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BEIS Committee Inquiry into Thomas Cook

I am grateful for the report of the predecessor Committee in the last Parliament following its inquiry into the collapse of Thomas Cook. The Government's response to the Committee's conclusions and recommendations is attached to this letter.

The collapse of Thomas Cook was a distressing experience for the people who lost their jobs and holidaymakers alike. Following the statement to the House in November made by the Secretary of State at the time, the Government stepped in swiftly to reassure those customers of Thomas Cook with the most serious outstanding personal injury claims. Legislation is being brought forward quickly to establish a capped statutory payment scheme. BEIS will consider the risks of a similar situation occurring again and will take steps to prevent any recurrence should it be necessary.

As the Committee's conclusions acknowledge, standards of audit and corporate governance have come under the spotlight on too many occasions. That is why the Government commissioned three major reviews covering audit regulation, the audit market and the audit product itself. The last of these reported in December. The reviews are interlinked, and we are now developing a coherent reform programme that takes account of all of their recommendations. We will respond with comprehensive proposals, and legislation to create the new Audit, Reporting and Governance Authority will follow as soon as Parliamentary time allows. In many areas we do not need legislation and where that is the case we are making progress with implementation.

Our goal is to ensure that the UK has a world leading corporate governance framework which commands the confidence of investors and the wider public and reduces the risk of avoidable and disorderly corporate failure.

I welcome the Committee's contribution to and continuing interest in audit and corporate governance and look forward to engaging with you further on these and other matters.

A handwritten signature in blue ink, appearing to read "Martin Callan". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Lord Callanan

BEIS COMMITTEE INQUIRY INTO THOMAS COOK
GOVERNMENT RESPONSE TO CONCLUSIONS AND RECOMMENDATIONS

Introduction

1. The Government is grateful to the Committee for the outputs of its inquiry into the collapse of Thomas Cook and its conclusions and recommendations, which the Government will take into account in developing its corporate governance and audit reforms.
2. Corporate failures in the last few years have contributed to a loss of trust and engagement between business and the communities it serves. It is vital that we take steps to restore that trust and strengthen our credentials as global leaders in corporate governance and corporate transparency.
3. The recommendations made in the Independent Review of the Financial Reporting Council for the creation of a new statutory regulator are one component of a comprehensive reform package which will be supplemented by the Government's response to the CMA's study of the statutory audit market and Sir Donald Brydon's review into the quality and effectiveness of audit, which reported in December. The Government will respond with proposals for reform of company audit and legislation will follow as soon as Parliamentary time allows.

Recommendation 1

In our report Executive rewards: paying for success, we noted the importance of not only the Corporate Governance Code, but also the establishment of a new and more powerful regulator to replace the Financial Reporting Council (FRC), in order to achieve lasting change on executive pay and its reporting. We are disappointed that the legislation to replace the FRC with the Audit, Reporting and Governance Authority (ARGA) has not been introduced, and agree with Sir John Kingman that this would be the "final, crucial piece of the jigsaw" in terms of corporate governance reform.

Government response

4. The Government shares the Committee's vision of a new and more powerful regulator, and is committed to putting ARGA on a statutory footing as part of a comprehensive and co-ordinated programme of reform taking account of the CMA's findings on the statutory audit market and the recommendations made in Sir Donald Brydon's Independent Review into the quality and effectiveness of audit. It will bring forward legislation as soon as Parliamentary time allows.
5. As part of the reforms, the Government intends to give the new regulator stronger powers to scrutinise and enforce compliance with relevant reporting requirements on executive pay and corporate governance as part of an expanded corporate reporting review function. We have already taken steps to strengthen the framework for

corporate reporting and to increase transparency and accountability for executive pay. We are actively considering what more we can do to make sure that remuneration is aligned with performance.

6. The reforms that we put in place have already had an impact. In 2012, median FTSE100 CEO pay was £4.5m. Last year it was £3.46m. This represents a 23% fall in average median CEO pay in the period from 2012 to 2019.

Recommendation 2

As with executive pay, changes to executive pension contributions are needed in order to create a fairer system. We expect the FRC's replacement to have a role here, alongside pressure from investors, stakeholders and remuneration committees.

Government response

7. As the Committee's conclusions acknowledge, this is an area where the Financial Reporting Council and investors have been active in seeking an alignment of executive pension contributions with those of the workforce.
8. The FRC introduced a new Corporate Governance Code provision, in force from the start of 2019, requiring that "pension contribution rates for executive directors, or payments in lieu, should be aligned with those available to the workforce". This has been backed up with pressure from institutional investors who made executive pension contribution rates a particular focus for their engagement with companies last year. As a result, more than 30 FTSE 100 companies made significant changes to their pension policies, in particular in relation to pension contributions for newly appointed directors.
9. In 2020, a significant number of companies will be preparing new remuneration policies, which will then be subject to a binding shareholder vote. The Government therefore expects to see significant further progress from companies this year, in particular, in aligning contribution rates for their existing directors with those for their wider workforce. This is supported by the Investment Association which has set out its expectation that pension contributions for incumbent directors should be brought into line with the majority of the workforce by the end of 2022 and that companies should show that they have a plan for achieving this.

Recommendation 3

We recommend that bonus scheme arrangements should always use measures that are pre-defined and not ambiguous, or open to interpretation or favourable adjustment. The schemes should be designed to address a balanced assessment of company objectives, rather than to focus on one aspect of company health to the detriment of another. Particular care should be taken in the design of bonus arrangements to avoid any potential for "gaming" the system merely to meet targets and generate bonuses.

We reiterate our previous recommendation that the Financial Reporting Council (FRC)'s successor engages with investors to develop guidelines on bonuses to ensure that they are

genuinely stretching and a reward only for exceptional performance, rather than being effectively an expected element of annual salary.

Government response

10. The Government agrees that using a range of financial, non-financial and strategic measures can help ensure that bonus targets are aligned with how the company will deliver value over the long-term in line with company purpose. It also agrees that metrics need to be reliable and credible to satisfy shareholders. It notes too that Sir Donald Brydon, in his report, calls for performance indicators used to calculate executive remuneration to be audited. Subjecting these measures of future financial performance to audit could be a way to provide users of accounts with more certainty that there were appropriate controls in place and potentially to deter “gaming” in order to hit bonus targets. The Government will consider this Committee recommendation as part of its response to Sir Donald’s report.
11. The Financial Reporting Council already takes a close interest in bonus arrangements and target setting. Principle P of the Code, for example, states that remuneration policies and practices should be designed to support the company’s strategy and promote long-term sustainable success. As part of this requirement, companies’ remuneration policies are expected to disclose the financial and non-financial performance indicators used to measure their annual bonus and Long-Term Incentive Plan awards, and how they are aligned to the company’s long-term strategy. A report published by the FRC’s Financial Reporting Lab in 2018 underlined that investors want performance metrics to be “aligned to strategy, transparent, in context, reliable and consistent”¹.
12. As part of the regulator’s new identity and focus, it is envisaged that it will engage at a more senior level in a wider and deeper dialogue with UK investors and other users of financial information on corporate governance and corporate reporting, including the executive pay framework.

Recommendation 4

We recommend that provisions on clawback need to be strengthened and the scope of clawbacks extended, in statute if necessary, to achieve the principles of natural justice. We recommend that all future performance bonus arrangements established are required to include suitable clawback provisions for a suitable period. These clawback provisions need to be enforceable and cover all elements of the bonus. It is not acceptable for large bonuses to be paid, for it to subsequently be clear that the terms of the bonus award were not met, but for it not to be possible, legally, to clawback the bonus.

Government response

13. The Government agrees that directors’ contracts should include malus and clawback provisions allowing companies to withhold remuneration, or recover it if it has already

¹ FRC, *Performance metrics - an investor perspective* (June 2018)

been paid, and that care should be taken to ensure that the provisions are capable of being enforced in practice.

14. The UK Corporate Governance Code states that directors' remuneration policies should "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." The Code's provisions apply on a comply or explain basis to premium listed companies, but Government expects companies to act on this provision and for shareholders, where necessary, to use their binding vote on remuneration policies to ensure that companies have robust malus and clawback arrangements in place.
15. Research undertaken by Deloitte in 2018 into FTSE350 remuneration policies suggests that 90% of companies operate malus and clawback provisions. This is encouraging, but further improvement is needed. The Government agrees that there should be no reward for failure and is committed to improving incentives to attack the problem.
16. In the specific case of Thomas Cook, the Committee will be aware that the Official Receiver has made it clear that he will review payments made to executives, and that where those payments are unlawful or unjustified, he will take action to recover them.

Recommendation 5

We repeat our recommendations that the Small Business Commissioner be given the powers he or she needs to tackle the issue of late payments, and that the Government introduces a statutory limit of 30 days for suppliers to be paid. We also recommend that the Government set more ambitious objectives in its conversations with the Financial Reporting Council on reporting supply chain finance in company accounts and audits.

A company's payments practices should be a measure by which CEO performance is measured, and by which bonuses are allocated.

Government response

17. The Government has a range of measures in place to tackle late payment with the aim of addressing imbalances in market power between parties, increasing transparency and encouraging better payment practices through culture change.
18. The Government response to its Call for Evidence on late payment culture was published in June 2019, announcing a broad package of measures, including:
 - consulting on strengthening the Small Business Commissioner's existing powers and new powers to tackle late payments through fines and binding payment plans;
 - strengthening and reforming the Prompt Payment Code;
 - taking a tough compliance approach to large companies who do not comply with the Payment Practices Reporting Duty;
 - establishing a Business Basics Fund competition of up to £1m for SMEs to utilise payment technology;

- reviewing the role supply chain finance plays in prompt payment; and
- greater transparency in companies reporting supply chain finance.

Work on implementing these announcements is well underway.

19. The Government does not agree with the Committee’s recommendation for introducing a statutory 30 days limit for paying suppliers. Setting maximum limits on legal payment terms might address the problem of lengthy payment periods in some contracts, but the disadvantages outweigh the advantages. Accepted payment terms vary across the economy from sector to sector and a ‘one size fits all’ approach is not the best way to deliver the change required. If we were to take a sectoral approach to this policy, there would be significant variations in payment terms between sectors which would complicate the framework for small businesses. Furthermore, government would be restricting businesses’ ability to negotiate business to business contracts. This flexibility is highly valued by business and ending it could have a negative impact on the economy.
20. The law already provides minimum safeguards. The Late Payment of Commercial Debts (Interest) Act 1998 sets out that payment terms between two businesses should not exceed 60 days, unless they are fair to both parties. Suppliers can also claim statutory interest and debt recovery costs on invoices not paid within the agreed period or (if no period is agreed) within 30 days. It also establishes maximum 30-day payment terms for transactions with public authorities.
21. Following the collapse of Carillion concerns were raised about the accounting treatment and disclosure of certain types of supply chain financing arrangements such as reverse factoring, and whether these were being appropriately classified in the accounts. The FRC has addressed this through its 2018/19 annual letter to audit committee chairs and finance directors. This warned that it expects the strategic report and the disclosures in the financial statements to describe the nature and amount of any material supplier financing arrangements and the impact on the company’s liquidity. The equivalent 2019/20 letter expected boards to have due regard to reporting on payments to suppliers in line with the BEIS response to its consultation ‘*Creating a Responsible Payments Culture*’.

Recommendation 6

The Government should undertake an evaluation of the current insolvency process, and assess how it could be streamlined or simplified to help those managing the application process whilst dealing with the practicalities of losing their job.

We welcome the letter sent by the Secretary of State on 23 September to UK Finance, but we would encourage the Government to go further, and to seek a binding commitment from lenders that those who have lost their jobs as a result of a corporate liquidation can benefit from a loan payment holiday or mortgage payment holiday.

Government response

22. The Government recognises that being made redundant is a very difficult time for the individuals concerned. The operation of the Redundancy Payments Service is designed to reflect the fact that it involves using public funds to pay those who are owed money by their employer. A range of payments can be made covering unpaid wages, statutory redundancy pay, holiday, and notice pay, and it is essential that certain statutory checks and processes are undertaken to ensure that all money paid is correctly calculated under the relevant legislation.
23. Every effort is made to ensure that the right information is provided to employees at the right time to ensure they understand what they can claim and how to do so, so that payments can be made as quickly as possible. In the case of Thomas Cook, the Insolvency Service was able to make payments to its former employees within 3-4 days of receipt of the necessary information. The Government welcomes the Committee's acknowledgement of that achievement. This is partly due to a new case management system introduced by the Insolvency Service which enables faster processing of payments, and greater capacity to handle large volumes of claims when they arise.
24. The Insolvency Service is working to maximise the benefits provided by its new IT system in addition to building closer relationships with its partners in the private and public sectors to improve the support and help available to employees when redundancy occurs. The Government therefore believes that an evaluation of the current process is unnecessary at this point.
25. Financial services firms understand that customers can experience difficulty with their finances, which is why there are a number of support mechanisms in place. In the case of Thomas Cook, the financial services industry convened a taskforce, co-ordinated by UK Finance, to ensure that customers facing redundancy were adequately supported. This included raising awareness of information relating to claims, redundancy and reduced income.
26. Under existing FCA rules for consumer credit contracts and mortgage lending, all authorised lenders are required to give customers a period of forbearance and to treat those who are at risk of financial difficulty fairly. During this time, customers will not be subject to collections or enforcement activity, and lenders have the ability to accept reduced payments or grant a payment holiday as appropriate for their customers circumstances.
27. There is currently no corresponding requirement for other creditors (such as for council tax or utility services) to show similar forbearance. HM Treasury, however, has

announced plans to lay regulations on extending ‘breathing space’ to all creditors and implement this by early 2021.²

Recommendation 7

We reiterate our predecessor Committee’s recommendation:

The more similar that individual directors think, act, and look, the more likely it is that they are not going to challenge each other, or innovate, or think imaginatively. Directors should not be appointed to the board solely on the basis of one particular background or area of expertise. Greater cognitive diversity promotes more effective challenge and more informed decision-making and we recommend that the FRC works with others to provide improved guidance on this aspect of diversity in the context of board membership.

Our predecessor Committee also recommended that the Government should legislate to ensure that all FTSE 100 companies and businesses publish their workforce data, broken down by ethnicity and by pay band. We welcome the Government’s consultation into this, and recommend that the new Government prioritises its implementation next year. The FRC’s new Corporate Governance Code, which entered into force on 1 January, should help to improve board diversity.

Government response

28. The Government strongly agrees with the Committee’s views and is committed to promoting business leadership diversity and inclusion. Companies should embrace diversity throughout the organisation including at board level, senior leadership and throughout the talent pipeline. A diverse board can lead to cultural change in the boardroom: it offers greater challenge to proposed decisions, reduces the level of “group think”, produces a broader spectrum of ideas and is potentially more ‘risk aware’.
29. The UK Corporate Governance Code, and now the Stewardship Code too, place important requirements on companies and investors alike to promote diversity and inclusion in the boardroom. Future corporate reporting will require better and fuller presentations, not only of company diversity policies, but of the outcomes they achieve and how this will link to the company’s strategy. Specifically, the Corporate Governance Code requires that all directors are subject to annual re-election and that the papers supporting the necessary shareholder resolution should state how each director contributes to the company’s long-term sustainable success.
30. Significant progress has been made through the Government commissioned Hampton-Alexander Review which focuses on increasing the representation of women on FTSE

² <https://www.gov.uk/government/consultations/breathing-space-scheme-consultation-on-a-policy-proposal>

350 boards. As of April 2020, there were 32.1% women on FTSE 350 boards compared to just 9.5% in 2011 and the number of all-male boards is at an all-time low of just 1, down from 152 at the same starting point. However, companies need to maintain momentum – further action is needed to create more gender-balanced leadership in UK business.

31. The Government also supports the Parker Review on ethnic diversity of UK boards and in 2018 launched The Race at Work Charter together with Business in the Community. This commits businesses to a bold set of principles and actions designed to achieve a step-change in the recruitment and progression of ethnic minority employees. The charter currently has 200 signatories. These initiatives aim to improve both board diversity and that of the talent pipeline for senior business leadership positions. As the Committee notes, the Government has consulted on Ethnicity Pay Reporting and will respond in due course.

Recommendation 8

We recommend that the use of goodwill and its impairment should be reviewed. Our Report on the Future of Audit, and Sir John Kingman's review, made the case for graduated findings and we recommend that this should be implemented swiftly so that serious doubts over issues such as goodwill can be clearly reflected in audit opinions.

Government response

32. The Government agrees with the first part of this recommendation and notes that work is already underway to improve reporting against International Financial Reporting Standards (IFRS) on accounting for goodwill and impairment. The International Accounting Standards Board (IASB) published a discussion paper setting out proposals for changes to goodwill accounting in March 2020. The comment deadline is 31 December 2020. This is a longer deadline compared to the Board's normal due process, set to allow additional time for Covid-19 related disruption. The Government also welcomes the FRC's new reporting requirements relating to going concern, which will provide users of accounts with greater insight into a company's key risks and how they are being addressed.
33. Sir John Kingman recommended that the new regulator consider further enhancements to the audit report to include graduated audit findings. These would offer more scope for the auditor to report on how cautious or optimistic a company had been in its financial reporting and on the judgements made by directors. Sir Donald Brydon's Call for Views last year also sought views on moving to disclosure of graduated audit findings. His recommendation, however, is that this should not be mandatory, but left as a matter for companies and their shareholders.
34. The Government is considering all of Sir Donald's recommendations carefully and, as promised in the Terms of Reference for his review, intends to consult on them. This will provide an opportunity for further consideration of the concept.

Recommendation 9

We reiterate our previous recommendation for audit firms to make a clear separation between the audit and non-audit parts of their businesses. Whilst we acknowledge that PwC eventually terminated their non-audit work for Thomas Cook, we are disappointed that this only came about as a reaction to a change in the law. In our view, the audit industry is not proactive; it always waits for legislation rather than demonstrating the professional grit and integrity required in order to reduce such conflicts of interest. We are frustrated that the industry appears to have failed to acknowledge that it has been complicit in a string of corporate failures, including BHS and Carillion.

Reform of the sector is urgently required, and we share Sir John Kingman's disappointment that proposals were not included in the Queen's Speech. We note the Secretary of State, the Rt Hon Andrea Leadsom MP's explanation that she was waiting for the conclusion of the Brydon review before bringing forward legislation. However, the collapse of Thomas Cook is yet another warning of the "risks of letting the FRC drift on, half-reformed and lacking the teeth that only legislation can give it", as Sir John Kingman said in his letter to us. We therefore recommend that the new Government recognise the "unequivocal consensus around the need for change" and make urgent provision for the required legislation, to be announced in the first Queen's Speech of the new Parliament.

Government response

35. The Government broadly agrees with this recommendation and welcomes the publication in December 2019 of the FRC's revised Auditing Standards and amended Ethical Standards which now prevent auditors of Public Interest Entities from providing non-audit services unless these services are closely linked to the audit itself or required by law or regulation.
36. The Government is committed to reform. The three previously mentioned independent reviews on audit regulation, the audit market and the quality and effectiveness of audit are inter-linked and it is important that they are considered together. The Government will respond with comprehensive proposals for reform of company audit and will then bring forward legislation as soon as parliamentary time allows.