



**CORE submission to BEIS initial consultation on recommendations by the Kingman
Independent Review of the Financial Reporting Council – 17/06/2019**

Introduction

CORE is the UK civil society coalition on corporate accountability. We aim to advance the protection of human rights with regard to UK companies' global operations by promoting: higher standards of conduct; compliance with the law as part of a more effective regulatory framework; and improved access to remedy for people harmed by UK-linked business activities.

CORE engaged with the Financial Reporting Council on changes to the UK Corporate Governance Code, Stewardship Code and development of the Wates Principles for Large Private Companies. We have also made submissions to the Department for Business, Energy & Industrial Strategy on various aspects of corporate governance reform, including s.172 reporting and director-worker pay ratios. The Kingman Review (the Review) raises several important issues within our purview and we welcome the opportunity to submit evidence.

The need for fundamental reform

The proposed reforms to the FRC in the Review represent on balance a welcome reaction to a clearly failing system. In the UK's legal framework auditors and shareholders are given responsibility for holding company boards to account. As the Carillion debacle showed this approach is severely flawed. Carillion's largest shareholders were passive investors with no interest in engaging constructively with the company. Both BlackRock Inc. and Deutsche Bank (with a combined stake of 15%) held their shares in passive funds which were sold automatically as prices fell. In addition, KPMG, Carillion's external auditor of 19 years, turned a blind eye to aggressive accounting and an extremely precarious financial position.¹

While we welcome attempts in the Review to improve the efficacy of shareholders' and auditors' oversight, inherent flaws mean that neither are ultimately a replacement for effective regulation and accountability mechanisms. The Government's focus should be on bringing forward legislation recommended by the Review that would place the new regulator on a stronger statutory footing with greater powers to intervene and ensure accountability for misconduct. In this respect, we particularly welcome recommendations 7, 15, 16, 29, 35, 36-7, and 44-50.

¹ <https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf>

However, we would also like to take this opportunity to restate our view that without fundamental corporate governance reform, corporate misconduct will continue to pose significant risks to workers, suppliers and other stakeholders both domestically and internationally. The UK is home to many firms of systemic importance and impact. It is essential that these entities are effectively regulated to mitigate these risks and ensure they meet their responsibility to respect rights everywhere in the world. The consequences of not doing so are only too clear.

When BHS went into insolvency 11,000 workers lost their jobs and 19,000 current and future pensioners faced seeing their pensions cut. Similarly, the collapse of Carillion saw 2,000 workers lose their jobs, 27,000 facing reduced pensions, £2billion owed to 30,000 suppliers and a cost to the taxpayer of £148million.² The Mariana tailings dam disaster offers an even more serious example. The dam was operated by Samarco, a Brazilian mining firm jointly owned by LSE-listed BHP Billiton. On 5 November 2015 the dam collapsed, causing 60 million cubic metres of waste to flow into a river. 19 people were killed and 600 families displaced from their homes. Ecosystems that support traditional livelihoods were destroyed, disrupting fisheries, agriculture, tourism and freshwater resources. The interruption of the mining activity severely affected the local economies of 37 villages and cities.³

In response to inadequate regulatory measures we have long called for more fundamental reforms. Our arguments have been two fold. First, we have made the case for stronger mechanisms for holding companies and company directors to account for misconduct and serious abuse. The evidence of such conduct is ample, but as the Work and Pensions and BEIS Committees recently stated, our systems of corporate accountability are insufficient. Second, in our view it is clear that the UK corporate governance model of 'enlightened shareholder value' is not working, and that a transition to a stakeholder model is needed.

We regret that Prime Minister Theresa May's commitment to putting workers on company boards has not been taken forward. Additionally, the events of the past few years have only reinforced our view that a serious debate is urgently needed on amending directors' duties under s.172 of the Companies Act 2006. At present, directors have concrete legal duties only to shareholders. We recommend that an obligation is placed on directors to mitigate serious harms, place stakeholders' interests on a par with shareholders, and make directors' primary duty to the long-term success of the company.

Chapter 1. FRC structure and purpose

Question 2. What comments do you have on the duties and functions set out in Recommendations 5 & 6?

² <https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/1718.pdf>

³ https://gridarendal-website-live.s3.amazonaws.com/production/documents/:s_document/370/original/RRaminewaste_flyer_screen.pdf?1509538685

Recommendation 6 proposes that the new regulator's functions should include maintaining 'wide and deep relationships with investors and other users of financial information'. We view this as an especially important function, but suggest that the wording could be clarified.

Our previous engagement with the FRC demonstrated that the FRC often struggled to reach out beyond a niche community of audit professionals and corporate governance specialists. While the FRC's nomination of the TUC to the coalition charged developing the Wates Principles for large private companies was welcome, we were disappointed in the decision to nominate only one civil society representative. We frequently found that FRC committees, boards and panels were comprised solely of business alumni and representatives. As a result, it was unsurprising that the FRC did not take a systemic approach to factoring in the views of a wider variety of stakeholders, including workers, suppliers, and others affected by business operations. The Review's efforts to address this situation are therefore welcome.

However, in light of Recommendation 9 in particular, which suggests that the new regulator should not seek to be 'representative' of stakeholder interests, we feel that the wording describing any future function as laid out by Recommendation 6 should specify with which stakeholders the regulator should maintain relations. Unfortunately, the phrase 'users of financial information' is all too often held to be synonymous with shareholders and auditors. It would be useful to specify that the new regulator must maintain substantial relations with civil society representatives, including but not limited to the trade union movement.

Q4. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

Recommendations 7-14 outline the structure of a new board with powers and responsibilities to 'effect the major shift in tone and culture to rebuild the respect of those it regulates and other stakeholders'. They aim to eliminate the FRC practice of informal appointments from the alumni networks of the Big Four. Part of this is to make the board significantly smaller and not representative of the many stakeholder groups interested. Recommendation 9 states that the board should 'not seek to be "representative" of stakeholder interests ... [but] appointments should be diverse, based on merit and objective criteria'.

As made clear above, we welcome much-needed attempts to transform the culture at the FRC. While it would be our preference to have significant stakeholder voice on the new regulator's board, we also recognise that this could result in capture by a wide variety of business groups, as listed under point 1.16 of the Review. If the new board itself is not to include civil society representatives, it must at least be given sufficient powers and confidence to maintain its independence from the large audit and accountancy firms and trade associations.

We stress, therefore, that the Government must follow through on the requisite primary and secondary legislation to properly empower the new regulator. Without concrete new powers it may be challenging for the new regulator to maintain an appropriate level of independence. Moreover, as stated in our response to Question 2. the new regulator must have systems in place to allow civil society and trade unions to exercise their voice.

In addition, while section 1.20 outlines the Review's concern with informal appointments to the FRC board from Big Four alumni, this appears to be contradicted by Recommendation 68 which proposes the regulator 'build on the experience of the Financial Reporting Review Panel and, like the other financial regulators, develop a pool of former or retired senior executives and experts – so called "grey panthers" – to boost its capacity to deploy expertise at short notice'. Our concern is that this will replicate existing problems at the FRC by drawing from the same narrow circles, undermining the efforts of the Review to build trust and renewed credibility in the regulator. At the very least, any such pool of experts must include civil society representatives and academics.

Chapter 2. FRC: Effectiveness of core functions

Question 7. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

Recommendations 24-30.

The Review recommends that the new regulator be given a power to direct changes to accounts rather than having to go to court, and that the corporate reporting review process be extended to cover the entire annual report. We welcome these recommendations. However, we have three reservations regarding the changes to corporate reporting.

First, while we see the value of avoiding the inclusion of superfluous information in reports to encourage meaningful engagement, we are unhappy with the proposal that promoting brevity should be the primary objective of the new regulator with regards to corporate reporting. Corporate reports should be accurate, relevant and lead to greater transparency. The danger is that promoting brevity above all else will lead to the sacrifice of these more important objectives.

The proposed objective could also encourage a reversal in the contemporary trend of large companies publishing more detailed information about the impacts and internal workings of their operations. Without such crucial information stakeholders, including shareholders, will find it harder to scrutinise whether companies are taking adequate steps to manage any risks that their business poses to human rights and the environment, and to avoid reckless practices that may threaten the company as a going concern.

Secondly, we are concerned that the Review expresses hesitation in supporting the new regulator's scope to intervene in matters of non-financial reporting 'because non-financial reporting is often more subjective and open to interpretation than pure numbers'. This is counter to the current direction of travel in domestic and international policy, which sees increased expectations that companies provide accurate narrative information on a variety of ESG issues.

The importance of non-financial reporting was recognized in UK law over a decade ago, with the introduction of the narrative reporting requirements in the Companies Act 2006. The scope of these requirements was later expanded via the transposition of the EU Non-Financial Reporting Directive and the Companies (Miscellaneous Reporting) Regulations. These

regulatory developments reflect the importance of companies accounting for how these issues are managed. Companies cannot be allowed to escape oversight simply because words are supposedly more subjective than numbers.

Hesitation to intervene in matters of non-financial reporting might be warranted if companies were meaningfully reporting in such areas. But the opposite is the case. A recent survey of pension funds, for instance, found that the quality and consistency of corporate data, and the lack of standard widely used metrics to monitor, manage and report against climate-related risks prohibited successful stewardship.⁴ Moreover, a recent study of company reporting under the Non-Financial Reporting Directive demonstrated the poor quality of much of the reporting. For instance, of the 25 UK companies surveyed (including companies such as Royal Dutch Shell, GlaxoSmithKline, and Vodafone) 80% had not described their due diligence processes in relation to environmental impacts, and 76% had not described due diligence processes in relation to social, employee and human rights risks and impacts. This is despite the fact that such description is now required by law. To improve compliance, the report recommends stronger monitoring by national governments.⁵ There is clearly a crucial role for the new regulator in this regard.

Finally, in our view the scope of the new regulator's corporate reporting review work should include large private companies and AIM listed companies. As the Review itself points out, the UK definition of a Public Interest Entity is narrower than in many other European countries. We agree that a review into the definition of a PIE is needed. Clearly, for instance, there was a public interest in the collapse of BHS. But in the meantime we see no reason why the scope of the CRR work should be restricted.

Recommendations 36-8.

CORE has long argued for greater accountability for individual directors. As demonstrated by the collapse of Carillion, the ability to hold individual directors to account for misconduct under the current legal framework is woefully lacking. The FRC's inability to hold non-member directors to account is a particularly egregious flaw. For that reason, Recommendations in this section are particularly welcome. We urge the Government to take forward Recommendation 36 as soon as possible.

However, the mapping carried out by the FRC, FCA and Insolvency Service outlining the arrangements in place to hold directors to account is misleading. For instance, while shareholders can act through the courts to hold directors to account for a breach of their duties, derivative actions under the Companies Act 2006 are unusual. While in the UK only shareholders can bring derivative actions, other jurisdictions, such as Canada and Singapore, allow actions to be brought by any person who at the discretion of the court has an interest

⁴ <https://shareaction.org/wp-content/uploads/2019/02/CorporatePensions2019.pdf>

⁵ http://allianceforcorporatetransparency.org/assets/2018_Research_Report_Alliance_Corporate_Transparency-66d0af6a05f153119e7cffe6df2f11b094affe9aaf4b13ae14db04e395c54a84.pdf

in the company. In addition, while the Insolvency Service has powers to disqualify directors for misconduct beyond insolvency, this power is - understandably - rarely used.

For these reasons, we disagree with Recommendation 38 that the power of director disqualification should continue to rest with the Insolvency Service alone. It would be highly appropriate to grant the new regulator powers of director disqualification where serious misconduct has occurred in a company that continues to operate as a going concern. This would provide a significant incentive for directors to be more proactive in seeking to promote the long-term success of the company.

Recommendations 42-3.

As stated above, we are sceptical about the extent to which investors are currently acting as effective stewards. However, attempts to improve stewardship are nonetheless worthwhile. We welcome the Review's recommendation to have the UK Stewardship Code focus on outcomes and effectiveness, not policy statements. We also agree that the Government should consider further powers to assess and promote compliance with the Code.

CORE laid out detailed views on the Stewardship Code in its submission to the high-level consultation on the Code, but we will take this opportunity to restate two recommendations.⁶ First, following the example of the UK Corporate Governance Code, it would be sensible to extend the remit of the Stewardship Code beyond signatories. The Code is not even enforced on a 'comply or explain' basis (although this has been proposed by the new draft Code), so it is unnecessary to also keep it a voluntary scheme. The Code's scope could be based on fund size or type, for example. Further, the Code largely consists in requests for disclosure. It would be more appropriate, again in line with the Corporate Governance Code, to frame it in terms of obligations to action.

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⁶ https://corporate-responsibility.org/wp-content/uploads/2018/03/AIUKCORE_FRC-Consultation-Response.pdf