



Governance *in brief*

BEIS issues legislation to deliver key corporate governance reforms

Headlines

- The legislative strand of the Government's package of corporate governance reforms announced by BEIS in August 2017 has been laid before Parliament.
- Subject to Parliamentary approval, the new requirements will apply for financial years starting on or after 1 January 2019. The first public reporting under the new regulations will be available early in 2020.
- As expected the legislation introduces new reporting requirements on executive pay ratios, share scheme outcomes, and section 172 of the Companies Act, as well as new requirements for large private companies to report on their corporate governance arrangements.
- The scope of companies affected by this legislation has changed from the Government's draft corporate governance reform package issued in August 2017 and will affect more companies than initially envisaged.

Executive pay

Scope

The legislation requires:

- 1) Publication of the pay ratio – applicable to all companies that are both quoted and UK registered with more than 250 UK employees.
- 2) Illustration of the effect of future share price increases on executive pay outcomes – applicable to all companies that are both quoted and UK registered

“Quoted” is defined by the Companies Act 2006 as meaning UK registered companies that are quoted on the UK Official List, the New York Stock Exchange, NASDAQ or a recognised, regulated stock exchange in the European Economic Area. It does not include companies listed on the Alternative Investment Market.

Reporting requirements

1) Publication of pay ratios



All companies that are both quoted and UK registered with more than 250 UK employees will be required to publish the ratio of their CEO's 'single figure' total remuneration to the median, 25th and 75th percentile total remuneration of their full-time equivalent UK employees in the **Directors' Remuneration Report**. The ratios will be calculated on a **group-wide** basis by reference to UK employees only.

Companies will be required to explain the reasons for changes to the ratio year on year and whether the company believes the median ratio is consistent with the company's wider policies on employee pay, reward and progression.

Supporting information will be required including the methodology used to calculate the pay ratios. Companies will also be required to publish the total remuneration and salary (£value) for the median, 25th and 75th percentile employees used in the pay ratio calculation.

The pay ratios will be disclosed in a table in the annual remuneration report, and will include pay ratio data that will build incrementally to a ten year period going forward. Therefore in the first year of reporting, only one set of pay ratios will be disclosed.

The regulations allow for three potential approaches in calculating the pay ratio. This is intended to recognise that some companies may find challenges in collecting data in a relatively short period of time.

CEO total remuneration will be the 'single figure' disclosed for the relevant financial year.

Employee total remuneration should include wages and salary, taxable benefits, annual bonus, share-based remuneration or other incentive plans and pension benefits. As a minimum, employee wages and salary must be used. Under the regulations, employee remuneration will be calculated on the same basis as the CEO single figure (i.e. this differs to requirements under the gender pay gap regulations).

2) Illustration of the effect of future share price increases on executive pay outcomes



In the next new remuneration policy, there will be a requirement to provide an illustration in the **Directors' Remuneration Report** of the impact of potential future share price increases on executive pay outcomes that are linked to performance periods of more than one financial year (e.g. LTIP awards), assuming share price growth of 50% over the period.

Remuneration committees will be required to provide a summary explanation of any discretion used in respect of executive remuneration outcomes reported in the year.

In the notes to the single figure table, there will be a requirement to provide:

- an estimate of the amount of remuneration that is attributable to share price growth;
- whether, and if so how, discretion has been exercised to determine remuneration as a result of either share price appreciation or depreciation.

Reporting on Section 172

Scope

The legislation requires:

- 1) A statement in the **Strategic Report** of how directors have complied with their duty to have regard to the matters in 172 (1) (a)-(f) – all companies (listed and unlisted) qualifying as large under the Companies Act 2006.
- 2) A statement in the **Directors' Report** summarising how directors have engaged with employees and taken account of their interests – all UK registered companies (listed and unlisted) with more than 250 UK employees.
- 3) A statement in the **Directors' Report** summarising how directors have engaged with suppliers, customers and others in a business relationship with the company – all companies (listed and unlisted) qualifying as large under the Companies Act 2006.

Please note – this legislation does not change which companies are required to provide a Strategic Report or the employee engagement disclosure in the Directors' Report, it is the content requirements that are new or changed.

As a reminder, companies qualifying as large under the Companies Act 2006 meet at least 2 of the following criteria:

- Turnover of more than £36m;
- Balance sheet total of more than £18m;
- More than 250 employees.

Reporting requirements

1) Section 172(1) statement



In their **Strategic Report**, all companies qualifying as large under the Companies Act 2006 will be required to include a separately identifiable "Section 172(1) statement" describing how directors have had regard to the matters set out in section 172(1)(a) to (f) of the Companies Act 2006 when fulfilling their duties as a director.

Section 172 – Duty to promote the success of the company

- (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,
 - (b) the interests of the company's employees,
 - (c) the need to foster the company's business relationships with suppliers, customers and others,
 - (d) the impact of the company's operations on the community and the environment,
 - (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
 - (f) the need to act fairly as between members of the company.

BEIS has suggested that companies will probably want to include information on some or all of the following:

- the issues, factors and stakeholders the directors consider relevant in complying with section 172 (1) (a) to (f) and how they have formed that opinion;
- the main methods the directors have used to engage with stakeholders and understand the issues to which they must have regard; and
- information on the effect of that regard on the company's decisions and strategies during the financial year.

The supporting FAQs issued by BEIS suggest the following points to note in relation to the Section 172(1) statement:

Tailoring	The disclosures should be tailored to the individual circumstances of each company. The focus should be on matters that are of strategic importance to the company and should be consistent with the size and complexity of the business.
Subsidiaries	All qualifying companies, including subsidiaries , will need to meet the new reporting requirements. This is because, under the Companies Act, the duty of directors is owed to their company. This approach to reporting by groups and their subsidiaries is not new. Qualifying subsidiaries already have to prepare their own strategic report, even where the parent company is required to prepare a "group strategic report" under s414A(3).
Website publication	The legislation states that this statement should be made available on a website. For quoted companies, who are required to make their annual report available on a website, this requirement will be met through the annual report. Unquoted companies, who are not required to publish their annual report on a website, will need to make arrangements to ensure that the Section 172(1) statement is available on a website. This can be a website maintained by or on behalf of the company (such as the website of a parent company) provided it identifies the company in question.
Further guidance	The Financial Reporting Council has agreed to include guidance to help companies meet these new requirements in its Strategic Report Guidance.

2) Employee engagement



In their **Directors' Report**, all UK registered companies with more than 250 UK employees will need to provide a summary of how their directors have engaged with employees, how they have had regard to employee interests, and the effect that this has had, including on the principal decisions taken by the company during the financial year. This expands on the information about employee engagement matters that companies already have to include in their current directors' report.

For companies that apply the UK Corporate Governance Code, it is worth considering this requirement alongside the anticipated new Code provision regarding boards gathering the views of the workforce, which will normally be through a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director.

3) Business relationships



All companies qualifying as large under the Companies Act 2006 will need to provide a summary in their **Directors' Report** of how the directors have had regard to the need to foster the company's business relationships with suppliers, customers and others, and the effect of that regard, including on the principal decisions taken by the company during the financial year.

The supporting FAQs issued by BEIS suggest the following points to note in relation to the employee engagement and business relationship disclosures:

Overlap with the Section 172(1) statement	<p>The Strategic Report can contain matters that would otherwise need to be included in the Directors' Report where the directors consider them to be of strategic importance to the company. Where a company has done this, it must state in the directors' report that it has done so and in respect of which information it has done so.</p>
	<p>BEIS makes it clear that this information does not need to be duplicated in the Directors' Report.</p>
Subsidiaries	<p>All qualifying companies, including subsidiaries, will need to meet the new reporting requirements. This is because, under the Companies Act, the duty of directors is owed to their company.</p> <p>This approach to reporting by groups and their subsidiaries is not new. Qualifying subsidiaries already have to prepare their own strategic report, even where the parent company is required to prepare a "group strategic report" under s414A(3).</p>

Corporate governance arrangements in large private and unlisted public companies

Scope

The legislation is applicable to UK registered companies with either:

- 2,000 or more global employees; or
- a turnover over £200 million globally and a balance sheet over £2 billion globally.

Companies already required to report on their corporate governance (such as premium and standard listed companies) are not within scope. Community interest companies and charitable companies are also exempted.

Reporting requirements



Companies in scope will have to include a statement as part of their **Directors' Report** stating which corporate governance code, if any, has been applied and how. If the company has departed from any aspect of the code it must set out the respects in which it did so, and the reasons. If the company has not applied any corporate governance code, the statement must explain why that is the case and what arrangements for corporate governance were applied.

The supporting FAQs issued by BEIS suggests the following points to note in relation to the disclosures:

Website publication	The statement will need to be included in the company's Directors' Report and published on a website maintained by or on behalf of the company.
Definition of "corporate governance code"	Regulation 25 explains that a "corporate governance code" means a code of practice on corporate governance. There is no preferred or prescribed code stated by the regulations. Companies can choose the most appropriate code for them or decide not to apply a code (subject to explaining why and what their arrangements are).
Smoothing provision on qualifying thresholds	Regulation 23 provides a 'smoothing provision' which addresses the situation where a company's size varies from year to year above and below the relevant qualifying thresholds. It provides for a two-year time lag before a company either drops out of, or is covered again, by the requirement. For example, if the company has fewer than 2000 employees in the first year of reporting, it will not be required to report in that year or in the second year even where it has more than 2000 employees in the second year. If it still had more than 2000 employees in the third year, it would be required to report.
Subsidiaries	Every company meeting the qualifying thresholds must comply with the new reporting requirement, including subsidiaries. This includes subsidiaries of listed companies required to meet the UK Corporate Governance Code and subsidiaries of parent companies who prepare a consolidated group directors' report.

The Wates Corporate Governance Principles for large private companies

In January 2018, BEIS appointed James Wates CBE as Chairman of a Coalition Group, comprising members from the FRC, British Private Equity and Venture Capital Association, the Climate Disclosure Standards Board, the Confederation of British Industry, ICSA: the Governance Institute, the Institute of Business Ethics, the Institute of Directors, the Institute for Family Business, the Investment Association, and the Trades Union Congress.

The Chairman and the Coalition Group have now issued the Wates Corporate Governance Principles for Large Private Companies for a 12 week public consultation. The aim is to finalise this voluntary framework for publication in December 2018 to align with the introduction of the Government's new reporting requirement.

	Principle
Purpose	An effective board promotes the purpose of a company, and ensures that its values, strategy and culture align with that purpose.
Composition	Effective board composition requires an effective chair and a balance of skills, backgrounds, experience and knowledge, with individual directors having sufficient capacity to make a valuable contribution. The size of a board should be guided by the scale and complexity of the company.
Responsibilities	A board should have a clear understanding of its accountability and terms of reference. Its policies and procedures should support effective decision-making and independent challenge.
Opportunity and risk	A board should promote the long-term success of the company by identifying opportunities to create and preserve value, and establishing oversight for the identification and mitigation of risks.
Remuneration	A board should promote executive remuneration structures aligned to the sustainable long-term success of a company, taking into account pay and conditions elsewhere in the company.
Stakeholders	A board has a responsibility to oversee meaningful engagement with material stakeholders, including the workforce, and have regard to that discussion when taking decisions. The board has a responsibility to foster good stakeholder relationships based on the company's purpose.

Using an apply and explain approach, companies which choose to report against the Wates Principles are expected to provide a supporting statement for each principle that gives an understanding of how their corporate governance processes operate and achieve the desired outcomes.

Further information

Further information can be obtained by visiting:

For the draft Statutory Instruments: <http://www.legislation.gov.uk/ukdsi/2018/9780111170298/contents>

For the BEIS FAQs: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/715740/corporate-governance-company-reporting-faq.pdf

For the Wates Principles: <https://www.frc.org.uk/news/june-2018/consultation-on-the-wates-corporate-governance-pri>

Deloitte View

- Boards should not underestimate the considerable work needed to meet these new requirements. In particular preparing the data for the pay ratios will be very difficult and systems capabilities will need to be assessed early.
- We support the move to ensure that remuneration committees are aware of, and take account of, remuneration levels across the wider workforce. The use of a pay ratio, and how it moves over time, is intended to help committees in considering this. Companies should focus on providing a clear narrative around how executive pay outcomes are aligned with business performance, as well as how success has been shared more widely across the organisation.
- Reporting on stakeholder engagement will also require the development of a well-considered approach which, above all, reflects the reality experienced by those stakeholders. Explaining how the outcomes of stakeholder engagement have impacted board decisions and strategies in the year will be challenging.
- Listed groups should bear in mind that elements of the legislation will have an impact on individual subsidiaries and will impose a higher burden on those subsidiaries in terms of individual corporate governance arrangements and reporting requirements.
- These regulations reflect increasing concern about subsidiary board governance. Large groups with complex subsidiary structures may wish to rationalise those structures and should think carefully about whether their subsidiary governance arrangements are suitably robust.

The Deloitte Academy

The Deloitte Academy provides support and guidance to boards, committees and individual directors, principally of the FTSE 350, through a series of briefings and bespoke training. Membership of the Deloitte Academy is free to board directors of listed companies, and includes access to the Deloitte Academy business centre between Covent Garden and the City.

Members receive copies of our regular publications on Corporate Governance and a newsletter. There is also a dedicated members' website www.deloitteacademy.co.uk which members can use to register for briefings and access additional relevant resources.

For further details about the Deloitte Academy, including membership, please email enquiries@deloitteacademy.co.uk.

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