CHAPTER 3
CORPORATE GOVERNANCE, SUSTAINABILITY, AND ETHICS

Quick test

Question 1

Corporate governance is all about how companies are run and who runs them, or as Cadbury defined it 'the system by which companies are directed and controlled.' Investors entrust the running of companies to the board of directors whom they elect, and need reassurance their money is well invested with a satisfactory return potential, and there is no fraud. Increasingly important is 'how' the returns have been made in addition to 'what' returns have been made. Corporate governance requires the directors to be fully accountable to the investors about their management of the company.

However, corporate governance issues have developed and now concern a wider audience than just investors – most stakeholders in companies are interested in whether there has been 'effective entrepreneurial and prudent management to deliver the long-term success of the business'.

The annual report is a key disclosure device and the most obvious starting place for stakeholders to turn to for corporate performance information. Many companies, recognising its importance, also devote a section of their web sites to corporate governance, but often much of the information here is replicated in the annual report. For publicly listed companies, the Listing Rules require corporate governance matters to be explained in the annual report.

Question 2

Corporate sustainability is a term which encompasses many different issues, including much of corporate governance, but also environmental, social and ethical concerns. Ultimately it is about businesses building long-term value for all involved in it – in other words all stakeholders. Investors, customers, suppliers, employees, local communities, society and the environment all have an interest in and are affected by the performance and practices of businesses.

Although sustainability reporting is not mandatory for companies, many choose to do so, as they consider that they should be accountable to all stakeholders, and perceive their reputation will be improved if they do so. There are inherent difficulties in the reporting of many sustainability issues, but one body, the Global Reporting Initiative (GRI), has produced guidelines for the reporting of many of these, and many high-profile companies follow these.

The latest G4 guidelines were updated and reissued in 2013 and are based on a number of key principles, one of which is that any sustainability report should be stakeholder inclusive – in other words, an organisation should identify its stakeholders and explain how it has responded to their reasonable expectations and interests. The guidelines

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specify general standard and specific standard disclosures, and recommend either a core reporting approach or one that is fully comprehensive.

The general standard disclosures are:

- Strategy and analysis
- Organisational profile
- Identified material aspects and boundaries
- Stakeholder engagement
- Report profile
- Governance
- Ethics and integrity

Less is reported on governance and ethics if an organisation chooses the core reporting approach.

The specific standard disclosures are concerned with the following issues:

- Management approach
- Economic
- Environmental
- Social, which is sub-divided into:
  - Labour practices and decent work
  - Human rights
  - Society
  - Product responsibility

If the core reporting approach is followed, fewer disclosures will be made.

These disclosures are much more comprehensive than the previous G3 guidelines, and certainly adhere to the stakeholder inclusive principle. Full details can be found on the GRI website https://www.globalreporting.org

Develop your understanding

Question 3

The *Conceptual Framework* sets out the concepts that underlie the preparation and presentation of financial statements and identifies principles for the IASB to use when it develops and revises its financial reporting standards. The existing 2010 *Conceptual Framework*, most of which is based on an earlier framework document dating from 1989, has enabled the IASB to develop high quality IFRS that have improved financial reporting. However, it does not cover some important areas and some guidance needs updating.

Although the IASB and US FASB commenced a convergence project to update the *Conceptual Framework*, by 2010 only two chapters were completed, The Objective of

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Financial Reporting and The Qualitative Characteristics of Useful Financial Information. In 2012 the IASB restarted the project to update the remainder of the *Conceptual Framework* and so improve financial reporting by providing a complete and updated set of concepts to use when financial reporting standards are developed or revised. In May 2015 an Exposure Draft of proposed changes to the *Conceptual Framework* was published and the IASB has been consulting on these since, with the new *Framework* due to be published in 2017.

The changes that have been proposed include:

- more explicit reference to stewardship as an objective of financial reporting together with decision-usefulness;
- the inclusion of prudence when dealing with uncertainty as a concept which will enhance neutrality;
- principles for determining the reporting entity;
- updated definitions of assets and liabilities;
- updated recognition criteria and the introduction of principles for derecognition;
- revision of measurement bases;
- presentation and disclosure principles; and
- principles to distinguish between profit/loss items and other comprehensive income.

Most of these are fundamental in considering the accountability of management. Stewardship is fundamental in this regard. The 2015 ED still states that the principle objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. However, the ED gives much more prominence to stewardship as an objective as it states that as part of this decision-making process the users will assess the stewardship of the entity's resources entrusted to management – in other words, the accountability of management. Users need to determine the returns obtained from the resources entrusted to management, and in order to do this, they need relevant and faithfully representational information which is based on sound accounting principles and methods.

The reintroduction of prudence as an underpinning concept in dealing with uncertainties is relevant in the context of accountability. Prudence is often viewed as a counter-balance to management's optimism in the reporting of net income and asset and liability values. Users want management to be cautious in their judgements; many would view over-optimism to be more harmful than the under-valuation of income and assets. However, the proposed reintroduction of prudence is as a reality check, not as a principle to enable companies to deliberately or systematically under-value income and assets or over-value expenses and liabilities.

Assets and liabilities are the basic building blocks from which the statement of financial position is constructed. Without unambiguous definitions of these items and consistent principles to determine when they are included or not in the statement of financial position, the user would not have clear information about the net resources the entity controlled. So the ED's proposals:

(a) focus the definitions more clearly on the fact that an asset is a resource, and a liability is an obligation;

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(b) clarify the status of those resources and obligations that are not certain to result in inflows and outflows of economic benefits; and
(c) provide criteria for when resources and obligations should be removed from the financial statements (derecognised).

Key to assessment of how management has used the resources entrusted to it, is the measurement of assets and liabilities. Measurement is the process of determining the amount to be included in the financial statements for an asset or a liability. The 2010 *Conceptual Framework* provides little guidance on measurement and when a particular measurement basis should be used. The ED limits the number of measurement bases used in financial statements to historical cost or current value which should enhance understandability and comparability. However, the proposals also suggest that a single measurement basis for all assets and liabilities may not provide the most relevant information. In selecting an appropriate measurement basis for a particular asset or liability, consideration should be given to how the asset contributes to future cash flows or how the entity will fulfil or settle the liability. For example, fair value (a current value) might be the most relevant measurement basis for a financial asset that has complex features and is held for trading, but depreciated historical cost might be more relevant for an asset, such as property, plant and equipment, that contributes to future cash flows indirectly.

By focussing on future cash flows, the proposals for measurement of assets and liabilities remain consistent with the decision-usefulness objective of financial reporting. Stewardship and accountability objectives can be considered to be more historic-looking, and under the proposals, as currently, there will be a mixture of measurement methods, with some assets' and liabilities' measurement based on historical cost, but others using cash flow bases.

The existing *Conceptual Framework* does not have a section on disclosure. A framework for disclosure is needed to ensure that information disclosed is more relevant to investors, so the project aims to develop principles that it will be able to use when developing future disclosure requirements in IFRSs. Some of these proposed principles relate to disclosures about the resources of the reporting entity, and management's decisions and judgements. For example, defining the actual reporting entity, describing unrecognised assets and liabilities and why the items have not been recognised, explaining the financial risks to which the entity is exposed and how those risks have been managed, and measurement methodologies, including assumptions made. All of these relate to management's accountability to the shareholders.

The proposals contained in the 2015 ED of the *Conceptual Framework* are not changing the principle decision-useful objective of financial reporting, and therefore most changes are consistent with this. However, it appears that they will largely improve information on the accountability of management.

Question 4

The relevance of ethics to corporate governance has become increasingly important, particularly since the financial crisis. Society is much less tolerant today of greedy and

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unethical behaviour by individuals in positions of authority and responsibility. Developing a more ethical approach to corporate governance is considered a critical issue.

Cadbury's basic definition of corporate governance is 'the system by which companies are directed and controlled', and its aim is to ensure wealth protection and wealth creation for the shareholders. Shareholders have entrusted their investment to the board of directors to act in their best interests. Trust in a company is key to its success, and this will come about by trusting the people who work for the company, including the board of directors. Trust will be achieved if people are honest and integral and if they behave in an ethical manner. Since it is the directors who are responsible for setting the principles and values by which companies operate, it is therefore vital that they demonstrate ethical behaviour.

So although Cadbury's initial definition of corporate governance may not imply that ethical behaviour by boards is necessary, later *UK Corporate Governance Codes* have emphasised that 'corporate governance is about what the board does and how it sets the values of the company'. This has also been reiterated by the ACCA which proposed a framework of best practice in corporate governance and included ethics as a central corporate governance issue:

> 'Boards should set the right tone and behave accordingly, paying particular attention to ensuring the continuing health of their organisations. Directors should regard one of their responsibilities as being guardians of the corporate conscience….. Boards should ensure they have appropriate procedures for monitoring their organisation's ethical health.'
>
> (ACCA, 2008, Principle 2)

Since the collapse of Enron, most large companies in the US have developed codes of ethical practice, and indeed the current *UK Corporate Governance Code* consists of lists of principles and processes. However following lists of codes and adopting a box-ticking approach to corporate governance is not enough to ensure that ethical behaviour will result, and even the current UK Code acknowledges that it cannot guarantee proper board behaviour. However, as Cadbury stated, corporate governance has to be followed in 'spirit' as well as its letter. The Maxwell Empire and Enron cases are significant examples of where this clearly did not happen.

Ultimately for a board of directors to exhibit ethical behaviour, high standards of ethics and integrity must be an essential requirement of the individual board members themselves.

Question 5

Arguments for include the following:

- The presence of a subcommittee will emphasise the importance of sustainability issues
- An internal subcommittee or the external auditor will be more up to date with current sustainability reporting developments, and are better placed to give advice on sustainability reporting issues
- An internal subcommittee will be assess the credibility of sustainability policy issues

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- A subcommittee will be appointed by and report to the main board and therefore its work should be aligned with the company's strategic direction. It may also have some influence over this.
- The external auditor may be able to conduct environmental audits and issue an environmental audit report, which offers credibility to the company's sustainability reports
- The external auditor is able to review sustainability disclosures for consistency with the financial statements

Arguments against include the following:

- The presence of an internal subcommittee adds to management layer and increases company costs
- Increased audit fees if the external auditor is expected to do substantial review of sustainability reports
- An audit report on sustainability matters is only of limited use because of the inherent difficulties in actually auditing the issues

Question 6

Arguments in favour of the role of accounting including a contribution to the protection of the environment:

- Financial reporting is seen as accountability to a wide group of stakeholders, many of whom are increasingly interested in the impact of companies on the environment.
- Accounting is about collecting, measuring and reporting financial information, and this process can be applied to environmental information.
- Companies should disclose costs of using natural resources and damage made to the environment.
- Some environmental matters are already connected to accounting:
    - IAS 37 requires provisions for future costs to rectify environmental damages at end of operations.
    - Reporting of certain environmental issues is actually required by statute in some jurisdictions, e.g. the reporting of greenhouse gas emissions in the UK.
    - Climate change levies and land fill taxes are paid by companies to the government, the latter using them to rectify the environment.
    - Tax on profits is paid by companies to the government, with the tax being used for environmental issues.
    - Fines, penalties and compensation are paid by companies in relation to environmental issues.

Arguments against the role of accounting including a contribution to the protection of the environment:

- The protection of the environment is the responsibility of the government – how it should be done is up to the government and world leaders.
- Financial reporting is principally for investors, and not a wider group of stakeholders.

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- The costs of protecting the environment reduce profitability.
- New costing and accounting systems would have to be developed – should this be the responsibility of a company?
- There are inherent problems in definition, recognition and measurement of environmental impacts, and accounting cannot solve these.
- One of the characteristics that enhances useful information is comparability – this would be difficult with environmental information.

Question 7

The barriers to businesses implementing an ethical framework include the problems of coming up with a clear definition of ethics and reasons for the necessity for action, how much cultural factors should be allowed to influence ethical thinking, and the need for an ethical framework to be more than superficial gloss. The compatibility of ethical and commercial concerns is also an important issue to raise.

What we mean by ethics
One has to consider what is ethical and is not. Ethical behaviour in one country may be unethical in another country. Ethics are guidelines or rules of conduct by which we aim to live by. It is not what the organisation says, but rather what it does which is the real issue. In the UK examples of areas where businesses have been considered less than ethical include workplace safety, product safety standards, advertising content and whistle-blowing.

Varying cultures
Globalisation and the resultant need to operate within different ethical frameworks have undermined the idea that ethical guidance can be defined in simple absolute terms. It may be culturally acceptable to pay custom officials, but taboo in other cultural contexts.

Ethical versus commercial interests
Ethical and commercial interests have, it is argued, always diverged to some extent. Some organisations have seen for example the issues of ‘being seen to be ethical’ as a good business move. However, this viewpoint is pragmatic rather than idealistic; being ethical is seen as a means towards the end of gaining a better reputation and hence increasing sales.

Policies of others
Modern commercialism places great demands on everyone in organisations to succeed and provide the necessary revenues for the future growth and survival of the business. Acting with social responsibility can be hard, as not everyone plays by the same rules.

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Take it further

Question 8

Note that the GRI's 2013 *Sustainability Reporting Guidelines* (G4) have been superseded by the *GRI Standards*, which were released on 19 October 2016. Use of the *GRI Standards* will be required for all reports or other materials published on or after 1 July 2018 – the *G4 Guidelines* remain applicable until this date.

The approach taken by the GRI is to require companies to determine which their material sustainability issues are. The three principal areas that both the *G4 Guidelines* and the *GRI Standards* require companies to consider are economic, environmental and social areas. Each of these areas is subdivided into more specific topics. For example, the environmental area covers topics such as materials, energy, water, biodiversity, emissions, and effluents and waste. The social area includes employment, labour management relations, occupational health and safety, diversity and equal opportunities, child labour, supplier social assessment, and local communities.

J Sainsbury plc appears to integrate corporate responsibility into its business – in the company's 2015 *Annual Report and Financial Statements* it states that it 'has looked to lead the way in corporate responsibility'. It has a Board level corporate responsibility committee (i.e. the same level committee as the others required by the Corporate Governance Code guidelines), which reports in the *Annual Report*. This committee reviews key corporate responsibility policies, taking into account the company's corporate responsibility objectives and the overall strategic plan. Also, like other companies, Sainsbury has a whole section of its website devoted to 'responsibility' which encompasses corporate responsibility and sustainability.

The company's business model is underpinned by five corporate values:

- Best for food and health
- Sourcing with integrity
- Respect for our environment
- Making a positive difference to our community
- A great place to work

These are all related to corporate responsibility and the three areas covered by the *GRI Standards*.

In 2011 J Sainsbury launched a *20x20 Sustainability Plan* which set out 20 key commitments related to its five corporate values which it aims to achieve by 2020. The company issues various reports of its corporate responsibility activities, some of which update how the company is performing in relation to the *20x20* commitments, and one of which is its bi-annual corporate responsibility report, in 2015 entitled *Closer to Customers*. This particular report analyses the findings of a survey Sainsbury conducted of over 5,000 consumers to find out what corporate responsibility issues were particularly important to them personally. The report details the values consumers prioritise, the motivations which influence where they shop and which products they buy, and explains how Sainsbury is addressing these issues.

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In this report the top three values ranked by consumers according to what is most important to them personally are:

1. Consumers wasting as little food as possible
2. Treating British producers fairly
3. Sourcing British food

These would come under the environmental and social areas of the *GRI Standards*.

Examples of how Sainsbury states it is addressing these issues:

Consumers wasting as little food as possible

For part bake bread lines, Sainsbury reports it has modified the gas mix to increase their product life and changed the packaging from one compartment to two, meaning customers need only use one loaf at a time. Similarly, our beef and lamb products now stay fresh for longer thanks to packaging improvements. In partnership with Google, Sainsbury has developed Sainsbury's Food Rescue, a mobile and online tool that helps customers turn leftovers into tasty meals. Once they've read out or typed in the ingredients they have at home, the tool offers them relevant recipes from over 1,200 options.

Treating British producers fairly

Sainsbury states it has a close relationship with its fresh milk farmers. Collectively they're part of the Sainsbury's Dairy Development Group (SDDG), and since 2008 regular meetings have been held with them across the UK. From 2012, the SDDG farmers have benefitted from a Cost of Production model, which aims to ensure their long-term sustainability and profitability. Milk prices are reviewed every three months to account for the volatility of farmers' costs for feed, fuel and fertiliser, ensuring they receive a fair deal. Bonus payments are also offered for outstanding animal welfare and environmental standards. The price Sainsbury charges customers for milk is not a function of the price paid to farmers. Sainsbury states that when it drops the price of milk to match its competitors' prices, the cost of doing so is not passed on to the dairy farmers.

Sourcing British food

Sainsbury states that developing strong, long-term partnerships with British farmers and growers is a key part of achieving sustainable and secure supply chains. For instance, it has ten Farmer and Grower Development Groups which help to ensure British farmers benefit from sustainable and profitable supply chains. Since 2012, the company has invested over £2.2 million in research and development projects that will directly benefit British agriculture. It also co-chairs the Government's Agri-Tech Leadership Council which is driving the strategic vision and directing investment in the sector by funding leading edge collaborative research. One project is dedicated to improving strawberry yields in UK glasshouses to reduce strawberries imports.

Other mappings of corporate responsibility issues to the GRI performance indicators can be seen from the *Annual Report and Financial Statements* and the latest performance report against the commitments set out in the *20x20 Sustainability Plan*. Examples follow.

Economic

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The financial statements prepared under UK Companies Act 2006 and IFRS report the financial performance to a level sufficient for an understanding of the company and its sustainability.

Environmental

The *20x20* commitments and achievements include:

- Source all our key raw materials and commodities sustainably to an independent standard: achievement - over 200 products made with physically certified palm oil
- Ensure our own-brand products won't contribute to global deforestation: achievement - Sector leader 2014 in the Carbon Disclosure Project's Forest Programme (Food and Staples Retailing)
- Ensure all the fish we sell will be independently certified as sustainable and we'll strengthen our position as the leading retailer for sustainable seafood: achievement - Sold £149m of Marine Stewardship Council certified products
- Put all waste to positive use: achievement - worked with our suppliers to donate 611 tonnes of surplus food (1.2m meals) from our chilled supply chain
- Reduce own-brand packaging by half compared to 2005: achievement - 5.1% absolute own-brand packaging reduction in 2013/14
- Reduce operational carbon emissions by 30% absolute and 65% relative, compared to 2005: achievement - 8.3% reduction in absolute carbon emissions in 2013/14
- Demonstrate robust water stewardship, ensuring the supply chain is sustainable in all areas of water vulnerability: achievement - 53% relative operational water reduction since 2005/06
- Work with own-brand suppliers to reduce carbon emissions across all own-brand products by 50% relative: achievement - 128,000 tonne reduction in collective carbon footprint of Development Groups to date

The Corporate Responsibility and Sustainability Committee report in the 2015 *Annual Report and Financial Statements* includes the following:

> 'During 2014/15 our store in Cannock became the first retail outlet in the UK to be solely powered by food waste, coming off the National Grid. In another first for the business, our store in Portishead runs fridges powered by 'green' gas, created using waste from sugar beet suppliers.
>
> During the year, Sainsbury's was the only UK company to be ranked as a Sustainability Leader in the 'Food and Staples Retailing' category of the Dow Jones Sustainability Index ('DJSI'). The DJSI is the leading global sustainability benchmark and Sainsbury's is one of the few companies that has been a member of the DJSI since its inception in 1999. This year we outperformed 92 per cent of our industry category and obtained the highest score for environmental performance worldwide. Sainsbury's also received our highest ever performance score in the Carbon Disclosure Project's ('CDP') annual survey. For the first time we were awarded a position in the CDP's Climate Performance Leadership Index for our actions to reduce carbon emissions and mitigate the business risks of climate change.'

Social

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The *20x20* commitments and achievements include:

- Reduce salt, saturated fat, fat and sugar in our own-brand products and lead on providing clear nutritional labelling, enabling our customers to make informed choices: achievement - over 95% of products meet maximum 2012 salt targets
- Hit £1 billion sales of fairly traded products: achievement - world's largest retailer of Fairtrade by value with sales of £319m
- Ensure all our meat, poultry, eggs, game and dairy products will be sourced from suppliers who adhere to independent higher welfare standards: achievement - leading retailer of RSPCA Freedom Food products with sales of £480m
- Ensure our suppliers will be leaders in meeting or exceeding our social and environmental standards: achievement - 40 workshops held with 504 supplier delegates trained, including a five day, accredited Lead Auditor for Social Systems course to further strengthen the ethical trade training on offer
- Encourage 20 million children to enjoy physical activity: achievement - £150m worth of Active Kids sports and cooking equipment and experiences donated since 2005
- Provide work opportunities for 30,000 people from groups who face challenges: achievement - over 21,000 employed via You Can scheme since 2008

Part of the Strategic report in the 2015 *Annual Report and Financial Statements* refers to Sainsbury's core values and includes the following:

> 'We are committed to producing healthier baskets and set tough salt reduction targets for our own-brand products over 15 years ago. Historically, around ten per cent of our products missed the Government's 2012 salt targets. We are addressing products such as bacon where, as signatories to the Government's Responsibility Deal 2017 pledge on salt, the targets present the greatest challenge in terms of customer perception. During the last year, we have also worked with our suppliers to reformulate our own-brand soft drinks and have removed 2,256 tonnes of sugar annually from our customers' baskets, equating to 8.9 billion calories per year.
>
> We continue to work with our suppliers to address the sustainability of our products.
>
> This year, with help from our customers, colleagues and suppliers, we raised £52 million for charitable causes, including around £7 million in support of The Royal British Legion and over £11.5 million for Red Nose Day 2015. Through our Active Kids scheme, we have now donated over £150 million worth of equipment and experiences to schools and clubs since 2005, and the scheme was recognised in March 2015 by the Prime Minister, David Cameron, with a Big Society Award. We have 384 stores with a local food donation partner, 59 more stores than last year. However, 71 per cent of our stores are without a partner so we are focused on increasing this number.'

Question 9

The Chairman of JD Wetherspoon is continuing his criticism of the UK's approach to corporate governance which he started in the 2014 Annual Report and Financial Statements by making some general and specific points.

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The corporate governance requirements of listed companies in the UK are set out in the *UK Corporate Governance Code 2012* (which was reissued in April 2016). The overall aim of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company. Its focus is the accountability, transparency, and probity of the board, and there is an emphasis on corporate governance being of relevance to all stakeholders, not just investors.

In order to achieve long-term success it is clearly important to ensure that those running the company have appropriate knowledge, expertise, skills and business acumen. Who these individuals are, and how they achieve the results increasingly matter to all stakeholders and, in the light of the many corporate failures, which have been in part due to poor governance, this information is in the public interest. Given the complexity and diversity of multi-national corporations conducting business today, appropriate Board and management structures are necessary to help achieve accountability and transparency. Some similarity between one company and another will also help comparability, and it should be noted that the *Code*'s provisions do allow flexibility rather than being a set of rigid rules.

The *Code* takes a 'comply or explain' approach to the reporting of corporate governance matters; however, with accountability in mind, the Listing Rules require companies to report on how they have adhered to the provisions of much of the *Code*. This inevitably adds to the length of the narrative reports included in the first half of a company's annual report, a criticism of the Chairman of JD Wetherspoon. Much of the reporting on corporate governance may appear to focus on procedural issues and use technical language, and parts of the reports do appear complex, for example, the details of the directors' remuneration. However, most of the reports are fairly straightforward to understand, and would be to investors who are familiar with such issues. The Financial Reporting Council (FRC), together with the International Integrated Reporting Council and other regulators, have been discussing complexity in reporting and length of annual reports for some years. Despite this, the narrative reports, financial statements and related disclosure notes are always seeming to grow, and this is also acknowledged by the IASB, the body responsible for financial reporting standards. The IASB is also reviewing principles of disclosure in the financial statements and notes as part of its work on the revised *Conceptual Framework*.

The Chairman refers to the short-term approach taken by many institutional investors. This is certainly recognised by the FRC, which, in addition to the *Corporate Governance Code*, has issued a *Stewardship Code*, directed at institutional shareholders. This emphasises that, although stewardship, which promotes the long-term success of the company, is the prime responsibility of the board, the shareholders should play their part by holding the boards of directors to account in fulfilling this aim. The *Stewardship Code* encourages these shareholders to sign up to the *Code* and to publish on their website that they have done so.

Despite this emphasis on the long-term, the bonus culture within investment firms of rewards based on annual or quarterly results, can lead to the investors being interested in more immediate results which they may achieve through trading rather than developing a long-term relationship with their investee company and sticking with them even when returns are not so good. It should also be acknowledged that a majority of shares of UK

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listed companies are now held by overseas institutional shareholders to whom the *Stewardship Code* does not apply. It is understandable that the JD Wetherspoon's Chairman considers he will further his company's success by concentrating relationships with business stakeholders, such as customers and employees, rather than these remote investors who may not be involved in the company for the long-term. The FRC encourages these shareholders nevertheless to adhere to the *Stewardship Code*.

The Chairman of JD Wetherspoon appears to criticise a number of aspects of how Boards are structured and the recommendations relating to Board appointments. The *Corporate Governance Code* does require there to be both a Chairman and a Chief Executive Officer (CEO). The Code defines the role of the Chairman to be principally that of running the Board, liaising with non-executive directors and shareholders, and generally being an independent individual who is the outward face of the company. This is a very different role from the CEO, who is responsible for the day-to-day running of the company and decision making. Both roles are important and require different approaches and skill sets. Whilst there may be some individuals who can transfer from CEO to Chairman and assume this different role, the *Code*'s provisions acknowledge that in many cases, the individual would not able to easily transition to the more independent hands-off role, and there may be less fresh thinking and the necessary challenging of the executive team.

Non-executive directors play an important role in corporate governance. Their role is to scrutinise the performance of the executive directors and to bring their wider expertise to the decision-making process. The *Corporate Governance Code* requires there to be an appropriate balance between executive and non-executive directors such that no individual or small group of individuals can dominate decision making. It requires over half the Board to be non-executives, which the Chairman of JD Wetherspoon is questioning. Although some Boards may be able to function well with a majority of executive directors provided the comments of the non-executives are listened to, it is considered that the success of the company may be improved with more independence at Board level. The requirement was built into the *Code* after a review into the role and effectiveness of non-executive directors conducted by Derek Higgs in 2003. After much consultation he concluded that a Board was strengthened significantly by having a strong group of non-executive directors with no other connection with the company. These individuals bring a dispassionate objectivity that directors with a closer relationship to the company cannot provide. At the time, the role of Board committees was increasing, with many of these comprising mainly or only non-executive directors. In the light of this, the need to manage conflict of interests, and the positive benefits of independence, the recommendation for a majority of non-executives was made.

The Chairman of JD Wetherspoon also questions the maximum tenure for non-executive directors as he feels that relevant experience may be lost, particularly of the effect of downturns in the economic cycle. The recommendation for a maximum of 9 years also stems from Higgs, with the reasoning that it is necessary to keep a Board refreshed with new members, ideas, etc. Many non-executive directors are also or have been executive directors of listed companies, and will be able to use their experiences of upturns and downturns in economic cycles in their role as non-executives.

The final criticism of the Chairman of JD Wetherspoon refers to the over-reliance on financial targets for executive directors, and in particular in the run-up to their retirement.

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Remuneration and the performance criteria on which they are based are often of a financial nature which may be for a number of reasons, including aligning the directors' and shareholders' interests, and setting targets which are measurable and auditable, and may appear objective. Agency theory does suggest that directors may focus their energies on achieving the 'right' financial targets rather than on taking decisions that are best for the long-term success of the company; however the remuneration committee, which is made up of non-executive directors, should ensure that the targets set for bonuses and other rewards are balanced, challenging but fair, and sufficiently long-term. Having said this, there has been excessive growth in the value of bonuses and long-term incentive schemes awarded to executive directors over the past 20 years, and this has and is continuing to attract attention, not least from the UK government. Legislative and other steps that have been taken over the years appear to have done little to prevent the exponential growth in these forms of remuneration. In part this may be because the non-executives forming the remuneration committee are or have been themselves well-rewarded executive directors, and do not wish to appear to be connected to a company which rewards its executives at the bottom or lower end of 'market' rates.

In conclusion, there is some merit in some of the JD Wetherspoon Chairman's criticisms of corporate governance. The UK's *Corporate Governance Code* is certainly well-intentioned and is regularly updated in response to changing business practices and also corporate failures that have happened. The 'comply or explain' approach does allow flexibility and permit companies to determine whether a particular recommendation is relevant or not – although directors will probably be reluctant to have to draw attention to a provision that their company has not followed. The *Code* does rely ultimately on how the directors set the tone and culture in their company and their ethical approach, which in part is a personal attribute.

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