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New governance reporting requirements for UK companies

Executive summary

The Government has now published the long-awaited legislation on corporate governance reporting.

Last year, in its response to BEIS's Green Paper, the Government re-confirmed its aim to reform UK corporate governance. In large part it seeks to achieve that through changes to the UK Corporate Governance Code applicable to premium listed companies – the final version of which is expected in July (for more details see our briefing). The Government, however, also noted that large privately held companies, which are not subject to the Corporate Governance Code, can have as much economic and social significance as publicly-owned ones. Certain of its proposed reforms are therefore more widely applicable and affect unlisted companies that do not have to comply with the Corporate Governance Code. Those reforms which required the enactment of legislation and related regulations were laid before Parliament on 11 June. The regulations also cover certain other new corporate governance reporting requirements.

In summary, the new legislation requires:

- large privately held UK incorporated companies to report annually on their 'corporate governance arrangements';
- quoted UK incorporated companies with more than 250 UK employees to report annually on pay ratio information comparing the CEO's annual remuneration with the 25th, 50th and 75th percentile of the annual remuneration of the company's UK employees;
- quoted UK incorporated companies to provide enhanced reporting on the exercise of discretion by the remuneration committee and certain matters relating to the impact of share movement on pay;
- certain large UK incorporated companies – public and private – to report annually on how the directors have:
  - complied with their section 172(1) Companies Act 2006 duty to promote the success of the company for the benefit of its members;
  - engaged with the company's employees and had regard to employees' interests; and
  - had regard to the company's business relationships with suppliers, customers and others.

In light of the Government's concern about the lack of transparency around how some large privately held companies were run, it also recommended that a voluntary set of governance principles be introduced. Alongside the new legislation, the FRC has therefore published the Wates Corporate Governance Principles for Large Private Companies for consultation. These are intended to be a set of principles which privately held companies caught by the new corporate governance disclosure requirement might choose to follow and report against.

Subject to the expected Parliamentary approval, the legislation will apply for financial years beginning on, or after, 1 January 2019.

As indicated above, the new provisions do not apply to just one type of company. For example, the new pay ratio requirement only applies to quoted companies, whereas the new s172(1) reporting requirement applies to all companies – whether public or private – with more than 250 employees. We set out below a table showing of the new requirements and details of the companies that they apply to. Currently the new reporting requirements only apply to companies and not LLPs.

New reporting requirement	Publication	Application
Statement of corporate governance arrangements	Directors' Report and, for unquoted companies, separate website publication	UK incorporated companies with: • more than 2,000 global employees; and/or • a turnover over £200m and a balance sheet over £2bn. Companies already required to report on their corporate governance are exempt from the new requirement.
Pay ratio reporting	Remuneration Report	UK incorporated, quoted companies with more than 250 UK employees
Other Remuneration Report changes	Remuneration Report	UK incorporated, quoted companies
Statement of how directors have complied with their duty to have regard to s172(1)(a)-(f)	Strategic Report and, for unquoted companies, separate website publication	Companies already required to produce a Strategic Report, unless they qualify as 'medium-sized' companies (see box below)
Statement regarding engagement with employees	Directors' Report	UK incorporated companies with more than 250 UK employees
Statement regarding engagement with suppliers, customers and others in a business relationship with the company	Directors' Report	UK incorporated companies meeting at least two of the following criteria: • turnover of more than £36m; • balance sheet total of more than £18m; • more than 250 employees

We set out below further details on the new requirements. BEIS has produced a useful Q&A on the new regulations which is designed to help companies and interested stakeholders understand how they will be affected by the new requirements.

1. Reporting on corporate governance arrangements

Which companies are affected?

Any company incorporated under the UK Companies Acts – public or private – with:

- more than 2,000 employees; and/or
- a turnover of more than £200m and a balance sheet total of more than £2bn,

unless it is already required to provide a corporate governance statement under the Companies Act 2006 and FCA rules (ie broadly, listed companies), it is a community interest company or a charitable company.

A company that is a subsidiary of a listed company, or a portfolio company under private equity ownership, which meets these criteria will therefore be required to report.

Employees are counted for this purpose wherever they work, including outside the UK. Balance sheet total for this purpose means the aggregate of the amounts shown as assets in the balance sheet.

What will a company have to report?

The annual Directors' Report must state:

- which corporate governance code, if any, the company applied in the financial year;
- how it applied that code; and
- if it departed from that code, 'the respects in which it did so, and its reasons for so departing'.

Notably, the Government has adopted an 'apply and explain' approach under which companies are required to explain how the relevant principles have been applied by way of a narrative explanation. If the company has decided not to apply any corporate governance code, it must explain the reasons for that decision, and explain what arrangements for corporate governance it has applied.

The company may include this information in the Strategic Report instead of the Directors' Report so long as the Directors' Report states that this is the case. In addition, it must be made available with free, unrestricted access on a website maintained by, or on behalf of, the company. Listed companies are already required to publish their annual reports and accounts on a website.

Consultation on Wates Governance Principles

Currently there is no widely adopted UK corporate governance code that is specifically for large privately held companies. A committee headed by James Wates was asked by the Government to develop a corporate governance code that large private companies might apply for the purpose of the new reporting requirements. The Wates committee published a draft for consultation on 13 June 2018 – for more information see our separate briefing, New Corporate Governance Principles for Large Privately Held Companies.

2. Pay ratio reporting

Which companies are affected?

The pay ratio rules will apply to UK incorporated, quoted companies with an average of more than 250 UK employees in the relevant financial year. Where the company is a parent company, the employee threshold (and consequently pay ratio information) is calculated by reference to the group and not solely the company.

Employees for this purpose means individuals employed under a contract of employment. The population relevant for pay ratio reporting is narrower than that for the gender pay gap reporting, which, for example, includes directly engaged contractors. This is potentially relevant because two of the prescribed methods for the pay ratio calculations allow companies to use gender pay gap data as their starting point. This lack of alignment between the two reporting regimes could make it difficult for companies to use the two seemingly less onerous methods (Methods B and C – see below) if payroll providers are not able easily to extract contractor data from the overall gender pay gap information which has already been reported.

What is a quoted company?

A quoted company is defined in section 385 of the Companies Act 2006 as a company whose equity share capital:

- has been included in the official list in accordance with the provisions of Part 6 of the Financial Services and Markets Act 2000; or
- is officially listed in an EEA State; or
- is admitted to dealing on either the New York Stock Exchange or NASDAQ.

Note: (i) the definition of 'quoted' company is not the same as 'traded company'. A traded company is one whose transferable securities are admitted to trading on a regulated market and includes those with only listed debt securities (section 474(1)); and (ii) an AIM company does not meet the definition of either a quoted or traded company.

What will a company have to report?

The annual directors' Remuneration Report for quoted companies will need to disclose three different pay ratios for the CEO's annual remuneration. These will require a comparison of the CEO's remuneration as disclosed in the single-figure table in the company's Remuneration Report with:

- Y25 – the 'pay and benefits' of the UK employee whose pay and benefits is on the 25th percentile of pay and benefits of the company's UK employees for the relevant financial year – this employee is referred to P25;
- Y50 – the 'pay and benefits' of the UK employee whose pay and benefits is on the 50th percentile of pay and benefits of the company's UK employees for the relevant financial year – known as P50; and
- Y75 – the 'pay and benefits' of the UK employee whose pay and benefits is on the 75th percentile of pay and benefits of the company's UK employees for the relevant financial year – known as P75.

What constitutes 'pay and benefits'?

The term 'pay and benefits' means the employee's full-time equivalent pay and benefits, defined by reference to the items in Columns A to E of the single-figure table. Broadly this means:

(a) wages and salary;

(b) all taxable benefits;

(c) annual bonus and deferred bonus payments (where deferral is dependent only on continued employment);

(d) long term incentive payments (including deferred bonus payments) which are dependent on performance conditions relating to a period ending in that year; and

(e) all pension related benefits.

The company can choose to omit any of (b) to (e) when determining Y25, Y50 or Y75 or to calculate any of (b) to (e) differently to how it calculates the equivalent component in the single-figure table, but, if it does, must disclose this. Any omission is likely to increase the pay ratio because those elements cannot be omitted when determining the CEO's annual remuneration.

How are the ratios calculated?

The company can choose one of three prescribed methods to calculate the pay ratio figures. The company must explain why it has chosen the method it has. It may change to a different method in a subsequent year but must explain any such change.

Option A will result in the truest ratio as it does not involve estimates or adjustments but may require more input from payroll. Both Options B and C allow the company to use information which is already available. The flexibility inherent in the three options is to be welcomed – it will allow companies to use, for example, gender pay gap data as the starting point for their calculations if they wish.

Option A requires the company to use actual, up-to-date pay and benefits information to identify the employees who are P25, P50 and P75 and their pay and benefits (ie Y25, Y50 and Y75).

Option B requires the company to use its most recently collected hourly rate gender pay gap data (which may not necessarily have been reported) to identify three employees who are the best equivalents of P25, P50 and P75 and then use available, up-to-date data to calculate their pay and benefits (ie Y25, Y50 and Y75). The company must disclose whether, and if so how, it has relied on estimates or adjustments.

Option C gives the company wider scope as to which data it uses to identify three employees who are the best equivalents of P25, P50 and P75 but the data used must not be more than two years old (and must not be less up-to-date than available gender pay gap data). It can then use available, up-to-date data to calculate their pay and benefits (ie Y25, Y50 and Y75). The company must disclose any methodology used to identify the three employees and any describe any estimates, adjustments, or material assumptions made.

For Options B and C, where data is not available for a particular pay/benefit component, the company may use a reasonable estimate. For all options, the company can choose to determine Y25, Y50, Y75 up to three months in advance of year end by using a projected calculation for salary.

How should the disclosure be set out?

The regulations require the pay ratio figures to be set out in the format below:

Year	Method	25th percentile pay ratio	Median pay ratio	75th percentile pay ratio
[year 1]	[Option A, B or C]	(X/Y25):1	(X/Y50):1	(X/Y75):1
[year 2]	[Option A, B or C]	(X/Y25):1	(X/Y50):1	(X/Y75):1

In addition to pay ratios for the relevant financial year, the table must also include all pay ratios reported in the past ten financial years (including the relevant financial year). In other words, for the fifth year after the legislation comes into effect, the company will need to disclose the pay ratio for that year, together with the relevant ratios for each of the preceding four years.

Summary explanation of pay ratios

As well as publishing the relevant pay ratio calculations, the company is also required to provide an explanation of the following:

- any reduction or increase in the pay ratios compared to those of the previous financial year;
- what this reduction or increase is attributable to (a change in the remuneration of the CEO or the employee population, a change in the employment models being used within the company, a change in method of calculation chosen);
- any trend in the median pay ratio over the period of financial years covered by the pay ratio table; and
- whether, and if so why, the company believes the median pay ratio for the relevant financial year is consistent with the pay, reward and progression policies for its UK employees as a whole.

As a practical matter, given that the CEO's pay arrangements are likely to include a greater proportion of performance related pay, the ratio may fluctuate materially from one year to the next. It seems likely that some form of acceptable explanation of this will develop relatively quickly.

3. Other Remuneration Report changes

There is a new requirement for the annual statement of the remuneration committee chair to summarise any discretion that the committee has exercised when determining the level of directors' pay awards. Many companies have already been making this type of disclosure.

Under the current rules, the remuneration committee has to disclose, in the single-figure table, whether it has exercised any discretion in determining the level of awards under any short-term and long-term incentive schemes. The new obligation requires the company to disclose 'whether the discretion has been exercised as a result of share price appreciation or depreciation'. The purpose of this disclosure is to make it easier for shareholders to understand whether the remuneration committee has properly translated any major changes in share price (whether upwards or downwards) into executive remuneration outcomes. The committee will also have to disclose whether the amount of the award (or an estimate of the amount) under any short-term and long-term incentive schemes is 'attributable to share price appreciation'.

4. Reporting on section 172(1)

Which companies are affected?

Any company that is required to publish a Strategic Report, unless it qualifies as 'medium-sized' under the Companies Act 2006.

What will a company have to report?

A company will have to make a 'section 172(1) statement' in its annual Strategic Report. The statement must describe how the directors have had regard to the matters set out in section 172(1)(a) to (f) when performing their duty under section 172 to promote the success of the company for the benefit of its members.

The section 172(1) statement must be made available with free, unrestricted access on a website maintained by, or on behalf of, the company. Listed companies are already required to publish their annual reports and accounts on a website.

What is a medium-sized company?

Sections 465-467 of the Companies Act 2006 deals with this. Broadly, a company is medium-sized if it meets two of or more of the following criteria: (i) its turnover is not more than £36m; (ii) its balance sheet total is not more than £18m; and (iii) it has no more than 250 employees.

Some companies cannot, however, qualify as medium-sized even if they pass this test. For example, companies that cannot qualify as being medium-sized include public companies, insurance companies and companies that are members of an 'ineligible group'. Any group which contains a traded company (see box above) is ineligible.

Section 172(1) Companies Act 2006

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.

Can a parent company or holding company fulfil the reporting obligation for its subsidiaries?

No. All qualifying companies, including subsidiaries, will need to report. This is the case even where the parent company is required to produce a consolidated 'group strategic report' or 'group directors' report'. In practice, BEIS has said that companies will be able to make cross-references to group statements and policies where appropriate.

FRC guidance on the section 172(1) statement

The FRC is planning to extend its Strategic Report guidance to cover the section 172(1) statement. It published draft changes last year, but later announced that these would be revisited when the scope and detail of the legislation were known. It encouraged boards meanwhile 'to continue to develop their thinking in this critical area'. The timing for the publication of this guidance is not clear.

Listed companies – related changes to the UK Corporate Governance Code

As well as having to make the section 172(1) statement, listed companies may also be affected by related changes to the UK Corporate Governance Code.

The draft Code on which the FRC consulted provided that the board should explain in the Annual Report how it has engaged with the workforce and other stakeholders, and how their interests and the matters set out in section 172 influenced the board's decision-making. It is not yet clear how this part of the Code might be reworded in the light of the new statutory requirements but it is hoped that that final version of the Code will mirror this requirement and that listed companies will not be faced with two similar, but slightly different, disclosure requirements.

The draft guidance on board effectiveness also contains more information about how the views of a wider range of stakeholders might be heard in the boardroom and cross refers to the joint guidance recently issued by ICSA, the Governance Institute and the Investment Association.

5. Reporting on employee engagement

Which companies are affected?

Any company incorporated under the UK Companies Acts – public or private – with more than 250 employees.

What will a company have to report?

UK companies with more than 250 employees must already put in their annual Directors' Report a statement describing the action that has been taken during the financial year to introduce, maintain or develop arrangements aimed at:

- providing employees systematically with information on matters of concern to them as employees;
- consulting employees or their representatives on a regular basis so that the views of employees can be taken into account in making decisions which are likely to affect their interests;
- encouraging the involvement of employees in the company's performance through an employees' share scheme or by some other means; and
- achieving a common awareness on the part of all employees of the financial and economic factors affecting the company's performance.

Under the new legislation, the Directors' Report will also have to summarise:

- how the directors have engaged with employees;
- how the directors have had regard to employee interests, and the effect of that regard, including on the principal decisions taken by the company during the financial year,

but this does not require directors to disclose information about impending developments or matters in the course of negotiation if the disclosure would, in the directors' opinion, be seriously prejudicial to the company's interests. Furthermore, 'employee' does not include any person employed to work wholly or mainly outside the UK.

The company may include this information in the Strategic Report instead of the Directors' Report – for example to sit with the section 172(1) statement – so long as the Directors' Report states that they have done so.

6. Reporting on business relationships

Which companies are affected?

Any company incorporated under the UK Companies Acts – public or private – must make a statement unless it meets two or more of the following criteria: (i) its turnover is not more than £36m; (ii) its balance sheet total is not more than £18m; and (iii) it has no more than 250 employees.

What will a company have to report?

The annual Directors' Report must contain a statement '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'.

Directors do not have to disclose information about impending developments or matters in the course of negotiation if the disclosure would, in the directors' opinion, be seriously prejudicial to the company's interests.

The company may include this information in the Strategic Report instead of the Directors' Report – for example to sit with the section 172(1) statement – so long as the Directors' Report states that they have done so.

Why do the regulations add new employee, customer and supplier reporting requirements to the Directors' Report when these could be covered in the section 172(1) statement?

BEIS has said that this is to make sure that company reports include 'information about these important aspects of the section 172(1) duty even where the directors do not judge the information to be of sufficient strategic importance to be included in the strategic report that year'.

Conclusion

The new legislation will catch a wide range of different companies in different ways. Companies will need to start to consider how they will deal with these new requirements and, specifically, their approach to disclosure. The first actual reporting under the new regulations (assuming they receive the necessary parliamentary approval) will not start until 2020 but will relate to behaviour and conduct in the financial year starting in 2019.

If you would like to discuss any of the points covered in this briefing in more detail, please speak to your usual Freshfields contact.

For information about the Government and Parliamentary consultations and reports that led to this legislation, see our briefings here and here.

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