Governance *in brief*

FRC reinforces the importance of corporate culture

Headlines

- A strong and transparent corporate culture is a valuable asset and can protect and generate value.
- A healthy corporate culture starts with clear alignment of business purpose, values, strategy and incentives where people at all levels of an organisation understand the values of the organisation and act in accordance with those values.
- Corporate culture is led by the board and is not about rules but about actions. A key challenge for boards, and for executives, is to model the behaviours they want to see in the business and to find constructive ways to encourage and build those behaviours.
- The importance of high quality, insightful reporting both to the board and externally to investors and other stakeholders in the annual report is another key focus of this report, which suggests drawing in HR, Internal Audit, risk and compliance, the company secretary and the external auditor as contributors to the board's understanding of culture throughout the organisation.
- The FRC will use the observations in this report, and any feedback received, to update the Guidance on Board Effectiveness, which was last updated in early 2011. No changes to the UK Corporate Governance Code are planned as a result of this exercise.

Why focus on culture?

The FRC launched its culture project against a backdrop of reducing public trust in business. Mistrust of the banking sector after misselling scandals and the financial crisis, and corporate scandals across different sectors have called into question the integrity of some of our most respected brands. The public, the media and government are asking more questions about corporate purpose, including contribution to society, taxation and the behaviour of directors. The message that companies need to have a strong purpose, culture and ethical values to succeed and be sustainable has never been clearer.

The culture project has drawn in the views and the expertise of a number of organisations under the "Culture Coalition" banner and has involved engagement with FTSE chairmen, chief executives and company secretaries. The 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."

Published on 20 July 2016, the report highlights the huge part culture plays in good governance and in supporting corporate purpose. It focuses on four key areas for boards to address:

- The role of the board in influencing and shaping culture
- Bringing values to life
- Building trust with stakeholders
- How boards can assess, measure and monitor culture

Feedback on the report is welcomed (to be sent to culturecoalition@frc.org.uk) and over the coming year the FRC will be monitoring reporting on culture by companies and investors.

The role of the board in influencing and shaping culture

Key report findings

- Boards are spending more time discussing culture than five years ago. 39% of the FRC's survey respondents reported that ethics and culture was a full board agenda item at least once every six months.
- Driving culture is a key part of the chief executive's role and they should be held to account for this by the board.
- 89% of chairmen surveyed felt their role was influential or very influential on culture in practice.
- 54% of chairmen felt the role of non-executive directors was influential or very influential on culture in practice – this was echoed by company secretaries.
- Almost 30% of company secretaries surveyed disagreed that their board had sufficiently discussed cultural due diligence ahead of a merger or joint venture.

Main observations and recommendations

Role modelling & behaviour of the board	Chief Executives	Culture on the agenda	Culture due diligence in M&A
Culture starts with board behaviour in the boardroom. ‘Leading by example’ was one of the themes most often emphasised by chairmen. Directors must demonstrate and communicate the values of the organisation when dealing with employees.	The chief executive has the most influence over the culture of the business. So for the board the recruitment, retention or potential termination of the chief executive is key.	Echoing recent developments on board discussion of risk, it is important for the board to recognise that culture should not (and cannot) be considered in isolation. An important role for boards and audit committees is to spot misalignment between behaviour, purpose and values. Management may require some redirection in certain circumstances.	When considering mergers and acquisitions, the board should carefully assess the cultural fit of the two companies, bearing in mind that a cultural fit on paper may not work in practice. Consistent and clear messaging on values and behaviours can help generate understanding and commitment to the culture of the acquiring company.

Bringing values to life

Key report findings

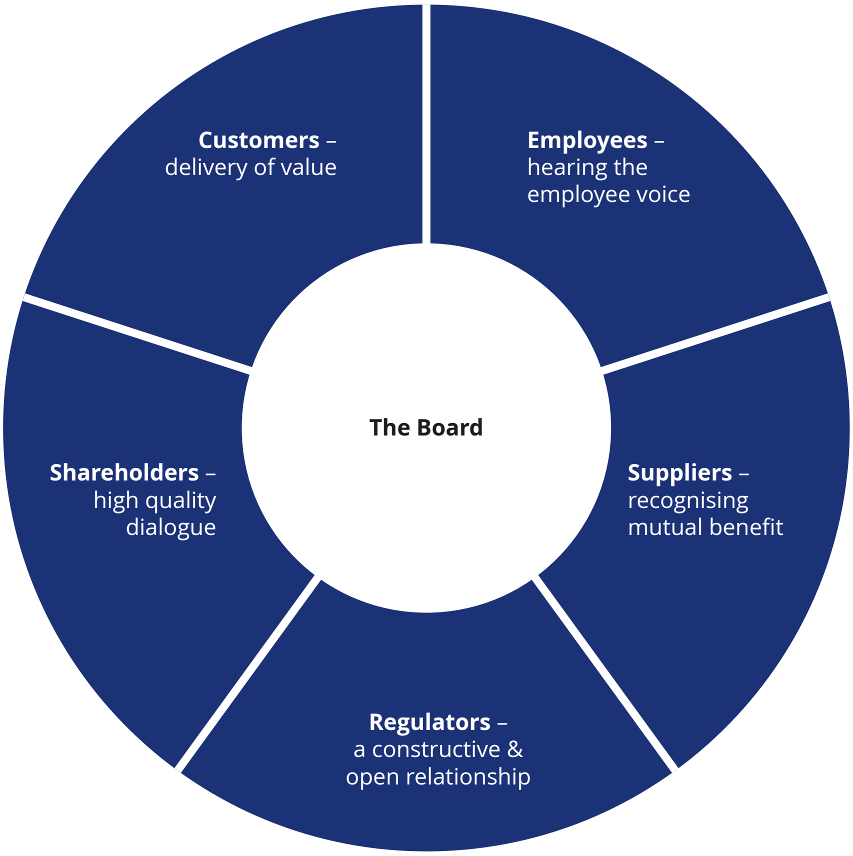
- Codes of conduct or codes of ethics reflecting an organisation's purpose and the values derived from that purpose are important and a starting point for a strong corporate culture.
- The most common values reported by FTSE 100 companies are integrity, respect and innovation.
- It is important to align remuneration and other incentives to desired values at all levels of the organisation – and to demonstrate that those are aligned.
- Illustrative ethical dilemmas and responses can be helpful to demonstrate behaviours in line with corporate values and are particularly effective at crossing differing geographic or cultural backgrounds.

Main observations and recommendations

Engaging middle management	**Human resources**	**Codes of ethics and conduct**	**Risk management and risk culture**
Middle management should be engaged at an early stage so that they feel invested. They must assume responsibility for owning and maintaining the culture. Investing in training on values and expected behaviours and in people management will help managers to develop and to embrace their role in embedding the desired culture.	The culture and values of the organisation should shine through from the very start of the recruitment process, covering the content and location of advertisements, through interview focus, induction, ongoing training and performance management. It is vital to ensure that values are held to irrespective of the performance of an individual against financial targets – attention to remuneration practices is necessary, alongside non-financial incentives such as promotion for good performers. Organisations can develop an effective early warning system by cultivating speak-up policies	These codes focus on how to handle ethical challenges when making decisions. They can be issues-based, stakeholder or values based. The existence of a code should allow disciplinary procedures to be fairer and reduce the risk of wrongdoing in the business. Monitoring code breaches (including the reasons for those breaches) can help measure the pervasiveness of the culture that the leadership wish to embed.	The board's responsibility for the organisation's culture is essential to the way in which risk is considered and addressed within the organisation. Often risk culture is not properly understood. It should be seen as the bridge between risk, reward and risk appetite. Key to achieving resilience to both expected and unexpected risks is to focus on behaviour and culture to avoid blaming and risk blindness.

The role of the board in influencing and shaping culture

Good governance requires openness and accountability. The way a company conducts business and engages with, and reports to, stakeholders will determine the level of trust it earns from those stakeholders and, therefore, its continued licence to operate.



Reporting on culture in the annual report

- There is a need for improvement in reporting, with investors believing there is not enough visibility on culture and values in annual reports – borne out by the figures that only 14% of annual reports discuss corporate culture.
- There are opportunities to improve communication on culture in annual reports, including:
  - providing a good explanation of the business model and the principal risks to the business;
  - focusing on actions the company has taken;
  - practical illustrations of how the company expects its business to be conducted in given circumstances; and
  - non-financial metrics, including on human capital.
- Non-financial metrics and indicators need to be relevant to investors and appropriate to the company and its industry, with the goal of reliable and consistent data allowing measurement year on year and against peers.

How boards can assess, measure and monitor culture

Encouragement to "walk the floor"

To understand culture it is important to listen to the organisation and hear the nuances. All chairmen and chief executives agreed that there is no substitute for spending time in the business speaking with employees 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. Some organisations also use culture audits to help them understand the current state or support root cause analysis for existing problems.

Cultural indicators

There is no single cultural indicator, many contextual factors play a part. It is important to build up a picture. There are red flags that may well be suggestive of a wider issue with culture. The red flags suggested in the report include:

- Dominant chief executive / long tenure of chief executive
- Pressure to meet the numbers / overambitious targets
- Low levels of engagement between leadership and employees
- 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

Obtaining assurance around culture

Boards should request access to relevant information regarding culture; interrogate that information; ask pertinent questions (including challenge where appropriate); take action if not satisfied with the results. Board presentations should include suitable analysis and insight to help boards to spot behaviours that are not in line with values before problems occur.

Sources of relevant information can include Human Resources, Internal Audit, Risk and Compliance, Finance and the Company Secretariat. The growing ability to leverage technology to assess and monitor cultural indicators means that boards are in a stronger position to understand how culture and behaviours impact performance. 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 move towards 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.

The role of the non-executive director will change, requiring non-executive directors to be proactive at spending more time in the business modelling company values and analysing what goes into the decision making process, including how that interacts with business values and culture – this will also affect non-executive director specifications and recruitment decisions.

Where using internal audit to provide assurance on culture, it is fundamental to ensure the credibility of the function so that they get appropriate buy-in and engagement, and also to recognise that there will not be hard data to underpin cultural observations as there are for financial or controls based observations.

External auditors can also be a useful source of insight into culture, as another piece of the "jigsaw puzzle" of culture, although again there is unlikely to be hard data to underpin their informal observations.

Deloitte view and insights on culture

- A variety of forces are coming together to make corporate culture a priority for many companies. The FRC report emphasises what many companies and boards have also recognised – that a strong culture can reduce the potential for damaging events and is a critical corporate asset that, carefully nurtured, should provide a source of competitive advantage.
- We welcome the FRC's focus on corporate culture and agree that boards are responsible for setting and embedding appropriate values and ethics throughout their organisation. The key challenge for boards is how to do this.
- By understanding how corporate culture and behaviours are embedded, the board can drive improved business outcomes for all stakeholders.

Our research shows that 86% of executives recognise culture as being important, but only 12% feel their company currently has the right culture. We believe that in articulating the desired culture organisations must go beyond the use of corporate buzzwords such as "customer focus" or "integrity" to create a vision that resonates as being distinctive, is connected to the real experience employees have of the organisation day to day, and is emotionally compelling.

Key to improving culture is the recognition that building belief in culture is a driver of business performance. This belief enables the organisation to attract and motivate the best talent and creates a set of behaviours that enables execution of business strategy. Achieving alignment between strategy, operating model and culture is the key to unlocking exceptional performance.

Cultural change is one of the most difficult transformations a company can undertake. It requires a well-structured, resourced, and professionally managed programme as for any organisation-wide transformation effort.

As the FRC report states, the board must recognise that they are responsible for setting the "tone from the top", and that responsibility for culture cannot be delegated. Board members, and other members of the organisation's leadership, must understand the impact that their actions, or their lack of actions, have in defining the unwritten rules for "what really matters" in an organisation. Leaders must be mindfully engaged in adjusting their actions and messages to create the desired cultural environment.

Leadership's aspirations and actions should be amplified across the organisation by engaging managers and employees meaningfully – making abstract cultural aspirations tangible and enabling them to take ownership for aligning their own and their colleagues' behaviours at a day to day level. Finally, the organisation's architecture of policies, processes, tools and so on, must be aligned to ensure that the desired set of behaviours is supported and embedded. HR policies and processes play an important role in defining the desired behaviours and in developing and rewarding these behaviours. However, HR policies and processes sit within the wider organisation's architecture of policies, structures, and processes which should also be assessed and aligned.

In our experience most organisations can significantly improve their board reporting on measures of culture. Establishing a data-driven assessment of culture enables more objective management, supports tracking of the effectiveness of culture change efforts, and enables ongoing monitoring and proactive identification of potential issues. The use of a robust culture diagnostic tool, such as Deloitte's CulturePath™ solution is often helpful in providing a data-driven, structured approach. Once a clear cultural aspiration has been defined it is possible to harness insight from substantial data sets that are already available through HR, risk or finance systems, although data needs to be identified, cleansed, analysed and suitably presented to the board.

External reporting on human capital is a fast developing area and is already under active consideration in leading organisations. We expect practice to emerge in this area over the next few years with the leaders in the field drawing on advanced analytics techniques to investigate and gain concrete insight on the links between an organisation's culture, the factors that influence culture and the organisation's performance. With this insight, superior returns become more accessible.

Further information

Corporate Culture and the Role of Boards: Report of Observations is available at: https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Corporate-Culture-and-the-Role-of-Boards-Report-o.pdf

Contacts – Deloitte Culture Solutions

Deloitte's next-generation CulturePath™ solution can deliver compelling and actionable visibility into an organisation, progressively guiding the organisation throughout its business journey and giving it confidence to lead the way forward.

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Contacts – Culture in the boardroom

"For boards, culture starts with their behaviour in the boardroom" - the FRC has highlighted the importance of boards acting as role models in relation to behaviours, holding management to account and embedding culture into the board agenda. Deloitte supports Boards in assessing their own effectiveness, including the way they set organisational values; oversee the culture of the organisation; and the extent to which they have a practical and insightful way to measure behaviours. We also support Chairmen and Chief Executives in banking and insurance to discharge their regulatory prescribed responsibilities in relation to culture under the Senior Managers Regime.

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The Deloitte Academy

The Deloitte Academy provides support and guidance to boards, committees and individual directors, principally of the FTSE 350, through a series of briefings and bespoke training. Membership of the Deloitte Academy is free to board directors of listed companies, and includes access to the Deloitte Academy business centre between Covent Garden and the City.

Members receive copies of our regular publications on Corporate Governance and a newsletter. There is also a dedicated members' website **www.deloitteacademy.co.uk** which members can use to register for briefings and access additional relevant resources.

For further details about the Deloitte Academy, including membership, please email **enquiries@deloitteacademy.co.uk.**

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Appendix – Questions for boards on corporate culture

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?

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 incentive pay?

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?

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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?

Risk

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)?

Gathering information

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?

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