HOUSE OF COMMONS LIBRARY

BRIEFING PAPER

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Corporate Governance Reform

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Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies.

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The Code applies to public listed companies – it does not concern private companies. In law, companies are primarily accountable to their shareholders, and the Code is largely, though not only, written to protect and benefit shareholders.

The Code consists of principles rather than detailed rules. Companies must apply these principles but have latitude over how they do so. Indeed, a key job of a company's board is to decide how to apply the Code's principles, and communicating their approach to shareholders and other stakeholders.

A fundamental feature of the application of the Code is the "comply or explain" principle. Under this principle, companies are required to comply with official guidance, or to explain why they have not done so. Comply or explain preserves flexibility for businesses that wish to deviate from best practice as laid out in the guidance. But the deviations must be duly noted, and justified, in the company's annual report.

Directors' duties

A key component of the corporate governance framework in the UK are the duties that company directors must discharge in law under the Companies Act 2006. The seven general duties of directors are:

1. To act within powers
2. To promote the success of the company
3. To exercise independent judgment
4. To exercise reasonable care, skill and diligence
5. To avoid conflicts of interest
6. Not to accept benefits from third parties
7. To declare an interest in a proposed transaction or arrangement

The duty to promote the success of the company (section 172 of the Act) requires directors to act in the best interests of the company's members (i.e. the shareholders in companies limited by shares), but also to have regard to other stakeholders, including employees, suppliers, customers, the community and the environment.

Reform

Narrowly defined, the purpose of corporate governance is 'to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company' (p1 of the 2016 Corporate Governance Code).

But recent reforms have had a much wider purpose and scope than simply facilitating long-term success. For example, the impetus to reform executive pay has come from concerns about social justice as much as from concerns about the effective management of companies.

A consultation on corporate governance reform was launched on 29 November 2016. On 29 August 2017, the Government published its response to the consultation. It proposed eight reforms across the three areas of pay, employee and stakeholder voice, and the governance of large private companies. All eight proposals have been implemented since. The Companies (Miscellaneous Reporting) Regulations 2018 brought into effect the reforms that required legislation, starting in 2019.

The Government also agreed to look at the powers of the Financial Reporting Council (FRC) – an issue that was raised independently by respondents to the consultation and by the BEIS Select Committee. On 17 April 2018, the Government launched an independent review of the FRC, led by Sir John Kingman. The review examined the role, governance and powers of the FRC, and reported on 18 December 2018. The review recommended that the FRC be replaced with an independent statutory regulator, accountable to Parliament, with a new mandate, new clarity of mission, new leadership and new powers.

Pay ratios

The Government requires public companies with more than 250 UK employees and listed on the stock exchange to report annually the ratio of CEO pay to the median pay, 25th-percentile and 75th-percentile pay of their UK workforce, along with a narrative explaining changes to that ratio from year to year. To illustrate, a median pay ratio of 50 means that the CEO is paid 50 times the median pay in the company. Pay ratio data will first be reported in 2020.

Analysis in this briefing of alternative, currently available data shows that:

- A company's ratio is partly predicted by the number of employees: larger companies have higher ratios – they are less equal.
- Differences in ratios between companies are also explained by the type of industry they are in – not just by company size. Some industries employ much higher proportions of highly-skilled, well-paid employees (e.g. finance), while others, like retailers, have large numbers of relatively less well-paid staff. The remuneration of chief executives also varies across industries.
- When looking at individual companies, ratios can fluctuate a lot from year to year. These fluctuations are due to the high volatility of top CEO pay, while pay in the wider workforce is more stable.

Taken together, company size, industry and the volatility of CEO pay can largely explain a company's ratio, and changes from year to year. One can expect these factors to feature in the narrative that companies will provide along with their ratios.

1. The corporate governance framework

Definition of corporate governance

Paragraph 2.5 of the 1992 Cadbury Report is still the official definition of corporate governance:

> Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting.[1]

Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies.

1.1 History of the Code

The 1992 Cadbury Report laid the foundations of the current corporate governance regime. 'Cadbury' was set up in reaction to two high-profile failures that took investors by surprise.

> The Committee on the Financial Aspects of Corporate Governance, forever after known as the Cadbury Committee, was established in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession. The spur for the Committee's creation was an increasing lack of investor confidence in the honesty and accountability of listed companies, occasioned in particular by the sudden financial collapses of two companies, wallpaper group Coloroll and Asil Nadir's Polly Peck consortium: neither of these sudden failures was at all foreshadowed in their apparently healthy published accounts.
>
> Even as the Committee was getting down to business, two further scandals shook the financial world: the collapse of the Bank of Credit and Commerce International and exposure of its widespread criminal practices, and the posthumous discovery of Robert Maxwell's appropriation of £440m from his companies' pension funds as the Maxwell Group filed for bankruptcy in 1992. The shockwaves from these two incidents only heightened the sense of urgency behind the Committee's work, and ensured that all eyes would be on its eventual report.[2]

The 1992 Cadbury Report laid the foundations of the current corporate governance regime.

The Cadbury Report and its successors established an approach to corporate governance that mainly relies, not on hard law and

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[1] Committee on the Financial Aspects of Corporate Governance, *Report*, 1 December 1992, para. 2.5

[2] Cambridge Judge Business School, The Cadbury Report, webpage visited 23 October 2017.

enforcement mechanisms, but on encouraging dialogue between companies and their shareholders.[3]

At the heart of this approach is the "comply or explain" principle. Under this principle, companies are required to comply with official guidance, or to explain why they have not done so. Comply or explain preserves flexibility for businesses that wish to deviate from best practice as laid out in the guidance. But the deviations must be duly noted, and justified, in the company's annual report.

Companies can choose to either comply with the Code, or explain why they are not complying.

Since Cadbury, corporate governance has gradually evolved, usually following reviews and reports aiming to tackle particular failings. Cadbury was followed in 1995 by the Greenbury Report which focused exclusively on executive remuneration. These two codes were subsequently revisited in 1998 by the Hampel committee. The Hampel Report consolidated the two earlier codes into the 'Combined Code' which provides guidance on good governance standards for listed companies. Further changes were made to the Combined Code by the Higgs Report in 2003, and by the Walker Report in 2009 with respect to the governance of banks.

This evolutionary approach to reform, although frequently reactive in nature, has served to refresh the UK's corporate governance framework and helped to keep it at the leading edge of international standards.[4]

The Government's consultation on corporate governance reform of 2016-2017 started the latest round of reform.

1.2 The Code

Legislative background

Section 1273: Corporate governance regulations of the Companies Act 2006 enables the Government to make regulations dealing with the corporate governance of companies whose securities are traded on a regulated market in the UK.

Subsection (3)(a) allows for regulations to be made by reference to a specified code on corporate governance that may be issued from time to time by a specified body.

The UK Corporate Governance Code (hereafter "the Code") is the specified code currently in force. The Financial Reporting Council (FRC) is the specified body currently responsible for the Code.

Administration of the Code

The Code is administered by the Financial Reporting Council (FRC). The FRC is also responsible for the Stewardship Code, for the regulation of

3 Business, Energy and Industrial Strategy Committee, *Corporate governance*, 5 April 2017, HC 702 2016-17, para. 6-8
4 Business, Energy and Industrial Strategy Committee, *Corporate governance*, 5 April 2017, HC 702 2016-17, para. 8

auditors, accountants and actuaries, and for a wide range of other company-related regulatory activities.

The Government intends to replace the FRC with a new, independent statutory regulator with stronger powers. FRC reform is discussed in section 2.2.

Content

The Code sets out good practice that boards should adopt to be effective, accountable, transparent and focused on sustainable success over the longer term. It covers board composition, remuneration, shareholder and stakeholder relations, accountability and audit.

The Code applies to public listed companies – it does not concern private companies. In law, companies are primarily accountable to their shareholders, and the Code is largely, though not only, written to protect and benefit shareholders.

The Code applies to public listed companies – it does not concern private companies.

The Code consists of principles rather than detailed rules. Companies must apply these principles but have latitude over how they do so. Indeed, a key job of a company's board is to decide how to apply the Code's principles, and communicating their approach to shareholders and other stakeholders.

Companies apply the Code on the basis of the "comply or explain" principle, which is the foundation of the Code's flexibility:

> It is recognised that an alternative to following a provision may be justified in particular circumstances if good governance can be achieved by other means. A condition of doing so is that the reasons for it should be explained clearly and carefully to shareholders, who may wish to discuss the position with the company and whose voting intentions may be influenced as a result. In providing an explanation, the company should aim to illustrate how its actual practices are consistent with the principle to which the particular provision relates, contribute to good governance and promote delivery of business objectives.[5]

The FRC last revised the Code in July 2018 (see Revised Code later), with the new version applying to reporting years starting on or after 1 January 2019.

Strengths and weaknesses

In the February 2017 announcement of a fundamental review of the UK Corporate Governance Code, the FRC's Chairman listed the following elements as strengths of the UK governance framework:

- The unitary board (directors are collectively responsible for the decisions of the board)
- Strong shareholder rights
- The role of stewardship
- The 'comply or explain' approach

[5] Financial Reporting Council, *UK Corporate Governance Code*, April 2016, p. 4

The FRC highlighted these other elements as areas for improvement:

- Helping boards take better account of stakeholder views
- Linking executive remuneration with performance
- Extending the FRC's enforcement powers to ensure that disciplinary action can be taken against all directors where there have been financial reporting breaches.

Grant Thornton, an accountancy firm, publish an annual corporate governance review that examines levels and quality of compliance with the Code by FTSE 350 companies. The Corporate Governance Review 2016 presented a broadly positive picture, but it also highlighted some areas where compliance is low, or quality poor. For example:

- 62% of companies claimed full compliance with the Code, but only 48% provide high-quality, forward-looking statements.
- 90% of the FTSE 350 comply with all but one or two provisions of the Code, but the highest rate of non-compliance relates to board independence: 9.4% of companies do not comply with the requirement that half the board be made of independent non-executive directors.
- Disclosure quality around company engagement with shareholders has decreased year on year since 2010. In 2016 only 36% of companies provided good or detailed explanations of how they understand the views of shareholders.
- Only 20% of companies provide good or detailed discussion on organisational culture.

1.3 Directors' duties

A key component of the corporate governance framework in the UK are the duties that company directors must discharge in law. Part 10, chapter 2 of the Companies Act 2006 codified the common law duties of directors. In summary, the seven general duties are:

1. To act within powers
2. To promote the success of the company
3. To exercise independent judgment
4. To exercise reasonable care, skill and diligence
5. To avoid conflicts of interest
6. Not to accept benefits from third parties
7. To declare an interest in a proposed transaction or arrangement

Company directors have a number of duties placed upon them by law.

Duty to promote the success of the company (section 172)

Section 172 of the Companies Act requires directors to act in the best interests of the company's members (i.e. the shareholders in companies limited by shares), but also to have regard to other stakeholders:

> 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.

In their duty to promote the success of the company, directors must also have regard to other stakeholders such as employees and the community.

To reiterate, "having regard to" the listed matters is clearly subordinate to the duty to promote the success of the company for the benefit of its members as a whole. But if the purposes of the company consist of or include purposes other than the benefit of its members, directors must act to promote these stated purposes (section 172(2)). Companies are therefore free to adopt other purposes in their constitutions.

It should also be noted the list provided is not exhaustive: directors should have regard to any other matters relevant to the success of the company.

2. Reforms

The first paragraph of the 2016 UK Corporate Governance Code describes the purpose of corporate governance:

> The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company.[6]

As will be seen in the following sections, recent reforms have much wider purpose and scope than simply facilitating the long-term success of listed companies. For example, the impetus to reform executive pay has come from concerns about social justice as much as (if not more than) from concerns about the effective management of companies.

Recent reforms have much wider purpose and scope than simply facilitating the long-term success of listed companies.

Similarly, the current Code only applies to public companies with a premium stock exchange listing, whereas two of the Government's reforms place new requirements on large private companies too. So the reforms go beyond the Code to look at corporate governance more widely.

2.1 Government proposals and reforms

Theresa May first put corporate governance reform on the agenda with her leadership speech in July 2016, just before becoming Prime Minister. This was followed by the launch of a consultation in the autumn of that year, and a reaffirmation of proposed reforms in the Conservative Manifesto of 2017.

Leadership speech and Conservative Manifesto

Theresa May talked about corporate governance reform and executive pay in her leadership speech of July 2016:

Proposals for reform featured in Theresa May's leadership speech of July 2016 and in the Conservative Manifesto of 2017.

> And I want to see changes in the way that big business is governed. The people who run big businesses are supposed to be accountable to outsiders… So if I'm Prime Minister, we're going to change that system – and we're going to have not just consumers represented on company boards, but employees as well.
>
> … I want to make shareholder votes on corporate pay not just advisory but binding. I want to see more transparency, including the full disclosure of bonus targets and the publication of "pay multiple" data: that is, the ratio between the CEO's pay and the average company worker's pay. And I want to simplify the way bonuses are paid so that the bosses' incentives are better aligned with the long-term interests of the company and its shareholders.[7]

These early proposals found their way into the nine reforms that the Government implemented (see Response and reform programme). However, in two areas the measures taken by the Government were not quite as radical as what was initially proposed.

6 FRC, The UK Corporate Governance Code, April 2016, p1
7 Theresa May, Speech in Birmingham launching her national campaign to become Leader of the Conservative Party, 11 July 2016

The Government did not make workers on boards mandatory. Instead, companies can also choose the option of a non-executive director designated to represent employee views; or the option of a formal employee advisory council. Like all Code requirements, implementing some form of employee representation will be open to "comply or explain", so companies could also decide to implement none of the options.

Similarly, the Government's reforms do not include making shareholder votes on corporate pay binding. Instead, the Government invited the FRC to revise the Code to 'be more specific about the steps that premium listed companies should take when they encounter significant shareholder opposition to executive pay policies and awards'.[8]

Conservative Manifesto 2017

Theresa May's early proposals were also found in the Conservative Manifesto 2017:

> **Fair corporate pay**
>
> […] The next Conservative government will legislate to make executive pay packages subject to strict annual votes by shareholders and listed companies will have to publish the ratio of executive pay to broader UK workforce pay. Companies will have to explain their pay policies, particularly complex incentive schemes, better. […]
>
> **Better corporate governance**
>
> […] To ensure employees' interests are represented at board level, we will change the law to ensure that listed companies will be required either to nominate a director from the workforce, create a formal employee advisory council or assign specific responsibility for employee representation to a designated non-executive director.[9]

Consultation

The Government launched a consultation on Corporate governance reform on 29 November 2016. The consultation sought views on how to improve three areas of corporate governance: executive pay, strengthening the voice of employees and other stakeholders, and the governance of large private companies. The problems identified by the Government and its aims are summarised below.

Executive pay

The Government seeks to curb excessive levels of remuneration of top executives. The Government argues that

> […] there is a widespread perception that executive pay has become increasingly disconnected from both the pay of ordinary working people and the underlying long-term performance of companies.[10]

8 BEIS, Government response: Corporate Governance Reform, 29 August 2017, p. 3
9 Conservative Party Manifesto 2017, p. 18
10 BEIS, Corporate governance reform: green paper, November 2016, p. 16

Strengthening the voice of employees and other stakeholders

The Government wants Boards to better reflect the views and diversity of the company's workforce, customers and wider community.

> The challenge is to ensure that all companies are taking the steps needed to understand and take account of wider interests and different social perspectives. […]
>
> Many companies and their boards recognise clearly the wider societal responsibilities they have and the enormous benefit they gain through wider engagement around their business activities. However, some have said that companies need to do more to reassure the public that they are being run, not just with an eye to the interests of the board and the shareholders, but with a recognition of their responsibilities to employees, customers, suppliers and wider society.[11]

Governance of large private companies

BHS's failure has come to illustrate concerns that private companies are not accountable enough. The Government thinks that privately-held businesses should meet higher standards of corporate governance and reporting.

> [G]ood governance is about more than the relationship between the owners and the managers of a business. There are other stakeholders with a strong interest in whether a business is well run, including employees, customers, supply chains and pension fund beneficiaries. They all suffer when a private company fails as the recent failure of BHS has demonstrated.[12]

Following a consultation, the Government announced nine reforms to do with executive pay, employee and stakeholder voice, the governance of large private companies, and the powers of the FRC.

Response and reform programme

Following the consultation, the Government published its conclusions on 29 August 2017.[13] It announced eight reforms across three areas of pay, employee and stakeholder voice, and the governance of large private companies. There was an additional proposal regarding the powers of the FRC – an issue that was raised independently by respondents. The nine reforms were taken forward by a combination of means (e.g. amendments to the Code, secondary legislation, new guidance) and are summarised below:

#	Area	Means	Reform
1	Executive pay	Corporate Governance Code	Invite the FRC to revise the Corporate Governance Code in the areas of (i) shareholder opposition to executive pay; (ii) responsibilities of remuneration committees; and (iii) minimum vesting and post-vesting holding periods for executive share awards.
2	Executive pay	Secondary legislation	Introduce secondary legislation to require quoted companies (i) to report annually the ratio of CEO pay to the average pay of their UK workforce, along with a

11 BEIS, Corporate governance reform: green paper, November 2016, p. 34
12 BEIS, Corporate governance reform: green paper, November 2016, p. 43
13 BEIS, Government response: Corporate Governance Reform, 29 August 2017

#	Area	Means	Reform
			narrative explaining changes to that ratio from year to year; and (ii) to provide a clearer explanation of potential outcomes from complex, share-based incentive schemes.
3	Executive pay	Public register	Invite the Investment Association to maintain a public register of listed companies encountering shareholder opposition to pay awards of 20% or more, along with a record of what these companies say they are doing to address shareholder concerns.
4	Employee and stakeholder voice	Secondary legislation	Introduce secondary legislation to require all companies of significant size (private as well as public) to explain how their directors comply with the requirements of section 172 to have regard to employee and other interests.
5	Employee and stakeholder voice	Corporate Governance Code	Invite the FRC to consult on a new Code principle establishing the importance of strengthening the voice of employees and other non-shareholder interests at board level. As a part of this new principle, the Government will invite the FRC to consider and consult on a specific provision requiring companies to adopt, on a "comply or explain" basis, one of three employee engagement mechanisms: a designated non-executive director; a formal employee advisory council; or a director from the workforce.
6	Employee and stakeholder voice	Industry-led guidance	Encourage industry-led solutions by asking the Institute of Chartered Secretaries and Administrators (the Governance Institute) and the Investment Association to complete their joint guidance on practical ways in which companies can engage with their employees and other stakeholders. The Government will also invite the GC100 group of the largest listed companies (FTSE100 General Counsels) to complete and publish new guidance on the practical interpretation of directors' duties in section 172 of the Companies Act 2006.
7	Governance of large private companies	New voluntary code for private companies	Invite the FRC to work with the IoD, the CBI, the Institute for Family Businesses, the British Venture Capital Association and others to develop a voluntary set of corporate governance principles for large private companies under the chairmanship of a business figure with relevant experience.
8	Governance of large	Secondary legislation	Introduce secondary legislation to require companies of a significant size to disclose their corporate governance arrangements in their Directors' Report and on their

#	Area	Means	Reform
	private companies		website, including whether they follow any formal code.
9	Powers of the FRC	New letters of understanding between FRC, FCA and IS; Review of the FRC	The Government will ask the FRC, the Financial Conduct Authority and the Insolvency Service to conclude new or, in some cases, revised letters of understanding with each other before the end of this year to ensure the most effective use of their existing powers to sanction directors and ensure the integrity of corporate governance reporting. The Government will also consider, in light of this work, whether further action is required.

The Government described its general approach to reform as aiming to avoid legislative means where possible:

> These measures are in line with the UK's approach of strengthening corporate governance through non-legislative means: through changes to the UK Corporate Governance Code overseen by the Financial Reporting Council and voluntary industry-led action where possible, and legislating where necessary.[14]

How is reform achieved?

The Government implemented its proposals using a variety of means that have different advantages and disadvantages. Some choices to make on how to achieve reform are:

- Government-led or business-led
- Legislative or non-legislative
- Voluntary compliance or compulsory

Asking industry bodies to publish guidance is business-led, non-legislative and voluntary compliance. This approach has the advantage of being fast, bottom-up and flexible. But the flip side is that it won't generate full compliance and it might lack ambition. Moreover, the existing legislative and regulatory framework places limits on the scope for industry-led reform, as legally-mandated provisions take priority over any guidance in case of conflict.

Opposite arguments can be made about the merits and demerits of reform by primary legislation. Legislated provisions will have maximum compliance, and the Government can be as radical and ambitious as it likes (provided it can carry Parliament with it too). But the approach can be slow and inflexible. And parliamentary time must be made available, at the cost of other legislative priorities.

14 BEIS, Government response: Corporate Governance Reform, 29 August 2017, p. iii

Amending the Corporate Governance Code is a bit of a hybrid. On the one hand, applying the Code is mandatory, but on the other hand, companies can decide not to comply with a provision of the Code as long as they explain why.

Timescales

The Government initially intended to bring the legislative reforms into effect by June 2018 to apply to company reporting years commencing on or after that date. A little delay resulted in the new rules coming into force for reporting periods starting on or after 1 January 2019. So the new information will start appearing in 2020, covering activities undertaken in 2019.[15]

The January 2019 start date coincides with that of the revised Corporate Governance Code, and the launch of the new Wates principles of corporate governance for large private companies.

New and revised letters of understanding between the FRC, the FCA and the Insolvency Service were published in late 2017 and early 2018. They can be seen on the FRC's Memorandum of Understanding page.

On 17 April 2018, the Government launched an independent review of the Financial Reporting Council, which reported on 18 December 2018 (see section 2.2).

Legislation

Draft secondary legislation was published on 12 June 2018 and made on 17 July 2018, The Companies (Miscellaneous Reporting) Regulations 2018. The regulations created the following requirements:

New requirements in law to apply from 1 January 2019.

- Large companies will be required to include a statement as part of their strategic report describing how the directors have had regard to the matters in section 172(1)(a) to (f) of the Companies Act 2006 [duty to promote the success of the company, having regard to a range of stakeholders].
- Companies with more than 250 UK employees will be required to include a statement as part of their directors' report summarising how the directors have engaged with employees, how they have had regard to employee interests and the effect of that regard, including on the principal decisions taken by the company in the financial year.
- Large companies will be required to include a statement as part of their directors' report summarising 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.

15 BEIS, The Companies (Miscellaneous Reporting) Regulations 2018 - Frequently Asked Questions, June 2018, p. 7

- Very large private and public unlisted companies will be required 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.
- Quoted companies with more than 250 UK employees will be required to publish, as part of their directors' remuneration report, the ratio of their CEO's total remuneration to the median (50th), 25th and 75th percentile full-time equivalent (FTE) remuneration of their UK employees. Alongside this, companies will have to publish supporting information, including the reasons for changes to the ratios from year to year and, in the case of the median ratio, whether, and if so how, the company believes this ratio is consistent with the company's wider policies on employee pay, reward and progression.
- All quoted companies will be required to illustrate, in the directors' remuneration policy within their directors' remuneration report, the effect of future share price increases on executive pay outcomes. Companies will also be required to include a summary in their directors' remuneration report of any discretion that has been exercised on executive remuneration outcomes reported that year in respect of share price appreciation or depreciation during the relevant performance periods.[16]

Corporate governance principles for large private companies

On 13 June 2018, the FRC published a consultation on corporate governance principles for large private companies, which was conducted by James Wates CBE. Large private companies are encouraged to follow six principles to inform and develop their corporate governance practices and adopt them on an "apply and explain" basis. The principles are sufficiently high-level that companies are expected to apply them all (the "apply" bit), but different companies will apply them in different ways, and so are expected to "explain" how they are achieving the desired outcomes.

The consultation closed on 7 September 2018. The Wates Corporate Governance Principles for Large Private Companies were published on 10 December 2018.

[16] BEIS, The Companies (Miscellaneous Reporting) Regulations 2018 - Frequently Asked Questions, June 2018, p. 4

The six principles are:

1. **Purpose and leadership** – An effective board develops and promotes the purpose of a company, and ensures that its values, strategy and culture align with that purpose.
2. **Board 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.
3. **Director responsibilities** – The board and individual directors should have a clear understanding of their accountability and responsibilities. The board's policies and procedures should support effective decision-making and independent challenge.
4. **Opportunity and risk** – A board should promote the long-term sustainable success of the company by identifying opportunities to create and preserve value, and establishing oversight for the identification and mitigation of risks.
5. **Remuneration** – A board should promote executive remuneration structures aligned to the long-term sustainable success of a company, taking into account pay and conditions elsewhere in the company.
6. **Stakeholder relationships and engagement** – Directors should foster effective stakeholder relationships aligned to the company's purpose. The board is responsible for overseeing meaningful engagement with stakeholders, including the workforce, and having regard to their views when taking decisions.[17]

The six Wates Corporate Governance Principles for Large Private Companies.

Gender: pay and leadership gaps

Gender pay gap reporting became mandatory from 6 April 2017 for employers in Great Britain with more than 250 staff. These companies must publish the following four types of figures annually on their own website and on the government website:

- Gender pay gap (mean and median averages)
- Gender bonus gap (mean and median averages)
- Proportion of men and women receiving bonuses
- Proportion of men and women in each quartile of the organisation's pay structure.[18]

Gender pay gap reporting became mandatory from 6 April 2017 for employers in Great Britain with more than 250 staff.

The gender pay gap data can be viewed here and downloaded here. More information and analysis can be found in our briefing, The gender pay gap.

[17] FRC, The Wates Corporate Governance Principles for Large Private Companies, December 2018

[18] Government Equalities Office, Gender Pay Gap Reporting (news story), 28 January 2017

To tackle the leadership gap, the Government commissioned an independent review by Sir Philip Hampton and the late Dame Helen Alexander to look at ways to ensure that talented women at the top of business are recognised, promoted and rewarded. The initial report of the Hampton-Alexander Review was published on 8 November 2016.

The key recommendations of the 2016 report were:

- 33% target for women on FTSE 350 Boards by the end of 2020
- 33% target for women on FTSE 100 Executive Committees and Direct Reports to the Executive Committee on a combined basis by 2020

In 2017, 27.7% of board positions in FTSE 100 companies were occupied by women – up from 12.5% in 2011. In that time, the number of all-male FTSE 350 company boards fell to from 152 to 8.[19] The proportion of FTSE 100 board positions held by women then rose to 28.7% in March 2018, and 23.4% for the FTSE 250.[20]

In 2018, 28.7% of board positions in FTSE 100 companies were occupied by women – up from 12.5% in 2011.

The 2017 report extended the target of filling one third of senior leadership positions below board level with women to all FTSE 350 companies (previously FTSE 100 only), and found that FTSE 100 companies are on track to meet the target of having one third of board positions held by women by 2020.

More information about women leading businesses can be found in our briefing, Women and the economy.

Share buybacks

In January 2018, the Government commissioned new research to understand how companies use share buybacks, as part of its corporate governance reforms and wider Industrial Strategy. The research is to address concerns that companies repurchase shares to artificially inflate executive pay.[21]

The Government appointed consultants PwC to undertake the research, along with Professor Alex Edmans (London Business School).

19 BEIS, FTSE 350 companies urged to fill senior positions with more women to make UK a world leader on gender diversity (news story), 9 November 2017
20 BEIS, Record number of women on FTSE 100 boards (news story), 8 March 2018
21 BEIS, Government to research whether companies buy back their own shares to inflate executive pay (News story), 28 January 2018

2.2 FRC

Revised Code

The FRC has published a new, revised Code to apply from 1 January 2019.

In February 2017, the Financial Reporting Council announced a fundamental review of the UK Corporate Governance Code, which would take into account the outcomes of the Government consultation and the BEIS Committee report (discussed below in section 2.4). On 5 December 2017, the FRC published its proposals for a revised Code, and commented:

> The Code is shorter and sharper and builds on the findings from the FRC's Culture Report published in 2016. The revised Code focuses on the importance of long-term success and sustainability, addresses issues of public trust in business and aims to ensure the attractiveness of the UK capital market to global investors through Brexit and beyond.

On 16 July 2018, the FRC published the final version of the new Code, which applies to accounting periods beginning on or after 1 January 2019.

The principal change is a new focus on stakeholders, corporate culture and diversity, in line with the Government's requests and the BEIS Committee's recommendations.[22]

The headings of the Code changed as follows:

Current headings	New headings
A: Leadership	1. Board leadership and company purpose
B: Effectiveness	2. Division of responsibilities
C: Accountability	3. Composition, succession and evaluation
D: Remuneration	4. Audit, risk and internal control
E: Relations with shareholders	5. Remuneration

Sections 1 – 3 of the new Code is where most changes have been made. These three new sections broadly cover sections A: Leadership and B: Effectiveness of the current Code. The Remuneration section has remained, while section E: Relations with shareholders has gone, but its principles have been integrated in the other sections of the Code. Appendix C sets out in detail where the current Code has been incorporated into the revised Code.

The revised Code is made of 18 principles.

The revised Code has a total of 18 principles, six of which are shown below (emphasis added):

A. A successful company is led by an effective and entrepreneurial board, whose role is to promote the **long-term sustainable**

[22] FRC, Proposed Revisions to the UK Corporate Governance Code, December 2017, p. 2

success of the company, generating value for shareholders and **contributing to wider society**.

D. In order for the company to meet its responsibilities to **shareholders and stakeholders**, the board should ensure effective engagement with, and encourage participation from, these parties.

E. The board should ensure that **workforce** policies and practices are consistent with the company's values and support its long-term sustainable success. The workforce should be able to raise any matters of concern.

G. The board should include an appropriate combination of executive and non-executive (and, in particular, independent non-executive) directors, such that no one individual or small group of individuals dominates the board's decision-making. There should be a **clear division of responsibilities** between the leadership of the board and the executive leadership of the company's business.

J. Appointments to the board should be subject to a formal, rigorous and transparent procedure, and an effective succession plan should be maintained for board and senior management. Both appointments and succession plans should be **based on merit and objective criteria** and, within this context, should **promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths**.

P. Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success. **Executive remuneration should be aligned to company purpose and values**, and be clearly **linked to the successful delivery of the company's long-term strategy**.

With a mere 15 pages, the revised Code is about half the size of the previous Code. To shorten the Code, the FRS removed the 'Supporting Principles' of the previous Code, with some of these supporting principles integrated elsewhere in the Code, and others transferred to the Guidance on Board Effectiveness. This change gives more emphasis to the 'Main Principles' of the Code.

A total of 12 Supporting Principles and Provisions have been deleted and not relocated elsewhere (see Appendix C). Two examples are provided below:

- Provision A.1.3: The company should arrange appropriate insurance cover in respect of legal action against its directors.
- Supporting Principles D.1: The remuneration committee should judge where to position their company relative to other companies. […]

The requirement for employee representation at board level is found in Provision 5 of the Code:

> For engagement with the workforce, one or a combination of the following methods should be used:

> - a director appointed from the workforce;
> - a formal workforce advisory panel;
> - a designated non-executive director.
>
> If the board has not chosen one or more of these methods, it should explain what alternative arrangements are in place and why it considers that they are effective.[23]

Kingman Review of the FRC

On 17 April 2018, the Government launched an independent review of the Financial Reporting Council led by Sir John Kingman. The review examined the role, governance and powers of the FRC.[24]

The consultation closed on 6 August 2018 and the report was published on 18 December 2018.

The Government intends to replace the FRC with a new, independent statutory regulator with stronger powers.

The independent review recommended that the FRC be replaced with an independent statutory regulator, accountable to Parliament, with a new mandate, new clarity of mission, new leadership and new powers. The new regulator would be called the Audit, Reporting and Governance Authority. There are 83 specific recommendations in the report.

The Review's conclusions are summarised as follows:

> The Review believes that the FRC should be replaced with a new body which:
>
> - Has a clear and precise sense of purpose and mission;
> - Is firmly focused on the interests of consumers of financial information, not producers;
> - Is respected by those who depend on its work, and where necessary feared by those whom it regulates;
> - Has the right powers and resources it needs to do its job; and
> - Is able to attract the highest-quality people.
>
> These are not unrealistic aspirations for a regulator. Broadly speaking, all these things are now, after a decade of post-crisis reconstruction, true for both of the UK's two main financial regulators. At the FRC, by contrast, none of these things is consistently true.[25]

Business Secretary Greg Clark said the government would 'take forward the recommendations set out in the Review to replace the FRC with a new independent statutory regulator with stronger powers'.[26]

[23] FRC, The UK Corporate Governance Code, July 2018, p5
[24] BEIS, Government launches review of audit regulator (press release), 17 April 2018
[25] Sir John Kingman, Independent Review of the Financial Reporting Council, December 2018, p5
[26] BEIS, Independent review of the Financial Reporting Council (FRC) launches report (news story), 18 December 2018

2.3 Investment Association

The Investment Association is the trade body that represents UK investment managers.

The Government invited the Investment Association to:

- Maintain a public register of listed companies encountering shareholder opposition to pay awards of 20% or more, along with a record of what these companies say they are doing to address shareholder concerns (reform number 3);
- Complete joint guidance with the Governance Institute on practical ways in which companies can engage with their employees and other stakeholders (reform number 6).

The Investment Association Public Register was launched on 19 December. A key purpose of the register is to focus attention on how companies respond to investor concerns. It highlights the public statements made companies on the register on how they have addressed shareholders' concerns. By publishing this information in one central location, it is hoped that the register will increase transparency, accountability and scrutiny of listed companies by shareholders, media and the wider public.

Analysis of the Register shows that:

- Over one in five (22%) companies listed on the FTSE All Share feature on the Public Register, due to having at least one resolution that received over 20% dissent or was withdrawn.
- Pay-related issues top the list of shareholder concerns, with 38% of resolutions listed on the Register to do with executive pay.
- The second most frequently opposed type of resolution is the re-election of company directors, with 32% of resolutions on the Register to do with the re-election of a company director in 2017.[27]

The Investment Association also completed reform number 6 on producing joint guidance on ways in which companies can engage with their employees and other stakeholders. The Investment Association and the Governance Institute published the new guidance in September 2017, The Stakeholder Voice in Board Decision Making.

2.4 BEIS Committee report

The Business, Energy and Industrial Strategy (BEIS) Select Committee published its report on corporate governance on 5 April 2017, following

27 The Investment Association, Over one fifth of FTSE companies listed on public register (press release), 19 December 2017

an inquiry on the same. The Committee made 28 recommendations across a number of areas. Board diversity and executive pay received the highest number of recommendations, with eight and five respectively.

The corporate governance inquiry followed the Committee's investigations into major corporate failings at BHS and Sports Direct. The Committee found that, although the UK's system of corporate governance remains broadly strong, there are a number of weak spots in need of reform. The Committee is concerned about pressures to deliver short-term financial again, about the public's lack of trust in business, and about levels of executive pay.

The BEIS Committee is concerned about pressures to deliver short-term financial again, about the public's lack of trust in business, and about levels of executive pay.

The Committee's recommendations have the following aims and reasons:

- To require **directors** to take more seriously their **duties to comply with the law and the Code**.

  This is because 'there are insufficient incentives for directors to consider seriously the interests of other stakeholders' (p. 17), and directors do not report well enough on how they have discharged their duties (including section 172 duties; p. 18-9).

- A wide expansion in the **role and powers of the Financial Reporting Council**, to enable it to call out poor practice and engage with companies to improve performance.

  The Committee is unhappy that 'the FRC has powers to monitor a company's strategic report and financial statements but not in respect of other aspects of reporting', and that 'it can take action against directors only if they happen to be accountants, auditors or actuaries' (p. 21). The Committee wants the FRC to be able to carry out investigations and to pursue directors for breaches of duties under section 172 of the Companies Act 2006.

- The development of a new **governance Code for the largest private companies** (currently subject to much weaker requirements than comparable listed companies).

  The Committee believes that standards of governance for large private companies are too low. Given that the size and impact on stakeholders of the largest private companies is similar to listed companies, the gap in governance requirements is not justified (p. 30-2).

- The **abolition of long-term incentive plans** (too complex and liable to create perverse incentives) in favour of a more simple pay structure, comprising salary, bonus, and payment by means of equity over the long term.

  So called long-term incentive plans (LTIPs) have turned out to be highly unpredictable and too difficult to understand (p. 39). The Committee found that 'badly designed performance related pay sometimes has led to rewards that do not properly reflect performance' (p. 34), and heard that 'LTIPs have a tendency to distort executive behaviour, with CEOs tailoring decisions to affect the share price around the time their shares are due to vest' (p. 39). LTIPs now account for around half of CEO pay in the UK, and *have contributed to an overall increase in pay (p. 38). They should be phased out as soon as possible (p. 40).*

The Committee also agreed with 'witnesses who suggested that bonuses should increasingly be awarded in respect of objectives other than share value, for example, in respect of customer service, safety, employment, or environmental issues' (p. 38-9).

- To improve engagement on pay through more transparency and better reporting, including the annual **publication of pay ratios**.

  The Committee reported that many submissions to its inquiry were supportive of pay ratios as a means of increasing transparency and exerting downward pressure on executive pay (p. 47-8). But other submissions warned about ratios being misinterpreted, and about unintended consequences such as companies outsourcing low-paid jobs to improve their ratio (p. 48).

  The Committee favour the publication of two ratios: between CEO and executive team; between CEO and median pay (p. 48). They believe that the public and charitable sectors should also be obliged to publish pay ratios (p. 49).

- To promote **board diversity, both gender and ethnic**.

  The Hampton-Alexander review set the target of women holding 33% of executive positions on FTSE 350 boards by 2020 (p. 52). The Committee agreed with the Equality and Human Rights Commission's Chair, David Isaacs, who proposed a new national target that half of all new appointments to senior and executive management level positions in the FTSE 350 and all listed companies should be women. The EHRC stated that 'this will guarantee a strong pipeline of women for the top jobs' (p. 53).

  On ethnic diversity, the Committee highlighted the 'shocking' underrepresentation of BAME people on the boards of listed companies in the UK (p. 53-4). In addition to social justice, the Committee also heard about the 'competitive advantage' argument for greater diversity. Ken Olisa, deputy Chairman of the Institute of Directors, told them that if the directors do not look like the stakeholders, 'the people whom they are trying to employ, trying to sell to, trying to buy goods from and being regulated by, then those people in the supply chain are less likely to be empathetic to the needs and requirements of the company'. Having found only one reference to race in the Code, the Committee recommended that wherever there is a reference to gender, the FRC should also include a reference to ethnicity in the revised Code (p. 54).

- The appointment of **workers on boards**.

  The Committee agrees with the Prime Minister's July 2016 plans to have workers represented on company boards, and is disappointed that 'by November 2016, in her speech at the CBI conference, the Prime Minister had apparently watered down her views' (p. 56). The Committee found that the Institute of Directors and the FRC are both in favour of worker representation in principle, but that primary legislation may be required to introduce it (p. 56). The TUC argued strongly in favour, citing *evidence that 19 out of 29 European countries have some provision for worker representation on boards (p. 57). The Committee believes that 'just as the drive for women directors has overcome initial doubts, it should become the norm for workers to serve on boards' (p. 57).*

The Government's response to the Committee's report was published on 22 September 2017.[28] Of the 28 recommendations made by the Committee, the Government accepted four in full and partly accepted another four. It rejected seven and responded to the remainder by saying that these recommendations were for others to consider – mostly the FRC. The table below shows the number of recommendations by area and by Government response. The appendix gives more detail of all 28 recommendations and responses.

Recommendations of the BEIS Committee for corporate governance reform

Area	Number	Government response: Accepted	Part accepted	Rejected	FRC to consider	Companies to consider
Board diversity	8			1	6	1
Executive pay	5		2	1	2	
Board effectiveness	3			1	2	
Employee and stakeholder voice	2	2				
Governance of large private companies	2	1		1		
Role of investors	2				2	
Dialogue between boards and investors	1	1				
Employee policies	1		1			
Equal pay	1			1		
Governance metrics	1				1	
Powers of the FRC	1			1		
Role of advisors - transparency	1			1		
Total	*28*	*4*	*4*	*7*	*12*	*1*

The Government did not propose to take new actions concerning boardroom diversity, even though the area attracted eight Committee recommendations, and was independently raised as an issue by a large number of respondents to the Government consultation.

On the other hand, there are a few instances where the Government agreed with the Committee and decided to go further than the recommendation to amend the Code. For example, the Committee recommended amending the Code to require directors to report on how they have discharged their section 172 duties, and companies to report on how they are engaging with stakeholders. The Government made reporting on these issues a legal requirement.

28 Business, Energy and Industrial Strategy Committee, Corporate governance: Government Response to the Committee's Third Report of Session 2016–17, 22 September 2017, HC 338 2016-17

3. Workers on boards

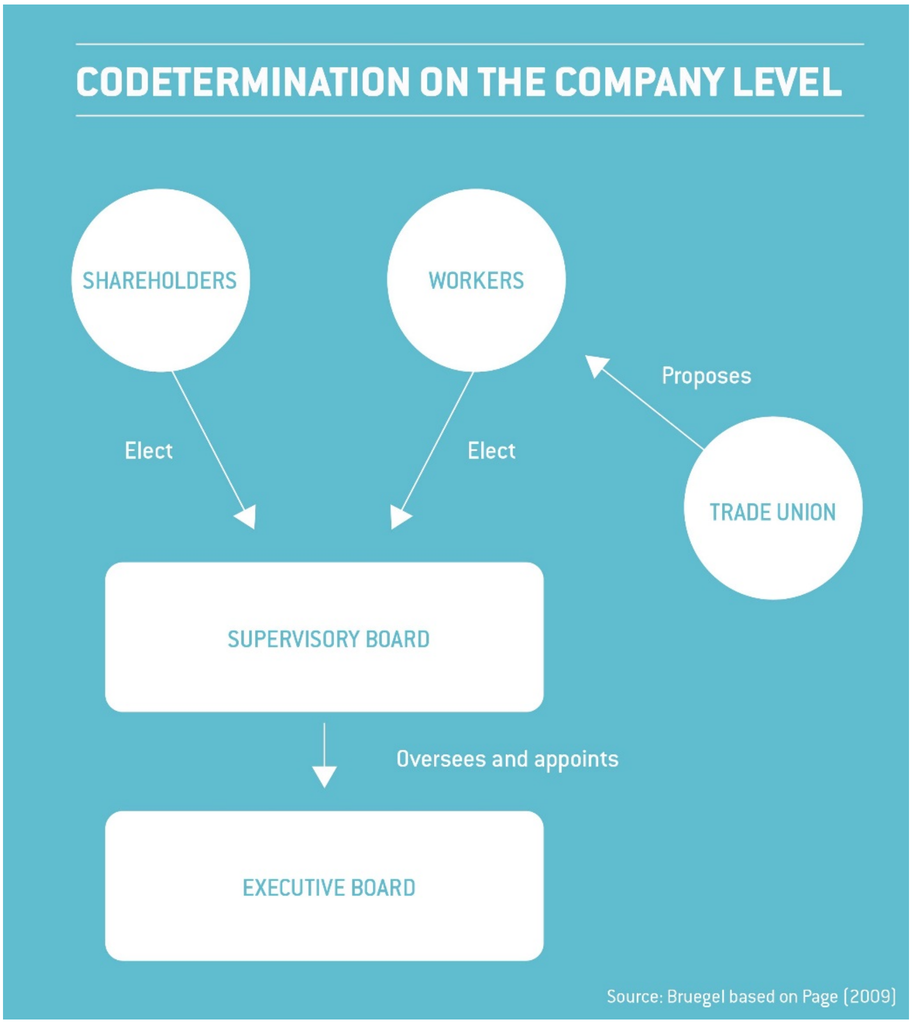
The Government wants employees to have a greater voice in the management of the company. Companies have a choice on how this might happen:

- a non-executive director designated to represent employee views;
- a formal employee advisory council; or
- a director from the workforce

The Government wants employees to have a greater voice in the management of the company.

A well-known example of employee engagement is the German system of worker representation on company boards.

German companies are generally managed differently than UK ones. Whereas there is just one board in the UK, Germany has a two-tier system: firms have a management board made of the most senior executives and chaired by the CEO, and a non-executive supervisory board, made of shareholder and employee representatives. For the largest companies, half of the members of the supervisory board are employee representatives. “Codetermination” refers to their participation in the company’s strategic decisions.



Researchers from Bruegel (an economic think-tank) wrote a blog reviewing the academic literature on the effect of workers on boards in

Germany, or “codetermination”. They found abundant evidence for a range of positive effects, although there are also studies concluding that codetermination reduces shareholder wealth and may lead to overstaffing.

> [S]tudies have found that equal representation on the supervisory board (versus one-third representation) reduces the market-to-book ratio – a measure of firm performance – by 31% on average (Gorton and Schmid (2004). The authors conjecture that “labor succeeds in altering the objective function of the firm – away from maximizing shareholder wealth”, e.g. by resisting lay-offs and thus using their voting power as an insurance for employees in response to negative shocks. They also find evidence for high staffing levels and thus potential overstaffing in equal-representation firms.
>
> On the other hand, employees might have a similar objective function as shareholders (or their representatives) aiming at the long-run survival of the firm, in which case employee representation could actually be beneficial for shareholders. One such overlap in employees’ and shareholders’ interest would be to prevent managers from pursuing overly risky projects, maximizing short-term profits, or engaging in expansion by mergers and acquisitions. The shareholders as members of the supervisory board can change the managers’ compensation structure to incentivize them to act according to their interest. Dyballa and Kraft (2016) find evidence that employee representation is beneficial in that regard.
>
> Furthermore, there may be benefits due to an improved flow of information between board and workers. Due to their knowledge of a firm’s operations and processes, employees are good at monitoring managerial performance and bring first-hand knowledge to the board’s decision making (Edwards et al 2009, Fauver and Fuerst 2006). The latter find that codetermination can increase firm efficiency and market value. This finding is not necessarily incompatible with Gorton and Schmid (2004) as they do not stipulate that one-half representation is optimal but simply that a positive number of employee representatives is beneficial.[29]

There are many other countries with some form of employee representation on company boards. A summary table of employee representation in European countries can be found in Appendix 1 of a Labour Party-commissioned review into corporate governance (September 2018).[30]

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29 Berger and Vaccarino, ‘Codetermination in Germany – a role model for the UK and the US?’, Bruegel blog, October 2016.

30 Prem Sikka, Alastair Hudson et al., A Better Future for Corporate Governance: Democratising Corporations for their Long-Term Success, September 2018

4. Pay ratios

The Government requires public companies with more than 250 UK employees and listed on the stock exchange to report annually the ratio of CEO pay to the median pay, 25th-percentile and 75th-percentile pay of their UK workforce, along with a narrative explaining changes to that ratio from year to year. To illustrate, a median pay ratio of 50 means that the CEO is paid 50 times the median pay in the company.

The Government requires listed companies to report on how much they pay their CEOs relative to the rest of their workforce.

This section calculates pay ratios in the UK based on available data for 319 listed companies (most of the FTSE 350). Mean average pay is used because median pay data for these companies is not available yet.

In 2016, the average ratio between CEO pay and average employee pay was 57. The highest ratio was as high as 826 at WPP PLC (a world leader in advertising and marketing services), and as low as 2 at IP Group PLC (a group that partners with universities to build tech businesses based on intellectual property).

Analysis shows that:

- A company's ratio is partly predicted by the number of employees: **larger companies have higher ratios** – they are less equal.
- This relationship between company size and ratio is the combined result of average pay tending to decrease as company size increases, whereas CEO pay tends to increase with company size.
- **Differences in ratios between companies are also explained by the type of industry** they are in – not just by company size. Some industries employ much higher proportions of highly-skilled, well-paid employees (e.g. finance), while others, like retailers, have large numbers of relatively less well paid staff. The remuneration of chief executives also varies across industries.
- When looking at individual companies, **ratios can fluctuate a lot from year to year**. These fluctuations are due to the high volatility of top CEO pay, while pay in the wider workforce is more stable.

Taken together, **company size, industry and the volatility of CEO pay** can largely explain a company's ratio, and changes from year to year.

One can expect these factors to feature heavily in the narrative that companies will be required to provide along with their ratios.

Taken together, company size, industry and the volatility of CEO pay can largely explain a company's ratio, and changes from year to year. One can expect these factors to feature in the narrative that companies will provide along with their ratios.

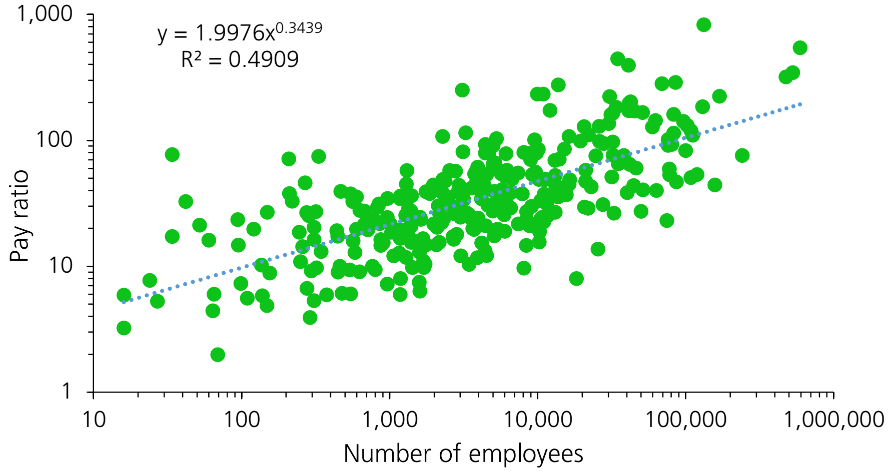
Ratios were calculated by taking CEO pay and dividing it by average employee pay. CEO pay is the 'single figure' total remuneration of CEOs, which includes salary, benefits, pension, bonus and long-term incentives, whether in cash, kind or shares. Average employee pay was calculated by taking total employee costs and dividing by total employee numbers. Total employee costs is not just wages and salaries, but also includes pensions, social security and other remuneration such as bonuses. These items (except social security) are included in CEO pay figures, so it is right to include them in the ratio's denominator too.

Detailed information about the data source, methodology and caveats is presented in the appendix.

Ratios and company size

Analysis of 319 companies shows a clear relationship between pay ratios and company size (as measured by the number of employees). Chart 1 below, plotted on a logarithmic scale[31], shows that larger firms have higher ratios.

Chart 1: Ratios and company size, 2016
Logarithmic scale

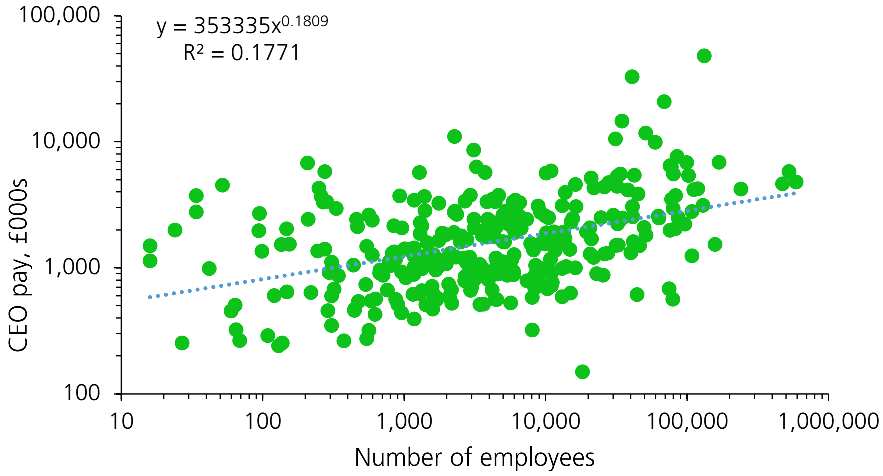


The R^2 value in chart 1 line implies that **almost half of the difference in pay ratios is explained by company size**.

This relationship between pay ratios and company size is the combined result of two other relationships. First, larger companies tend to pay their CEO more. This link is shown in chart 2 below, where company size explains 18% of the difference in CEO pay.

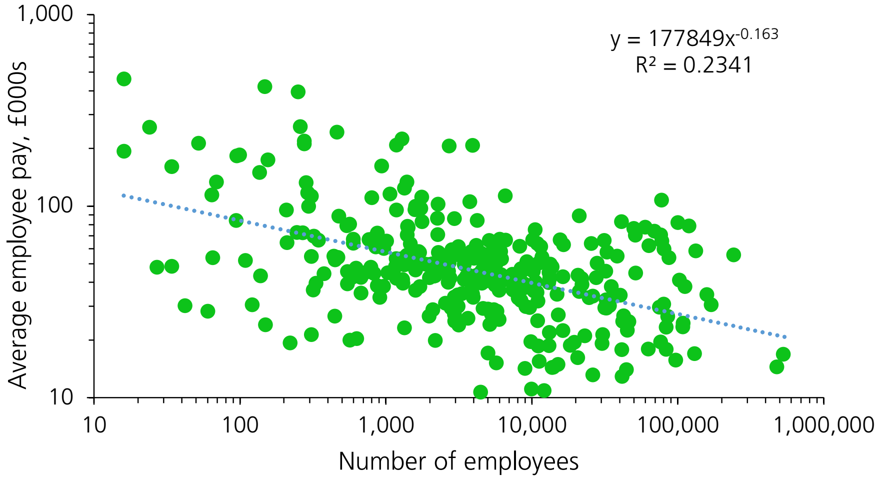
31 This data is better visualised using a non-linear, logarithmic scale. The intervals of a logarithmic scale don't represent a fixed number of units, but exponential increments. The tick marks show how the scale accelerates. Taking the horizontal axis, the first tick mark after 10 is equal to 20, the one after is 30, next is 40, and so forth to 100. The first tick mark after 100 is equal to 200, then comes 300, and so on.

Chart 2: CEO pay and company size, 2016
Logarithmic scale



Second, average pay tends to be lower in larger companies.[32] This link is shown in chart 3 below, where company size explains 23% of the difference in average employee pay.

Chart 3: Employee pay and company size, 2016
Logarithmic scale



These two links reinforce each other's effect on pay ratios: **larger companies pay their CEOs more while paying their employees less on average**, both of which push up the resulting pay ratio.

However, it should be noted that the link between size and average employee pay is to some extent a result of choosing the mean as the average measure, especially in smaller companies. While CEO pay was excluded from the calculation of mean averages, the pay of other top managers remains. So for example, the remuneration of the two next highest-paid executives has a large impact on the average pay in a 20-employee company, while the impact on companies with 100,000+ employees is insignificant.

32 This is not true of all companies in the economy, where the smallest private companies tend to pay less well than larger companies.

This partly explains why a small majority of respondents to the Government's consultation preferred the use of medians instead of mean averages:

> 1.32 Those in favour of pay ratio reporting provided a range of views on how it should be implemented, including which metrics should be used and the overall scope. There were marginally more responses in favour of comparing CEO pay to the median rather than to the mean average of the workforce, […].[33]

Separately, the Resolution Foundation published an analysis of pay ratios using medians, and argued strongly in their favour.[34]

But medians aren't perfect, either. For instance, using medians has the consequence that boosting the wages of the lowest paid can have no effect whatsoever on the company's ratio. Initially, the Government had proposed to use mean averages, so that

> the new reporting requirement [can] be based in most cases on existing pay roll data, while also complementing the existing legislative requirement for companies to report the annual increase in CEO pay compared to the annual increase across the average of the workforce.[35]

Ratios and industry

Differences in ratios between companies are also explained by the type of industry they are in – not just by company size. **Some industries employ much higher proportions of highly-skilled, well-paid employees (e.g. finance), while others, like retailers, have large numbers of relatively less well paid staff**. The remuneration of chief executives also varies across industries.

The table below shows average pay ratio and pay by broad sector for listed companies with 1,000+ employees.

[33] BEIS, Government response: Corporate Governance Reform, 29 August 2017, p. 15
[34] Resolution Foundation, When it comes to pay ratios, it's time to choose meaningful medians not meaningless means, 14 February 2018
[35] BEIS, Government response: Corporate Governance Reform, 29 August 2017, p. 20

Ratios by sector, 2016

Companies with 1,000+ employees

Sector	Number of companies	Average company ratio	Average CEO pay, £	Average employee pay, £
Energy	5	29	2,277,590	74,550
Information Technology	19	31	1,559,274	57,251
Real Estate	4	44	1,494,639	37,568
Health Care	10	47	3,029,631	57,114
Utilities	7	56	2,708,743	50,787
Industrials	64	57	2,055,773	44,476
Telecommunication Services	5	64	2,920,538	57,242
Financials	25	66	4,819,482	89,400
Materials	18	76	2,669,156	41,146
Optional consumer items*	70	79	2,639,952	36,203
Everyday consumer items*	18	134	3,532,575	31,577
Average of sectors		*62*	*2,700,668*	*52,483*
Lowest value		*29*	*1,494,639*	*31,577*
Highest value		*134*	*4,819,482*	*89,400*

*: These two sectors are known as 'consumer discretionary' and 'consumer staples'. Consumer staples are essential items, such as food, beverages, tobacco and household items, that people are unable or unwilling to cut out of their budgets regardless of their financial situation. Discretionary items are desirable but not essential. They include durable goods (e.g. cars), apparel, entertainment and leisure.

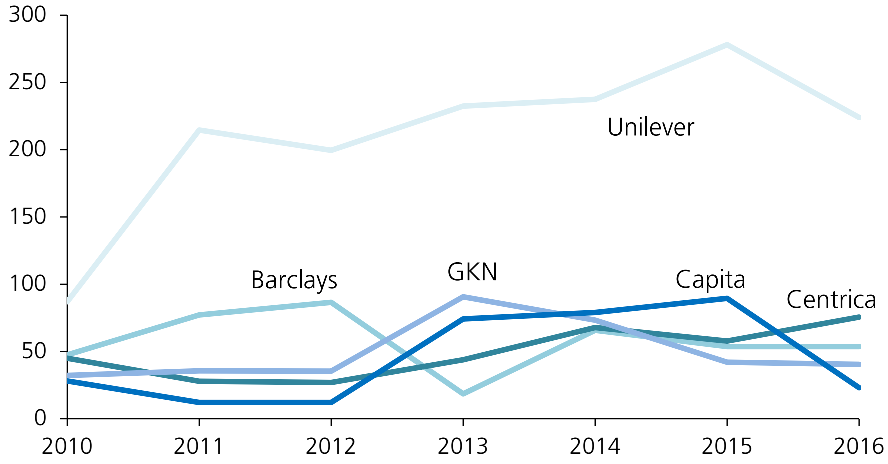
Everyday consumer items is the sector with the highest average ratio (i.e. pay is most unequal) at 134. This sector covers companies such as Tesco, Unilever, Tate & Lyle and British American Tobacco. These are big companies which pay their CEOs better than average while at the same time having large numbers of relatively poorly paid employees.

Perhaps contrary to expectations, the average ratio in the financial sector is only half that in everyday consumer items – even though finance CEOs are paid the most. The sector owes its relatively low ratio of 66 to its many well-paid professionals, who make the sector’s average pay the highest of all too.

Company-level time series

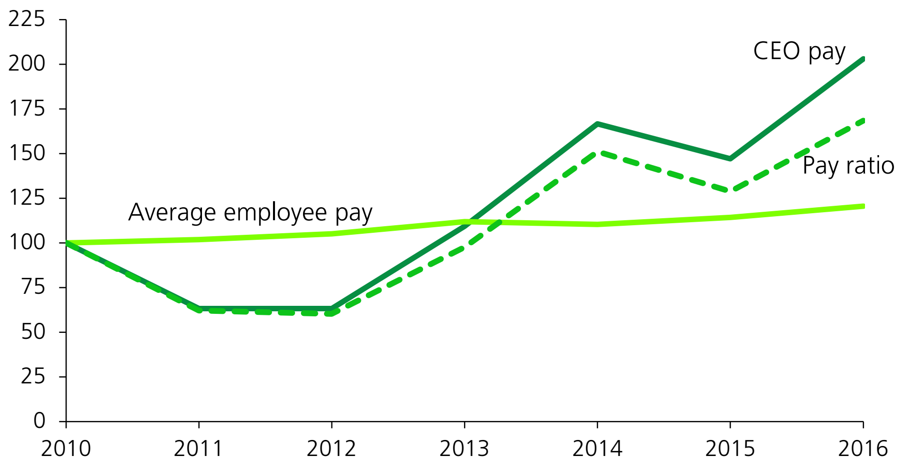
When looking at individual companies, ratios can fluctuate a lot from year to year. Chart 4 below shows ratios since 2010 for five companies in five different sectors.

Chart 4: Volatility of ratios
Unilever, Barclays, Capita, Centrica, GKN



These fluctuations are due in large part to the **high volatility of CEO pay**, while pay in the wider workforce is more stable. Taking Centrica as an example, chart 5 shows how the pay ratio mostly follows CEO pay.

Chart 5: Centrica PLC
2010 = 100



The difference between the CEO pay line and the pay ratio line that opens up gradually is the result of employee pay growing slowly but steadily.

Appendix 1: Comply or explain

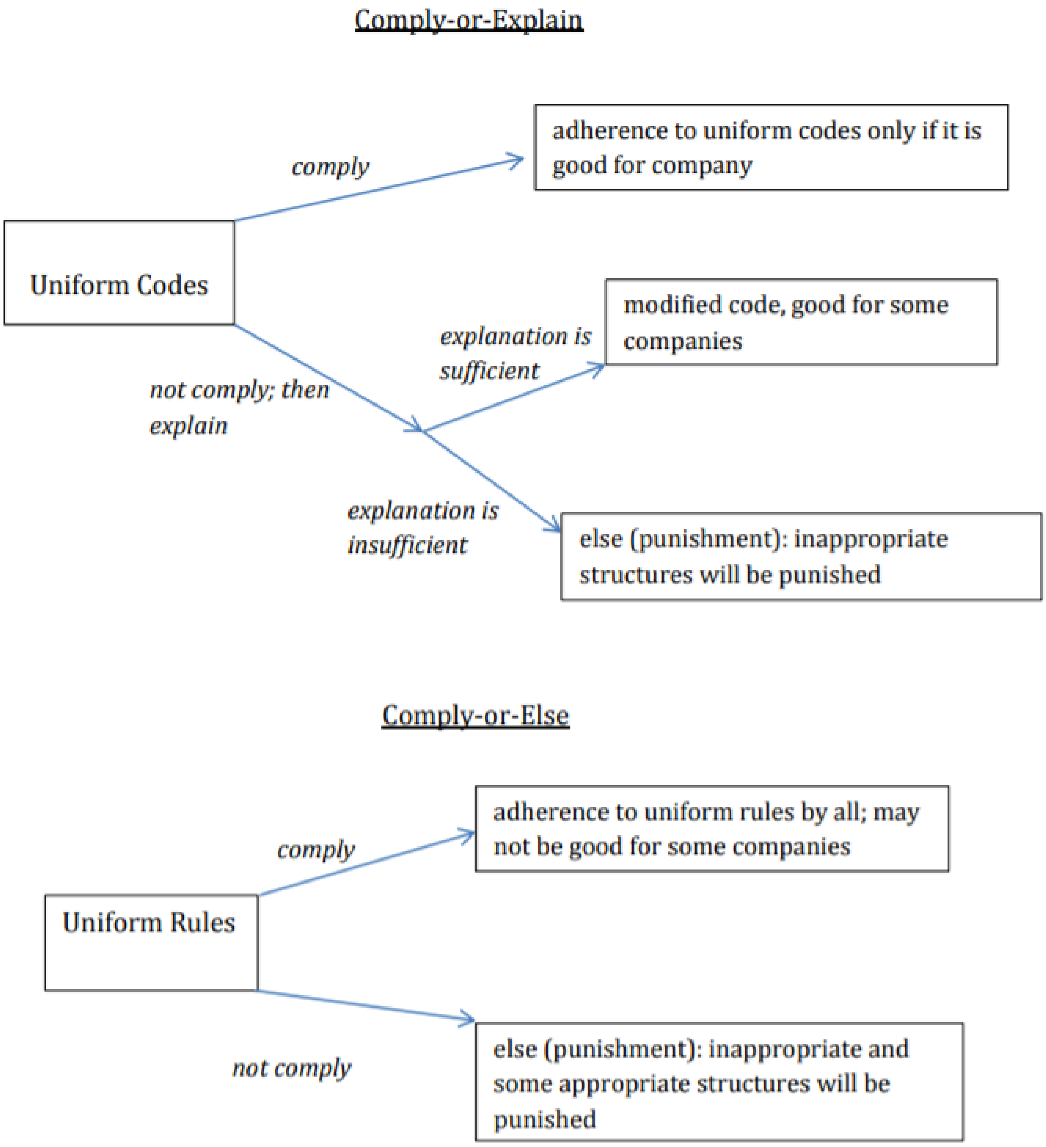
The "comply or explain" approach stands in contrast to less flexible, more prescriptive regimes of corporate governance. Regimes where compliance with the rules is mandatory are often referred to as "comply or else". "Comply or explain" makes it possible to write short codes based on high-level principles, instead of lengthy, detailed rule books.

> The merits of such flexibility are thought to lie in its ability to encourage companies to adopt the spirit of the Code, rather than the letter, whereas a more statutory regime would lead to a "box-ticking" approach that would fail to allow for sound deviations from the rule and would not foster investors' trust.[36]

Figure 1 below schematises the two approaches.[37]

36 Arcot, Sridhar and Bruno, Valentina and Faure-Grimaud, Antoine, 'Corporate Governance in the UK: Is the Comply or Explain Approach Working?', International Review of Law and Economics 30 (2010), p. 193
37 Figure 1 is taken from: Sarkar, Subrata, 'The Comply-or-Explain Approach for Enforcing Governance Norms' (July 15, 2015). Available at SSRN.

Figure 1: Comply-or-Explain versus Comply-or-Else



Many countries have moved to "comply or explain" in recent years, as shown in the table below.[38] A notable exception is the USA.

[38] Table 1 is taken from: Sarkar, Subrata, 'The Comply-or-Explain Approach for Enforcing Governance Norms' (July 15, 2015). Available at SSRN.

Table 1: Adoption of Alternative Approaches to Corporate Governance

Country	***Year***	***Name of Regulation/Code***	***Comply-or-else or Comply-or-explain***
USA	2002	Sarbanes-Oxley Act	Comply-or-else
India	2000	Clause 49 of Listing Agreement	Comply-or-else
U.K.	1992	UK Governance Code (from Cadbury Report)	Comply-or-explain
France	1995	Corporate Governance of Listed Corporations (From Vienot I Report)	Comply-or-explain
South Korea	1999	Code of Best Practice for Corporate Governance	Comply-or-explain
Malaysia	2000	Malaysian Code on Corporate Governance	Comply-or-explain
Brazil	2001	Novo Mercado Corporate Governance BOVESPA Listing Rules	Comply-or-explain
Singapore	2001	Singapore Code of Corporate Governance	Comply-or-explain
Germany	2002	Cromme Code of Corporate Governance	Comply-or-explain
China	2002	Code of Corporate Governance for Listed Companies	Comply-or-explain
OECD	2004	OECD Principles of Corporate Governance	Comply-or-explain
Hong Kong	2005	Appendix 14 Corporate Governance Code HKEx	Comply-or-explain
Spain	2006	Unified Good Governance Code	Comply-or-explain
Australia	2007	Australian Securities Exchange Corporate Governance Principles	Comply-or-explain
Sweden	2008	Swedish Code of Corporate Governance	Comply-or-explain
Belgium	2008	Corporate Governance Code	Comply-or-explain
Indonesia	2014	Indonesian Good Corporate Governance (GCG) Roadmap	Comply-or-explain
South Africa	2010	King III Corporate Governance Code	Apply-or-explain

Appendix 2: BEIS Committee recommendations and Government response

Committee recommendations			Government response	
#	Area	Recommendation	Accepted / rejected	Response
1	Employee and stakeholder voice	The FRC should amend the Code to require informative narrative reporting on the fulfilment of section 172 duties. 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.	Accepted	The Government considers that this form of reporting is so important that it intends to go further than the Committee recommendation for a Code change and make it a formal, legal requirement.
2	Governance metrics	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.	For FRC to consider	This is a recommendation for the FRC to consider as they have responsibility for the UK Corporate Governance Code. The Government, however, has some concerns that this recommendation, if implemented, could have the effect of forcing companies into "tick-box" compliance with the Code.
3	Powers of the FRC	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. If companies were not to respond satisfactorily to engagement with the FRC, the FRC should be given authority to initiate legal action for breach of section 172 duties.	Rejected for the time being	It is important to recognise that the FRC is one amongst a number of bodies with powers and functions relating to corporate behaviour and the conduct of directors, some of which overlap. The Government has asked the FRC, the Financial Conduct Authority and the Insolvency Service to work together to identify whether there are any significant regulatory or enforcement gaps. In light of this work, the Government will consider whether further action is required.
4	Dialogue between boards and investors	The Investor Forum should seek to become a more pro-active facilitator of dialogue between boards and investors by engaging in regular routine dialogue in order to pick up on any widespread concerns.	Accepted	The Government agrees with the Committee that investors have a key stewardship role in encouraging and driving improvements in corporate governance and tackling poor practice

Committee recommendations			Government response	
#	Area	Recommendation	Accepted / rejected	Response
				and would support further development of the role of the Investor Forum.
5	Employee and stakeholder voice	The Code should be revised to require a section in annual reports detailing how companies are conducting engagement with stakeholders.	Accepted	The Government agrees that companies should be required to explain how they are engaging with stakeholders. As mentioned in the response to recommendation 1, the Government intends to introduce secondary legislation to require all companies of significant size (private as well as public) to explain how their directors comply with the requirements of section 172 to have regard to employee and other non-shareholder interests. It is envisaged that, as a part of this, companies should explain the mechanisms they have used to engage effectively with stakeholders.
6	Role of investors	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.	For FRC to consider	This recommendation is for the FRC to consider as they have responsibility for the Stewardship Code. The Government understands that the FRC intends to carry out a review and consultation on amendments to the Stewardship Code during 2018.
7	Role of advisors - transparenc y	The Government should consult upon new requirements on 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.	Rejected	The Government agrees that companies' use of advisers should be subject to appropriate transparency and accountability. The Government, however, believes that the current legal and regulatory framework is robust in this area and is mindful that any new requirements should be proportionate.
8	Role of investors	The FRC should include in its revised Stewardship Code stronger provisions to require the disclosure of voting records by asset managers and undertakes to name those that subsequently do not vote.	For FRC to consider	This recommendation is primarily for the FRC to consider as they have responsibility for the Stewardship Code. Changes to the Code would be subject to consultation.
9	Board effectivenes s	We recommend that the FRC includes best practice guidance on professional support for non-executive directors	For FRC to consider	This is a recommendation for the FRC to consider as they have responsibility for Code. However, Government supports

Committee recommendations			Government response	
#	Area	Recommendation	Accepted / rejected	Response
		when it updates the Code and that companies include training of board members as part of reporting on their human resources policy.		actions which boost the strength and effectiveness of non-executive directors and is ready to discuss possible approaches with the FRC and other interested bodies if needed.
10	Board effectiveness	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.	For FRC to consider	This is a recommendation for the FRC to consider as they have responsibility for the UK Corporate Governance Code. Government supports actions which boost the strength and effectiveness of non-executive directors and is ready to discuss possible approaches with the FRC and other interested bodies if needed.
11	Board effectiveness	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.	Rejected (Gov disagrees that more needs to be done)	Specific provisions in the UK Corporate Governance Code already require non-executive directors to undertake that "they will have sufficient time to meet what is expected of them" and that other significant commitments should be disclosed to the board before appointment. Government agrees that companies should consider this robustly before appointing NEDs.
12	Governance of large private companies	The FRC, Institute of Directors 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. They should contribute to the establishment of a new body to oversee and report on compliance with the Code.	Accepted	The Government agrees that an appropriate Code or set of principles should be developed. Its recent response document announced that it has invited the FRC to work with the IoD, the CBI, the Institute for Family Businesses, the British Venture Capital Association and others to develop a voluntary set of corporate governance principles for large private companies.
13	Governance of large private companies	We further recommend that the new Code includes a complaint mechanism, under which the overseeing body could pursue with the company any complaints raised about compliance with the Code. 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	Rejected	The Government does not envisage making compliance with a Code (or set of principles) mandatory and considers that large private companies should continue to be able to adopt the arrangements that suit them best. In these circumstances, a formal complaints mechanism would be impractical because

Committee recommendations			Government response	
#	Area	Recommendation	Accepted / rejected	Response
		reveal high rates of unacceptable non-compliance, then a mandatory regulatory regime should be introduced.		there will be no single set of principles against which to monitor compliance.
14	Executive 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.	For FRC to consider	This is primarily a recommendation for the FRC to consider as they have responsibility for the UK Corporate Governance Code.
15	Executive pay	The consultation should develop guidelines for the structure of executive pay with the following features: a) A simpler structure based primarily on salary plus long-term equity, to divest over a genuinely "long-term" period, normally at least five years b) Limited use of short-term performance-related cash bonuses c) Clear criteria for bonuses: they should be genuinely stretching and be aimed to provide incentives rather than just reward.	Part accepted and part rejected	The Government believes that companies should continue to have the flexibility to choose the long-term share remuneration policies and models that they put to investors for approval, which are subject to a binding vote. They and shareholders, however, should be more open to alternatives to the currently dominant LTIP model. We agree with the Committee that long-term share-based remuneration should divest over at least a five year period, and have invited the FRC to consult on this as part of its review of the Corporate Governance Code
16	Executive pay	The Government should legislate 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.	Rejected	We do not intend to legislate to introduce a binding vote.
17	Executive pay	Any Chair of a remuneration committee should normally have served on the committee for at least one year previously.	For FRC to consider	A majority of business and investor respondents felt this should be introduced on a 'comply or explain' basis through the UK Corporate Governance Code rather than through legislation. They thought that some flexibility was required to take account of the limited circumstances where it might be appropriate to appoint someone with less experience.
18	Employee policies	We recommend that companies should set out clearly their people policy, including the rationale for the	Partly accepted but partly	The Government has invited the FRC to consult on a revision to the UK Corporate Governance Code and its supporting

Committee recommendations			Government response	
#	Area	Recommendation	Accepted / rejected	Response
		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.	not addressed	guidance to give remuneration committees greater responsibility for demonstrating how pay and incentives align across the company, and to explain to the workforce each year how decisions on executive pay reflect wider pay policy.
19	Executive pay	The FRC should work with other relevant stakeholders on the detail and 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.	Partly accepted (listed companies only; wider workforce only)	Government intends to introduce secondary legislation to require pay ratio reporting which will compare CEO remuneration to average pay in the wider company workforce. The Government envisages the ratio being set out alongside a narrative explaining any changes to the ratio from year to year and setting the ratio in the context of pay and conditions across the wider workforce. This requirement will apply to companies already subject to the existing executive remuneration reporting requirements (i.e. quoted companies as defined in the Companies Act 2006).
20	Board diversity	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 FTSE 350 and all listed companies should be women.	Rejected	The Hampton-Alexander Review set a target in November 2016 that 33% of FTSE 350 board members as well as 33% of Executive Committees and their direct reports in the FTSE 100 should be women by 2020. This would require approximately 40% of new appointments to these roles going to women. We believe this is stretching but achievable target and will be monitoring progress against it over the next three years.
21	Board diversity	The FRC should embed the promotion of ethnic diversity of boards within its revised Code. At the very least, we recommend that 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	For FRC to consider	This is a recommendation for the FRC to consider as they are responsible for the Corporate Governance Code. The Government agrees with the Committee that it makes business sense to recruit directors from as broad a base as possible across the demographic of the UK, and

Committee recommendations			Government response	
#	Area	Recommendation	Accepted / rejected	Response
		given as much prominence as gender diversity.		agrees with the recommendation to make explicit the issue of ethnic diversity.
22	Equal pay	The Government should legislate to ensure that all FTSE 100 companies and businesses publish their workforce data, broken down by ethnicity and by pay band.	Rejected	The Government's preferred approach is to set out the value of employing a diverse workforce to companies and institutional investors in order to increase demand for such information. We have said that we believe a non-legislative solution is the right approach for now, but will monitor progress and stand ready to act if sufficient progress is not delivered.
23	Board diversity	The FRC should work with others to provide improved guidance on cognitive diversity in the context of board membership.	For FRC to consider	The Government agrees with the Committee on the value of cognitive diversity, and would welcome efforts by the FRC and others to improve guidance on this.
24	Board diversity	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.	For FRC to consider	The Government has noted the Committee's recommendations for further company reporting on diversity issues, including more reporting on the steps that companies are taking to enhance the diversity of their executive pipeline. The Government will continue to work closely with the FRC and others to ensure that diversity disclosures are effective in helping drive further progress.
25	Board diversity	The revised Code should require the narrative about 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.	For FRC to consider	This is a recommendation for the FRC to consider when consulting on the revised Code.

Committee recommendations			Government response	
#	Area	Recommendation	Accepted / rejected	Response
26	Board diversity	Companies should be recruiting non-executive and executive directors from the widest possible net of suitable candidates, which should include recruiting internally. We encourage more companies to appoint workers on boards. It should become the norm for workers to serve on boards.	For companies to consider	The Government agrees with the Committee that companies should be doing more to ensure that they are recruiting directors from the widest possible pool of potentially qualified candidates. The Government believes that greater diversity within the boardroom can help companies connect with their workforces, supply chains, customers and shareholders.
27	Board diversity	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.	For FRC to consider	The Government notes the Committee's recommendation, which is for the FRC to consider in their consultation on the revised Code.
28	Board diversity	The FRC should be given the extra role of overseeing the rigour of the 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.	For FRC to consider	The Government considers that it is primarily for shareholders to satisfy themselves about the rigour of the boardroom evaluation process. It is not convinced that FRC should provide a separate layer of monitoring and scrutiny. The Government considers that there could be value in a periodic exercise to assess how companies have approached boardroom evaluations and to draw out examples of best and worst practice. This might be carried out by the FRC or another independent organisation. The Government has asked the FRC to give this further consideration.

Appendix 3: Pay ratios: source, methodology and caveats

The data behind this analysis originates in publicly available company reports and accounts, but was pulled out of a Bloomberg Terminal. The Terminal provided suitable data to calculate ratios for 319 listed companies domiciled in the UK (most of the FTSE 350). While the Terminal helps make data across companies more comparable (e.g. by converting figures into the same unit and currency), neither the Terminal nor the original source documents are certifiably error-free.

Ratios were calculated by taking CEO pay and dividing it by average employee pay. CEO pay is the 'single figure' total remuneration of the CEO, which includes salary, benefits, pension, bonus and long-term incentives, whether in cash, kind or shares. Average employee pay was calculated by taking total employee costs and dividing by total employee numbers. Total employee costs is not just wages and salaries, but also includes pensions, social security and other remuneration such as bonuses. These items (except social security) are included in CEO pay figures, so it is right to include them in the ratio's denominator too.

Note that CEO pay was deducted from total employee costs, since not doing so pushes up average employee pay, thus lowering the pay ratio – with the distortion more pronounced the smaller the company.

There are however two important differences between ratios calculated here and those proposed by the Government. First, the Government wants companies to calculate pay ratios for their UK workforce only, while this analysis includes all employees regardless of where they are based. The entire workforce was used simply because UK-only data is not readily and systematically available (yet). Second, the Government decided to use medians and quartiles instead of mean averages.

The data was plotted on a logarithmic scale. This is because the data is better described and explained logarithmically (changes in one variable explaining 49% of changes in the other variable) than linearly (34% of changes explained).

The dotted trendline in chart 1 predicts that pay ratios are about two times the cubic root of the number of employees. For example, a firm with 1,000 employees is predicted to have a ratio of about 20 (calculation: $2 \times \sqrt[3]{1{,}000} = 2 \times 10 = 20$). The trendline in chart 1 may look straight, but that is only because the chart's scale is logarithmic. On a linear scale, this trendline draws a curve.

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