Grant Thornton
An instinct for growth™

Getting smart about governance

And its link to financial performance

2019

Sarah Bell
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Welcome

Do stronger governance practices lead to better business performance? In our experience, they do. But there has never been conclusive proof that this is the case – until now.

Our new study, spanning 10 years of data from FTSE 350[1] companies, proves once and for all that governance is integral to an organisation's ability to create and retain value.

Companies with the strongest[2] governance practices achieve total shareholder returns of 8.5x the initial investment. This is double the return achieved by those with the weakest[3] governance.

This alone should act as a call to boards and investors, urging them to pay closer attention to the design and execution of their company's governance practices.

Changes to governance regulations, including the new UK Corporate Governance Code 2018[4] (the Code), are coming into effect in many areas. These changes provide you with the perfect opportunity to intentionally structure your corporate governance and build the right environment for effective decision-making and profitability.

In this report we will

Prove the link between best practice corporate governance and value creation

Point to a recognised blueprint from which to develop strong corporate governance

Reveal the priority areas of focus for establishing best practice governance in organisations

Make the business case for establishing best practices in corporate governance

Corporate governance: the neglected indicator of future value?

The proven correlation between strong governance and value creation

Our new research reveals the very real role that strong corporate governance plays in helping to shape a decision-making environment that creates sustainable value. In a survey of over 2,300 FTSE 350-listed company entries, we found that **strong corporate governance is a robust indicator of consequential higher performance across a wide range of financial measures.**

2x

The total shareholder return delivered by governance leaders is double that delivered by companies scoring lowest for quality of governance

Governance leaders had an EBIT 43% higher than those companies with the weakest governance practices

Retaining your value

Governance leaders are twice as likely to stay in the FTSE 350 as companies with the weakest governance practices

Those with strongest governance practices are 15% less financially leveraged and have 25% more liquidity

Value for everyone

For senior teams looking to generate sustainable value and/or retain value, the evidence of the link between strong corporate governance and consequent financial performance demands action.

For investors, the findings are similarly important. An assessment of corporate governance practices as part of a wider investment review can be an important indicator of a business's capacity to generate better value from the resources it has.

Lenders will also be interested in the metrics showing that strong corporate governance is associated with well-managed businesses with better capacity to make loan repayments over both the short and long term.

Strong governance and value creation: proving the link

Strong corporate governance doesn't create value in itself. It does, however, form the basis of the conditions for value generation.

It does this by creating a corporate decision-making environment with clearer purpose and stronger strategic intent, focusing all the organisation's assets (financial, human, intellectual, etc) on aligned value generation – rather than an ambiguous environment, which allows them to be diverted across a range of agendas.

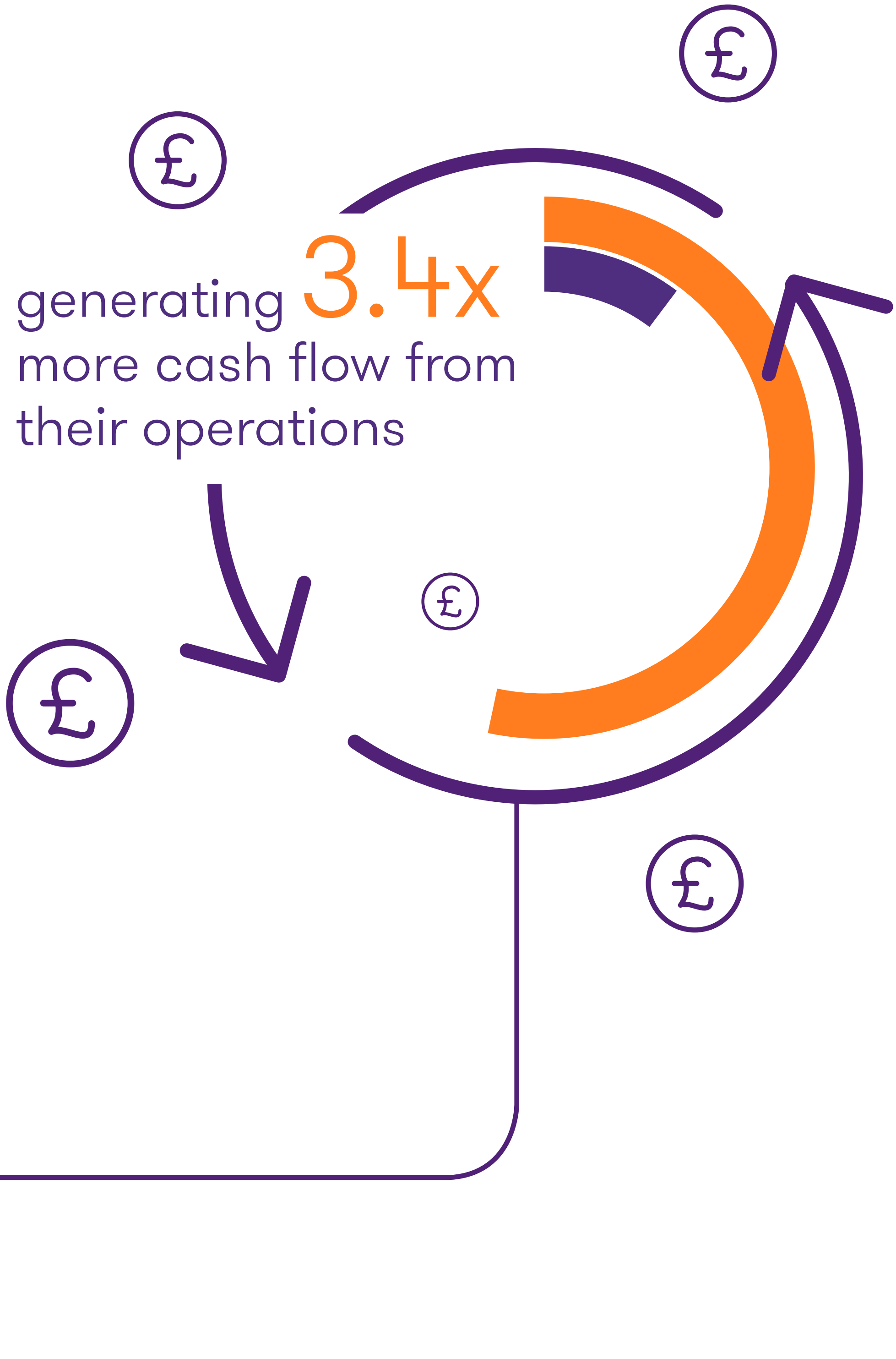
It also ensures that risks are taken and managed appropriately in support of strategy, resulting in more predictable operating performance and long-term value creation.

The impact of strong corporate governance on value creation and retention is evident in the organisations we work with. They are better at making more agile and responsive decisions and have higher levels of trust which improves operational efficiency. There's also a growing body of academic research showing positive links between strong corporate governance and the value that organisations create.

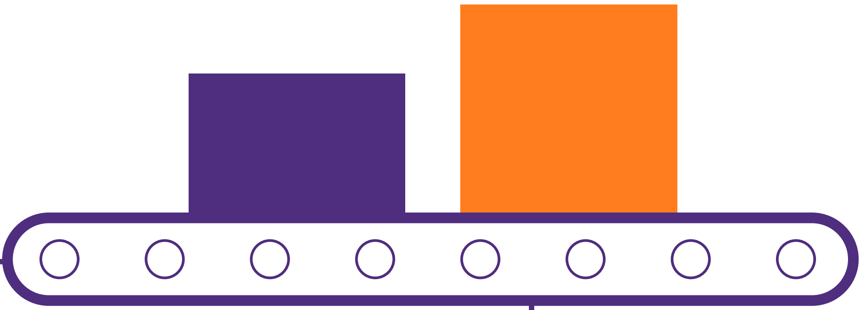
Key findings

Our research highlights close links between governance and performance both in terms of creating, transforming and retaining value.

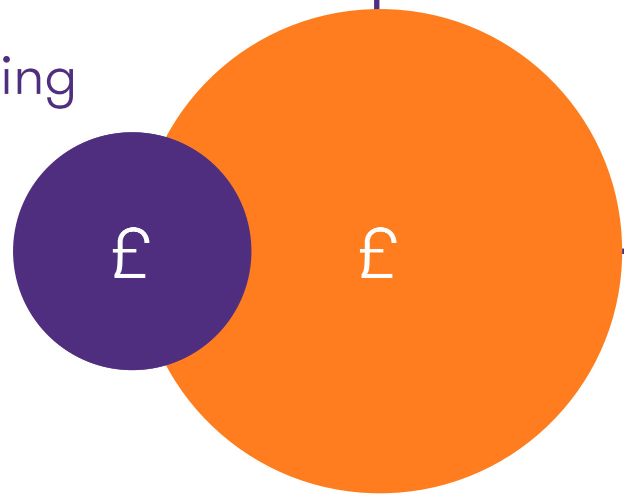
When it comes to value creation, companies with the strongest governance practices perform better:

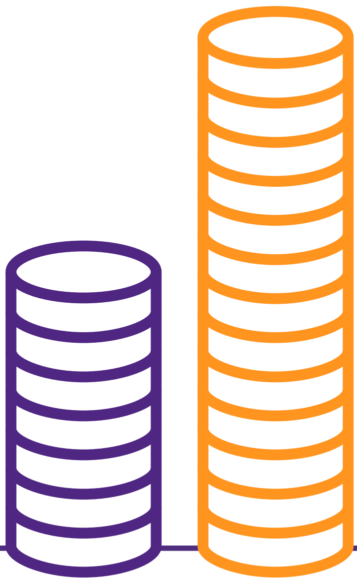


are 43% more efficient at making and selling products/services



have 3.4x more cash remaining (after investment in operations) to pay off lenders and investors





generate double the returns for shareholders

These findings hold across all 10 sectors covered by the research.

Most companies with strong corporate governance are better at retaining value

Similarly, those companies with the strongest governance practices perform better across a range of indicators associated with retaining value. These companies:

are 15% more solvent[5]

and are better able to pay off long-term debts

have 25% more liquidity[6]

and are better able to pay off short-term debts

are 29% more efficient at generating profits[7]

with the financial resources allocated to them

are more than

twice as likely to stay in the FTSE 350

These findings hold for most of the 10 sectors covered by the research.

Companies that improve corporate governance also improve financial performance

In companies that progressively improve their corporate governance score, we identified a strong link between improved governance and subsequent financial performance.

↑44%

increase in operating cashflow

↑46%

increase in free cashflow

↑10%

improvement in operational efficiency

What does strong corporate governance look like?

The top performing governance companies apply, as opposed to purely comply with, the Code. The guidance of the Code provides a basis for designing and embedding a framework for better decision-making in day-to-day operations.

In many organisations, corporate governance is approached with a tick-box mentality: the business seeks to do the minimum needed to fulfil the requirements of a particular code. This type of basic compliance is rightly viewed as a cost that delivers very little benefit.

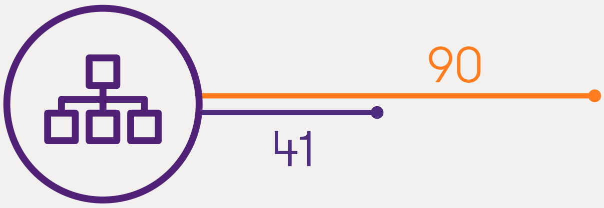
To stay relevant and competitive in the current business environment and wider community, a company and its employees need to act consistently and instinctively in line with their purpose, brand and values.

The most effective corporate governance practices are found in organisations that understand the opportunity to create and embed a consistent decision-making framework.

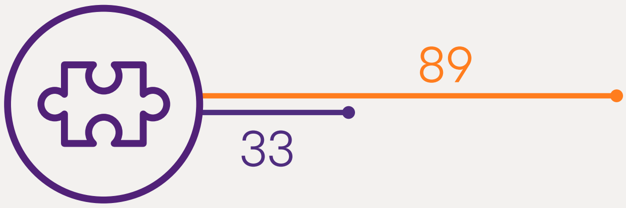
Six priority areas for corporate governance top performers

Looking more closely at the common governance attributes of companies in the Grant Thornton Corporate Governance Index, we found that companies in the top quartile achieve high scores in six key areas:

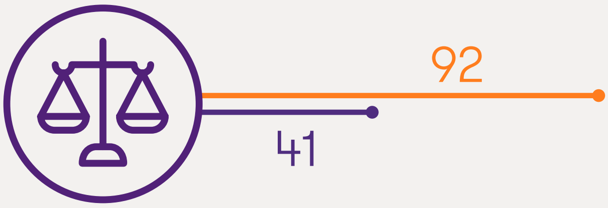
Business model clarity and connectivity



Culture and value integration



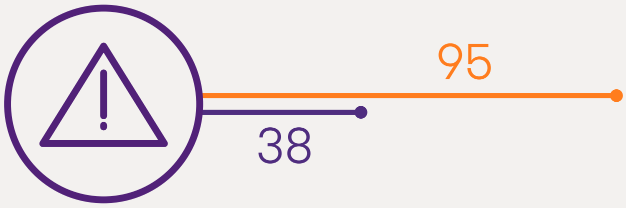
Board effectiveness evaluation



Succession planning

Risk management

Internal controls



% Top-quartile companies
% Bottom-quartile companies

Many of these areas receive particular focus in the latest iteration of the Code suggesting that each new version is a distillation of the best practices developed and evolved over time by the top performing companies.

Business model clarity and connectivity

Companies implementing best practice on business model clarity and connectivity are spending the time to develop trust in their companies. They link their business model with their company strategy and demonstrate to their people and stakeholders how it will create long-term, sustained value. Not only does this help build trust, it helps everyone prepare for future challenges and opportunities. It provides a framework that empowers decision-making.

Best practice pointers

Understand how your business makes money and articulate it clearly

Clearly link your business model with strategic objectives and risks

New Code update

The 2018 Code broadens the focus on connecting business model and strategy with a new emphasis on purpose. It asks companies to think beyond their ambition to make profits and articulate how they and their stakeholders will judge them to be successful as a business. Ultimately, a purpose should underpin decision-making, providing clarity in 'dilemma' situations.

Environmental Social and Governance (ESG) matters are starting to drive investor attitudes. This is seen, for example, in the growth in specialist funds investing in companies with strong ESG credentials.

Sarah Bell
Partner, Governance and Board Advisory

Culture integration

Culture frames how the organisation and its people behave. Embedding a consistent culture will help to mitigate risk by ensuring employees act consistently and intuitively in line with strategy – whether for example, servicing a customer, awarding a contract or appointing a new senior leader.

Best practice pointers

Define and articulate your culture, values and behaviours

Decide how you will measure and monitor culture

Incentivise your senior executives to embody company values

New Code update

The 2018 Code places culture at the top of the agenda, a marked difference to earlier versions. This new emphasis has its roots in the Financial Reporting Council's 2016 culture review[8] which found that culture is fundamental to an effective control environment. Where culture is not fully understood and embedded, or not shaped and driven from the top by the board and CEO, corporate performance is likely to be undermined.

Culture is a vital part of strong governance. We know that defining and articulating culture, monitoring metrics and communicating well, consistently and strongly is important and the 2018 Code reflects this. When reviewing culture with clients, we have seen where this works well and where it has missed the mark.

Working with a global bank, and assessing culture across continents, we uncovered both topics that had been missed, and countries where a sub-culture was evident. Challenges included a mismatch between the design and operation of the main system and the stated culture, and, in one region, very different leadership and communication styles with different messages serving to undermine the overall group culture. Consistency and alignment are so important when it comes to culture. It is not only the employees in the region that can see the mismatch, everyone can. It throws wider question marks about intent to a larger population.

Elsewhere, we see culture challenged at certain periods of the year, year-end in particular. When leaders are under pressure for financial figures they can easily demand counter-cultural behaviour. Push through that sale that doesn't quite meet quality standards, run down stock to improve the figures. These are the times when employees watch and know that when you are pushing cultural messages the rest of the year, that you don't really mean it. The end result is wasted leadership effort, an undermining of message and a lack of engagement from employees.

Boards are heading in the right direction when it comes to culture. But more can be done. After all, regulators – and auditors – cannot develop or embed corporate culture. Culture can only be authentic – and sustainable – if it comes from the leadership of the organisation and is important enough to feature as a key part of its strategy.

Sue Jex
Director
Business Risk Services

Board effectiveness evaluation

Board evaluations are often seen as an assurance exercise undertaken for stakeholders around the board's activities and structures. Instead, you should consider it a learning and development exercise. A chance to ensure your board works as a team, reflects the company's strategic priorities, markets and risks. Through this process, you should uncover whether the capacity, team dynamics and processes are fit to deliver against your future strategy.

Best practice pointers

Embrace the evaluation by acting on the outcomes

Understand how to optimise the team's abilities and address the blind spots

Create a development plan for the board and senior management

New Code update

A refreshed Guidance on Board Effectiveness has been introduced with renewed emphasis on board composition, diversity and skills. ICSA acting on behalf of BEIS are currently leading a review of board evaluations with consultation underway and a draft report is anticipated later in 2019.

Board evaluations should be much more than a confirmation of the quality of governance from the board and committees. The review process should get to the heart of any challenging issues in positive and developmental ways. Diagnostics provide the opportunity to open up awareness of the interpersonal dynamics through data and feedback. And what happens at board level often translates into the executive team's execution and their support of the tier one and two future leaders. There is much to be gained in taking a different approach.

Karen Brice
Director, Governance and Board Advisory

Case study

FTSE listed financial services firm

The company was undergoing an extended period of change, including the appointment of a new chair and CEO. Significant increases in regulatory accountabilities also meant the board and executive team needed the capacity to address current and future challenges. An independent review was needed which went beyond the Code requirements.

Our board effectiveness review:

- evaluated board governance and the oversight of the company's reputation and risk management frameworks to ensure protection of value today
- identified how the board balanced its governance oversight with executing future direction, supporting the executive team to drive growth

- evaluated the ‘softer’ measures that underpin effectiveness such as the key relationships, behavioural dynamics in the room, and degrees of conflict/trust.

We provided the board, its committees and secretariat team with a review giving options for development. Long-term experience in coaching boards and executives, combined with our governance benchmarking service, meant we were able to highlight sensitive issues impacting effectiveness, alongside the many strengths of the wider results.

Succession planning

Succession planning is about equipping future leaders to not only deliver the strategy but also to encourage the culture that will deliver it. Looking beyond the future board and executive team, it's about building depth and resilience across leadership.

As the world we work in changes, so do the challenges businesses face. We've recently seen new technologies change the way we do business and interact with one another. Without rigorous planning, you will find yourself in a position where you do not have the talent to respond to the changing environment we operate in. Prioritise succession planning to make sure your people – your greatest asset – are equipped to deliver your strategy in the future.

Best practice pointers

Identify the skills needed to deliver the future strategy

Use board evaluations to inform succession planning

Use succession planning at board level and below to improve diversity

New Code update

The new 2018 Code expands the responsibilities of the nomination committee to include the identification and development of talent to meet future leadership needs. They must now shift their focus to the next level beneath the executive team. Match an effective board and team evaluation with increasingly powerful diagnostic techniques and there is clear opportunity to develop your internal talent to meet tomorrow's succession needs.

Simon Lowe
Chair, Grant Thornton Governance Institute

Risk management and internal controls

Businesses have worked hard to strengthen their risk management processes in recent years. The most successful recognise that they must anticipate the challenges, understand what is key and choose the level of mitigation they want to embrace.

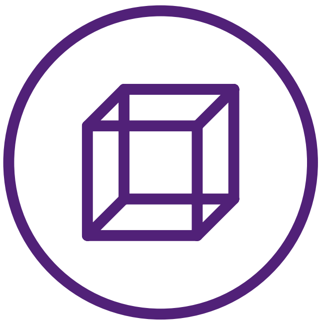
We've seen those companies doing it best also embed risk awareness in their day-to-day operations. This empowers employees to consider the potential impact of each decision they make and ensure they are aligning to the company's strategy and purpose.

Best practice pointers

Empower your people to make decisions in line with your risk appetite

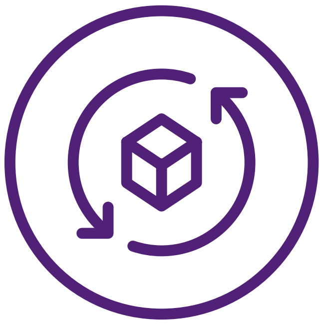
Anticipate the risks and plan for an appropriate level of mitigation

Provide detailed disclosure of your principal risks



Understand your controls framework and how it operates to manage all principal risks (not just financial risks)

Have a system for frequent monitoring of the effectiveness of your controls throughout the year



Maintain consistent controls across divisions, review and align after reorganisations, mergers and acquisitions

New Code update

Given companies' growing focus on risk management, it's no surprise to find that the Code gives this topic significant emphasis. The 2018 Code, while not significantly different, does place greater emphasis on anticipating future, emerging risks. It is implicit that as new risks emerge, controls environments need to be regularly reviewed to ensure they provide effective mitigation, particularly in the area of technology.

Integrating risk management and control into an organisation is a fundamental aspect of delivering strong governance and creating sustainable growth and value.

Key to this is articulating risk appetite and embedding a framework, culture and control environment which drives this in a consistent and pragmatic way. Culture and the control environment must be designed and maintained to ensure risks and opportunities are managed in accordance with strategy and the board's risk appetite. An integrated approach to risk management serves to improve performance and influence behaviour, decisions and activities which in concert contribute to the value premium which this latest research is identifying.

There is also increasing potential to use technology as an enabler and accelerator of good risk management and control, with increasing prevalence of data analytics and automation being used to provide enhanced risk insight, control and assurance.

Eddie Best
Partner, Business
Risk Services

Making the case for targeting best practice

We recommend these key steps to build the case for shaping a better environment for long-term value creation:

Share the full findings of our research with your board. They make a compelling case for investment.

Ask us how best practice corporate governance could improve your organisation's ability to create and retain value.

Ask us to benchmark your governance arrangements against best practice and your industry peers. With this insight, we can help you deliver fast (and persuasive) wins.

Ask us to do a board effectiveness review. You'll understand how you are framing and leading governance and culture and how you can role model the change you need.

Meet our team

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Endnotes

1 Excluding investment trusts, which follow the AIC Code rather than the UK Code of Corporate Governance
2 Strongest as defined by those in the top quartile
3 Weakest as defined by those in the bottom quartile
4 The UK Corporate Governance Code – Financial Reporting Council – July 2018 https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf
5 Does not apply in Consumer services and Financials
6 Does not apply in Consumer services, Healthcare and Utilities
7 Does not apply in Basic materials, Financials, Oil & Gas and Utilities
8 Corporate Culture and the Role of Boards - Financial Reporting Council - July 2016 - https://www.frc.org.uk/getattachment/3851b9c5-92d3-4695-aeb2-87c9052dc8c1/Corporate-Culture-and-the-Role-of-Boards-Report-of-Observations.pdf

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