



**Department for Business, Energy and Industrial Strategy (BEIS)
Response to Green Paper on Corporate Governance Reform**

17 February 2016

Introduction

1. ICAS welcomes the opportunity to comment on this Green Paper. 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. We are supportive of the objectives to achieve fairness, balance and sustainable business. We believe it is appropriate to have 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, not just because of their legal form.
4. We would caution against too much focus by regulators on one aspect of expenditure as this risks skewing attention towards regulated areas at the expense of more balanced scrutiny. Too much regulation on specific aspects drives complexity which can reduce transparency more widely and therefore inhibit understanding. Our preference is for a framework based on the existing approach i.e. the principles based UK Corporate Governance Code and 'comply or explain'.
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. ICAS is also proactively pursuing the ethical agenda through its [The Power of One initiative](#).
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.
7. A copy of our submission to the Business, Energy and Industrial Strategy Committee Corporate Governance inquiry is available [here](#).

Specific responses to Green Paper questions

Executive pay

- 1. Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance? If so, which of the options mentioned in the Green Paper would you support? Are there other options that should be considered?**

Option (i): Make all or some elements of the executive pay package subject to a binding vote. This could be the full remuneration report or refer only to variable pay elements of the pay award (such as the annual bonus, the Long-Term Incentive Plan and any proposed increase in basic salary). It could be applied annually to all companies or only to companies that have encountered significant shareholder opposition to the remuneration report.

We are not supportive of introducing a binding vote on elements of the executive pay package/ specific payments. This disempowers the Remuneration Committee and raises practical problems which could be awkward to resolve.

Option (ii): Introduce stronger consequences for a company losing its annual advisory vote on the remuneration report

We do not object.

Option (iii): Require or encourage quoted company pay policies to (a) set an upper threshold for total annual pay (from all elements of remuneration), and (b) ensure a binding vote at the AGM where actual executive pay in that year exceeds the threshold

Thresholds for total pay are an option for the company to consider. We would not be supportive of a regulatory approach

Option (iv): Require the existing binding vote on the executive pay policy to be held more frequently than every three years, but no more than annually, or allow shareholders to bring forward a binding vote on a new policy earlier than the mandatory three-year deadline

We do not object.

Option (v): Strengthen the Corporate Governance Code to provide greater specificity on how companies should engage with shareholders on pay, including where there is significant opposition to a remuneration report

We support this.

- 2. Does more need to be done to encourage institutional and retail investors to make full use of their existing and any new voting powers on pay? Do you support any of the options mentioned? Are there other ideas that should be considered?**

Option (i): Mandatory disclosure of fund managers' voting records at AGMs and the extent to which they have made use of proxy voting

We note that 68% of signatories to the Stewardship Code (2015) already routinely disclose their voting records. We welcome the efforts of the FRC to encourage greater compliance and help embed good practice more consistently.

We agree that it would be useful for asset managers to publish more detail on the rationale for their voting decisions but would request greater evidence on the potential burdens of doing this and on any related potential legal risks.

Our preference would be to continue to use a voluntary approach to seek to achieve more consistent disclosure. We are supportive of the Stewardship Code as the main vehicle for this.

Option (ii): Establish a senior “shareholder” committee to engage with executive remuneration arrangements

We have no objection to this as a voluntary option to help inform the board/ remuneration committee. However, one of the challenges that exists is the diversity of views from shareholders, so this senior committee may agree to something other shareholders do not like. Therefore, a voluntary approach would enable organisations to develop a model which works for them and allow them to determine what is the most effective means for generating greater shareholder engagement. We would welcome wider sharing of good practice, similar to what the FRC is doing on the topic of organisational culture.

Option (iii): Consider ways to facilitate or encourage individual retail shareholders to exercise their rights to vote on pay and other corporate decisions

We have no objection to improving communication on how individual investors can exercise their voting rights and how to opt in. Care, however, is required to ensure any actions are not overly costly, onerous in volume for the retail shareholder to manage or complex to administer. Introducing a means for such shareholders to vote on the internet easily would be helpful and might encourage more to exercise their rights. Of course, they can and in some cases do, attend the AGM.

3. Do steps need to be taken to improve the effectiveness of remuneration committees, and their advisers, in particular to encourage them to engage more effectively with shareholder and employee views before developing pay policies? Do you support any of the options set out in the Green Paper? Are there any other options you want to suggest?

Option (i): Require the remuneration committee to consult shareholders and the wider company workforce in advance of preparing its pay policy

Option (ii): Require the chairs of remuneration committees to have served for at least 12 months on a remuneration committee before taking up the role

We have no objection to options (i) & (ii) being incorporated in the UK Corporate Governance Code. We note that it is a challenge to reconcile all the different views of shareholders and there are some reservations about how pre-approval consultation with employees would work in practice. We therefore support the suggestion to designate a non-executive director to represent the workforce and wider stakeholders and to ensure that

these broader perspectives are reflected in board/remuneration committee discussions. Good practice guidance on consultation would also be helpful.

- 4. Should a new pay ratio reporting requirement be introduced? If so, what form of reporting would be most useful? How can misleading interpretations and inappropriate comparisons (for example, between companies in different sectors) be avoided? Would other measures be more effective? Please give reasons for your answer.**

Option (i): Pay ratio reporting

The responsibility for pay rests primarily with the board and its remuneration committee who should be able to demonstrate: how they achieve fairness and balance in pay across the organisation; that it appropriately reflects performance; and how they mitigate against awarding egregious pay in the first place.

We are not convinced that a statutory requirement to disclose a pay ratio is the answer. It risks creating another point of excess focus at the expense of the bigger picture. We prefer a voluntary approach supported by good practice guidance which could help inform internal assessment and benchmarking to identify any asymmetries. Pay ratios are one option. We have heard of one company which tracked executive pay over 10 years and found this to be an insightful exercise for the remuneration committee to identify and question outliers.

Our preference would be for the UK Corporate Governance Code to include further guidance on how the company is considering/ addressing public expectations and avoiding the award of excessive executive pay. Good practice may include using a range of management information indicators to help remuneration committees better understand the balance between pay, performance and how well this aligns with the wider workforce.

Examples may include pay ratios, comparisons of senior versus wider workforce pay increases, trends over time and comparisons with performance (general economy / more specific to the company). Comparisons with business metrics over time that indicate not only performance but also indicators of complexity such as the number of offices/factories/employees are useful. If the business has fundamentally changed shape over time, then that could be a reason for higher or even lower pay/rewards. The outcome of such an exercise could be made available to shareholders.

There is quite intense scrutiny 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 an outlier, then there is evidence to tackle it. If it is within the wider business range, then it suggests that there is more of a societal issue than a governance one. To get to the right answer, we also need more information on the pay structures in those businesses which are sheltered from the public market world.

- 5. Should the existing, qualified requirements to disclose the performance targets that trigger annual bonus payments be strengthened? How could this be done without compromising commercial confidentiality? Do you support any of the options outlined in the Green Paper? Do you have any other suggestions?**

Option (ii): Disclosure of bonus targets

We support the option outlined in paragraph 1.59 of the Green Paper to increase non-legislative pressure to provide full disclosure of retrospective bonus/ performance targets in the annual report and strengthening the FRC's remuneration guidance (as part of the UK Corporate Governance Code). Appropriate caveats would need to be included to ensure that legitimate commercially sensitive information does not need to be disclosed.

- 6. How could long-term incentive plans be better aligned with the long-term interests of quoted companies and shareholders? Should holding periods be increased from a minimum of three to a minimum of five years for share options awarded to executives? Please give reasons for your answers.**

We are supportive of the suggestion in paragraph 1.65 to retain share awards until they build up a shareholding equivalent to 2x gross total salary to encourage longer term focus.

Our understanding is that at present, most LTIPs vest after 3 years but for many executives there is then a 2-year holding period. We are supportive of the proposal to state a minimum 5 years holding period as it reflects current practice and a requirement would ensure greater consistency. We also support the proposals for restricted share awards (paragraph 1.64). When the shares vest, the executives pay tax and sell shares to do this. These after-tax shares are held and count towards the 2x gross total salary target. We are supportive of the proposals, provided that the executives are still allowed to sell shares when they vest to pay tax.

Strengthening the employee, customer and wider stakeholder voice

- 7. How can the way in which the interests of employees, customers and wider stakeholders are taken into account at board level in large UK companies be strengthened? Are there any existing examples of good practice that you would like to draw to our attention? Which, if any, of the options (or combination of options) described in the Green Paper would you support? Please explain your reasons.**

Option (i): Create stakeholder advisory panels

Option (ii): Designate existing non-executive directors to ensure that the voices of key interested groups, especially that of employees, is being heard at board level

Option (iii): Appoint individual stakeholder representatives to company boards

Option (iv): Strengthening reporting requirements related to stakeholder engagement

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 to build trust in business.

Our preference is option (ii), this could be supported by option (i) as explained in paragraph 2.19 of the Green Paper. We are not convinced a committee would be required as explained in paragraph 2.20. Option (iii) is not supported as it does not sit well with the unitary board structure.

For option (iv) we would welcome further clarity through guidance on effective reporting of how directors discharge their section 172 duties¹ (including stakeholder issues) in the Strategic Report.

8. Which type of company do you think should be the focus for any steps to strengthen the stakeholder voice? Should there be an employee number or other size threshold?

This does not need to be restricted to listed companies.

9. How should reform be taken forward? Should a legislative, code-based or voluntary approach be used to drive change? Please explain your reasons, including any evidence on likely costs and benefits.

Our preference is for reform to be driven by the UK Corporate Governance Code as it is a flexible and effective alternative to regulation.

Corporate governance in large, privately-held businesses

10. What is your view of the case for strengthening the corporate governance framework for the UK's largest, privately-held businesses? What do you see as the benefits for doing so? What are the risks to be considered? Are there any existing examples of good practice in privately-held businesses that you would like to draw to our attention?

We support a greater symmetry of corporate governance, financial and corporate reporting requirements on larger corporate entities based on their impact on society and the number of people employed by such entities. The key factor is to implement it in a way that is proportionate. There is also merit in extending disclosures on the policy for paying suppliers and in adopting the extended auditor report model for such entities. This requires the auditor to communicate key audit matters in their audit report and is a requirement for the audit of listed entities² (although some entities apply this on a voluntary basis).

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.

11. If you think that the corporate governance framework should be strengthened for the largest privately-held businesses, which businesses should be in scope? Where should any size threshold be set?

¹ [Companies Act 2006 section 172](#)

² Refer to the FRC's International Standard on Auditing (UK) 701

A strengthening of the corporate governance framework would need to be proportionate and appropriately targeted so the focus should be on large private businesses (based primarily on the number of employees) as a matter of public interest given their potential impact on society.

Private companies are currently categorised in the Companies Act 2006 based on a combination of turnover, balance sheet total and number of employees. A similar 3 criteria approach would be simple to adopt but a significantly higher threshold for the number of employees would be more appropriate, as currently one of the criteria for a large private company is that it has over 250 employees.

12. If you think that strengthening is needed how should this be achieved? Should legislation be used or would a voluntary approach be preferable? How could compliance be monitored?

We would be supportive of a similar but more proportionate UK Corporate Governance Code (the Code) for unlisted businesses. Further consideration will however be needed in terms of how it should be applied as currently the requirement to comply with the Code, or explain where there is non-compliance, is driven by the Listing Rules, as the Code itself is voluntary good practice. Some additional driver for encouraging compliance will be needed for an equivalent Code for privately-held businesses to ensure sufficient adoption, as the Listing Rules will not be relevant.

13. Should non-financial reporting requirements in the future be applied on the basis of a size threshold rather than based on the legal form of a business?

Yes.

Other issues

14. Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens? Apart from the issues addressed specifically in this Green Paper can you suggest any other improvements to the framework?

The current framework is appropriate but should be subject to on-going evaluation and improvement – as is currently the case. We support the approach of ‘comply or explain’ and principles not rules and the combination of legislation, good practice codes and developing guidance/ sharing good practice on values, ethics, behavioural standards and organisational culture. Our preference is for minimal statutory intervention unless there is evidenced need that no other option is feasible.

The Stewardship Code also needs to be subject to regular review and improvement to embed good practice more widely across asset managers as well as business and to maintain a similar pace of reform as the UK Corporate Governance Code has achieved.

A more level playing field for the larger organisations which have a potential impact on society is needed, whatever the business structure adopted.

A strong and ethical board is fundamental. It is important to develop and disseminate good practice on board culture and ethical behaviour.

The key point for us is that the long-term success should be measured in broader terms than just for shareholders.

We support a more balanced and holistic approach to decision making by directors which reflects the various dimensions identified in their statutory duties (Companies Act 2016 section 172). It is increasingly unacceptable for one aspect of these duties to be pursued irrespective of the harm it may cause another. For example, the blind pursuit of capital growth or shareholder profit at the expense of fair treatment of employees or suppliers.

To embed good practice more effectively, we suggest that guidance is provided which encourages directors to report how they have considered and discharged their broader duties under section 172 and their approach to fair and balanced decision making which gives effect to this.

In our view, the volume of enforcements for corporate law breaches is low. We suggest that a more consistent approach to corporate enforcement would be beneficial. Whilst we support the preventative approach and increasing transparency, on its own this approach lacks teeth. We need a combined preventative and detective approach to police the current system with enforcement action to reduce corporate law breaches.

Regulatory approach - we would caution against too much focus by regulators on one aspect of expenditure as in practice, this can be at the expense of other areas. As an example, we have anecdotal feedback that a chair of a remuneration committee was requested to attend 15 meetings with investors whereas the chair of the audit committee only had 1 meeting request. This regulatory focus risks skewing the accountability and stewardship process and missing the bigger picture. Effective scrutiny includes appropriate tailoring to consider an individual business's actual risks and prospects.

We support an approach based on encouraging companies to meet the spirit of a concise number of good practice principles rather than the letter of a plethora of specific rules.

Executive remuneration and its relationship with employee pay and performance is one category of expenditure worthy of monitoring and challenge, but others include dividends, pension fund payments and capital investment decisions which also require sound judgement and can impact on business sustainability. Various topics may be worthy of challenge and justification and these are likely to vary across different organisations. It is not necessarily in the business's best interests to encourage greater focus on one, particularly if there are no other risk indicators and it is not a significant expenditure category in the context of the business as a whole.

Moreover, too much individual regulation on specific aspects drives complexity which can reduce transparency more widely and therefore inhibit understanding.

Ultimately it is the directors who are responsible for ensuring how well they discharge their duties bearing in mind the wider expectations and perceptions. This is the starting point and whilst it is important to identify and remove any barriers or obstacles to assist those with accountability and scrutiny duties, a preventative based approach is better than a complex system of multiple checks and balances.