Annex: Conclusions and Recommendations

Thomas Cook pay and bonuses

Remuneration

Our March 2019 Report *Executive rewards: paying for success* concluded that "huge differentials in pay between those at the top and bottom remain the norm. Executive greed, fed by a heavy reliance on incentive pay, has been baked into the remuneration system. With that comes a public perception of institutional unfairness that, if not addressed, is liable to forment hostility, accentuate a sense of injustice and undermine social cohesion and support for the current economic model". In evidence to the Committee, former Thomas Cook CEO Peter Fankhauser noted that "I am not going to try to defend my base pay because, in relation to a normal worker's base salary, it is an enormous amount".

It is not for this Committee to specify how much private companies pay their CEOs and Board members. However, public awareness and acceptance of executive pay is changing. In our March 2019 Report, *Executive rewards: paying for success*, we welcomed the remuneration guidance set out in the revised Corporate Governance Code as well as new remuneration reporting requirements. We noted, however, that the Corporate Governance Code and guidance alone would not achieve change; the regulator to replace the Financial Reporting Council has to be given the tools to take decisive action, where necessary, on executive pay and its reporting.

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.

Pensions

We were shocked to learn that Peter Fankhauser, Thomas Cook CEO from 2014 until the company's collapse, received an annual taxable cash allowance of an amount equivalent to 30% of his base salary for his pension contribution. In evidence to the Committee, Warren Tucker, the former Chair of the Thomas Cook Remuneration Committee said that, at the time of Mr Fankhauser's appointment, the 30% contribution was decided upon "having carefully looked at what the marketplace was doing and taken advice from our advisers […] subsequently, that accepted level has come down".

In our March 2019 Report *Executive rewards: paying for success*, the Committee noted:

> *….we have advocated greater alignment in the way in which profits are shared between executives and employees. The same should apply to pension contributions.*

As we have seen, there has been a tendency for a crackdown on one element of pay to lead to corresponding increases in other elements. Pension contributions is one such area, where chief executives in the FTSE 100 have enjoyed pension contribution rates around 25-30%, while their employees receive around 9%-10%: an unacceptable example of weak corporate governance and flagrant disregard for any notion of fairness.

Our Report also recommended that the replacement regulator of the Financial Reporting Council seeks public explanations from any company that fails to deliver alignment on pension contributions. We welcome the inclusion in the new Corporate Governance Code that "pension contribution rates for executive directors, or payments in lieu, should be aligned with those available to the workforce". We also welcome the September announcement by the Investment Association, that they will give a "red top" warning to companies who pay their existing directors more than 25% of salary as a pension contribution.

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.

Criteria for bonuses

Between 2014 and 2019, bonuses for the CEO of Thomas Cook "were targeted on five different measures: free cashflow generation, underlying operating profit, customer satisfaction, employee satisfaction and turnaround milestones." The underlying operating profit figure excluded any "separately disclosed items", which over 8 years totalled £1.5 billion.

Bonus criteria need to be more transparent. In our view, bonuses should be awarded for actions to promote the long-term interest of the company, with a focus on debt and the wider culture in which the company operates. At present it is all too easy for companies to establish criteria for the award of bonuses which are too easy to achieve or measure only certain aspects of performance; which ignore more intractable issues; or which allow management discretion in the determination of the measures on which the bonuses are based.

For example, the terms "underlying operating profit", or "underlying earnings before interest and tax", on which Thomas Cook bonuses were at various times based, depended on which costs were included as part of the calculation and which costs were "separately disclosed"— an issue over which the company management and auditors were at times in disagreement. At the same time performance measures at Thomas Cook in 2018 did not directly address high levels of debt— highlighted by Peter Fankhauser himself as a key cause of the Group's ultimate demise.

It is important that the bonus schemes determined by remuneration committees are not only robust, but the measured data on which they are based is too.

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.

Clawback and malus

There is understandable indignation when bonuses have been paid to senior executives in recognition of success, only for the company to fail a short time later. For instance, as recently as 2017, Thomas Cook awarded its CEO a large bonus, only for the group to fail two years later in 2019. The former CEO himself was unable to answer how much of that bonus might be clawed back.

Whether a bonus already awarded can be clawed back depends on whether suitable provisions for clawback were made in advance, usually in a contract of employment. Any clawback must also avoid being considered as a penalty clause- which generally would make it unenforceable under UK law.

In some cases, provisions exist not only to clawback bonuses already paid but to withhold and subsequently withdraw bonuses before they can be paid- a concept known as malus. This could be when the original assessment on which the performance was based is later revised and as a result the bonus is no longer due.

The UK Corporate Governance Code says 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." However, during our inquiry into the collapse of Carillion last year we often found that bonuses which had been paid could not be clawed back, despite the declining performance of the company, due to the narrowly defined nature of the contractual clawback provisions.

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.

Late Payments

The Committee has previously looked at the issue of late payments to suppliers, both as part of our May 2018 Report on the collapse of *Carillion* and in our December 2018 Report on *Small businesses and productivity*.

As we noted in our *Small businesses and productivity* Report, being paid fairly and on time is crucial for a small business to succeed. That many large companies continue to pay their suppliers late is a sign that the reporting and compliance regime is not working. It also indicates more widely a flawed corporate culture.

During evidence as part of our inquiry into Thomas Cook, we heard from Martin McTague of the Federation of Small Businesses that Thomas Cook "had a lousy payment record. It was consistently posted as poor […] we saw clear examples of suppliers to Thomas Cook getting paid in 90 days plus, and that they were spending an inordinate amount of time chasing them". Thomas Cook was not a signatory to the Prompt Payment Code.

The Committee has previously recommended that the Government should introduce a statutory requirement for companies to pay within 30 days, and that the Small Business Commissioner should be given the powers to fine those companies who pay late. Whilst we welcome the Government's plans to consult on strengthening the role of the Small Business Commissioner, and its plans to bring greater transparency to how supply chain finance is reported in company accounts and assessed in audits, tougher and more urgent action is needed to end the culture of late payments.

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 practises should be a measure by which CEO performance is measured, and by which bonuses are allocated.

Insolvency

When Thomas Cook went into liquidation on 23 September, its 9,000 UK employees were immediately impacted. We heard that employees were due to be paid on 30 September, and that from "day one, people had no money". We welcome the Government's creation of a National Taskforce, and the letter written by the Secretary of State for Business, Energy and Industrial Strategy on 23 September to UK Finance to explain the position of former Thomas Cook employees. The Insolvency Service has since sped up the processing of redundancy payments, and we place our thanks to them on the record. In evidence, we heard about the difficulties that employees face in applying for redundancy payments as well as the time it takes for that money to be released.

The Government should undertake an evaluation of the current insolvency process, and

asses 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.

The role of the Board

The Institute of Directors notes that a Board's key purpose *"is to ensure the company's prosperity by collectively directing the company's affairs, while meeting the appropriate interests of its shareholders and relevant stakeholders"*. This requires directors to balance objectives which can seem contradictory, for example: being entrepreneurial whilst exercising prudence; being familiar with and answerable for the company's workings whilst being able to stand-back and retain an objective view; and being sensitive to short-term pressures whilst taking accounting of broader, long-term trends.

It appears that the board of Thomas Cook Group failed to balance these competing objectives effectively. Over the period 2007-2011 it oversaw a series of acquisitions which saddled the Group with high-levels of long-term debt; this hovered around £1 billion for most of the Group's lifetime. We heard no compelling evidence to indicate that non-executive directors had challenged the decision to take on such substantial levels of debt during the early years of the company. The Group did make efforts to reduce its debt levels, with numerous disposals over 2010-2014. However, these were insufficient to bring debt down to a level that would be manageable in the long term – and several opportunities to reduce debt further seem to have been missed. As a result, the Group typically paid between £100 and £170 million per year in financing costs. This severely limited the potential for investments to diversify the business, as well as to close down costly high street stores in later years.

Our predecessor Committee's April 2017 *Corporate Governance* Report highlighted the dangers of "groupthink" on boards, and the necessity of gender, ethnic, social background and cognitive diversity to ensure that board dialogues are constructive and challenging. Harriet Green was both Thomas Cook Group's only female CEO and its only CEO to be recruited from outside the travel sector. Of the Executive Directors we took evidence from, she was also the only one to acknowledge significant challenge from the rest of the board. Green further raised concerns about the board's lack of cognitive diversity, suggesting that the board had not sufficiently understood "how to change business models". It is notable that she was asked to leave Thomas Cook in 2014 so that the Group could "return to more traditional travel-oriented leadership", despite her success in raising the company's share price from 16p to 136p.

It is not possible to prove causality between lack of diversity on the Thomas Cook board and the collapse of the company. Nonetheless it appears that the board was insufficiently challenging of repeated decisions to take on very substantial debts, and that there was significant resistance to following-through on new business approaches.

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.

Audit

In December 2018, Sir John Kingman published his independent review of the Financial Reporting Council (FRC). He made 83 recommendations, including the creation of a new regulator to replace the FRC with the Audit, Reporting and Governance Authority (ARGA). In March 2019, the Government published its response, noting that it intended to move swiftly to implement the reforms and overhaul the sector.

In our April 2019 Report, *the Future of Audit*, we made a number of recommendations in relation to reform of the audit market, including: a full structural split between audit and non-audit services; the use of a market cap in the audit market and a pilot of joint audits; increased rotation of audit firms (for a maximum period of 7 instead of 20 years); and a cooling off period of three years within which an audit firm could not sell non-audit services to a firm it had audited.

In April 2019, the Competition and Markets Authority (CMA) published its final report with recommendations to address serious competition problems in the UK audit industry. The Government has completed an initial consultation on the CMA's proposals and is considering the responses. Sir Donald Brydon's independent review into the quality and effectiveness of audit is expected to report this year.

Goodwill

We have previously questioned the use of "goodwill" as an accounting practice. Goodwill is an intangible asset associated with the purchase of one company by another and can include items such as the skills of the workforce and brand of the company being acquired, or synergies with the purchasing company. It is recorded as the difference between the net assets and the amount paid for a company. Our Report on the collapse of Carillion found that its performance was propped up by goodwill (£1.6 billion in 2016), that was not impaired or treated like tangible assets, and that was not challenged by its auditors, KPMG. We concluded that the inability to question this was fundamental to the misleading picture of corporate health presented in Carillion's audited annual accounts. It represented a failure by KPMG in failing to exercise—and voice—professional scepticism towards Carillion's aggressive accounting judgements.

We are therefore very disappointed to find yet another corporate collapse in which goodwill has played a major part. We heard, for example, that goodwill on Thomas Cook's balance sheet had not been written down since 2012 because its auditors, PwC and then EY, had considered that its cash flows and business plans continued to justify its unchanged status. It did not impair significant further amounts until the final interim results were released in May 2019. Indeed, in 2018, the decision not to amortise any goodwill was arrived at by basing goodwill value on somewhat optimistic assumptions contained in Thomas Cook's plan of constant growth in earnings before interest and tax ("EBIT") of 28.3% from year 1 to year 4. At the end of September 2018, 39.4% of the assets on the balance sheet were represented by goodwill.

Both PwC and EY told us that they asked the right questions and challenged Thomas Cook's management. EY said that they had followed accountancy standards and procedures in this respect. If the latter is true, and goodwill is being treated in this way across the FTSE 350, it should be cause for grave concern. This would mean that more Carillion and Thomas Cook collapses are potentially already locked into the system. It also presents a picture of audit automatons that are incapable of drawing the most basic of conclusions from a balance sheet, questioning what they add to the corporate reporting process.

We recommend that 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.

Potential Conflicts of Interest

Most external audits are conducted by the Big Four (PwC, EY, KPMG and Deloitte). Each of these has a consultancy arm which also offers services for companies other than audit. It is not uncommon for the same audit firm that audits a company's accounts also to provide some other services to that company, although generally there will be some measures in place (such as ensuring separation of management responsibility) within the audit firm to minimise the potential for conflicts of interest. The Financial Reporting Council (FRC) is currently considering whether the rules about conflicts of interest between the two types of work by audit firms need to change. For instance, the FRC is consulting on better tests for audit firms to appraise their independence when offering such services and a shorter list of those services that audit firms can offer to their audit clients.

We were not surprised then to yet again uncover a catalogue of failures and misjudgements in the relationship between Thomas Cook and its auditors. PwC were Thomas Cook's auditors between 2008 and 2016. Between 2007 and 2012, PwC also earned £4m providing "recruitment and remuneration" advice to Thomas Cook. This was a clear conflict of interest, with insufficient measures in place to manage this conflict internally – as profit sharing occurred across the whole business with no distinction between audit and consultancy work.

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.