Governance in large privately-held businesses and the Wates Principles

July 2018

Introduction

Large privately-held businesses in the UK will for the first time have to make public disclosures on their governance arrangements. This forms part of the wider Corporate Governance Reform agenda initiated by the Prime Minister in 2017 in an effort to improve trust in business. All UK incorporated companies over a certain size will be required to make a statement on their corporate governance arrangements for financial years beginning on or after 1 January 2019. This statement must detail: which corporate governance code the company applies; how the code is applied; and, if the company departs from the code, both the respects in which it did so and its reasons for departing. For those that choose not to apply a code, they are required to make a statement about their governance arrangements, including an explanation of the reasons for not choosing to apply a corporate governance code. The regulations can be viewed in full here.

To provide large privately-held businesses with a corporate governance code that is proportionate and relevant, the Government invited a coalition of industry experts to develop a voluntary set of governance principles tailored to large private companies. James Wates CBE was appointed to chair this group and the FRC published a consultation on the Wates Corporate Governance Principles devised by the Coalition in June 2018. The Coalition has aimed to keep the principles as flexible as possible. However, if companies choose to adopt these principles, the proposed application is on an 'apply and explain' basis. There are six high level principles included; purpose, composition, responsibilities, opportunity and risk, remuneration and stakeholders, with associated guidance for each. The guidance provides further details on why each principle is important.

Should companies want to go further than the Wates' principles they can opt to comply with the UK Corporate Governance Code or the Quoted Companies Alliance Code. Some companies may also already comply with industry specific governance codes which would fulfil the criteria.

This paper provides an overview of the scope, timing, and implications of the 'corporate governance statement' requirement and the Wates Corporate Governance Principles for Large Private Companies.

Are you captured by the 'corporate governance statement' requirement?

A UK company needs to make a statement of corporate governance arrangements if it meets the qualifying conditions for the financial year, and is not otherwise exempt. The qualifying conditions are met if the company satisfied either or both of the following:

- It has more than 2000 employees (based on monthly average totals)
- It has (1) a turnover of more than £200 million and (2) a balance sheet total (i.e. total assets) of more than £2bn.

The qualifying conditions are determined for the company itself (rather than the group it heads, if the company is a parent). This means that the statement would not be required in the group annual report, if the parent company did not itself meet the criteria. However, a subsidiary company meeting the qualifying conditions would need to make its own statement even if its parent company made a statement in the group annual report. The turnover threshold is pro-rated if the financial year is not in fact a year.

There are provisions to address companies which fluctuate in and out of the qualifying conditions. If the qualifying conditions are met in the first financial year, a statement is required in that year. In subsequent years, the statement is made if the qualifying conditions are met in both that year and the preceding financial year. Further detail can be found in the regulations.

The requirement applies both to quoted companies (i.e. companies whose equity share capital has been included in the Financial Conduct Authority's Official List, or is officially listed in an EEA State, or is admitted to dealing on either the New York Stock Exchange or Nasdaq) and to unquoted companies. However, a company that is already required to provide a corporate governance statement (pursuant to the Disclosure Guidance and Transparency Rules - DTR 7.2.1) is exempt. Therefore, for example, UK companies with equity listed on the London Stock Exchange will already be making a corporate governance statement as required by DTR 7.2.1. However, this exemption does not extend to other corporate governance statements made by companies, e.g. under the AIM Rules or voluntarily. There are also exemptions for community interest companies and charitable companies.

When and where does the statement need to be made?

The statement must be in the Directors' Report or cross referenced from it if disclosed in the Strategic Report (permitted where the directors consider the information to be of strategic importance). The requirement applies in relation to financial years beginning on or after 1 January 2019. For unquoted companies, the statement must also be made available on a website that is maintained by or on behalf of the company and identifies the company.

Under the recent Rule 26 change for AIM companies, all AIM companies will need to provide a website disclosure with details of the recognised corporate governance code they comply with, how they comply and where they depart from it, ahead of the implementation date for this legislation. Whilst the content of this statement for AIM companies is similar in nature (with the exception that they do not have the option not to apply a code), AIM companies will also now need to add these disclosures into their Directors' Report (or cross referenced from it, as above) in order to comply with the 'corporate governance statement' requirement.

Who is this reporting for?

The suite of corporate governance reforms set in motion by the Government in 2017 have the primary aim of improving trust in business in the UK. High-profile corporate failures in large private companies led to the particular focus on bringing reform to this group of businesses which, though unlisted, have large stakeholder groups (including large pension liabilities) and significant societal impact.

The companies that fall under this requirement are not homogenous. A wide range of businesses are captured including solely owned companies, family owned businesses, private equity owned businesses, subsidiaries of groups and more. For private companies, which do not sell shares on an open market, shareholder ownership tends to be concentrated and those owners tend to already be closely connected to the company. With this in mind the new requirements do beg the question, who are these disclosures for? In our view it is likely that compliance with the legislation will be monitored by the FRC's conduct committee. However, in terms of engagement on the quality of the disclosures, the FRC has indicated that this disclosure is aimed at wider stakeholders, such as employees, suppliers and the community. Whether stakeholders will look at, and engage companies on their disclosures will be interesting to see.

Compliance burden or opportunity for engagement?

It is not yet clear how compliance with this requirement will be monitored and many have questions about the practicability and reasonableness of the requirement. Some argue that companies are judged by their stakeholders on what they *do*, rather than on what they say, and that a disclosure requirement produces unhelpful boilerplate information. Others, including some in the private equity community, suggest that this new disclosure requirement represents an opportunity for private companies to demonstrate how their governance framework contributes to their success and use good governance as a differentiator in the competition for investment and gaining trust from stakeholders.

For some subsidiaries, these principles may provide a useful framework. In particular, groups with a significant alignment of their corporate and operating structures, where the governance and composition of subsidiary boards and the management of key personal risks to directors are key considerations. For others, whose governance processes don't follow legal entity lines, they may be less relevant.

Should you follow a corporate governance code or explain governance arrangements in your own style?

The 'corporate governance statement' must detail: which corporate governance code (if any) the company applied in the financial year; how the company applied that code; and if the company departed from that code, both the respects in which it did so, and its reasons for so departing. If no code was applied for the financial year, the statement must explain the reasons for that decision and what corporate governance arrangements were in place for that year. Depending on how companies view the requirement, some will choose to publish a very high level description of their governance arrangements while others will seek to provide more detail. When selecting a corporate governance code, a company many want to choose a code that is proportionate and relevant to the company and we agree that the Wates Corporate Governance Principles (currently under consultation) offer a more proportionate alternative for private companies. The expectation from the Government is that these principles will be a commonly used code of practice for a broad range of private companies and they do not see this as limited to those captured by the reporting requirement only.

In relation to subsidiaries, the BEIS Guidance states: *"A subsidiary could, in principle, and if the circumstances warranted it, state that it did not apply a code because its parent applied the UK Corporate Governance Code which was applied throughout the group. This might shorten the statement, but the subsidiary would still need to explain how the Code actually applies to governance arrangements in the subsidiary and its directors."*

What are the Wates Corporate Governance Principles for Large Private Companies?

This newly developed draft set of principles aims to act as a tool for companies of all types and sizes, not just those captured by the legislation. Application is proposed on an 'apply and explain' basis and explanations should be in the Directors' Report and on the company's website including how the application of the principles has led to improved corporate governance outcomes. Each principle comes with associated supporting guidance. The principles and guidance are currently under consultation and there is therefore potential for them to change depending on the feedback received.

Principle One – Purpose
An effective board promotes the purpose of a company, and ensures that its values, strategy and culture align with that purpose.

Principle Two – 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.

Principle Three – Responsibilities
A board should have a clear understanding of its accountability and terms of reference. Its policies and procedures should support effective decision-making and independent challenge.

Principle Four – Opportunity and risk
A board should promote the long-term success of the company by identifying opportunities to create and preserve value, and establishing oversight for the identification and mitigation of risks.

Principle Five – Remuneration
A board should promote executive remuneration structures aligned to the sustainable long-term success of a company, taking into account pay and conditions elsewhere in the company.

Principle Six – Stakeholders
A board has a responsibility to oversee meaningful engagement with material stakeholders, including the workforce, and have regard to that discussion when taking decisions. The board has a responsibility to foster good stakeholder relationships based on the company's purpose.

What are EY's reflections on the principles?

Whilst there has been some resistance to the incoming requirement for a 'corporate governance statement' impacting large private companies, the Wates Corporate Governance Principles should be assessed separately. Do they provide a useful tool for large privately held businesses to consider their corporate governance arrangements and report on their practices? In our view, the Wates Principles are high level enough to provide flexibility in the context of a wide variety of ownership structures and there are a number of benefits of using the principles as a tool for engagement and improving governance practices. Some of the principles bring in concepts which are also new for listed companies, for example, discussion around purpose and stakeholder engagement. However, there are also some aspects requiring further consideration.

We have observed with large listed companies that reporting can drive behaviours and processes in a positive direction. Reporting is an outcome of underlying processes which create or protect value e.g., reporting on risk management processes, and having to articulate certain practices and values can create useful discussion amongst the board as it focuses efforts in achieving specificity and alignment on key issues. This can be a helpful exercise for all companies, especially those with less mature governance structures looking to develop and improve their governance. Consideration and disclosure in line with the principles may also present large private companies with the opportunity to make themselves more attractive to private equity investment.

Some of the companies in scope already have good disclosures on their websites and may look to the UK Corporate Governance Code in order to be guided by best practice. Companies in scope already have to make certain disclosures on their website such as gender pay gap reporting and their modern slavery statements and many who seek to demonstrate the positive value they bring to society also have some disclosures about their corporate social responsibility on their website. For these companies, the new corporate governance requirement may not present as large a challenge and it may make sense to bring these disclosures together in one section of the website.

In addition, for regulated companies, there are likely already requirements from regulators which may even go beyond what is required by the 'corporate governance statement' and would likely sit alongside this new disclosure. Some regulators have their own governance principles which companies in scope are already complying with, for example, Ofwat's principles for Board leadership, transparency and governance.

While we see benefits for companies in reporting on their governance arrangements, whether using the Wates Principles or not, there are also some areas requiring further consideration. The proposed 'apply and explain' approach for the Wates principles seems at odds with the ambition for the principles to be as flexible as possible and to also appeal to companies not required to make a 'corporate governance statement'. One area we felt was perhaps under-addressed by the principles however, is the governance oversight of financial and other external reporting. Though it is mentioned briefly in the guidance, we felt this might require further consideration given that private companies publish accounts, strategic reports and make other external statements required by legislation. Boards may be involved in this in a similar way to the 'fair, balanced and understandable' requirement in the UK Corporate Governance Code.

It is also noted that a focus on effective CEO oversight and succession planning is not drawn out in the principles. Effective recruitment, retention and succession planning of the CEO is a key board role and for family owned businesses, a focus on governance can also help with creating smooth succession in terms of changes in ownership, whether the business ultimately stays in the family or is sold.

In our view it is likely that compliance with the legislation will be monitored by the FRC's conduct committee. However, in terms of engagement on the quality of the disclosures, the FRC has indicated that this disclosure is aimed at wider stakeholders, such as employees, suppliers and the community. Whether stakeholders will look at, and engage with companies on their disclosures will be interesting to see.

Overall, for companies looking to further enhance their governance and build trust with stakeholders, the Wates principles may represent a helpful tool on that journey, however, the quality of disclosures will depend on the value the company sees in increased transparency with wider stakeholders.

We will be responding to the consultation with detailed views on each of the principles and encourage you to also have your say by responding to the consultation by the deadline of 7 September 2018.

To discuss any of the issues in this paper further, please contact EY's Corporate Governance team.

Appendix: Timeline of recent and upcoming developments affecting large privately-held businesses

August 2017	Government response to Green Paper consultation on corporate governance reform explains intention to introduce 'corporate governance statement' requirement and development of new corporate governance principles for large private companies.
Jan 2018	James Wates CBE appointed as Chair of the Coalition Group working with the FRC to produce corporate governance principles for large private companies.
11 June 2018	Draft regulation is laid before Parliament amending the Companies Act 2006 to include requirement for 'corporate governance statement' for large and medium sized companies.
13 June 2018	The Draft Wates Corporate Governance Principles for Large Private Companies are published for consultation.
9 July 2018	Parliamentary approval of the 'corporate governance statement' regulation.
7 Sept 2018	Consultation period for the Draft Wates Corporate Governance Principles for Large Private Companies closes. Responses should be sent to corporategovernanceprinciples@frc.org.uk.
Dec 2018	Finalised Wates Corporate Governance Principles for Large Private Companies to be published.
1 Jan 2019	The new 'corporate governance statement' requirement will apply for financial years beginning on or after 1 January 2019.

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Corporate Governance team

Ken Williamson
kwilliamson@uk.ey.com
+44 20 7951 4641

Natalie Bell
nbell1@uk.ey.com
+44 20 7951 1316

Fiona Burgess
fburgess@uk.ey.com
+44 20 7951 0461

Find more of our resources on:
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Ernst & Young LLP, 1 More London Place, London, SE1 2AF.

ED None

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