

Insights

FRC ADVICE ON IMPROVING THE QUALITY OF 'COMPLY OR EXPLAIN' REPORTING

Mar 02, 2021

SUMMARY

The FRC has published advice, based on an analysis of 100 companies (FTSE 100 & 250 and Small Cap companies), on how listed companies can report transparently and effectively when departing from provisions of the 2018 UK Corporate Governance Code (the "Code"). This advice builds on the findings of the FRC's Review of Corporate Governance Reporting issued in November 2020 which found a number of inadequacies when it came to reporting against the new (2018) Code.

The quality of reporting against some of the Code provisions (particularly around stakeholder engagement) will be even more important this year in light of the pandemic so companies should take note and ensure their explanations are fulsome and adequate.

BACKGROUND

Unlike in other jurisdictions like the US, which follow a mandatory rules-based approach to corporate governance (e.g. the US Sarbanes-Oxley Act 2002), the UK follows a principles-based approach comprising voluntary best practice largely set out in the Code and QCA Corporate Governance Code (largely followed by AIM quoted companies). The Code therefore follows a 'comply or explain' approach which allows companies the flexibility to choose which principles and practices of corporate governance they believe are appropriate for the company at any particular time. However, in order for good governance to prevail rather than simply be explained away and for shareholders to have adequate information regarding a company's compliance with the Code, the FRC has sought to publish further advice on how the quality of 'comply or explain' reporting can be improved.

FRC ADVICE

The FRC's advice, summarised below, is intended to help companies achieve good quality explanations when departing from the Code.

- **Companies should offer clarity about the provisions they have departed from by making it easy for a reader to find this in their annual reports**

Companies should state in the compliance statement whether the company has:

- fully complied with all elements of the provisions of the Code; or
- departed from any of the provisions of the Code citing any provisions they have not complied with and state where in the report the explanation can be found.

- **Companies should report any departure from any provision of the Code**

One of the FRC's most concerning findings was that many companies were not transparent about their compliance claiming full compliance whilst on further investigation, they had not acknowledged departure from one or more provisions. For example:

Provision 5 – stakeholders' interests and workforce engagement. The FRC noted that whilst many companies identify their key stakeholders and describe their interests in their annual reports, many fail to adequately explain how their interests were taken into account in board discussions/decision-making and what the outcome was. This explanation of compliance with Provision 5 is therefore incomplete. Companies should be particularly mindful of the FRC's focus on fuller explanations around stakeholder engagement and how their interests have been taken into consideration during board discussions and strategy setting as this will also remain a key focus of investors particularly in light of COVID-19 and indeed was noted by the Investment Association as a key shareholder priority for 2021 ([Investment Association Shareholder Priorities for 2021](#)).

Provision 9 – chair must be independent on appointment. This provision had the highest rate of non-compliance in the FRC sample. Examples of unsatisfactory explanations for non-compliance include:

"On listing, the Board unanimously supported, and continues to support, my appointment as Chairman to retain my skills and experience and ensure continuity of service for customers and commercial partners."

"The Non-Executive Directors have determined that [the Chair] continues to lead the Board effectively."

In contrast, a better explanation of the rationale for non-compliance should include the reasons why:

- retaining the chair is beneficial for the company and its stakeholders, including the skills, experience and any other factors considered; and
- a new independent chair may not offer the same or better skillset.

Provision 19 – chair tenure. The FRC found that companies did not acknowledge departure from this provision despite the chair being a member of the board for more than nine years. Departures from this provision are permissible to facilitate effective succession planning or for the development of a diverse board but this should still be acknowledged as a departure and accompanied by an effective explanation.

Provision 38 – executive pensions aligned with the workforce. Where companies have not aligned some or all of their executive pensions with those of the workforce, the explanation for such a departure should include a timeline for alignment.

Provision 36 – post-employment shareholding. The FRC confirmed that unless such a policy is in place, companies cannot confirm compliance with this provision.

Provisions 23, 26 & 41 – describing the work of the nomination, audit and remuneration committees. To comply with these provisions all elements need to be effectively explained. For example, if a company has not undertaken any specific engagement with its workforce to explain how executive remuneration aligns with wider company pay policy, it is not possible to claim full compliance with provision 41.

Provisions 40 & 41. Provision 40 states that companies “*should be transparent and promote effective engagement with shareholders and the workforce*”. The FRC noted that “*effective engagement*” is more than workforce surveys and should involve two-way engagement. Explanations of compliance should describe the method of engagement, the parties involved, what explanation was given to the workforce as to how executive remuneration aligns with wider company pay policy and the views expressed by the workforce.

- **Clear and meaningful explanations for departures from the Code**

A good explanation should:

- Set the context and background
- Give a convincing rationale for the approach being taken
- Consider any risks and describe any mitigating actions
- Set out when the company intends to comply (e.g. timescales)
- Explanations should be understandable and persuasive

CONCLUSION

In summary, when a company departs from a Code provision, the explanation for non-compliance included in its annual report should clearly demonstrate:

- the action taken by the company: what provision it has departed from and what alternative approach it has chosen – companies should re-visit existing disclosure in light of the FRC's guidance summarised above and really test whether the proposed disclosure fully explains any departure and why any alternative approach has been taken; and
- the outcome: how is that alternative approach more efficient and appropriate than that prescribed by the Code, and how is it helping the company to achieve good governance? – companies should ensure that their explanations are not purely descriptive, and that they adequately demonstrate the effect on a company's governance of any alternative approach or non-compliance with a particular provision of the Code.

[FRC Review of corporate governance reporting November 2020 >](#)

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