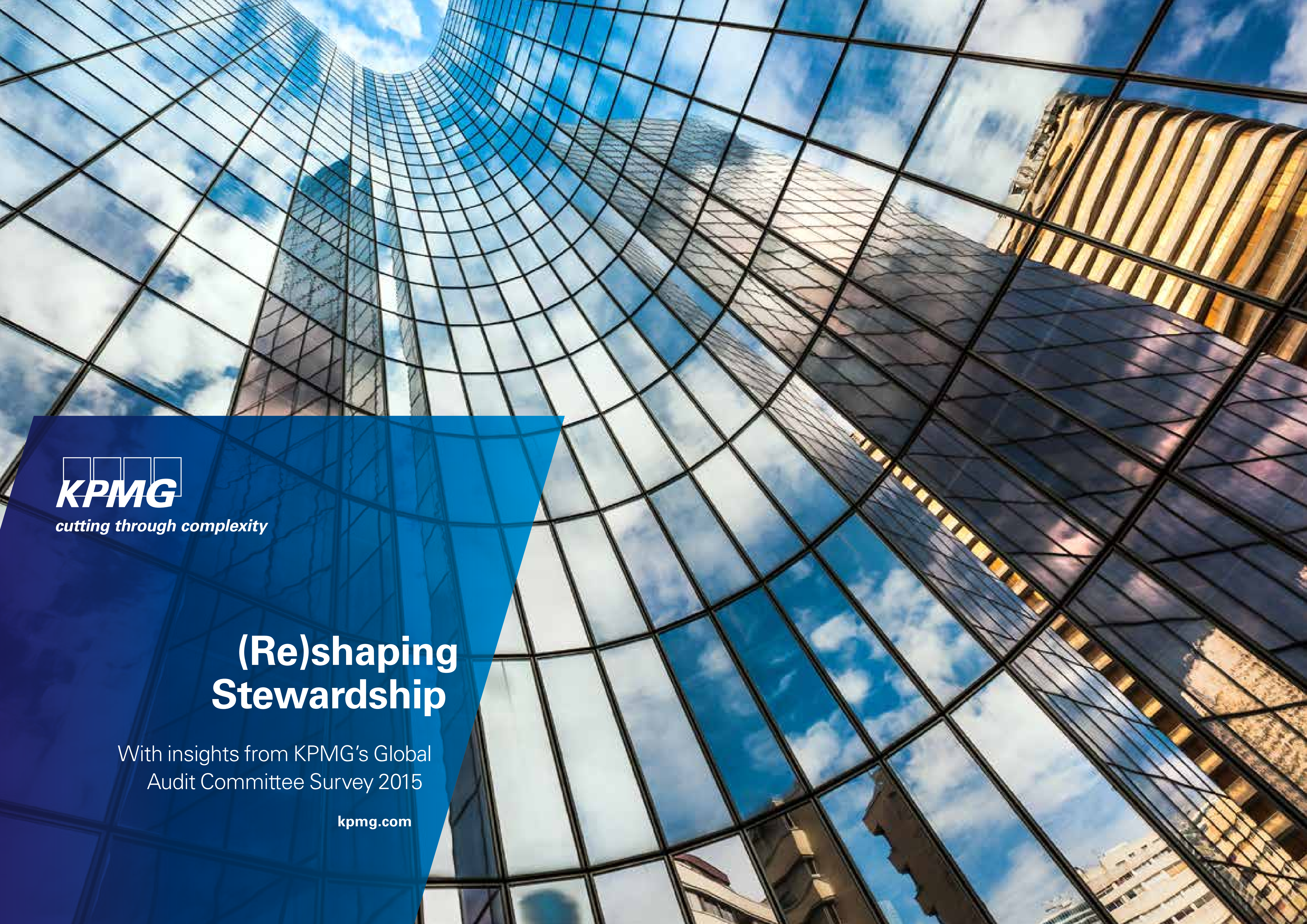

KPMG

cutting through complexity

(Re)shaping Stewardship

With insights from KPMG's Global Audit Committee Survey 2015

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Introduction

The concept of stewardship has been around for as long as people have been asserting ownership over more things than they can, literally, keep in view. Historically a steward was the overseer of a large household or estate, the collector of taxes and the keeper of keys. Although not always popular, think of Malvolio in Twelfth Night, they were the right hand of the owner, whose household would have descended into chaos without them.

Stewardship is now recognised as the assignment of responsibility to safeguard and shepherd the valuables of others. People have a natural desire to instil accountability in those entrusted with managing other people's assets and it's from this instinct that corporate governance and audit were born.

Developments in legislation and regulation, along with the ever increasing speed of decision-making required in the modern business world all test the existing stewardship model. On top of those pressures, the financial crisis has led to calls for an even more fundamental rethink of managed investment structures.

Four of our experts on corporate governance and audit give their opinion on areas that need to be addressed as the stewardship model is increasingly stretched. We will look at their ideas and marry those with findings from the recent KPMG Global Audit Committee Survey, to give a fresh perspective on the stresses and structures of contemporary governance.

Tim Copnell, chairman of the UK Audit Committee Institute, leads with the argument for greater diversity of thinking on Boards. This isn't about equal opportunities to do with race, gender or sexuality, all of which are entirely valid points, but more the psychological make-up of Board members.

The board: more than the sum of its parts

Tim Copnell

Non-executive directors are expected to develop strategy and ensure the robustness of executive decisions. But they need to be recruited on the basis of their skills and behaviour, not just their gender, ethnicity or social profile.

I believe for a Board to be effective, it has to be an effective team – and non-executive directors have to work as part of that team. I would hope the combined use of people's talents on a Board results in it becoming more than the sum of its parts. But I think there's the danger of the opposite happening – a Board becoming weaker than the sum of its parts.

I'd compare an effective Board to an effective football team. You can spend millions on some of the greatest players in the world, but if you play them out of position, if you don't create an effective team, you still risk being turned over by lower league sides.

The real meaning of diversity

Diversity is very much a hot topic – and rightly so; there isn't any good argument to be made against the fundamental fairness of creating a truly level playing field. If a business starts by identifying the skills it needs, then goes fishing for these using fair processes in the widest possible pool of talent, the resulting board should be more visibly diverse.

But for Boards to operate effectively they also need a less visible diversity – diverse thinkers.

Cognitive diversity can help produce a group of individuals that together are greater than the sum of their parts. A business that recognises the need for a range of thinking patterns, behaviours, problem-solving styles and strengths in leadership is actually aspiring to real inclusivity.

This is increasingly recognised by audit committees with 38% of respondents to the Global Audit Committee Survey advocating greater diversity of thinking, background, perspectives and experiences, with a further 23% calling for 'fresh thinkers' on the committee.

Accordingly, I don't think that Government should mandate the composition of Boards by gender, ethnicity or age. These are just elements of diversity, not the full picture. So, instead of assuming that women are less risk-averse than men and recruiting non-exec Board members on that basis, let's psychometrically test all current Board members and candidates.

A recent UK survey of 165 members of KPMG's Audit Committee Institute, sought an unscientific picture of its member's cognitive attributes. The results were not entirely unexpected; they indicated a relative shortage of individuals that are risk adventurous, detail people, ruled by their hearts and autonomous rather than collaborative! You can imagine needing more than one individual to fill that particular cognitive lacuna.

The Global Audit Committee Survey responses on where audit committees expect to be spending more time also show 'traditional' issues, such as tax and the external audit giving way to new areas like pace of technology change and cyber security instead. Uncertainty and volatility emerged as the greatest challenge or concern for audit committees; perhaps Boards need more members who can tolerate ambiguity.

Ideas around diversity of thinking potentially also throw light on to some of the findings around the quality of Board interaction with other management. Despite their concerns about technology risk, almost 50% of audit committees say the communication with their CIO could do with improvement. Could this communication difficulty reflect a clash of thinking styles?

The board: more than the sum of its parts

Tim Copnell

When I took the Myers-Briggs personality test, it showed I was introverted, intuitive, feeling and judging. I suspect that's quite a rare combination in my profession. So, even though I'm a 49 year old white guy, in those respects, perhaps I am a desirable member of a diverse cognitive team.

In contrast, there's no guarantee a female non-exec director who has been to public school, Oxbridge and then spent 30 years at the same merchant bank is any more diverse than the average so-called stale white male. They just have different chromosomes. It's just as dangerous to assume women are more likely than men to challenge norms, just because they are women, as it would be to assume the opposite.

Supporting Board mavericks

That brings me to question the idea that the best way to avoid group-think on a Board is to fill it with non-execs who are mavericks or lone voices. That's just as likely to lead to indecision, frustration and paralysis. Instead, disruptive thinkers need to be paired with strong managers; visionaries with pragmatists. That's what creates the right tension and balance.

It's certainly a good idea for Boards to recruit non-execs with hard skills outside their own organisation's area of expertise. For example, a high-street bank should acknowledge it's a retail organisation – maybe they need to recruit a non-exec from Primark or M&S. It's also a provider of mobile phone apps, so why not appoint someone from the tech sector to the Board? In fact, one of the ways HSBC has set an example is by recruiting an ex-MI5 chief to its Board.

Changing the non-exec role

Boards need to have a diverse mix of soft skills as well as hard skills. They need to appoint non-execs whose whole approach to life is different; people who have emotional intelligence and are used to the speed and energy of the contemporary world of work. It's not a question of whether they're young or old. It's more about whether they're in sync with modern work rhythms. But given every generation is expected to live longer and work longer than the one before, even if non-execs are older, it doesn't mean it's the last job they'll ever have. This is not a role for people who see it as a nice, easy wind-down into retirement.

The issue here is really a cultural shift. I believe the role of the non-exec director needs to be rethought so that it becomes more of an active, developmental stage of a career. If we are to populate successful Boards of the future maybe we should plan their development. This could include senior execs/non-execs at FTSE 100 companies – who are very bright, very talented – sharing their time and expertise with companies a bit lower-down the listing order: a win-win situation.

Audit committees have also been shown to be concerned about CFO succession planning with 42% rating their committee as not effective in this area. Given that they interact and communicate more effectively with the CFO, 66% rating their communication as excellent, than with any other individual or function this is no small concern. The relationship between the CFO and the Board is absolutely key. To get the best talent, they need to be searching as widely as possible – not just among clones of the current model.

All of this brings me back to the profound belief that Boards will need to fish in the widest possible pool of talent to find a Board that collectively has appropriate, inclusive diversity. Their very success may depend on it.

Tim argues for a greater spread of skills and attitudes in order to get the best out of Boards. Unsurprisingly there's a dearth of risk adventurous non-exec directors out there – maybe there's a place for them too.

Governance should assist Boards in ensuring the best outcomes for their business and their shareholders. However, the increasing levels of complexity can create more problems than they solve. Hugh Green, audit partner at KPMG UK, takes a look at the emergence of a governance arms race. While it's not a killer blow, it can act as a slow strangulation of entrepreneurship. If the code begins to work against them, Hugh argues that Boards should have the confidence to use the flexibility it allows.

Ending the governance arms race

Hugh Green

It's fine for big organisations to comply fully with the UK Corporate Governance Code, but more entrepreneurial businesses should have the courage to explain why it doesn't always work for them.

I believe that investors back a business because they believe in the strength of its management team, not because it adheres in all particulars to the UK Corporate Governance Code. Investors should set the ground rules for governance and then be prepared to let management get on with running the business. They shouldn't let red tape get in the way of what makes a business successful in the first place.

The Code explicitly states that companies can adapt its standards to fit the way they operate. It's pretty clear – there's a 'comply or explain' approach. What that means for me is that if a company lacks any of the governance provisions specified in the Code, they should explain why they don't need them and why they have confidence in their own decision-making process, rather than complying with the Code just for the sake of it.

Code as strait-jacket

I don't think we should expect everyone to comply with everything in the Code. When that happens, it becomes a strait-jacket. Either companies think, "Oh well, here's another load of paper-work, let's just get on with ticking all the boxes and get it out of the way." Or they think, "We can just pay lip-service to all this nonsense and carry on doing what we've always done."

I suspect that quite a lot of companies think like this. As a result, they have a governance model which is a kind of mirage. And investors are complicit in this. They are keen to see all the Code's boxes ticked but don't really want to clip management's wings. They want it both ways, really – the high returns that come with extra risk and the perceived safety that comes with layers of compliance.

Governance arms race

This kind of thinking contributes to something I call the governance arms race. The corporate governance community is pretty small and word tends to travel fast within it. As soon as someone comes up with a new process to add to the governance model, suddenly everyone else adopts it as well, just to be on the safe side. But no process is ever removed. It's like with the statute book – things are always added, but nothing is ever taken away.

A significant majority of audit committees surveyed felt the amount of time required to carry out their responsibilities had increased either moderately or significantly over the past two years. There is an increase in areas that are being covered, on which many audit committees wish to spend more time: 55% would like more time to deal with cyber security; 40% with emerging technology; 40% on the adequacy of internal controls; 36% on succession planning among others. However, the number of areas that they believe require less time are in single digits. In reality, they can't endlessly add to their workload without taking anything away.

I believe that traditional process-driven approaches to governance can stifle innovation and make it hard for an entrepreneurial culture to thrive. This manifests itself when a reasonably fast-moving business comes to the stock market for the first time and has to start following the Code. They are being asked to change the way they operate. And that means the features that made them successful – informal governance, short lines of control, rapid decision making – are suddenly much harder to maintain.

Variety in governance

Some might say that strict compliance with the Code is the price a business has to pay for access to the capital markets. And that's fair enough when it comes to big organisations. For example, I would rightly expect any of the major banks to have governance coming out of its ears. But shareholders are not backing an entrepreneurial business in the same way they're backing a big bank. They see how a chief exec has been successful and expect that by backing him or her they can enjoy some of the benefits of that success themselves.

I believe that businesses should identify what works for them in terms of governance, and then be brave enough to say 'no' to any parts of the Code that don't. So, for example, a business may think that rather than having to hire lots of non-exec directors, they may prefer their chief exec to simply get on and run things. If that's the governance model that enables them to deliver best value to investors, they should be prepared to take the 'explain' route rather than complying with an approach they don't really believe is working.

This insistence on complying with all aspects of regulation, has led to Boards which are heavy on legal and regulatory compliance expertise, and light on technology expertise. This links back once more to Tim Copnell's point about a lack of diversity. How can Boards cover all the bases if they're being forced to focus so heavily on the regulations?

John Hughes, Audit Partner at KPMG UK, takes up this challenge in his article on the unrealistic expectations placed upon audit committees. John feels that there are challenges faced by companies and non-executive directors that need to be owned by a wider tranche of society. Audit committees simply don't have the time and resources to act as goalkeepers for every problem, particularly if they're not getting the information they need.

Stewardship stretched to breaking point?

John Hughes

The traditional model of stewardship has taken a knock since the financial crisis. But it's no good just blaming companies and non-execs. Society should recognise there are deeper problems that need solving.

Society has traditionally deemed that executives should run the company, audit committees and auditors should hold them to account, and fund managers should analyse companies diligently and allocate capital to the best opportunities. And I believe that is still what most people expect to happen today.

There are clearly problems with this model of stewardship, many stemming from the distance, and consequent lack of communication, that exists between the underlying owners and the directors of modern listed companies. However, I think that in the wake of the financial crisis, not all of these problems have been getting society's attention.

People have wanted to blame companies and non-executive directors for the crisis. But I think this distorts the natural, healthy tension that should exist between all the component agents of stewardship. Too much pressure is being put on companies and non-executive directors to fix problems that should be more widely owned. It's certainly unrealistic to expect a non-exec to have the time or resources to act as a goalkeeper for every potential issue that may arise.

I can think of at least four problems that have not received the attention they deserve, and which society as a whole needs to review.

Hard-pressed fund managers

First, fund managers are not necessarily focused on, or equipped to perform, the long-term oversight role that the governance model implies. Many funds explicitly state that their investment strategy is not long term. Even where it is, they need good short-term results to compete. Fund managers are also deluged with information. Most of them employ few analysts relative to the number of investments they hold and cannot do the in-depth analysis of companies that their oversight role requires. So who's going to fill the oversight gap?

Muddled approach to reporting

Second, company reporting is in a muddle. Reporting traditionally consisted of producing hundreds of pages of rules-driven data. It was assumed investors would analyse this in detail and draw the right conclusions from it. The crisis showed that, in practice, this did not happen. People often ignored the data. So I don't see how anyone can say that the way to improve reporting is to demand even more data – as if it were cost-free! Stakeholders need to decide what they really need to understand the business. And they need to identify where story would be more useful for them than data.

Unclear government regulations

Third, government is increasing the role of regulations in business in a way that creates uncertainty and undermines investment. I'm not saying that some regulation isn't needed, but the objective of much of it is unclear and it's often not very well connected. So, for example, I agree that banks should hold more capital and liquidity. But six years on from the crisis, regulators still haven't defined the amounts or explained how this might optimise growth in the economy.

In fact, 58% of Audit Committee Survey respondents rated the quality of information on the impact of public policy initiatives as generally good but with periodic issues arising, and a further 15% stated it needed improving.

Unrealistic attitudes to risk

Fourth (and last), expectations of corporate governance are inappropriate. The measure of good governance shouldn't be a total absence of any corporate failure. That's not the way the capitalist system works. Capitalism is a risk-taking business. The US economy can destroy 15% or more of its economy's jobs each year, but normally creates more. It's by this creative destruction that economies develop. Until there is an acceptance that companies will fail and that, within reason, this is healthy, it will be impossible for corporate governance to meet the unrealistic expectations placed upon it.

To sum up, I think society should face up to the fact that the accepted model of stewardship is throwing up lots of problems that companies and non-execs can't be expected to solve by themselves. Responsibility needs to be spread more widely and links between companies, audit committees, auditors and fund managers straightened out. It may even be that the received model of stewardship needs rethinking in its entirety, but that's a topic for another time.

The Audit Committee Survey's investigation into agenda and workload identifies this issue of audit committees being asked to take responsibility for areas that they simply do not have the capacity to cover. 40% of respondents indicated that it was increasingly difficult to oversee the major risks on their agenda in addition to carrying out their core oversight responsibilities. There is a limit to what audit committees can achieve, particularly if reporting is muddled and government regulation is unclear.

In his conclusion John indicates that the entire stewardship model may need an overhaul. In his second article, Tim Copnell takes on that exact challenge when he calls on investors to hold management to account, and proposes a new structure for stewardship.

Tim Copnell

The stewardship pyramid?

Along with clear accountability, relevant and reliable information is the life-blood of the capital markets. If it fails to flow freely between all invested parties, then confidence in the capital markets is lost and the economy, jobs and future pensions will suffer.

The effective stewardship of any large company depends upon the quality of relationships between four sets of people: management (primarily the Chief Financial Officer), the audit committee, the external auditor and the investors. Conceptually their relationship can be viewed as a pyramid. The CFO, audit committee and auditor sit at the vertices of an equilateral triangle while the investor sits above at the apex of the pyramid.

This is not just an exercise in geometry. It is really important that distance between the CFO, audit committee and auditor is appropriately balanced. The investors sit above because the roles played by the CFO, audit committee and auditor need to be transparent to them.

The new reporting expectations enshrined in the UK Corporate Governance Code and associated Auditing Standards are designed to provide investors with insights into how the CFO, audit committee and auditor triangle is balanced, including how the audit committee and auditor are working on behalf of the shareholders. This provides a small window of opportunity for the major players in the 'stewardship pyramid', to restore confidence in the UK's once acclaimed corporate governance framework. If the key players can't get it right, and soon, then perhaps the whole governance framework will need revisiting.

It's no longer sufficient for audit committees to provide robust oversight behind closed doors. Robust oversight must be seen to be happening which means audit committee reports need to become better at showing investors what the audit committee has done on their behalf.

I have seen some good examples in the first reporting season, but many still provide little insight into what the audit committee actually does, why it does what it does and what it concludes. In short, little information as to how well the audit committee is fulfilling its governance role.

Auditors also need to rethink their role and drive forward the new-style reporting regime. KPMG recently field-tested a new audit report that went further than identifying risks and describing what was done in response to them; these reports also disclosed the auditor's findings and judgements.

Investors also have a part to play. It's no good grumbling about reports if they don't help drive change. If they like an innovative approach, they need to share their preference, not just with the audit committee or auditor that drafted it, but across the industry – they can't remain silent. All the reforms will fall to ruin unless investors speak up about what information they want, from whom, when and how.

The new reporting regime has been with us a year and while we have seen some startling advances, there's no mechanism for driving good practice throughout the FTSE 350 (let alone beyond that group). Unless the investor community get on the front foot and make their expectations known, then what we have seen to date will become the new norm: some transparent and informative reporting, but in most cases, lots of new 'boiler-plate'. More words but no more information.

If a significant number of institutional investors ask to see findings and judgements in the audit report, then audit committees may well find themselves at a crossroads with dramatic consequences.

31% of the Audit Committee survey respondents thought that committees would be more effective if they were willing and able to challenge management. The need to have the courage of their convictions and improve their ability to challenge formed the basis of other responses as well. This could be a new era for constructive criticism from audit committees, with an increase in accountability to shareholders.

For years it has been argued that an effective audit committee plays a crucial role in protecting shareholder interests. If, when put to the test, we find audit committees closed to the wishes of shareholders then those that have questioned the balance between CFO, audit committee and auditor will be proved right and the 'stewardship pyramid' in which I hold so much faith, will fall into ruin like the once proud pyramid of Djedefre.

Tim calls for a balanced relationship between audit committees, CFO and auditors. Within the Audit Committee Survey, the overwhelming majority of respondents rated their interactions with CFOs and auditors as positive, which sounds like the pyramid is in good shape. However 44% of respondents indicated that they had no significant interaction with major investors at all. This hardly sounds like healthy investor engagement.

Our final piece by Helen Brennan examines who these investors actually are. While it might be news to the man in the street, we are all investors through vehicles such as stakeholder pensions and so the needs of the many need to be taken into consideration.

We're all investors

Helen Brennan

The question of how best to achieve engagement between investors in and managers of listed companies is as old as the limited company itself. But the question of who or what is an investor is more pivotal. The increase in intermediation – funds, asset-managers, custodians – has the end result that the ultimate providers of finance may be transitory, have differing objectives from each other and/or be unknown to management.

In the UK, we are all "investors" in that we are exposed to the risk of loss of capital in public companies whether through direct holdings, pensions, mutual funds, insurance policies or bank deposits. But the man on the street doesn't see himself as an investor. Mistrust between society and business has built to the point where many see institutional investors as part of the problem; they're seen as representing a wealthy elite, rather than acting for all of us.

The suspicion that companies are run to achieve short term performance metrics used in executive incentive plans, and that institutional investors accept this, is bad news for confidence in business. It puts ordinary people off making long term savings which then reduces investment in the businesses that society relies on, to generate innovation, employment and wealth. It also holds open the apparent gap between a financially sophisticated "them" and a financially alienated "us".

Where is the auditor in all this? External audit is intended to enable investor trust in management (or not, as the case may be), but the legal framework draws a very narrow definition of an "investor". Auditors haven't previously pushed for recognition of the wider role their work can play in restoring trust between business and wider society.

However, I'd argue the investors could be defined very broadly – not in terms of legal duty, but certainly when it comes to considering the scope of the audit and the usability of the report. All of us, as members of society, put our shared social and monetary capital at risk in return for "dividends" from a company. This could take the form of money towards our pensions, employment at the company or even the socio economic costs paid through taxation, such as schools and hospitals. To some extent we all suffer when there is an economic downturn.

So what needs to change? First: management need to engage constructively with direct and indirect shareholders as well as institutional investors. After all, where intermediaries are primarily incentivised to develop an attractive track record for their fund, their interests may well not align with those of other direct shareholders, nor with society, the ultimate provider of capital.

Do the challenges and concerns identified by audit committees in the survey, tally with the public's concerns over corporate behaviour?

Arguably some of them do. Economic and political volatility (the biggest vote winner with 52% of respondents identifying this as a challenge), growth and innovation or the lack of it (26%), the pace of technological change (21%) and risks to society through social unrest are all liable to affect everybody. Even some of the other challenges which sound very audit specific such as operational risk/ control environment (30%) could link to the possibility of preventing unethical behaviour, which aligns strongly with public interest.

Second: intermediaries need to do more to find out what the ultimate provider of capital wants from them. There should be no excuses for ignoring the objectives and views of the man on the street. The idea that businesses should take into account what promotes sustainable growth in the economy as a social good should not, in my view, be seen as a niche strategy. Mainstream funds should be engaging effectively with savers, and taking their views into account in stewardship policy. Not all savers are financially sophisticated, so we need to break down barriers enabling everyone to engage in a meaningful way.

Third: auditors need to accept a moral responsibility to a wider group. I'm not suggesting increasing the group to whom the auditor is legally liable. However, a good audit should serve the whole of society. I suggest auditors use technology such as videos and podcasts and better presented information to ensure the report can be understood and digested by a wider stakeholder group – the general public.

There are no short cuts for company management and auditors in the process of identifying and engaging with the universe of investors. If we do try to cut corners, we'll end up relying on superficial, unhelpful axioms – the classic one being: long-term investors are good for sustainable growth; short-term investors are bad. If we want to see sustainable growth in the economy, we have to be prepared to think harder than that.

Helen argues for increased communication between companies and their ultimate investors, the general public. This is more relevant than ever at a time when the corporate world is viewed with suspicion.

Increased communication about the challenges facing the business community and transparency around the solutions should go some way to healing the divide that has grown. As stewards of the corporate world, audit committees have the ability to hold their executives to account and improve understanding around how they do that; a role which is ever more important in the current climate.

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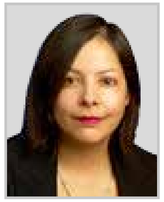

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