship with respect to the role of their organisation and specific investment or other activities?

Yes.

Q31: Should the Stewardship Code require asset managers to disclose a fund's purpose and its specific approach to stewardship, and report against these approaches at a fund level? How might this best be achieved?

Yes. This could be achieved by reporting purpose and approach which applies to all funds and additional approaches applying to specific funds.

regards

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