

1 Companies (Miscellaneous Reporting) Regulations 2018 (Lecture A664 – 12.15 minutes)

On 19 July 2018, The Companies (Miscellaneous Reporting) Regulations 2018 (the Regulations) were issued and will apply to financial years commencing on or after 1 January 2019 (i.e. December 2019 year ends will be the first ones affected by the Regulations). The exception to this is the requirement for companies to illustrate the impact of increases in share prices on executive pay outcomes which will apply to any new remuneration policies brought forward by companies from 1 January 2019.

The Regulations will only affect large companies, i.e. those with:

- Turnover of more than £36 million;
- Balance sheet total¹ of more than £18 million; and
- More than 250 employees

Two out of the three must be met for two consecutive years to be within scope of the Regulations.

It will also affect:

- UK incorporated companies with more than 250 UK employees. Where the company is a parent company, it is the number of employees in the group and not just the company itself which is used.
- UK incorporated companies with either more than 2,000 global employees or a turnover of £200 million globally plus a balance sheet total of over £2 billion globally. It should be noted that premium and standard listed entities which are already required to report on their corporate governance arrangements under DTR 7.2 are not within scope. Community interest companies and charitable companies are also out of scope.
- UK incorporated quoted companies with more than 250 employees. The term 'quoted' means UK incorporated companies who are quoted on the UK Official List, the New York Stock Exchange, NASDAQ or a recognised stock exchange in the European Economic Area. However, it does not include those companies which are listed on the Alternative Investment Market.

¹ Balance sheet total is fixed assets plus current assets (not net assets).

1.1 What is covered by the Regulations?

The following areas are dealt with by the Regulations:

- Reporting on matters in section 172(1) of the Companies Act 2006.
- Reporting on corporate governance arrangements in large private and unlisted public companies.
- Executive pay – pay ratio reporting.
- Executive pay – share price impact reporting.

Reporting on matters in section 172(1) of the Companies Act 2006

The Regulations effectively expand the content of the strategic report and the directors' report.

Section 172(1) of the Companies Act 2006 outlines the directors' duty to promote the success of the company. Section 172(1) states:

'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 (among other matters) to—

*S172(1)
Companies Act
2006*

- (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.'*

A company is required to include a statement which describes how the directors have had regard to the matters set out in s172(1)(a) to (f) when performing their duties. In addition, this statement also has to be available on a website. This is unlikely to affect quoted companies because they already have to make their annual report available on a website and the statement is a new component of this report. However, unquoted companies are not required to publish their annual report on a website but the Regulations require them to make the s172(1) statement available on a website.

The website in question need not be the company's own website – it can be one which is maintained on behalf of the company (e.g. the parent company's website) provided that the identity of the company in question is clear.

The directors' report must provide a summary of how their directors have:

- engaged with employees;
- had regard to employees interests; and
- the effect of that regard (including on the principal decisions taken by the entity during the financial year).

Large companies already provide information about employee engagement matters and the Regulations expands on that information.

The Regulations also require the company to provide a summary of how the directors have had regard to the need to foster the business relationships with customers, suppliers and others together with the effect of that regard (including on the principal decisions taken by the company during the financial year).

The content of the information provided in the s172(1) statement will vary depending on the individual circumstances of the company. The FRC have recently revised its *Guidance on the Strategic Report* and this can be downloaded from the FRC's website at <https://www.frc.org.uk/news/july-2018/revised-guidance-on-the-strategic-report>.

Companies will have to use professional judgement in determining how much detail should be provided in the s172(1) statement. However, the objective is that the statement should be meaningful and informative for the shareholders and provide useful information on matters which are considered to be of strategic importance to the company. The statement must be consistent with the size and complexity of the business.

Elevating information to the strategic report

Under s414C(11) of the Companies Act 2006, the new information required in the directors' report can be provided in the strategic report as part of the section 172(1) statement where the directors consider the information to be of strategic importance to the company. Where this is done, the company must state in the directors' report that it has done so and in respect of which information it has done so in order to comply with sch 7, para 1A of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410).

Reporting on corporate governance arrangements in large private and unlisted public companies

The Regulations require those companies in scope to include a statement as part of their directors' report stating which corporate governance code, if any, has been applied and how. If the company has departed from the code, then it must provide particulars of how it has departed together with the reasons why (i.e. a 'comply or explain' approach).

When the company has not applied any corporate governance code, the statement must explain why and what arrangements for corporate governance were applied.

The statement itself must be included in the directors' report. It can also be placed in the strategic report under s414C(11) of the Companies Act 2006. It must also be published on a website which is maintained by, or on behalf of, the company.

In terms of detail, companies are expected to provide sufficient detail in the statement so that their corporate governance arrangements are adequately explained.

At the end of 2018, corporate governance principles for large private companies were developed by James Wates and a coalition group. Where an entity applies these 'Wates principles', they should provide a short supporting statement for each principle explaining how it has been applied to achieve better outcomes.

Every company meeting the qualifying thresholds must comply with this new reporting requirement (including subsidiaries). This includes both subsidiaries of listed companies required to meet the UK Corporate Governance Code and subsidiaries of parent companies which prepare a consolidated group directors' report.

Executive pay – pay reporting ratio

Companies within scope must disclose, in tabular form, within the directors' remuneration report², the ratio of their CEO's latest Single Total Figure of Remuneration to:

- the median (i.e. 50th percentile) full-time equivalent (FTE) remuneration of the company's UK employees;
- the 25th percentile FTE remuneration of the company's UK employees; and
- the 75th percentile FTE remuneration of the company's UK employees.

Below this table, the company must provide supporting information and explanations including the:

- methodology chosen for calculating the ratios;
- reasons for any changes to the ratios compared to the previous year;
- in the case of the median ratio, whether, and if so why, the company believes this ratio is consistent with the company's wider policies on employee pay, reward and progression.

² Only quoted companies are required to prepare a directors' remuneration report. The requirement does not extend to companies quoted on the AIM market.

All persons who have a contract of service with the company must be included, regardless of hours they are contracted to work (but this does not include persons employed to work wholly or mainly outside the UK). It is unlikely to include persons employed under contract by another organisation, such as an agency or a contractor. In addition, persons working as contractors or consultants of the company (whether in a self-employed capacity or not) would not typically be identified as employees under a contract of service with the company.

Smoothing provisions

The Regulations include 'smoothing provisions' which can be used for companies whose headcount varies from year to year above or below 250 UK employees. The Regulations provide for a two-year time lag before a company either drops out of, or is covered again, by the pay ratio disclosure requirement. Thus:

- when the company is required to report its pay ratio for the first financial year in which the Regulations take effect, it must disclose its pay ratios for the following financial year even if it has less than 250 UK employees in the second year;
- in the third year, if the company still has 250 or fewer UK employees, it will not have to disclose its pay ratios (although it could voluntarily choose to do so);
- in the fourth year if it has more than 250 UK employees it will not have to disclose its pay ratios because it did not need to do so in the previous year; and
- in the fifth year if it has more than 250 UK employees, it will have to disclose its pay ratios because it has now been above the employee threshold for two consecutive years.

Example – 240 UK employees for 31 December 2018 year end

Massive Co PLC had an average of 240 UK employees in the financial year ended 31 December 2018 which is the financial year before the Regulations came into effect. For the year ended 31 December 2019 it had 260 UK employees.

Under the smoothing provisions, the company would not have to report its pay ratios in the 31 December 2019 annual report even though it has more than 250 UK employees during that year. If it has more than 250 UK employees for the year ended 31 December 2020 then it would have to report its pay ratios.

Going forward, the pay ratios should cover a ten-year reporting period hence the disclosure will build in the table incrementally to a ten-year period. In the first year of disclosure, only one set of ratios will be disclosed.

If the company wishes, it can report a longer time period.

Pay ratio methodology

The Regulations provide three options to companies:

- Option A;
- Option B; and
- Option C.

Option A requires the company to calculate the three ratios each year by:

- determining the total full-time equivalent (FTE) remuneration for all of its UK employees for the relevant financial year (the 'relevant financial year' is the financial year being reported on in the directors' remuneration report);
- ranking all those employees based on their FTE remuneration from low to high; and
- identifying the employees whose remuneration places them at the 25th, 50th (media) and 75th percentile points of this ranking.

Option B allows a company to identify the employees at the 25th, 50th and 75th percentiles using their latest gender pay gap information.

Option C allows the employees to be identified at these percentiles using other existing pay data provided that this data was gathered no later than the previous financial year (i.e. the financial year prior to the financial year being reported on in the latest remuneration report).

In respect of Options B and C, companies must subsequently calculate the indicatively identified employees' remuneration for the financial year being reported on in the remuneration report before the pay ratios are calculated.

Summary – Option A

Step 1:

Identify all UK employees in the company. If the company is a parent company, identify all UK employees within the whole group.

Step 2:

Calculate on a day no earlier than three months prior to the end of the relevant financial year³ the pay and benefits for every UK employee for the relevant financial year.

Step 3:

³ The 'relevant financial year' is the financial year reported on in the latest remuneration report.

Identify the employees (P25, P50 and P75) whose pay and benefits in the relevant financial year places them at the 25th, 50th and 75th percentiles of the company's UK employees in terms of pay benefits for that year, ranked from lowest to highest.

Step 4:

Use the pay and benefits for P25⁴, P50 and P75 to represent Y25⁵, Y50 and Y75 and then use Y25, Y50 and Y75 to calculate the pay ratios as follows, where X is the CEO's Single Total Figure of Remuneration (STFR):

(X/Y25):1 – ratio of CEO STFR to 25th percentile

(X/Y50):1 – ratio of CEO STFR to 50th percentile

(X/Y75):1 – ratio of CEO STFR to 75th percentile

Summary – Option B

Step 1:

Use the most recent hourly rate gender pay gap information collected by the company to identify three UK employees whose remuneration places them at the 25th, 50th and 75th percentiles of the company's UK employee population ranked by pay and benefits from the lowest to the highest. In the Regulations, the three employees are referred to as 'best equivalents' of P25, P50 and P75, pending Step 2 below.

Step 2:

On a day no earlier than three months prior to the end of the relevant financial year, calculate the pay and benefits for the relevant financial year for the three 'best equivalents' of P25, P50 and P75 identified in Step 1.

Step 3:

Make any necessary adjustments to the pay and benefits identified in Step 2, in order to provide further assurance that the pay and benefits are representative of P25, P50 and P75 for the relevant financial year. For example, an employee identified as the best equivalent of P25, P50 or P75 using gender pay gap information may receive much higher or lower variable pay in the relevant financial year to which the pay ratios must relate. An adjustment may be necessary in such cases to prevent a misleading representation of employee pay and benefits at the 25th, 50th and 75th percentiles.

The pay and benefits identified for P25, P50 and P75 in the relevant financial year, after any adjustments, should then be used as Y25, Y50 and Y75.

Step 4:

Follow the same for Step 4 in Option A.

⁴ 'P25, P50 and P75' represents the UK employees whose pay and benefits corresponds to Y25, Y50 or Y75 respectively.

⁵ 'Y' is the label for denominator for the pay ratio calculation with 'X' being the label for the numerator which is the CEO's Single Total Figure of Remuneration.

Summary – Option C (use of other pre-existing pay data)

Step 1:

Use other pre-existing pay information for UK employees as an alternative to, or in combination with, gender pay gap information to identify three UK employees whose remuneration places them at the 25th, 50th and 75th percentiles of remuneration of the company's UK employee population.

Steps 2, 3 and 4:

Follow the same steps for Option B.

Executive pay – share price impact reporting

Companies within scope must provide:

- (a) In the next new directors' remuneration policy, an illustration of the potential impact of growth in share price on executive remuneration outcomes which are linked to performance targets or measures relating to more than one financial year.
- (b) In the annual directors' remuneration report, as an additional disclosure under the Single Total Figure of Remuneration (STFR) table:
 - (i) an estimate of the amount of the STFR which may be attributable to increases in share price; and
 - (ii) whether, and if so how, discretion has been exercised as a result of either increase or decrease in share price.
- (c) In the annual directors' remuneration report, within the Remuneration Committee Chair's statement, a summary of any discretion which has been exercised on executive remuneration outcomes reported that year.

Companies affected are those which prepare directors' remuneration reports (i.e. all UK incorporated entities who are quoted on the Official List, the New York Stock Exchange, NASDAQ or a regulated stock exchange within the EEA).