

Wates Corporate Governance Principles for Large Private Companies

CONSULTATION

Summary

High quality regulation should focus on outcomes and provide evidence to support new rules and principles. Both the government and the FRC seem to be impervious to either. The Wates proposals identify neither outcomes nor evidence. They require private companies to disclose more about governance, but don't identify who will use this information nor what they will do with it.

The FRC has missed another opportunity to research and think deeply about why companies get into difficulties and how it can reduce the likelihood of this happening. Clear corporate governance is probably a 'good' thing for all companies, but there is little evidence that it actually leads to better outcomes. The corporate governance principles proposed for private companies are well-meaning and are hard to disagree with, but, as currently written, are not specific enough to be other than a gentle nudge to companies, and more likely a cause of more boiler-plate wording in annual reports. A few specific questions for companies to answer would give clearer disclosure. The Principles need also to be applied to the actual governance of companies, rather than their legal structures.

1. What is the objective?

It is not clear what the objective is of this exercise. Paragraph 2 talks about a loss of public trust in big business. Paragraph 3 refers to the 'privileges of limited liability status' and lower reporting and accountability requirements than listed companies, highlighting public interest in whether companies 'operate in a sustainable and responsible manner'. The Consultation Questions explain that 'The Principles and the guidance are designed to improve corporate governance practice...' Presumably, the assumption is that 'good' corporate governance will build public trust. Sadly, the evidence from the listed arena is that this is not true. Carillion, for example, complied very closely with the Corporate Governance Code.

The foreword explains that the Principles are intended to help companies comply with a new legislative requirement on governance. The FRC is simply responding to a government edict. Without a clear objective, it is not easy to test whether the principles meet their aim, other than to turn a vague statutory requirement into something that companies can comply with.

There is no estimate of how many companies will be caught by those provisions, nor how much it will cost to comply, and least of all any idea of what the benefit will be.

2. Are the Principles sufficiently specific to achieve the objective?

The Principles themselves are a set of very high-level statements, with which it is difficult to disagree. It's unclear how a company can realistically claim not to comply with them. Turn each of the sentences into the negative and see who would claim that this applies to them;

- 1. The board does not promote the purposes of the company.*
- 2. The board does not have an effective chair. The size of the board is not guided by scale & complexity of the company.*
- 3. The board does not have a clear understanding of its accountability and terms of reference.*
- 4. The board does not promote the long-term success of the company.*
- 5. The board does not promote executive remuneration aligned to sustainable long-term success of the company.*
- 6. The board does not have meaningful engagement with material stakeholders.*

What status does the more specific "guidance for consideration" have? It appears to be largely discursive, so would not need to form part of a company's assessment as to whether it complies with the principles. It seems that the FRC has pulled back from being too prescriptive, but in doing so has ended up with principles that, whilst undoubtedly worthy, are largely motherhood and apple pie.

3. Do the Principles and guidance take account of the various ownership structures of private companies?

The Companies (Miscellaneous Reporting) Regulations 2018 confuses legal structure and governance. Legislators appear to believe that every company has a board that manages that individual business on a day to day basis. This may be true of some independent companies, but it doesn't take account of group structures. A number of subsidiary companies may together constitute a group, which is managed by a board at that level. The size tests apply at company, rather than consolidated level. Yet many holding companies do not directly employ significant numbers of employees, not have large revenue themselves. The Regulations will therefore miss some large groups that are presumably the principal intended target of this legislation. It may also cause subsidiaries to invent bogus governance to comply or have to explain why they don't comply.

The FRC should make it clear that the Principles apply to the board that actually constitutes the main governance for each entity, irrespective of the legal structure, provided that this is explained and disclosed in each company annual report. A subsidiary could simply report that its main governance structure sits with a parent entity and that details will be found in that company's report and accounts.

The FRC should also clarify that the tests for the need to comply (employee numbers, turnover and net assets) should apply to the consolidated accounts, rather than the parent company alone.

4. What more could be done?

To make these proposals have any meaning, the FRC should consider making adequate disclosure a key part of the Code. I appreciate that this is implied, but it should be made explicit and specific. The proposals in the guidance could be backed by a small set of simple disclosure requirements;

Purpose

1. Describe the values by which the Board and the Company operate.
2. How does the Company promote behaviour in line with its values whilst discouraging misconduct and unethical practices?

Board composition

1. How are board members appointed and what relationship does each have with the shareholders or parent group?
2. What does each board member bring to the board?

Board responsibilities

1. Describe how the board governs the company, including through use of subcommittees.
2. How does the board ensure that the company systems and controls work effectively?

Opportunity and risk

1. How does the board evaluate and manage risk?
2. What is the board's appetite for risk?

Remuneration

1. How does the board set remuneration for directors and senior executives?

This list of disclosure questions should be kept short and high level. The risk is that everyone will want to add a question, but the longer the list the greater likelihood of a box ticking mentality and boiler plate answers. This should be the minimum number of questions that a company would need to answer to give adequate disclosure on the Principles.