CIMA

Chartered Institute of Management Accountants

A LONG-TERM FOCUS FOR CORPORATE BRITAIN – A CALL FOR EVIDENCE.

Key messages

- It is important to explore what drives long-term corporate success as well as focus on perceived failure. A fruitful area of focus is to look at those UK companies which are genuine world leaders and consider how they grapple with challenges such as investor short-termism.

- While we would accept that short-termism has negative consequences, it is important to assess its relative significance compared to other factors eg performance-related issues such as strategic clarity and execution.

- It is important to understand and communicate the major drivers of long-term success such as quality information and reporting as well as clear articulation of the business model. The key question to ask is what are the performance factors that create world-class successful businesses.

- It is essential to grasp the limitations of regulation and the increasing acceptance that behavioural factors are key in achieving effective governance. Good governance will always be work in progress and it is likely that there is no single regulatory structure that will solve all corporate governance problems.

Introduction and general remarks

CIMA welcomes the opportunity to respond to this consultation. You will be aware that we have also submitted a response to the earlier consultation on the future of narrative reporting. We also note that this review forms part of the overall Growth Review, the objective of which we are pleased to support.

CIMA has made an active contribution to the global corporate governance and reporting debate for many years. We are currently members of the Tomorrow's Company Good Governance Forum (which we understand will be submitting a separate response) and the Report Leadership Group (with PWC and Radley Yeldar). With the latter group, we are currently working on a report looking at effective governance reporting.

CIMA's perspective on governance

Boards should be focused on the long-term sustainability of their business. They should be confident that their business models will deliver this – with appropriate risk

mitigations as necessary – and that performance indicators and incentives reinforce the desired behaviours.

Corporate governance – developments in the UK, CIMA briefing July 2010, http://www.cimaglobal.com/Thought-leadership/Research-topics/Enterprise-governance-restoring-boardroom-leadership/

With 172,000 members and students operating in 168 countries at the heart of business, we have a global perspective on what drives the world's most successful organisations and we have endeavoured to bring this perspective to the UK government's current consultation. Within the last year, for instance, we have published reports focusing on sustainable business in South Africa as well as Asian governance. We believe that it is essential to consider 'UK plc' within the context of a global environment. Ultimately, CIMA's goal is to contribute to the overall health of the global corporate sector.

At the heart of this current review is, we believe, the objective to create world-class sustainable businesses. We share the UK government's desire to create the conditions in which businesses can thrive in the long-term. We believe that the UK government should formulate and communicate a corporate mandate – this could be a powerful and inspirational statement as to how the UK plans to make its way in the world. This is particularly important in the current rather negative climate. Such a mandate could contain a clear articulation of the UK's strengths and core competences. We have based the idea of the mandate on the work done by the Tomorrow's Good Governance Forum on the case for the 'board mandate' and which is likely to be raised in its separate response to the review.

Nevertheless, we recognise that the primary area of focus is the system in which companies operate and we note that the questions posed are very much in this vein.

We understand that the Cadbury takeover has been disquieting and there is a temptation to hold such examples up as more evidence that all is not well with UK plc. Yet, there are many UK success stories and we would like to see the balance of the review redressed by focussing on what creates success rather than dwelling on perceived failure. There are UK companies which are genuine world leaders and perhaps a fruitful area of focus would be to look at how such companies grapple with challenges such as investor short-termism. This focus on success is at the very heart of CIMA's philosophy of enterprise governance. In essence, this considers both the 'conformance' aspects of governance such as board structures and investor relations

together with the 'performance' aspects such as formulation and execution of a robust, sustainable strategy. CIMA's project on enterprise governance established through a series of global case studies that while good corporate governance can help to prevent failure, it cannot on its own create success. Strategy and performance are key. A summary of this work can be found in a recent CIMA report *Enterprise governance – restoring boardroom leadership* (see http://www.cimaglobal.com/Thought-leadership/Research-topics/Enterprise-governance-restoring-boardroom-leadership/).

Issues to consider – the review in context

Some of the questions in the review are very broad-ranging and difficult to answer. As you will be aware, a number of them, particularly those on the role of shareholders have been the subject of considerable debate in recent years and will continue to be so. These are not questions that lend themselves to quick, easy solutions and the best that may be achieved is to articulate and continue the debate. This is the perspective from which we have prepared this response.

We believe that there are a number of key broader issues or questions to consider putting the more specific review questions into context:

- How significant are such issues as investor behaviour in determining corporate success - in comparison with others such as board behaviours, management ability and so on? We will explore this in more depth, but we would like to propose the hypothesis that organisations that focus on long-term sustainability with a well-articulated and coherent strategy will succeed 'whatever the weather' or whatever the ownership structure. This is consistent with our performance focus on long-term sustainability and our endorsement of such tools as the board mandate.

- Is there sufficient understanding and communication of what drives long-term success? Good narrative reporting is relevant here. As we emphasised in our response to the narrative reporting consultation, CIMA believes that effective narrative reporting is a sign of a well-managed organisation and can drive improved decision-making eg in relation to takeovers. We therefore believe that there needs to be sufficient consideration of the role of effective information in driving improved decision-making right along the corporate governance supply chain. As part of the UK corporate mandate, it is also essential to communicate the importance of why focussing on the long-term benefits everybody with a clear articulation of how it works eg why focussing on customers is crucial. This may be stating the obvious, but we believe that it would be of considerable

value. CIMA's stewardship model (see Appendix 1) clearly demonstrates the key areas of focus when articulating a sustainable business model. In summary, these include understanding the external environment and the associated strategic risks and opportunities, generating a range of strategic options and the capacity to evaluate these and select, then moving through to effective implementation. Critical areas of focus of the business model that organisations and their boards must focus on are cost leadership, durability of the supply chain, motivating staff and attracting and retaining customers. In a similar vein, the 'board mandate' includes such questions as 'how do we make money?' and 'how are we investing in a sustainable future?' It appears that during the last crisis, some boards did not know the answers to such questions. Better board understanding and articulation of the business model would therefore represent a significant step forward.

- It is essential to take account of some of the current thinking on corporate governance. The global financial crisis has provoked considerable soul-searching, not least in the UK. Our reading of the situation, however, is that there has been widespread recognition that there is a limit as to what further regulation can achieve. The emphasis has very much been on behaviours and ethical values. As Mervyn King, Chairman of the King Committee in South Africa recently pointed out, rule-making cannot be the basis of governance as it tends to distract from performance. He argues for a move to value-creating systems based on principles. It is also notable that the Walker Review concluded that 'the principal deficiencies in boards related more to patterns of behaviour than to organisation' and that the revised UK Corporate Governance Code puts particular emphasis on the spirit rather than the letter of the code. We do not believe that the current review has taken sufficient account of this current thinking on the behavioural dimension of corporate governance.

- There is understandably a temptation to look for the silver bullet in the form of the right 'regulatory structure' that will solve all corporate governance problems. But in this regard, it is well to consider the views of the former Chairman of HSBC, Stephen Green. He has pointed out that the market system has many failings, but it is the best we have and it is necessary to continue to learn lessons from corporate failures. But it is always work in progress. In keeping with the above paragraph on behaviours, his view is that regulation is necessary but not sufficient. It is not possible to devise rules to create good behaviour. It is therefore essential to look at questions of purpose, ethos and responsibility. Our conclusion from that is that the key corporate governance question is not just

about short-termism, but there should be questions of value and values. These are not mentioned in the consultation.

- Lord Green has also highlighted the importance of the sustainable and profitable business model – customer relationships have to be sustainable and employees need to be engaged over the longer-term. His view is that no company will get this right all the time, but it is better to do this than to adopt cynical short-termism. Leadership by the board with a clear understanding of purpose with a long-term focus is essential. Regulation cannot achieve this. We believe therefore that it is essential to recognise the limitations of regulation in achieving good corporate governance. In our submission to the FRC in respect of the review of the UK Corporate Governance Code, we suggested that case studies of good practice could be useful.

- In recognising the limitations of regulation in achieving the 'right behaviours', a good example can be found in the UK Corporate Governance Code which stipulates quite clearly that boards are responsible for long-term success – ie 'the purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company'. Similarly, Section 172 of the Companies Act 2006 states that company directors must have regard to the long –term consequences of their decisions. Proof that it is possible to legislate for long-termism, but it still may not be possible to achieve it in practice. One difficulty is that it is not always apparent and agreed between all parties what is actually in the long-term interest of the company.

- It is our view that companies can and do have long-term vision and we are not persuaded that structural governance factors are as powerful as is often thought. Successful companies seem to be so whatever their mode of ownership although it may be worth asking the question as to whether certain industries are better suited to particular company forms. We would therefore caution against excessive focus on 'conformance' or regulatory solutions. We believe that a more productive approach is to ask what are the performance factors that create successful world-class businesses.

- Alongside rebalancing the focus of the review on to performance issues, we would also emphasis the value of good information and reporting. We believe that these can address or at least mitigate some of the perceived or actual structural shortcomings of the current governance system.

Boards of directors

The question of whether boards have a long-term focus is probably not one which can be answered with a simple 'yes or no'. There are a number of factors which impact on this focus, some of which are addressed above. An additional question to ask is the extent to which long-term focus is affected by external economic pressures. The challenge for businesses is to maintain a balance between the short-term and the long-term. The extract below is from a recent article in CIMA's *Excellence in Leadership.* Although the company quoted is a US one, the points are equally valid in the UK context.

The tension between short-term gains and long-term investment is a feature of any business, and shapes how crucial issues such as business transformation are dealt with, but for a business as diverse and international as Pitney Bowes it is especially important to find the right balance…..the accent has to be on the long term even if the strategy of some investors is sometimes focused on short-term gains. 'You need to decide what is best for the business, and you need to attract the right type of investor. We can't look just at the next 90 days. We must look at being around for the next 90 years,'..

Maintaining this long-term view becomes harder, however, when the wider economic environment comes under pressure, as it has during the financial crisis…..This has brought short-term indicators of market direction to greater prominence,….but this trend should not force the CFO to put too much emphasis on cost-cutting. Innovation is the driver of long-term success and the goal for any global company should be to increase efficiency while also developing new products and services for the future.

Clear direction, Excellence in Leadership, Issue 17, Winter 2010/11, CIMA

Shareholders and their role in equity markets

As you will be aware, there has been extensive debate on the role of shareholders in equity markets and this remains very much a work in progress.

As CIMA indicated in its response to the FRC in relation to the proposed Stewardship Code, we supported the code but expressed the view that it should not be regarded as the complete solution to what is a complex problem and that careful consideration should be given to the costs and benefits of operating such a code. We said that we would therefore like to see development of the proposed code as part of a broader review of the shareholder's role in good governance. The changing pattern of UK share

ownership – and, in particular, the increasing importance of foreign investors – may mean that there is simply not the critical mass of investors prepared to exercise an active stewardship role. It would therefore be appropriate to assess the extent to which the phenomenon of 'ownerless corporations' is a reality and the consequent implications. This should then lead to the generation of a range of possible options designed to address this link in the chain of accountability such as incentives to support greater investor engagement.

We also felt that another key factor that could contribute to improved investor engagement is better reporting.

We argued that it was important to have realistic expectations as to what active shareholder engagement could achieve. While the issue of stewardship should be addressed, we believed that the area where there was greatest scope for effecting significant improvements in practice was that of boardroom performance and behaviour. We emphasised that this should remain the primary area of focus for governance reform.

Building on our views in relation to the Stewardship Code, it may be useful to look at the governance chain as a whole – not just focus on shareholders. For example, the media also has a key role to play. The question we should be asking here is 'how can we ensure that companies are getting the challenge and/or oversight they need which serves the public interest and which will help them to succeed?' – even if that challenge is not comfortable. We may need to accept that this constructive challenge does not necessarily need to come from shareholders.

It is also worth reviewing the current debate on the primacy of the shareholder and shareholder value – which is by no means universally accepted. As one US academic has pointed out, different stakeholder groups contribute to success and it therefore does not make economic sense to concentrate solely on shareholders. These views have been more recently articulated by industry leaders such as Paul Polman, Unilever CEO who has been quoted as saying *I do not work for the shareholder, to be honest; I work for the consumer, the customer. I discovered a long time ago that if I focus on …the long term to improve the lives of consumers and customers all over the world, the business results will come.*

Directors' remuneration

CIMA has produced a number of reports on this issue, most recently *Executive remuneration schemes and their alignment with business sustainability.*

(*http://www.cimaglobal.com/Thought-leadership/Research-topics/Sustainability/Executive-remuneration-and-sustainability/*)

This also refers to some earlier work we did as members of the Report Leadership Group on executive remuneration reporting. We talked with investors as to what they wanted when they looked at the remuneration section of the annual report. Their needs were clear:

- A description of the overall policy, principles and purpose behind each element of pay
- A prominent display of the main elements of pay and how they were calculated
- An explanation of how strategic aims are reflected in executive awards
- Details of how executive rewards are aligned with the shareholders' interests
- An explanation of how under performance could affect executive compensation
- Clear messages backed by evidence, including comparisons with relevant peer groups.

We believe that a good remuneration report which has as its main aim to be a communications tool, can play a significant role in assisting scrutiny and accountability.

Takeovers

This is not an area of particular expertise for CIMA, but we note recent developments in relation to the Takeover Code.

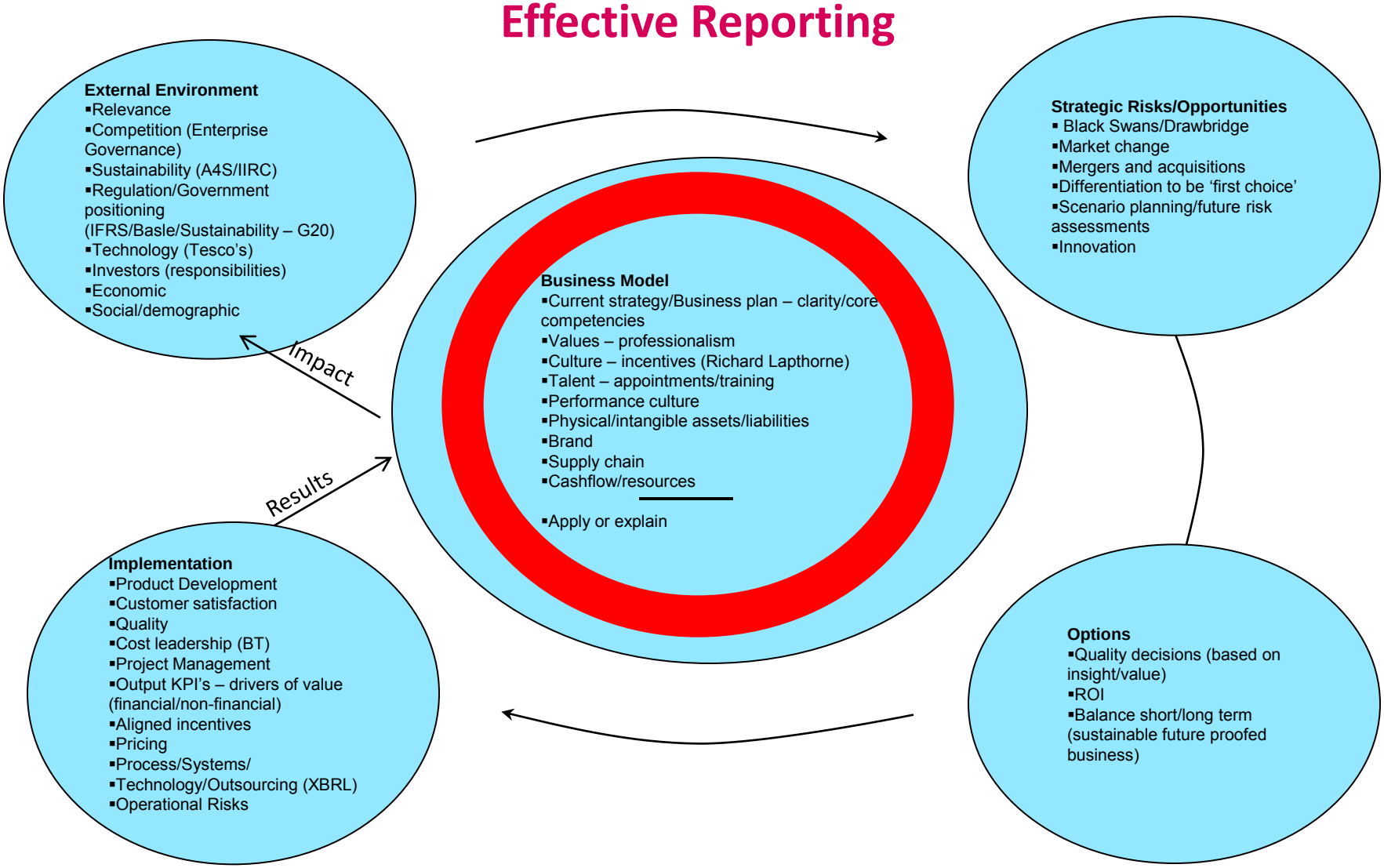
Clearly, the quality and scope of information relating to the case for and against proposed takeover is crucial. In addition, there is also scope for exploring and articulating the economic case for takeovers in more detail. Our own limited research in this field bears out the view that ability to succeed at mergers and acquisitions is a 'core competence, which businesses need to consciously develop as part of a coherent long-term strategy.

Concluding remarks

We trust that these comments are helpful and we look forward to participating further in the government's reviews on corporate governance and reporting. We would be pleased to discuss any aspect of our response in more detail.

January 2011

Stewardship – Driving a Sustainable Business Model – Effective Reporting



▪Economic environment – 'perfect storm'
▪Globalisation – Technology, complexity, transparency, speed
▪Quality information, analysis – specific to needs - transparency
▪Fair value – trade off relevance and reliability
▪Audit/assurance – professionalism, liability –'substance over form', prudence
▪External Reporting – Narrative (MDNA/OFR)/Financial (IFRS)/Report Leadership/cost – value management commentary – PWC/TMC
▪Litigation/'safe-harbour'
▪A4S/IIRC