Association of Accounting Technicians response to the FRC consultation on a revised Corporate Governance Code

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1. Introduction

1.1. The Association of Accounting Technicians (AAT) is pleased to have the opportunity to respond to the consultation paper on a revised Corporate Governance Code dated 5 December 2017.

1.2. AAT is submitting this response on behalf of our membership and for the wider public benefit of achieving sound and effective administration of taxes.

1.3. AAT has added comment to add value or highlight aspects that need to be considered further.

1.4. AAT has focussed on the operational elements of the proposals and has provided opinion on the practicalities of implementing the measures outlined.

1.5. Furthermore, the comments reflect the potential impact that the proposed changes would have on SMEs and micro-entities, many of which employ AAT members or would be represented by AAT's 4,250 licensed accountants.

2. Executive summary

2.1. **AAT agrees that nine years, as applied to non-executive directors and chairs, is probably an appropriate time to be considered independent but does not agree with the decision not to apply maximum periods of tenure.** If a NED or Chair is no longer independent, they should be removed.

2.2. **The Public Register for FTSE All-Share companies who have received significant shareholder opposition to proposed resolutions is far from sufficient.** As a result, questions asking whether 20 per cent is 'significant' and that an update should be published no later than six months after the vote are largely irrelevant.

2.3. **AAT agrees that the Hampton-Alexander recommendations should be extended beyond the FTSE 350 to the FTSE All-Share and that reporting on ethnicity levels should mirror these requirements.**

2.4. **Although the requirement to publish pay ratios will aid transparency and act as a useful assessment tool, it will do almost nothing to curb excessive executive pay.** A clear majority of AAT members believe the time has come for a mandatory pay ratio to be imposed as at companies like the John Lewis Group (a 75:1 pay ratio). The AAT Corporate Governance survey (2017) found that 41% of AAT members want an across the board pay ratio of 20:1. This compares to 0% who felt the current average FTSE 100 pay ratio was appropriate and a mere 7% who believe there should be no pay ratio at all.

3. AAT response to the consultation paper

3.1. The following paragraphs outline AAT's response to the 16 Corporate Governance Code questions outlined in the consultation paper.

1. Do you have any concerns in relation to the proposed Code application date?

1.1. AAT is concerned that the lengthy duration of making improvements to the code will negatively impact upon companies, investors and the public but simultaneously accepts the need to get this right, to ensure companies have sufficient time to understand the changes and adequately prepare for their implementation.

1.2. As a result, publishing a final version of the Code by early Summer 2018, to apply to accounting periods beginning on or after 1 January 2019 does not seem unreasonable.

2. Do you have any comments on the revised Guidance?

AAT does not have any specific comments on the revised Guidance other than to welcome the decision to move some elements of the Code to the Guidance.

3. Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?

3.1. No. The AAT response to the Government Green Paper on Corporate Governance last year [1] highlighted that the original proposals to improve the way employees' views are taken into account at board level in large UK companies were very small steps in the right direction but that , *"requiring employee representation on boards as originally implied would be preferable as this is likely to bring about better alignment of employer/employee interests, could lead to increased productivity and help to bring about greater public confidence in big business."*

3.2. The AAT Corporate Governance Survey (2017) found some AAT member support for the creation of stakeholder advisory panels (11%) that an existing NED should be responsible for ensuring employee and customer voices are considered (23%) that individual stakeholder representatives should be appointed to boards (19%) and that reporting requirements relating to stakeholder engagement should be strengthened (26%).

3.3. However, the greatest level of support was for these proposals to be adopted **together** (50%) not for companies to pick and choose as has been recommended.

4. **Do you consider that we should include more specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance?**

4.1. The UN SDGs are very important and those on gender equality, reducing inequality and responsible production are particularly important in relation to Corporate Governance. However, including additional detail on UN SDGs either in the Code or in the Guidance will make what are arguably already overly lengthy documents even longer.

4.2. As a result, a single sentence suggesting that all companies should "*have regard to the UN SDGs*" in the guidance would probably suffice, especially given Principle A already states that, *"A successful company is led by an effective and entrepreneurial board, whose function is to promote the long-term sustainable success of the company, generate value for shareholders and contribute to wider society."*

5. Do you agree that 20 per cent is 'significant' and that an update should be published no later than six months after the vote?

5.1. At the Prime Ministers instigation, the world's first public register of companies that ignore shareholder concerns and award pay rises to bosses that outstrip the company's performance was published by the Investment Management Association in December 2017.

5.2. The register lists those companies who have suffered shareholder votes of 20% or more against pay and other policies.

5.3. Government stated that this register would help to tackle the "*abuses and excess in the boardroom*" and "*restore public confidence*" in big business.

5.4. It was obvious when announced that, whilst a miniscule step in the right direction, it clearly wouldn't help tackle abuses or restore public confidence. It is immensely frustrating that the solution favoured by a clear majority of AAT members and the public at large – to impose a pay ratio – has again been completely ignored.

5.5. Almost a quarter of FTSE All-Share companies appeared on the list and save for a day or two of negative publicity, which was quickly forgotten - and could arguably be said to have damaged public confidence rather than restore it - it has had no discernible impact on company behaviour and is very unlikely to in the future.

[1] https://www.aat.org.uk/prod/s3fs-public/assets/Corporate-Governance-Reform.pdf

5.6. AAT does not believe the register is significant, that publishing updates - whether a month, three months or six months - after a vote is meaningful and that having a 10, 20 or 30 per cent figure is therefore immaterial.

5.7. Companies like Pendragon, Safestore or Entertainment One who were listed in the register as respectively having 45%, 49% and 47% of shareholders vote against their remuneration policy and similarly high opposition to their share scheme policy, are not going to suddenly alter their behaviour simply because they must publish a couple of sentences of explanation within a few months of such votes.

6. **Do you agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years? If not, please provide information relating to the potential costs and other burdens involved.**

6.1 AAT agrees with the removal of the exemption in principle because independent board evaluation can provide invaluable feedback for organisations and, in some cases, lead to significant improvements in Corporate Governance as well as in overall organisational effectiveness.

6.2. The value many FTSE 350 companies clearly derive from such evaluation is partly demonstrated by the many companies who undertake independent board evaluation either on an annual basis or every other year, rather than simply meeting the minimum obligation to be evaluated every three years. Likewise some smaller listed companies already undertake independent board evaluation as they realise there is merit in doing so.

6.3. Before removing the exemption it would of course be sensible to carefully examine the potential costs that removing the exemption could impose.

6.4. The costs involved in undertaking such an evaluation every three years are inconsequential to a FTSE 100 or FTSE 250 company but they may well prove substantial to a small listed company as they can range from anything between £10 -£100,000. It is likely that the costs for evaluating a smaller company would be at the lower end and an increase in the customer base is also likely to provide an increase in those providing evaluation services, and consequent competition on price.

6.5. It may be worth considering introducing a requirement for companies to report the cost of the evaluation. This additional transparency may have some impact on pressuring evaluation firms to further reduce costs, would limit the amount listed companies pay as they would be able to see comparative costs and if the costs are proving prohibitive then the exemption could be reviewed in three years-time once a wide range of cost data has been collected.

6.6. Whilst it is important to note the considerations at 6.3-6.5, AAT would like to stress that price considerations should not be the overriding factor given the benefits and value that could be gained from effective evaluation as indicated at 6.1 and 6.2 above.

7. **Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?**

7.3. According to research from Spencer Stuart[2], when examining Board tenure across 18 countries, the average tenure of a Board director in the UK was four years, with only Poland (three years) having a lower average. In contrast, the highest average was nine years (Peru).

7.4. This would suggest that for most organisations in the UK, the question of independence after nine years will not be a significant problem.

7.6. Given the link between independence and maximum term limits (see 8.1-8.6) it would appear to be a reasonable time limit for board members in the UK because nine years should be the maximum limit of tenure too.

[2] Spencer Stuart https://www.spencerstuart.com/research-and-insight/boards-around-the-world

8. Do you agree that it is not necessary to provide for a maximum period of tenure?

8.1. AAT does not agree. If a NED or Chair is no longer independent (and the suggestion is that they will not be after nine years) then they should be removed once they have served nine years.

8.2. Lengthy tenure can prevent board up-skilling, diversification and general board refreshment but many boards are incapable of addressing this problem themselves because of self-interest.

8.3. In the US, although 50% of S&P 500 companies have imposed term limits of fifteen years and 29% have limits of twelve years, the average time spent on boards of S&P 500 companies was nine years in 2016 and the median was seven and a half years[3].

8.4. This suggests that many board members know when it is time to go but for those that don't regulation can provide a very useful backstop.

8.5. An enforceable maximum period of tenure would provide some companies with the necessary cover to take action i.e. where they would ideally like to refresh the board but entrenched individuals are keen to continue, they can state with confidence that they are legally obliged to replace the board member after nine years has passed.

8.6. Imposing maximum term limits has also worked well in other countries e.g. Hong Kong and Singapore where nine years has been adopted as the maximum term limit for Board Directors.

9. Do you agree that the overall changes proposed in Section 3 of revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

9.1. This is likely to encourage more companies to build diversity in the boardroom but it will not ensure this happens across the board because there is a failure to provide for a maximum period of tenure.

9.2. This omission will ensure that companies who already ignore encouragement in this area will likely to continue to do so.

9.3. The FRC should therefore provide for a maximum period of tenure as happens in many other countries.

10. Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not, please provide information relating to the potential costs and other burdens involved.

10.1. Yes, AAT agrees that this should be extended beyond the FTSE 350 to the FTSE All-Share Index and believes that this should have occurred at the outset.

11. What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relating to the practical implications, potential costs and other burdens involved, and to which companies it should apply.

11.1 As with Hampton-Alexander recommendations, these should apply to all listed companies. The FRC has recognised that limiting Hampton-Alexander recommendations to the FTSE 350 was probably a mistake and for the same reasons, limiting requirements to report on ethnicity to the FTSE 350 would be.

11.2. It would also send out mixed messaging about the importance of ethnicity and gender if one was limited to certain companies whilst the other was not.

[3] Connect Society: https://connect.societycorpgov.org/blogs/randi-morrison/2017/05/31/board-practices-average-director-tenureterm-limit-trends

12. **Do you agree with retaining the requirements included in the current Code, even though there is some duplication with the Listing Rules, the Disclosure and Transparency Rules or Companies Act?**

    12.1. If a company is required to undertake certain activities then whether it is in the Code or not will not currently make any difference. However, there is some merit in retention given the Companies Act, Listing Rules and so on may be revised and amended in the future. Retention provides certainty.

13. **Do you support the removal to the Guidance of the requirement currently retained in C.3.3 of the current Code? If not, please give reasons.**

    13.1 AAT does support the removal of C.3.3 and supports the recommendation that it instead be inserted into the Guidance.

14. **Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?**

    14.1. AAT agrees with a wider remit for the remuneration committee.

    14.2. Requiring chairs of remuneration committees to have served at least 12 months on a remuneration committee is a common-sense proposal that in practice occurs at most companies already. Given this helps to ensure greater knowledge of both the company and the executive – and crucially the shareholder base – ensuring all companies behave in this way will inevitably have some value.

    14.3. Consideration should be given to the development of a process whereby the members of the Remuneration Committee are nominated by the board or shareholders and elected to serve a fixed term of (say) three years and could be de-elected by the shareholders, as this would give the Remuneration Committee greater independence.

15. **Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?**

    15.1. The requirement to publish pay ratios will aid transparency, shining a light on excessive pay and acting as a useful assessment tool. However, it will do almost nothing to curb excessive executive pay.

    15.2. According to the AAT Corporate Governance Survey (2017) only 21% of AAT members believe introducing a requirement to publish pay ratios is sufficient to make a difference in terms of curbing excessive executive pay.

    15.3. A clear majority of AAT members believe the time has come for a mandatory pay ratio to be imposed as at companies like the John Lewis Group (a 75:1 pay ratio).

    15.4. The High Pay Centre has previously suggested a 40:1 pay ratio, David Cameron recommended a 20:1 pay ratio for the public sector and many others have suggested this would be a reasonable ratio for private companies too.

    3.13. The AAT Corporate Governance survey (2017) also found that 41% of AAT members want an across the board pay ratio of 20:1. This compares to 0% who felt the current average FTSE 100 pay ratio was appropriate and only a mere 7% who believe there should be no pay ratio at all.

16. **Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?**

    16.1. AAT agrees that the changes enable significant discretion and believes this to be a large part of the problem given the persistently poor Corporate Governance of a significant minority of companies.

17. About AAT

a. AAT is a professional accountancy body with approximately 50,000 full and fellow members and over 90,000 student and affiliate members worldwide. Of the full and fellow members, there are more than 4,250 licensed accountants who provide accountancy and taxation services to over 400,000 British businesses.

b. AAT is a registered charity whose objectives are to advance public education and promote the study of the practice, theory and techniques of accountancy and the prevention of crime and promotion of the sound administration of the law.

18. Further information

If you have any queries, require any further information or would like to discuss any of the above points in more detail, please contact Phil Hall, AAT Head of Public Affairs & Public Policy at:

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