ACCA Think Ahead

ACCA Department for Business Energy and Industrial Strategy Corporate Governance Green Paper Response

Executive summary: key recommendations

Executive Pay

- Government should remain alive to the relationship between tighter regulations on executive pay and the attractiveness of the UK as a work destination for highly mobile executives, particularly for larger firms.

- Regular company/shareholder engagement is vital to a strong accountability structure and the Government should consider steps to increase the effectiveness of the Financial Reporting Council's stewardship code to this end.

- We support steps to improve the effectiveness of company remuneration committees and we also support non-legislative measures to provide full disclosure of performance targets as outlined in the existing Corporate Governance Code. We support pay-ratio reporting only if it is accompanied by meaningful narrative information.

Strengthening the employee, customer and wider stakeholder voice

- The communicability of company pay policy is arguably as important as the pay policy itself.

- We support measures to increase the transparency of company pay policies through a voluntary approach and not through a legal mandate. We support measures to encourage active stakeholder panels.

- Giving employees a stake in the performance of their organisation is the first steps towards encouraging worker activism and representation. Stakeholder panels are desirable but should not be mandated legally.

Corporate governance in large, privately-held businesses

- Government should remain alive to the resource implications of increasing reporting requirements, even with very large companies.

- Additional reporting standards should only apply to companies that exceed size thresholds contained within the Companies Act.

- The application of a one-size-fits-all approach to corporate governance codes are unlikely to address malpractice by a minority of large public and private companies. Indeed in practice, many organisations have already voluntarily adopted best practice principles of corporate governance regardless of legislative requirements to do so.

SECTION ONE: Executive Pay

Executive pay is a complex issue, and we ought to consider factors beyond the board and executives, remuneration advisors or shareholders.

Market forces have contributed to the upward trend of executive pay; UK companies take into consideration the global competitiveness of their pay policies when aiming to attract the talent to executive positions. As the UK prepares to exit the EU and enter an unknown global business position, this trend may intensify as UK companies fear an exodus of global talent.

Some may also argue that executives have different performance measures and pay criteria. Executives have unique roles and responsibilities and are exposed to a number of risks which impact on a company's strategic direction. The additional risk and public accountability is not always subject to the scalability that employees elsewhere within the company may be subject to.

These considerations do not mitigate the need for a clear link between performance measures and pay levels for executives. The Corporate Governance code requires employers to be sensitive to individual employees' 'pay and employment conditions'. However we should not be naïve in expecting proposed measures to have an instanteffect, particularly if implemented without co-ordinated effort and buy-in from stakeholders.

Finally, our research suggests that organisations perform better when employees feel proud of the company objectives and feel included in what the organisation is setting out to achieve. ACCA's project *Culture and Channelling Corporate Behaviour* (2014-2015) and the subsequent *Culture-Governance Tool* (2017) illustrates the impact of culture on the behaviour of individuals within organisations.

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?**

We are unconvinced as to the effectiveness of options (i)-(iv) as potential methods for holding companies to account on executive pay and performance. Changes to make shareholder voting rights more decisive and final may not necessarily change their voting behaviour. Some of these measures may help, by tweaking existing arrangements, to raise voting turnout, encourage retail investors to vote, or increase disclosures. However, these outcomes do not necessarily lead to better pay practice. Other measures, such as strengthening the remuneration committee and encouraging shareholder-company engagement, may be more effective in addressing the substance of the issue.

Shareholders have a financial stake in company performance. They are often well-informed and resourceful. Shareholders vote as a result of various considerations and this would not necessarily be affected by a change in voting rules.

As demonstrated in the Green Paper, the shareholder voting turnouts at AGM are largely unchanged whether the voting is advisory or binding. In the given analysis, over 90% of shareholders voted to approve both remuneration reports and remuneration policies. This leads us to believe that the impact of proposals (i)-(iv) would be limited if implemented.

On the contrary, some shareholders may be more reluctant to vote against pay proposals should the outcome disrupt the pay cycle and require further time and resource of the board and executives.

ACCA supports the Financial Reporting Council's work to improve the effectiveness of the Stewardship Code (2010) in order to enhance the quality of engagement between investors and companies. We believe that regular company/shareholder engagement is vital to a strong accountability structure. The Government should consider proposals to increase the effectiveness of the Stewardship Code to ensure investors comply. These include, but are not limited to, encouraging all institutional investors to publish a statement on their website on the extent to which they have complied with the Code, to notify the FRC when they have done so and whenever the statement is updated and to name in the statement an individual who can be contacted for further information and by those interested in collective engagement.

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?**

ACCA supports regular engagement between companies and shareholders such as that envisioned in the FRC's Stewardship Code. Shareholders that are engaged regularly in a company and its performance are more likely to exercise powers on pay.

Regarding institutional investors and large asset managers, the existing voluntary regime seems to be effective. Responding to the call from beneficiaries and to peer pressure, many asset managers have voluntarily signed up to the Stewardship Code. The FRC's recent initiative to rank signatories based on the quality of published reports should further encourage positive behaviour. We do not consider that mandatory disclosure of fund managers' voting records at AGMs and the extent to which they have made use of proxy voting proposed under option (i) is necessary as this is part of the Stewardship Code.

We oppose the option (ii) proposal to introduce a senior Shareholder Committee to scrutinise remuneration. Firstly, this duplicates the tasks of the Remuneration Committee. Secondly, this goes against one of the foundations of the existing corporate governance regime that oversees engagement between company boards and investors. Finally, setting up another committee without replicating membership will present a significant time and cost challenge to smaller listed companies.

We are supportive of measures to encourage individual retail shareholders to exercise their rights (option (iii)).

It should be noted however that retail investors choose nominee accounts for smaller costs as well as their simplicity. Based on the government publication *Exploring the intermediated shareholding model* (2016), the level of interest among retail investors in voting and attending AGM is limited. Considering this, any measures that have disproportionate cost in terms of time and resource should be approached cautiously.

It is important that retail investors are aware of their rights, so that they have clear ideas about how they may exercise their powers. This is already done by organisations such as ShareSoc and UKSA. However, we are cautious about mandating brokers to offer voting options to all voters. The cost of making arrangements or setting up necessary facilities to do so will come with costs which will be ultimately borne by retail investors.

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?**

We support steps to improve the effectiveness of remuneration committees. Remuneration committees should lead in engaging shareholders and considering the pay and conditions of the wider company workforce.

We believe that measures to improve the sharing of best practice between companies will be beneficial. This could be carried out through amendments to the guidance contained within the Corporate Governance Code. It should not be necessary to mandate this through legislation.

We do not support the introduction of a requirement to designate a specific non-executive director (NED) to be responsible for representing workforce and wider stakeholder interests. The deliberation of pay is a collective responsibility of the remuneration committee and the onus should not be attributed to a single individual.

We support option (ii) to require the chairs of remuneration committees to have served for at least 12 months on a remuneration committee before taking up the role.

The option currently suggests that the chairs of remuneration committees should 'have served for at least 12 months on remuneration committee' but does not specifically say that this should be at the company. ACCA would encourage that this be reworded to require the chair to have served for at least 12 months on the remuneration committee <u>of the company in question.</u> This way, the chair will obtain a sound understanding of the company and its business, risk, and long-term goals, and executives. This should be implemented on a comply or explain basis as it may present practical difficulties to smaller boards.

The remuneration committee is ultimately responsible for the appointment of any consultants. However, the responsibility for setting the remuneration of executive directors including pension rights remains within the delegated responsibility of the committee.

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.**

We support the disclosure of quota but it must also be accompanied by by relevant narratives, for example:

- how it is calculated;
- how it compares with the average within the sector and the ratio from the previous years;

- what ratio the company considers to be reasonable; and
- if it is very different from benchmarks, what actions the company has taken or intends to take.

This narrative is essential in addressing potential adverse implications. For example, if a company dismisses its lowest paid job to reduce the ratio, it may be contrary to the organisational integrity and effectiveness. There is also a risk that companies could outsource roles at the lower end of the pay scale to improve the perception of the pay ratio. This would further undermine good corporate culture and boost the relative influence and importance of more senior colleagues in permanent in-house positions.

The disclosure of ratio is unlikely to add costs for businesses as the current information around pay is sufficient to calculate it. However, by including this disclosure proactively, companies are consciously addressing the perception issues surrounding pay.

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?**

We support increasing non-legislative pressure on companies through the Investment Association and other shareholder advisers providing full disclosure of performance targets. We also support strengthening the FRC's remuneration guidance, which is part of the Corporate Governance Code.

The statistics in 1.58 appear convincing in terms of the effectiveness of non-legislative means. We do not support retrospective disclosure. This would add little value for shareholders or other stakeholders.

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.**

The award structure is far more communicable and transparent than typical long term incentive plans. The proposal made by the Executive Remuneration Group report to halve the value of the reward is an option worth exploring. However, there is also an argument that it may not be stretching in terms of performance. Without further research, we are unable to say that one approach is always superior to the other. Rather, it should be aligned to the business model of individual companies and the role executives play in the context.

We neither support nor oppose the proposal to extend holding periods. We feel that more research should be done in this area to understand potential benefits, including case studies of companies that have adopted this approach and the ramifications of such.

SE£CTION TWO: Strengthening the employee, customer and wider stakeholder voice

Organisations are most successful when they provide employees with an experience at work that includes a sense of purpose and direction and a clear line of sight to strategy; good communication

across the hierarchy; and demonstrable fairness by treating people in a consistent manner--for example, pay needs to be seen to be fair.

Communication of pay policy is important – it becomes a commitment which leads to accountability. Companies should be doing this voluntarily because it benefits them. Creating stakeholder advisory panels is beneficial for companies as they obtain input from a broad range of stakeholders and can optimise opportunities and identify risks at the earliest stage. However, this should not be confused with passing accountability for good governance to other stakeholders including shareholders – that always rests with the board.

It is important to recognise that, in substance, some organisations are well integrated in terms of the alignment of organisational purpose, employee engagement and communication with shareholders. ACCA has adopted the International Integrated Reporting Framework for the last 3 years and this has facilitated ACCA to implement the idea of integrated organisation in full. We consider this is a successful example of a voluntary initiative that has enabled better employee and stakeholder engagement.

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.**

It is important to consider the aim of strengthening employee, customer and wider stakeholder voice. ACCA see the benefit of having stakeholder panels (option (i)) but not by way of mandating it. Companies should benefit from setting up panels (or similar) to absorb the views of its key stakeholders.

The mixture of the voluntary initiatives facilitated by industry associations, such as Investor Associations, with additional guidance in the Corporate Governance Code will develop standard practice in due course.

Advocating best practice will be useful, focusing on what can be done but also how it can lead to better performance. ACCA supports a voluntary approach – possibly stakeholder panels and guidance on principles, frameworks—such as integrated reporting—and thinking by listed and unlisted companies. Making them legal requirements could lead to meaningless boiler-plate statements, especially from the unlisted companies.

ACCA does not support the designation of a NED to a specific panel. This risks the requirements of s172 being de facto delegated to an individual director. [Further rationale under the discussion on Option (iii).] It may give the designated NEDs undue responsibility and accountability for stakeholders. Even if in reality there is only one director attending a specific panel, the responsibility for considering the voice should remain a collective responsibility for the board.

ACCA does not support option (iii)

We note that Worker Councils (eg, in Germany) may give employees representation at the highest level, but even then, it is not always seen to be conducive to the running of the organisation in the most effective way.

There will also be practical issues in identifying a suitable individual. For example, in a large retail company or service company, appointing an individual is unlikely to reflect the diversity of its customers.

It would also be unfair to the worker representative who may come under pressure from fellow workers to defend the employee interests, rather than a solution that works for the organisation as a whole. This person cannot be held responsible for the employees either. Even where this is not the case, there may be an unhelpful perception as such. A single employee representative on the board would have little power.

This arrangement does not absolve companies' duty to comply with s172.

One approach in for-profit organisations, whether public or private, would be to give employees a stake in the performance of the organisation that would be equitable whatever level in the company you are.

We note the integrated reporting approach which looks to stakeholder engagement as one of its guiding principles. Companies may find it helpful to reflect on this approach and identify their significant stakeholders, explaining how they identify the concerns of the stakeholders and the effect that it has had in terms of the business and reporting. Our discussions with businesses that have adopted integrated reporting suggest, for example, that in their opinion, the process has facilitated more active engagement from employees with the business strategy.

As mentioned in response to option (i), ACCA supports a voluntary approach – possibly including stakeholder panels and encouraging the principles of integrated reporting. Making reporting requirements legal on the other hand risks rather meaningless boiler-plate statements, especially if applied to unlisted companies.

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?**

Larger companies do tend to have more layers of corporate governance, but also some may be able to override these when it comes to company structure – for example, they may have the same person as Chairperson/Chief Exec. When it comes to C-suite remuneration, they pay high salaries because they can.

Privately owned businesses are subject to much less public scrutiny of their internal practices and ACCA's view is that a reasonable threshold to assess practices would be a business that has three or more levels between the CEO and frontline workers.

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.**

ACCA supports a voluntary approach – possibly gathering feedback by way of stakeholder panels and encouraging the adoption of principles of integrated reporting.

It is also important to draw in feedback from shareholders to examine opportunities to encourage greater participation. Companies should be encouraged to assess the extent to which shareholders feel they have parity of voice and to open up more opportunities for engagement. Improving shareholder confidence that feedback will be addressed or at least acknowledged will encourage continued feedback and participation.

A legislative approach risks an outcome where companies submit uninformative, boiler-plate statements, particularly unlisted companies of very limited value with less motivation to report.

SECTION THREE: Corporate governance in large, privately-held businesses

We do not consider that the application of blanket corporate governance codes should be the way forward in addressing issues that surfaced due to a minority of private companies that have been under spotlight for their malpractice. Private companies are not a homogenous group: there arevast variations in their business models, board structures, corporate cultures and levels of stakeholder influence.

It is unrealistic to assume that these kinds of measures would resolve issues related to mismanagement, the lack of financial discipline, or inappropriate decision-making. These issues can happen in listed companies that come under a stricter corporate governance framework, as well as in private companies, partnerships, charities and family owned companies.

In practice, many organisations outside the scope of listed companies, including private companies, have voluntarily adopted best practice principles of corporate governance. This is because of a widely held view – which ACCA supports - that good governance contributes to sustainable business growth and motivates staff and stakeholders to contribute to the delivery of business goals. Mandating them can end up reducing our approach to follow the best practice to a compliance exercise.

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?**

There is a risk that the widely recognised issues around corporate governance within large, privately-held companies may be overstated due, in part, to the media attention it generates. There are currently many checks and balances in place to protect minority shareholders in listed companies which are unavailable for private companies.

In the majority of private companies, the board members and executives are shareholders and therefore have a vested interest in the sustainability and continued growth of the business which leads to prudent decision-making. The investors in this sector are often more aware of the risk or reward of their investment decisions and act accordingly.

Their success is dependent on the owner managers' knowledge of the business, as they are able to manage and take risk, and identify opportunities for the company. Preliminary ACCA research into the corporate governance of smaller private companies indicates that they prioritise their resources on financial governance and compliance. Our 2015 paper *Governance for all: the implementation challenge for SMEs* sets out challenges and practical recommendations for smaller private companies. However, some of these discussions will also apply to larger private companies.

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?

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?

Response combined for 11 and 12

We do not support the mandatory application of a specific corporate governance framework for the largest privately-held businesses due to the diversity of the group. Looking at the capital and corporate structures alone, there are: family owned companies, state-owned companies, group-owned companies, private investor-owned companies, joint ventures, and privatised companies. The leading initiatives by organisations such as OECD tend to focus specific types of entities (such as state-owned companies) and they develop guidance, rather than rules.

The UK Corporate Governance Code is unlikely to be a suitable framework for private companies. The Code was drafted with listed companies in mind from the start. While its high-level principles may be relevant for private companies, the specific guidance assisting companies in implementing the principles is unlikely to be applicable.

In terms of developing a separate corporate governance code, we note that there are already many initiatives exist, including:

- *Governance guidance and principles for unlisted companies in Europe (2010)* by the European Confederation of Directors Associations;
- *Corporate governance code for small and mid-size quoted companies* (2013) by the Quoted Companies Alliance; and
- *Corporate Governance Guidance and Principles for Unlisted Companies in the UK* (2010) by the Institute of Directors, UK.

It might be useful to raise awareness of existing frameworks, but we do not believe that there is the need for another corporate governance framework for privately held businesses.

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?

Reporting requirements come with costs for any companies. Further non-financial reporting requirements therefore need to take into account the extra resource implication.

Such requirements for larger companies should be in line with existing definitions within the Companies Act 2006 (Amendment)(Accounts and Reports) Regulations 2008. Any non-financial reporting requirements should be accompanied by government guidelines on what the reports should address. Priority areas should be tailored to shareholders, stakeholders and employees.

For example, for those just inside the thresholds and expanding quickly, it may be more important to undertake detailed reporting around projected growth and employee retention, while for the largest businesses it may be profiling potential reputational risks. It is reasonable that matters relating directly to internal management or commercially sensitive information may be excluded.