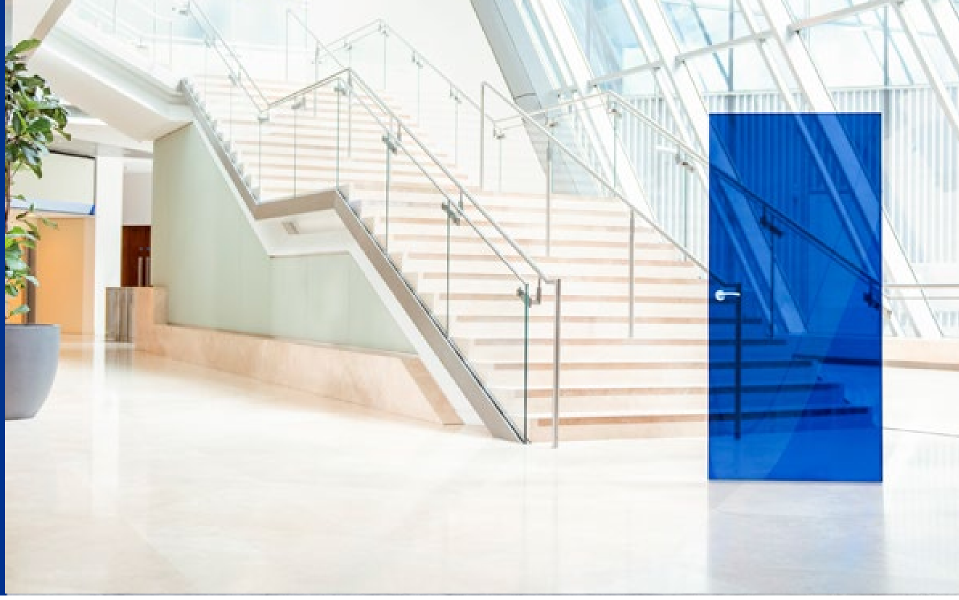
Review of corporate governance reporting

KPMG Board Leadership Centre



The recent Financial Reporting Council (FRC) report [Annual Review of Corporate Governance] sets out that there has been a general improvement in reporting against the UK Corporate Governance Code and highlights areas of high-quality reporting. However, the FRC caution that there is still room for further improvement in areas such as substantive disclosures on board appointments, succession planning and diversity. The report also found that more focus on reporting the effectiveness of internal control and risk management systems would enhance the level of confidence in the company's control framework.

This is the second year that the FRC has reviewed how UK premium listed companies have reported on their application of the 2018 UK Corporate Governance Code.

One of the major concerns last year was that companies were failing to disclose non-compliance with the Code. As a result the FRC issued [Improving the quality of 'comply or explain' reporting]. As expected, this year there has been an increase in the number of disclosures of non-compliance. However, the FRC note that there is still room for improvement in relation to the quality of explanations as they continue to see the use of boilerplate statements seldom substantiated by actions or examples.

On a more positive note, the FRC note an improvement in reporting on environmental and social issues, with better quality information on the issues under consideration and how this has been considered at board-level. However, while the quality of principal decisions reporting has improved, very few companies reported on areas where they underperformed or failed to meet targets.

Diversity and inclusion and succession planning at board-level and through the pipeline continue to remain a concern for the FRC. Here they note that there is often a lack of cohesion between policies and succession plans, and there continues to be minimal information on how diversity and inclusion policies and objectives link to company strategy. The FRC highlight the generally poor reporting by nominations committees on succession planning – typically addressing little more than the processes.

On risk management and internal control, the FRC found that all companies reported that they had reviewed their systems – which was expected. However, in a year where they expected to see new, refreshed and more informative disclosures, very few companies commented on how they had reviewed the effectiveness of their systems – an issue raised as part of the recent BEIS consultation on audit and governance reform.

Significantly, the FRC set out that following the annual review of risk management and internal controls systems, companies should comment on the outcome. "***If they are satisfied that their systems are operating effectively, they should state this in the annual report.*** *Similarly, any identified inefficiencies or weaknesses should be specified in the report, followed by an explanation of any remedial actions that have been or will be taken.*"

On remuneration, the FRC report that while most companies confirmed that their remuneration arrangements support their strategy, only some of them explained how. Very few companies explained how remuneration aligns with company purpose and values.

What do the FRC expect?

The review sets out the FRC's expectations across the five areas of the Code. For each area they set out their general conclusion, areas where reporting could be improved and examples of good practice along with expectations.

Code compliance

The FRC expects:

— Companies to report in a clear and transparent way any non-compliance with any Provisions of the Code.

— Companies to provide a clear and meaningful explanation for any departures from the Code.

Leadership

The FRC expects:

— Companies to demonstrate further improvements in the quality of disclosures of how purpose, values and strategy are connected.

— More companies to take a more rigorous approach to culture and set up effective ways of monitoring and assessing both the culture and its alignment with purpose, values and strategy.

— Companies to genuinely engage with a wide spectrum of their shareholders, not only the largest few, to understand and try to address their concerns as far as practically possible. Also, views received from shareholders and other stakeholders, and actions taken, need to be communicated in a clear manner and within a specified timeframe.

— Companies to address their shareholders' concerns formally and publicly, and in a timely manner.

— Companies to report on how the board oversees stakeholder decisions. Issues include how, and on what basis, stakeholder information is passed to the board, as well as on how often the board reviews engagement methods and identification of any issues discussed.

— Further clarity to ensure that investors and stakeholders are aware of how companies engage with their workforce.

— Outcomes from employee engagement to be illustrated within the report, alongside views and workforce concerns that ought to be taken on board. In addition, feedback from management should be provided on how the situation has been dealt with.

— Companies to report on the actual or intended outcomes of engagement and decisions on both (i) the company's key stakeholder and (ii) the business.

— Companies to provide evidence to support their statements when they are reporting on the performance of particular decisions, which may come in the form of key metrics supported by narrative or case studies.

— The information provided to be a fair and honest assessment of the company's performance in relation to stakeholder engagement, including the identification of any areas where they failed to meet targets.

— More information and transparency on why the board approved community initiatives or programmes, and how these align with strategy.

Division of Responsibilities and Board Composition

The FRC expects:

— Companies to either describe their diversity policies in full in their annual report or summarise them and link to the full document on their website to enable easy access.

— To see all companies promoting and recruiting on merit. Those that use it as a justification for not actively pursuing diversity policies should demonstrate how their approach brings about diversity in the boardroom and workforce.

— To see an improvement in reporting on succession planning. This is particularly the case for companies that highlight succession planning as an outcome of a board evaluation as an area to improve.

Audit, risk and internal controls

The FRC expects:

— Companies to report fully and clearly on both the tender process and tenure for the external auditor.

— Companies to provide disclosures, specific to the company, of their governance structure (who and what) and processes (how and when) in place to manage risk that clearly demonstrate the way that the company identifies, monitors and mitigates risks.

— Companies to explain: the process of how the board has determined the company's risk appetite; and the risk appetite for each of the company's principal risks.

In a year where so much focus has been on the proposals for a stronger UK framework for reporting on internal controls over financial reporting (as set out in the BEIS whitepaper, Restoring trust in audit and corporate governance), it is interesting to read the FRC's views on how companies have been complying with the current disclosure 'requirements' and what the FRC believe is missing.

Compliance with the Code currently requires that "*the board monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness and report on that review in the annual report. The monitoring and review should cover all material controls, including financial, operational and compliance controls.*"

The FRC specifically note that simply confirming that an annual review of the risk management and internal controls systems has taken place is not enough for compliance with the Code. "*Reporting should include a detailed description of the whole process that the board or the committee has undertaken to do this.*"

Furthermore, the FRC assert that companies should comment on the outcome of the review. "*If they are satisfied that their systems are operating effectively, they should state this in the annual report. Similarly, any identified inefficiencies or weaknesses should be specified in the report, followed by an explanation of any remedial actions that have been or will be taken.*"

What good reporting should look like:

1. Give a detailed description of the process for reviewing the effectiveness of risk management and internal control systems.
2. Explain the outcome of the review. Are these systems operating effectively? If not, what weaknesses or inefficiencies were identified?
3. If any weaknesses or inefficiencies were identified, explain what actions the board has taken, or will take, to remedy these.

Source: Review of Corporate Governance Reporting, FRC, 2021

Remuneration

The FRC expects:

— Companies to explain in their annual reports how their chosen performance metrics: support company's strategic objectives; are linked to the successful delivery of long-term strategy; and promote long-term sustainable success.

— Companies to improve reporting on how remuneration is aligned to company's purpose and values.

— Companies to state whether or not the remuneration committee has used its discretionary powers in determining final remuneration outcomes, and clearly explain the reasons for doing (or not) so.

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