EXPLANATORY MEMORANDUM TO

THE COMPANIES (MISCELLANEOUS REPORTING) REGULATIONS 2018

2018 No. 860

1. Introduction

1.1 This explanatory memorandum has been prepared by the Department for Business, Energy and Industrial Strategy and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 This instrument introduces new company reporting requirements on executive pay, corporate governance arrangements, and how directors are having regard to the matters in section 172(1) (a) to (f) of the Companies Act 2006. The purpose of these new reporting requirements is to build confidence in the way that large private and quoted companies are run. In addition, Part 4 of the instrument clarifies that small Community Interest Companies ("CICs") must report on their directors' remuneration.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

Other matters of interest to the House of Commons

3.2 Disregarding minor or consequential changes, the territorial application of this instrument includes Scotland and includes Northern Ireland and is not a financial instrument that relates exclusively to England, Wales and Northern Ireland.

4. Legislative Context

4.1 Part 15 of the Companies Act 2006 and the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 set out a reporting framework for companies. They specify information, both financial and non-financial, that companies are required to include in their annual reports and accounts. Subject to size criteria, companies are required to prepare a strategic report and a directors' report. Quoted companies also have to prepare a directors' remuneration report. This instrument specifies further content to the strategic report, the directors' report and the directors' remuneration report for certain companies.

4.2 The Companies (Audit, Investigations and Community Enterprise) Act 2004 ("the CAICE Act 2004") requires CICs to produce a community interest company report annually, including information about directors' remuneration. This instrument is correcting the Community Interest Company Regulations 2005 ("CIC Regulations") in relation to the requirement on small CICs which refers to a schedule which has been revoked, by reinserting the content of the revoked schedule in the CIC Regulations.

5. Extent and Territorial Application

5.1 The extent of this instrument is England, Wales and Scotland. It also applies by agreement in Northern Ireland.

5.2 The territorial application of this instrument is England, Wales and Scotland. It also applies by agreement in Northern Ireland.

5.3 The UK Government is responsible for the operation and regulation of business entities in England and Wales, and in Scotland. Previously the Northern Ireland administration has agreed that, while the operation and regulation of business entities remains a transferred matter within the legislative competence of the Northern Ireland Assembly, amendments to the Companies Act 2006 and legislation regulating business entities including Part 2 of the CAICE Act 2004 regarding Community Interest Companies should be made in the same terms for the whole of the United Kingdom

6. European Convention on Human Rights

6.1 Andrew Griffiths MP, Parliamentary Under Secretary of State and Minister for Small Business, Consumers and Corporate Responsibility, has made the following statement regarding Human Rights:

In my view the provisions of the Companies (Miscellaneous Reporting) Regulations 2018 are compatible with the Convention rights.

7. Policy background

What is being done and why

7.1 Corporate governance facilitates effective, entrepreneurial and prudent management that can deliver the long-term success of a company. It involves a framework of legislation, codes and voluntary practices. Periodic reviews and improvements have ensured that the UK framework has kept pace with business practices and society's changing expectations of business and maintained its international reputation.

7.2 The Government published a Green Paper on Corporate Governance Reform on 29 November 2016 to consider ways in which the framework could be strengthened and updated. In a speech to the CBI in November 2016, the Prime Minister said that the Green Paper was about "establishing the best corporate governance of any major economy, ensuring employees' voices are properly represented in board deliberations, and that business maintains and – where necessary – regains the trust of the public". The Green Paper had a particular focus on increasing shareholder scrutiny of executive pay, strengthening boardroom engagement with employees, customers and other stakeholders and strengthening corporate governance in large privately-held businesses.

7.3 The Government's response to the Green Paper consultation, published on 29 August 2017, set out nine reform measures to be delivered through a combination of new statutory reporting requirements, changes to the UK Corporate Governance Code and industry-led measures. The new reporting requirements are being introduced through this instrument; the new requirements and their anticipated benefits are described below.

- Directors of UK companies have a duty to promote the success of their company for the benefit of the members as a whole (unless the company adopts a different purpose), and in doing so, must have regard to the matters set out in section 172(1) of the Companies Act 2006, including the interests of employees and the need to foster business relationships with suppliers and customers. There is increasing interest amongst investors and the public in how companies are taking account of these matters because they are important to a company's sustainable long-term success and the contribution it makes to wider society. The new requirement to prepare a section 172(1) statement is intended to encourage directors to think more carefully about how they are taking account of these matters. And extending the requirement in the directors' report should encourage better boardroom engagement with employees and other stakeholders while giving shareholders more information with which to hold boards to account. In addition, better reporting should improve the visibility of good boardroom practice, allowing it to be replicated and adopted more widely.

- The UK's strongest corporate governance and reporting standards are currently focused on listed public companies. However, large private companies have an increasing economic importance, and their conduct and governance can have an equally significant impact on the interests of employees, suppliers, customers and others. The new requirement for very large private companies to describe their corporate governance arrangements is intended to encourage directors to consider the robustness of their existing arrangements and the ways in which they are communicated externally. It should encourage uptake of a new set of voluntary corporate governance principles for large private companies that is being developed in parallel by a group of industry and other stakeholders as a separate part of the reform package. Extra transparency should also strengthen public confidence in the way very large companies are being run.
- There is strong public interest in levels of executive pay, which have increased significantly over the last two decades. There is a widespread perception that executive pay has become increasingly disconnected from both the pay of ordinary working people and the underlying long-term performance of companies. The new executive pay reporting requirements will give shareholders additional information with which to hold directors to account and ensure that executive remuneration arrangements can be justified, including by reference to pay, reward and progression policies in the wider company workforce. Specifically, quoted companies with more than 250 UK employees need to disclose and explain annually the ratio of their CEO's total annual remuneration to the median remuneration of their UK employees, as well to the 25th and 75th percentiles of their UK employee population. The policy intention is to give shareholders a new tool to assess whether, and how, pay at the top of quoted companies is consistent with pay and incentives throughout the company, rather than to compare pay ratios between different companies or prescribe 'good' or 'bad' ratios. Additionally, all quoted companies need to report on the impact of share price growth on share-based executive pay. The intention is to give shareholders greater understanding of how significant share price growth over an executive pay performance period can push up executive pay, and to encourage remuneration committees to consider, if appropriate, whether any discretion should be exercised to avoid mechanistic pay outcomes.

7.4 Part 4 of the instrument is not related to the corporate governance reform project; it is specific to CICs and corrects a gap in the legislation caused by a reference to a schedule in other regulations which has been revoked. The CAICE Act 2004 requires CICs to produce community interest company reports and that regulations include provision requiring CICs to report on directors' remuneration. The instrument amends the CIC Regulations to ensure the continuation of reporting on directors' remuneration by CICs of all sizes.

Alternatives to legislation

7.5 Non-legislative measures were fully considered and form an important part of the Government's set of measures to improve corporate governance. While a number of the measures could be delivered without legislation, the only means by which to introduce new mandatory reporting requirements is through legislation. The new reporting requirements support and reinforce the following non-legislative measures.

7.6 Regulation 13 underpins the proposed revisions to the FRC's UK Corporate Governance Code (on which consultation has now been completed) to include a new principle establishing the importance of strengthening the stakeholder voice at board level and a new provision requiring companies to adopt, on a 'comply or explain' basis, one of three employee engagement mechanisms: a designated non-executive director; a formal employee advisory council; or a director from the workforce.

7.7 Regulation 14 requiring a statement of corporate governance arrangements is supported by the non-legislative work undertaken by a coalition group made up of industry and wider society bodies to develop corporate governance principles for large private companies under the leadership of James Wates, the Chairman of Wates Construction.

Consolidation

7.8 The regulations amend the Companies Act 2006, as well as the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 and the Community Interest Company Regulations 2005. The department does not intend to consolidate the relevant legislation.

8. Consultation outcome

8.1 The new reporting obligations contained in Parts 2 and 3 of this instrument are derived from consultation on the Green Paper on Corporate Governance Reform published on 29 November 2016. The Green Paper asked for views on options for strengthening shareholder oversight of executive pay, strengthening the employee, customer and wider stakeholder voice, and the case for strengthening the corporate governance framework for large, privately-held businesses. During the 13 week consultation period, Ministers and officials participated in a large number of conferences, panel events, roundtables and meetings, including in the devolved administrations. The Government received 375 written responses. It also benefitted from the House of Commons Business, Energy and Industrial Strategy Committee's report on Corporate Governance published on 5 April 2018.

8.2 The Government's response was published on 29 August 2017 (https://www.gov.uk/government/consultations/corporate-governance-reform) and included a qualitative and quantitative analysis of the views of the respondents, as well as the Government's conclusions, including the decision to legislate for the new company reporting requirements. Analysis relevant to the content of the statutory instrument is as follows:

- 53% of respondents (including a small majority of institutional and other investors) favoured the introduction of pay ratio reporting. Of the rest, the main objections were that it could produce misleading comparisons between companies in different sectors and that it might incentivise companies to off-shore or outsource work to achieve a better-balanced pay ratio;
- 86% agreed that steps should be taken to strengthen the stakeholder voice; and
- 85% agreed that there was a case for strengthening the corporate governance framework for the UK's largest privately-held businesses

8.3 The detailed content of the reporting requirements was developed following publication of the Government's response. This involved two phases of informal consultation with a balanced set of external stakeholders and professional experts, including the CBI, the TUC, the CORE coalition, the Investment Association, ICSA (the Governance Institute), GC100 and a small number of law and accountancy professionals. The final version of the instrument took account of the external input.

8.4 Part 4 of the instrument does not implement a policy change. The CAICE Act 2004 requires that the CIC Regulations provide for the reporting on directors' remuneration. Informal engagement was undertaken with key Community Interest Company stakeholders about the amendment to the CIC Regulations to restore an effective requirement for small CICs to report the information. Stakeholders understand the requirement in the CAICE Act 2004 and hold an expectation that reporting directors' remuneration will continue to help fulfil the regulatory remit and community benefit requirement of CICs.

9. Guidance

9.1 These Regulations are not accompanied by formal Guidance. However, the Department for Business, Energy and Industrial Strategy has published Q&A on the Regulations to help companies and interested stakeholders understand how they will be affected by the new reporting requirements https://www.gov.uk/government/publications/corporate-governance-new-reporting-regulations

9.2 The Financial Reporting Council is currently revising its Guidance on the Strategic Report and has agreed to include guidance on how companies should make a section 172(1) statement. The revised guidance is due to be published later this year. The Government is also aware that the GC100-Investor Group will be updating its Executive Remuneration Guidance to FTSE companies.

9.3 Guidance for CICs reporting on directors' remuneration already exists from the original regulations. It remains relevant and is accessible on the website of the Office of the Regulator of Community Interest Companies.

10. Impact

10.1 Total costs for business arising from the new reporting requirements are expected to be £16.7 m in year one; £9.8 m annually thereafter. There is no impact on charities or voluntary bodies unless these operate as companies and are above the relevant reporting thresholds, in which case the impact on these organisations is included in the total costs for business described above.

10.2 There is no impact on the public sector.

10.3 An Impact Assessment has been submitted with this memorandum and has been published alongside the Explanatory Memorandum on the legislation.gov.uk website.

10.4 The CICs provisions will not have an impact on eligible companies as they will not result in any changes to current practice. The director's remuneration reporting requirement rectifies a gap which occurred as a consequence of amending other regulations. Reporting on directors' remuneration was established by original regulations and small CICs have continued to provide this information.

11. Regulating small business

11.1 Parts 2 and 3 of the instrument do not apply to small businesses. The new reporting requirements have different qualifying thresholds but are targeted at large companies, generally using one or more of the large company thresholds set out in the Companies Act 2006 or – in the case of reporting on corporate governance arrangements – significantly higher thresholds.

11.2 Part 4 of the instrument applies to activities that are undertaken by small businesses. The amendment clarifies in the CIC Regulations that small CICs must report on their directors' remuneration as required under the CAICE Act 2004 The CIC Regulations referred to schedule 3 to the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 which was revoked in the course of implementing the Accounting Directive in 2015, although small CICs have continued to file the information. This instrument reproduces the schedule in the CIC Regulations; no specific action is proposed to minimise regulatory burdens on these small businesses.

12. Monitoring & review

12.1 The Government will monitor how companies respond to the amendments made by Part 3 of the instrument to the Large and Medium-sized Companies and Groups (Accounts and reports) Regulations 2008. A review provision has been included and the amended provisions will be reviewed after 5 years to assess their impact on businesses and the wider economy. Monitoring will include reviewing examples of relevant company reporting. It will also involve an assessment of the impact of increased transparency (alongside the related, non-legislative, measures announced by government) on the quality of engagement between companies, shareholders and wider stakeholders and the extent to which large private companies have adopted good corporate governance principles. The Government will also continue to access data on remuneration levels and structures via its data subscriptions.

13. Contact

13.1 Stephen Clark at the Department for Business, Energy and Industrial Strategy, Telephone: 0300 068 6148 or email: stephen.clark@beis.gov.uk can answer any queries regarding the instrument.