



Corporate Governance BEIS Committee report April 2017

Audit Committee Institute

Introduction

After taking oral evidence from a cross section of over 170 organisations and individuals who submitted written evidence – and after discussions with a range of chairmen and chief executives of major companies – the Business, Energy and Industrial Strategy (BEIS) Committee inquiry on corporate governance has published its report. The inquiry – focussing on executive pay, directors duties and the composition of boardrooms – follows on from the corporate governance failings highlighted by the Committee's recent inquiries into BHS and Sports Direct, and in the wake of commitments from the Prime Minister to overhaul corporate governance.

While recognising the overall strength of the UK corporate governance system, the report notes the damage caused by high-profile failings and a dramatic ratcheting up of executive pay in recent years, at a time of stagnant wage growth for many workers. The Committee recommends a series of actions on executive pay, a new and stronger voluntary code of governance for private companies, better reporting by companies on how directors fulfil their duties and responsibilities and a major expansion of the role and powers of the Financial Reporting Council (FRC), with a new rating system for companies to be assessed for their corporate governance performance.

On executive pay, the Committee calls for businesses to simplify the structure of executive pay and put an end to long-term incentive plans (LTIPs), which lack transparency and which can distort decision-making. The Committee also suggests workers be represented on remuneration committees and for the chairs of remuneration committees to be expected to resign if shareholders fail to approve the company's pay policy. The report calls for companies to explain their pay policies better, including publishing pay ratios annually.

On gender diversity, the Committee calls for the Government to set a target that from May 2020 at least half of all new appointments to senior and executive management level positions in the FTSE350 and all listed companies should be women, and for companies to explain if they fail to achieve this ambition.

A summary of the BEIS Committee recommendations is set out below. Feedback from BEIS's own Green Paper *Corporate Governance Reform* – which posed many of the same questions as the BEIS Committee inquiry – is expected by the middle of May.

The BEIS Committee's recommendations

- The FRC should amend the UK Corporate Governance Code to require informative narrative reporting on how the directors have fulfilled their duty under Companies Act section 172 duties (duty to have regard to other stakeholders and the long-term consequences of decisions). Boards must be required to explain precisely how they have considered each of the different stakeholder interests, including employees, customers and suppliers and how this has been reflected in financial decisions. They should also explain how they have pursued the objectives of the company and had regard to the consequences of their decisions for the long term, however they choose to define this. Where there have been failures to have due regard to any one of these interests, these should be addressed directly and explained.
- The FRC should work with business organisations to develop appropriate metrics to inform an annual rating exercise. This should publicise examples of good and bad practice in an easy-to-digest red, yellow and green assessment. Companies must be obliged to include reference to this rating in their annual reports.
- The Government should bring forward legislation to give the FRC the additional powers it needs to engage, and hold to account, company directors in respect of the full range of their duties – including the authority to initiate legal action for breach of section 172. The Government should consider re-establishing, renaming and resourcing appropriately the FRC to better reflect its expanded remit and powers.

- The Secretary of State should be more prepared than is presently the case to use existing powers where there is any suspicion of serious wrongdoing that may be in breach of the law.
- The Investor Forum should seek to become a more proactive facilitator of a dialogue between boards and investors by engaging in regular routine dialogue in order to pick up on any widespread concerns, for example those identified by the new FRC rating system (see above).
- While not mandatory, companies should consider establishing stakeholder advisory panels. Furthermore, the Code should be revised to require a section in annual reports detailing how companies are engaging with stakeholders.
- The FRC should review its Stewardship Code with a view to providing: more explicit guidelines on what high quality engagement would entail; a greater level of detail in terms of requirements; and an undertaking to call out poor performance on an annual basis.
- The Government should consult on new requirements for listed and large private companies to provide full information on advisors engaged in transactions above a reasonable threshold, including on the amount and basis of payments and on their method of engagement.
- The FRC should include in its revised Stewardship Code stronger provisions to require the disclosure of voting records by asset managers and undertake to name those that subsequently do not vote.
- The FRC should update the Code to include best practice guidance on professional support for non-executive directors and a recommendation that companies include training of board members as part of reporting on their people or human resources policy.
- The FRC should update the Code to provide guidance on how companies should identify clearly and transparently the roles of non-executive directors where they have particular responsibilities and how they should be held to account for their performance. We further recommend that non-executive directors should be required to demonstrate more convincingly that they are able to devote sufficient time to each company when they serve on multiple boards.

Private companies

- The FRC, Institute of Directors (IoD) and Institute for Family Business should develop, with private equity and venture capital interests, an appropriate code with which the largest privately-held companies would be expected to comply; and contribute to the establishment of a new body to oversee and report on compliance with the code.
- The new Code should include a complaint mechanism, under which the overseeing body could pursue with the company any complaints raised about compliance. The scheme should be funded by a small levy on members. Should this voluntary regime fail to raise standards after a three year period, or reveal high rates of unacceptable non-compliance, then a mandatory regulatory regime should be introduced.

Pay

- Companies should make it their policy to align bonuses with broader corporate responsibilities and company objectives and take steps to ensure that they are genuinely stretching. Policy in this respect should be considered by the FRC in their corporate governance rating system (see above).
- LTIPs should be phased out as soon as possible. No new LTIPs should be agreed from the start of 2018 and existing agreements should not be renewed.
- The FRC should consult with stakeholders with a view to amending the Code to establish deferred stock rather than LTIPs as best practice in terms of incentivising long-term decision making. Overall, this consultation should develop guidelines for the structure of executive pay with the following features:
 - A simpler structure based primarily on salary plus long-term equity, to divest over a genuinely “long-term” period, normally at least five years, without large steps;
 - Limited use of short-term performance-related cash bonuses, which should be aligned, where possible, to wider company objectives or corporate governance responsibilities;
 - Clear criteria for bonuses: they should be genuinely stretching and be aimed to provide incentives rather than just reward.
- The current scale of opposition to remuneration reports and policies does not, at present, justify annual binding votes on pay levels; however, the FRC should revise the Code to include a requirement for a binding vote on executive pay awards the following year in the event of there being a vote against such a vote of over 25 per cent of votes cast. This requirement should be included in legislation at the next opportunity.
- Employee representation on remuneration committees would represent a powerful signal on company culture and commitment to fair pay. This option should be included in the Code and we expect leading companies to adopt this approach.
- Remuneration committee chairs should normally have served on the remuneration committee for at least one year previously. To further incentivise strong engagement, remuneration committee chairs should be expected to resign if their proposals do not receive the backing of 75 per cent of voting shareholders.
- Companies should set out clearly their people policy, including the rationale for the employment model used, their overall approach to investing in and rewarding employees at all levels throughout the company, as well as reporting clearly on remuneration levels on a consistent basis. The FRC should consult with relevant bodies to work up guidance on implementing this recommendation for inclusion in the Code.

- The FRC should amend the Code to require the publication of pay ratios between the CEO and both senior executives and all UK employees. We further recommend that the Government requires that equivalent pay ratios should be published by public sector and third sector bodies above a specified size.

Board composition

- Companies should communicate how they are approaching the encouragement and engagement of women throughout the organisation. The FRC should take this into account as part of its rating system (see above).
- The FRC should amend the Code, so that all FTSE350 listed companies are required to disclose in their annual report the gender balance on the Executive Committee and direct reports to the Executive Committee.
- The Government should set a target that from May 2020 at least half of all new appointments to senior and executive management level positions in the FTSE350 and all listed companies should be women. Companies should explain in their annual report the reasons why they have failed to meet this target, and what steps they are taking to rectify the gender inequality on their Executive Committees.
- The FRC should embed the promotion of the ethnic diversity of boards within its revised Code. At the very least, wherever there is a reference to gender, the FRC should include a reference to ethnicity, so that the issue of ethnic diversity on boards is made explicit and is given as much prominence as gender diversity.
- The Government should legislate to ensure that all FTSE100 companies and businesses publish their workforce data, broken down by ethnicity and by pay band.
- The FRC should work with others to provide improved guidance on cognitive diversity in the context of board membership.
- The revised Code should have the issue of board diversity as a key priority and there should be a public explanation of the reasons why members are part of the board. The Code should require boards to cover in their annual reports information diversity on their boards and in the workforce, covering diversity of gender, ethnicity, social mobility, and diversity of perspective. Annual reports should be required to include a narrative on the current position, and an emphasis on what steps the company has taken, and will continue to take to enhance the diversity of the executive pipeline, with agreed targets. This narrative should include how accurately the board mirrors the diversity of both the workforce and the customer base.
- The detailed narrative of board diversity in annual reports should be a working document throughout the year, informing the board, the Nomination Committee, middle and senior managers, and the workforce and other stakeholders, about the seriousness that companies are taking diversity and succession issues. The revised Code should make this requirement explicit.
- Companies should be recruiting non-executive and executive directors from the widest possible net of suitable candidates, which should include recruiting internally.
- Worker directors should not be compulsory, but companies should be encouraged to appoint workers on boards. Just as the drive for women directors has overcome initial doubts, it should become the norm for workers to serve on boards.
- Employees appointed to boards should be directors in their own right, with the necessary skills and aptitudes to play a part as a full board member rather than a representative of the workforce. They would not be a delegate, but would provide the same strategic evaluation and challenge that every director should bring.
- The revised Code should state explicitly that the procedure for the appointment of new directors to the board should be by open advertising, and by an external search consultancy, and detailed explanations should be given if one or both of these requirements is not met.
- The FRC should be given the extra role of overseeing the rigour of the externally facilitated board evaluation process to ensure that it is genuinely independent, thorough and consistent across companies.
- The FRC should highlight best and worst practice among Nomination Committees.

Next steps

The BEIS Committee recommendations have a potentially significant wide-reaching impact on the FRC - their remit, funding and resources.

In terms of next steps, the FRC will continue their fundamental review of the UK Corporate Governance Code with a formal consultation on its proposals due in Autumn 2017. Based on the outcome of the review and the Government's response to the recent Green Paper on Corporate Governance reform. It is anticipated that the revised Code would be launched in early 2018.

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