Financial Reporting Council

FRC UK, 2018b

THE WATES CORPORATE GOVERNANCE PRINCIPLES FOR LARGE PRIVATE COMPANIES

DECEMBER 2018

With thanks for the participation and assistance of our coalition partners

BVCA
British
Private Equity &
Venture Capital
Association

Institute for
Family Business

CBI

IoD Inspiring business

CDSB
Climate
Disclosure
Standards
Board

THE
INVESTMENT
ASSOCIATION

ibe
Institute of
Business Ethics

TUC
Changing the world
of work for good

icsa
The Governance
Institute

CONTENTS

The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

The Financial Reporting Council Limited is a company limited by guarantee.
Registered in England number 2486368.
Registered Office: 8th Floor, 125 London Wall, London EC2Y 5AS

1 FOREWORD

I believe that good business, well done, is a force for good in society. While not always recognised for it, business creates the jobs, economic growth, and tax revenue that society so desperately needs. Although most business leaders have an intuitive moral compass that guides them towards delivering this value, these Principles provide them with a framework for ensuring that their companies are well managed and aligned behind a clear purpose.

The Wates Corporate Governance Principles for Large Private Companies provide a tool to help large private companies look themselves in the mirror, to see where they have done well and where they can raise their corporate governance standards to a higher level. This can in turn result in better engagement with their stakeholder base and ultimately build trust.

Many companies are justifiably proud of what they are doing already. They have extensive processes in place to engage with the broad range of stakeholders that are integral to the company's success, and in particular to ensure that workforce concerns are addressed at board level. The Wates Principles offer a structure for reporting on corporate governance that not only helps them fulfil their legal requirements, but also allows them to shine.

My hope is that a wide range of companies – and not just those included in the new legislative requirement to report on their corporate governance arrangements – will use the Wates Principles. Accordingly, we have kept them flexible and high-level, with guidance provided not as requirements, but to help companies understand how they can apply the Principles. After all, good corporate governance is not about box-ticking. If we are to increase the public's confidence in business, then surely, we cannot achieve that through a regulatory regime that uses somebody else's words. It can only be achieved if companies think seriously about why they exist, how they deliver on their purpose, and then explain – in their own words – how they go about implementing the Wates Principles. That is the sort of transparency that can build the trust of stakeholders and the general public.

The Wates Principles and its supporting Guidance are the result of 12 months of concerted effort by a Coalition Group of diverse organisations representing a cross-section of interests related to private business, with secretariat support from the Financial Reporting Council. The Wates Principles draw from a deep pool of experience and insight into what works. This effort was complemented by a consultation process that ran for three months, as well as meetings with an Executive Sounding Board consisting of representatives from privately-owned businesses. These consultations elicited pointed and constructive feedback from numerous organisations and individuals and have strengthened the output considerably.

I am pleased that the Coalition Group and the FRC have signalled their willingness to continue to work as a team to promote the Wates Principles, ensure an appropriate monitoring system is in place, and to adjust them as needed in the future. We will only start seeing the first reporting against these in 2020, and it will take some years to develop an understanding of reporting trends and a body of good practice, so this is a long-term effort, and the release of the Wates Principles is but a start.

I would like to extend my sincere thanks to all the members of the Coalition Group, the Executive Sounding Board and especially the FRC for their efforts in delivering what I feel to be an outstanding body of work.

James Wates

James Wates CBE
Chairman

2 INTRODUCTION

The case for corporate governance reporting from large private companies

Strong, successful businesses generate value for their owners and wider society. Throughout the UK, large private companies contribute to productivity, generate employment, and provide vital goods and services. Many large private companies are established and run in accordance with a clear purpose and strategy that enables them to generate value for the communities in which they operate.

Nevertheless, several large-scale corporate failures have not only drawn public attention to the need for improved transparency and accountability, but also highlighted the risks to wider stakeholders, including the workforce, suppliers and customers, when problems arise.

In the response to its *Green Paper on Corporate Governance Reform* the Government stated that it believed the case had been made for strengthening the corporate governance framework for the UK's largest private companies, noting 'the conduct and governance of large companies, whatever their legal status, has a sizeable impact on the interests of employees, suppliers, customers and others'.[1] In addition it was in the interests of businesses themselves to have strong corporate governance, stating: 'It provides confidence not just to shareholders, but to other key stakeholders including the workforce, customers, suppliers, pensioners and the environment, that a company is being well run'.[2]

The Government invited the FRC to work with a variety of partners to develop a set of corporate governance principles for large private companies. By explaining the application of the Principles, large private companies will be able to meet their obligations under new regulatory requirements.

Development of the Wates Corporate Governance Principles for Large Private Companies

In January 2018, the Secretary of State for Business, Energy and Industrial Strategy, the Rt Hon Greg Clark, appointed James Wates CBE as Chairman of a Coalition Group, with FRC membership and secretariat support. Membership of the Coalition Group consists of the British Private Equity and Venture Capital Association, the Confederation of British Industry, the Climate Disclosure Standards Board, the Institute of Business Ethics, ICSA: the Governance Institute, the Institute for Family Business, the Institute of Directors, the Investment Association, Mark Goyder, and the Trades Union Congress.

Under the Chairman's leadership, the Coalition Group has developed the Wates Corporate Governance Principles for Large Private Companies (Wates Principles) following an extensive work programme and public

[1] Department for Business, Energy and Industrial Strategy, *Corporate Governance Reform: the Government response to the green paper consultation* (2017), p.40.

[2] Ibid, p.44.

consultation. This included analysis of existing national and international corporate governance codes, a series of roundtable discussions with stakeholders, and additional input from an Executive Sounding Board consisting of senior executives from large private companies.

The Wates Principles offer all companies that are not subject to a formal corporate governance code an opportunity to consider their approach to governance and aspire to meet the Principles. The Wates Principles offer companies, even those not subject to the regulation, an opportunity to demonstrate good practice and how they achieve long-term success of the company.

Background

In large private companies the relationships between shareholders, directors and senior management can vary considerably. Large private companies are not a homogenous group and are established under a variety of differing ownership and legal structures, including family businesses, private equity-owned businesses, sole-owners and subsidiaries.

Private companies benefit from the privileges of limited liability status, but are not subject to the same level of reporting and accountability requirements as publicly listed companies. The traditional rationale for this is that private companies stem from private ownership and have no reliance on public equity markets to raise capital. However, many respondents to the Green Paper noted the economic and social significance of large private companies can be as great as publicly listed companies and, when problems occur, there are comparable risks to as wide a range of stakeholders.

The House of Commons' Business, Energy and Industrial Strategy Committee published its Corporate Governance *report* in April 2017 and considered the need for improved transparency and accountability for large private companies. In its report, the Committee noted that 'arguments in favour of greater transparency and accountability for private companies are based on the premise that those with a significant presence in the community should be required to report on non-financial matters for the benefit of employees and other stakeholders'.[3] It noted that while no law or set of principles could remove the risk of serious corporate failings, a code of corporate governance for large private companies 'can serve to raise awareness of good practice and, over time, help to improve standards of corporate governance in private companies, large and small'.[4]

[3] House of Commons Business, Energy and Industrial Strategy Committee, *Corporate Governance, Third Report of Session 2016-17* (2017), p.30.

[4] Ibid, p.31.

THE WATES PRINCIPLES AND OTHER LEGISLATIVE REQUIREMENTS

In June 2018 the Government introduced secondary legislation. *The Companies (Miscellaneous Reporting) Regulations 2018* (the Regulations), requires all companies of a significant size, that are not currently required to provide a corporate governance statement, to disclose their corporate governance arrangements as set out below:

> **Extract from The Companies (Miscellaneous Reporting) Regulations 2018**
>
> 26. (1) The directors' report must include a statement (a "statement of corporate governance arrangements") which states:
>
> (a) which corporate governance code, if any, the company applied in the financial year,
>
> (b) how the company applied any corporate governance code reported under sub-paragraph (a), and
>
> (c) if the company departed from any corporate governance code reported under sub-paragraph (a), the respects in which it did so, and its reasons for so departing.
>
> (2) If the company has not applied any corporate governance code for the financial year, the statement of corporate governance arrangements must explain the reasons for that decision and explain what arrangements for corporate governance were applied for that year.

This new reporting requirement applies to all companies that satisfy either or both of the following conditions:

- more than 2,000 employees;
- a turnover of more than £200 million, and a balance sheet of more than £2 billion.

The Coalition Group was asked to prepare principles to help those companies which are subject to the thresholds comply with the Regulations. The Wates Principles introduce an approach to good corporate governance that offers sufficient flexibility for a diverse range of companies to explain the application and relevance of their corporate governance arrangements, without being unduly prescriptive.

Directors' duties

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.

172. Duty to promote the success of the company

(1) 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'.

Following the various consultations and inquiries considering corporate governance, the Government concluded that greater clarity was required to determine to what extent directors have regard for the matters set out in (1)(a)-(f) when making decisions. The Government also identified the need for a legal requirement for those companies with the greatest interaction with those factors to widely disclose how their directors have fulfilled this duty. The Wates Principles are intended to support directors to meet these requirements.

In addition to the requirement set out above in the Regulations, two other relevant reporting requirements have been introduced:

- Companies that produce a Strategic Report are now required to provide a section 172(1) statement on their website which describes how the directors have had regard to the matters set out in section 172(1)(a) to (f) of the Companies Act 2006.
- The Directors' Report has been amended to require companies to explain how they have engaged with employees,[5] and how directors have regard to employee interests, and the effect of that regard. Large private companies are also required to explain how they have engaged with suppliers, customers and others in a business relationship with the company.

In its *FAQs* the Department for Business Energy and Industrial Strategy acknowledges that it is expected that many companies will want to report on employee, customer and supplier issues as part of their Strategic Report statement. This information does not need to be duplicated in the Directors' Report. Nor does it need to be duplicated to explain application of the Wates Principles thus cross-referencing is encouraged. The FAQs also explain which companies are required to report under the Regulations, and offer additional guidance on reporting against all the new requirements.

The new corporate governance reporting requirements will apply to company reporting for financial years starting on or after 1 January 2019. Companies will be able to adopt the Wates Principles as an appropriate framework when making a disclosure about their corporate governance arrangements under the Government's new reporting requirement. In addition, the Wates Principles offer companies an effective way of linking their corporate governance statement to the other reporting requirements. Explanations of the application of the Wates Principles combined with and cross-referred to other reporting will together achieve an increase in transparency from large private companies and contribute to building trust.

[5] The regulations use the term 'employee' whereas the Wates Principles use 'workforce', which is explained under Principle One.

HOW TO REPORT

The Wates Principles recognise the variety of large private companies incorporated within the UK. Differing management and ownership structures means that a 'one-size-fits-all' approach to corporate governance in large private companies is not appropriate.

A company that adopts the Wates Principles should follow them using an 'apply and explain' approach in a way that is most appropriate for their particular organisation. Accordingly, boards should apply each Principle by considering them individually within the context of the company's specific circumstances. They should then be able to explain in their own words how they have addressed them in their governance practices.

This approach - in which one *applies* principles is not new. UK premium listed companies are subject to the Financial Conduct Authority's Listing Rules, which require a statement of how the Principles set out in the UK Corporate Governance Code have been *applied* in a manner that shareholders can evaluate.

The UK Corporate Governance Code also includes Provisions that a company should additionally comply with - or offer an explanation where it does not. The Wates Principles take a different approach; they do not set out detailed provisions, but offer guidance under each Principle. This guidance is provided to assist companies in explaining their approach to applying each Principle appropriate to their circumstances. Accordingly, the guidance does not need to be reported on in the same way as premium listed companies need to 'comply or explain' against Provisions in the UK Corporate Governance Code.

By providing broad Principles with supporting Guidance, the intention of the Wates Principles is to move beyond a 'tick box' approach to describing and explaining how the implemented practices achieve the Principles and demonstrate the outcomes. This approach offers increased transparency for stakeholders and links to the other reporting requirements set out above.

Companies should provide a supporting statement that gives an understanding of how their corporate governance policies and processes operate to achieve the desired outcome for each Principle. Where appropriate the statement may cross-refer to information reported under other legislation, for example, information which may be in the Strategic Report or another company document.

Additional Information

The importance of stakeholder engagement is demonstrated throughout the Wates Principles and companies should outline methods of engagement with both the workforce and other stakeholders and demonstrate how boards have considered the issues raised.

Subsidiary companies meeting the tests set out in the Regulations are required to make a corporate governance statement. Directors of these companies are subject to section 172 like any other director, but it is recognised that parent companies may in some cases influence policies. For example, remuneration practices and policies may be set by the board of the parent company. In such cases, any explanation that demonstrates application of the Principles could refer to the parent company's corporate governance statement, if that report explains the governance procedures of the subsidiary.

Many companies which are required to make a corporate governance statement under the Regulations will also be required to provide a section 172 statement, and unnecessary repetition can be avoided by cross-referral. The FRC's *Guidance on the Strategic Report* can support companies in meeting these and other reporting requirements. For example, it considers risks and opportunities arising from factors such as climate change and the environment. It also suggests methods for engagement with the workforce.

Financial Reporting Council

FINANCIAL REPORTING COUNCIL
8TH FLOOR
125 LONDON WALL
LONDON EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk