



BEIS SELECT COMMITTEE ON CORPORATE GOVERNANCE INQUIRY

EXECUTIVE SUMMARY

ICAEW welcomes the opportunity to provide written evidence to the *BEIS Select Committee on Corporate Governance*. We have addressed all of the questions published on 16 September 2016 which are available from this [link](#).

ICAEW acts in the public interest by offering insights into business and the economy that help shape government policy and regulation. We have a proud track record of innovation in corporate governance. In 2013 we embarked on an ambitious programme of [thought leadership](#) to challenge commonly held assumptions about corporate governance. We have addressed many of the issues which underpin the questions which the Select Committee is asking and plan to do further work on them.

This ICAEW response of 26 October 2016 reflects consultation with the ICAEW Corporate Governance Committee which informs our thought leadership and policy work on corporate governance issues and related submissions to regulators and other external bodies. Its members are drawn from the business, investment, professional services, NGO and academic communities who provide us with a broad spectrum of views.

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 145,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

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INTRODUCTION

1. We understand why recent high-profile business failures have led to this inquiry and we are receptive to legislative change. However, we also recognise that businesses need to understand why changes will support their business operations and strengthen their reputation. This will ensure that changes are taken to heart and supported by long-term shifts in behaviour and culture.
2. We have answered all the Committee's questions and would be pleased to help the Committee in any way that we can as it pursues its inquiry.

RESPONSES TO SPECIFIC QUESTIONS

Directors' Duties

Is company law sufficiently clear on the roles of directors and non-executive directors, and are those duties the right ones? If not, how should it be amended?

3. The Companies Act (2006) (the Act) which clarified directors' roles and duties was subject to extensive debate which took nearly a decade to complete. Each business is different and priorities vary over time, and this is why the articulation of the duties in the Act is high-level and augmented by common law. The worthwhile corollary is that directors and courts have discretion to reach decisions which reflect changing social norms, and are proportionate and fact-specific.
4. Any review of the duties should take into consideration:
 - the full range of duties which apply to executive and non-executive directors which are scattered in numerous legislative and quasi-legislative sources, and in employment contracts and service agreements;
 - the diverse mix of skills that are required for board effectiveness, and the de facto differences in the role of executive directors and the role of non-executive directors;
 - whether directors should be under a duty to have a clear and up-to-date understanding of the idiosyncrasies of the business they are managing; and
 - whether directors' fiduciary or contractual duties of confidentiality to the company should be made a general statutory duty, with appropriate enforcement mechanisms.

Is the duty to promote the long-term success of the company clear and enforceable?

5. Section 172 of the Act retained the traditional focus on benefit (economic value) for members as a whole, but this was balanced with the interests of other stakeholders. Some uncertainty is inevitable because views will vary as to what long-term success should look like and how long a particular company should exist. There should not be greater prescription because directors need flexibility and room to innovative.
6. Shareholders can bring derivative actions and unfair prejudice petitions, but both of these legal actions involve meeting stringent thresholds. The Law Commission could consider whether the other stakeholders referred to in section 172 should also be allowed to bring these actions.

How are the interests of shareholders, current and former employees best balanced?

7. Boards should work hard to keep up-to-date regarding the interests of these groups, including having an understanding of any tensions or synergies between or within the groups, eg, the interests of former employees are likely to be limited to pension issues, but current employees will also have a keen interest in this area.

How best should the decisions of Boards be scrutinised and open to challenge?

8. It is critical not to overlook the correct starting point which is how to create an environment that provides optimum opportunity for making good decisions which stand up to scrutiny. Factors include having the right people, strong values, transparency and accountability.
9. The Committee may wish to examine whether the requirement to hold an Annual General Meeting (AGM) is fully achieving all of its aims, or whether the concept of a face-to-face meeting held annually at a single location is outdated. AGMs have the dual purpose of company administration and shareholder engagement, but companies should be encouraged to engage with shareholders more regularly using real-time methods. The availability of the AGM allows companies to claim that they are engaging with shareholders even if few attend and there is little meaningful contact between meetings.
10. The actions of large companies are already open to scrutiny because of the intensity of journalistic interest, and particularly because of social media coverage. There is a growing lack of deference towards all institutions including big business. The new forms of questioning are rigorous. Questioners may be informed or uninformed, and they may be anonymous. The immediacy and impact of social media has meant that the focus has drifted away from trawling financial or narrative reports for anomalies, raising concerns at formal meetings such as the AGM or making reference to minutes.
11. This environment is positive in as much as it has democratised business so that it is held to account by society and not just by its owners. This goes some way to redress the fact that business leaders are very powerful but only elected by owners rather than by the general public who are also affected by their actions. Business leaders know that they must work hard to preserve their company's reputation as once it is lost it is very difficult to recover.
12. ICAEW's recent thought leadership paper '[Connect and Reflect](#)' describes this phenomenon in more detail. We want businesses to take a new approach which fits the modern landscape, by being receptive to feedback, having the confidence to respond to criticisms frankly and directly using plain English, or to change direction if it is impossible to justify behaviour. The next stage of our thought leadership programme will explore how companies can thrive on social media. We want to take this opportunity to allay fears about the possible negative outcomes of social media and greater transparency, eg, slow decision making, sitting on the fence or a new insurance frenzy because of the fear of making a wrong decision.

Should there be greater alignment between the rules governing public and private companies? What would be the consequences of this?

13. The public and government are right to expect all companies to abide by certain minimum standards. That is why our papers '[What should companies be responsible for?](#)' and '[What are the overarching principles of corporate governance?](#)' did not distinguish between different types of companies.
14. Any greater harmonisation in law or regulation based on the Corporate Governance Code (the Code) is challenging because of the huge diversity of companies and the complexity of the Code. Private companies vary from personal service companies to Public Interest Entities. Large private companies may have few problems complying with either the Code or with all aspects of the Act, but for smaller companies it will be important to think about unintended consequences.

Should additional duties be placed on companies to promote greater transparency, e.g. around the roles of advisors. If so, what should be published and why? What would the impact of this be on business behaviour and costs to business?

15. Boards need to be able to access the information they need to make the best possible decisions and ultimately this benefits all stakeholders. It is unrealistic to expect board members

to have expertise in all of the areas for which they have responsibility. Companies must not be dissuaded from taking advice, including speculative strategic advice.

16. Shareholders and others are already able to ask companies about the advice they are taking; remuneration committees must disclose fees paid to remuneration consultants; and there are rules which deal with the independence of advisors and conflicts of interest. In our thought leadership paper about '[Who should be covered by codes?](#)' we explore the idea of a framework or overarching code which would complement sector-specific codes and which would have wide application. A high-level code could reduce loopholes and the regulatory arbitrage but the challenges include how it would be enforced and by whom.
17. Enhanced transparency poses the problem of what more could or should be disclosed. Although the identity of advisers may be disclosable, their advice will often need to be kept private because of confidentiality, legal professional privilege or commercial sensitivity.
18. ICAEW is about to publish revisions to [Professional Conduct in Relation to Taxation](#) in order to address public concern about aggressive tax avoidance, and also strengthen our ability to take disciplinary action against members, including those in advisory roles, who transgress.

How effectively have the provisions of the 1992 Cadbury report been embedded?

19. It is difficult to exaggerate the impact of the Cadbury Report on UK corporate governance, but it should be recognised that Cadbury was just the start of a continuing process of review and refinement of corporate governance, eg, the 1998 Hampel Report, the 1999 Turnbull Report, the 2003 Higgs Report and the 2003 Smith Report. These initiatives were trail blazing for their time, but they have now largely reached maturity which is why, starting in 2013 ICAEW began developing its own [thought leadership](#) papers which have been referred to as a Cadbury Code for the 21st Century.

How best can shareholders have confidence that Executives are subject to independent challenge?

20. The role of non-executive directors is articulated in the Code, and it includes constructive challenge. Worker directors could increase confidence that executives are subject to independent challenge.
21. The Code requires challenges to be recorded in board minutes but shareholders are not routinely allowed to access minutes and, for good business reasons, published summaries may not cover challenges or name challengers.
22. There should be open communication with shareholders beyond the AGM and shareholder reports. Bringing shareholders onto committees may have advantages but there could be difficulties, eg, the availability of shareholders and whether they would be prepared to undertake the significant amount of work involved in committee membership.

Should Government regulate or rely on guidance and professional bodies to ensure that Directors fulfil their duties effectively?

23. The architecture for ensuring that directors fulfil their duties effectively, could include: certification, continuing professional development, new standards, personal accountability, monitoring, investigation and disciplinary action. ICAEW performs these functions in relation to all its Chartered Accountant members including those serving as board directors.
24. We believe that around 17,500 UK ICAEW members are company directors. ICAEW can accept complaints from the public, investors and others about acts or defaults which arise from directorships if wrongdoing is likely to bring discredit on the member, ICAEW or the profession of accountancy.

25. ICAEW takes disciplinary action as a result of information brought to our attention concerning members who have been disqualified as directors. The body who instigated the disqualification may contact us, eg, insolvency practitioners or HMRC. We may be informed about a disqualification by our members (including the member who has been disqualified) as they have a duty inform us about the conduct which gave rise to the disqualification if this amounts to gross incompetency, a serious breach of faith or serious financial irregularity. ICAEW members also have a duty to inform us about imprisonable offences under the Company Directors Disqualification Act (1986), ie, breaches of Directors' Disqualification Orders.
26. In general we strongly support professional regulation as it tends to be principles-based, less easy to circumvent by legalistic device and more adaptable to unanticipated market failures. However we recognise the pressure to apply the same requirements to all directors, because:
- not all directors belong to a professional body and those who do belong may resign their membership;
 - not all professional bodies discipline their members in the public interest; and
 - there are significant variations in disciplinary methods, timeframes and outcomes of different professional bodies.
27. The creation of a regulatory architecture for company directors would be a significant and expensive endeavour which is bound to impose additional costs on business which impact their profitability, as well as having implications for consumers, and current and former employees. There would have to be a detailed evidence-based analysis of the likely benefits versus likely cost before additional regulation was imposed. As business is increasingly international it would also be necessary to study the extent of regulation in other countries.

Executive pay

What factors have influenced the steep rise in executive pay over the past 30 years relative to salaries of more junior employees?

28. Globalisation and the geographical mobility of senior executives have had an important influence. Having said that there are interesting cultural differences, eg, in the US it is more common for executives to employ their own consultant to represent their interests with the remuneration committee.
29. The trend for more complicated pay policies has made it more difficult for shareholders and others to fully understand the implications and the total remuneration packages which are likely to result. However, complicated pay policies and structures are often seen as necessary to balance long-term success with short-term achievement.
30. The Code requires remuneration committees to carefully consider what compensation commitments (including pension contributions and all other elements) their directors' terms of appointment would entail in the event of early termination. However there are still concerns around settlement agreements. Clearer contractual clauses in terms of appointment would generate greater certainty, but in reality there is likely to be negotiation in areas such as restrictive covenants.
31. Executive pay consultants have an important role in advising on market conditions. ICAEW expects during 2017 to publish research by Professor Ruth Bender and Dr Monica Franco-Santos of Cranfield School of Management about the work of executive pay consultants. This research will highlight practices in terms of companies' use of multiple consultants and how the extent of the consultant's brief impacts on outcomes. A recurring theme will be the importance of the CEO's personality, the role of companies' internal advisers and the effectiveness of the remuneration committee.

32. Executives and executive remuneration consultants will always benchmark against the pay of comparable peers based on sector, size, company stage of development, etc. These are the fair measures of whether an executive is being paid appropriately for their level of responsibility and whether they could be poached. However the practice of consultants sending executives unsolicited comparisons of their salaries with salaries of other executives in comparable roles is a relatively recent development, and this is an example of an unintended outcome resulting from greater transparency.

How should executive pay take account of companies' long-term performance?

33. Companies need to have flexibility in this area. Executives and those who decide their pay may not have a long-term relationship with the company, even though they have a legal duty to consider its long-term success. There will also be situations when decisions on executive pay should focus on short-term survival otherwise there won't be a long-term. A failing or struggling business requires strong leadership, especially if it is high-profile. Executives may be reluctant to accept assignments which have a high chance of failure, less security of tenure, as well as personal and public accountability, unless these risks are reflected in the quantum and structure of their remuneration.

Should executive pay reflect the value added by executives to companies relative to more junior employees? If so, how?

34. Remuneration committees should take whole-company and cross-company perspectives when it comes to pay so that stark anomalies are highlighted, and either remedial action is taken or rational justifications are discussed and agreed.

35. The problems that arose in the financial sector because of too much focus on incentive pay are legendary. Nevertheless, although there are alternatives, many companies will want executive pay to reflect a retrospective assessment of the value that an individual executive has added. In these circumstances remuneration committees should address the difficult question of establishing the optimum proportion of incentive pay as part of the overall remuneration package.

36. We caution against executive pay being limited to multiples of the pay of junior employees within the same organisation. This may have unintended consequences, eg, companies with large low paid workforces may outsource.

What evidence is there that executive pay is too high? How, if at all, should Government seek to influence or control executive pay?

37. Media and public criticism do not prove that executive pay is too high, but this criticism must not be ignored by politicians or companies. This is recognised in ICAEW's commitment as part of our [Connect and Reflect](#) initiative to share experience around 'How to end excessive pay'. What has occurred in recent years could be described as a market failure. Listed companies in particular benefit from a social licence to operate which means that special criteria apply which do not necessarily apply in other sectors, eg, sport and entertainment.

38. Any proposals for new legislation must be based on evidence, eg, pay levels in comparable countries; membership and operation of remuneration committees; what information is provided to shareholders before they decide whether to approve a long-term incentive plan; the effectiveness of the new provision which empowers shareholders to reject overall pay policies; and a gap analysis of UK legislation with the US Dodd-Frank Wall Street Reform and Consumer Protection Act (2010).

Do recent high-profile shareholder actions demonstrate that the current framework for controlling executive pay is bedding in effectively? Should shareholders have a greater role?

39. Recent high-profile shareholder actions do demonstrate that the current framework is working. Any proposals around greater roles for shareholders should examine the reasoning behind the repeal of the requirement in the Companies Act (1862) that directors' remuneration should be approved by companies in general meetings. Proposals would also need to take into account that a large proportion of UK shares are held by overseas investors.
40. In relation to any potential greater role, the High-Pay Centre could be asked to look in detail at the role of shareholders and make recommendations. For example, should the shareholders' vote on directors' remuneration policy be made mandatory and could this lead to companies being discouraged from listing or remaining listed?

Composition of Boards

What evidence is there that more diverse company boards perform better?

41. We can provide the Committee with details of a range of academic studies concerning gender diversity and workers on boards. Having said this, it is difficult to provide evidence of a direct and definite causal link between either board diversity and board effectiveness, or between board diversity and corporate success. Even if evidence was available it may be of limited value because individual companies are unlikely to be persuaded to make a specific board appointment on the basis of statistical studies.

How should greater diversity of board membership be achieved? What should diversity include, e.g. gender, ethnicity, age, sexuality, disability, experience, socio-economic background.

42. It would be useful to reframe this debate to focus on how boards benefit from a diverse range of views when they make their decisions. Diversity of board representation is important because it can support this objective but it is not a prerequisite or an end in itself.
43. In our thought leadership paper '[How diverse boards should be?](#)' we explain why diversity should be interpreted broadly and in a way that fully reflects our society. Different approaches will be needed for different groups. The more nebulous the grouping the less visible it will be and this increases the challenge. For example diversity of experience is open ended. Does this mean diversity of educational experience, cultural experience, work experience or something else? Similarly it can be difficult to determine an individual's socio-economic background, although schooling can be a useful indicator. Favouring a candidate on the basis of their age is discriminatory and unlawful.
44. The supply of individuals to sit on boards is a matter for society as a whole and not just individual businesses. Therefore achieving greater diversity on boards requires the government to make sure its education strategy supports social mobility and opportunity so that companies have access to a diverse pool of talent. Access to aspirational careers advice is critical.
45. ICAEW practices what it preaches when it comes to diversity and recognises that our ACA qualification is a proven route to board membership:
 - There are a number of routes into ICAEW's Chartered Accountancy qualification, the ACA, including: school leaver programmes, Higher Apprenticeships, graduate training and the ICAEW Certificate in Finance, Accounting and Business which has no educational entry requirements and which is popular with career changers.
 - A competition open to all schools and colleges in the UK called [BASE](#) involves more than 500 schools. 3,000 students participate on an annual basis, working in teams of six and being mentored by an ICAEW Chartered Accountant.

- Our Women in Accountancy campaign profiles female ICAEW Chartered Accountants and their career stories through events and webinars.
- In financial education sessions with school students our members share their expertise and provide a real life context to learning about personal finance.
- We publish case studies of ICAEW members and students which illustrate through example that a career as a Chartered Accountant is open to all.
- Activities with students at almost 100 universities in the UK provide free resources and hints and tips on how students can develop and showcase their skills.
- ICAEW Training Vacancies – a jobs portal for students seeking work experience and ACA training agreements – provides a free and easy to use service to all job seekers.

46. ICAEW is also a founding signatory of Access Accountancy, an initiative aimed at improving access to the accountancy profession by:

- providing work experience to school students meeting specific criteria relating to their socio-economic background;
- collecting and monitoring socioeconomic data of applicants and hires on an annual basis;
- taking part in externally validated reviews of Access Accountancy; and
- generating interest in accountancy by delivering common messages in target schools and colleges.

Should there be worker representation on boards and/or remuneration committees? If so, what form should this take?

47. We have noticed a recent shift in sentiment on the issue of worker directors. As part of our Connect and Reflect initiative we have committed to share experience on how worker directors add value.

48. In principle ICAEW supports the introduction of worker directors and we favour achieving this through a new provision in the Code which would operate on a comply or explain basis. A new Code principle should outline the objectives of the role so that companies without a worker director would be required to explain how they meet the objectives in other ways. For example, an existing director might be given specific responsibilities in respect of workers' input or the board might establish alternative arrangements for worker input.

49. For worker directors to be effective and credible their role should be to broaden the perspective of views which inform board decisions rather than representing workers' demands or grievances. Therefore the nomenclature of worker director is preferable to representative. This focus will help allay concerns about confidentiality of board discussions, prevent conflicts of interest and fits with the application of the full range of duties which apply to all company directors. Similar points already apply to directors nominated by shareholders.

50. Companies will need to decide the proportion or number of worker representatives on the board. There will also be issues around who can be a director and how they are appointed. Possible criteria for candidacy may include geographical factors, minimum periods of employment or levels of seniority. There should be an expectation that companies and groups of workers will take measures to include part-time workers and that time spent on training, preparation for board meetings, travel to board meetings and the meetings themselves should count as work time. Designing the process of selection will require consultation with workers and decisions in areas such as voting rights and the role of any unions and works council.

51. The chair of the board will be responsible for the integration of worker directors into board decision-making so that their contributions are properly taken into account.

52. Currently, the Code envisages a board comprising executives and independent non-executives. It is possible that a third category will be needed as worker directors will not be executives, and will not fulfil the definition of independence in the Code.

What more should be done to increase the number of women in Executive positions on boards?

Earlier this year ICAEW gave evidence to the Women and Equalities Select Committee. In summary, we favour targets over imposed quotas. The key is to encourage women to assume management positions so that they are poised to step into senior executive positions when they become available. In order to allow women the opportunity to reach management positions there need to be opportunities for career breaks, flexible working and respect for people who work from home.

53. We [responded](#) recently to the Government Equalities Office's consultation on the gender pay gap. Legislation which requires greater transparency may focus minds on the scale of the problem and the scale of the solution that is needed, but the design and implementation of solutions must be employer-led. A change in culture is conditional upon the belief and commitment of business, and this will take time.
54. The introduction of worker directors would present an additional opportunity for women to sit on boards.