Governance, compliance and insurance

During 2019 we looked at a variety of issues relating to governance, auditing and compliance. Also, as part of our colleagues work on 'Resilient Households' we published some blogs on the topic of insurance.

Misleading company accounts

This is the first of two articles about recent problems with accounting and auditing and considers factually what went wrong with the accounts of Carillion and **Patisserie Valerie**. The second considers audit and how the system of incentives may have played a part in auditors apparently not detecting when accounts are materially wrong.

A year after the compulsory liquidation of the construction and outsourced contracts provider **Carillion** it was the turn of cake chain **Patisserie Valerie** to collapse last month. According to their most recent annual financial statements both companies were profitable and both had reported rising profits and rising sales. The accounts of both companies suggested they were in good financial health with rosy prospects and the audit reports were both unqualified. So how come they both collapsed?

Carillion's accounts for the year ended December 2016 were issued in March 2017. It boasted a strong order book, financial strength, high standards of corporate governance and accountability, a responsible culture and a highly effective board.

The company also claimed strong risk management and the directors confirmed that they had "*carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity*". They said *"on the basis of both reasonably probable and more extreme downside scenarios, the directors believe that they have a reasonable expectation that the Company will be able to continue in operation and meet its liabilities as they fall due over the three-year period of their assessment."* The report confirmed the Audit Committee had "*reviewed the Group's Annual Report and Accounts and recommended them to the Board as representing a fair, balanced and understandable assessment of the Group's position*".

A few months later in July 2017 a **'trading update'** issued to the London Stock Exchange reported *"an unexpected contract provision of £845m"*. In layman's language this meant a loss. The loss wiped out all the group's retained earnings and turned what had been the accounting value of its net assets at 31 December 2016 of £729m into a net liability of £116m – meaning in balance sheet terms that the company was worse than worthless. By 29 September, in its interim statement on the results to 30th June, further losses were reported taking the net liabilities to £405m. Nevertheless the Group reported that it was *"compliant with its (banking) covenants at 30 June 2017 and is forecast to be in compliance with covenants as at 31 December 2017 and 30 June 2018"*and that *"taking account of the projected trading for the Group over the remainder of the year and the additional bank facility, the Board has a reasonable expectation that the Company and the Group will be able to operate within the level of its available facilities and cash for the foreseeable future*". Other parts of the trading update (which is also known as a profits warning) and the interim statement were upbeat about the group's prospects and gave no hint of immanent failure. By January 2018 Carillion was so bust the Government had to pay the liquidator.

The subsequent **Parliamentary joint inquiry by the Business, Energy and Industrial Strategy and the Work and Pensions Committees** revealed that both the directors and the external auditor had been taken by surprise by both the need to make the contract provision and by the company's subsequent failure. It was clear that governance was poor, the board was ineffective, the financial statements misleading and the claims about risk management and the group's viability for the next three years were wrong. The inquiry report said *"in failing to exercise professional scepticism towards Carillion's accounting judgements over the course of its tenure as Carillion's auditor, KPMG was complicit in them"*.

Unfortunately, the inquiry did not reveal how or why they were so wrong. The UK corporate governance system confers much of the initial responsibility for the financial statements and risk management on audit committees while leaving the board as a whole ultimately responsible. It was a pity that the inquiry did not ask

Carillion's audit committee members to give evidence. We do not know whether they were simply inept, failing to understand the significance of what the committee claimed it considered, failed to investigate where it should have been curious, dishonest in the statements made or whether there is a wider problem. The wider problem being whether expecting audit committees to ensure accounts are reliable and risk management effective is just too big an ask for them.

There is unlikely to be a Parliamentary inquiry into **Patisserie Valerie**. Unlike Carillion it has not left tens of thousands without jobs, a £2.6 billion hole in the pension fund, £2 billion owed to 30,000 suppliers, £1 billion owed to banks or government contracts in turmoil. So we know less about what happened. We do know that on 10th October 2018 **Patisserie Valerie announced** to investors that the board had *"been notified of significant, and potentially fraudulent, accounting irregularities and therefore a potential material mis-statement of the Company's accounts*". This, it said, had *"significantly impacted the Company's cash position and may lead to a material change in its overall financial position".* As a result the company requested that its shares be suspended from trading on AIM while it conducted a full investigation with its legal and professional advisers into its true financial position. Two days later the company said it required an immediate cash injection of £20 million without which there was no scope for the Group to continue trading in its current form. Its chairman and major shareholder, Luke Johnson, a highly successful investor and entrepreneur, would loan the company £20m while fresh capital was being raised. Further finance would be required and various reports suggested a black hole of £40m.

In mid-January the company **reported** that work carried out by the forensic accountants had revealed that the misstatement of its accounts was extensive, involving very significant manipulation of the balance sheet and profit and loss accounts and thousands of false entries into the Company's ledgers. A week later the company was unable to renew its credit facilities and as a result was put into administration. Ironically, perhaps, Johnson in September 2018, a month before the fraud was revealed, had written a column **'A business beginner's guide to tried and tested swindles'** in the **Sunday Times**. He called it an aide-memoire for those looking to spot the next fraud. How could such a financially experienced person have been taken by surprise by what seems to have been a large scale fraud in a company he owned part of and whose board he ran?

The next article will discuss why audits may fail to alert people to massive misstatements in a company's annual accounts.

Written by Paul Moxey, SAMI Fellow and a chartered accountant and fellow of ICSA – the Governance Institute. He is also Visiting Professor of Corporate Governance at London Southbank University and author of a ***text book on corporate***

__governance__ published by ICSA. In the past he has been both an external auditor and the CFO and company secretary of a listed company and responsible for the preparation of reliable accounts. Blog published 27 February 2019

Bad audits – a problem with incentives

The first article in this two-part series looked at how the accounts and annual report gave no hint of the impending collapse of Carillion and highlighted a surprise £40m accounting black hole at **Patisserie Valerie**. This article considers the role of the auditor and why the system of incentives may mean audits fail to identify large errors in company accounts.

The **objective of an external audit** by an independent auditor, according to the **Financial Reporting Council**, is to obtain reasonable assurance about whether a company's financial statements *"as a whole are free from material misstatement"*. It is accepted by accountants, if not the general public or politicians, that it is not an auditors' job to detect fraud. The Chief Executive of Patisserie Valerie's auditor Grant Thornton confirmed this to the Business, Energy and Industrial Strategy Committee on **30 January 2019** as part of its inquiry into the **future of audit**. This caused some consternation among the Committee members who thought an audit should find fraud. Strictly speaking he was right. Following a landmark case in 1896, re **Kingston Cotton Mill Company**, the judge clarified that auditors have a role more like that of a bloodhound than a watchdog meaning that they are not supposed to seek out fraud; it is their job, however, to detect material misstatement of the accounts however caused which includes material misstatement caused by a fraud. As with Carillion we can reasonably expect auditors to spot when accounts are massively wrong. In the case of Patisserie Valerie we can expect the auditor to spot a missing £40m when material to the accounts and as the reported profit for the year ending 30 September 2017 was just £16m a £40m fraud would have been material. The Times and others have disclosed that a forensic investigation by PwC for the company identified a £40m fraud involving forged company minutes, forged signatures on bank contracts and fictitious invoices for shop refurbishments. The PwC report has not been made public but **reports** suggest the fraud had been undetected for at least three years.

According to the **Financial Times** the motivation for the fraud was *"trying to keep people happy. Luke Johnson had certain expectations. He is hard-nosed and results-driven. It was easier to fiddle the numbers than admit to bad results."*

Keeping people happy may have been the incentive to perpetrate a fraud. Let's consider the incentives to ensure accounts are reliable and an audit is thorough. The diagram shows the main incentives for each of the main players involved in the preparation and audit of a set of accounts.

On the left we have people who we can reasonably expect will want fair, balanced and understandable accounts and a good audit. Junior auditors, new to the profession will want to do a thorough job and keep their bosses, mainly the audit senior happy. We expect non-executive directors (NEDs) to ensure the accounts are right but they have little real incentive to do so. They would probably prefer a quiet life to looking for problems in the accounts and risking being called troublemakers. For each day they work they are paid a fraction (around 10%) of what a chief executive would earn so why should they try to second guess what management say? Shareholders ought to want reliable accounts but what they really do not want is bad news so will not thank a board or an auditor who reveals problems before they have had a chance to sell their shares.

On the right we have people who may not really care if the accounts are reliable, may avoid following up possible problems or even worse manipulate them or stand idly by knowing that accounts are misleading. By the time an auditor becomes an audit senior or manager, a few years into their career, they will be under no illusion that what the audit partner wants is an audit done profitably within budget. The financial budget will be based on estimated hours for different parts of an audit. The time budget is likely to be challenging, leaving little or no time for audit staff to look into problematic audit findings. An auditor soon learns it is wise to look the other way

rather than escalate an unresolved audit finding for a manager or partner to worry about. Auditors who are too dogged in their job may find themselves looking for another position. The audit partner's main concern will be to have a profitable audit and hopefully procure more profitable consulting work for the team. S/he knows that raising problems with the client could jeopardise getting consulting work and even lose the audit contract. The audit firm as a whole wants to be highly profitable and avoid public censure or negligence claims although it is willing to accept both to an extent as the price of doing business.

Finally we have executives whose main priority may be to keep their jobs and maximise their performance related pay. It has been conclusively demonstrated by peer-reviewed research that executives have manipulated earnings to boost their pay. It is also well known that pressure to meet expectations can lead people to corrupt behaviour. I have written more on this in a **publication** by Transparency International looking at the role of formal and informal incentives in corrupt behaviour.

As the broken see-saw in the diagram suggests the system is broken.
The **Competition and Markets Authority** has been looking at what's wrong with audit and reported in December. The CMA proposes legislation to separate audit from consulting services. Although the report makes 91 references to incentive it does not look at the incentives within audit firms in the way set out above. As a result any reforms are unlikely to address the real problems which are lack of professionalism by auditors and incentives to look the other way rather than do a good job. The Big Four audit firms seem likely to act before legislation comes into force and ban themselves from offering non-audit services to FTSE 350 audit clients. Time will tell whether this amounts to little more than placing a fig leaf over the problem. There is not much room for optimism.

Written by Paul Moxey, SAMI Fellow and a chartered accountant and fellow of ICSA – the Governance Institute. He is also Visiting Professor of Corporate Governance at London Southbank University and author of a ***text book on corporate governance*** *published by ICSA. In the past he has been both an external auditor and the CFO and company secretary of a listed company and responsible for the preparation of reliable accounts. Blog published 6 March 2019*

COVER Magazine: Technology and Innovation Forum 3rd April 2019, Technology and the "Protection" industry

Life protection, health insurance and income protection insurance are often overlooked areas of the financial sector. The industry constantly worries about the "protection gap": that fewer than 35% of the population have any protection insurance cover, either provided by their employer or bought by themselves. This event, organised by the leading industry magazine COVER, set out to explore whether new technology could change this.

Artificial Intelligence (AI) is making inroads into so many areas of life, and so many professions, that naturally the Forum began with a Keynote talk about it – "AI methods for evidence-based risk assessment", delivered by Professor Sophia Ananiadou, Director of the National Centre for Text Mining (**NaCTeM**).

In what was quite a dense and challenging talk (I'm sure I wasn't alone in losing track of the details), the Professor explained some of the key principles of text mining and their applicability to underwriting, using health records. She discussed how "explainable" AI could be applied, at least in specific domains such as biology and chemistry, with semantic metadata adding structure to the analysis. In particular, she talked about **THALIA**, a semantic search engine that can recognise concepts occurring in biomedical abstracts indexed on **Pubmed**. She covered a number of examples of how text mining can help quantify mortality risk.

In the second session, David Vanek CEO of **Anorak** talked about robo-advisors and digital advisors. Referring to a previous COVER article "The Rise of the Robots" he argued that while big data and AI could add extra analysis to the economics of advice, it was clearly necessary to have a combination of online and offline services to support customers. He acknowledged that automated systems could link with bank accounts and other information sources to identify changes in customers' circumstance, but argued that selling protection required an emotional connection and a very personalised, responsive approach.

The last of the pre-coffee sessions was Paul Huggett, Commercial Director of **Rocketer** talking about how social media could be used to close the "protection gap": remarkably few people have income protection. He described how some paid social media advertising could address the 40m UK Facebook and 29m Whatsapp users. These approaches were fairly standard online marketing techniques. The concept of "life triggers" was interesting – analysis of social media content could tell you for example when someone bought a new house or had a child, giving you a key moment to attract them to your protection product. He also introduced the concept

of “look-alike audiences” – people whose characteristics were similar to your existing customer base, and so who might be seen as more likely to buy your product.

After coffee (and it has to be said some excellent pastries) there were two panel discussions. The first, with Paul Yates of iPipeline, Adam Higgs of FTRS and Paul Huggett, addressed the question of “knowing your customers”. They discussed how algorithms could produce better pricing and risk models and how Google Analytics etc could help you see the profiles of your customers and contacts. They view AI as a kind of sophisticated calculator, helping you find efficiencies, but essentially a back-office activity. Chatbots might have a role, but the panel thought human advice was vital. In the Q&A a question about diversity came up – this to a panel of balding white men. Everyone agreed (!) that more transparency and diverse approaches, avoiding a “one size fits all” model was required.

The second panel session looked into “direct-to customer” (D2C) sales, and how it fitted with the advisor market. There was general agreement that a “blended” approach combining online and offline contact, depending on the needs of the client, was best. There would be different levels of complexity and hence of confidence, so the first contact needed to be a “triage” to determine the best channel to use. Only those with “clean lives” could be dealt with online.

The discussion covered several issues. There was a feeling that the way the industry tackled issues of mental health was not sufficiently nuanced. The view that AI could never replace the emotional contact of an agent surfaced again. My feeling was that this session hadn’t really got to grips with the radical changes new technology was going to bring – the D2C discussion was well behind what other industries already do, and the attitude to AI bordered on the complacent.

In his round-up comments, Adam Saville, COVER’s editor, identified the project that SAMI are doing with the Chartered Insurance Institute on the **digitalisation** of medical health records as a key way of improving access to protection. The ready availability of information on health conditions should provide benefits to consumers, GPs and underwriters with faster, more accurate assessments. This could underpin even more radical change.

Written by Huw Williams, SAMI Principal, published 18 April 2019

Activist Shareholders – Agents of Change?

Photo by JESHOOTS.com from Pexels

Some people invest in a company because they trust the leadership to deliver shareholder value, due to track record and board composition. Some people invest in company because they like the product or service proposition, the basic business model. Activists invest for the latter and certainly not the former. Activists have faith in the underlying business but not the leadership, in fact an activist typically wants to replace the CEO, an impediment to releasing higher return for investors.

The activist takes a position from which to lobby other shareholders and their influencers, he is an agent of change and a disruptor, so to the board he is always an unwelcome intrusion. The activist takes on a significant challenge which, if successful, will bring substantial reward that is why he has a higher appetite for risk than the incumbent board and why he is invariably an aggressive hedge fund.

The first challenge he faces is to convince fellow shareholders that their trust in the incumbent board is misplaced and the business, having exhibited sluggish growth in a buoyant sector, is overdue for a new leader. In short it is time to call time on the CEO. If he manages to convince some shareholders of his defenestration strategy, there will be others who baulk at such drastic action.

The second challenge he faces is to convince fellow shareholders that he has a viable alternative to the existing CEO, a replacement who will adopt a new strategy to release value trapped within the business. Nervous fellow shareholders will be wary that to endorse the candidacy of the activists' man could be simply of jumping from the frying pan into the fire and may not result in anything more than unnecessary upheaval. The status quo is a powerful advocate of inertia.

The third challenge he faces is to win a confidence vote at the AGM, by a significant majority ie over 50% and the size of some individual shareholdings might make this almost impossible. The activist will also aim to win over proxy voting agencies to his proposal, but not all agencies will be open to change. For example, pension funds tend be quite conservative and see any external pressure to impose new leadership as a risk to their long-term investment strategy.

The fourth challenge for an activist is to be patient as even a lost motion at an AGM can sow the seeds of discontent which come to fruition months or years later. Look at Premier Foods from July 2018 to date. At the AGM on 18 July 2018 the Hong Kong based activist and minority shareholder (10%) Oasis called a vote of no confidence in the CEO with a proposal to replace him with the Finance Director and a new strategy of asset disposal to release value.

The incumbent board presented the activist as an asset stripper. *'If these activist investors succeed in removing him, they risk destroying significant value, rather than creating it'* said former head of Waitrose Mark Price. The motion duly failed by 59% – 41% votes but having achieved support from well over a third of all shareholders, the proposal had achieved consideration. This despite the Chair rallying support for his CEO from the largest shareholder, Japanese Nissin Foods (20%).

In November 2018 the CEO surprised the market by announcing he would step down in three months so a successor could be found to pursue a new strategy. This appears to be by 'mutual agreement' but no doubt the confidence vote had some bearing. Two months later the UK activist Paulson increased its share from 7% to just under 12% suggesting that the CEO departure was a positive move, and there was indeed latent value in the business awaiting release. This seems to vindicate the Oasis AGM motion last July, despite it failing to succeed at the time.

Activists are truly agents of change, welcome or not, they make an impact even if it is just not always immediate.

Written by Garry Honey, founder of ***Better Boards,*** *CEO,* ***Chiron Reputation Risk*** *and SAMI Associate, published 25 April 2019.*

Risk management and the impact of culture

With so many examples of poor corporate behaviour and poor governance, it seemed a good time to address why getting the culture of an organisation right was so important. The CRSA (Control and Risk Self Assessment) Forum is an independent group of enthusiastic practitioners and academics led by SAMI Fellow Professor Paul Moxey, and it used its recent meeting to explore culture and governance.

The day was kicked off by Simon Lowe of Grant Thornton describing the research they had done on culture and its role in effective governance, and their approach to auditing culture. He described how compliance with the UK Corporate Governance (UKCG) Code was improving, but it was now apparent that assessment needed to go beyond compliance to the application of the principles.
Good governance needs a proper understanding of risk – "the board should carry out a robust assessment of the company's emerging and principal risks" (UKCG). Clearly technology is one major area of risk. However,from their analysis of company accounts, Grant Thornton found that, in several sectors – including, astonishingly, the financial sector – many companies had not identified technology as a risk. And, of those that had, fewer than 30% had a board member with technology expertise.

Annual reports did contain references to corporate culture, but few CEOs (29%) referred to what they might do about it. Monitoring health and safety and running some employee engagement surveys seemed to be as far as it went. One or two examples of how culture might be captured in a “dashboard” were shown.
Then Simon’s colleague, Karen Brice, led an exercise on producing metrics for culture. She proposed a 6-factor “culture web” including such things as “rituals and routines”, “control systems” and “power structures”. The point of the exercise was not so much the absolute values assigned but the different perspectives different people’s assessments revealed.

The session generated an intense and lively discussion. There was some scepticism as to whether board members really wanted to get to grip with risks, preferring instead “plausible deniability” – several of the well-known governance disasters were explored. The challenges of creating common cultures following mergers were raised (an example being AT&T and HBO). And the idea of making the challenge a positive by promoting “Boardroom Brilliance” was also proposed.
The next session led by Peter Hanley and Colin Perris talked about “risk exploitation” and the work they were doing to formalise a process – even an app – to help with that. Their basic tenet was that a risk management approach tended to try to limit the forces pulling the organisation away from its goals. Instead what was needed was a focus on achieving the positive outcome. They too led us in an exercise, where we role-played being board members of a social housing organisation facing the post-Grenfell world. The exercise highlighted how easily one fell into considering risk as negative, rather then driving towards a positive. A key idea of a “Golden hour” emerged – pre-prepared mitigation strategies that would enable boards to react quickly to major challenges.

Later in the day SAMI Associate Garry Honey discussed creating a positive risk culture. Different people, even within the same organisation, will have different risk appetites, often depending on their role or inclination. A CFO is likely to be risk averse, while a hedge fund manager sees risk as an opportunity for higher profit. Garry explored the known/knowns and unknown/unknowns matrix, showing how best to expand the former area. He then went on to discuss reputation management, arguing the need for prevention rather than cure. Ultimately, he too was arguing that coping with risk was all about culture rather than process.

The day ended with a session by SAMI Emeritus Fellow Gill Ringland talking about the “Ethical Reading” (the place not the activity!) project she is involved with. Again, the point was that compliance is not enough. In multi-cultural and fragmented societies, traditional norms and structures, and the support of the community can break down. So there needs to be a strong lead focus on common ethical principles, such as respect, co-operation, collaboration, integrity, fairness and responsibility. Happily, she had found many willing volunteers and champions to participate in

promoting these ideas – see #itstartswithme. Her goal is to spread these ideas out into a much wider “Ethical cities” programme.

All in all it was a very inspiring day with loads of interaction and involvement of the audience. The value of scenarios in the consideration of risk came out strongly. One can but hope that the days of truly valuing and understanding the role of culture and ethics in organisational decision-making is coming that much closer.

Written by Huw Williams, SAMI Principal, published 8 May 2019

The Private Rental Sector – A New Market for Income Protection

In 2017-18, the private rented sector accounted for 4.5 million or 19% of households. Throughout the 1980s and 1990s, the proportion of private rented households was steady at around 10%. The sector has doubled in size since 2002 and the rate has hovered at around 20% since 2013-14.

25-34-year olds are now more likely to be private renters than owner occupiers. So if you look at the age range of 25 – 44 years, which is the majority of the IP (income protection) market for new customers, a very significant number are private renters. Despite this change anecdotal evidence suggests that only around 6.5% of IP customers are renters.

A significant proportion of them are pretty similar to those with mortgages. More than a third have at least one dependent child and most are working. Between 15 and 20% of rent arrears in the private rental sector can be put down to sickness.
So what happens when sickness strikes and a household doesn't have IP? If the household is entitled to Universal Credit (UC) and they live in social housing their rent is normally met in full minus the "bedroom tax". This is not the case for private renters. Here their eligible support is determined by Local Housing Allowance Rates (LHAs), which are pegged at the cheapest rent in an area for a particular size of property or capped. In addition, LHAs were frozen in 2016 until 2020 while private rental costs have gone up. A growing gap has been created by this system between the rent households have to pay and the amount of UC they receive for that purpose.

The gap is very variable. In most of London and some other UK hotspots the gap can be very large indeed and even in less well-off areas the gap is still significant. Here are five examples of the average monthly gap – Hounslow (£437); Cambridge (£531); Bristol (£217); Milton Keynes (£148) and York (£107). To meet the gap households have to find the extra money from the living expenses element of their UC. In 2017, 38% of private landlords experienced UC tenants going into rent arrears. Three out of 10 of those going into arrears were evicted. Homelessness has grown by 40% in the past five years. Apart from the financial impact of the gap there is also the social burden on families caused by relocation – often well away from their original homes. And as well as the short-term emotional disruption, the longer-term health and social consequences of homelessness can be significant, particularly for families with children.

For most customers, buying IP is a lifestyle choice not to be dependent on means-tested benefits from the State, having own occupation cover and rehabilitation support. For those in social housing this remains a situation of choice. For private

renters the choice is starker. Either you have IP to cover your rent and living expenses, or you will not have sufficient money to pay your rent and support your family.

The growth of the gap is a strong incentive for IP purchase and is an opportunity for local intermediaries to get to know a new market, form relationships with tenants, letting agents and landlords to meet an ever-growing household resilience need. As with all IP advised sales documentation should include a warning with regard to the possible interaction between IP policies and State benefits and for rentals it may also be wise to document that the purpose of the product is to support rental payment and living expenses.

*Written by Richard Walsh, SAMI Fellow and co-chair of BRHG, and originally published on the **IPTF website**, June 2019. Blog published 12 June 2019*

Should You Fear an Activist Shareholder?

Image by Gerd Altmann from Pixabay

How should you respond when an overseas hedge fund takes an active interest in your business? Many CEOs treat this as impertinence: an outsider questioning strategy and competence of the executive to make sound stewardship decisions. Activists believe shareholder return is hampered by a complacent board driven by risk aversion not value realisation. In short, activists have a higher risk appetite than the board: they see potential higher returns but they need to convince fellow shareholders new leadership will adopt a strategy to deliver higher shareholder value.

A typical activist is based in the US or Asia and views many UK companies as fertile ground for their investment fund. Activists have a different perspective on corporate risk to an incumbent board. An activist takes a long-term view of value creation despite a sometimes unwarranted reputation for impatience for short term gains. Many see the composition of a FTSE company board as part of the problem, too many like-minded individuals susceptible to groupthink or commitment escalation. The activist is less risk averse than the average UK board and prepared to take higher risk in order to reap the benefit of higher reward. It really does boil down to a difference in risk appetite.

What creates a difference in risk appetite? There are two key determinants, perception and attitude. Perception is whether you view risk as a threat or opportunity, attitude is whether you seek it or avoid it. If you view it as a threat you

will prefer to avoid it, conversely if you view risk as opportunity you will prefer to seek it. Avoiders tend to sit on group boards whereas seekers tend to sit as fund managers. Compliance and governance regulations also nurture a risk avoidance culture, something behavioural economics confirms to be a common feature of decisions taken collectively by boards.

The activist shareholder is more comfortable viewing risk as opportunity and tends to view it within the context of strategy as opposed to governance and compliance. The activist recognises that both strategy and risk are estimated future outcomes, neither of which can deliver certainty: strategy merely being future direction and risk being future uncertainty. A risk averse culture will never offer returns that a risk seeking one can. The former sees hazard and unfavourable outcomes whereas the latter sees opportunity and beneficial outcomes. Glass half full or half empty? ..or even Glass Lewis!

What do activist shareholders really want as a disruptor to the status quo? As investors they believe in the business and its true potential, it is unfair to assume they only wants to asset strip, make a 'quick buck' and exit, this is rarely the case today. The activist wants to release value they feel is trapped by a complacent board, comfortable with a strategy that has not been challenged by any passive shareholder party, in short, a board afraid to make bold decisions and increase shareholder value. They see hubris in corporate leadership content to justify weak performance through excuses about market forces or competitor activity but never prepared to acknowledge its own shortcomings and lack of enterprise. They need to secure a mandate for change.

Activists bring a new vision from overseas and with an attitude to risk that is refreshingly different. Their job is to make other shareholders doubt the trust they placed in the incumbent management team: to question fitness for purpose where that purpose is maximising shareholder return. Unfortunately some institutional shareholders refuse to share this view, either because they don't want to admit they were wrong to trust the board, or it still retains their trust, or simply because their modest forecast returns are being met satisfactorily: *'if it ain't broke don't fix it'* or more likely: *'better the devil you know'.* Not all shareholders are in it for the same thing and an activist cannot expect them all to share their view.

An activist taking interest is a wake-up call, an opportunity to invite endorsement of your strategy from major shareholders and secure their backing for your board. It is an opportunity not a threat.

Written by Garry Honey, founder of ***Better Boards,*** *CEO,* ***Chiron Reputation Risk*** *and SAMI Associate, published 15 August 2019*

Activism Is A Wake-Up Call for Your Board

Image by Gerd Altmann from Pixabay

Shareholder activism is on the rise and according to **Lazards** more investors are using activism as a tactic putting increasing pressure on boards to defend their strategy in the face of calls for change.

The activist will typically own less than 10% of the shares and needs to convince another 40% of shareholders that their planned business strategy is more attractive than that of the incumbent board, and will release pent up value. This is an enormous challenge; they must find and motivate the disillusioned from among the institutionally conservative and inherently inert. This is not impossible as they only need deal in expectation, trust and confidence rather than fact. A brighter tomorrow and higher dividend is a no-brainer to anyone seeking a better return on their investment.

Meanwhile the company board will be busy contacting all shareholders to secure support. Many of these will not have previously taken much interest in the strategy itself but will begin to once an activist criticises it and makes waves in the market. The smaller shareholders and proxy voting agencies will be bombarded with information to justify the current strategy, board composition, CEO competence and

overall common sense of the status quo. The activist will be portrayed as an ‘asset stripper’, an out and out bad guy, a charlatan whose promises will turn to dust.

The activist need only expose a vein of latent dissatisfaction irrespective of its source, much as the Leave campaign did in the June 2016 referendum. The precise trigger for dissatisfaction doesn’t itself matter because it all hinges on a achieving a majority in a binary choice vote. The activist only need sow doubt and question trust, highlight poor decisions and timidity of action. It is relatively easy for them to show that the incumbent leadership could have performed better because there is always a ready example to support their hypothesis.

Conversely the board will be fighting for their existence and the CEO will want the Chair to wholeheartedly back him against possible defenestration. There will be a huge PR push to rally shareholder support and win a vote of confidence at the shareholder meeting – AGM or EGM. The current strategy will be defended using supporting evidence, selected and presented to demonstrate competence and capability. The status quo will be defended as the safest option for shareholders.

Who wins depends on winning hearts and minds through an effective campaign. The Cameron/Osborne faction on the Remain ticket failed to convince the country they had the right strategy, whereas the Johnson/Gove faction on the Leave ticket tapped into dissatisfaction and promised a brighter tomorrow. They didn’t have to be specific in how this would be achieved, they just tapped into a well of discontent. Conversely the activist shareholder does have to propose a different CEO or strategy, but they also tap into the well of disillusionment and dissatisfaction.

Why is activism increasingly being used as a tactic? It is a vehicle for achieving change that appeals to shareholder emotions like frustration and impotence. It is not restricted by the requirement for proof but lives off expectation and belief. It cuts to the very currency of reputation: character and trust. Once doubts are raised about competence and performance, their spread is contagious. The activist questions whether confidence in a board, once willingly given, is overdue for retraction. The activist has conducted their own due diligence and spotted an opportunity to release value. Invariably a hedge fund, the activist probably has a better understanding of risk than the incumbent board.

*Written by Garry Honey, founder of **Better Boards,** CEO, **Chiron Reputation Risk** and SAMI Associate. Originally posted on Chiron Reputation Risk website **14th February 2019**. Published by SAMI Consulting 29 August 2019*