

# Corporate Governance Reforms in the United Kingdom

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## Abstract

The purpose of this article is to identify, explain and critique the substantial changes in the UK revised Corporate governance Code as well as the Wates Principles. This article argues that these changes could promote the performance of the investors and companies in dealing with economic issues. On the other hand, these changes are less effective when it comes to social and environmental issues.

**Keywords:** corporate governance, reforms, revised Code, Wates Principles

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## Introduction

Substantial global attention has been paid to corporate governance since the Financial Crisis of 2007-2008. A strong corporate governance can make a country an attractive place for both investors and business. Britain has been a global pioneer in corporate governance for a long time. The Cadbury Committee published in 1992, the first edition of the UK Code for Corporate Governance (the Code). While major business failures in the UK have given rise to social and business worries, the UK has always pursued a proportionate mechanism for improving corporate governance. The Green Paper of the Government, released on 29 November 2016, initiating a broad-based dialogue on how to improve the corporate management system in the United Kingdom. As a response from the Government to the green paper the Government invited the Financial Reporting Council (FRC) to revise the Corporate Governance Code. In 2018 The FRC Issued the revised Code and established the Wates Principles with a variety of partners and in 2020 issued the revised the Stewardship Code. However, The FRC believe these substantial changes will improve the role of investors and companies in resolving economic, environmental and social problems.

## The UK Corporate Governance Code (2018)

In 2018, the FRC issued the revised UK Corporate Governance Code with some substantial changes and a different structure. The new Code has five sections: leadership and purpose, division of responsibilities, composition succession and evaluation, audit risk, and internal control and remuneration. Some principles and provisions of the previous Code were incorporated into the revised Code's principles and provisions. However, the revised Code emphasises some concepts by altering some principles and provisions or by establishing new ones.

One of the main changes to the revised Code is its focus on the importance of positive relationships between companies, shareholders and stakeholders through detailed changes, such as the emphasis on the quality of the board and on a company's relationships with a wider range of stakeholders.<sup>1</sup> Despite the primary responsibility of managers to support their company's long-term success, the FRC is persuaded that businesses should consider the importance other stakeholders in this success. Thus, the new Code promotes corporate governance policies and practices that create shareholder value and seek to support society. Principle A states that "A successful company is led by an effective and entrepreneurial board whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society".<sup>2</sup> The Code's focus on a wide range of stakeholders is also apparent in Provision 5, which confirms that the board should consider the interests of other key stakeholders of the company and explain in the annual report that the board considered their views in their consultations and decision-making, in compliance with section 172 of the Companies Act 2006.<sup>3</sup>

Although Principle A and Provision 5 of the revised Code affirm the significance of a positive relationship between the company and wider society, the Code does not provide much detail about who is included in the wide range of stakeholders with which the company must maintain a good relationship or how this should be done. Moreover, only part of Provision 5 covers company-stakeholder relationships, while the other part covers the company's engagement with the workforce. However, Provision 5 refers to section 172 of the Companies Act 2006, which provides more detail about this issue, such as the need to cultivate good ties between a company and its suppliers and consumers and others. In addition to section 172 of the Companies Act 2006, the Guidance

<sup>1</sup> Financial Reporting Council (FRC), Revised UK Corporate Governance Code 2018 highlights (2018)

<sup>2</sup> Financial Reporting Council (FRC), The UK Corporate Governance Code (2018)

<sup>3</sup> Ibid

on Board Effectiveness 2018 adds further explanation of how this relationship should work.<sup>1</sup> Thus, not providing adequate details about this relationship in the revised Code's provisions makes it possible that companies may not comply with this issue in a way that is beneficial to its main purpose.

The emphasis on the significance of positive relationships between companies, shareholders and stakeholders is also apparent in another detailed change to the Code, which is to encourage companies to foster effective engagement with their shareholders. Several provisions encourage engagement with shareholders. Provision 3 indicates that the chairman should establish frequent contact with key shareholders, in addition to regular general meetings, to clarify their opinions on governance and performance in response to the plan. The chairs of the Committee should try to include the shareholders in discussion of significant issues affecting their areas of responsibility. The Chairman should ensure the board interprets the views of shareholders consistently.<sup>2</sup> However, the statement that committee chairs should engage with shareholders about important issues relating to their areas of responsibility could prove problematic in certain cases. For instance, audit committees often find that constructive communication with clients can be difficult to achieve. The Committee chairs may have to strengthen their actions, but progress in that field would require the society's dedication and additional resources.<sup>3</sup>

A change to Provision 4 also provides more information regarding this relationship. Companies should communicate with shareholders in their general meetings where they obtain large votes against resolution. Provision 4 of the revised Code says that, if 20% or more of the board votes against a proposal, the company should clarify, when reporting the results, what steps it plans to take to inform shareholders and consider the reasons for the results.<sup>4</sup> Moreover, the Guidance on Board Effectiveness 2018 argues that, when the board focuses mainly on large shareholders, minor investors may be ignored. The board can suggest additional ways to involve smaller shareholders, such as collective engagement strategies including roundtables and webinars with shareholders.<sup>5</sup> By specifying 20% or more votes against and by directing companies to consider smaller shareholders as well as major ones, the revised Code puts more stress on the importance of effective shareholder engagement, which will contribute substantially to a company's success.

The last detailed change regarding the importance of positive relationships between companies, shareholders and stakeholders concerns workforce engagement. Provision 5 directs the board to engage with the workforce through one or a combination of the following methods: a director appointed by the workforce, a formal workforce advisory panel and a designated non-executive director.<sup>6</sup> In addition to Provision 5, Provision 6 states that the workforce should be able to raise concerns in confidence.<sup>7</sup> Often, the communications between the workforce and the company is deemed as the employee voice, and thus the policy of communication should include those with structured work arrangements (permanent, fixed-term, zero-hour) and all staff members who are impacted by the board's decisions. For instance, businesses should consider including persons engaged in service arrangements, department staff and remote workers irrespective of their geographical location. Companies should know who they employ and why.<sup>8</sup> Although the revised Code emphasises workforce engagement by directing companies to appoint a director from within the workforce, it does not provide the mechanism for choosing that director even in the Guidance on Board Effectiveness, so this process may be challenging for companies.

Another substantial change in the revised Code is its emphasis on the composition of high-performing boards and on diversity through deferent detailed changes. One such change is the Code's focus on the boardroom's independence and on constructive challenges. To ensure the boardroom's independence, the revised Code requires the board to provide a clear explanation of when circumstances likely to weaken a non-executive director's independence (mentioned in Provision 10 or other relevant circumstances)<sup>9</sup>. This requirement aims to assert the importance of the boardroom's independence; the FRC wish all companies take it seriously. In addition to this demand, for the first time, the FRC asks chairs not to remain in their position for more than nine years.<sup>10</sup> However, it may be challenging for companies to comply with this limited period. Currently, 25 companies in FTSE 100 and 49 in FTSE 250 fail to comply with this provision.<sup>11</sup> Moreover, it has been argued that, although the 'comply or justify' system can be exploited to make non-compliance with the Code more

<sup>1</sup> Financial Reporting Council (FRC), Guidance on Board Effectiveness (2018)

<sup>2</sup> Corporate Governance Code, (n 2)

<sup>3</sup> The UK corporate Governance Code, KPMG (2018) <<https://assets.kpmg/content/dam/kpmg/uk/pdf/2018/07/uk-corporate-governance-code.pdf>> accessed 28 April 2020

<sup>4</sup> Corporate Governance Code, (n 2)

<sup>5</sup> Ibid

<sup>6</sup> Corporate Governance Code, (n 2)

<sup>7</sup> Ibid

<sup>8</sup> Guidance on Board Effectiveness, (n 4)

<sup>9</sup> Corporate Governance Code, (n 2)

<sup>10</sup> Ibid, Provision 19

<sup>11</sup> Financial Reporting Council (FRC), Annual Review of the UK Corporate Governance Code (2020)

acceptable, a culture of compliance can contribute to a turnover in leadership.<sup>1</sup>

Emphasis on diversity within high-performing boards is another detailed change. The revised Code seeks to expand boards' understanding of diversity and to ensure that recruitment and succession planning activities are targeted at fostering diversity, not just of gender but also of social and ethnic backgrounds. Principle J of the revised Code notes that “appointments to the board should be subject to a formal, rigorous and transparent procedure, and an effective succession plan should be maintained for board and senior management. Both appointments and succession plans should be based on merit and objective criteria and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths”.<sup>2</sup> It was not enough for the FRC to encourage the companies to promote diversity in the boardroom. Therefore, the revised Code requires firms to promote workforce diversity by expanding the nominating committee’s tasks to oversee the creation of a diversified pipeline.<sup>3</sup> Provision 23 of the revised Code says that the nomination committee’s work should be described in the annual report, including the gender balance of those in senior management and their direct reports.<sup>4</sup> Although the FRC stresses the importance of different types of diversity, only gender balance is required to be reported. Thus, companies might consider other forms of diversity to be less serious.

The third fundamental change confirms the significance of a well-defined purpose and an approach consistent with a healthy corporate culture. The board should determine the company’s purpose and create a plan to achieve it, based on the principles and behaviours that form its culture and its way of conducting business. A company's purpose is the reason it operates. It is the board's duty to establish and confirm the business’s function and purpose. A company with a clear purpose is more likely to express its operations plans and to have a well-developed policy and approach to risks. Moreover, a well-defined purpose could help companies to engage with their workforces, consumers and wider society.<sup>5</sup> It is clear that the revised Code encourages companies to pay more attention to their purpose, and this is expressed explicitly in Principle B.<sup>6</sup> The company’s purpose should be consistent with its culture, as it is explained in Provision 2. The FRC is convinced that organisational culture is a critical element of long-term, sustainable success. Within a stable society, structures, procedures and individuals coalesce to promote long-term sustainability and build trust. Likewise, a bad culture poses considerable business risk.<sup>7</sup> The board is expected to assess and monitor the health of the company’s culture. Furthermore, the Guidance on Board Effectiveness 2018 provides some features of a healthy culture that can be used in the assessment process, namely honesty, openness, respect, adaptability, reliability, recognition, acceptance of challenge, accountability and a sense of shared purpose.<sup>8</sup> Thus, positive culture should be considered in the boardroom’s discussions and should be reported in the annual report.

Although the revised Code encourages companies to adopt and report on a healthy culture, companies face some problems in establishing such a culture. Changing the corporate culture may be easy in principle, but it is difficult in practice. Proof of this is the story of Volkswagen discussed by Professor Alice Belcher.<sup>9</sup> She argued that an obstacle to companies’ assessment of the health of their culture is the differing concepts of corporate culture. The functionalist philosophy considers business culture to include all that can and should be exploited in the interest of corporations.<sup>10</sup> The interpretive approach considers corporate culture to be generated by everyone in an enterprise and not fully controllable by the boardroom.<sup>11</sup> According to Professor Belcher, the management literature also shows the enormous intellectual, technical and functional challenges UK boards experience in attempting to assess and comment on their company culture, as mandated by the UK Code for 2018.<sup>12</sup> As result of this problem, the FRC noted in its Annual Review of the UK Corporate Governance Code (2020) that many companies faced challenges in creating an effective culture.<sup>13</sup> Consequently, the FRC may need to better explain its concept of a healthy corporate culture in the Guidance on Board Effectiveness.

The last primary change to the Corporate Governance Code is the new emphasis on designing proportionate remuneration policies and implementing practices to promote sustainable success. The aim of this change is demonstrated in the Government’s response to the Green Paper consultation.<sup>14</sup> The reason for this reform is public concern about the unnecessary complexity of executive pay, the role of driver compensation and the

<sup>1</sup> KPMG, (n 6)

<sup>2</sup> Corporate Governance Code, (n 2)

<sup>3</sup> KPMG, (n 6)

<sup>4</sup> Corporate Governance Code, (n 2)

<sup>5</sup> Guidance on Board Effectiveness, (n 4)

<sup>6</sup> Corporate Governance Code, (n 2)

<sup>7</sup> KPMG, (n 6)

<sup>8</sup> Guidance on Board Effectiveness, (n 4)

<sup>9</sup> Belcher, Claire, Corporate culture: Changing board responsibilities and changing governance rhetoric. In RAIS Conference Proceedings (2018) <<https://doi.org/10.5281/zenodo.1568368>>

<sup>10</sup> Ibid

<sup>11</sup> Ibid

<sup>12</sup> Ibid

<sup>13</sup> Annual Review, (n 16)

<sup>14</sup> Department for Business, Energy & Industrial Strategy, The Government response to the green paper consultation (2017)

connection between executive pay and broader workplace experiences. As a consequence of this concern, the government invited the FRC to revise the Code to clarify the steps that listed companies should take when major shareholders are opposed to executive compensation policies and awards and to give remuneration committees greater responsibility for controlling their company's salaries and benefits, as well as allow them to communicate with the workforce to clarify how executive remuneration is harmonised with broader company remuneration policies. Thus, being aware of the purpose of the revised Code facilitates the understanding of it.

One of the revised Code's detailed changes regarding remuneration is that it encourages directors to exercise critical judgment and discretion about remuneration results, taking broader circumstances into consideration. Provision 37 states that "Remuneration schemes and policies should enable the use of discretion to override formulaic outcomes. They should also include provisions that would enable the company to recover and/or withhold sums or share awards and specify the circumstances in which it would be appropriate to do so".<sup>1</sup> When deciding on remuneration incentives, the remuneration committee must exercise discretion and must be mindful of the potential numerical consequences and public reaction resulting from its decisions. Remuneration programmes should have the flexibility to circumvent formulaic findings.<sup>2</sup> For example, the revised Code enables remuneration results to be overridden, such as if the calculation of a given performance situation does not reflect the company's actual performance over time or the success of a particular director.<sup>3</sup> However, overriding formulaic outcomes is a critical issue and may backfire when it is not done appropriately.<sup>4</sup>

### Wates Principles

Corporate governance reforms did not stop at this point with reforming the Corporate Governance Code; the Wates Corporate Governance Principles for Large Companies came out in 2018 to continue this reform. The purpose of the Wates Principles is to provide a structure to help large private companies satisfy legal standards and promote long-term sustainability in this critical field. Recognizing this, the Wates Principles urge businesses to adopt a series of core behaviours to protect stakeholders' trust and to support the economy and the community in general.<sup>5</sup> Moreover, companies should report on these principles, which took effect on 1 January 2019.

The Wates Principles consist of six principles, some of which are very similar to those in the Corporate Governance Code (2018) discussed previously in this document; however, two principles require further explanation, as they differ from those in the revised Code and have not yet been mentioned in this article.

The first is that there should be a good perception of their role and obligations by the board and individual directors.<sup>6</sup> The board's performance should promote effective decision-making.<sup>7</sup> A successful board should develop and retain corporate governance policies, including consistent reporting lines and obligations to promote efficient decision-making. A board should develop structured and rigorous internal mechanisms to ensure that programmes and controls function efficiently and that the information it collects is accurate and credible, allowing managers to track and analyse the company's results to make informed decisions.<sup>8</sup> The second is that the board should support the company's long-term sustainable success by identifying opportunities to generate and retain value and monitoring the assessment and mitigation of risks.<sup>9</sup> An organisation's board should determine how it produces and retains long-term profitability.<sup>10</sup> An effective board has a great ability to identify future opportunities and risks.

As mentioned above, the Wates Principles are similar to those in the Corporate Governance Code (2018). The difference is in the way they operate. The Corporate Governance Code provides principles and provisions that require compliance or explanation in the absence of compliance. In contrast, the Wates Principles do not have provisions, and they include a guidance that helps companies fully understand the principles and explains the principles' application given the company's circumstances. However, many responses to the consultation about the Wates Principles issued by the FRC found the guidance to be too discursive.<sup>11</sup> Although the Corporate Governance Code's comply or explain policy does not restrict companies to the principles and provisions, the Wates Principles gives companies even more flexibility in reporting on their compliance. However, the similarity between the Wates Principles and the Corporate Governance Code might affect the expected effectiveness of the Wates Principles since they do not provide the desired addition.

The FRC claims that these substantial changes would lead to better actors in the capital market, resulting in

<sup>1</sup> Corporate Governance Code, (n 2)

<sup>2</sup> Guidance on Board Effectiveness, (n 4)

<sup>3</sup> KPMG, (n 6)

<sup>4</sup> The Guidance on Board Effectiveness 2018 provides relevant information about how the overriding should take place

<sup>5</sup> Financial Reporting Council (FRC), The Wates Corporate governance Principles for Large Private Companies (2018)

<sup>6</sup> Ibid

<sup>7</sup> Ibid

<sup>8</sup> Ibid

<sup>9</sup> Ibid

<sup>10</sup> Ibid

<sup>11</sup> Financial Reporting Council (FRC), Feedback Statement the Wates Corporate Governance Principles for Large Private Companies (2018)

benefits to the environment, economy and broader society. However, the effectiveness of these changes in producing investors and companies that can solve economic, environmental and social problems should be assessed separately. Solving economic problems is the main purpose of corporate governance reform, as it results from the collapse of some UK companies. Most of the principles and provisions of the revised Code and the Wates Principles focus on enabling companies to overcome economic difficulties and bolster the national economy. This aim is welcomed by companies and investors as it aligns with their wish to avoid business collapse; this means they should comply with the principles and improve the national economy.

Environmental and social problems did not receive the same attention, and many responses to the consultation about the Wates Principles said that environmental and social problems were not accorded satisfactory significance in the Guidance.<sup>1</sup> Moreover, companies and investors might be less motivated to comply with principles referring to social and environmental issues, which could make them even less effective. It is argued that the Wates Principles do not adequately apply corporate governance to the ties between business and society; however, the Wates Principles are welcomed as a starting point.<sup>2</sup> Thus, the changes made regarding economic problems may be considered substantial enough to enable companies to solve them. In contrast, the changes regarding social and environmental issues are less effective, but they may be deemed a starting point for further effort in these fields.

## Conclusion

In conclusion, the FRC made some substantial changes to the Corporate Governance Code in 2018. One of the major changes is the new emphasis on good relations between businesses, shareholders and stakeholders. The second fundamental change is the focus on diversity in the composition of high-performance boards. The third primary shift is the recognition of the value of clearly established goals and strategies that align with a healthy corporate culture. The last significant adjustment to the Code is the focus on implementing pay systems and procedures for sustainable results. Moreover, as part of the corporate governance reforms, the FRC also established the Wates Principles in 2018. However, these substantial changes might promote companies' performance when facing economic issues and enable them to solve these problems. On the other hand, the revisions regarding social and environmental problems are less effective; therefore, more work on these issues is required in the coming years.

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<sup>1</sup> Ibid

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