Debevoise In Depth

UK Corporate Governance Update: New Reporting Requirements and The Wates Principles

17 January 2019

This note is intended for directors of UK private companies. It provides a summary of the new UK corporate governance reporting requirements contained in the Companies (Miscellaneous Reporting) Regulations 2018 (the "Regulations") and an overview of the Wates Principles, a set of new corporate governance principles for large private companies, which interrelate with some of the new reporting requirements.

Executive Summary

The Regulations introduce additional annual reporting requirements for UK companies, depending on the company's size and whether or not it is quoted. "Large" companies (as defined in the Regulations) are required to disclose in their annual strategic report how the directors have considered the factors listed in section 172(1) Companies Act 2006 (the "Act") when carrying out their duty to promote the success of the company. "Very large" companies will need to annually disclose certain information regarding their corporate governance arrangements. It is likely that a number of very large companies will choose to adopt and consider the Wates Principles—which were issued on the same day that the Regulations came into effect—as part of their reporting on corporate governance arrangements, and that other companies may adopt them as they seek to implement emerging best practices.

In addition, the directors' report of "large" companies must include a statement explaining how the directors have considered the need to foster relationships with suppliers, customers, and other third parties, and companies with more than 250 employees will also be subject to additional annual disclosure requirements regarding employee engagement.

The new requirements apply to reporting periods from 1 January 2019, so the first reports will be made in 2020 as part of each company's annual report. This timetable aligns with the Financial Reporting Council's plans for bringing a revised UK Corporate Governance Code (for premium-listed companies) into effect.

Detailed Review

A. Overview of New Requirements

The Regulations introduce new corporate governance reporting requirements for large companies by amending the Act. The new disclosure requirements applicable to a given company are determined by its size and whether it is quoted.

- "Large" companies (see chart for criteria) must include a statement in their strategic report describing how their directors have considered the factors in s172(1) of the Act when carrying out their duty to promote the success of the company. Large companies also must explain in their directors' report how the directors have considered the need to foster relationships with suppliers, customers, and other third parties.

- "Very large" companies (see chart for criteria) must include a statement in their directors' report that either

  - identifies a corporate governance code adopted by the company and explains how that code has been applied or departed from (the "apply or explain" approach), or

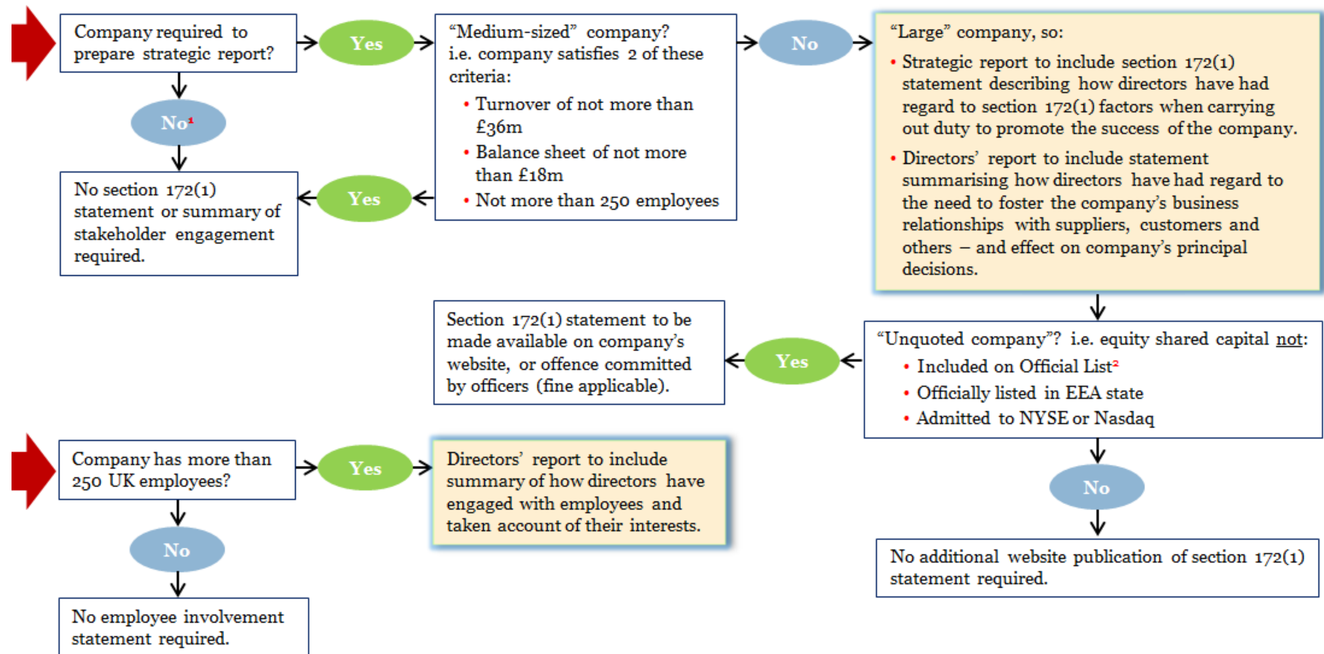
  - if no such code has been adopted, explains the corporate governance arrangements that are in place.

- A company with more than 250 employees must disclose in its directors' report how the directors have engaged with employees and considered its employees' interests throughout the year.

- Quoted companies must publish the ratio of CEO pay to average employee pay and provide additional information on awards to directors.

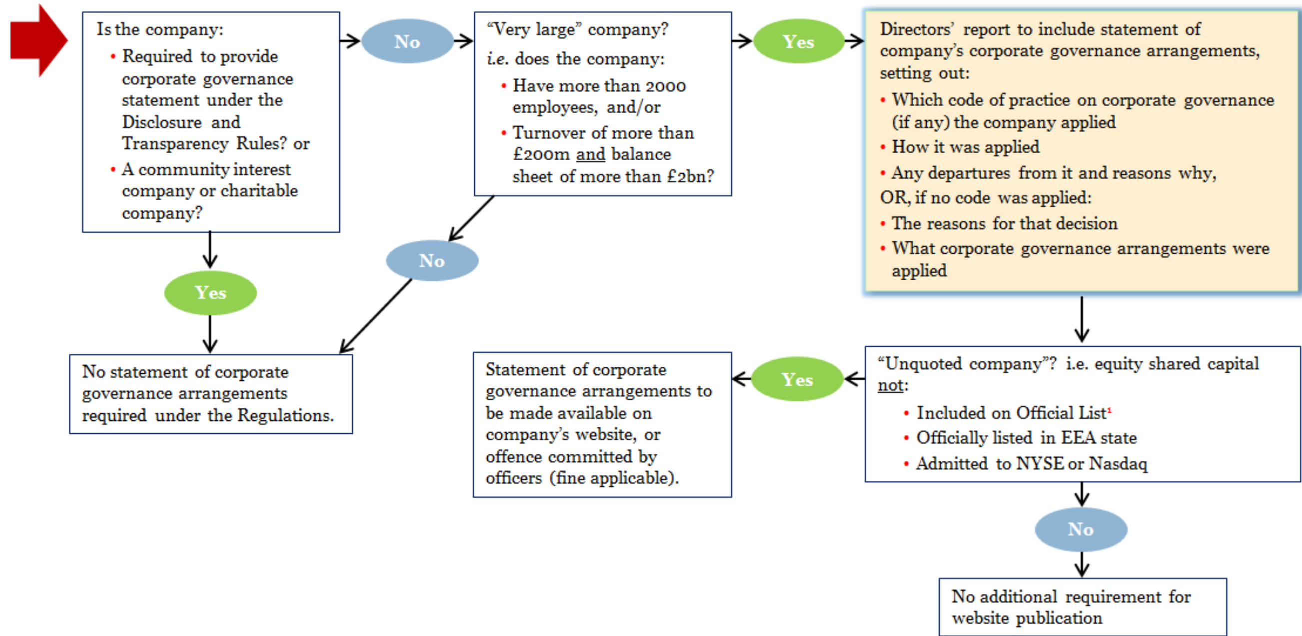
The following diagrams illustrate how the qualifications for the various disclosures are determined.

Section 172(1) Statement and Stakeholder Engagement



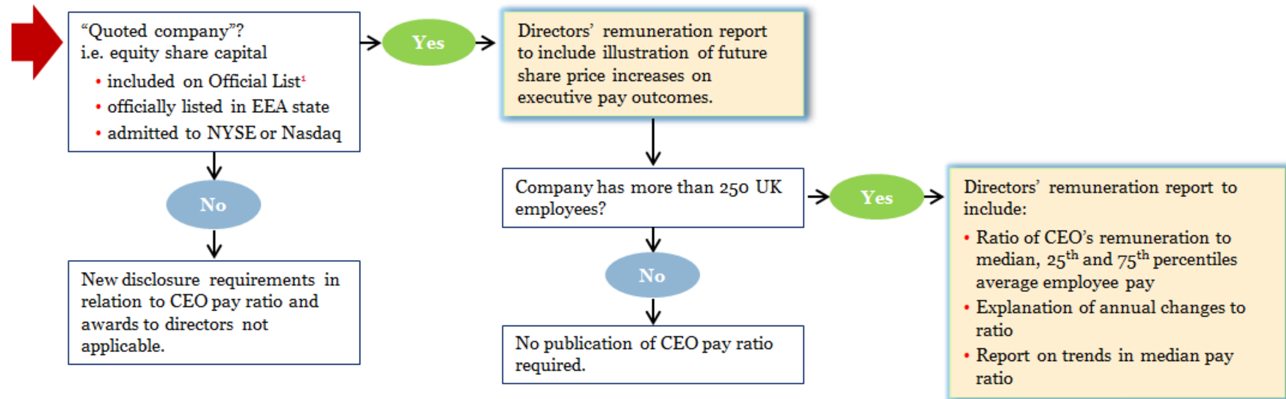
1. *i.e.* falls within small company exemption.
2. *e.g.* companies on AIM or NEX Growth are "unquoted" for these purposes.
3. Note: The Regulations follow the Act when calculating the number of employees, including in circumstances where numbers fluctuate. Guidance on the tests for remuneration disclosures also applies to agency staff, contractors, consultants and staff on zero hours.

Corporate Governance Statement



1 *e.g.* companies on AIM or NEX Growth are "unquoted" for these purposes

Remuneration Disclosures



1 *e.g.* companies on AIM or NEX Growth are considered to be not quoted for these purposes.

B. Role of the Strategic Report and Directors' Report

As noted above, these new disclosures are to be contained within the company's annual strategic or directors' report (and in some cases, on the company's website). For reference, the key features of these reports are as follows:

- Strategic report:
  - Part of company's annual report; separate from the directors' report.
  - All UK-incorporated companies must prepare a strategic report, other than "small" companies.
  - Should include the information necessary for an understanding of the development, performance and position of the business, and of the principal risks it faces.
  - Additional disclosure requirements may apply, depending on the size and type of company.
  - Approved by the board.
  - Noncompliance with the requirements for a strategic report is an offence – director liability.

- Directors' report
  - Part of company's annual report; separate from strategic report.
  - All UK-incorporated companies must prepare a directors' report, other than "small" companies.
  - Should include information about directors (including any indemnities in their favour), dividend recommendation, confirmations on audit information.
  - Additional disclosure requirements may apply, depending on the size and type of company (*e.g.* political donations, likely future developments, R&D, financial instrument risk information, employee involvement).
  - Often also includes statement of directors' responsibility.
  - Approved by the board.
  - Non-compliance with the requirements for a directors' report is an offence – director liability; fine and possible imprisonment depending on type of non-compliance.

C. Section 172(1) Statement

The requirement to produce a section 172(1) statement applies to all UK-incorporated companies if they satisfy at least two of the following criteria:

- turnover of more than £36 million;
- balance sheet total of more than £18 million;
- more than 250 employees.

Such a company is defined as a "large" company and must include a statement in its strategic report describing how the directors have included in their decision-making the factors listed in Section 172(1) when performing their directors' duty to act in the way "most likely to promote the success of the company for the benefit of its members". The non-exhaustive list of factors includes the interests of employees, a decision's likely long-term consequences and its impact on the environment or community and similar issues. While considering such factors in decision-making is not a new requirement, the disclosure of how they have actually been considered is a key change.

Large companies that are also unquoted are also required under the Regulations to publish the section 172(1) statement on their website "as soon as reasonably practicable". It should remain there until, broadly, it is replaced by the statement for the next financial year. Companies may also fulfill this obligation by publishing the entire annual report or the entire strategic report on their website, rather than the statement itself.

What to Include in the Section 172(1) Statement

According to government guidance, companies will need to determine for themselves the level of detail that is appropriate given the company's individual circumstances, but the statement should be "meaningful and informative for shareholders, shed light on matters that are of strategic importance to the company and be consistent with the size and complexity of the business". Companies will probably want to include information on some or all of the following:

- The issues, factors and stakeholders that the directors consider relevant in complying with section 172(1)(a) to (f) and how that determination was made.
- The main methods the directors have used to engage with stakeholders and to understand the factors which they must include in their decision-making.

- The effect of those factors on the company's decisions and strategies during the financial year.

It is important that the section 172(1) statement is provided in a "separately identifiable statement" within the strategic report to give shareholders and stakeholders a clear understanding of the directors' performance of their duties. The Financial Reporting Council is revising its "Guidance on the Strategic Report" to address the section 172(1) statement.

Revisiting Section 172(1)

Section 172(1) of the Act contains what is often viewed in the UK as the most fundamental of a director's duties: the duty to promote the success of the company for the benefit of its members. The section includes a non-exhaustive list of factors to which the directors should have regard when making decisions.

> ***s172 (1) Duty to promote the success of the company***
>
> *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.*

While not frequently seen in trading companies, companies are free to adopt other purposes in their constitutions. For example, a company could choose to include a specific reference to its workforce. Under section 172(2) of the Act, in these circumstances, section 172(1) is read as if "promoting the success of the company for the benefit of its members" were achieving those alternative purposes.

Guidance for Group Companies

Government guidance makes clear that the disclosure requirements apply to all companies that meet the relevant criteria, including subsidiaries. As the guidance notes, "directors of subsidiaries are not puppets of their parent companies". This is the case even when the parent company is required to produce a consolidated group strategic report or group directors' report. The guidance notes that "in practice, decisions and policies affecting employees, the environment, suppliers and so on will often be taken or made at the group level (with directors of each company in the group ensuring when doing so that they are meeting their duties to their respective companies)". Where appropriate, companies may make cross-references to group statements and policies.

If a subsidiary company meets the reporting threshold but the parent does not, and the parent prepares consolidated group accounts, the guidance provides that the parent company needs to publish a section 172(1) statement as part of the group strategic report. The subsidiary must still comply with its separate section 172(1) reporting requirement. This is in line with existing rules requiring subsidiaries to prepare their own strategic report even when their parent produces a group strategic report.

If both parent and subsidiary are individually below the relevant thresholds but, through consolidation, the parent meets the threshold, it will need to produce a section 172(1) statement. This may give greater emphasis to matters significant to the consolidated entities taken as a whole. As the subsidiary falls below the threshold, it does not also need to report.

D. Corporate Governance Statement

The requirement to produce a corporate governance statement applies to UK-incorporated companies that are deemed "very large" companies, defined by the Regulations as either:

- having more than 2,000 employees globally; or
- having both turnover of more than £200 million and total assets of more than £2 billion globally.

A company subject to this disclosure requirement must publish a statement in its annual report and on its website, that:

- identifies a corporate governance code adopted by the company and explains how that code has been applied or departed from (an "apply or explain" approach), or

- if no such code has been adopted, explains the corporate governance arrangements that are in place.

Government guidance explicitly states that there is no preferred corporate governance code and that companies can choose the most appropriate code for them.

Companies that are "very large" and unquoted also have an obligation under the Regulations to publish the corporate governance statement on their website "as soon as reasonably practicable". It should remain there until, broadly, it is replaced by the statement for the next financial year.

What to Include in the Corporate Governance Statement

According to government guidance, companies will be expected to provide sufficient information to explain their corporate governance arrangements. For example, companies choosing to adopt the Wates Principles as their corporate governance code should provide a short supporting statement for each principle explaining how it has been applied to achieve better outcomes.

"Corporate Governance" under the Regulations

The definition of corporate governance under the Regulations is fairly broad:

> ***"Corporate governance"****, in relation to a company means—*
>
> *(a) the nature, constitution or functions of the organs of the company,*
>
> *(b) the manner in which organs of the company conduct themselves,*
>
> *(c) the requirements imposed on organs of the company,*
>
> *(d) the relationship between different organs of the company, and*
>
> *(e) the relationship between the organs of the company and the members of the company.*

Guidance for Group Companies and Companies whose Size Fluctuates

In relation to group companies, the guidance notes that:

- Every company meeting the qualifying thresholds must comply with the new corporate governance reporting requirement, including subsidiaries. This includes subsidiaries of listed companies required to meet the UK Corporate Governance Code and subsidiaries of parent companies who prepare a consolidated group directors' report.

- Under the Act, directors' duties are owed to their company, not to the parent company, and the corporate governance statement needs to be prepared from the perspective of the subsidiary company and its directors.

- The structure of subsidiary companies and their relationships with parent companies differ widely. Some subsidiaries, such as those within a conglomerate, can be distinct and run largely independently. Others can be part of a more integrated and cohesive group structure. In practice, therefore, the detail of what companies report will depend on their circumstances.

This reasoning is the same by which a subsidiary of a premium listed company covered by the UK Corporate Governance Code also has to prepare a corporate governance statement. However, in certain circumstances it would be possible for a subsidiary to state that it did not adopt a code because its parent applied the UK Corporate Governance Code throughout the group. But even in this case, the subsidiary would still need to explain how the Code applies to its governance arrangements and its directors.

In circumstances where a subsidiary company meets the qualifying conditions but not the parent, and the parent prepares consolidated group accounts, the parent company does not need to publish a corporate governance statement as part of the group directors' report.

Government guidance for companies whose size varies from year to year above and below the relevant qualifying thresholds notes that the Regulations include a "smoothing provision" to address this situation. It provides for a two-year time lag before a company either drops out of, or is covered again, by the requirement.[1]

E. The Wates Principles

As noted above, the entering into force of the Regulations on 10 December 2018 coincides with the publication of the Wates Corporate Governance Principles for Large Private Companies (the "Wates Principles"). The Wates Principles are particularly relevant for companies required to include a corporate governance statement in their annual report. It is likely that many of the companies required to produce such a statement will choose to adopt the Wates Principles for this purpose; in his foreword,

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[1] For example, if a company has more than 2000 employees in the first year of reporting, it will have to report in both that year and in the second year even if it has fewer than 2000 employees in the second year. If in the third year the company still has fewer than 2000 employees, it will not have to report (although may choose to do so voluntarily).

Similarly, if a company has fewer than 2000 employees in the first year of reporting, it will not be required to report in that year or in the second year even if it has more than 2000 employees in the second year. If the company still has more than 2000 employees in the third year, however, it will be required to report.

James Wates notes the hope that other companies who are below the reporting threshold will also adopt the Wates Principles (as appropriate) as a matter of good governance and best practice.

The Wates Principles recognise that corporate governance should not be a "one-size-fits-all" endeavor, given the broad range of UK companies. Instead, the Wates Principles take a high-level approach, with six principles and more detailed guidance for each. An "apply and explain" approach is encouraged, whereby a supporting statement for each principle would be included in the company's directors' report (and website) explaining how the company's corporate governance processes operate and achieve desired outcomes.

The UK's Trades Union Congress was involved in the consultation prior to publication, and perhaps as a result, there is a focus in the Wates Principles on employees as key stakeholders to be engaged by companies. There is some debate regarding possible tension with directors' strict company law duties—broadly, the creation of shareholder value—and some concern around the potential to cause confusion.[2]

The six principles are set out below, with the guidance for each principle included in Annex B.

1. **Purpose and Leadership:** An effective board promotes the purpose of a company, and ensures that its values, strategy and culture align with that purpose.

2. **Board 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.

3. **Director Responsibilities:** The board and individual directors should have a clear understanding of their accountability and responsibilities. The board's policies and procedures should support effective decision-making and independent challenge.

4. **Opportunity and Risk:** A board should promote the long-term sustainable success of the company by identifying opportunities to create and preserve value, and establishing oversight for the identification and mitigation of risks.

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[2] *Note*: The Wates Principles includes the following explanation in its introduction:
"***Nothing in the Wates Principles overrides or is intended as an interpretation of directors' duties as set out in the Companies Act 2006****. The duties of directors are set out in sections 170-177. These include, in section 172, the duty of a director to promote the success of the company for the benefit of its members as a whole. This duty applies to all directors, regardless of whether the company is public or private, a parent or a subsidiary, large or small.*"

5. **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.

6. **Stakeholder Relationships and Engagement:** Directors should foster effective stakeholder relationships aligned to the company's purpose. The board is responsible for overseeing meaningful engagement with stakeholders, including the workforce, and having regard to their views when taking decisions.

F. The QCA Code: An Alternative

As noted above, the requirement of the corporate governance statement is to identify which corporate governance code (if any) the company has adopted. While the expectation is that many companies will choose to adopt the Wates Principles for this purpose, it is not compulsory to do so. In fact, other corporate governance codes may be more appropriate, depending on the size and nature of the company. For example, the QCA code, drafted by the Quoted Companies Alliance, is designed for smaller and mid-sized quoted companies (such as AIM-listed companies) but may be adopted by any company.[3] We consider it here as a point of comparison with the Wates Principles (see Annex A for a side-by-side examination of the two codes).

As might be expected, while the Wates Principles are employee-centric, the QCA Code is shareholder/investor driven, and aims to be proportionate, flexible and pragmatic. The QCA Code also has a focus on disclosures, since "good corporate governance will not be complete until it has been adequately communicated and reported to shareholders and other stakeholders."

Like the Wates Principles, the QCA Code is principles-based with additional guidance to help companies meet the principles and make appropriate disclosures. The ten QCA Code Principles are set out below. The guidance for each principle is included in Annex C.

Deliver growth

1. Establish a strategy and business model which promote long-term value for shareholders

2. Seek to understand and meet shareholder needs and expectations

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[3] Other corporate governance codes that can be considered include the New UK Corporate Governance Code (designed for premium-listed companies) and South Africa's King Code (IV).

3. Take into account wider stakeholder and social responsibilities and their implications for long-term success

4. Embed effective risk management, considering both opportunities and threats, throughout the organisation

Maintain a dynamic management framework

5. Maintain the board as a well-functioning, balanced team led by the chair

6. Ensure that between them the directors have the necessary up-to-date experience, skills and capabilities

7. Evaluate board performance based on clear and relevant objectives, seeking continuous improvement

8. Promote a corporate culture that is based on ethical values and behaviours

9. Maintain governance structures and processes that are fit for purpose and support good decision-making by the board

Build trust

10. Communicate how the company is governed and is performing by maintaining a dialogue with shareholders and other relevant stakeholders.

G. Looking Forward

It remains to be seen whether the new requirements will lead to substantive improvements in corporate governance. In any event, they will certainly increase reporting requirements for private companies and seem likely to re-focus some boards on the importance of a structured approach to governance and wider stakeholder engagement.

Please do not hesitate to contact us with any questions.

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Annex A: Wates Principles vs. QCA Code

The concepts addressed in each are broadly similar, but with an emphasis on different stakeholders—employees in Wates, shareholders in QCA.

Topic	Wates Principle	QCA Code Principle	Key Differences
Strategy	1 – Purpose and Leadership	1 – Strategy/Business model	QCA: greater emphasis on value for shareholders
Shareholder needs	N/A	2 – Shareholder needs	WP: does not specifically address
Stakeholders, social responsibilities and communication	6 – Stakeholder Relationships and Engagement	3 – Stakeholder and social responsibilities 10 – Dialogue with shareholders and others	WP: greatest emphasis on employees QCA: feedback from shareholders crucial
Risk and opportunities	4 – Opportunity and risk	4 – Embed risk management	
The Board	2 – Board Composition	5 – Well-functioning and balanced board led by chair 6 – Skills, experience, capabilities 7 – Evaluation/improvement	WP: draws out same concepts in guidance
Culture and values	1 – Purpose and Leadership	8 – Culture and ethical values	
Governance structure	3 – Director Responsibilities	9 – Fit for purpose governance	QCA: proportionality emphasised in guidance

Annex B: Wates Principles Guidance

1. **Purpose and Leadership** – An effective board develops and promotes the purpose of a company, and ensures that its values, strategy and culture align with that purpose.

   - A well-developed and defined purpose will help companies of all sizes and structures articulate their business model and develop their strategy, operating practices, workforce,[4] and approach to risk.

   - All directors should promote the success of the company. Boards should have a clear understanding of the views of shareholders including those with a minority interest. Directors should act with integrity and lead by example, setting the tone from the top, building positive relationships with all stakeholders, particularly the workforce.

   - Effective boards ensure that the company operates with a clear sense of purpose and collective vision. To promote this, boards will appreciate the importance of dialogue with the workforce and wider stakeholders around the company's stated purpose and be proactive in ensuring that it takes place. Effective boards are able to demonstrate how the sharing of this purpose has informed the decision-making process to achieve long-term sustainable success.

   - A company's purpose and values should inform expected behaviours and practices throughout the organisation. The values should be explained and integrated into the different functions and operations of the business. This may include internal assurance, employment practices, risk management and compliance functions.

   - A healthy culture is critical to the company's competitive advantage, and vital to the creation and protection of long-term value. Culture can be defined as a combination of the values, attitudes and behaviours manifested by a company in its operations and relationships with its stakeholders. The board, shareholders and management must make and maintain a commitment to embedding the desired culture throughout the organisation.

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[4] Note: 'Workforce' will involve those with formal contracts of employment (permanent, fixed-term and zero-hours) and other members of the workforce who are affected by the decisions of the board, so for example companies should consider including individuals engaged under contracts of service, agency workers and remote workers. Companies should be able to explain who they have included and why. The term is not meant to align with a legal definition of employee, worker or similar.

- Effective ways of monitoring culture include (but are not limited to) employee surveys, engagement with trade unions, absenteeism rates, exit interviews and board feedback sessions.

- An effective board develops a strategy and business model to generate long-term sustainable value. It is responsible for ensuring that its strategy is clearly articulated and implemented throughout the organisation, and that it, along with the company values, supports appropriate behaviours and practices.

- The board should lead on the establishment of transparent policies in relation to raising concerns about misconduct and unethical practices; such polices should include effective review processes.

- The board manages conflicts of interest and a balance should be struck between short-term targets or needs, and long-term aspirations.

2. **Board 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.

    - The chair leads the board and is responsible for its overall effectiveness, promoting open debate and facilitating constructive discussion. The chair should ensure that all directors have appropriate information and sufficient time is made available for meaningful discussion.

    - Consideration should be given to separating the roles of the chair and chief executive to ensure a balance of power and effective decision-making.

    - The board should collectively demonstrate a high-level of understanding relevant to the company's business needs and stakeholder interests.

    - Appointments to the board should promote diversity in line with the protected characteristics within the Equalities Act 2010. An effective board should be able to demonstrate that there has been a considered effort to establish an appropriate balance of expertise, diversity and objectivity.

    - A policy on diversity and inclusion aligned to company strategy can support appointments to the board and succession planning. Such a policy should

also consider targets and aspirations promoted by Government and industry initiatives or expert reviews.[5]

- A board should give careful consideration to its size and structure so that it is appropriate to meet the strategic needs and challenges of the organisation and enables effective decision-making.

- Companies should consider the value of appointing independent non-executive directors to offer constructive challenge. Appointment of independent non-executive directors should be subject to a transparent procedure. Boards may wish to delegate some functions to committees which can consider specific issues such as risk or remuneration; however, this will be dependent on structure, complexity and size of the company.

- The closely held nature of ownership within many large private companies means directors are often required to maintain objectivity in complex situations, in particular when there is an influential shareholder.

- Companies should demonstrate a commitment to the ongoing professional development of their board, and directors should embrace such opportunities and ensure that they have sufficient time to discharge their duties.

- Regular evaluation of the board can help individual directors to contribute effectively and highlight the strengths and weaknesses of the board as a whole. The chair should act on the recommendations of such evaluations. This approach may be part of board refreshment and succession plans.

3. **Director Responsibilities** – The board and individual directors should have a clear understanding of their accountability and responsibilities. The board's policies and procedures should support effective decision-making and independent challenge.

    - An effective board should establish and maintain corporate governance practices that provide clear lines of accountability and responsibility to support effective decision-making.

    - Clear corporate governance policies, practices and company leadership, all working together, promote effective stewardship to deliver long-term value.

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[5] Note: The Hampton-Alexander Review and The McGregor-Smith Review are examples of reviews that promote diversity targets.

- A company should set out policies and practices that govern the internal affairs of the company. These include matters relating to the authority, accountability, role and conduct of directors, and may include specific information relating to shareholders, such as shareholder agreements and protection of minority shareholders.

- Conflicts of interest can arise and compromise objective decision-making. In such cases the board should agree and set out how such conflicts should be identified and managed.

- The chair and the company secretary should periodically review the governance processes to confirm that they remain fit for purpose and consider any initiatives which could strengthen the governance of the company.

- Transparent corporate governance policies and practices can clarify the relationship between the company and its owners, including that of a parent company and its subsidiary in order to deliver long-term sustainable success.

- A board may make use of committees to help with the consideration of matters such as financial reporting, risk, succession and remuneration. The terms of each committee should be set out including authorities delegated to it. A board retains responsibility for any final decisions.

- The provision of independent challenge in board and committee decision-making should mitigate the risk of individuals having unfettered powers. Independent challenge encourages constructive problem-solving that benefits companies in the long term.

- A board should establish formal and robust internal processes to ensure systems and controls are operating effectively, and that the quality and integrity of information provided to it is reliable, enabling directors to monitor and challenge the performance of the company, and make informed decisions.

- A board may rely on a broad range of information sources, including, but not limited to::

  - financial reporting;

  - key performance indicators;

  - workforce data;
  - environmental data;
  - stakeholder engagement feedback; and
  - consumer data.
- Board papers and supporting information should:
  - be accurate, clear, comprehensive and up to date;
  - contain a summary of the contents of any paper;
  - inform the director what is expected of them on each issue; and
  - be issued in good time.

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

    - A board should consider and assess how the company creates and preserves value over the long term. This requires boards to consider both tangible and intangible sources of value, and the stakeholders that contribute to it.

    - This should include processes for the identification of future opportunities for innovation and entrepreneurship. Such opportunities may often be dependent on an agreed risk appetite and the company's long-term strategy and prospects. It may also include processes for ensuring that new business opportunities of a certain value are considered and approved at board level.

    - A board has responsibility for an organisation's overall approach to strategic decision-making and effective risk management (financial and non-financial), including reputational risk. This requires oversight of risk and how it is managed, and appropriate accountability to stakeholders.

    - The size and nature of the business will determine the internal control systems put in place to manage and mitigate both emerging and principal

risks.[6] Some companies may decide to delegate to a committee to oversee such matters.

- The board should establish an internal control framework with clearly defined roles and responsibilities for those involved. It should agree an approach to reporting, including frequency of reporting and the points at which decisions are made and escalated. Responsibilities may include:

  – developing appropriate risk management systems that identify emerging and established risks facing the company and its stakeholders. Such systems should enable the board to make informed and robust decisions, including those associated with material environmental, social and governance matters, such as climate change, workforce relationships, supply chains, and ethical considerations;

  – determining the nature and extent of the principal risks faced and those risks which the organisation is willing to take in achieving its strategic objectives (determining its 'risk appetite');

  – agreeing how the principal risks should be managed or mitigated and over what timeframe to reduce the likelihood of their incidence or the magnitude of their impact;

  – establishing clear internal and external communication channels on the identification of risk factors, both internally and externally; and

  – agreeing a monitoring and review process.

5. **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.

   - Appropriate and fair levels of remuneration help companies to secure and retain high-quality directors, senior management and their workforce. Remuneration for directors and senior managers should be aligned with performance, behaviours, and the achievement of company purpose, values and strategy. In setting director and senior manager remuneration consideration should be given to remuneration throughout the organisation to reinforce a sense of shared purpose.

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[6] Note: Description of principal risks is set out in the FRC's Guidance on the Strategic Report.

- The board should establish clear policies on remuneration structures and practices which should enable effective accountability to shareholders. This should take account of the broader operating context, including the pay and conditions of the wider workforce and the company's response to matters such as any gender pay gap.

- Such accountability can be supported by clear remuneration structures that are aligned with the company's purpose, values and culture, and the delivery of strategy to support long-term sustainable success. Policies may include robust consideration of the reputational and behavioural risks to the company that can result from inappropriate incentives and excessive rewards.

- Boards should consider the benefits of greater transparency of remuneration structures and policies which will build trust from wider stakeholders. Additional transparency could extend to commenting on how executive remuneration reflects general practice within the sector or voluntary disclosure of pay ratios.

- The establishment of a committee is a way some boards may wish to delegate responsibility for designing remuneration policies and structures for directors and senior management. Such a committee might benefit from the contribution of an independent non-executive director.

- In some companies, director pay will be controlled by a parent company, and in such circumstances the subsidiary should explain this and cross-refer to information available elsewhere which explains the policy in relation to the subsidiary.

6. **Stakeholder Relationships and Engagement** – Directors should foster effective stakeholder relationships aligned to the company's purpose. The board is responsible for overseeing meaningful engagement with stakeholders, including the workforce, and have regard to that discussion when taking decisions.

    - Large private companies create their own social, economic and environmental impact, but are also affected by changes to their operating environment. Sustainable business benefits wider society, and large private companies have a responsibility to create and sustain long-term value for their shareholders and stakeholders. This includes consideration of how a company's activities may impact both current and future stakeholders, which, for example, could include impacts on the environment.

- Dialogue with stakeholders helps boards understand the effects of company policies and practices, predict future developments and trends, and realign strategy. A company should identify and prioritise stakeholder relationships for those affected by company operations and are integral to its ability to generate and preserve value. These are likely to vary dependent on the size and nature of the company.

- Stakeholders include the workforce, customers and suppliers, but also other material stakeholders specific to company circumstances or sectors, such as regulators, Governments, pensioners, creditors and community groups.

- The board should present to stakeholders a fair, balanced and understandable assessment of the company's position and prospects and make this available on an annual basis.

- Boards should ensure that there are channels to receive appropriate feedback from discussions with stakeholders. When explaining impact on the community or environment, boards may want to refer to recognised international standards or frameworks that it follows.

- For many large private companies, their largest material stakeholder group is their workforce. Companies should develop a range of formal and informal channels that enable them to engage in meaningful two-way dialogue, enabling the workforce to share ideas and concerns with senior management. This might include engagement with trade unions, focus or consultative groups. Such forms of engagement provide useful feedback about business practices and can support the desired culture.

- Workforce policies and practices should be aligned with the company's purpose and values. Such policies should establish clear procedures for raising concerns (for example, speak up and whistleblowing policies), and should be reviewed regularly to ensure that they are effective.

- A board should demonstrate how the company has undertaken effective engagement with material stakeholders and how such dialogue has been considered in its decision-making.

- Companies may also wish to comment on any good practice which may have emerged and contributed to the success of the company.

- Explanations in support of applying this Principle will be closely aligned to other disclosure requirements of the Regulations (section 172 reporting, and

reporting on workforce engagement). Additional guidance on how to meet these requirements can be found in the FRC's *Guidance on the Strategic Report* , including sections 8.14 - 8.22.

Annex C: QCA Code Guidance (Application)

1. Establish a strategy and business model which promote long-term value for shareholders

   - The board must be able to express a shared view of the company's purpose, business model and strategy. It should go beyond the simple description of products and corporate structures and set out how the company intends to deliver shareholder value in the medium to long term. It should demonstrate that the delivery of long-term growth is underpinned by a clear set of values aimed at protecting the company from unnecessary risk and securing its long-term future.

2. Seek to understand and meet shareholder needs and expectations

   - Directors must develop a good understanding of the needs and expectations of all elements of the company's shareholder base.

   - The board must manage shareholders' expectations and should seek to understand the motivations behind shareholder voting decisions.

3. Take into account wider stakeholder and social responsibilities and their implications for long-term success

   - Long-term success relies upon good relations with a range of different stakeholder groups both internal (workforce) and external (suppliers, customers, regulators and others). The board needs to identify the company's stakeholders and understand their needs, interests and expectations.

   - Where matters that relate to the company's impact on society, the communities within which it operates or the environment have the potential to affect the company's ability to deliver shareholder value over the medium to longterm, then those matters must be integrated into the company's strategy and business model.

   - Feedback is an essential part of all control mechanisms. Systems need to be in place to solicit, consider and act on feedback from all stakeholder groups.

4. Embed effective risk management, considering both opportunities and threats, throughout the organisation

    - The board needs to ensure that the company's risk management framework identifies and addresses all relevant risks in order to execute and deliver strategy; companies need to consider their extended business, including the company's supply chain, from key suppliers to end-customer.

    - Setting strategy includes determining the extent of exposure to the identified risks that the company is able to bear and willing to take (risk tolerance and risk appetite).

5. Maintain the board as a well-functioning, balanced team led by the chair

    - The board members have a collective responsibility and legal obligation to promote the interests of the company, and are collectively responsible for defining corporate governance arrangements. Ultimate responsibility for the quality of, and approach to, corporate governance lies with the chair of the board.

    - The board (and any committees) should be provided with high-quality information in a timely manner to facilitate proper assessment of the matters requiring a decision or insight.

    - The board should have an appropriate balance between executive and non-executive directors and should have at least two independent non-executive directors. Independence is a board judgement.

    - The board should be supported by committees (*e.g.* audit, remuneration, nomination) that have the necessary skills and knowledge to discharge their duties and responsibilities effectively.

    - Directors must commit the time necessary to fulfill their roles.

6. Ensure that between them the directors have the necessary up-to-date experience, skills and capabilities

    - The board must have an appropriate balance of sector, financial and public markets skills and experience, as well as an appropriate balance of personal qualities and capabilities. The board should understand and challenge its own diversity, including gender balance, as part of its composition.

- The board should not be dominated by one person or a group of people. Strong personal bonds can be important but can also divide a board.

- As companies evolve, the mix of skills and experience required on the board will change, and board composition will need to evolve to reflect this change.

7. Evaluate board performance based on clear and relevant objectives, seeking continuous improvement

   - The board should regularly review the effectiveness of its performance as a unit, as well as that of its committees and the individual directors.

   - The board performance review may be carried out internally or, ideally, externally facilitated from time to time. The review should identify development or mentoring needs of individual directors or the wider senior management team.

   - It is healthy for membership of the board to be periodically refreshed. Succession planning is a vital task for boards. No member of the board should become indispensable.

8. Promote a corporate culture that is based on ethical values and behaviours

   - The board should embody and promote a corporate culture that is based on sound ethical values and behaviours and use it as an asset and a source of competitive advantage.

   - The policy set by the board should be visible in the actions and decisions of the chief executive and the rest of the management team. Corporate values should guide the objectives and strategy of the company.

   - The culture should be visible in every aspect of the business, including recruitment, nominations, training and engagement. The performance and reward system should endorse the desired ethical behaviours across all levels of the company.

   - The corporate culture should be recognisable throughout the disclosures in the annual report, website and any other statements issued by the company.

9. Maintain governance structures and processes that are fit for purpose and support good decision-making by the board

    - The company should maintain governance structures and processes in line with its corporate culture and appropriate to its:

        – size and complexity; and

        – capacity, appetite and tolerance for risk.

    - The governance structures should evolve over time in parallel with its objectives, strategy and business model to reflect the development of the company.

10. Communicate how the company is governed and is performing by maintaining a dialogue with shareholders and other relevant stakeholders

    - A healthy dialogue should exist between the board and all of its stakeholders, including shareholders, to enable all interested parties to come to informed decisions about the company.

    - In particular, appropriate communication and reporting structures should exist between the board and all constituent parts of its shareholder base. This will assist:

        – the communication of shareholders' views to the board; and

        – the shareholders' understanding of the unique circumstances and constraints faced by the company.

    - It should be clear where these communication practices are described (annual report or website).