



Improving the quality of 'comply or explain' reporting

KPMG Board Leadership Centre



The FRC have issued [Improving the quality of 'comply or explain' reporting](#) – a hard hitting analysis of 'comply or explain' reporting intended to help companies improve transparency when reporting against the 2018 UK Corporate Governance Code and in particular how to achieve good quality explanations when departing from the Code. In November 2020 the FRC published their [Review of Corporate Governance Reporting](#) – another uncompromising report that found that 'tick-box compliance' continues to be preferred over high quality reporting of good governance practice. The FRC's analysis, of a random sample of 100 companies, found that too many companies strive to disclose strict compliance with the Code and that such a formulaic approach leads to boilerplate language and ineffective reporting that lacks substance and information about governance outcomes.

The [UK Corporate Governance Code](#) offers flexibility through its 'comply or explain' approach, which is designed to encourage companies to develop the governance processes and practices that are the most suitable for their circumstances and to report them in a meaningful way. The FRC have found from their review that companies seem hesitant to disclose departures from the Provisions of the Code, with some annual reports lacking clarity or transparency in this respect. The FRC encourages companies to embrace the flexibility offered by the Code, consider their circumstances carefully and choose what is best for them, while clearly explaining any departures from the Code. The key aspects of the FRC report are set out below.

Clarity over departures from the Code

Annual reports should make it easy for the reader to clearly understand if a company has fully complied with all the Provisions and if not, the Provisions they have not complied with along with the explanation.

To do this, companies should state in their 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 that they have not complied with and state where in the report the explanation can be found.

The FRC specifically set out that disclosures that note departures from the Code, but do not clearly state which Provisions or where the explanations can be found, do not provide sufficient clarity.

The following examples would therefore **not be considered acceptable**.

"Other than where expressly stated below, throughout the financial year ended 31 December 2019, the company complied in full with all relevant provisions of the Code."

"The Board is committed to the highest standards of corporate governance and, except as set out below, the Board has complied with and intends to continue to comply with the requirements of the UK Corporate Governance Code."

Rather, the FRC expect companies to make departures clear by naming the Provision(s) in the compliance statement, for example:

"Throughout the financial year ended 31 December 2019, the company fully complied with all the provisions of the Code, except for provision 9 and we have provided a full explanation."

Report all departures from the Code

One of the most concerning findings from the FRC review was that many companies were not transparent about their compliance with the Code. Several companies in their sample, including some that claimed full compliance with the Code, on further investigation had not acknowledged departure from one or more Code Provisions.

In line with the Listing Rules, the FRC expect companies to clearly acknowledge any departures from the Code and provide full and comprehensive explanations.

Some specific examples highlighted in the FRC report included the following.

Provision 5 – stakeholders’ interests and workforce engagement

To comply with this Provision, companies need to give clear and specific examples of how they have considered in their board discussions and decision-making the interests of the key stakeholders of the company and section 172 matters. If a company does not provide a description as required by Provision 5, it is not complying with it.

The FRC note that many companies explain what the interests of different stakeholders are. However, they do not describe how these were taken into account in board discussions and decision making and what was the outcome – and therefore do not comply with the provision.

Provision 19 – chair tenure

Companies can declare compliance with this Provision only if the chair has been on the board for nine years or less. Departures from the Code to facilitate effective succession planning or the development of a diverse board are supported by the FRC – nevertheless, such cases should still be acknowledged as a departure from the Code and accompanied by an effective explanation.

Provision 38 – executive pensions aligned with the workforce

Companies can declare compliance with this Provision only if all executive pension contributions are in line with those of the workforce. This would also be the case when executive pension contributions are less than those of the workforce. In those cases where not all executive pension contributions are in line, companies should provide an explanation, which should include a timeline for alignment.

Provision 36 – post-employment shareholding

Provision 36 states that companies “should develop a formal policy for post-employment shareholding requirements encompassing both unvested and vested shares”. Therefore, unless such a policy is in place, companies are not in compliance with this Provision. It is not enough to state that the vesting and post-vesting periods apply after the departure of the directors from the company. The FRC expect that the corporate governance report references the policy that requires directors to hold their shares post-employment in addition to the vesting period.

Provisions 23, 26 and 41 – describing the work of the nomination, audit and remuneration committees

These three Provisions require companies to describe the work of each committee by reporting on various elements in relation to each committee.

To comply with any of these Provisions, all the elements of the Provision need to be effectively explained.

The FRC note that they have seen companies that do not cover some of these points but still claim compliance. For example, some companies do not describe what engagement with workforce has taken place to explain how executive remuneration aligns with wider company pay policy, but do not disclose non-compliance with Provision 41. If a company has not undertaken any specific engagement of this nature, then it is not possible to claim compliance with this Provision.

Provisions 40 and 41 – engagement with shareholders and workforce

Provision 40 requires that companies “should be transparent and promote effective engagement with shareholders and the workforce”. Provision 41 requires companies to provide a description of the engagement that has taken place with shareholders and the workforce in relation to executive remuneration. If a company has not engaged with shareholders or the workforce in relation to remuneration, then it is not compliant with Provisions 40 and 41.

Effective engagement is more than reporting that the company has sought the workforce’s views on remuneration via surveys. Engagement should be two-sided. It 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 of the workforce on it.

Moreover, it is not sufficient to state that there has been engagement with shareholders; there needs to be an explanation of what impact, if any, this engagement has had on remuneration policy.

Clear and meaningful explanations

The FRC were disappointed with the quality of the explanations provided by companies for non-compliance with Code Provisions and struggled to find robust explanations. Their sample identified 74 cases of non-compliance with the Code, but only four explanations were considered high quality and offered an insight into the companies’ approach to good governance. The majority of explanations were considered inadequate, and in one instance, not given at all.

Good explanations are key to the ‘comply or explain’ philosophy. A full and meaningful explanation for non-compliance should show that an alternative arrangement is more appropriate and beneficial in upholding high standards of governance. The FRC encourage companies to write full and meaningful explanations that offer investors and other stakeholders the opportunity to consider whether effective governance is achieved even though there is a departure from the Code.

The FRC set out some criteria for a good explanation.

Set the context and background – Companies should name the Provision that they have not complied with. They should then explain the circumstances, and as required by the Listing Rules, state the reasons why they are not complying or are unable to comply.

A convincing rationale – Companies should set out the alternative arrangement that they have chosen and state the reason(s) why they have chosen it. This should be easy and straightforward if the departure from the Code is unavoidable, but the FRC expect companies to provide a more detailed explanation when non-compliance is indefinite. For example, if the company decides to keep the chair in position for longer than nine years, a strong rationale should be provided, with clear reasons why this is important, and the criteria used to evaluate it.

Risks and mitigating actions – Companies should consider whether departing from the Code and following an alternative approach contains any risks, and disclose any actual risks arising. Where directors consider that there is no, or negligible risk, companies should state any potential risks that might arise in the future. They should then explain any actions that they have taken or will be taking to mitigate such risks. For example, the loss of independent directors could reduce challenge to board decision-making.

Set out when the company intends to comply – A good explanation should indicate whether departure is limited in time or is indefinite. When companies have not complied with a Provision only for part of the accounting year or where the departure is limited in time, they should clearly specify the time that they were unable to comply along with an estimate of when the company plans to comply and the steps it is taking to assure compliance. When departure is indefinite, companies should state this and explain whether there could be any future factors or circumstances that would give them a reason to review or change their alternative approach.

Understandable and persuasive – Considering all the above elements, companies should ensure that their explanation is understandable and persuasive. It should be written in plain language that is easy to understand and leaves no room for ambiguity. It should provide enough level of detail so that investors and stakeholders fully understand and evaluate why the company has not complied with a Provision and what the chosen alternative entails.

The KPMG Board Leadership Centre

The KPMG Board Leadership Centre offers support and guidance to non-executive directors, whether managing a portfolio non-executive career or embarking on a first appointment. Membership offers you a place within a community of board-level peers with access to topical and relevant seminars, invaluable resources and thought leadership, as well as lively and engaging networking opportunities. We equip you with the tools you need to be highly effective in your role, enabling you to focus on the issues that really matter to you and your business.

Learn more at www.kpmg.com/uk/blc.

Contact us

Timothy Copnell
Board Leadership Centre
T: +44 (0)20 7694 8082
E: tim.copnell@kpmg.co.uk

kpmg.com/uk



The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2021 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Designed by CREATE | CRT134815A