



## Profile: John Coombe

### Black Swans Do Exist

*Non-executive director and former CFO John Coombe feeds the business reporting debate with a few (personal) lessons from the financial crisis.*

## Intro

“The days when directors turned up to meetings not having read the papers and had a good lunch and chatted for an hour or two and then went home are long gone,” according to John Coombe in the following interview given in late 2009. He explains that being a director is hard work, especially in companies that land in a crisis and have to work their way out. Having gone through the experience a number of times, and still going strong, John Coombe is *the* director to go to for a few lessons from the financial crisis.

### John Coombe: A brief bio

John Coombe started his career at chartered accountants Dixon Wilson & Co. in the UK. He then moved to the position of management accountant at British Oxygen Group Ltd, followed by a number of senior financial roles within Charterhouse Group plc and Charter Consolidated plc. In 1986, he joined the then Glaxo Holdings, and retired in 2005 as chief financial officer of GlaxoSmithKline plc. Until 2003, he was a member of the UK Accounting Standards Board. From 2003 to 2008 he was member of the Supervisory Board of Siemens AG. Currently he is, among other roles, non-executive chairman of Hogg Robinson Group plc, non-executive director of HSBC, and non-executive director of Home Retail Group plc.

See also his executive profile at [HBusinessWeekH](#).

## Increase your focus on risk

*Due to the financial crisis, corporate governance has certainly moved up the level of priorities. What are the one or two big things that organizations generally should be doing in terms of governance?*

“The thing that has leapt off the page on most people’s agendas recently has been increased focus on risk. The focus is on critical risks, because of course we are going through really difficult times. The time may come again when boards want to challenge managers more on what they are doing to grow the business, but right now the challenge is all on, ‘What are you doing to protect the business,’ and ‘What are you doing to make sure that we don’t tumble into a black hole like [Northern Rock](#), [HBOS](#), or [RBS](#)?’<sup>1</sup> I certainly think, as far as financial services companies are concerned, getting directors to engage more in understanding the risks in their products and product areas has become much more important. It is certainly something I feel as a bank director we will have to do more of.”

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<sup>1</sup> These three UK financial institutions ran into trouble during the financial crisis and had to be bailed out by the British government.

## **Directors need to understand their risks**

*How (then) could boards get a better grip on those crucial risks?*

“The boards I sit on are all very diligent in pursuing those risk areas that may derail the business. Realistic risk assessment is quite difficult, however. Furthermore, recent events were such that it would have been very difficult for some companies to avoid what did happen.

“In the normal situation, the executive will say, ‘We want to do this.’ And the non-executives will respond, ‘Hmm, let’s go through that one more time, because we understand your desire to make money but, in certain circumstances, we feel that’s a risk too far. We would rather make less money and not run that particular risk.’ But it requires quite an involvement in the business to be able to pursue that line of questioning. In the financial services sector and banking sector, I am finding one of the most challenging things is understanding the product areas well enough to be able to ask the critical questions. For some of these products, it is hard enough just listening to the explanations. To go the next stage and say, ‘What would happen if a certain series of events occurred.’ These are difficult calls and hard to quantify in terms of saying, ‘That is a very complex product. As long as it is sold properly; and as long as the market is moving within certain parameters; and as long as you have a system set up that rings early-warning alarm bells if the market moves outside the parameters, so you can shut down operation or at least curtail its activities, then...’ Managing risk is very hard to do.

“In terms of establishing whether a new product or line of business fits within your risk appetite, a director is reliant on the joint wisdom of the committee looking at the decision to say, ‘Taking everything together, we think that is a product or line of business worth pursuing.’ Or you come to the opposite view. It is clearly essential to establish risk appetite.”

## **Place parameters on your risk appetite**

*How can boards establish their risk appetite and quantify it?*

“The glib words ‘establishing your risk appetite’ conceal one of the hardest areas that exist for directors to put parameters around. Setting your risk appetite is essential, but difficult to quantify. Therefore, in my experience, it can turn out to be a pragmatic exercise because people don’t know how to deal with it in any other way. You go through the risk map every year—or the executive goes through it and brings it to the board—and there are some new risks added, some dropped off. You sit at the committee meeting and you discuss it: ‘Does that properly reflect the world economy or the local market as we see it today?’ and ‘Can we think of any risk that they haven’t thought of?’ You may decide that you want more emphasis put on a particular type of risk, because you have seen it going wrong in another business. The process can become very mechanical, and this must not be allowed to happen. There is more to establishing risk appetite than preparing a risk map.

“The fundamental question is, ‘What is the level of risk that a board may be willing to run?’ Some boards may deliberately take on a more risky strategy, because they think the returns are worth it. They may not get it right all of the time, but then they must ensure that they are well prepared to move quickly and deal with the results before they become terminally critical. Boards must establish and quantify their risk appetite by reference to the key control and performance indicators in their business (see also ‘Having a high-risk appetite: “We thought the returns were worth the risk””).”

### **Having a high-risk appetite: “We thought the returns were worth the risk”**

“Take the example of property lending by some banks, and the degree to which they geared up their balance sheets to improve their return on capital. I am guessing that if you challenged the boards, they would have said, ‘We knew that was a higher-risk strategy than some others, but we thought the returns were worth it, and furthermore, our shareholders for many years also thought the returns were worth it.’ Never did anyone imagine that the wholesale lending markets would dry up. There will always be some risks that boards will run that go wrong because of unexpected consequences.”

### **Black swans do exist, so be alert**

*The sudden disappearance of liquidity in the market place was a terrible shock to everybody. What can we learn from this?*

“One valuable lesson is that ‘black swans do exist.’ So we are very much more aware of that when someone says, ‘Don’t be ridiculous, it is impossible to anticipate that the wholesale markets might dry up, that’s an extremely remote risk we will live with.’ I think we are all now much more alert to the fact that such events—even at the extreme end of risk possibility—can actually happen. That is a valuable lesson learned. However, my worry would be that with the passing of time, people’s alertness to extreme risk events diminishes. That is a statement of the obvious, I suppose, and evidenced by banking crises or over lending in the property market every 10, 15, or 20 years.”

### **Establish a specialized risk committee**

*What could we do to keep risk management current on the board agenda?*

“There is quite a debate at the moment on maintaining directors’ attention to risk. One of the recommendations coming out from these debates, at least for financial institutions, is that we should have separate risk committees. I think this makes sense. However, it does raise the issue of time commitment for directors, as many of the most suitable candidates will already be on the audit committee, and if they have a full-time job elsewhere it may be difficult to make more time available. Yet there is value in having executives contribute as non-executive directors in other companies.”

### **Consider employing a risk specialist**

*Did you come up with any solutions?*

“I do wonder whether a new advisory service might be established, focusing specifically on risk. Maybe risk committees should have someone who is a specialist in this area, rather like employing a recently retired audit partner at the audit committee to help out on some of the more complex accounting issues.”

*And would this specialist be reporting to the board and specifically to the non-executives, rather than to management?*

“I would have them advising and reporting to the risk committee, which is likely to be comprised of non-executive directors with relevant executives in attendance.”

## Let traders put some of their own money in as well

*The financial crisis also revealed that people were incentivized to take more risk with other people's money than they probably would have with their own. Going forward, shouldn't they be required to put more of their own money or income on the line?*

"It has to be that way, and I think that that point is being grasped. It is one of the new areas of focus for the governance experts, who now say, 'One of the reasons it went wrong is that too many people were gambling with other people's money and getting paid huge bonuses when it worked, but losing nothing when it didn't work; when it went wrong.'"

*So, basically, they had a one-way bet?*

"They did, but this is largely now being addressed by remuneration policies, which require deferral of bonuses and clawback if subsequent events demonstrate changed circumstances such that the bonuses should have been smaller, or not paid at all. To go to the next stage and create vehicles where traders partially invest and bear real personal risk can be done, but is probably impractical in large institutions other than hedge funds."

## Align remuneration with (longer-term) real performance

*What should we do in other circumstances?*

"What is now being done in many banks and other financial institutions is to pay out a large part of the bonus in shares, making sure that it is deferred for a period of time. If they can't get the shares for two, three, or four years, they will suffer the ups and downs of the share-price movement, which ought to reflect longer-term performance and alignment with the shareholders. When this is combined with potential clawback, we have a fairer and more rational system (see also 'Effects of deferred remuneration')."

### Effects of deferred remuneration

"If someone earns a £2 million bonus, they may get a third of it in cash and two-thirds in shares. They can't get their hands on the shares for one, two, three, or four years, and if something then does go wrong, they can get penalized in at least two ways:

- Firstly, it is much easier to remove those shares from them and say they are only going to vest if that particular bit of the business continues to make real money for the next two years. So the shares don't actually vest unless solid continuing business is achieved.
- Secondly, if there are areas of disaster or poor performance, the share price will fall. So the shares you have been entitled to become worth less anyway.

In my view, it is difficult currently to see changes to the remuneration system much beyond that—although, in the UK at least, there continues to be debate about the quantum of pay for those in the financial sector."

## **Make sure that incentive schemes reflect profitability and not sales volume**

“The other area we have to be very careful of is making sure that incentive schemes truly reflect profitability and not sales volume. If I would try to generalize it, remuneration committees just have to minimize the risk of unintended consequences from incentive schemes.”

## **To split up or not: is that the question?**

*Shouldn't we conclude from the financial crisis that some of these financial institutions have become too big to manage?*

“The question has been asked a lot in the last few months. Governments and regulators have come up with a number of variations on this theme. My view is, this would be a big step to take and one that would not necessarily solve anything. The early failures in the UK were straightforward lending banks, not the complex large mixed-business banks. There are differing views on the causes of the crisis, and I would prefer globally coordinated improved regulation rather than populist knee-jerk reactions which are not necessarily based on facts.”

## **Regulators have to play a role as well**

*What should be the role of the investor in dealing with these governance issues?*

“In the UK, the government is putting great pressure on the big investors to play much more of a part in enforcing governance. The problem is that the big UK investment companies own less than one third of the FTSE 100 Index on the London Stock Exchange. The rest of it is owned by foreign investors, by hedge funds and others. So we are turning to the holders of a small percentage of capital to enforce governance discipline. Whilst many large investors are committed to this role and fulfill it effectively and responsibly, the greater power and likely probability of success lies with the regulators.

“To only look to investors being more active is unlikely to be effective. Governance issues are probably best tackled with a mixture of all three of regulators, investors, and of course the most important group, the board of directors.”

## **Integrate corporate governance issues in the annual report**

*Should all these governance issues also be publicized?*

“Yes, they should, but here we have the dilemma that the thicker the annual report gets with additional or expanded reports, the less there is any chance of an investor plowing through it and making sense of it. We have a volume-and-complexity versus clarity issue here. One of the proposals should be to integrate corporate governance issues in the annual report.”

## **Forget about making the annual report more concise**

*Talking about the volume and complexity of the annual accounts, is there anything that we could take out?*

“I fear we are in an area where it is easy to work out additional bits of reporting, but extremely difficult to scale back. We particularly see this with the banks: the regulator is constantly asking for more and more explanation of how things are valued, what the credit crunch has done to us, et cetera. The annual report gets longer and longer. Banks are under pressure now to produce a specific corporate

governance report, rather than integrating in the directors' report, the audit committee report, and the remuneration committee report. It is difficult to see this trend diminishing, but it is not helping the clarity and value of company accounts as a communication tool."

## **Produce an additional communications report that tells a company's story**

"The only solution that I can come up with is that the annual accounts become absolutely a compliance document, with various different reports written for various different agencies who are interested in them. But in addition, the board is required to publish a 50- to 70-page communications document that tells the story of that year's results and performance as the board would wish to have it told.

"So I am edging toward a world where, first, you have a communications report in some smartened-up form of the current MD&A.<sup>2</sup> In addition, you have a whole series of compliance filings, which include audit committee reports, remuneration committee reports, directors' reports, specific issues, and all the detailed accounting reports. This would all be available on the web, and so those investors who really want to dig into the detail will have the ability to do so.

"Maybe this should be the price for being a director: at the end of the year, you have to put your name to that communications report and say, 'We, the board, consider that this communications report is giving the shareholders a balanced story of how the company has done and the issues it is facing.'"

*Do we need more forward-looking information than we have at the moment, particularly about risk?*

"I do think we need more forward-looking information, but speaking as a director, and bearing in mind the increasingly litigious world in which we live, I think it is a real challenge to produce forward-looking business information that attempts to guide without creating hostages to fortune. It is a great aspiration, but it is difficult to achieve. Forward-looking information on risk is worthy of continuing effort. By its nature, risk information must be forward-looking, and the shareholders are entitled to have the board's best view on this."

*"Forward-looking information on risk is worthy of continuing effort. By its nature, risk information must be forward-looking and the shareholders are entitled to have the board's best view on this."*

## **Limit liability for directors**

*Do we need to address the issue of liability for directors?*

"When you expose directors to unlimited liability and increasing responsibility, logically you run a serious risk of people just deciding they don't want to sit on boards anymore. Interestingly, candidates continue to put themselves forward. This is combined with increased professionalism and focus on governance among directors."

*Could you limit liability on that communications report if you said it was subject to full liability only under the full compliance report?*

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<sup>2</sup> Management Discussion and Analysis which, according to the [US Securities and Exchange Commission](#), should be: "a discussion and analysis of a company's business as seen through the eyes of those who manage that business."

“Obviously, the short-form communications report would have to reflect what the compliance documents show in infinitely greater detail. It would be a short version of that. And as long as the directors—if they were challenged—could show that the communications report is a fair reflection of all those detailed compliance documents, then there should be no liability for them.”

## **Allow auditors to certify this communications report**

*Should there also be some form of external assurance?*

“It would require some mechanism to ensure that this communications report, for want of a better word, is genuinely telling a balanced story. My suggestion would be to put pressure on the auditors to confirm that, in their view, this communications report is a true and fair description of the company’s activities for the year just ended. That would also avoid cherry-picking. It would be a ‘warts-and-all’ disclosure. The communications report would have to highlight the tricky stuff as well as the good stuff.

“Now, that would cause angst among the auditors because of the liability aspects of that, but I do think you need some independent comment. Realistically, it is only the auditors that can do that, because they are the ones who know the detail.”

*Maybe you could ask the auditor to provide some sort of negative assurance on this short-form report?*

“An opinion such as, ‘We have not seen anything in this report which is not right,’ could be an option. There may be something there, and maybe you combine it with a limit on liability, so the auditors are limited to, say, a multiple of the fees they have received in all their time as auditors of the company.”

## **Fair value accounting has exacerbated the financial crisis**

*In terms of the financial accounts, do you subscribe to the view that fair value accounting is partially the cause of the financial crisis?*

“I am in the camp that thinks yes—I wouldn’t use the word ‘caused,’ I would use the word ‘exacerbated’—that fair value accounting has exacerbated the financial crisis, by requiring companies to use pricing mechanisms or price relativities that are based on forced selling into a very unusual market. Therefore, fair value in this specific situation is not a good reflection of the underlying value of a particular security. So I am in the ‘fair value has exacerbated the problem’ camp.

“The banks had to write down the bonds they held because they had to show them at market value. That meant that, because the write-down exceeded a certain amount, they had to repay money to investors. The only way they could do that was to sell the bonds. The direct result of selling the bonds to repay the money was that it drove the price down further. It became a vicious circle.”

## **Fair value information has to be given, but not necessarily always in the key accounts**

*Do the changes that have now been made<sup>3</sup> address your previous concerns, or still leave you concerned?*

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<sup>3</sup> This refers to, for example, the [various measures](#) taken by the IASB in response to the financial crisis.

“They do help, but I think we should look again at whether further easing of the application of fair value accounting is possible for a wider range of instruments, and if it would allow, for example, for more holding at amortized cost rather than writing down. I am not trying to abandon market value. I think it is absolutely clear that fair value information has to be given, but the question is whether you make it the key figure in the accounts, or a note to the accounts. It would work for me if a bank says, ‘We will hold these instruments; the market is unusually low at the moment, but it will recover at some stage, and we have no need to sell until it does recover. We continue to get the interest on them, the issuer is solvent and thus they are not impaired. Therefore, we continue to hold them at cost. If we were forced to sell them today, however, then there would be a loss of X.’”

*They could also present it the other way around: writing the assets down in the accounts and explaining in their management analysis that this is not a realistic view of what they think it is worth.*

“The only trouble with that is that the headline figure includes all the write-downs, whereas my headline figure would not. My headline figure would allow the company to report on what they believe to be the fairest basis, but it would require them to make very clear what the situation would be if they applied market value.”

## **Allow for more accounting prudence, not hidden reserves**

*What would be your accounting suggestions going forward?*

“We should allow for more accounting prudence in assessing the size of provisions. We got rid of using prudence in accounting some 10 or 15 years ago, because too many companies had made big-bath provisions only to produce good figures in future years as a result. On the other hand, it is very frustrating when you see that losses are going to arise in the future, but you can’t provide for them because a particular event has not yet happened. There are some signs that easing in this area may be possible, and I hope that proves to be the case.

“However, I wouldn’t go the hidden reserves route. I am old enough to have accounted for a bank with hidden reserves an awful lot of years ago, and I think that is dangerous, because it disguises the true and fair financial position, potential problems, and risks. I suspect the outcomes of both methods at the end of the day are not very different, but if it is restricted to accounting prudence, it is possible at least to have a worthwhile debate with your auditors as to the rationale behind your prudent action.”

## **Single set of accounting standards is good but not vital**

*Is getting to one set of financial accounting standards worldwide a prize worth having at any cost, even if that would mean moving increasingly towards a rules-based system? Or would you say that preservation of principles is actually more important than a single set of accounting standards?*

“I think I am in that second camp: a single set of standards is a good prize, but I am not sure it is something I would regard as absolutely vital (see also ‘No one ever asked a question about it’).



### **No one ever asked a question about it**

“For all the years that I was CFO of GlaxoSmithKline, we were a UK company with a US listing. Therefore, we had to reconcile UK GAAP to US GAAP, which was tiresome and used several pages in the accounts. No one ever asked a question about it (except the SEC). All the interviews with American analysts or investors took place on the basis of UK GAAP. They were totally unconcerned with the US GAAP reconciliation!”

“I have wavered on this. There is a part of me that really believes that if you were trying to explain to a man from Mars why America might account for something one way, and an identical situation might be accounted for differently in the UK or Europe, I would have to say that would be a very difficult explanation to give. On the other hand, there are cultural, business, and regulatory differences between the US and UK/Europe which have caused accounting standards to evolve in different ways, most noticeably rules versus principles. The situation is now exacerbated by the desire of politicians in Europe to be involved in the approval of accounting standards.”

### **Let’s go for simpler reporting rather than more complex reporting**

*Apart from what you have already mentioned above, are you generally satisfied with the current accounting standards in the UK?<sup>4</sup>*

“Generally yes, but there is one other thing I would like to mention. Some of the accounting standards have taken complexity to a level that creates impediments to understanding rather than improving clarity of understanding. The accounting standard setters have pursued technical, theoretical, and detailed accuracy to a point at which the actual plot has sometimes been lost.

“One example, in my view, is International Financial Reporting Standard 2, [Share-based Payment](#), where immense amounts of detailed calculations are introduced into the accounts. And the degree of complexity of reporting is leading to pages in remuneration reports. I think we can cut that out. There are many other examples in the reporting area where we should go for simpler reporting rather than more complex reporting.”

*How did we end up with this complexity, and more importantly, how can we get rid of it?*

“The [International Accounting Standards Board](#) (IASB) has taken up something that I first experienced with the UK [Accounting Standards Board](#), which is a desire to break every transaction down into its smallest unit part. That has led to a great deal of complexity. Instead, there should be more freedom to look at rounded transactions. I know you run a risk of burying the details, but I don’t see how we can ever simplify corporate reporting without taking a deep breath and saying, ‘We really can do without that.’

“So the general point is, ‘Could we please look again at accounting standards and see whether there aren’t some of them—just as with pursuing the holy grail of a single set of standards—possibly beyond the bounds of reasonableness?’ And in those cases where good understanding is being lost under the welter of information that is being provided, we need to redress that balance. Somehow!”

<sup>4</sup> Which is IFRS in the case of listed companies.

### **Key recommendations from John Coombe**

1. Directors should increase their focus on risk, and engage more in detailed appreciation and understanding of the risks in their company's products and service areas. For the financial services industry, a solution could be for boards to establish a specialized risk committee, and consider the employment of an external risk specialist.
2. Black swans do, and will always, exist. Therefore, be much more alert to the fact that, even at the extreme end of risk possibility, things do actually happen.
3. Executive remuneration should be better aligned with the longer-term real performance (in terms of profitability, not sales volume) of the organization—for example, via deferred remuneration in the form of shares.
4. Governance issues are probably best tackled with a mixture of regulatory, investor, and board responsibility. To only look to investors being more active is unlikely to be effective.
5. Let the annual accounts become a compliance-filing exercise with various different reports written for the various different agencies, but publish an additional short-form communications report that tells the story of that year's performance and outlook as the board would wish to have it told.
6. External auditors should ensure that the communications report tells a balanced story.
7. Fair value information has to be given, but the question is whether it should be in the key figures or in the notes to the accounts, and how the assumptions and implications are explained.
8. Accounting standards should allow more prudence, and should allow for less detailed reporting.

***We welcome your feedback on these recommendations. To provide us with your feedback, please complete this brief [survey](#).***