



CORPORATE CULTURE AND THE ROLE OF BOARDS

REPORT OF OBSERVATIONS

Coalition partners



Chartered Institute of
Internal Auditors

Research partner

INDEPENDENT AUDIT 

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FOREWORD

The way companies create and sustain value is directly linked to the debate about the role of business in society.



Sir Winfried Bischoff
Chairman
Financial Reporting Council

There needs to be a concerted effort to improve trust in the motivations and integrity of business. Rules and sanctions clearly have their place, but will not on their own deliver productive behaviours over the long-term. This report looks at the increasing importance which corporate culture plays in delivering long-term business and economic success.

A healthy culture both protects and generates value. It is therefore important to have a continuous focus on culture, rather than wait for a crisis. Poor behaviour can be exacerbated when companies come under pressure. A strong culture will endure in times of stress and mitigate the impact. This is essential in dealing effectively with risk and maintaining resilient performance.

Strong governance underpins a healthy culture, and boards should demonstrate good practice in the boardroom and promote good governance throughout the business. The company as a whole must demonstrate openness and accountability, and should engage constructively with shareholders and wider stakeholders about culture.

In taking action on culture, I should like all those involved to consider three important issues:

Connect purpose and strategy to culture. Establishing a company's overall purpose is crucial in supporting the values and driving the correct behaviours. The strategy to achieve a company's purpose should reflect the values and culture of the company and should not be developed in isolation. Boards should oversee both.

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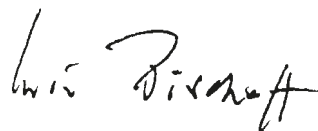
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Align values and incentives. Recruitment, performance management and reward should support and encourage behaviours consistent with the company’s purpose, values, strategy and business model. Financial and non-financial incentives should be appropriately balanced and linked to behavioural objectives.

Assess and measure. Boards should give careful thought to how culture is assessed and reported on. A wide range of potential indicators are available. Companies can choose and monitor those that are appropriate to the business and the outcomes they seek. Objectively assessing culture involves interpreting information sensitively to gain practical insight.

I also ask investors and other stakeholders to engage constructively to build respect and trust, and work with companies to achieve long-term value. Investors should consider carefully how their behaviour can affect company behaviour and understand how their motivations drive company incentives.

In its research for this project the FRC has seen abundant evidence that companies and boards are taking action to shape their culture in order to encourage investment. This will drive efficient capital allocation, improve productivity and deliver sustainable value. We commend these companies and encourage them to maintain this focus. We encourage those companies yet to take action, to consider the benefits of addressing this important issue.



Sir Winfried Bischoff

Chairman
July 2016

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INTRODUCTION

The FRC's mission is to promote high quality corporate governance and reporting to foster investment. The UK has a good reputation in this field which has underpinned a substantial amount of business success, but it is by no means perfect.

There are valid questions about how effectively existing corporate governance arrangements address the board's responsibilities to stakeholders other than shareholders, as envisaged in the Companies Act 2006. The framework of corporate governance in the UK is based on a shareholder primacy and value model of equity capitalism. There is a continuing debate about what this means. One view is that it necessarily involves a short-term focus since shareholders are most interested in the certainty of more immediate financial returns. This inevitably has consequences in terms of the decisions and actions which companies and investors take. Short-termism can drive poor business behaviours and conduct, for example: inappropriate incentives, market-rigging, poor customer service, low levels of investment and opaque financial structures and arrangements.

The view of the FRC is that the UK governance model remains an efficient and effective means of meeting the objectives of, and arbitrating between, the many stakeholders in the market. The combination of legislation, regulation and codes provides a flexible framework for companies and their stakeholders to pursue their objectives and achieve long-term success. Success depends, however, on the spirit with which companies and investors apply the principles and use the flexibility they have.

The FRC embarked on this project to gain a better understanding of how boards are currently addressing culture, to encourage discussion and debate, and to identify and share good practice to help companies. This report seeks to address how boards and executive management can steer corporate behaviour to create a culture that will deliver sustainable good performance. This report looks at the increasing importance which corporate culture plays in delivering long-term business and economic success – an issue very much to the fore this year. In doing so it focuses on the role of the board in shaping, monitoring and overseeing culture.

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With the help of our partners in the project, the Chartered Institute of Management Accountants (CIMA), the City Values Forum, the Chartered Institute of Personnel and Development (CIPD), the Institute of Business Ethics (IBE) and the Chartered Institute of Internal Auditors (IIA), we focused on broad aspects of company culture – the role of the board in delivering sustainable success, engagement with employees, customers, shareholders and other stakeholders, how to embed the desired culture, and how to assess culture. Our partners have published separate reports on each of these aspects, listed in Appendix 2.

This report was informed by an extensive literature review, the submissions from our partners in the coalition, interviews with FTSE chairmen and chief executives, surveys of heads of internal audit, chairmen and company secretaries, and many roundtables and discussions with investors, a range of professionals working in companies, and organisations with expertise and experience in company culture.

The FRC is very grateful to all those who responded to our invitation to participate, and would particularly like to thank our partners for their contribution and guidance throughout the project. We would also like to thank Independent Audit Limited for their invaluable work in surveying and interviewing chairmen, chief executives and company secretaries.

The report is designed to stimulate thinking around the role of boards in relation to culture, and encourage boards to reflect on what they are currently doing. Over the next year we will be monitoring reporting on culture by companies and investors. We welcome feedback on this report, which will inform our review of the *Guidance on Board Effectiveness* in 2017. Please email: culturecoalition@frc.org.uk to get in touch.

Meetings

300

Interviews

23

FTSE chief executives

58

FTSE chairmen

Surveys

44

FTSE chairmen

EXECUTIVE SUMMARY

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.

Key observations

From our discussions with chairmen, chief executives, investors and a broad range of stakeholders and professional organisations we make the following observations about corporate culture:

RECOGNISE THE VALUE OF CULTURE

A healthy corporate culture is a valuable asset, a source of competitive advantage and vital to the creation and protection of long-term value. It is the board's role to determine the purpose of the company and ensure that the company's values, strategy and business model are aligned to it. Directors should not wait for a crisis before they focus on company culture.



DEMONSTRATE LEADERSHIP

Leaders, in particular the chief executive, must embody the desired culture, embedding this at all levels and in every aspect of the business. Boards have a responsibility to act where leaders do not deliver.



BE OPEN AND ACCOUNTABLE

Openness and accountability matter at every level. Good governance means a focus on how this takes place throughout the company and those who act on its behalf. It should be demonstrated in the way the company conducts business and engages with and reports to stakeholders. This involves respecting a wide range of stakeholder interests.



EMBED AND INTEGRATE

The values of the company need to inform the behaviours which are expected of all employees and suppliers. Human resources, internal audit, ethics, compliance, and risk functions should be empowered and resourced to embed values and assess culture effectively. Their voice in the boardroom should be strengthened.



ASSESS, MEASURE AND ENGAGE

Indicators and measures used should be aligned to desired outcomes and material to the business. The board has a responsibility to understand behaviour throughout the company and to challenge where they find misalignment with values or need better information. Boards should devote sufficient resource to evaluating culture and consider how they report on it.



ALIGN VALUES AND INCENTIVES

The performance management and reward system should support and encourage behaviours consistent with the company's purpose, values, strategy and business model. The board is responsible for explaining this alignment clearly to shareholders, employees and other stakeholders.



EXERCISE STEWARDSHIP

Effective stewardship should include engagement about culture and encourage better reporting. Investors should challenge themselves about the behaviours they are encouraging in companies and to reflect on their own culture.



Business, society and the corporate governance framework

Companies do not exist in isolation. They need to build and maintain successful relationships with a wide range of stakeholders in order to prosper. These relationships will be successful and enduring if they are based on respect, trust and mutual benefit.

Business' reputation is still recovering from the impact of the global financial crisis and continuing examples of poor corporate behaviour. As we have seen, cultural failures damage reputation and have a substantial impact on shareholder value. Intangible assets such as intellectual property, customer base and brand now account for over 80 per cent of total corporate value, compared to under 20 per cent 40 years ago.¹ This shift magnifies the impact on total value when a reputational crisis occurs. This is a challenge for boards, which must find ways to understand and influence the factors which affect culture and behaviours.

The debate about the role of business in society is directly linked to the way in which companies create and sustain long-term value for the benefit of a wide range of stakeholders. From the outset of our work the FRC has been clear that we wish to offer constructive observations which have practical application. We are not suggesting changes to the current flexible framework of corporate governance. While legislation, regulation and codes influence individual and corporate behaviour, they do not ultimately control it.

The Companies Act 2006 makes it clear that in pursuit of the overarching duty to promote the success of the company for the benefit of the members as a whole, directors should take account of a range of stakeholders in making decisions. Inevitable conflicts will arise between the interests of different sets of stakeholders but where there is a broad alignment between their objectives, a focus on how business is conducted and how stakeholders are treated will create opportunities for value creation that have mutually reinforcing benefits for all.

UK Companies Act 2006, Section 172.

- (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –
- (a) the likely consequences of any decision in the long-term,
 - (b) the interests of the company's employees,
 - (c) the need to foster the company's business relationships with suppliers, customers and others,
 - (d) the impact of the company's operations on the community and the environment,
 - (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
 - (f) the need to act fairly as between members of the company.

¹ Ocean Tomo LLC, 2015. Intangible asset market value study. S&P500 <http://www.oceantomo.com/2015/03/04/2015-intangible-asset-market-value-study/>

The UK Corporate Governance Code (the Code) ascribes to boards a responsibility for setting the company's values and standards (supporting principle A.1), while the preface to the Code states:

'One of the key roles for the board includes establishing the culture, values and ethics of the company. It is important that the board sets the correct "tone from the top". The directors should lead by example and ensure that good standards of behaviour permeate throughout all levels of the organisation. This will help prevent misconduct, unethical practices and support the delivery of long-term success.'²

Culture is closely linked to risk and risk appetite and the Code asks boards to look at the risks which might affect the company and its long-term viability.

Chairmen and chief executives recognise the relevance of major shifts in the broader environment in which business operates. Acceptable behaviour evolves over time so culture has to be adjusted for the context and the times in which the company is operating. For example, consumers are far more concerned with the environmental impact of companies and of their own behaviour than they were 30 years ago. Well-chosen values typically stand the test of time, but need to be tested for continuing relevance as society changes and business adapts.

Purpose, strategy and the business model

Several chairmen told us that a clear purpose – why the company exists and what it is there to do – is the starting point for a successful company and closely tied to culture. In an increasingly complex business environment, boards and executive teams need to have a good understanding of the company and how it makes money – its business model – in order to have a clear line of sight between the decisions they take and how these impact on the company's culture and deliver its purpose.

Companies are recognising the value in defining and communicating a broader purpose beyond profit which generates wealth and delivers benefits to society as a whole. This can help create shared goals, motivate employees and build trust with customers. As organisations become less hierarchical, and flexible working more prevalent, many companies are finding that common purpose is helping to bind organisations together.

Chairmen felt strongly that there is no 'one-size-fits-all' when it comes to culture. What matters is that the culture is appropriate for the context in which the company is operating and that there is internal alignment between company purpose, values, strategy and business model(s). Aligning business decisions with purpose and values and focusing on how financial targets will be achieved, will over the long-term lead to more sustainable value creation. One example of a framework that can help boards to achieve alignment has been developed by the City Values Forum.³

FTSE chairmen and chief executives interviewed strongly agreed that culture is integral to everything they do and features implicitly or explicitly in discussions about strategy, and in particular how to achieve that strategy.

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The focus on long-term performance is critical and reduces the risks of short-term, inappropriate behaviour. Poor short-term behaviour and performance gets found out in the longer-term.

Sir Martin Sorrell,
Chief Executive
WPP

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We need to make sure that we are clear-sighted enough about our culture, and that it is sufficiently adaptive to a changing world and changing interpretations.

Sarah Bates
Chairman
St James's Place

“

Culture is most definitely factored into discussions on the strategy.

Derek Mapp
Chairman
Informa

² FRC, 2016. UK Corporate Governance Code <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-April-2016.pdf>

³ City Values Forum and Tomorrow's Company, 2016. *Governing culture: risk and opportunity – a guide to board leadership in purpose values and culture*

Chairmen also report that culture impacts the strategy that is chosen, for example:

- Which international markets should the company operate in?
- Can the desired culture be maintained in particular markets?
- How quickly should the company expand?
- Will rapid growth affect the culture in a harmful way?

For most chairmen, culture is the enabler, the differentiator and a source of competitive advantage. The importance of culture to the successful operation of the firm is amplified still further when the capital of the firm is vested primarily in the quality of its people.

Chief executives we interviewed told us that culture is an intrinsic part of how the business is managed and an output of how the business is run. Key enablers for achieving strategic targets include the business model(s), employee behaviour, processes and management. Many chief executives agreed that, in normal circumstances, what works best for many companies is making sure behavioural considerations are a prominent, consistent part of everything they do.

Investors echoed much of this sentiment, pointing out that they gain a good deal of insight into the culture of a company through its articulation of its business model and the attitude to employees.

For most large organisations, the business model comprises a complex and connected series of relationships, activities, processes and stakeholders, drawing on a range of inputs and resources to achieve the stated purpose. For boards to have the capability to assess whether its culture is aligned with its purpose, a business model framework can be used to support board discussion and to assist in understanding this complexity. One example of such a framework has been developed by the Chartered Institute of Management Accountants (CIMA).⁴

At a strategic level, the board's focus will be on setting and monitoring the company's culture, in terms of the values and behaviours which best deliver value creation over the short, medium and long-terms and the incentives which support this. At an operational level the focus will be on obtaining assurance that the company's operations are aligned with its culture. In this way, boards and executive management can ensure that decisions around value creation and values are fully integrated.

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Culture is a crucial issue which is inseparable and inextricable from strategy. It is critical to execution of strategy – and is all about how we are going to go about this.

António Horta-Osório
Chief Executive
Lloyds Banking Group

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Our culture is at the heart of the company and is recognised as our differentiator. It is our most cherished asset and one on which the board is heavily focussed to ensure it does not change as the business grows and becomes more complex.

Alastair Lyons, Chairman, Admiral

⁴ CIMA, 2016. *Financial Management – Rethinking the business model* <http://www.cimaglobal.com/Thought-leadership/Research-topics/Budgeting-and-planning/Rethinking-the-business-model/>

View from the boardroom

Chairmen and chief executives agreed overwhelmingly that boards must have a responsibility for culture and must exercise oversight in this area. The board can influence culture in many ways. The board is responsible for appointing and removing the chief executive. Cultural change may take a long time to bed in; and boards can provide continuity. Boards also find it easier to be objective since they are not immersed in the day to day running of the business.

Strong governance is essential for a healthy culture. As well as the processes and practices in the boardroom, governance needs to focus on the substance of what boards do, who they engage with, what information they are given and what questions they ask. Boards should see that good governance runs through all areas of the business, including the executive committee and the layers of middle management. This will deliver improved decision-making and better outcomes.

Shareholders rely on the board to oversee a healthy culture that is compatible with the business model, steers the executive and delivers the strategy. Boards must be actively engaged in the business of shaping, overseeing and monitoring culture and holding the executive to account where they find misalignment with company purpose and values.

It can be difficult for non-executive directors (NEDs) to obtain sufficient knowledge of business operations to challenge management effectively. It is important for the chairman to set the tone in the boardroom so that NEDs are empowered to raise concerns where they have doubts.

The key challenge for boards is to understand what in practice drives the behaviour of employees and management and to shape and influence those drivers in a way that will foster greater sustainability and improved performance over time.

The inherent difficulty in understanding and measuring intangibles such as behaviour and culture, means that boards need to start by defining their purpose and values and setting out clearly the desired culture and behaviours, against which they can benchmark actual behaviour throughout the organisation. They then need to develop frameworks and tools to assess behaviours and culture to guide management and board decisions.

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People on the board must never accept something that they don't understand. This applies to established members as much as new members. If something is not clear, the board must ask the question even if it seems a stupid one. They must have the confidence to admit that they don't understand.

Anthony Habgood
Chairman
RELX Group

HOW CAN THE BOARD INFLUENCE AND SHAPE CULTURE?

A recurring theme in our discussions was the importance of trust and openness as enablers of positive and productive behaviours.

Culture is much more about people than it is about rules. Codes of conduct are a baseline; a culture is created by what you do rather than what you say. The alignment and consistency of behaviours of leaders, and how they communicate through words and actions is the essential starting point.⁵

Large organisations, particularly those with global reach, will have sub-cultures which can reflect different geographies, business units and remits. Nevertheless it is realistic to aspire to a common set of expected behaviours based on company purpose and values.

Throughout our engagement, NEDs were comfortable with the board's responsibility for setting the values of an organisation. However many were much less comfortable about their role or ability to embed the values in the organisation, and some felt this is not the role of the non-executives.

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It is vital to have a genuinely independent chairman who can bring unique perspectives and expertise to their leadership of the board. They should be properly remunerated for this role under governance rules.

Richard Solomons, Chief Executive, IHG

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It's a challenge to influence the culture – it takes a lot of time and effort to change it.

John Allan
Chairman
Tesco

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The Board sets the values and culture (how people treat each other, how they operate within the supply chain and how they work with employees) and management is then responsible for implementing this.

John Watson
Chairman
Bellway

⁵ CIPD, 2016. *A duty to care? Evidence of the importance of organisational culture to effective governance and leadership*
<https://www.cipd.co.uk/>

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What counts is the actual behaviour of the organisation and its top people. This is far more significant than a hundred statements about a company’s culture or its ethical policy.

David Tyler, Chairman, J Sainsbury

Yet, when we surveyed chairmen on how influential different individuals were on company culture in practice, 89 per cent felt the role of the chairman is influential or very influential and 54 per cent viewed the role of NEDs as influential or very influential.⁶ The views of company secretaries were in line with this.⁷

Even though not directly responsible for embedding culture, boards nevertheless play an important role in influencing culture and in supporting the efforts of the executive to embed the values and reinforce desired behaviours and culture. Two of the most important ways in which boards can influence culture are in leading by example – displaying and communicating the values when in the business – and the selection and management of the chief executive.

Role modelling and behaviour of the board

For boards, culture starts with their behaviour in the boardroom.⁸ Employees need to see that the leadership is held to account and to the same standards as the rest of the organisation. ‘Leading by example’ was one of the themes most often emphasised by chairmen when speaking about the board’s influence on culture. For example showing respect to senior managers who present to the board.⁹ Several chairmen spoke of managers evaluating the board’s behaviour and many emphasised behaviour as important. When chairmen were asked how much attention they give to setting the tone through leading by example, 58 per cent said ‘we do enough for now’ and 36 per cent answered ‘some – but we could do more’.¹⁰

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Leading by example is about ensuring boardroom behaviour is exemplary and in line with the values, ethics and integrity.

**Roberto Quarta
Chairman
Smith & Nephew
and WPP**

6 Independent Audit Limited, 2016. *Survey of 44 chairmen of FTSE 100 and 250 for FRC*

7 Independent Audit Limited, 2016. *Survey of 33 company secretaries of FTSE 100 and 250 for FRC*

8 Independent Audit Limited, 2016. *Cultivating Culture: What boards can and can’t do about behaviour* <http://independentaudit.com/publications/cultivating-culture-boards-can-cant-behaviour/>

9 Independent Audit Limited, 2016. *Interviews with 58 chairmen of FTSE 100 and 250 for FRC*

10 Independent Audit Limited, 2016. *Survey of 44 chairmen of FTSE 100 and 250 for FRC*

Chief executives

A view that came through consistently in our engagement was that the chief executive has the most influence over the culture of the business. This is even more marked in smaller companies.¹¹

If accountability for owning, assessing and overseeing culture lies with the board, then accountability for driving culture lies primarily with the executive management team, starting with the chief executive. It is the chief executive that sets expectations and drives behaviour and change throughout the organisation.

“The tone has to come from the CEO – he is responsible for the delivery globally of a culture that values high standards of conduct. It’s about personal leadership and being very visible. There is no substitute for speaking to people face-to-face. Good stories, employee experiences are also important.”

Stuart Gulliver, Chief Executive, HSBC

“There is board culture and organisational culture. The two are linked but it is the CEO who most influences organisational culture. The key is to balance the focus of the board so as to encourage the right behaviours across the organisation without trying to do the job of the CEO.”

Ian Durant, Chairman, Greggs

Chairmen, chief executives and company secretaries all told us that the most powerful way in which the board influences culture, other than through its own behaviour, is through its selection and management of the chief executive. The nominations committee should support the board by building culture in to recruitment considerations.

In *A duty to care?*, CIPD supports this view: “...for many boards the single greatest influence they have on the culture of the organisation is the appointment, remuneration and firing of the CEO – if they get the decision wrong there may be severe repercussions felt across the culture of the business.”¹²

Several chairmen expressed the view that appointing the chief executive is one of the most important tasks of the board, while removing a chief executive who does not fit is one of the most difficult, particularly if current company performance is good.¹³ Company secretaries surveyed reported that 73 per cent of boards consider the cultural and behavioural fit of an individual during recruitment.

Chief executives we interviewed agreed unanimously that driving culture was a key part of their role and the board should hold them to account for doing that.

They believe that NEDs have an important role in helping executives anticipate unintended consequences, including behavioural ones, of management proposals.

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It is very difficult for the board to drive culture down the organisation. However, they can influence senior management.

Philip Aiken
Chairman
AVEVA

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Driving culture is a key part of my job. ‘Driving’ is the right word, the world is changing too fast just to speak about maintaining. I expect the board to hold my feet to the fire over it.

Rob Noel, Chief Executive, Land Securities

11 Roundtable with executives and non-executive members of the Quoted Companies Alliance – April 2016

12 CIPD, 2016. *A duty to care? Evidence of the importance of organisational culture to effective governance and leadership*

13 Independent Audit Limited, 2016. *Survey of 44 chairmen of FTSE 100 and 250 for FRC*

Chief executives need to be visible and communicate constantly with the organisation through meetings, events, messages, webcasts and video. Several chief executives emphasised the importance of being approachable and accessible to customers and employees. Making it easy to communicate directly also provides good insight.

Communications from the chief executive can have a significant effect on behaviour. Consistent, regular and open communication of simple messages are key to building trust and encouraging the desired behaviours. A number of chief executives found sharing stories of good and bad culture (from the business) was effective in demonstrating expected behaviour.

If the board is seeking a change in culture, it must clearly understand and articulate the values and behaviours it wishes to promote in order to guide its choice of chief executive. Several chairmen stressed the importance of including values and expected behaviour in a new chief executive's job profile, alongside skills, experience and track-record.

Planning the succession of the chief executive well in advance, and having an open discussion about the values and attitudes required in a new chief executive is important. Most chairmen stated that cultural fit was a major factor in senior executive selection. Internal promotion is perceived as considerably less risky, given the individual is much better known, and will have demonstrated adherence to the company's values.

"If the culture is working and the company is a financial success, there is much less risk in selecting an internal candidate. If something is wrong and you want to make big changes, it is better to get an external candidate who will bring in new values as CEO."

Gareth Davis, Chairman, Wolseley

The board has a role in assessing the performance of executives. The chairman/ chief executive relationship is seen as vital by both chairmen and chief executives – it should be collaborative, constructive and open. Basing this relationship on trust rather than competition allows the chairman to act as their sounding-board.¹⁴

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As CEO, everything you say is amplified manifold and the 'say/do' ratio is what really matters.

Javed Ahmed
Chief Executive
Tate & Lyle

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It is essential to avoid dilution of the message, to maintain simplicity and use simple language.

António Horta-Osório
Chief Executive
Lloyds Banking Group

“

War stories are a useful way to get the culture solidified.

Jeremy Darroch
Chief Executive
Sky

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The board can do nothing without the CEO who has to lead. The board has to influence through him which is why CEO selection is the most important thing a board has to do.

Ian Durant, Chairman, Greggs

¹⁴ Independent Audit Limited, 2016.
Survey of 33 company secretaries
of FTSE 100 and 250 for FRC

“The relationship between the chairman and CEO is important in defining cultural behaviour and policies across the business. The more closely they work together, the more likely it is that a strong ethical culture will evolve across the business.”

Alan Thomson, Chairman, Bodycote

One of the most important tasks for boards is to hold the chief executive and senior executives to account. Where boards become aware that the chief executive (or another member of the executive committee) is not demonstrating the desired behaviours, they should take action.

If the individual is not receptive to the board's efforts, it may mean the board must exercise its power to dismiss them. While this can be unsettling for investors and employees, several chairmen spoke of having to change the chief executive to gain control of the culture and the positive impact bringing in a new chief executive can have.

“Dominant personalities can be disruptive in all sorts of ways especially culture. Choosing the correct balance of people is key to culture.”

John Watson, Chairman, Bellway

Culture on the agenda

Boards, on the whole, are spending more time discussing values, behaviours and culture than they were five years ago.¹⁵ Some boards are addressing the topic as a standalone agenda item, while others report actively discussing and addressing values, behaviour and culture in a more integrated way, for example as part of discussions on customer and employee feedback, remuneration and reward policies or health and safety incident reports. Most boards agreed that they could be seeking more assurance on culture. There was also considerable agreement that audit, nominations, remuneration and risk committees could do more to support the board in addressing culture.

“The chairman's responsibility for culture has moved to the top of my agenda as a result of my responsibilities under the Senior Managers' Regime. Now I receive a lot of information on culture, a year ago none.”

Mark Nicholls, Chairman,
Rathbone Brothers

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The chairman is a very important ambassadorial figure. He travels and represents. There needs to be a close chairman/CEO relationship.

George Weston
Chief Executive
Associated British Foods

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The Board needs to show it has zero risk appetite for poor ethical behaviour. This sends a clear signal. Turning a blind eye to dubious behaviour is very dangerous.

Sir Peter Gershon
Chairman
National Grid

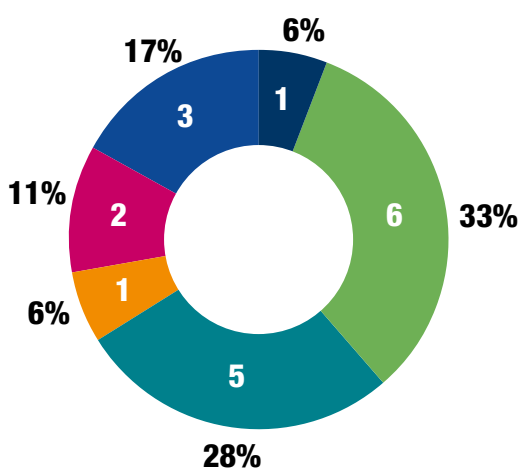
¹⁵ Financial Times & Institute of Chartered Secretaries and Administrators, 2016. *Boardroom Bellwether – Insights into what boards are thinking from the survey of FTSE 350 company secretaries* <https://www.icsa.org.uk/knowledge/research/ft-icsa-boardroom-bellwether-survey-summer-2016>

“
Culture is not a separate item but there are elements of it in all other discussions, decisions and actions – customer service, measuring and managing people, how we are dealing with suppliers and agents – and they all come together.

Philip Rogerson, Chairman, Bunzl

The figure below illustrates how often some FTSE companies discuss culture as a full board agenda item:

How frequently is ethics and culture a full board agenda item?
(Number/percentage of respondents)¹⁶



- Once a quarter
- Every six months
- Once a year
- Less than once a year
- Never
- Other

Base: Of the 24 survey participants, 18 responded to this question

The challenge for boards is how to coordinate across the organisation and build a holistic approach to addressing culture. One large UK bank has recently tasked a number of its business divisions to work together to provide a single report of cultural indicators to the board. The individual functions each track many different data points in relation to behaviour and culture across the bank. Discussion at the board is focussed on a small number of the most meaningful measures that provide crucial insight and can be tracked over time. The chairman is confident this is a significant step in helping the board perform its role in seeking assurance on culture.

Those boards reporting that values, behaviours and culture were rarely discussed, explained that company culture is intrinsic and expected behaviours are understood by all and do not need to be articulated. This may be a result of a long established culture, a sense of complacency or a reluctance to address the subject because it is perceived as difficult to pin down.

“
Our business model requires us to focus on the needs of customers and employees. The board conversation is not framed or informed by an aggregated set of cultural or values-based indicators and there are few formal reports, but the board spends a great deal of time looking at culture and values, driven by specific issues or by regular feedback, surveys and information from the frontline.

Patrick Lewis
Group Finance Director
John Lewis¹⁷

¹⁶ Institute of Business Ethics, 2016. *Culture by committee – the pros and cons*

¹⁷ Roundtable with heads of internal audit, human resources, finance, and risk and compliance – January 2016

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Like risk, culture doesn't benefit from being given its own separate status and processes. It is part of doing good business and needs to be intrinsic in everything.

Sir Peter Gershon, Chairman, National Grid

Cultural due diligence in mergers and acquisitions

Participants highlighted how important it is to consider cultural fit and alignment of values during a prospective merger or acquisition. Many chairmen and chief executives said they had not pursued a merger because of a lack of cultural fit or because they had concerns about the values and behaviours in the other company. Private equity houses also said it was common for them to walk away from a deal because of an overly dominant managing director or chief executive that they did not feel they could work with.¹⁸

In contrast, our survey of company secretaries revealed that while 40 per cent felt the board had sufficiently discussed cultural due diligence ahead of a merger or joint venture, almost 30 per cent disagreed.

The head of investor relations of a private equity firm who had experienced a merger with a European business reflected on his experience.

“Both companies were in the same business and had a similar history. On paper they were the perfect match for each other but no one asked about cultural fit and in the end it did not work. We were still talking about ‘us and them’ two years later, we haven’t had the results we expected when the two businesses came together and now we’re looking at a reverse takeover.”

Chief executives we interviewed reported it was important to address culture in a merger or acquisition proactively without seeking to impose it. Consistent and clear messages on values and behaviours can help generate understanding and commitment to the culture of the acquiring company.

¹⁸ Roundtable discussion with members of the British Venture Capital Association – May 2016

Questions for boards

Values and behaviours

How are we demonstrating the board's behaviour reflects the behaviour we expect throughout the company?
Are we leading by example?

Are we clear about the values and behaviours we expect when recruiting new executives?

Do we hold the chief executive to account where we see misalignment?

Are we discussing culture in sufficient depth at board meetings?

How are we taking account of culture in our board effectiveness reviews?

How can we ensure we consider the impact on culture in all the decisions we take?

Do the committees support the board on culture?

Is there a need for a specific conduct, ethics or culture committee?

What is the company telling the outside world about what it stands for and how it conducts business?

Has the company made a public commitment to the values?

What behaviours are being driven when setting strategy and financial targets?

What percentage of board time is spent on financial performance management against targets? And on behavioural performance management? Is the balance right?

Is company tax policy consistent with stated values?

How are we challenging 'group think' and testing key decisions for cultural alignment?

Are we seeing evidence of sub-cultures or pockets of autonomy in the business that could undermine the overall culture?

Mergers and acquisitions

How confident are we that we can achieve a cultural fit within a reasonable timeframe and what could be the cost to the business of a cultural misalignment?

What is our strategy for addressing culture if we proceed?

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When doing M&A, there are two major concerns: financial control and culture. On the culture side, it is either rushed through too quickly or the target never culturally integrates. It is important to take time to understand how to embed and cross-fertilise culture – not super-impose it.

Jeremy Darroch, Chief Executive, Sky

BRINGING THE VALUES TO LIFE

If values are to be more than just words on a poster they need to be translated into a set of expected behaviours that are meaningful to the company and those who work there.

Built to Last – successful habits of visionary companies highlighted that strategies and practices change, but values do not.¹⁹ While a few of the companies we spoke with had recently updated their values, most have had the same set of values for many decades. Integrity, respect and innovation are the three most commonly expressed values of the FTSE 100.

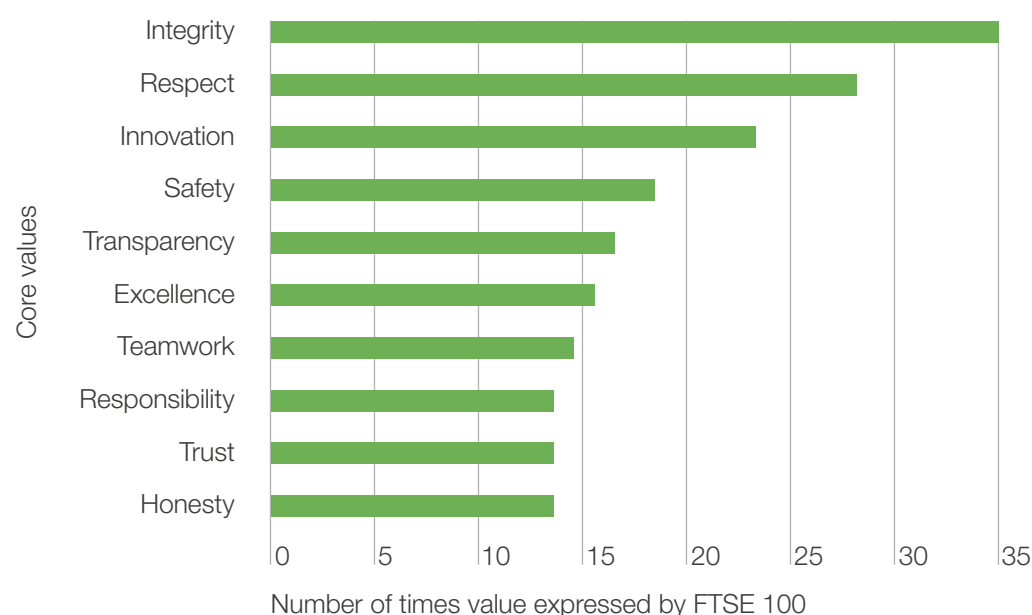
Blueprint for Better Business encourages companies to first establish their purpose. Companies including Unilever, Old Mutual and Vodafone actively support this approach to ‘uniting corporate purpose and personal values to serve society’ which starts with having a purpose which delivers long-term value.²¹



Most companies find it difficult to define culture in a way that makes it actionable. It is important to make it concrete in terms of the behaviours that are expected and then consider how every element of the organisation sends messages about what the behaviour norms should be.

Lord Blackwell
Chairman
Lloyds Banking Group

The values most valued by FTSE 100 companies²⁰



¹⁹ Collins, J. and Porras, J.I., 2011. *Built to Last – successful habits of visionary companies*. London: Random House Business

²⁰ Maitland, 2015. *The values most valued by UK plc*. <http://www.maitland.co.uk/news/business/the-values-most-valued-by-uk-plc>

²¹ Blueprint for Better Business <http://www.blueprintforbusiness.org/>

The G30 report on banking conduct and culture said that focusing on values and conduct are the building blocks of culture and the ‘what to aspire to’ is largely in place in banks, through the bold statements that they have made about their intended future behaviour. The report pointed out, however, that failing in implementation and embedding these values remains a serious issue for the banks.²²

Simply adopting formal values statements is not enough. In order to have an impact on behavioural outcomes and influence the way business is done, values need to be embedded in the company and:

- the purpose, strategy and business model of the company;
- translated into expected behaviours;
- widely and consistently communicated, including through codes of ethics/ conduct;
- reinforced through recruitment, performance management and reward processes; and
- integrated within the different functions, processes and operations in the business.

Engaging middle management

Management at every level must assume responsibility for owning and maintaining the culture. Middle managers may be best able to observe the culture in a business and should be involved in communicating change and developing ideas to ensure success. Middle managers are often cited as not being receptive to change, yet this may be because they are not effectively engaged at an early stage. Investing in training on the values and expected behaviours and in people management will help managers to develop and to embrace their role in embedding the desired culture.

“

I do not believe you can just command and control anymore. Business now is just not like that – especially with so many outposts and the ‘instancy’ in this internet age. You have to work by having and sharing very deep-seated beliefs across the organisation. It is about beliefs, not just rulebooks.

Javed Ahmed
Chief Executive
Tate & Lyle

²² The Group of Thirty, 2015. *Banking conduct and culture: a call for sustained and comprehensive reform*. <http://group30.org/publications/detail/166>

The first line of supervision, i.e. those employees responsible for managing teams on the shop floor, have a good lens into the true culture of the organisation. These individuals know whether the culture is open, lines of accountability are clear and the workforce is motivated. As immediate line managers, they also have a significant impact themselves on culture and sub-cultures.

“The layer below middle management is key. By looking closely at that you can really tell whether values and culture have trickled down. That is where you see culture played out.”

FTSE 100 Company secretary

One chief executive we interviewed reported that reducing the number of layers of management and the number of direct reports has had a positive effect on culture. It has increased accountability and ownership and improved communication throughout the organisation.

Human resources

Human resources (HR) has an important role to play in embedding the values in the business. Where there is a separate ethics and/or compliance function the effectiveness is enhanced through close collaboration with HR. Aligning HR policies and processes with the values is a critical step in driving culture.²³ CIPD's report, *A duty to care* recommends:

‘Invest in building HR and people management strategy and capability which focuses on leadership and management culture, and embedding cultural values across all levels of the organisation. The board must work closely with the HR function to create the appropriate organisational culture through aligned strategic human resources management practices, from recruitment, induction, training initiatives, leadership development, performance management resourcing and succession.’

“

A good culture helps when hiring.

Jeremy Darroch
Chief Executive
Sky

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It isn't about slogans and soundbites. It pervades throughout the organisation.

David Bellamy
Chief Executive
St. James's Place

²³ CIPD, 2016. *A duty to care? Evidence of the importance of organisational culture to effective governance and leadership*

Recruitment, induction and training

Communicating the values and expected behaviours starts early with the person specification for prospective employees. Where and how you advertise and recruit is in itself a reflection of the values of the company and may influence the type of candidates you attract.

Communication of the company values continues throughout the recruitment process, for example in the way the company interacts with candidates and the areas of focus and questioning at interview. Once appointed, the messages can be reinforced through induction, ongoing training and performance management, ensuring individuals understand the company's values, and how they are translated into expected behaviours.

Developing leadership capability and succession planning

Building leadership capability is a central concern for boards and chief executives and there is an opportunity for more effective collaboration between the board and executive. Several chief executives we interviewed said that internal talent is their preferred method of developing leadership capability; the chances of a successful appointment are greater because you know the candidate well and they already understand the company and its culture.

Research shows that leadership capability is also important to effective cultural change.²⁴ As part of its ongoing role in overseeing and monitoring culture, the board must ensure that senior leaders of the organisation have the desire and capability to align their leadership with the values and to hold to account those who are not willing to conform, however strong their performance against financial targets.

Incentives, remuneration and reward

Pay is a sensitive issue in the UK and affects the standing of business in society. Unfortunately the continuing inconsistent alignment between executive remuneration and company performance and between the remuneration of senior executives and employees has led to a lack of public confidence. This has taken place despite increasing regulation to improve transparency and accountability.

Remuneration practices are often cited as a driver of poor behaviour. The incentives created by performance related pay, and the corresponding impact on employee behaviours, is something that should be of utmost concern to boards and remuneration committees, which could do more to apply a cultural and values lens to the design of remuneration policies and individual remuneration decisions.

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You need a strong learning and development team to keep the culture alive because it's vital to give people the professional skills and the management tools to be able to do their jobs in the right way.

Dorothy Thompson
Chief Executive
Drax

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Most companies measure individual performance against objectives. In future more companies will measure individual behaviour against a standard.

John Stewart
Chairman
Legal & General
(until 01.06.16)

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People and succession come up too rarely at boards. There should be more focus on the top 100, developing the mix and spending time with the leadership group. It's about having a pipeline of talent. You have to be clear about succession and have a strategy.

Adam Crozier, Chief Executive, ITV

²⁴ CIPD, 2016. *A duty to care? Evidence of the importance of organisational culture to effective governance and leadership*

Adherence to values and expected behaviours should be an important part of how all leaders and employees are assessed and rewarded. This may be difficult because it requires greater discretion in remuneration committees to reward or penalise behaviour, which is more difficult to measure precisely than profits. Investors do not generally favour discretion and subjective measures; but they do not like the consequences of bad culture either.

Salary and bonus are not the only levers for driving the right behaviours in employees. Powerful non-financial incentives can be created, especially via promotion, termination policies and decisions.

Speaking up

Recent research shows that cultivating speak up and whistleblowing policies can lead to an increased level of trust within organisations.²⁵ Trust is key in influencing the culture of a business. One way to increase trust is through the continuous development of visible policies to encourage transparency around possible bad practice. This means developing collaborative policies that allow people to speak up, a well-organised set of procedures and an effective system of response to concerns that arise.

Also critical to success is the independence of channels through which whistleblowing information flows. Issues that can affect this include anonymity, the seriousness with which management treat those who speak up and legal issues. When communication channels are developed effectively, evidence shows that speaking up becomes more engrained in the organisational culture.

Measuring the effectiveness of a whistleblowing policy can also be useful to boards in assessing how effectively a culture is embedded. A healthy 'speak up' culture breaks down the barriers that can often exist between the workforce and the board. External publication of the data can also give investors confidence that a genuine culture of openness exists and where it does not that the board knows about it. Demonstrating how the policy is working can also inspire employees to speak up in other ways and the culture becomes self-reinforcing.

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It is easier to see signs of departure from the desired culture (e.g. instances of bullying) than positive evidence of its existence. So whistleblowing is very important. We find it valuable – it isn't dominated by day-to-day complaints. People know that they will be protected, but they also know that it comes to the board so they don't use it lightly.

Sir Roger Carr
Chairman
BAE Systems

²⁵ ACCA (the Association of Chartered Certified Accountants), 2016. Effective speak-up arrangements for whistleblowers <http://www.accaglobal.com/uk/en/technical-activities/technical-resources-search/2016/may/effective-speak-up-arrangements-for-whistle-blowers1.html>

Chief executives who pride themselves on having a healthy culture told us that an open culture which supports employees when they speak up acts as an early warning system and alerts management if behaviour starts to slide. It is important to treat the whistleblower fairly and with respect and to look into any concerns that are raised. It is also vital that there is a feedback mechanism to close the loop.

Codes of ethics and conduct

A tool many organisations use to help embed a desired culture is their code of ethics or conduct. A code can translate generic values into more specific policies and guidance, which in turn can influence behaviour. Repeated behaviour over time creates a corporate culture. Codes also signal to those in and outside the organisation that the company sees the value in acting with integrity.

There are different ways companies can structure their code of ethics/conduct.²⁶ All focus on how to handle ethical challenges when making decisions. An issue-based approach gives guidance on topics relevant to the company.

A stakeholder-based approach considers how a company's stakeholders may perceive certain actions and some more recently developed codes are values-based, such as the Bank of England's Code.²⁷ Many companies such as Vodafone illustrate what they expect from employees, with common ethical dilemmas. This approach is particularly helpful in large, international businesses where there may be significant cultural and geographical differences.²⁸

Regardless of the specific model it is clear that the existence of a code and the process of developing a code help to foster a positive culture. Its development helps to engender a sense of trust amongst employees and stakeholders, and communication and promotion by the ethics and compliance function and senior management can help inform critical business decisions. Initiatives to embed codes are often accompanied by encouraging employees to speak up where they see the code not being followed.

The existence of a code may also allow disciplinary procedures to be fairer and reduce the risk of wrongdoing in the business. Investors may use the presence, communication and frequency of review of a code of ethics/conduct as a risk indicator of the culture of a company.

The monitoring of code breaches, and particularly the reasons for those breaches and where in the business they occur, can help measure the pervasiveness of the culture that the leadership wish to embed and show whether the desired culture is truly embedded.

26 Institute of Business Ethics, 2006. Making business ethics work: The foundations of effective embedding, http://www.ibe.org.uk/userassets/pubsummaries/embedding%20_summary.pdf

27 The Bank of England, 2015. Our Code, Our commitment to how we work <http://www.bankofengland.co.uk/about/Documents/humanresources/ourcode.pdf>

28 The Vodafone Code of Conduct: Doing what's right (2016) <http://www.vodafone.com/content/index/about/conduct.html>

Risk management and risk culture

The Institute of Risk Management defines risk culture as the ‘values, beliefs, knowledge and understanding about risk, shared by a group of people with a common intended purpose, in particular the leadership and employees of an organisation.’²⁹

Globalisation, the rate of technological and environmental change, and regulatory requirements present increasing complexity and challenge for businesses. Risk taking is a fundamental part of growing a successful business and companies should not seek to eliminate risk. They should be ensuring that their approach to risk taking – their risk appetite – is aligned to their values and an intrinsic part of their culture. Companies may also want to consider if the culture they have presents any risks to the business.

The FRC’s *Guidance on risk management, internal control and related financial and business reporting* states that the board’s responsibility for the organisation’s culture is essential to the way in which risk is considered and addressed within the organisation and with external stakeholders.³⁰

One risk professional told us that risk culture is not given enough prominence because it is not properly understood. Others suggested that organisations do not engage because they are reluctant to appoint risk managers who ask difficult questions, and want access to sensitive information.

The Association for Insurers and Risk Managers (Airmic) advises that risk culture should be thought of as a way of framing risk and culture in the organisation’s overall culture and management system – acting as a bridge between risk, reward and risk appetite. This sentiment was echoed by some of those we interviewed.

Roads to resilience looked at the way leading organisations were building their ability to withstand both expected and unexpected risks.³¹ Researchers found that key to achieving resilience is to focus on behaviour and culture and achieving resilience should be at the heart of strategy and the business model of every organisation. In order to achieve resilience companies should establish a culture based on trust and respect that also avoids risk blindness. The result is a no blame culture which ensures all in the company are committed to a common purpose and values.

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The values are an important part of the board’s discussion of the risk appetite – the values are an integral part of this – and in turn risk appetite is part of the culture.

António Horta-Osório
Chief Executive
Lloyds Banking Group

29 Institute of Risk Management (IRM), 2012. Risk culture: under the microscope Guidance for Boards

30 FRC, 2014. Guidance on risk management, internal control and related financial and business reporting, Section 1.6

31 Cranfield School of Management and Airmic, 2014. *Roads to resilience – building dynamic approaches to risk to achieve future success* <https://www.airmic.com/technical/library/roads-resilience-building-dynamic-approaches-risk-achieve-future-success>

Questions for the board to ask

Aligning HR processes and reward

How well are our values and expected behaviours embedded in all our HR processes from recruitment to exit interviews?

How is corporate reputational risk considered in the setting of incentives?

Does the balance between financial and non-financial incentives support the desired culture?

Are behavioural objectives included in leadership and employee goals and are behaviours formally assessed as part of performance review activity?

Have we considered whether top tier executive pay awards and those of other employees could undermine culture?

Ethics and compliance

Is our code of ethics/conduct up to date and clearly communicated to all employees?

How do we measure that the code of ethics/conduct is adequately communicated and understood by all employees?

Is our ethics training programme up to date and have all employees completed it?

Risk³²

Are we clear about the company's risk appetite and is it communicated effectively?

What risks does our current corporate culture create for the organisation?

How do we acknowledge and live our stated corporate values when addressing and resolving risk dilemmas?

How do we actively seek out information on risk events and near misses – both ours and those of others – and ensure key lessons are learnt?

How do we reward and encourage appropriate risk taking behaviours and challenge unbalanced risk behaviours (either overly risk averse or risk seeking)?

³² Institute of Risk Management, 2012. Risk culture: under the microscope guidance for boards (Adapted)

BUILDING TRUST WITH STAKEHOLDERS

A 2013 global survey of executives by McKinsey & Company showed that a majority believed that issues relating to external affairs would affect their company's income.³³

Those that reported a more capable external relations team were more likely to take regular action and were in turn more likely to see successful results. 'The results and our experience suggest that not engaging isn't an option; neither is neglecting the organisational capacities and resources that support meaningful action' the report said.

McKinsey suggested that there are three elements to a successful approach to external stakeholders. First, the company must have a clear purpose built around a set of values that will inform the message. Second, the approach needs to be strategic, and based on a clear understanding of which relationships with which groups matter and why. Third, companies need to decide on the nature of the approach – will it be open and proactive or defensive.

Customers

Delivery of value to the customer is vital for corporate success and an essential indicator of trust. Senior leaders need to be familiar with customers and their expectations and make customer service a priority for their workforce. Culture that puts the customer first, with appropriate training and incentives that underpins this, communicates this clearly to staff. In the course of our research, we spoke with many companies that have a renewed focus on the customer.

Higher levels of customer satisfaction translate into increased sales.³⁴

Communicating with frontline employees and ensuring good morale is therefore a key part of the requirement to look after customers. Strategic commitment to customer service and the development of long-term relations with business partners sharing the same values and ethos are important ingredients of successful customer focus.³⁵



The board has a duty of care to those who depend on it (staff, suppliers, customers etc.) and it has to demonstrate that it fulfils that duty.

Peter Johnson
Chairman
Electrocomponents

33 McKinsey & Company, 2013. External affairs at a crossroads <http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/external-affairs-at-a-crossroads>

34 Institute of Customer Service Customer Satisfaction Index 2014

35 The Institute of Customer Service, 2015. *Leading by example: How values-based leaders will shape the future of customer service.*

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The purpose of a company can't be to maximise shareholder value. That's a derivative of the purpose not the purpose itself. The purpose has to be about serving customers.

Anthony Habgood, Chairman, RELX Group

It is important that the company allows its customers ready access when they have a problem that needs resolving. Companies also need to be careful in the way they handle confidential personal data, as unauthorised release can severely damage customer confidence. Boards need to monitor customer service indicators regularly and consider the implications for reputation, risk management and long-term business performance.

Employees

A key ingredient of a healthy culture is a willingness on the part of senior management to listen to their employees and recognise that their commitment is often long-term. Employees usually want their organisation to succeed, and have good ideas about how to make this happen. It makes sense to empower them.³⁶

Employee voice

Employee voice is the two-way communication between employees and the organisation.³⁷ Engagement activities help employees to share ideas and concerns with senior teams to steer decisions regarding the business. A culture of engagement and 'permission' is required for employees to feel able to voice their ideas and concerns. Measuring the extent to which employee voice processes are enabled and used is a useful measure of culture on which boards can draw.

Mechanisms and channels for employee voice range from leaders and managers who listen to and actively encourage employees to speak up, to formal and informal internal channels of communication – such as: 'town hall' or networking meetings and use of social media; engagement of employees at all levels in projects and change initiatives – and formal structures, such as unions and employee councils, and external channels, such as whistleblowing or external social media.³⁷

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Our entire customer-centric strategy is driven by the need to embed cultural issues around service and integrity.

Sir Richard Lapthorne
Chairman
Cable & Wireless
Communications

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It's about doing things our way – strong beliefs and values need to be built into the way we manage the business. Those beliefs need to drive business decision-making and that means driving customer excellence.

Vittorio Colao
Chief Executive
Vodafone

³⁶ IBE, 2016. Stakeholder engagement – values, business culture and society. Interview with Frances O'Grady – Secretary General, the Trade Unions Congress <http://www.ibe.org.uk/>

³⁷ CIPD, 2016. *A duty to care? Evidence of the importance of organisational culture to effective governance and leadership.*

Changing workforce

The modern workplace differs markedly from those of previous generations. Business relies increasingly on trust and on influence as well as on production and control. This inevitably has an impact on the workforce and on the culture of an organisation. What has emerged is a more open workforce which delivers discrete projects with flexibility and mobility. This reduces costs and enhances reach.

The number of people who are not full-time permanent employees, but are flexible workers and contractors, continues to grow. In these circumstances, maintaining a certain culture can be harder. The flexible workforce has greater empowerment but also greater scope for deviation from core values. The detachment of some employees and contractors can impede the creation of a sound culture as they may not have bought into the values of the company and have less to lose when things go wrong. Clearly, while difficult to address, these risks need to be managed.

New ways of working – managing the open workforce suggests that successful companies should seek to monitor and manage their talent through understanding the risks and developing new tools to enhance performance and decision making.³⁸ The research argues that having a strategy in place to recognise these challenges can significantly improve the impact and create a culture beyond traditional organisational boundaries. It is clear that the change in ways of working should not present a barrier for focusing on cultural change.

Suppliers

Many companies today have extensive supply chains. A challenge for companies is how to ensure that supplier culture and behaviour meet the standards that apply within their own group. This can be difficult because suppliers may have their own set of values and working methods and they may be supplying a number of different companies, each with its own set of requirements. In other cases people representing the company in customer facing roles may be employed by a sub-contractor where the customer would assume they are a direct employee of the company and expect no difference.

A starting point for engagement with suppliers is to treat them with respect and to recognise the mutual benefit of the relationship. For example, paying suppliers promptly is fair and builds trust and goodwill.

In extreme cases, supplier companies that are not clear about what is expected of them or the law, may cause more serious compliance issues for companies. There is also a reputational risk from not selecting companies that understand the client company's values and represent them. Procurement policy therefore has to be consistent with company values. Companies need to be clear that preference will be given to suppliers that meet the expected standards. In some cases this may involve helping suppliers to develop and train their own workforce in the expected standards of behaviour.

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Most people define themselves by their job so there has to be a match between how they see themselves and how the organisation sees itself. They must have the same values in order to be comfortable, engaged and for them to get something from their work.

Geoff Cooper
Chairman
Card Factory

³⁸ CIMA, Chartered Global Management Accountant, 2014. *New ways of working – managing the open workforce* <http://www.cgma.org/resources/reports/pages/new-ways-of-working.aspx>

Regulators

Relations between a company and its regulators are not always easy given that their interests are not fully aligned. A company's attitude to regulators can often be a useful indicator of culture; is the relationship driven by narrow self-interest and a desire to disclose as little as possible or does it approach the relationship in a constructive and open manner and regard it as a source of support and mutual benefit. A focus on how the executive engages with the regulator is one way in which boards can understand the prevailing culture and seek to influence it. Regulators too need to be aware that the requirements they make of companies may have unintended behavioural consequences.

Shareholders

Shareholders have a unique relationship with companies, as providers of capital and because of their ownership rights. Shareholders elect the board and directors are formally accountable to them. Boards, particularly chairs and board committee chairs, are therefore often directly involved in relations with shareholders, while engagement with other stakeholders is undertaken by management.

The composition of organisational value has changed rapidly over the last 40 years. In 1975, 83 per cent of the market value of companies in the S&P 500 was accounted for on their balance sheets. In 2015 that figure stood at just 16 per cent.³⁹ CIMA's Global Intangible Finance Tracker 2015 put the UK's intangible asset value at 64 per cent of total enterprise value.⁴⁰

"Culture often provides the most important insight into the intrinsic value of a company, but can be difficult to evaluate from company reporting alone. Therefore shareholder engagement should play a critical role."

Andy Griffiths, Executive Director,
Investor Forum

As these figures demonstrate, an increasing proportion of enterprise value is now made up of intangibles that are not capitalised such as brand, reputation, intellectual property, human capital and culture. These factors are inherently difficult to measure in the traditional sense. However, they are closely associated with risk and opportunity and are of significant interest to shareholders who need to be able to hold boards to account for assessing and monitoring these intangible assets.

Shareholders have an important role to play in engaging with companies on culture.⁴¹ While they cannot directly intervene, they can help to bring about change through high quality dialogue. They can also support companies that want to innovate and change culture, for example through changes to methods of incentivisation.

Shareholders, chairs and chief executives all report a degree of frustration in establishing a dialogue about culture. Some companies believe that most shareholders are primarily interested in the short term outlook and unwilling to spend time discussing how embedding a strong culture contributes to long-term success. Excessive focus by shareholders on short-term performance – or the perception that this is the case – can be a driver of poor behaviour.

The key issue for shareholders is how culture impacts and underpins performance. Companies with a 'poor' culture may perform well in the short term but this is unlikely to be sustainable over the longer term. Investors report that the answers to simple questions can reveal much about culture, for example the extent to which senior managers care about their employees. The way answers are given can also reveal attitudes to their wider stakeholders.

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The right corporate culture is critically important for the delivery of sustainable, long-term performance, and hence sustainable pensions for our members.

Chris Hitchen
Chief Executive
Railpen Investments

39 Ocean Tomo LLC, 2015. Intangible Asset Market Value Study. S&P 500 <http://www.oceantomo.com/2015/03/04/2015-intangible-asset-market-value-study/>

40 Brand Finance and CIMA, 2015. Global Intangible Financial Tracker – An annual review of the world's intangible value http://www.cimaglobal.com/Documents/Thought_leadership_docs/reporting/Brand-Finance-GIFT-Report-2015.pdf

41 IBE, 2016. Stakeholder engagement – values, business culture and society <http://www.ibe.org.uk/>

Some shareholders are not convinced that they have the power or the ability to change culture. Where they perceive a weak culture they are more aware of the risks to value and may be more likely to sell their shares. A number of passive fund managers believe that engaging on culture is an important way of preserving value on behalf of clients. However, most asset managers reported to us that their clients rarely put them under pressure to put resources into engaging on corporate culture. It may, therefore, be helpful for asset owners to encourage their fund managers to raise the subject of culture with the companies they invest in on their behalf.

Nevertheless, discussions with shareholders identified a growing appetite for an improved dialogue with companies on culture. This trend is likely to continue. It has implications for boards and for corporate reporting, and regulators will need to monitor this. There is also a recognition by investors that collective action could deliver a consistent message to companies and build trust. The Investor Forum presents an opportunity for greater collaboration.

Shareholders need to guard against concluding too much from a single set of indicators which may give some signals on risk but give little insight into the long-term sustainability of the business. Cultural indicators can act as a starting point for discussions with directors, but context is important and the quality of dialogue is key for assessing culture. Shareholders report that they seek reliable data and consistency which allows comparison with previous years and with other companies in the sector.

It is clear that shareholders need to talk to a wide range of people involved in a company in order to build an accurate picture of its culture. This includes executives as well as NEDs and so it is important that investment houses ensure that they are avoiding a siloed approach to dialogue. Companies often feel that corporate governance specialists and fund managers operate in isolation from one another. Adopting a joint approach to engagement could help deliver a more holistic view and improved ability on the part of investors to understand culture. Investment houses should also pay attention to their own cultures, encourage challenge and practice what they expect of investee companies.

An increasing number of shareholders believe that corporate culture should be an important part of shareholder dialogue with NEDs. Ultimately shareholders rely on NEDs and should pay close attention to the way they are discharging their responsibilities, including around culture, when exercising their right to elect them.



Companies need to come up with their own metrics on culture and report on those, on a year on year basis, so that investors can understand what boards are focusing on and how well they are achieving their objectives.

Helena Morrissey
Chief Executive
Newton Investment
Management

Questions for investors

Do the board and senior management seem to have a clear idea of the company's purpose?

Do the company's values seem to be aligned to its business model or models?

What first-hand experience do NEDs have of conditions in the operating parts of the business?

How is the board assessing culture and how does it hold the executive to account?

How does the board take account of culture when structuring remuneration?

How does the board ensure incentives do not encourage undesirable behaviour?

How does the company deal with employees who are in breach of company rules or codes of conduct?

What actions has the company taken in the last year to reinforce culture?

Are there examples of where the company has turned down business or not pursued a relationship with a potential business partner because of a lack of cultural fit?

What steps has the company taken to ensure that suppliers meet expected standards of behaviour?

Questions for boards

How do we include culture questions in employee surveys?

Is there a forum for employees to share ideas and concerns?

How do we demonstrate we listen to the ideas and concerns from employees?

How comfortable do employees report they are with challenging and reporting bad behaviour and is there any evidence that they are doing this?

Do employees report that leaders and senior managers live the values?

Is the chief executive willing to listen, take criticism and let others make decisions?

Reporting on culture

There was strong consensus among investors that there is a need for companies to improve reporting on culture and communicate openly about the impact of culture on the business. In the annual reports of FTSE 100 companies while 48 per cent define the values of the company, and 35 per cent the purpose, only 14 per cent discuss their corporate culture.⁴² At an investor event at EY, 81 per cent of investors said that companies are not currently providing in their public reports, the information investors need to assess culture.⁴³

A good explanation of the business model and key risks can also convey meaningful insights into the culture. A commitment to report is a good discipline and can translate into a commitment to take real action on culture – what gets reported tends to get done. By focussing on what action companies have taken investors can get a sense of whether they mean what they say. Companies could also disclose non-financial metrics and practical illustrations of how it expects business to be conducted and provide more context around data that they make public.

Companies and investors agree that a uniform set of cultural measures or indicators applied across all companies and sectors may not be fit for purpose. Instead, indicators need to be relevant for investors and meaningful in the context of the specific operating environment of the company concerned. Shareholders report that they seek reliable and consistent data, which allows comparison with previous years and with others in a sector. Boards should consider carefully what information is most useful.

Efforts to encourage more consistent ways of reporting in some areas are taking place. The *Valuing your Talent* initiative proposes measures and frameworks to report on human capital including employee engagement, total workforce and investment in training and development. These may be useful indicators of culture to investors and other stakeholders and allow comparisons to be made across company, sector and from year to year.⁴⁴

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The annual report shows how our distinctive culture links to the business model and strategy. It includes customers, colleagues, corporate partners and the shareholders. It fits with the company's customer-centric brand but is wider. It's unique to the company and is our path to commercial success.

Glen Moreno
Chairman
Virgin Money

42 Black Sun, 2016. Corporate Culture: a thought piece on reporting http://bestpractice.blacksunplc.com/files/2016/culture_report_v5.pdf

43 EY Investor Dialogue event November 2015 – audience poll of 21 institutional investors <http://www.ey.com/UK/en/Services/Assurance/EY-assurance-services-cultural-assessments>

44 Valuing your talent is an initiative between UK Commission for Employment and Skills (UKCES), CIPD, CIMA, the Chartered Management Institute and Investors in People – <http://www.valuingyourtalent.com/for-external-stakeholders/external-perspectives/towards-standardised-measures>

HOW CAN BOARDS ASSESS, MEASURE AND MONITOR CULTURE?

Views are divided about the extent to which culture can be measured. The majority of the chairmen we interviewed feel that measuring culture is difficult and understanding it means drawing on information from a range of sources. A minority are more confident about the ability to measure culture.

Chairmen recognise that there are limitations on the board's ability to know what is going on in the business. This can constrain the board's ability to challenge the executive.

Management information to the board is inevitably summarised and can be presented to conceal the existence of real issues. Nevertheless, boards can do more by requesting access to relevant information; being smarter in their interrogation of that information; asking pertinent questions; probing and challenging where appropriate; and making sure action is taken when it is not satisfied that senior management is embedding the desired culture effectively. As well as requesting access to a range of information sources, chairmen agreed that spending time in the business was critical for getting a true sense of the prevailing culture in different parts of the business.

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The most important thing in monitoring culture is to have effective 'antennae'. Culture is, by definition, intangible so you really need to listen to the organisation and hear the nuances. There are also leading indicators like retention rates, staff surveys – and you can monitor externally using Glass Door, for instance. You bolt them all together to form a picture.

Coram Williams
Chief Finance Officer
Pearson

Understanding culture

There is strong agreement among stakeholders that a determined effort is required to build a picture from various indirect indicators and proxies of the true culture at different levels in the organisation.

Companies report that they struggle fully to understand the complex chain of interactions that drive individual behaviour. Traditionally, management has focussed on the mechanisms, policies and processes that make up the operational framework of the company and which establish boundaries, norms and minimum standards of behaviour.

The realisation that management and boards need to understand and address less tangible drivers of behaviour, such as closely held values and attitudes or social and power-driven pressures, that can lead people to make poor choices is changing the conversation in the boardroom. To do this justice boards need to shift focus and seek new ways of understanding what is really going on in their organisations.

This suggests that the role of the NED is changing, with inevitable implications for the skillset, diversity and experience that NEDs will add to the board in the future. Certainly NEDs will need to become more culturally aware, more tuned in and more knowledgeable about human behaviours and relationships.

NEDs will also need to be more proactive in their engagement with employees and other aspects of the business and in their modelling of company values. This will have implications for which aspects of their role NEDs prioritise and how they allocate their time. There will also be a corresponding effect on the policies, practices and processes around the recruitment, induction and training of NEDs.

When assessing culture, boards need to be aware of a number of contextual factors that can influence culture, such as history of the firm, impact of macroeconomic conditions, political and regulatory climate, market sector, degree of competition, local business environment and cultural norms.

Beyond these broader issues, they need to assess information from a wide variety of company specific sources to gain a broad range of insights into the overall culture and individual sub-cultures.

Spending time in the business

Chairmen and chief executives agree that there is no substitute for 'walking the shopfloor' to ensure the board has a live understanding of the culture at different levels of the business and is able to intervene before cultural problems take hold.

Site visits were cited as giving a good sense of what is going on, provided they were not run as 'state visits', although they are not always practical in organisations with multiple global locations and operations and such visits have their limitations. Chairmen and chief executives emphasised that site visits are not only an opportunity to find out what is going on but also demonstrate the importance and presence of the board. It is the degree of engagement and preparation of NEDs that makes the biggest difference; NEDs need to be focussed and ready to ask the right questions. An open discussion with the chief executives to prepare the ground can guide NEDs to engage in a way that reinforces the values and culture and supports management's message and reinforce culture. Debriefs with the chief executives on their return are also important and can provide useful insights for management.

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There are a number of different ways of measuring it – but experiencing it is the most valuable and insightful.

Derek Mapp
Chairman
Informa

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Receiving reports and information is all very well, but there is no substitute for going out into the business and experiencing the culture for yourself. By and large, NEDs don't do enough of this and boards should be more rigorous in insisting they do.

Adam Crozier
Chief Executive
ITV

Stakeholders agreed that informal time with executives and employees was valuable in talking through things that seemed to be out of alignment with company values and the desired culture. NEDs need to be aware that power differentials make it hard for a member of staff to challenge a senior executive.

Chairmen interviewed provided many practical examples of how they improve their understanding of how the business operates.

An important role for boards and audit committees is to spot misalignment between behaviour, purpose and values. Where they spot gaps or misalignment, they should be challenging robustly and taking action to investigate further and where necessary to redirect management. Boards need to challenge themselves and build a cultural lens into their discussions and decision-making, for example by asking questions with a culture focus.



Chairmen's top tips

Listen to the internal grapevine and pick up quiet messages

Host town halls – operations/frontline staff usually welcome the opportunity to engage

Become a customer/mystery shopper

Talk to frontline staff and the first line of supervision

Talk to external stakeholders

Ask the simple questions – generally employees know if there is something wrong

Increase visibility, for example, expose new people to the board

Meet with future leaders without their bosses

Focus on culture during induction meetings

Assess the talent pool coming up through the organisation

Conduct deep dives into business units and engage with local management

Engage with a wide range of executive directors from different business functions, who can cascade the message back into their business units

Encourage NEDs to mentor middle managers

Listen for anecdotes and personal observations

Review customer complaints and follow up



It's good for NEDs to go out into the business but they need to do it carefully. Orchestrated royal visits by herds of NEDs are in my view often not very productive, whereas individual NEDs popping in to sniff the breeze works well.

Rupert Soames
Chief Executive
Serco

Cultural indicators

Chairmen, investors and chief executives were clear that a common set of cultural measures or indicators for all companies would not be fit for purpose. What is important is that the indicators used are meaningful for the context and environment in which the company operates and relevant for the outcomes the company wants to achieve.

Boards need to ask themselves what is most relevant for their company and seek appropriate information accordingly.

Companies report using a range of information sources and tools to gain insights into culture and behaviours and make the intangible tangible. Traditional types of data and numerical indicators such as employee turnover can give a sense of scale and, as trends develop, a clear indication of the direction of travel and areas of potential concern.

Other sources offer qualitative evidence that when analysed and interpreted with sensitivity can give boards a more nuanced understanding of the prevailing culture and behaviours and offer a means of identifying cultural misalignment and the root causes of problems. Targeted efforts to gather qualitative information from employees and other stakeholder groups, for example via focus groups or interviews, can inform a more comprehensive cultural assessment and highlight cultural risks which merit closer inspection.

Digital developments have led to a vast increase in the volume of data and information that is available. Access to data and information creates new opportunities to better spot misalignment and respond to culture risk. The tools for analysing and mining those information sources and extracting the hidden messages have become more sophisticated.

The growing ability to leverage technology to assess and monitor culture risk means that boards are in a stronger position to understand how culture and behaviours impact performance.⁴⁵ Objective, evidence-based tools are already available which are capable of layering and presenting information from a range of sources and across different sites to give a clear picture. Boards need to understand and utilise technology to assess and monitor the existing culture and foster the desired culture. Boards should therefore be asking themselves whether they are using technology to its fullest and whether they have the right skills and knowledge on the board to do this.

Culture indicators presented to senior management and the board should include analysis of what the indicators mean, and draw insights from them into what they tell the company about its culture, what the areas of concern are and what recommended actions should be considered. This should capture information about sub-cultures and identify outliers. Leading indicators are particularly important, as they can help boards to spot misalignment before a serious problem arises.

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While the board cannot directly drive change, it can monitor and understand how individuals at various levels behave.

Philip Aiken
Chairman
AVEVA

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We carry out positive climate index surveys every month which provokes conversation. Scores are recorded and questions asked as to why particular sites are lower scored. Sooner or later it affects the financial results.

Nigel Stein
Chief Executive
GKN

⁴⁵ Institute of Chartered Secretaries and Administrators, International Corporate Governance Network and IBE, 2016. Report of a senior practitioners' workshop on identifying indicators of corporate culture

When assessing culture, it is important to first establish localised cultural norms against which scores can be benchmarked. This is necessary in order to get a sense for whether an individual score is cause for concern. For example, a higher incidence of whistleblowing in the USA than in Japan may be more a reflection of cultural norms than an indication that there is an issue.

A report by the Institute of Chartered Secretaries and Administrators, the International Corporate Governance Network and IBE published in February 2016 identified three main drivers of bad behaviour: corporate stress, which led people to take short cuts; excessive focus on short-term financial targets; and a tolerance of small breaches of the rules or a tendency to push at the limits of what was permitted by the rules or regulations, which allowed misdemeanour to grow incrementally. It identified the following symptoms of a flawed culture: flawed executive remuneration practices, complex legal structures, a tendency for takeovers to proliferate and lax financial discipline and excess leverage.

Our engagement identified a number of areas for particular vigilance. Where boards spot any of these things, a closer look will usually be warranted. These red flags may well be suggestive of a wider issue with culture.

Areas for vigilance

Silo thinking
Dominant chief executive
Length of chief executive tenure
Leadership arrogance
Pressure to meet the numbers/ overambitious targets
Lack of access to information
Low levels of engagement between leadership and employees
Lack of openness to challenge
Poor succession planning
Misaligned incentives and flawed executive remuneration practices
Tolerance of minor regulatory or code of ethics/conduct breaches by star employees
Lack of diversity
Hierarchical attitudes

Providing assurance around culture

Boards can turn to HR, internal audit (IA), risk and compliance and other business functions such as finance to provide much of this data. A trusted and independent company secretary can be another important source of information and conduit for those wishing to raise concerns.

A small but significant number of chief executives singled out the finance function as key to unearthing any behavioural lapses in the company.

Human resources

HR has expertise and access to many information sources which can provide a useful lens on culture and give an indication of whether behaviour is at the limit of, or is broadly in line with values and expected behaviours. This in turn sheds light on the sort of culture individuals may be encouraging or tolerating. In many organisations HR is best placed to lead cultural assessment, engagement and change, however some stakeholders felt that HR needs to further develop its skills and approach to contribute effectively to the assessment of culture.

By far the most commonly used tool for gauging culture is the employee engagement survey. More than 80 per cent of companies report conducting such a survey to capture employee sentiment. The results of these surveys are frequently shown to the board. While they are a useful source, employee engagement surveys are not, on their own, a reliable indicator of culture, and can produce misleading results depending on how the questions are posed, and whether employees feel they can answer honestly. However, when used in conjunction with other employee voice mechanisms, engagement surveys can be a powerful way to engage the workforce, and gain insight on cultural issues.

Many companies are therefore supplementing the results of the engagement survey with other sources of information, and attempting to overlay information and data points from those sources to build a picture of the interaction between values, behaviours and decision-making. For example, integrating HR measures of engagement with business performance measures such as sales and revenue to understand whether engaged employees are driving business results.

A board focus on what action is taken with the results of the employee engagement survey to identify root causes can give an indication of how committed senior management is to promoting the desired culture.

Companies that have tried in-depth surveys with a sample of employees involving interviews with staff at different levels, particularly operations/frontline staff, find them helpful and illuminating and over time they provide useful trend data.

Another development is the use of short, sharp employee pulse surveys at regular intervals to gain insight into discrete issues; regular and ongoing engagement with employees is a trend and ultimately may replace the annual survey.

A particular risk area for companies exists around the way people are incentivised. Boards should ensure they are paying significant attention to the nature and structure of incentives and the behaviour they drive. Remuneration and risk committees are in a position to support boards in evaluating alignment between incentives, values and behaviours. HR is well placed to lead discussions on structuring incentives and work with the board to develop these in line with cultural values.

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We look closely at staff turnover and customer complaints.

Ian Durant
Chairman
Greggs

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Culture goes wrong when people are more interested in what they would like the truth to be, rather than in what it is. They say a fish rots from the head but in my experience corporate rot often starts in the finance department if they forget that their principal role is to ensure that management and owners understand the truth.

Rupert Soames
Chief Executive
Serco

HR sources of insights into culture

Responses to employee surveys, especially those shedding light on middle and senior management attitudes
Succession plans
Staff turnover and absenteeism rates
Workforce diversity
Staff training data
Recruitment policies and practices
Promotion decisions
Exit interviews
Remuneration policies and practices, particularly the structure of financial and non-financial incentives
Grievance data

Internal audit

Obtaining a realistic view of the culture at the coalface is a common problem for boards across all sectors.

IA has the potential to be an important provider of assurance to the board alongside functions such as HR, and risk and compliance. For companies with an IA function, its positioning and reach are important factors. IA needs to demonstrate independence and accountability and to have effective mechanisms for communicating its concerns about culture to board members. This can begin with a clear mandate from the audit committee. In financial services firms the head of internal audit is required to report to the audit committee and this is becoming best practice for other sectors.

Results can be reported informally or formally within internal audit reports and areas of potential weakness identified can be investigated. Audit committee members and senior executives, however, must be open to the idea that the sort of hard evidence to underpin conclusions found in more traditional areas of audit will not always be available. Most heads of IA told us that assigning experienced senior auditors who understand the organisation and have sound working relationships in place with managers is key to success.

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The intensity of incentive schemes says something about the company. The focus boards put on measures other than financial is important.

Nigel Stein
Chief Executive
GKN

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The head of internal audit is a good source of intelligence and insights. He has his ear close to the ground.

Mike Evans
Chairman
Hargreaves Lansdown

Internal auditors will need to develop a broader set of skills than has been traditional, and place more emphasis on asking questions about why certain behaviours occur and understanding the pressures that are driving the behaviours. However, IA can suffer from a perception it is a backwater and is not always valued as highly by management.

The credibility of IA is fundamental and it needs to be appropriately resourced. Some companies are taking steps to strengthen its role and reputation, for example by requiring business units to be always audit ready and given no more than a month's notice before an audit. A stint in internal audit as part of the graduate training programme can give participants a better grasp of the business and a keener appreciation of the value IA can add, which makes it more likely they will use it effectively.

Compliance and control indicators of culture

Health and safety record, including near-miss reporting
Whistleblowing/speak up incidents
Promptness of payments to suppliers
Control failures and instances of poor compliance
Fines/regulatory breaches
Expense claims
Breaches of the code of ethics/conduct

External sources of insights into culture

Customer complaints
Customer satisfaction data
Supplier feedback
Social media, for example, Glassdoor

Behavioural indicators of culture

Attitudes to regulators
Senior management attitudes to employees
How management responds to IA recommendations
Action taken to deal with poor behaviour/instances of non-adherence to values

Internal audit functions are valuable and are able to provide advice on where we are missing a trick. One way to gain value from internal audit is by having them work on projects and not just doing standard visits.

Andrew Page
Chairman
Northgate

Snapshots of existing IA practice

A survey of heads of IA conducted by the Chartered Institute of Internal Auditors (IIA) in early 2016 as part of the FRC's project, found that IA works most closely with HR and risk management functions when it comes to assessing culture.⁴⁶ However, group discussions and one on one interviews conducted by IIA between November 2015 and March 2016 found little evidence of this, suggesting that, while it may be recognised as a good idea, in practice it is not happening on a significant scale.

IA's role in auditing culture is to provide independent advice and assurance to the board that the culture and values it has set are appropriate given the organisational risk context, and being lived throughout the organisation. 60 per cent of the IA heads who responded to the IIA's survey reported that their boards have established and articulated the culture they want. Where organisations have values statements, the challenge is how to gather evidence and demonstrate that the values are being lived at every level of the organisation. This is by no means straightforward. According to the IIA's survey, only a minority (20 per cent across non-financial services organisations, 42 per cent in financial services) of IA heads have been asked to assess the extent to which the company's values are evident in the behaviour of employees. To close this gap audit committee chairs could ensure that values assessment is incorporated into the audit plan.

GSK (GlaxoSmithKline) carries out a values assurance programme across all operations internationally. A multidisciplinary team spends four to five weeks on site, interviewing employees at different levels in the organisation, which enables the company to see where leaders communicate the values and how people are demonstrating them in the way they work.

The IIA's survey revealed that staff surveys, whistleblowing activity and governance structures are the most common proxies IA uses to audit culture. Other proxies include HR grievance data and exit interviews; management of customer complaints; values statements and their incorporation into recruitment and performance management; and pay, reward and incentive structures. Supplier feedback can also be a useful gauge of culture as highlighted by the Groceries Code Adjudicator's investigation into Tesco.⁴⁷

The most popular methods used to audit culture by far were interviews and observation – nearly nine in 10 internal auditors use each of these methods. Other methods include: focus groups; reputational analysis; and capturing reviews and lessons from near misses. Surveys and interviews can provide indirect insights and indicators of behaviour but the results may be skewed if employees do not feel able to speak openly and honestly.

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Internal audit is now beginning to bring up different issues compared to the past. There's now more focus on root causes.

António Horta-Osório
Chief Executive
Lloyds Banking Group

⁴⁶ The Institute of Internal Auditors, 2016. Organisational Culture: Evolving approaches to embedding and assurance. <https://www.iaa.org.uk/media/1591840/FINAL-0885-Culture-report-17-5-16-v4.pdf>

⁴⁷ Groceries Code Adjudicator, 2016. Investigation into Tesco plc. London: Groceries Code Adjudicator https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/494840/GCA_Tesco_plc_final_report_26012016_-_version_for_download.pdf

Root cause analysis, cited by 39 per cent of respondents, is an important way to get underneath the skin of the behavioural/ cultural issues. It is about looking not just at what has happened but also at why things happened. Root cause analysis can uncover organisational and process factors that may have been contributory factors, for example, how targets and incentives are set and communicated, and how appraisals are conducted.

Leeds Building Society recently conducted a standalone audit of culture using a mixture of the methods outlined above.

Boards can reflect on whether they are maximising the opportunity to utilise IA by asking some pertinent questions, such as:

Questions for boards

Is IA sufficiently highly valued within the organisation?

Does IA have the degree of independence needed or do we need to change the reporting lines for IA?

Does IA have a clear mandate to incorporate cultural issues into its audits and is this mandate written into the audit charter?

What steps do we need to take to invest in IA and develop the skills base and capabilities?

Could we do more to ensure IA, HR, compliance and risk, work collaboratively and report jointly to help us draw insights into culture?

External audit

Culture is an important consideration for external audit, in particular its work around the control environment and in identifying specific risk issues.

External auditors are not embedded in the organisation to the extent of IA so the opportunity to observe and assess culture might be more limited. In addition, the external auditors' focus will be on the behaviours which impact integrity of the financial statements and hence some aspects will fall outside the scope of a typical external audit. This makes it difficult for external auditors to give a formal view on culture as part of their audit opinion.

External assurance and observations are valuable nonetheless; it is independent and credible as it is not steeped in the organisation's culture. This can support boards and audit committees' assessment and monitoring of culture and an informal conversation with the chair, chief executive or audit committee can be a valuable source of insight.

Participants at a roundtable for FTSE 100 audit committee chairs hosted by KPMG agreed that external auditors are a useful source of insight into culture, but observed they can be reluctant to share views that are not backed up by hard evidence.

Many external auditors say they already give informal feedback on culture to audit committees, pointing out that a few leading indicators can stimulate a conversation. Some firms are making significant investments to develop their capabilities and services to measure and assess culture.

Participants at a roundtable of the top nine external audit firms hosted by The Institute of Chartered Accountants in England and Wales felt strongly that boards need to support progress in measuring culture by articulating more clearly the culture they want, translating that into behaviours and establishing benchmarks against which culture can be measured.

In the future, there is the potential for internal audit and external audit to collaborate in this area as they do in relation to assurance around financial and non-financial controls, but the IIA's survey shows that only six per cent collaborate on culture at present.

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I am happy for internal and external auditors and staff to raise issues based on a 'gut feeling'. This is all part of the jigsaw puzzle.

Nick Land
Non-Executive Director
and Chair, Codes and
Standards Committee
FRC and
Audit Committee Chair
Vodafone

CONCLUSION AND NEXT STEPS

This report aims to stimulate thinking around the role of boards in relation to culture, and encourage boards to reflect on what they are currently doing.

It sets out the key elements which boards should be considering in relation to corporate culture. This is a wide field of commercial and academic study. The reports of our coalition partners (Appendix 2) and other research referred to in the footnotes of this report provide more detailed information.

The FRC's next steps will be to:

- reflect on feedback to this report;
- update our 2011 'Guidance on Board Effectiveness', taking into account the feedback we receive;
- continue to work with our partners to encourage debate on culture and to identify and share good practice.

Please email:
culturecoalition@frc.org.uk
to get in touch.

APPENDIX 1: CASE STUDIES



OLD MUTUAL GROUP VALUES AND CULTURE UNDERPINNING STRATEGY



OLDMUTUAL

Old Mutual Group is an international investment, savings, insurance and banking group made up of four financial services businesses – Old Mutual Emerging Markets, predominantly in South Africa and Africa, Nedbank in South Africa, Old Mutual Wealth in the UK and Old Mutual Asset Management in the US.



Background

Following the financial crisis in 2007/2008, Old Mutual decided to put the customer back at the heart of the business, and knew that values and culture would be crucial to this. How the business set out its vision and strategy is made up of a customer promise – four values and six behaviours.



Action

Sponsored by the board, the group's HR function led a review of the values (integrity, respect, accountability, and pushing beyond boundaries) to see if they were aligned to the new customer-centric vision. Employees felt the values were still relevant, but they were generic and help was needed to understand what they meant in practice.

Through interviews with the top 100 leaders, a survey of employees at all levels of the group and workshops with the executive committee, Old Mutual identified six guiding behaviours that described the values in practice in the context of the new customer-centric vision and strategy:

- Aim high and take your team with you
- Customer first – they're the reason we're here
- Treat the business like it's our own
- Need to listen carefully and talk honestly
- Own our decisions, decide and deliver
- Win together and help others succeed

Employees were regularly assessed against these behaviours. Performance management included compulsory 360 degree feedback for all leaders solely around the behaviours, and this feedback

influenced individual performance scores which were linked to rewards.

Once the new behaviours had been introduced, Old Mutual looked to how it was going to measure progress with the required overall shift in culture and chose to use the Barrett Values survey across the group. Barrett differs from employee engagement surveys, as it starts with an individual's personal values, the values they perceive exist in the current organisation and the values they believe are needed to take the business forward. By identifying misalignment, the data is used to generate conversations and then actions.



Impact

The first survey in 2011 identified a number of areas of dysfunction and only two matches (of ten possible) between existing and desired culture as described by the company's leadership group. Actions to address these areas included work to focus on the customer, changing the operating model to reduce bureaucracy, changing its product offering and future scenario planning to reduce short-term focus. The result was that by 2015 the leadership group reported there were seven matches between existing and desired culture and a 'healthy' culture score. How culture is measured is now central to how Old Mutual assesses and manages cultural risk.

In March 2016, Old Mutual announced its plans to separate the group into four stand-alone businesses. Consequently, the group culture and behaviours will change again to reflect the individual businesses and the new role for the plc. This is an historical case study reflecting the position up until the change in strategy.



LEAR CORPORATION LEADERSHIP DEVELOPMENT AND CULTURAL CHANGE



Lear Corporation is a Fortune 200 automotive supplier.



Background

Recovering from a period of bankruptcy, the Lear Corporation was forced by the financial crisis to seek efficiency savings and radically alter its business model.



Action

These changes necessitated an assessment of culture. Working from an individual and organisational values perspective, HR focused on embedding cultural change through four enabling phases of culture change.

The first stage of the change, labelled awareness, involved communicating the culture change initiative through internal publicity, such as posters. Leaders were integral in communicating the change programme through clear and coherent messaging.

Lear also focused on training and development for middle managers about new business behaviours and cultural assessment techniques in team environments. This included a number of away days exploring new behaviours, led by senior executives.

Lear updated performance management programmes to embed and assess values-based behaviours, and restructured or made redundant roles which did not fit the new cultural model. They also addressed bad-behaving high-performers.

The final stage involved an assessment after six months' participation in the training for managers. This included sharing across management to ensure development conversations included values-based assessment and that leaders in the programme owned changes that enabled the new culture to develop.



Impact

The programme changed the business and Lear believe that this demonstrates the importance of structured leadership development and engagement programmes. The full effectiveness of the cultural change programme will not be understood until after the first tranche of activity; however, initial signs of improved business performance are encouraging, and show that the initiative is having the right impact on the competitiveness of the business (Gill and DiDonato 2015).



L'ORÉAL EMPLOYEE ENGAGEMENT WITH ETHICS

L'ORÉAL®

Headquartered in Paris, L'Oréal is the world's largest cosmetics and beauty products company, with 80,000 employees worldwide and sales of €25.3bn in 2015.

Background

L'Oréal's approach to ethics is about having a large international staff adhere to a common set of ethical values, engaging them, and helping them to make good decisions. This goes beyond compliance with rules and, to emphasise this, its ethics and compliance departments are separate, with the chief ethics officer reporting directly to the chief executive.

The company has four ethical principles: integrity, which enjoins people not to lie or cheat; respect, which reminds them to treat others as they would wish to be treated; courage, which encourages them to speak up if they have concerns, recognising that for many people this is very difficult; and transparency, which promotes an open environment in which there is less need for formal procedures and controls.

Action

Since 2009, the chief executive has made himself available one day every year to answer questions on any ethical matter of concern from staff worldwide through a live web chat. This is followed by a similar session conducted by each of the country managers.

Last year more than 4,100 questions were submitted, of which 1,300 were directed specifically to the chief executive. The company estimates that the web chat was followed by around 56 per cent of its staff.

L'Oréal has a network of 67 ethics correspondents. Their job is to bring ethical leadership to all parts of the business, including providing advice to employees about how to handle concerns and explaining how the group ethics approach can be adapted to local customs. They also ensure that the company's code of ethics is properly communicated, and that the relevant training is in place and they are empowered to ensure that the programme is delivered.

Each ethics correspondent serves a term of three years. The country manager submits at least two names to the chief ethics officer who interviews the candidates and has the last say on selection. L'Oréal estimates that the role takes up around 10 to 15 per cent of their time. About 20 per cent come from each of the HR or finance functions and the remainder from other disciplines.

Impact

L'Oréal believes the ethics correspondents are a good way of spreading understanding of ethics throughout the organisation. They provide leadership at a local level and help staff feel able to speak up.



TALKTALK CUSTOMER COMMUNICATION IN A CRISIS

TalkTalk

TalkTalk is a TV, broadband, mobile and phone provider. Based in London, it has a focus on innovation and value for money.



Background

In October 2015, TalkTalk suffered a cyber-attack accompanied by a ransom demand. The perpetrators stole data that could have compromised the security of the customers.



Action

The first decision the company took was to admit what had happened. There was no legal requirement to make a public statement, but the deciding factor was the desire to warn customers of the heightened risk. Beside emphasising how seriously the company was taking the situation and the efforts it was making to repair the damage, there was a strong focus on customer safety, including arrangements for them to arrange free credit reference monitoring. Internal communications and staff morale were also important and at the height of the crisis the chief executive was communicating with staff twice a day.

Less than a week after the attack, the company was able to confirm that the stolen data was insufficient on its own for the perpetrators to take money from customers' bank accounts and the police had arrested a suspect in connection with the case.

Even though their trust had been shaken, the majority of customers, when polled, thought the company had done a good job in keeping customers informed.



Impact

The crisis exposed a need for cultural change and TalkTalk will focus on team spirit and reducing silos in future.

The board has become much more aware of risk and is now asking questions in a different way to ensure that it understands the nature of the company's risks and how well they are mitigated.



BAE SYSTEMS BUILDING TRUST WITH ORGANISED LABOUR

BAE Systems is a leading international defence, security and aerospace company headquartered in London with operations in the US, Australia and Saudi Arabia.

BAE SYSTEMS



Background

The company recognises a number of trade unions and has high levels of union membership. The unions have full time conveners (trade union officials paid for by BAE Systems) in each business and site. Separately the company has a bargaining and consultation framework at group level.

The current relationship has evolved over many years and is, at least in part, a response to BAE Systems' acquisition of defence and shipbuilding businesses where there was a tradition of poor and often confrontational industrial relations.



Action

BAE Systems and the unions describe their relationship as one of trust. This is based on a culture of openness, a structure which allows potentially serious issues to be escalated and addressed before they become critical, and a recognition that, in many areas of public policy, the unions and management have common interests.

The central element is the Corporate Consultative Committee that allows BAE Systems to engage with its own union officials at convener level. This has about 30 members and meets quarterly. It discusses issues of mutual interest to the unions and the group. This allows the company to engage with unions at every level throughout the group, while giving individual sites and businesses the freedom to conduct their own bargaining on wages and other specific local issues.



Impact

The company's approach is to be as open as possible with its union interlocutors and this is valued by employees. The regular involvement of BAE Systems' senior leadership has fostered a high level of personal trust. Confidentiality is essential, and so far the record has been good, as both sides recognise the mutual advantage of the arrangements.



MARKS AND SPENCER SUPPLY CHAIN STANDARDS

YOUR M&S

Head-quartered in London, Marks and Spencer is a leading retailer of clothing, home products and food.



Background

Marks and Spencer's business model aims to create long-term value through the effective use of its resources and relationships. It manages these in line with its core values of inspiration, innovation, integrity and in touch.



Action

Marks and Spencer launched Plan A in January 2007 setting out 100 commitments to achieve in five years covering responsible sourcing, reducing waste and helping communities. It has since introduced Plan A 2020 which consists of 100 new, revised and existing commitments.

Plan A on supply chain standards means working with industrial bodies, opinion formers and suppliers to deliver innovation and working practices that will reduce hazardous waste discharges from clothing manufacture to zero by 2020.

In food production, this means an incentive for suppliers through a gold, silver and bronze benchmarking standard for human resources, environmental and resource efficiency management. Orders flow to suppliers that meet the highest standards. The company bought 32 per cent of its product from suppliers meeting at least the silver standard in 2015, up from 19 per cent the previous year. It is now looking to buy 100 per cent of products from factories that have met at least the silver level by 2020.

Deforestation is an example of an issue where it works with other global retailers and food producers to promote sustainably produced palm oil, low carbon refrigeration and eliminate food waste. This is helping the company to meet its target of zero deforestation from the use of palm oil, soy, cattle and paper materials in the company's products by 2020.

A critical part of the process is audit and assurance where it must both satisfy itself that the required standards are being met and avoid alienating its suppliers. The company has opted for defining a period in which an audit will take place.



Impact

Plan A delivered measurable savings of £160m in 2014/15 and a total of £625m since 2007. The figure relates to savings generated through reduction of waste and environmental efficiency. Some of these savings accrue to the supply chain where, for example, it has required its top clothing suppliers to install energy efficient lighting, and improved insulation and temperature controls.

However, the company does not seek to measure the financial impact of Plan A in terms of margin, corporate earnings and brand value. The trust Plan A generates with customers, as well as the impact on the morale of its workforce and that of its suppliers, will make the company more resilient and adaptable.



GSK (GLAXOSMITHKLINE) PROVIDING ASSURANCE ON COMPANY VALUES



GSK is a science-led global healthcare company that researches and develops a broad range of products.



Background

GSK's Values Assurance programme is designed to evaluate how well GSK's four values are embedded in the culture of the company, and to support the business to further embed the values.



Action

The methodology is similar to a 360 degree feedback process; it includes a leadership self-assessment supplemented by an independent evaluation. The process captures both quantitative and qualitative data to form a holistic view of the values maturity, behaviours and culture.

A number of actions were taken to address the areas of opportunity identified in the Values Assurance process. They include: creating values-based case studies for training; integrating values into recruitment and selection processes; implementing recognition programmes to reinforce values-based behaviour; storytelling to role model the values; and conducting resiliency programmes to sustain energy and good health during change. At an organisational level, the insights gleaned from the programme are being used to drive culture change across emerging markets. Priorities include promoting speak up behaviour worldwide.

The nature of the Values Assurance reviews requires a multidisciplinary team including auditors, psychologists, operational staff and those with lean six sigma experience. Values Assurance addresses a critical gap in traditional audit programmes, providing an independent perspective on leadership, attitudes and behaviours that underlie the internal control framework.



Impact

The programme is not only an important component of GSK's internal assurance plan, but delivers fresh insights that are making a difference to risk management, strategy, and GSK's reputation.

LEEDS BUILDING SOCIETY INTERNAL CULTURE AUDIT

Leeds Building Society was established in 1875 to help people save money and to buy their own home and this is still its core purpose.



Background

As a result of the Financial Conduct Authority's Risk Outlook 2014, which identified culture as a key issue for the sector, Leeds Building Society undertook a culture audit.

In order to benchmark the results of the audit and describe the existing culture, the internal audit team developed a Culture Maturity Path. Colleagues were requested to score their assessment of culture and board members were asked for their views for comparison.

Action

The audit was based on six themes in a Culture Cluster, setting the scope and approach for each theme was conducted as an audit in its own right while leveraging other audit plan deliverables wherever possible. The themes were: tone at the top, risk culture, governance, member value, aspirational values, and colleague advocacy.

Expected and actual controls for each theme were categorised into three types: enablers – the processes and frameworks in place to support the desired culture; drivers – the incentives to encourage the right behaviours, such as recruiting the right people, reward and performance management; and belief – focussed on what colleagues actually felt and believed in. Experienced senior auditors were trained to ensure consistency and get to the core of colleagues' beliefs. The responses were scored by colleagues on a scale of 1–6.

Impact

The results from the review were assessed to identify key themes for improvement. Internal audit reported these results to the board in 2015 and the chief executive has initiated a programme to implement changes. The results and planned actions were shared via the Society's intranet.

To continue their review of culture the audit team are developing cultural indicators to consider as part of audits in 2016 and to be reported to the audit committee and board.

APPENDIX 2: METHODOLOGY

The FRC held a roundtable with FTSE 100 chairmen and initial discussions with some of our stakeholders in early 2015 to identify the important themes on the subject of company culture.

We formed a Steering Group which included our partners, the Chartered Institute of Management Accountants (CIMA), the City Values Forum, the Chartered Institute of Personnel and Development (CIPD), the Institute of Business Ethics (IBE) and the Chartered Institute of Internal Auditors (IIA) to help us pursue the themes in four workstreams.

- 1. Delivering sustainable success – the role of an effective board.**
- 2. People issues – delivering alignment between culture, values, human resource practices and performance reward systems.**
- 3. Stakeholder issues – relationships with shareholders, customers and suppliers, and the impact on the wider community and environment.**
- 4. Embedding and assurance – measuring and monitoring culture, the role of internal audit, risk management and public reporting of cultural indicators.**

Together, with our partners, we held hundreds of meetings and discussions with individuals working in, directing, and advising companies, as well as academics, professional bodies and not for profit organisations with expertise and experience in company culture, to gather evidence and inform our report. We also undertook an extensive literature review.

We would like to thank Independent Audit Limited for their work to survey 44 FTSE chairmen and 33 FTSE company secretaries, and to interview 22 FTSE chief executives and 58 FTSE chairmen. This work provided rich insight into the views and practices of companies and made an invaluable contribution to the project.

We would particularly like to thank our partners for their contribution and guidance throughout the project.

Steering Group members

Peter Cheese, Chief Executive, CIPD

Philippa Foster Back, Director, IBE

Deborah Gilshan, Head of Sustainable Ownership, Railpen

Nick Land, Non-Executive Director and Chair of the Codes and Standards Committee, FRC and Non-Executive Director, Vodafone

Tony Manwaring, Executive Director, External Affairs, CIMA

Alisdair McIntosh, Director of Policy, IIA

Richard Sermon, Chairman, the City Values Forum

Charles Tilley, Chief Executive, CIMA

The reports of our project partners produced as part of this project or referred to in this report

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APPENDIX 3: ACKNOWLEDGEMENTS

Appendix 3: acknowledgements

The FRC is very grateful to all those who responded to our invitation to participate, and contributed.

A

Aberdeen Asset Management
ACCA (Association of Certified
Chartered Accountants)
Admiral
Anderson Risk
Anglo American
Antofagasta
aSource Global
Associated British Foods
Association for Insurers
and Risk Managers (Airmic)
Association of Financial Mutuals
Aster Group
AVEVA
Aviva
AXA UK

B

Babcock International
BAE Systems
Balfour Beatty
Bank of England
Banking Standards Board
Barclays
BBA Aviation
BDO
Beever Struthers
Bellway
Berkeley Research Group
Black Sun
Blackrock
Blueprint for Better Business
BNY Mellon
Board Insight
Board Intelligence
Bodycote
BP
BP and E Global
British American Tobacco
British Private Equity
and Venture Capital Association
British Standards Institute
BT Group
Building Societies Association
Bunzl
BUPA
Bwin Party Marketing (UK)

C

Cable & Wireless Communications
CAH
Card Factory
Cardiff Business School
CBI
Centrica
Chartered Accountants Ireland
Chartered Bankers Institute
Chartered Management Institute
Chiron Risk
Close Brothers
CLS Holdings
Cobham
CORE
CRSA Forum
Cutting through the Grey

D

DAC Beachcroft
DCC
Deloitte
Department for Business,
Innovation and Skills
Diageo
Diploma
DMGT
Domino's Pizza Group
Drax
DuplexR

E

EasyJet
EDF Energy
Electrocomponents
EMIS
Emperor Design
Engage for Success
Essentra
Esure Group
Ethics in Business
Experian
Expo Link
EY

F

F&C Commercial Property Trust
Financial Conduct Authority
FirstGroup
Foreign & Colonial Investments
Freshfields
Future Value

G

GC100
GCP Infrastructure Investments
GKN
Glencore Xstrata
GO Investment Partners
Grant Thornton
Greggs
GSK (GlaxoSmithKline)

H

Hansteen
Hargreaves Lansdown
Hasley Keetch
Hedley May
Heidrick & Struggles
Henley Business School
Herbert Smith
Hermes
HomeServe plc
Howden Joinery
HSBC

I

ICAP
IG Group
Imperial Brands
Informa
Institute of Chartered Accountants
in England and Wales
Institute of Chartered Accountants
of Scotland
Institute of Chartered Secretaries
and Administrators
Institute of Directors
Institute of Risk Management
IHG
Intermediate Capital
Intertek Group
Intu Properties
Investor Forum
ITV

J

J Sainsbury
Jardine Lloyd Thompson Group
John Lewis Partnership
Johnson Matthey
JP Morgan
Jupiter Asset Management

K

KBM Strategy
KPMG

L

Land Securities
Leading in Risk
Leeds Building Society
Legal & General Investment Management
Lloyds Banking Group
London School of Economics
London South Bank University
Londonmetric Property
L'Oréal

M

Man Group
Manifest
Marks & Spencer
Marston's
Mazars
McKinsey & Co
Merlin Entertainments
Morrisons

N

National Grid
Navex Global
Newton Investment Management
Next Generation NED Network
NMC Health
Northgate
Nostrum Oil and Gas

O

Old Mutual Group
Organisation for Economic Co-operation
and Development

Appendix 3: acknowledgements

P	T
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Pensions and Lifetime Savings Association	Thomson Reuters
Polymetal International	Tomorrow's Company
Poundland	TR Property Investment Trust
PricewaterhouseCoopers	Trades Union Congress
Prudential	Travis Perkins
Prudential Regulation Authority	TSB Banking Group
Public Concern at Work	Tullow Oil
PZ Cussons	
Q	U
Quoted Companies Alliance	UBM
	UBS Asset Management
	UK Financial Investment
	UK Shareholders Association
	Unilever
	Unipart
	USS
R	V
Railpen	Value Alpha
Rathbone Brothers	Vectura Group
RELX Group	Vesuvius
Rentokil Initial	Virgin Money
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Rio Tinto	
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Royal Bank of Scotland	
Royal Dutch Shell	
Royal London Asset Management	
Royal Mail	
RPC Group	
S	W
Santander	Wolseley
Schillings International	Woodford Funds
Schroders	Workspace Group
Serco	WPP
Severn Trent Water	
Shire	
Simmons & Simmons	
Sky	
Slaughter and May	
Smith & Nephew	
Spencer Stuart	
Sports Direct	
St. James's Place	
St. Modwen Properties	
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Standard Chartered	
Standard Life	
Standard Life Investments	
	Y
	Yorkshire Building Society Group

Financial Reporting Council

8th Floor
125 London Wall
London EC2Y 5AS

+44 (0)20 7492 2300
www.frc.org.uk