Business, Energy and Industrial Strategy (BIS) Committee Response to inquiry on corporate governance

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Introduction

1. ICAS welcomes the opportunity to comment on this inquiry. We are a leading professional body for chartered accountants with over 20,000 members working across the UK and internationally. Almost two thirds of our working membership work in business; others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

2. ICAS's Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Key Points

3. Increasingly the public interest is looking for business to consider a wider stakeholder group than just the shareholders and other relatively narrow definitions in company law. This is reflected in the successful enlargement and application of the UK Corporate Governance Code for listed companies. Such a transformation is not evident in the same way in privately held companies who are not subject to the Code and are therefore more likely to only apply the narrower interpretations of company law.

4. We support a greater symmetry of corporate governance, financial and corporate reporting requirements on corporate entities based on their impact on society and the number of people employed by such entities. We therefore support greater alignment with listed company disclosure requirements for large private businesses (based primarily on the number of employees) as a matter of public interest given their potential impact on society. We do however also seek to ensure that new unnecessary burdensome requirements are not mandated for all large private companies as currently defined in the Companies Act 2006. Therefore, careful consideration would need to be given to ensure that any new such requirements are proportionate and appropriately targeted.

5. This topic is closely integrated with encouraging wider social responsibility, ethical behaviour in business and developing the appropriate culture. Establishing the right culture and behaviours within all corporates is fundamental. We have to rely on boards and shareholders to do the right thing and therefore we need to seek to help create the right business environment for them to do so. If we have to rely on the law it will be too late as the damage will already have been done. This broader perspective and the question of ethical behaviour needs greater profile at board level across both listed and private companies. We therefore welcome the ongoing work of the Financial Reporting Council (FRC) on corporate culture.

6. Other important topics which we believe benefit from greater board attention and challenge include how well management are facilitating the long term success of the company, the robustness of long term plans, an understanding of the organisation's impact on the wider economy, society and communities and how decisions can impact on these areas. Ultimately, creating a strong and balanced functioning board and ensuring that an appropriate succession plan is in place is vital. There is no easy or single solution to this.

Specific responses to inquiry questions

Directors' Duties

Question 1 - Is company law sufficiently clear on the roles of directors and non-executive directors, and are those duties the right ones? If not, how should it be amended?

7. The duties themselves are clear. We note that in practice, there continues to be an overly shareholder centric view of company law. Please refer to our comments on long term success below.

Question 2 - Is the duty to promote the long-term success of the company clear and enforceable?

8. The key point for us is that the long term success has to be measured in broader terms than just for shareholders. This is discussed further in our response to question 3.

   In terms of the legislation, the director's duty does not specifically and directly state a duty to promote the long term success of the company (Companies Act 2016 section 172(1)[1]). In contrast, the UK Corporate Governance Code (which is only targeted at listed companies) does as follows:
   "*The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent* <u>*management that can deliver the long-term success of the company*</u>."[2]

   In practical terms, we are not convinced the current wording of the legislation is sufficiently clear to generate a shift in behaviour. However, we also appreciate that a duty in relation to the" long term success" could be impossible to achieve. Companies fail for all sorts of reasons including a business model which does not work anymore, so we would prefer wording for a "duty to encourage/facilitate the long term success of the company" – as we recognise that there can be no such guarantees.

   We acknowledge that this is a difficult area to enforce, and we suspect that it would be very difficult to be successful in a legal action against a board which claimed that they had not encouraged success and also to define such a breach of law in practice. However, a clearer statutory duty may serve to help to raise this aspect higher up the board's agenda and also raise its importance for challenge by scrutineers.

   More broadly, we believe that corporate enforcement is weak. Whilst we support the preventative approach and increasing transparency, on its own this approach lacks teeth. We need a preventative and detective approach to police the current system with clear government enforcement for reducing corporate law breaches.

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[1] "(1)A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
(a)the likely consequences of any decision in the long term,…"

[2] Included in the introduction to the UK Corporate Governance Code section 'Governance and the Code'

Question 3 - How are the interests of shareholders, current and former employees best balanced?

9. We support a broader view of stakeholders to include suppliers, customers and the public interest which extends beyond a company's legal responsibilities. We believe it is important that organisations demonstrate an understanding of their impact on the economy, society and communities in order to build trust in business. Publicity around examples of unethical behaviour to staff, not treating customers or suppliers fairly and unsustainable business practices can have very serious consequences on a company's reputation and its financial condition.

   There needs to be a clear requirement for directors to take a long term view of sustainable success of the company and a more holistic understanding of what this means. This is particularly relevant when the company is of a size which risks having a significant impact on society.

   We would encourage shareholders to be part of this, to take a longer term view and provide greater challenge on areas where this may not be the case. We support consideration of other measures, including encouraging more large private companies to adhere to the provisions of the UK Corporate Governance Code, to encourage the longer term view, or whether a specific code should be introduced for such entities.

   A strong board has a critical role to challenge decision/actions which may not be supporting the long term sustainable success of a company. The board also needs to be clear that their role should include taking into account the various interests of stakeholders and reaching a balanced decision. A holistic view which meets the spirit, not just the letter of the legislation is critical.

   Dividends must take into account a variety of factors including the perceived future cash needs of the company, balance sheet liabilities, the business plan and longer term viabilities as well as the assumptions on which the business would be successful/viable. Perhaps companies should do more to ensure that the longer term plans are sensible.

   There is also a price of obtaining equity, and without some element of regular financial return (dividend) it may not be possible to raise capital of this nature. For earlier stage companies, the risks of creditors, staff and shareholders have to be carefully balanced in sometimes highly risky circumstances. Creating a strong board is vital but there is no single solution for this.

   Decisions to approve dividend payments need to take a holistic perspective and include long term impacts. Where actions are taken that reduce the asset base of the sponsoring company, such as a major change of dividend policy, a major return of capital or share buybacks etc., it may be appropriate to consider what impact this could have longer term. It raises the question of whether it would be more prudent to consult the pension trustees in circumstances where there is a long term pension fund deficit. Our understanding is that certain companies have taken the broader perspective and consulted their pension trustees in particular situations e.g. on a takeover or a return of capital. We see this as good practice and 'doing the right thing' but are not convinced that this approach is consistent.

   We have to rely on boards and shareholders to pay appropriate dividends. Ethical behaviour is fundamental. This point links to the topic of corporate culture which is being explored with a focus on listed companies. We are supportive of the FRC findings in their report Corporate Culture and the Role of Boards - Findings. ICAS's submission is published here.

Question 4 - How best should the decisions of Boards be scrutinised and open to challenge?

10. In the first instance, scrutiny and challenge is from the shareholders and wider stakeholders, ultimately by a regulator and the courts. The AGM is a key forum for people to challenge boards – we would strongly encourage more to use this. Shareholders can vote board members off the board every year, although we cannot cite particular examples of this actually happening, and it is very much a nuclear option.

    Scrutiny of board decisions for listed companies is also through the publication of fair, balanced and understandable business information via the annual report that is appropriately assured and available for wide dissemination to interested parties. While all businesses, especially large ones, have an impact on society, listed companies are required to comply with more stringent corporate reporting disclosure requirements. These requirements better enable interested parties to scrutinise board decisions and the actions of their decision.

    We do not support any form of intrusion into the confidence of the boardroom itself by opening up the detailed decision-making more publicly. As an example, minutes that are to be scrutinised by external parties will be written briefly rather than exposing perhaps confidential discussions. The best scrutineers are the Board themselves as long as they are up to the job and appropriately briefed.

Question 5 - Should there be greater alignment between the rules governing public and private companies? What would be the consequences of this?

11. We believe it would be appropriate to support a greater symmetry of corporate governance, financial and corporate reporting requirements for certain large private companies based on the number of employees. Eligibility criteria may also need to include the potential impact a company can have on society.

    As examples, the policy for paying suppliers and any changes should be the same for large private and public companies. We also believe there is merit in making the extended audit report a requirement for the audit of large private companies. This requires the auditor to communicate key audit matters in their audit report and is a requirement for the audit of listed entities[3].

Question 6 - Should additional duties be placed on companies to promote greater transparency, e.g. around the roles of advisors. If so, what should be published and why? What would the impact of this be on business behaviour and costs to business?

12. In general, we have no objection to greater transparency (e.g. roles and fees) although we are not sure how greater transparency around the role of advisors would change boards' behaviour. Disclosure of auditor's remuneration (including non-audit services) in the financial statements is already a statutory requirement[4]. The question is which other advisors it may be useful to report and in what circumstances. Broader remuneration disclosure may discourage broader egregious behaviour. To avoid contributing to even longer corporate reports, if the amounts are not material it may be more appropriate to cross reference to the company's website for further details.

[3] Refer to the FRC's International Standard on Auditing (UK) 701

[4] SI 2008/489

There may be situations where a company is in financial distress and an insolvency practitioner is engaged to provide advice in relation to restructuring or insolvency solutions, where it may be against the stakeholders' or companies' best interests for information to be in the public domain.

It should also be clear however, that responsibility and decision making rests ultimately with the board.

Transparency should include who is on the board and for key corporate information to be easily accessible on the company's website (e.g. financial statements). We would encourage good practice corporate governance for large private companies to be followed (similar to the UK Corporate Governance Code for listed companies) including the appointment of non-executive directors and for compliance to be reported on a "comply or explain" basis.

Question 7 - How effectively have the provisions of the 1992 Cadbury report been embedded? How best can shareholders have confidence that Executives are subject to independent challenge?

13. Corporate governance in the UK has improved immensely in the last 20 years and the UK is recognised as a leader in the field – this is something we should be proud of. The FRC and Grant Thornton regularly report progress on implementation of the UK Corporate Governance Code for listed companies. This suggests that the good practice is substantially embedded and that a comply or explain approach works well, although there is scope for improvement.

    There is no good practice corporate governance code for UK private companies. Although some large private entities do seek to adhere to certain aspects of the Code on a voluntary basis, good practice is not consistently applied or reported in this sector. We believe there would be merit in encouraging greater consistency. We support further evaluation of the need to require such a code for larger private companies.

Question 8 - Should Government regulate or rely on guidance and professional bodies to ensure that Directors fulfil their duties effectively?

14. There are no current eligibility criteria for directors of UK companies, including listed companies.

    The UK has a number of regulated professions. All members of professional regulatory bodies are subject to high standards of professionalism, including being bound by ethical codes and competency requirements, with enforcement if these standards are not met. In order to become members involves years of training and examinations as well as other admission criteria including fit and proper checks, creating a high barrier to entry.

    There is a regulatory imbalance at present whereby directors who are members of professional accountancy bodies (such as ICAS) are subject to both membership disciplinary action and the Financial Reporting Council's Public Interest Disciplinary Scheme. In most instances, their colleagues are not so regulated, and are therefore not held to account for their actions. Companies are legal entities and the current arrangements mean that some directors are regulated, and their fellow directors are not.

    We would believe it would be beneficial for Government to consider how this imbalance could be addressed, even if the solution only creates parity for Public Interest Entities, such as listed companies.

The recent EU audit reforms provide for disciplinary powers against the directors of public interest entities (PIEs), but Government has maintained the separation between professional regulated directors and non-regulated directors; the former still fall within the remit of the professional accountancy bodies and the FRC and the latter would fall within the remit of the Directors Disqualification Unit. This is perceived to be give unregulated directors an unfair advantage as there might be a reluctance for proceedings to be brought against them (not least because of the costs involved). Leaving the professional bodies to fund the regulation of our members might not result in any public expenditure, but it does promote this unfortunate imbalance among the leadership of UK PIE companies.

We would encourage Government to work with the FRC and the profession to find a balanced and fair solution. That might include the setting of eligibility criteria for board members of PIE companies, so that there is a common minimum standard of ethics and behaviour. ICAS is leading on the promotion of ethical leadership, through our "Power of One" initiative.

Executive pay

Question 9 - What factors have influenced the steep rise in executive pay over the past 30 years relative to salaries of more junior employees?

15. We note that one unintended consequence of greater disclosure of executive pay is to inadvertently contribute to ratcheting pay and an expansion of remuneration consultants.

    Any listed company can compare its directors' pay to other listed companies and that creates a push (often from the executives themselves) to pay in the top quartile of comparable companies. It is impossible for every company to be consistently in the top quartile so this dynamic creates a ratchet effect with executive pay inflating well in excess of general pay which is less visible and therefore less easy to compare. Fuelling an increase in executive pay is not a phenomenon confined to the listed company sector as large private companies, including private equity backed companies, can benchmark themselves against disclosures by listed companies.

    There is also a link between pay and risk. As part of a wider blame culture, there is an increasing belief that a director should be personally responsible for everything that occurs within the company and its subsidiaries. While there needs to some notion of ultimate accountability and well paid directors should accept their jobs are at risk, the push for more personal legal sanctions (fines, custodial sentences) increases the personal risk for directors. Perceived high pay feeds a view that directors should be held personally liable and in turn, the higher risk fuels the argument for higher pay. Re-setting the approach to director risk as well as director pay could play a role to help reduce or moderate further increases in both.

Question 10 - How should executive pay take account of companies' long-term performance?

16. There are various arrangements already in place, further evidence is needed of how well these are functioning in practice. LTIP's are generally targeted over a three-year period and longer shareholding periods for directors all link pay to long term performance. There are also share options schemes and repayable loan notes so that share options will not vest until several years later, and would be repayable in the event of failure. This is a better arrangement than say, capping bonuses at maximum multiples of basic pay which can result in driving up the basic pay.

Question 11 - Should executive pay reflect the value added by executives to companies relative to more junior employees? If so, how?

17. There may be scope for greater scrutiny and accountability on executive remuneration. We note that some significant differentials exist between board and employee pay. Although regulating for the presentation of median pay is difficult across varied industries, a voluntary approach (perhaps supported by good practice guidance) may provide one means of developing an assessment as to whether an asymmetry exists between executive remuneration and the wider corporate team.

    This information could be useful to those involved in governance, investors, shareholders and other stakeholders to help support scrutiny and holding directors to account as to whether they are meeting their duties of long term company stewardship without unnecessary excess cost. Information could help them to question and challenge, to reassure themselves that remuneration is not egregious and therefore detrimental to the objective of long term sustainable success of the company. Encouraging greater voluntary presentation and explanation of pay patterns may be one mechanism.

    Consideration could also be given to the disclosure of Exec pay benchmarked over a few internal metrics that try to give a sense of role complexity and how it might have changed. Some remuneration committees have looked at tracking executive pay over a ten-year period against the number of employees and revenues to see if there was a correlation which proved to be quite insightful.

    Use of benchmarking needs to be appropriate. Where international comparisons for pay are used, these need to be balanced and not just a tool for establishing the highest possible figure.

Question 12 - What evidence is there that executive pay is too high? How, if at all, should Government seek to influence or control executive pay?

Question 13 - Do recent high-profile shareholder actions demonstrate that the current framework for controlling executive pay is bedding in effectively? Should shareholders have a greater role?

18. Further evidence is required. It does appear that shareholders of listed companies are now mitigating large pay increases (if not reducing large pay packages) and boards are more conscious of this topic. We believe it would be worthwhile giving the most recent changes time to bed in before considering whether further changes are necessary.

General observation

19. There is greater scrutiny (even an over focus) on executive remuneration in listed companies whilst only comprising a small minority of business executives. This has created an asymmetric debate, we would support levelling the playing field.

    To aid comparison and context for judging whether executive pay packages are too high in relation to more junior staff we also need to understand what the ratio would look like in other businesses such as private companies, the asset management industry, audit and legal firms etc. If in public companies this ratio is out of kilter then there is evidence to tackle it. If it is within the range, then it suggests more a societal than governance issue. In order to get to the answer we also need more information on the pay structures in those businesses sheltered from the public market world.

Composition of Boards

Question 14 - What evidence is there that more diverse company boards perform better?

Question 15 - How should greater diversity of board membership be achieved? What should diversity include, e.g. gender, ethnicity, age, sexuality, disability, experience, socio-economic background?

20. ICAS submitted a response to the [EC on gender imbalance on EU boards](), these messages still stand. We support an approach based on merit, not quotas. Key points have been noted below.

    a) To align arrangements for recruiting, identifying and mentoring (under represented) talent to provide a pipeline which is aligned with gender and diversity targets.

    Companies should have in place a wider diversity strategy which addresses diversity at all levels of the organisation, including board level. We support diversity in its widest sense and are in favour of promoting and encouraging ways of developing diverse talent at all levels in an organisation. This in turn, will support board level appointments

    A diversity strategy would need to reflect the organisation's own statistics, performance and targets (for example, recruits, promotions, management team and board balance). It should seek to understand any barriers where discrepancies exist and identify strategies for addressing any particular difficulties.

    Looking solely at board appointments fails to consider the broader pool of available talent. A strategy should address the issue of diversity at a much earlier stage than board level.

    The diversity strategy should also consider the performance criteria necessary for achieving management and board positions. If, for example, a company requires its board directors to have a certain level of experience, judgement and skill-set, then it needs to assess how different groups of individuals within the organisation can be provided with the opportunities that would enable them to acquire those skills so as to increase the available pool of suitably talented individuals with the required experience and skillset.

    It is also recommended that companies should question the skill-set they need from a diverse board, as the whole point of diversity is the strength that comes from people bringing different skills, experiences and points of view to the table. As an example, a global organisation may require senior managers/directors to have worked in different countries throughout their careers. If this is found to be overly restricting the available pool of potential candidates, consideration needs to be given to identifying other ways that the same skill-set can be acquired.

    b) Transparency

    More transparent reporting of how the organisation is developing diversity, its remuneration policy, performance against diversity targets, current diversity levels, progress against targets over time and benchmarking against peer groups in areas which are key for setting the tone at the top such as Chair, Board (exec and non-exec) as well as the bodies responsible for board nominations and remuneration. We would encourage companies to set their own targets which reflect their circumstances.

    Publication enables companies to be held to account if they fail to meet their targets. In view of attempts to streamline annual reports, it may be more appropriate to publish details on the organisation's website, with a summary and cross reference provided in the annual report (or financial statements).

c) The “comply and explain” approach

We are supportive of this approach to reporting adherence to good practice, currently used by the FRC for its Corporate Governance Code. An organisation could publish its performance (as above), why the target has not been achieved if this is the case, and any remedial actions which are necessary.

Question 16 - Should there be worker representation on boards and/or remuneration committees? If so, what form should this take?

21. Worker representation is difficult to achieve on the board itself as the UK company law and corporate governance framework operates within the paradigm of the unitary board and collective responsibility. The unitary board is a model which we support as an effective means of encouraging greater challenge and ownership of decisions.

    Further evidence is needed as to whether employees would be willing to take on the additional responsibility and liability of being a board member. As well as taking responsibility the employee(s) will also need to have the right skills to be effective in their role. This could present a challenge.

    Our understanding is that in other countries where representatives are members of boards, it is in a completely difference company law context. Anecdotal evidence of a dual board structure (e.g. Germany) suggests that key decisions can be taken out of the board room which undermines the effectiveness of representation.

    We are supportive of engaging the employee perspective but suggest that there are other ways of achieving this such as a forum which includes board and employee representation to discuss worker’s issues, surveys etc.

Question 17 - What more should be done to increase the number of women in Executive positions on boards?

22. See our response to question 15 above.

Other points – distributable profits

23. We suggest that it is timely to review whether the existing framework and current rules for distributable profits are still fit for purpose.

    The complexity of applying the legislation in the context of current financial reporting requirements is exemplified by the need for extensive guidance from ICAS and ICAEW - Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Companies Act 2006. Responsibility lies with the directors and such complexity does not reflect a user friendly approach to regulation which seeks to reduce the risk of breaches – i.e. a preventative approach to compliance. We have noted some examples of illegal dividend payments in practice arising through error rather than intention.

    A review of the existing framework is also increasingly pertinent in light of accounting changes which may make it even more complex for directors to identify distributable and undistributable reserves as more fair value gains/losses are charged to the P&L. This increases the risk of illegal dividends. If the objective is to afford some protection to creditors, in our view, distributable reserves are not especially effective. It is also a system which is less transparent to users of the accounts.

A new mechanism could involve moving away from distributions being subject to an accounting/legal test of distributable reserves to a new framework where the onus is on directors to assess solvency/liquidity perhaps through a new solvency statement and reduce the complexity inherent in the current framework.