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23. Corporate governance — towards best-practice corporate reporting

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Reporting is a fundamental part of the UK Corporate Governance Code (the Code). It is through appropriate reporting of governance that companies earn the right to the flexibility that a principles-based framework allows.

It is expected that companies will comply with most of the provisions of the Code most of the time — and indeed a report from the Financial Reporting Council (FRC) in December 2011, 'Developments in Corporate Governance', showed 50 per cent of FTSE 350 companies claiming full compliance and 80 per cent of the remainder complying with all but one or two of the Code's provisions. However, the UK framework crucially allows boards to exercise their judgement in respect of their governance arrangements as long as they explain their reasons for non-compliance with the Code. This judgement is not generally challenged by regulators; it is the responsibility of shareholders to consider the judgements and the explanations that are provided when a company does not follow a certain provision.

The FRC's proposed revisions to the Code for years beginning on or after October 1, 2012 include a number of measures that are intended to enhance engagement and stewardship by building the confidence of stakeholders in company reporting. The hope is that this will encourage the taking of a long-term view in decision-making and counteract the risk of a repeat of the short-termism that is often seen as a root cause of the financial crisis.

Governance reporting is an integral part of the FRC's proposals, which include enhanced audit committee reporting. But governance reporting also has a wider role to play in building investor confidence and encouraging the taking of a long-term view. Governance is not just about confidence in the financial statements; it is about confidence in the company in general. It is about showing how the company's business model, strategy and objectives, risk, performance and reward are governed.

The European Commission and 'comply or explain'

"There is some scepticism in Brussels about the effectiveness of the 'comply or explain' approach to corporate governance, and the willingness and ability of shareholders to hold boards to account. Some in the UK may feel that its track record should speak for itself, but in the current environment there is a need to demonstrate that 'comply or explain' continues to deliver strong and effective governance, and is taken seriously by companies and investors. Failure to do so could result in an approach which could be more prescriptive about the way companies organise themselves, and could give more power to regulators at the expense of shareholders."

FRC: 'Developments in corporate governance'

Governance reporting is a real opportunity to reap the benefits of the good practice that exists within companies, and to build the confidence of investors and other stakeholders and therefore company value. Few companies take this opportunity successfully.

Current governance reporting practice — why companies are missing their opportunities

With a few exceptions, despite the huge potential benefits outlined above, the reporting of corporate governance in the UK could do more to embrace

Post-IPO considerations

Personal reporting

"Chairmen are encouraged to report personally in their annual statements how the principles relating to the role and effectiveness of the board (in Sections A and B of the new Code) have been applied. Not only will this give investors a clearer picture of the steps taken by boards to operate effectively but also, by providing fuller context, it may make investors more willing to accept explanations when a company chooses to explain rather than to comply with one or more provisions. Above all, the personal reporting on governance by chairmen as the leaders of boards might be a turning point in attacking the fungus of 'boiler-plate' which is so often the preferred and easy option in sensitive areas but which is dead communication."

FRC: Preface to the Corporate Governance Code

The role of auditors

The role of auditors in 'reviewing' the corporate governance statement is set out in the Listing Rules and under auditing standards. The responsibilities are restricted to reviewing nine specific provisions of the code (C.1.1, C.2.1, and C.3.1 to C.3.7) and the going concern statement that is required of UK incorporated companies under Listing Rule 9.8.6R (3). Other than this responsibility, auditors read the corporate governance statement for consistency with the financial statements and for any material mis-statements of fact based on the knowledge they obtain from their other audit work. They will not want to be associated with any misleading statements in the governance report, but this does not mean they will look for disclosures relating to every provision of the Code.

the spirit of the Code. The FRC has recognised this and in the Preface to the Code (see the panel above) it recommends personal reporting by the chairman of the company as a way of improving the situation.

Why are companies missing the opportunity for effective communication with stakeholders that governance reporting represents? Why are boards risking the flexibility to exercise their judgement that the UK framework affords?

The Listing Rules and the 'checklist mentality'

Although relatively few of the detailed provisions of the Code require specific disclosures (and these are listed in Schedule B to the Code), the Listing Rules require companies to provide a narrative statement of how they have applied its Main Principles. Many companies find that the easiest way to demonstrate this is to explain how they have complied with each of the provisions that relate to the Main Principles. The result of this approach is often apparently standardised disclosure, as companies repeat the wording of the Code provisions. This leads to a lengthy report that reads like 'boiler-plate' and can make it difficult for the reader to identify important information from mere procedure — to 'see the wood for the trees'.

Reinforcing this, many companies have also experienced a negative reaction from shareholder groups or proxy advisers that take a mechanistic approach to checking compliance if they attempt to omit mention of a specific provision. Our advice on this is to resist. A number of leading governance reporters do not run through each and every provision of the Code in their disclosures. Similarly, external auditors have no mandate to insist on a 'box ticking' report (see the panel above).

Corporate reporting challenges

A number of the challenges that apply to corporate reporting in general play out in governance, and

there are also a number of specific challenges in governance reporting:

- Standardised disclosures are seen as a safe option in corporate reporting. To give company-specific information — for instance, about particular events or challenges that the company faces — is seen as potentially risky even where it is not obviously commercially sensitive
- It takes courage to 'lead the way' in reporting, moving away from precedent in the form of similar disclosures published previously by others. Of course larger organisations may have more resources at hand to allow them to do this, but there are many examples of creative approaches outside the FTSE 100
- Corporate reporting is used by a number of different audiences, each with differing needs; companies worry that too much customisation will mean their reporting fails to meet the needs of a particular group
- The various elements of the front half of the annual report are often drafted separately, leading to differing approaches and styles and also to a lack of integration, perhaps beyond some basic cross-references. This is particularly limiting for corporate governance as it can be related to many areas of the organisation — in fact to almost everything in the annual report
- Governance deals with particularly sensitive areas: board-level governance focuses specifically on the activities of the directors, and their individual characteristics, relationships and even the evaluation of their performance.

To help address these challenges it pays for there to be oversight that ranges across the whole annual report. Assemble a group who will be aware of the overall plan and messaging.

Cutting clutter

Those preparing annual reports should refer to the FRC's 'Cutting Clutter' publication. This includes a specific disclosure aid on governance reporting, but its real importance lies in its emphasis on only reporting information that is material, and in a way that is open and honest, clear and understandable, and interesting and engaging.

Also ensure that the project plan allows enough time for initial mapping out of the content and for review and integration after the content is drafted.

Most importantly, corporate reporting needs to be owned by those able to see the big picture and who have a vested interest in making sure it is communicated; the directors should be involved early enough to be able to influence the process. The FRC's encouragement of personal reporting on governance by the chairman recognises this, and governance reporting particularly benefits from these strategies.

The FRC's proposed changes to the Code from October 1, 2012 also include a requirement that the board, with the advice of the audit committee, should set out the basis on which they consider that the whole annual report is "fair, balanced and understandable" and "provides the information necessary for users to assess the company's performance, business model and strategy". If they are introduced, these changes will emphasise the direct responsibility of the board and the audit committee for good reporting.

Going beyond compliance – starting to take the communication opportunity

Because current governance reporting is often uninspired, it's not difficult to make an impression. Here are some quick wins to consider:

Figure1: Towards best-practice reporting: the 'backbone' of the annual report

Don't just report on process

Meaningful governance reporting does not *just* report governance processes. It reports how governance activities have been applied to the 'backbone' of the annual report.

Useful tips include:

- Don't just list what the board and its committees are responsible for; explain what they actually did
- Give real-life examples of what they did; mini case-studies can work well
- Explain how governance was applied to key challenges or events in the year. Do this particularly where there has been controversy; readers will not be impressed by silence on subjects they expect to see covered.

Go beyond the bare facts

To take one example, in order to comply with the Code, every company has to give information about the roles of directors and the composition of the board and its committees. The biographies of directors generally show that they are well-qualified and experienced individuals and, following the FRC's 2012 revisions to the Code, companies will also have to explain their policies on diversity and their progress towards any measurable objectives set.

Companies can go beyond these bare facts by:

- explaining the directors' most relevant skills or experience for the particular board
- showing how the skills and experience of the directors complement each other
- when reporting on the board evaluation, explaining why a particular conclusion was reached and what actions arose; not just setting out the process and reporting the overall conclusion.

All of this can make a real contribution to building the confidence of stakeholders in the robustness and effectiveness of the board.

Communicate what makes the company distinctive

The business model is part of what makes a company distinctive — it should capture the essence of the commercial proposition. Establishing the business model is very much part of governance.

Ensure also that challenges and issues in particular industries are addressed; too many governance reports could be picked up from one annual report and dropped into the report of another company in a different industry.

Focus on the key messages and use structure to help with this

To start with, decide on a small number of key messages for the reader to 'take away' and ensure that they are clearly communicated. To help do this, think about how the report can be structured. Consider communicating key messages separately from the other required disclosures and 'standing data'. This can be done simply by 'boxing out' from the rest of the text. Increasingly, these messages are introduced in the chairman's personal reporting

rather than in the main body of the governance report.

A number of the disclosure requirements in the Code may be met by placing information (such as the terms of reference of committees) on the company's website. The provisions that allow for this are listed in Schedule B to the Code.

Towards best-practice reporting of corporate governance

Achieving good practice in governance reporting is the first step. Really to build stakeholder confidence means tackling matters of importance that are rarely addressed properly in governance reporting or that continue to be particularly sensitive, such as some aspects of remuneration reporting.

The challenge for companies is to move the game on. The Code and the guidance around it need to be applied in a wide range of circumstances, so they do not deal with the 'content' of disclosures in detail. This allows companies to add real value; best-practice corporate reporting gets to the heart of what stakeholders want to know and governance reporting should be a part of this.

Building confidence in the annual report as a whole

Following the financial crisis, the FRC has been behind two initiatives related to building confidence in not only financial reporting but the annual report as a whole:

Revisions to the Code

As discussed above, under the FRC's proposed revisions to the Code after October 1, 2012, boards will have to set out the basis on which they consider that the whole annual report is "fair, balanced and understandable" and "provides the information necessary for users to assess the company's performance, business model and strategy". If this is to go beyond a description of process, boards will need to disclose the key points considered in arriving at their conclusion.

To help them with this, the audit committee is to report on "the significant issues that it considered in relation to the financial statements and how these issues were addressed". Currently, only a few best-practice reporters discuss the key judgements and estimates made by the board in the preparation of the financial statements; this will in future be part of the Code itself.

The Sharman Inquiry into going concern and liquidity risk assessments

Going concern disclosures have often been viewed as a technicality, particularly where there is no perceived problem within the usual time horizon of 12 months (in the UK) from the date of signing the financial statements. Currently, although the FRC issued guidance in 2009 designed to improve the quality of going concern disclosures, relatively few companies have taken this fully on board.

The Sharman Inquiry, which reported in 2012, signalled a move away from the current model — where a company only highlights going concern risks when there are significant doubts about the entity's survival — to one that integrates the

directors' going concern reporting with the other elements of their discussion of strategy and principal risks. It also signalled a move away from the current 'three category model' for auditor reporting to an explicit statement in the auditor's report that the auditor is satisfied that, having considered the assessment process, there is nothing to add to the disclosures made by the directors.

These are both real opportunities to build confidence in the annual report, and we encourage companies to embrace them when they become applicable.

Getting to the heart of what stakeholders want to know — 'applied governance'

Stakeholders are interested in each element of the content 'backbone' of the annual report, and they are also interested in how governance has been applied to each of them. But they are not interested in mere descriptions of process. To build their confidence in the board and in the company as a whole, stakeholders should be provided with information on how governance has been applied. This is not to confuse governance with 'management' or 'control'; the focus is on how the board and its committees have been involved in the right things, and at the right time.

The particular content of 'applied governance' disclosures will of course vary from company to company and it is beyond the scope of this chapter to go into detail, but we have provided illustrative examples below for each element of the backbone.

Business model – people and relationships

Many organisations rely on the expertise of their people, built up over many years in some cases, leading to close working relationships that create value in the business. In our experience, the importance of people and relationships is seldom recognised in annual reports in any depth, though in such businesses we would expect it to be a high priority year in, year out for the board and perhaps the nomination committee.

People and relationships: reporting to build confidence in the company and the board:

- recognition that this is a key feature of the business model
- discussion of employee satisfaction, including retention and professional development
- evidence that there is succession planning and a pipeline of talent
- appropriate recognition of the relationship between diversity in the company and understanding the customer base.

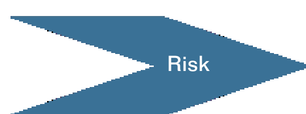
Strategy and objectives — mergers and acquisitions activity

A lot of time is devoted to the financial reporting issues around M&A activity, such as acquisition accounting and impairment reviews, and there is generally extensive disclosure of underlying and adjusted profitability numbers, exceptional items, and even tracking the financial benefit of

M&A activity: reporting to build confidence in the company and the board:

- the key issues that went to board level
- significant risks that the board considered in relation to the deal (price and terms, for example)
- how the board is monitoring/driving synergies (restructuring decisions, for example)
- the outcome of post-investment reviews.

synergies. The financial statement disclosures are often accompanied by commentary in the front half of the annual report, typically including some indication of future developments. However, there is rarely much discussion of how the underlying decisions and judgements were reached by the board, or of how they continue to monitor outcomes.



Risk — appetite and management
Although there has been an improvement in recent times in the quality of the disclosures of principal risks and uncertainties in annual reports, there is rarely any meaningful connection between these disclosures and the governance of risk. This is despite the re-emphasis of the board's responsibility for risk in the Code (see the panel above).

This reworded principle focuses on 'risk appetite' without using the specific term. In the narrative disclosures of how the main principles of the Code have been applied, it is therefore particularly important to focus on this aspect of risk, which is the key link between risk and strategy and very much a board responsibility.

The Turnbull Guidance, published by the FRC in October 2005, provides more information on how the board's responsibilities around risk management and internal control should be addressed. However, it has not tended to generate disclosures that cover everything stakeholders would be interested in.

Risk appetite and management: reporting to build confidence in the company and the board:

- how the board engineers 'risk resilience' into the company, including resilience against 'black swans', or unforeseen risk events
- how risk is measured and reported to the board and how governance is applied to it.

Board responsibility for risk

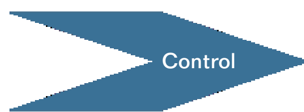
"The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems."
FRC: UK Corporate Governance Code, Main Principle C.2

Example — supply chain governance. An example of how reporting could be improved is governance of the supply chain, which is fundamental to the operation of companies and is frequently partially outsourced or dependent on joint ventures or associates. This brings with it a number of governance challenges that are rarely addressed in the annual report. The Turnbull Guidance requires disclosure where joint ventures or associates are excluded from the risk and internal control systems of the group but nothing more specific than this. There is also a tendency for such issues to be seen as 'below board level' and not part of the governance to which the annual report disclosures relate.

To build confidence in the company and the board, reporting might detail how a decision to outsource or place reliance on a third party was seen by the board as consistent with the company's risk appetite. It could also address the question of what the board has done to make sure it's clear where the responsibilities of the company stop and start — avoiding the risk of 'falling between stools'.

Group and subsidiary governance: reporting to build confidence in the company and the board:

- how the structure of the group/business maps to territories or legal entities
- how the governance structures inter-relate
- an outline of where responsibilities lie.



Control — group and subsidiary governance

Annual report governance disclosures tend to focus on the group, but there can be a disconnect between the group governance structures and those that operate in (often very significant) individual territories. This can lead to a lack of clarity around responsibility for matters that do not map easily to the group structure, such as local legal or regulatory requirements (including tax and pensions), and also to uncertainty as to the responsibilities of directors in local statutory entities.

Control — anti-bribery measures

The UK Bribery Act 2010 came into force in the middle of 2011 after much initial uncertainty and delays in guidance on the expectations for 'adequate procedures'. With its widening of liability to those acting on a company's behalf worldwide, the Bribery Act represents a major source of ongoing reputational risk that boards should be measuring and managing.

Anti-bribery measures: reporting to build confidence in the company and the board:

- how the board tracks the group's response to the new anti-bribery regime — is it part of ongoing monitoring?
- continuous reassessment of the risks based on experience.

Many companies currently note that processes have been put in place (as the Bribery Act requires) but few provide disclosures beyond the bare facts.

Performance — governance over non-financial measures

Non-financial measures are intrinsically bound up with governance, and this will become more significant as corporate reporting moves towards integrated reporting, driven by initiatives launched by groups like the International Integrated Reporting Council to link financial performance with non-financial areas such as the environment and corporate social responsibility. A number of companies are already providing performance statements on environmental issues such as the consumption of finite resources.

Governance over non-financial measures: reporting to build confidence in the company and the board:

- Does the board consider these issues throughout the elements of the 'backbone' of the annual report, from business model to reward?
- Are the issues dealt with by the board or are they wholly delegated to a subcommittee?

As these developments continue, stakeholders will become more and more interested in how the board has engaged with them.

Reward — reporting remuneration

The reporting of directors' reward is part of the 'backbone' of the annual report, and there is a particular focus on its alignment with the rest of that backbone. This alignment is a key concern for many investor groups, including proxy advisers, who regularly recommend that shareholders vote against or consider withholding their votes on the remuneration report at the annual general meeting. In respect of the remuneration policy part of the report, this is to change to a binding vote from 2013, when it is planned that the Enterprise and Regulatory Reform Act will come into force.

Remuneration: reporting to build confidence in the company and the board:

- showing that the remuneration committee and its chairman have been active during the course of the year, including taking advice from appropriate parties and engaging with stakeholders on a timely basis
- being clear about the performance-reward link in all variable elements of remuneration, and particularly the alignment of that performance with business objectives
- providing clear disclosure of amounts earned in the year and the entitlements for future years
- dealing head-on with specific known issues — especially where these have been raised by shareholders
- recognising any industry-specific challenges, and discussing how they have been addressed, but being careful not to imply over-reliance on market benchmarks
- dealing with the remuneration of senior employees below board level
- clear disclosure of potential or actual exposure to compensation for loss of office.

Companies' remuneration policies will come under even more scrutiny and careful disclosure will be one way to avert a crisis. It is certainly not in anyone's interest to create uncertainty, which may give rise to unnecessary questions.

Reporting for newly listed, Standard Listed and smaller listed companies

A number of specific challenges can arise for newly listed or smaller listed companies, though some of these may also apply to any company.

Newly listed companies

Although adequate financial reporting procedures should be in place prior to listing, it may take time for companies to work towards full compliance with the Code (or compliance to the extent thought appropriate for the particular organisation).

As all Premium Listed companies must now apply the Code, those that are incorporated overseas and are therefore accustomed to other governance frameworks may take time to adjust their arrangements. This may result in a need to explain more departures from the Code than is the case with other companies and — for those provisions of an ongoing nature where arrangements were put in place during the year — the periods of non-compliance and compliance.

We recommend that this is done clearly in the governance report, with areas of non-compliance at the end of the period being identified separately. Strictly speaking, all instances of non-compliance for provisions of an ongoing nature should be included in the compliance statement required under Listing Rule 9.8.6 (6), but we believe that it is adequate for them to be mentioned in the narrative statement under LR 9.8.6 (5), provided that the non-compliance is clearly described and the compliance statement identifies those provisions that have still not been complied with at the end of the period.

‘Comply or explain’: explanations

Where appropriate, companies should take into account the FRC’s February 2012 guidance on the three elements of a meaningful explanation:

“It should set out the background, provide a clear rationale for the action it is taking, and describe any mitigating actions taken to address any additional risk and maintain conformity with the relevant principle. The explanation should indicate whether the deviation from the Code’s provisions is limited in time and, if so, when the company intends to return to conformity with the Code’s provisions.”

Standard Listed companies

Although Standard Listed companies (regardless of their place of incorporation) do not have to report against the Code under the Listing Rules, if they apply any code (one applicable in their country of incorporation, for instance) on either a voluntary or mandatory basis, they must report against it to comply with the Disclosure and Transparency Rules.

Smaller quoted companies

The Quoted Companies Alliance (QCA) issues guidelines for smaller quoted companies on how they may implement the Code appropriately. The Code still applies to all Premium Listed companies, and the only relaxations from it are for those provisions that the FRC has applied exclusively to FTSE 350 companies, mainly around the composition of audit and remuneration committees, the re-election of directors and external facilitation of board performance.

Our recommendation is that smaller companies aim to implement the Code to the extent that it applies to them, and refer to the QCA guidelines where they believe that a specific provision does not suit their circumstances.

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