Wates Corporate Governance Principles for Large Private Companies
Institute for Family Business Response

Summary

- Overall we support the six Principles.
- The Principles should provide private businesses with a useful tool to judge what good practice in corporate governance looks like.
- Monitoring should reflect this; it should be used to support and encourage continuous improvement.
- There is a need to add to the guidance in some areas.
- Businesses must not be required to provide commercially sensitive information in the explanations of their application of the Principles.

About the Institute for Family Business

The Institute for Family Business (IFB) is the UK's family business organisation, supporting and promoting the UK family-owned business sector through representation, thought leadership, analysis, events and networking.

We work closely with family firms to support them in growing enterprises for generations to come. A central part of our work is to provide educational resources and knowledge-sharing designed to support business owners and those who work in family business. We champion best practice within the family business community and help others to learn from these examples.

About Family Business

Family business is the backbone of our economy, and the bedrock of our communities. In the UK, family firms generate a quarter of GDP and employ over twelve million people. By their very nature family businesses take a long term view, building on long-term stewardship of people and resources. Their commitment to passing a healthy business on to the next generation is locked into their corporate DNA.

The family business sector is extremely diverse. Family businesses come in all sizes and are found in all industries and communities across the UK. Whilst the majority of family firms are small or micro businesses, there are around 17,000 medium and large firms. The yearly tax contribution of family businesses now stands at £149 billion – more than the annual NHS budget.

The UK family business sector continues to grow. In the UK there are 1 million more family businesses than in 2010, and family businesses have created an additional 2.3 million jobs. Family firms now turn over £1.4 trillion annually, up 7.2 per cent since 2010 - family business turnover has grown by more than that of non-family businesses since 2010[1].

Whilst family businesses generate a quarter of UK GDP, they recognise that success in business is about more than short term financial results. Success is about sustainable value creation. Family businesses perform better than non-family firms in non-financial metrics such as investing in their employees and in supporting communities.[2] And the best-run family businesses outlast others by a factor of two.[3]

A long term outlook is at the heart of family business. Shareholders in family businesses view their role as that of a steward, with an obligation to pass the business on to the next generation in a stronger state than they found it. They feel a sense of responsibility not only to future generations of their own family, but also to the legacy of their forebears, their employees, and the community in which they are based.

Most family businesses are privately owned and do not have large numbers of disparate and institutional shareholders. On the contrary, shareholders tend to have a close relationship with the family business and play an important role in shaping the culture and values in the business. Family businesses have an in-built natural tendency to approaching corporate stewardship in ways that ensure that the pursuit of good financial performance supports their long term objectives and values, rather than harming them.

Families care about having a business which is well governed, to ensure that it is viable and sustainable in the long term. Because they intend to own the business for the long term, rather than expecting to sell their stake within a few years, they also understand that good corporate governance is in their own best interests, as their own family's future would be significantly affected were they to ignore corporate governance and allow a short term focus.

1. Do the Principles address the key issues of the corporate governance of large private companies? If not, what is missing?

Overall we support the six Principles, which we believe will provide private businesses with a useful tool to judge what good practice in corporate governance looks like.

The private business landscape is extremely diverse. Companies owned by private equity investors have very different behaviours, cultures and criteria for success, compared to multi-generational family businesses. Even within the family business sector, which forms only part of the whole private business community in the UK, no two businesses are the same. Many family businesses have formal family governance structures, as well as corporate governance.

[1] State of the Nation: The UK Family Business Sector 2017/18, Oxford Economics for the IFB Research Foundation
[2] M Institute and IFB Research Foundation (2012) *Sustainable Value Creation*
[3] Miller, D and Le Breton-Miller, I. (2005) *Managing for the Long Run: Lessons in Competitive Advantage From Great Family Businesses*

Given the diversity of this group, we believed that a principles based approach was the most appropriate way forward. We believe the Principles do address the common issues amongst the group, without covering areas which are not appropriate from some parts of that group. Our comments in this response focus on the application of the Principles for family companies, and on feedback we have received from the owners and managers of family companies.

Regarding Principle One, we believe it is appropriate for the board to ensure that a private business has a well-defined purpose. However, it should not be assumed that this purpose must be set by the board. In a family owned business it is likely that the family owners will define this purpose, given that it is intertwined with their own family heritage and vision. If a business does not have a well-defined purpose, the board should take a role in ensuring this is articulated by the family or the board.

Culture within business is a key component in how a business, and its employees, behave responsibly. In family business this culture often originates from the family's values, and should then be reflected in the work of the Board. Where failings have arisen in other businesses, this has often originated in the culture and values of the business and its investors.

We support the wording of Principles Two to Six, and support an approach which ensures businesses have the flexibility they need to put in place the structures, policies and mechanisms to support a well-governed and growing business.

2. Are there any areas in which the Principles needs to be more specific?

The publication of guidance, alongside the Principles, is an important step in ensuring that businesses can use the Wates Principles to improve their governance, rather than introducing a box-ticking compliance exercise. We believe there that there is a need to add to the guidance in some areas to better support this, particularly in relation to the 'apply and explain' approach. In its current form, the guidance will help businesses to apply the Principles, but does not provide sufficient clarity on how they should explain their application.

For example, the guidance for Principle One explains why purpose, values, strategy and culture are important in business and how the board can support their development. However, it does not give a clear direction on how a business could explain how the Principle is applied. Is the company expected to detail how often the Board revisits the purpose or strategy, or how it communicates with the family shareholders on the matter of purpose? On fostering culture, should the company detail board outreach to employees, or their role as a brand ambassador?

In Principle Two the guidance mentions the evaluation and training of directors, but does not give an example of how this could be explained. Should companies specify the number of days training directors receive, or how they are evaluated? Businesses may be concerned that they will be expected to publish information on the 'cognitive and personal strengths' of their board members.

Principle Four talks about the development of appropriate risk management systems. Is the expectation that these systems would be explained, or that it would be sufficient to explain that a system exists?

Principle Five, for example, discusses transparency of remuneration structures 'that enable effective accountability to key shareholders'. Would this include an explanation of how the board communicates with shareholders about remuneration, or what the remuneration structures are? It is essential too that the Principle and guidance are not interpreted by businesses as a barrier to being able to setting remuneration policies that support them in attracting the talent they require to be successful.

For businesses to be able to effectively explain their application of the Principles we feel more work is needed on the guidance in this area. Whilst we do not want to introduce guidance which supports box ticking, examples with each piece of guidance might help businesses understand what is expected of them in terms of their explanations. There will be a limited amount of time between the launch of the Principles and the start of the application, so we support providing as much clarity for businesses as possible.

3. Do the Principles and guidance take sufficient account of the various ownership structures of private companies, and the role of the board, shareholders and senior management in these structures? If not, how would you revise them?

There are many different types of ownership structures within the private business community, and within the family business sector. The Principles have to work for first generation businesses with a very small number of shareholders, to multi generation businesses with dozens of shareholders or more. Some of these businesses will be managed by family members, some will have family on the board, and others will have no family members on the board or executive. Some may have a family council, a shareholder committee or other formal governance structure, others will have no formal family governance.

In our view the overarching Principles do take in to account the diverse nature of the group in question, and cover the core areas of corporate governance they all have in common. However, it does not specify how businesses with different structure may decide to adopt the principles and whether there are areas of particular interest to certain types of businesses. For example, the board of a family business which has no family members on the board or in a management role may want to provide information on remuneration to a broader group of shareholders than one which has a family member on the board, or operates a family council.

We do not believe that this level of detail is appropriate for the guidance that accompanies the Principles, and is designed to help businesses identify what kinds of information they should disclose. However, we would suggest that the Coalition discuss whether it would be beneficial to develop supporting documents tailored to the component parts of the private business sector to provide case studies and examples of how the Principles could be applied in practice.

4. Do the Principles give key shareholders sufficient visibility of remuneration structures in order to assess how workforce pay and conditions have been taken account in setting directors' remuneration?

The guidance which accompanies Principle Five states that 'the board should establish a clear policy on the transparency of remuneration structures that enable effective accountability to key shareholders'. We believe this is sufficiently detailed for the overarching Principle and guidance. However, as discussed in Question 3, there will be differing needs between shareholders in family companies, depending on the structure of the company.

Assessing the appropriateness of levels of remuneration is based on a broad range of factors. This includes not only workforce pay and conditions, but also company performance, sectoral norms and company strategy. It is essential that all aspects are equally assessed, and that neither the guidance nor the Principles inhibit the ability of family businesses to attract the top talent they need to continue to grow and invest for the long term.

5. Should the draft Principles be more explicit in asking companies to detail how their stakeholder engagement has influenced decision-making at board level?

No. In our view this is not necessary, given that this is being dealt with in separate legislation. Requiring additional information on that aspect here will impose an additional burden on businesses without providing any useful extra information. In our view it would simply result in unnecessary duplication.

6. Do the Principles enable sufficient visibility of a board's approach to stakeholder engagement?

In our view, the Principles do enable sufficient visibility of a board's approach to stakeholder engagement. As stated in response to question 5, given this is an area subject to separate legislation we believe it is important that the Principles do not result in unnecessary duplication.

7. Do you agree with an 'apply and explain' approach to reporting against the Principles? If not, what is a more suitable method of reporting?

Whilst we understand the reason that the 'apply and explain' approach has been chosen, we believe it is essential that explanations of application do not place an undue burden on businesses, nor stray into areas which risk undermining their competitiveness. For this reason, we support an approach which does not require detailed explanations of all aspects of the application.

Section 'Application of the Principles – 'Apply and Explain'' of the consultation states that Principle Three could be applied by a family company in the following way:

"A large family owned company might seek to appoint an independent director to its board to introduce independent challenge. It could explain how the appointment of this director has delivered improved outcomes to its board's decision-making process by identifying an example where the provision of independent challenge from the independent director has improve board decision-making."

We do see that it is appropriate for a business to explain how they have introduced a system which encourages independent challenge. And that this example might be useful for businesses to think about how they have introduced challenge. However, we do not agree that detail should be given on individual board decisions and how they were reached, as this level of disclosure could discourage open discussion in the board and risk exposing commercially sensitive information.

It is appropriate for businesses to explain the systems and processes they have put in place to improve governance, but we do not agree that it is apposite to expect businesses to give detailed information on outcomes or decision making – particularly in areas which may be commercially sensitive.

This has been highlighted as an area of particular concern by the many family businesses we have spoken to during the course of this consultation. They have raised significant concerns about the purpose of the 'Apply and Explain' approach; the rationale for detailed explanations; the burden of providing lengthy and detailed explanations; the benefit of doing so and the impact it would have on raising governance standards; the practicality of providing detailed information on decision making; and concerns about disclosing commercially sensitive information.

8. The Principles and the guidance are designed to improve corporate governance practice in large private companies. What approach to the monitoring of the application of the Principles and guidance would encourage good practice?

The guidance in its current form offers information on both how the Principles could be applied, and how that application could be explained. As discussed in answer to Question 7, we believe there may be areas where guidance on the application should not be viewed as guidance on the explanation, as this would place an undue burden on businesses.

Therefore, it should be made clear in the guidance – or in additional guidance on the monitoring process - which guidance is to support the application, and which is specifically there to support the development of explanation statements.

We believe that at this stage there is a strong case to be made for a light touch approach to monitoring of the Principles. The purpose of the Principles is to help improve corporate governance across the board, in an authentic and long term way. Change takes time. Businesses should be encouraged to consider the changes they might make, assess them, and implement them in a sustainable fashion, rather than feeling they have to quickly bring in poorly thought through systems and procedures.

A prescriptive monitoring regime – particularly one which 'named and shamed' – would encourage box ticking and decision making to meet artificial deadlines, rather than to embed lasting cultural change. Any monitoring should be designed to help businesses identify areas where changes can be made, to help support continuous and genuine improvement.

A monitoring regime which is seem as onerous and burdensome to businesses would also likely put off smaller businesses from deciding to adopt part, or all, of the Principles. This would undermine a key desire of the Coalition that the Principles help businesses of all sizes to improve their governance.

It is important also to take into account the wider context of these Principles, and the corporate governance reforms which are underway. These Principles are being developed alongside changes to the regulatory framework, which will require the largest private companies to publish details of their corporate governance arrangements online and in their Directors' Report. This will allow interested parties – particularly shareholders – to review the governance of the company in question on an annual basis, and to empower them to ask questions and make judgements. Encouraging this kind of engagement by interested parties should bring about a genuine sense of engagement, responsibility and culture change.

9. Do you think that the correct balance has been struck by the Principles between reporting on corporate governance arrangements for unlisted versus publicly listed companies?

The majority of private family businesses are well governed, and act in a responsible manner. They have a strong culture and a long term outlook. While there have been high profile failings, these are extremely rare.

It is essential that these Principles, and the wider corporate governance reforms, do not put private businesses at a disadvantage to listed companies. Most family businesses are privately-held, including some of the most successful and largest businesses. There are many reasons that these businesses remain private, and private business is an important part of a diverse business community. Listing should not be seen as an inevitable route for every business, and it isn't appropriate or desirable for many.

For many families the decision to keep the business private is based on a desire to ensure that it is able to maintain a long term multigenerational outlook, with a smaller group of shareholders who are committed to long term, sustainable and responsible growth.

Keeping a business private allows for longer term planning, rather than a short term focus on quarterly reporting. Taking a business public can risk the introduction of shareholders who are more interested in short term results than genuine, long term, sustainable growth.

We believe that the Principles in their current form they do not disadvantage private family businesses. It is important that any amendments to the current do not create an unequal playing field between private and listed companies, as this could damage the long term growth of family businesses.

10. We welcome any commentary on relevant issues not raised in the questions above.

The consultation paper speaks about a desire for the Principles to be used by a broad group of businesses, not just those that will be caught by the new Reporting Requirement for Large Privately-Held Companies. We support this ambition, as we believe it may be beneficial for growing SMEs to be mindful of the changes they need to make to their corporate governance as they grow. We would welcome the opportunity to discuss with the FRC and other parties how information about the principles can be disseminated amongst this group.

Conclusion

While the majority of private family businesses are well governed and act in a responsible manner, there will be areas of corporate governance where businesses can improve their structures and systems.

Given the diversity of private companies we believed that a principles based approach was the most appropriate way to address this challenge. Overall we support the six Principles, which we believe will provide private businesses with a useful tool to judge what good practice in corporate governance looks like.

We believe there that there is a need to add to the guidance in some areas, particularly in relation to the 'apply and explain' approach. For example, it should be made clear in the guidance – or in additional guidance on the monitoring process - which guidance is to support the application, and which is specifically there to support the development of explanation statements.

It is also important to establish a proportionate approach to monitoring – one that supports genuine improvement and cultural change, rather than encourages rushed decision making.