Financial Reporting Council

REVIEW OF CORPORATE GOVERNANCE REPORTING

NOVEMBER 2020

ABOUT THE **FRC**

The FRC's purpose is to serve the public interest by setting high standards of corporate governance, reporting and audit and by holding to account those responsible for delivering them. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

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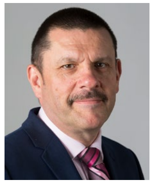
1. FOREWORD



SIR JON THOMPSON
CEO, FRC

"I am very proud of the UK's international reputation for good corporate governance. This must not lead to complacency; the events of this year have reminded us of that.

The quality of governance is tested in a crisis. Maintaining integrity in board decision-making, the management of risk, and effective engagement with all stakeholders, are essential for maintaining the trust which attracts the investments on which our economy relies. Learning from the corporate decisions and actions taken during the pandemic will much better enable us to build a sustainable and resilient economy in the future.

The most recent UK Corporate Governance Code recognises much more clearly the wider economic and social benefits of good governance, which arguably had been overlooked.

We saw some examples of excellence in reporting. This often involved the setting of ambitious goals, and a clear communication of progress. We have used these examples to inform our expectations for next year. One of the improvements we recommend is better quality engagement with shareholders and wider stakeholders, making sure that dialogue is effective by considering views from each party, and that boards can demonstrate that they have listened through their decision-making. Not only will this build a better understanding of different company approaches, it will build trust.

However, it is disappointing to see that – overall – reporting does not demonstrate the high quality of governance that the FRC expects. This cannot be put down to dealing with the pandemic, as a large proportion of annual reporting would have been completed before COVID-19 had begun to affect our lives. We are aware that stakeholders report that they will support companies that 'did the right thing' in responding to the pandemic.

Much of what we have analysed is formulaic. Too often the objective of reporting appears to be to claim strict compliance with the Code concentrating on achieving box-ticking compliance, at the expense of effective governance and reporting. This approach is a disservice to the interests of shareholders and wider stakeholders, and ultimately is not in the public interest; it undermines trust.

Worryingly, while some companies have sought to claim full compliance, we found on closer inspection that this was not the case.

The Code establishes best practice, but importantly it offers flexibility. This flexibility is an opportunity, not a threat; it allows boards to take a thoughtful approach to governance. Where companies depart from the Provisions of the Code they need to provide clear and compelling explanations for why the approach taken is the right one for the particular circumstances of the company.

It seems that too often, boards appear reticent to use this opportunity. This is also highlighted in the FCA's recent analysis of corporate governance disclosures by listed issuers.

I strongly encourage companies to review this approach to reporting, particularly in the light of the events of this year. Despite the severe hardships it has presented – and I understand the continuing pressure that boards and workforces are under – we can use this situation to bring about lasting changes which will benefit us all in the long term.

As we transition to becoming a new regulator – the Audit, Reporting and Governance Authority – we expect to receive further powers to engage with companies about the quality of their governance reporting. We will do this constructively; by working together we will be able to develop the quality of reporting so that it achieves the highest standard for which the UK is rightly known. However, where appropriate we will call out poor behaviour.

The role of investors is crucial. Next year will see asset managers and owners sign up to a new and more demanding Stewardship Code; a Code which focusses on the activities and outcomes of stewardship, bringing sustainable benefits to the economy and wider society.

I strongly encourage companies and investors to recognise the opportunities for progress offered by both Codes, and to engage constructively to deliver the high quality governance and stewardship needed for the future."

2. EXECUTIVE SUMMARY

This is the first year in which all UK premium listed companies reported on their application of the *2018 UK Corporate Governance Code* (Code).

In our *Annual Review of the UK Corporate Governance Code reporting*, published in January 2020, we stated that: "*effectively applying the Principles is much more important than a 'tick box' approach*". Our assessments of reports this year now give us an evidence base to drive forward better quality reporting. This is essential if investors and other stakeholders are to evaluate the quality of governance effectively.

As part of our assessment, we were looking for a high standard of reporting which demonstrated that boards had considered matters beyond process and reassessed issues such as company purpose, culture, and strategy, in order to set them at the heart of governance.

Whilst we have found examples of good reporting, overall, we are disappointed with the response to the new Code.

The FRC's analysis, together with assessments by third parties, shows that the objective of too many companies is to claim full compliance with the Code, which has led to the 'tick-box' practices we have tried to discourage.

Too often companies who are not compliant with the Code, do not declare non-compliance but offer vague explanations, and continue this pattern year on year. This approach demonstrates a disregard for implementing good practice and questions whether the leadership of the company is fully committed to good governance and transparency.

A far better aim is to set out the approach to the company's application of the Code's Principles, explain why this approach is right for its individual circumstances and, if necessary, what actions it has taken to mitigate the impact of not following the Code. We welcome explanations which demonstrate a thoughtful approach to corporate governance, an approach which is unfortunately lacking from too many of the reports that we have assessed.

This is in line with the findings of the FCA in their report on *Corporate Governance Disclosures by Listed Issuers* where they set out how corporate governance disclosures could be improved, especially when disclosing how the Principles have been applied.

We were surprised that in many cases corporate governance reporting was not coherent and cohesive. For example, many companies stated the importance of diversity and diverse boards but offered little explanation in the way of evidence to support their assertions, including: a lack of targets to improve diversity at the board and executive committee levels; little or no discussion of succession planning; and minimal reporting on how board evaluations are leading to the development of diverse talent pools. Many companies discussed diversity and inclusion committees or LGBTQ+ networks but did not describe the impact of such groups on the company's long-term success.

We reported in 2020 that more work was required on purpose and culture. We were pleased to see that reporting on both of these issues improved, but many companies continue to set out a purpose that is more of a marketing slogan. Many companies still appear to be considering how to define purpose and embed culture throughout the organisation. Work is required in terms of monitoring culture, with only a minority of companies setting out in detail how they plan to assess their culture beyond the use of surveys and site visits.

Companies were better at commenting on stakeholder engagement, but we are concerned about the reliance on process and the lack of reporting on feedback received and outcomes. In many cases, it was not clear how issues were raised to board level, and how any discussions of such matters affected decision-making.

This lack of evidence of any feedback also manifested itself in relation to remuneration policies. We were pleased to see that most companies had embraced Code changes into their new remuneration policies and many companies stated that they had considered wider (workforce) remuneration when setting executive remuneration polices. That said, we were concerned to see that there was almost no discussion of how the new policies had been debated with and explained to shareholders and wider stakeholders.

As the impact of the COVID-19 pandemic was not captured in most of the reports that we assessed, we have not commented in any detail on this significant issue in our report. Next year we will evaluate how well companies responded.

In our research we assessed a sample of up to 100 companies. The sample included both FTSE100 and 250 companies, as well as Small Cap companies. In addition, we considered third party reports on governance and drew on statistics from external sources to show the broader context. We also refer to our commissioned reports on diversity, remuneration policies and workforce engagement.

The report presents our findings and sets out the FRC's expectations for the future application of the Code and reporting.

3. REPORTING EXPECTATIONS

Corporate reporting is an effective tool to communicate the company's corporate governance standards, policies and practices. It should be underpinned by the principles of transparency, clarity and integrity, and give a true overview of the company's business model and operations, structure, activities and performance.

Companies reporting against the Code are expected to move away from boilerplate statements towards a more meaningful narrative in support of their application of the Code's Principles and to report non-compliance with Provisions. Use of examples is strongly encouraged, to demonstrate application of any non-compliance with the Code. Recognising that no one size fits all, the Code should serve as a guide to good governance practice, which companies ought to use to tell their unique story.

To help navigation through the Annual Report and Accounts and ensure cohesion with the corporate governance statement, companies should be using signposting, linking different elements of the report, with clear reference to the Code. The report needs to be informative and understandable for all company stakeholders.

The Code puts greater emphasis on companies' relationships with their stakeholders, in line with s.172 of Companies Act 2006 and strategic reporting requirements. The FRC expects companies to report on their engagement efforts with their stakeholders, which should be conducted in an open manner. Reporting should also include a discussion on how any received feedback has informed company decisions and strategy.

Quality corporate reporting maintains the confidence of company stakeholders by demonstrating the resilience of the company business model, or flag the need for the model to adapt. By providing evidence and examples about statements and commitments in their reporting, companies can be more accountable and thus gain the trust of their stakeholder.

As a result of this year's review, we expect improved reporting in the following ways:

- Companies to have a well-defined purpose and to clearly show the progress towards achieving it
- Discussion of the issues raised, topics considered, and feedback received during engagement with shareholders and employees
- Clearly show the impact of engagement with stakeholders, including shareholders, on decision-making, strategy and long-term success
- Increased focus on assessing and monitoring culture, including consideration of methods and metrics used
- Increased attention and better reporting of succession planning, diversity and board evaluation
- Clearly show the impact of engagement with shareholders on remuneration policy and outcomes
- Clearly show the impact of the engagement within the workforce in relation to executive remuneration policy

What to keep in mind when reporting:

- Strive for transparency, clarity and integrity
- Use signposting, avoid boilerplate and ensure cohesion
- Tell a story about your company, avoiding a "tick box" approach
- Explain clearly and comprehensively when you depart from the Code's Provisions
- Disclose impact of actions via use of examples

4. MAIN FINDINGS

A. CODE COMPLIANCE

When following the Code, companies should apply the Principles and report against the Provisions. This section assesses the extent to which companies reported compliance and non-compliance. We remind companies that they should provide clear and detailed explanations of any non-compliance with the Provisions. We encourage companies to be fully transparent about their reasons for non-compliance. This section does not assess the application of the Principles; these matters are examined in sections B and C.

COMPLIANCE STATEMENT

All but one company made a statement about Code compliance. In the majority of cases the statement was clear and to the point. However, for a few companies, the statement was vague in relation to any Provisions that had not been complied with.

To ensure transparency, companies should clearly declare within the statement whether they have:

I. Fully complied with the Code by applying the Principles and reporting against the Provisions

II. Not complied with any of the Provisions, and in such circumstances disclose the relevant Provision(s)

We found a number of instances where non-compliance is "hidden" through the use of ambiguous language and often unnecessary signposting, which makes it difficult to determine whether the Provisions have been complied with.

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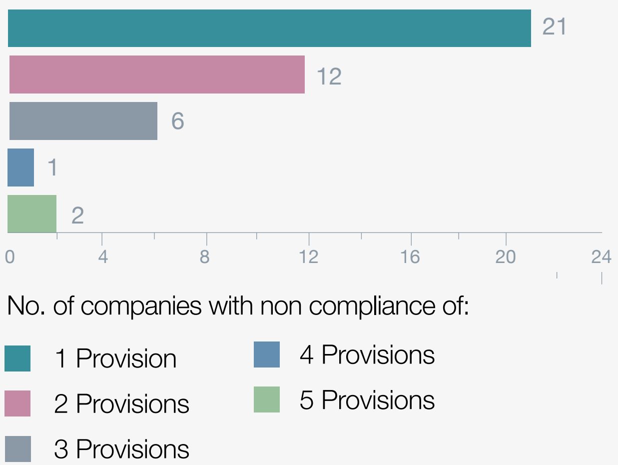
FRC expects that companies should be clear and transparent about the Provisions of the Code that they have not complied with. They should clearly name these Provisions in their compliance statement. They should also avoid the use of jargon and ambiguous language and use signposting only to point to the explanation.

Declaring full compliance

From our sample of 100 companies, 58 (including 29 FTSE100 companies), have reported full compliance with all the Provisions of the Code. There were also a number of companies that disclosed non-compliance with more than one Provision, and these are set out below:

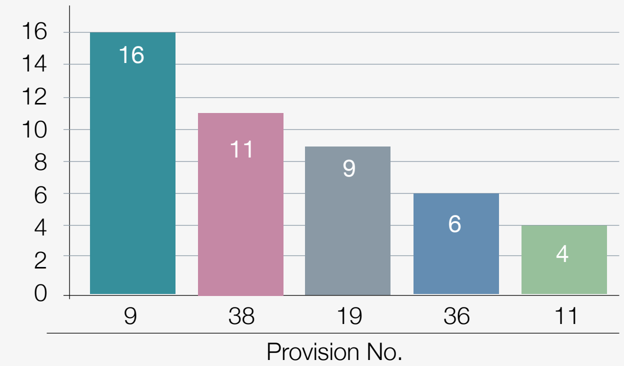
Non-compliance with Provisions of the Code



The Provisions that companies within our sample of 100 declared the most non-compliance against were:

- **Provision 9**
  Chair independent on appointment
- **Provision 38**
  Alignment of pension contributions
- **Provision 19**
  Chair remaining in post beyond 9 years
- **Provision 36**
  Share awards subject to total vesting and holding periods of five years or more
- **Provision 11**
  At least half the board should be independent

No. companies that declared non-compliance by Provision



Declaring full compliance should mean that a company has applied all the Principles and complied with all the Provisions of the Code. If a Provision is not complied with, a full and detailed explanation must be given.

We are concerned that an unexpectedly high number of companies in our sample claimed full compliance but could not demonstrate this in their reports. For example, 43 of those companies did not report non-compliance with Provision 38; pension contributions for directors were neither currently aligned with the workforce, nor scheduled to be aligned at a later date, or were not fully disclosed.

In the case of four companies the remuneration committee had not developed a formal policy for post-employment shareholding, but failed to report that they were not in compliance with Provision 36. These figures are in line with *Grant Thornton's finding* that while 48 companies have had their chair on the board for more than 9 years, only 31 of them reported non-compliance with Provision 19.

There may be many reasons why a company has taken a different approach to achieving good governance practice, this should be clearly stated in their reports.

FRC Financial Reporting Council

FRC expects companies to report in a transparent way any non-compliance with any Provisions of the Code.

Explanations

For those that disclosed their non-compliance, too often the explanation is boilerplate. For example, most of the companies that declared non-compliance with Provision 9, regarding the chair's independence, stated that this was to retain the chair's skills and experience. None of those companies provided a meaningful justification of the rationale.

"We view good quality explanations as an effective way to achieve compliance with the Code."

We would like to remind companies of the elements of a good explanation, as outlined below:

Do

- Set the context and background
- Give a convincing rationale for the approach being taken
- Describe any mitigating actions
- Consider any risks
- Set out when the company intends to comply (timescales)
- Ensure that the explanation is understandable and persuasive

An example of good explanation is "*The chair has been in post for 9 years, however, last year they began to lead takeover discussions. These are complex discussions and once completed will impact on our ability to achieve our long term strategy. Unsatisfactory completion of this process is set out as a principal risk. We expect the completion of these negotiations to take a further 6 months. Following the completion of this process, the senior independent director jointly with members of the nomination committee (excluding the chair) will commence the procedure of recruiting a new chair. Our expectation is that a new chair will be appointed within 1 year.*"

Don't

- Assume the reader understands any background
- Just state that the board agreed with the deviation from the Code
- Offer vague reasons for non-compliance

Last year we said: "*Full strict compliance has never been the aim, nor has it reflected the spirit, of the Code due to the 'comply or explain' approach on the Provisions. Detailed and comprehensive explanations offer the reader a greater insight into how the company operates.*"

Our view has not changed; we want companies to maintain the high standards of the Code by taking the good practice demonstrated within it, apply it to the company and report the approach by use of detailed explanations.

FRC Financial Reporting Council

FRC expects companies to provide a clear and meaningful explanation of how a company's actual practices achieve good governance standards in line with flexibility offered by the Code even though they may not have fully complied with a Provision of the Code.

B. LEADERSHIP

The Annual Report is the board's responsibility. The cohesiveness of the report and the detail set out within it should demonstrate how good governance supports the overall strategy.

This section of our review addresses issues as set out, broadly, in sections 1, 2 and 3 of the Code. We have considered how companies applied the Principles of these sections, reporting on purpose, culture and values. We have also considered the make-up of boards and diversity, along with succession planning and board evaluations. As the Code states, the board must set the tone from the top and drive culture and change.

PURPOSE

Articulation of purpose

Principle B states: *"The board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned"*

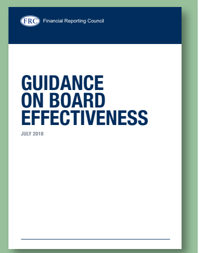
A company purpose matters for many reasons, not least of which is that a clear explanation of purpose helps boards make better strategic decisions. Purpose also lays the foundations upon which a company can build its future. Stakeholders consider company purpose in many different ways; for example, investors may consider purpose as part of their due diligence to help inform their investment decisions.

Our research found that an overwhelming majority, 86% of companies, disclosed a purpose statement, which we welcome. However, the quality of those purpose statements varied greatly. Of that 86%, 11% used a marketing slogan or conflated vision, values, or their operations with their purpose.

There are many contributors to the debate about how companies should undertake the definition of their purpose, and it is important that boards make their own decisions based on their business model and strategy.

In our review last year, we noted that around half of our sampled companies provided a purpose statement, but also that many companies used a slogan or marketing line. We expected to see significant improvements in purpose disclosures in 2020.

"A well-defined purpose will help companies to articulate their business model, and develop their strategy, operating practices and approach to risk. Companies with a clear purpose often find it easier to engage with their workforce, customers and the wider public."



The FRC's *Guidance on Board Effectiveness*

Quality of purpose statements

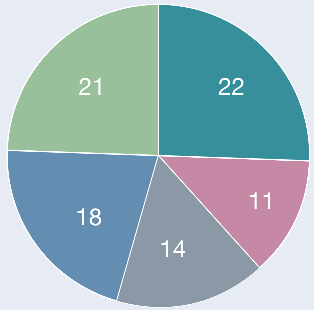


Chart refers to the 86% of companies that disclosed their purpose statement.

- Had a vague purpose that did not specifically articulate why the company existed, the market segment they operate in, their unique selling points, and/or how they intend to achieve their purpose
- Utilised a marketing slogan or conflated vision, values, or their operations with their purpose, which is not in line with the spirit of the Code
- Disclosed a purpose that met one or two of these elements
- Incorporated most of these elements
- Described a purpose that was clear about why they specifically existed, their market segment, their USP, and how they will achieve their purpose

Our view is that a purpose must be simple to understand and act as a reference point for decision making.

The purpose may contain the following elements
Why the company exists
What the company does/market in which the company operates
What the company is seeking to achieve
How they will achieve that purpose

Purpose statements should not be any of the below because each of them fulfils something different than a company's purpose:

The purpose should not be
Marketing slogans
Vision statements
Mission statements
Value statements
Operational descriptions

An example of a good purpose from a fictional company is:

"*We exist to build furniture in an ethical and sustainable way by sourcing our materials solely from carbon-neutral certified suppliers*".

This purpose is clear (building furniture), describes the market segment (furniture), what makes the company unique (ethical and sustainable), and how they will achieve it (sourcing only from carbon-neutral certified suppliers).

In contrast, an example of a poor purpose from a fictional company is:

"*Enabling your life*".

This purpose is bad because it appears to be a marketing slogan, it is vague and does not describe what the company does. Moreover, it is unclear what market segment the company operates in, there is no apparent USP for the company, and it does not state how this purpose will be delivered.

When it is well articulated, a purpose can be a powerful statement of intent that drives a company. We encourage companies to consider the above factors when developing their purpose statements.

Connection between purpose, values, and strategy

A strong connection between purpose, company values and strategy goes a long way to ensuring its effectiveness.

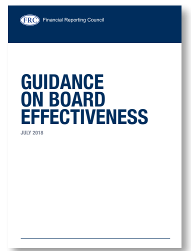
> "Our research found that a majority of companies, 62%, did not articulate a clear connection between their purpose, values, and strategy despite the good practice outlined in the Code."

In many annual reports, the three concepts were largely presented separately, with linkages either absent or unclear. 22% stated one form of connection between their purpose, values, and strategy, such as encouraging employees to act in line with all three. 16% of companies described connections with either two or all three of purpose, values, and strategy by clearly demonstrating how each one informed the other.

In addition to the guidance provided by this report, we recommend that companies consult the following publications:

Lab's Business model reporting; Risk and viability reporting – Where are we now? Report

Our 2019 Annual Review of the UK Corporate Governance Code



The Guidance on Board Effectiveness

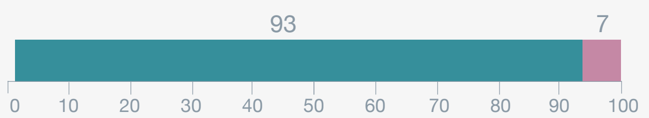
Financial Reporting Council

FRC expects companies to demonstrate further improvements in the quality of disclosures of how purpose, values, and strategy are connected.

Social/stakeholder dimensions

Principle A of the Code recognises the importance of "*generating value for shareholders and contributing to wider society.*"

Last year, we noted that many companies had articulated their purposes through the prism of profits or shareholder value. This year, we expected this to change, especially as many companies committed to reviewing their purposes during 2019.



Of that 93%, however, 45% of purpose statements either did not describe any social or stakeholder dimensions or indirectly referenced them. 23% of companies mentioned either a social or stakeholder dimension in their purpose, such as serving their customers, while 32% clearly described social and/or stakeholder dimensions to their purpose.

These changes acknowledge that companies have different stakeholders, and we encourage this to be reflected in company purpose statements.

Board oversight

Company purpose should act as a driver for decisions and actions. It is therefore critical that the board agrees the purpose and oversees the alignment between values.

We found the following:

76% Do not clearly describe how the board satisfied themselves with the alignment of their purpose with their business practices

24% Companies exercise oversight over their purpose implementation in a variety of different ways, such as receiving reports at board meetings, monitoring engagement channels, and periodically assessing the application of purpose statements using KPIs

Many boards appear not to be exercising their oversight function to ensure that company purpose works as a driver for the company. Oversight can be exercised by boards in many ways, such as requesting regular reports from executives on key areas, purpose implementation updates, and meeting company employees to hear their views directly about how the company's purpose works in practice. By reporting such matters, boards are evidencing the quality of their oversight.

COMPANY CULTURE

Like purpose, company culture should be led from the top and aligned with purpose, values and strategy as noted in Principle B of the Code.

It was good to see this year that almost all companies within our sample discussed their company culture, often in the letter from the chair. The degree to which culture appears to be embedded in each company varies.

KEY MESSAGE

Company culture supports the success of the strategy, and if a board embeds a culture that is supported by the employees, then companies should have a motivated and high performing workforce which delivers the outcomes necessary for long term success.

We found that 52% commented on their culture in a meaningful way and 75% also commented on their values and linked this to culture. Our findings are in line with the *Grant Thornton assessment* of the FTSE350 where they found that 83% of companies articulated their values.

Many companies have reported that culture, incorporating values and behaviours, continues to be a work in progress or that a significant review has been completed during 2019 and therefore, culture is taking time to bed in.

Companies have reported that they have undertaken a number of events to promote and embed the desired culture. These included culture road shows and working through employee groups to discuss culture and its relationship with values. Some companies set up culture committees and others noted that culture was now a standing item on board agendas.

The better disclosures explained how the senior leadership teams had sought insight from all stakeholders (internal and external) when reviewing their culture and linking it to values and strategy. This, in particular, helped the articulation of the values when aligning to both purpose and behaviours.

Many companies linked culture and values to other issues – for example, improving training and health and safety, achieving improved diversity within the company or consideration of principal risks. We observed that many companies set up advocacy groups, for example for ethnic minorities, LGBTQ+ colleagues or women returners. Others discussed the importance of wellbeing and mental health issues.

Better reporting was observed when companies made a clear link between the actions to improve culture with associated KPIs.

Better reporters explained the link between supporting the health and wellbeing of the workforce and investing in training to achieve high performing culture.

A number of companies reported that by supporting diversity and inclusion they were able to achieve a high achieving culture and improve the talent pipeline.

Monitoring and assessing culture

Although reporting on culture has improved compared to early adoption reporting last year, there is still more work to do on monitoring and assessing company culture. Within our sample - 65%, reported or alluded to the use of an employee survey (either in isolation or in combination with other indicators) as a way of monitoring culture. Surprisingly, 20% did not report any such monitoring.

Staff surveys can offer insight into culture but have significant limitations, especially when considered in isolation.

People surveys

We have the following concerns in relation to people surveys:

When reporting on people surveys, companies tended to cite high engagement scores and scores related to whether the company was a 'great place to work' or would be 'recommended' to others. Few companies reported looking beyond the headline figures to try and better understand any negative comments or poorer scores.

The better reports acknowledged where more could be done to follow up on surveys and introduced specific culture surveys, set up working groups to address any concerns and in one or two cases explained that additional training had been offered. In some cases, sessions were set up to discuss culture and values with senior managers.

Site visits

We also have concerns about the reliance on site visits to gauge culture. Such visits can be helpful for directors and non-executive directors (NEDs) to improve understanding of the business and its operations. However, whether an escorted visit to a 'site' offers valuable insight into company culture is questionable.

EXAMPLE

A good example of the use of a site visit was for the workforce engagement NED to visit a specific site and meet a section of the workforce without the manager in attendance. The example went on to explain that there was a discussion and Q&A session on company strategy and values.

"It is important that members of the board and the executive team meet with a cross section of employees when on a visit – not just those in senior positions – and discuss specific issues."

We suggest that for site visits to be effective, they should have a purpose beyond familiarisation.

Considerations for an effective site visit:

Do

- Set aside specific time to meet with a smaller team or division.
- Arrange for board members and senior managers to speak with employees both with and without line managers in attendance
- Have a purpose or theme for most of the discussion e.g., values, strategy
- Allow for general Q&A at the end
- Offer to follow up issues, and feedback

"In 2021 we will be revisiting our Culture report of 2016, to support further improvements in embedding and monitoring culture."

Don't

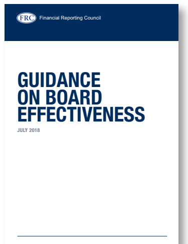
- Just hold a meeting and leave
- Have a guided tour only
- Put employees on the spot with direct questions they may not be prepared for

KEY MESSAGE

Our analysis aligns with the sentiment referenced in our previous report released earlier this year which highlighted that there is limited disclosure of how the information gleaned from such visits was fed into wider board discussion and whether it had informed future strategy, culture, risk or other matters.

Other approaches to monitoring and assessing culture included a number of metrics, often referred to as a 'culture dashboard' which the board considers on a regular basis.

It was not always clear what metrics were used in all cases, but a useful list is contained in the *Guidance on Board Effectiveness*.



Examples of metrics to monitor and assess culture:
Turnover and absenteeism rates
Training data
Recruitment, reward and promotion decisions
Use of non-disclosure agreements
Whistleblowing, grievance and 'speak-up' data
Board interaction with senior management and workforce
Health and safety data, including near misses
Promptness of payments to suppliers
Attitudes to regulators, internal audit and employees
Exit interviews
Information from internal audit on the impact of policies and processes

Other approaches used culture pillars, which linked to strategy and values and were assessed by the board at regular intervals. As already mentioned, a number of companies have a culture committee which includes the consideration of monitoring and assessment of culture.

"Internal audit can also be used to consider the effectiveness of policies and processes introduced to improve culture."

EXAMPLE

One company reported that they were aware of silo working within the company and explained how they had taken action to deal with this.

Other examples included setting out broad issues that had been highlighted through the whistleblowing hot line and then explained, giving statistics, how these issues had been resolved.

Although both of the above examples highlight less positive aspects of company culture, explaining how this has been dealt with demonstrated a commitment to improve the situation.

Very few companies discussed company behaviours, but most companies commented on the importance of aligning values and behaviours. Many companies had codes of conduct which were seen either as a tool to offer support to employees or as a rule book.

FRC Financial Reporting Council

FRC expects 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, including setting out any actions taken in this area in line with Provision 2.

TENURE, SUCCESSION PLANNING AND BOARD EVALUATION

Independence

Our analysis considered compliance with Provision 9 of the Code which recommends that the chair should be independent on appointment and that the roles of the chair and the chief executive should not be exercised by the same individual. We found that this Provision had the highest figure of disclosed non-compliance, with 16 companies reporting non-compliance. 12 of these disclosed that the chair had not been independent on appointment, three stated that the roles of the chair and the CEO were combined and in one company neither of these Provisions applied.

KEY MESSAGE

A clear and meaningful statement explaining why the chair is not independent should be provided, stating the rationale, and reason for this, along with how this benefits the interests of the company and its stakeholders.

Companies are reminded that the chair should be independent on appointment when assessed against the circumstances set out in Provision 10.

Where such circumstances are proposed by the board, companies must consult major shareholders ahead of the appointment. Reasons for the approach should be shared with all shareholders at the time of appointment and published on the company website.

Companies should value the input independent NEDs can provide on constructive challenge, strategic guidance, specialist advice and holding management to account. We were pleased to see that (with the exception of three companies where non-compliance was temporary) only one company reported continuous non-compliance with this Provision.

Provision 11 advises that: "*At least half of the board, excluding the chair, should be Non-Executive Directors whom the board considers to be independent.*"

Boards are reminded that they should identify in their annual reports each NED they consider to be independent, by evaluating their independence based on the criteria given in Provision 10. Some of the companies we reviewed have identified directors who, despite being subject to one of the criteria of Provision 10, are still considered to be independent. The explanations provided were mostly vague and not clear enough to justify the independence of the NED in question.

FRC Financial Reporting Council

FRC expects companies to provide clear explanations of how they have determined a NED to be independent if they fall under one of the criteria in Provision 10.

Chair tenure

> Provision 19 advises that: "*Chair should not remain in post beyond nine years from the date of their first appointment to the board.*"

Our analysis found nine companies where the chair remained in post beyond this period. On the whole, the explanations provided for this were poor. In some cases, companies provide no explanations at all; others stated that the tenure was extended while a replacement was found which in turn questions the effectiveness of their succession planning.

The better explanations provided a clear rationale for extended tenure – for example, to complete a significant transaction or steer the board through a difficult period. Such matters are clearly crucial to the long-term success of the company and in some cases are better completed by one individual if possible. These explanations often provided a timeline for the extension, which offers further clarity to the reader.

KEY MESSAGE

Unless there is a strong case for an individual to stay in their role beyond nine years there is a risk of becoming too reliant on the views and skills of one individual. Boards are more effective when they have a broad mix of skills, knowledge and experience and regularly refreshed.

Companies should discuss tenure at the time of appointment to help to inform and manage the long-term succession strategy. We accept that there will always be times when the unexpected happens and an individual leaves unexpectedly. In such cases a detailed explanation should be provided in the report.

Provision 19

We examined and analysed the compliance of the chair's tenure in our sample of 100 companies.

2 out of 9 highlighted that the chair retired or was replaced **before the end of year**

9 companies within our sample **DISCLOSED NON-COMPLIANCE** with **Provision 19**

companies that noted that the chair was set to be replaced: **3 in 2020**, **2 in 2021**

1 company noted that the Chair will continue to stay in his position

1 company is unclear

As a result of the COVID-19 pandemic, we expect a number of companies will ask their chairs and NEDs to remain in post beyond the nine-year rule, but we would expect to see the reasons for continuing on the board explained in much more detail.

Equally, we will be interested to see how those individuals with more than one directorship discharged their duties during the pandemic, particularly given that many companies introduced more frequent meetings of boards and committees.

During a time of significant stress on companies, it is vitally important that all board/committee members have sufficient time to read through and consider matters under discussion, in order to play a continuous and effective role in leading the company.

FRC Financial Reporting Council

FRC expects all companies to pay closer attention to the issue of overboarding by their directors and the size and membership of committees.

Succession planning

The nomination committee is responsible for board recruitment and it should conduct a continuous and proactive process of planning and assessment. It must take into account the company's strategic priorities and the main trends and factors affecting the long-term success and future viability of the company.

> "We found little improvement from our review published earlier this year."

The reports we reviewed provided minimal insight into company succession planning; many continued to focus on the appointment process rather than providing information on how companies plan for succession. Only one outlined their considerations and outcomes related to their succession arrangements for NED, executive and senior management roles, whilst others simply noted the use of an external recruitment agency.

Succession plans should be in writing to help ensure adherence to them, particularly when a company states that it wishes to improve diversity. We hoped to see clear links between diversity targets, succession plans and board evaluation, but this was not the case. There was little discussion of the need to expand talent pools to achieve diversity targets or the use of recruitment companies to provide diverse long and shortlists.

Further consideration should also be given to how the planning arrangements are operated across contingency, medium-term, and long-term planning.

> Under Principle J of the Code: "*Appointments to the board should be subject to a formal, rigorous, and transparent procedure, and an effective succession plan should be maintained for board and senior management.*"[1]

Reporting suggests that succession arrangements are reactive as opposed to continuous and ongoing. This is particularly disappointing given that many of the companies within the sample stated that succession planning was a major focus for the nominations committee in the reporting period and an area to improve upon following an outcome of its evaluation.

[1] Refers to the executive committee or the first layer of management below board level.

What to consider when reporting on your succession arrangements:
Include a summary of short, medium and emergency succession plans within your report
Ensure that your succession plans are proactive and not just purely reactive
Ensure that your disclosure offers a structured way of identifying the board's composition needs (i.e. a skills matrix)
Consider how succession plans link to other policies and targets such as diversity targets
Ensure that you disclose how frequently succession plans are reviewed, the scope of these plans, how internal talent is managed and whether external search consultants are engaged

FRC Financial Reporting Council

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

We would also like to see improved cohesion between diversity commitments, board evaluations and succession plans.

Board evaluation

Our analysis suggests that transparency surrounding the evaluation process has improved. There remain concerns in relation to companies providing sufficient details about the outcomes from the evaluation process, particularly when it is facilitated internally.

Internal evaluations can build on the recommendations of external evaluations and should also address any other matters of board dynamics. They should be undertaken in a rigorous manner, ensuring anonymity of views of board members. Internal evaluations should not be seen as a check-in between the external evaluation every three years.

External facilitation adds value by introducing an independent perspective, new ways of thinking, and a critical eye to board composition, dynamics and effectiveness. The nature and extent of the external evaluator's contact with the board and individual directors can be a defining factor of the quality of the evaluation.

An explanation as to why the chosen approach or method selected (e.g., surveys, document reviews and one-to-one interviews) was considered the best at measuring the effectiveness of the board is considered good practice. We remind companies that the *Guidance on Board Effectiveness* states that questionnaire-based external evaluations are unlikely to get underneath the dynamics in the boardroom and a more rigorous approach should be considered.

Approaches to reporting on board evaluation

When explaining the process of evaluations, companies often used diagrams and flow charts showing the timeline; when interviews took place; when questionnaires were issued; and, what those involved. This offers some insight in relation to Provision 23 but fails to deal with those elements of the Provision relating to "*the outputs and actions taken, and how it has or will influence board composition*".

Many companies simply state that: "*the board is working effectively together*", and fail to provide any additional information.

We understand that certain details of outcomes can be considered too sensitive to disclose in the annual report, but we would note that it is encouraged under the *Guidance on Board Effectiveness* that the chair should provide a summary of the outcomes and actions of the board evaluation process in their statement in the annual report.

The reluctance to provide detail on the outcomes is also reflected when commenting on recommendations from previous evaluations. Whilst a few companies have provided information in this area, the level of detail was limited and tended to indicate broad future areas of focus with little explanation of changes made during the year following the evaluation.

EXAMPLE

An example of this would be a disclosure along the following lines: "*following the previous evaluation, an increased focus has been placed on board composition, particularly diversity*".

Reporting in these terms is ambiguous and does not provide the reader with any substantial information on what action is required as a result of the evaluation. In such circumstances, companies should take note of Provision 23 of the Code and consider whether its succession plans should be revised to achieve any amendments to board composition.

KEY MESSAGE

Reporting on board evaluations should not be approached as a compliance exercise. Instead, a clear set of recommendations, actions, and a time period for review of progress against agreed outcomes should be made.

Enhanced reporting may include a statement explaining whether actions have been agreed jointly by both the evaluator and the board.

Board dynamics

EXAMPLE

Companies regularly reported that the evaluation found that independent NEDs "*offered an effective challenge in the boardroom*" – statements such as this were seldom supported with any additional insight. Reporting would be improved by explaining whether the challenge was observed, if it led to more creative thinking or the introduction of new ideas or approaches.

We observed that reporting on evaluations tended to focus on board activities rather than dynamics (where reporting was vague, if provided at all). Principle L of the Code does not focus on what the board does but on its composition.

FRC Financial Reporting Council

FRC expects companies to consider reporting on how the board works together as a unit, the tone set by the chair, and the chief executive, the relationships between board members particularly chair/chief executive, chair/senior independent director, and executive/non-executive directors.

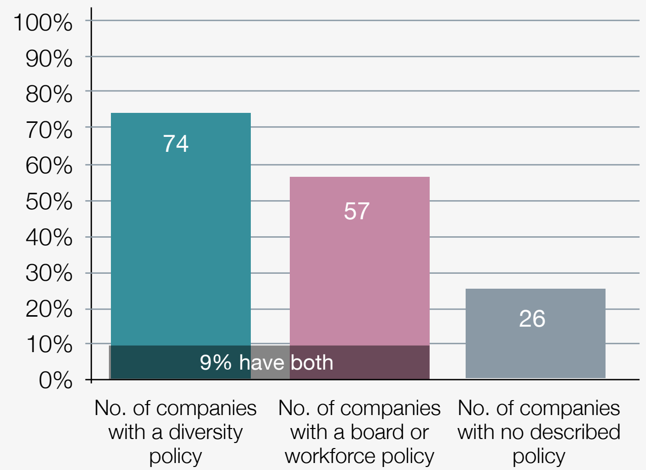
DIVERSITY

Provision 23 of the Code states that the Nomination Committee should describe "*the policy on diversity and inclusion, its objectives and linkage to company strategy, how it has been implemented and progress on achieving the objectives.*"

Diversity policies

Our review last year noted that almost all companies had a diversity and inclusion policy. This year, we aimed to establish exactly how many companies described their diversity policies in their annual reports, if a link to the policy on their website was provided, and to identify who the diversity policies apply to. The graph below shows the percentages of companies with diversity policies, what type of policies they have, and how they signpost them.

Type of diversity policy taken in our sample of 100 companies



Some companies cited their diversity policies in their annual reports without describing them or providing a link. Companies should 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.

Other regulators support this stance - the FCA have themselves encouraged companies that have not yet adopted a diversity policy to consider doing so in their recent *report* on corporate governance disclosures. Companies should have both a board and a workforce diversity policy, and we expect those companies that have not published their policies or easily signposted them to do so next year.

Diversity targets

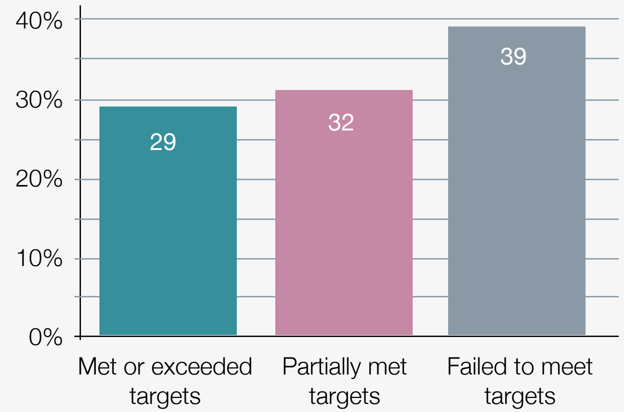
The Code states that companies should describe their diversity objectives. Our previous review noted that given the publication in 2018 of the FRC's review of *Board Diversity Reporting*, we expected more companies to disclose their targets, and we have looked more closely at annual reports this year to see if there has been an improvement.

We found that a majority of companies, 63%, disclosed diversity targets in their annual reports. However, not many companies had board targets other than gender (many of which were solely in line with the Hampton-Alexander Review), while those that had ethnicity targets were primarily focused on the Parker Review. 26% of companies had targets for both the board and senior management.

Generally, senior management diversity targets received far less attention than their board counterparts. Few companies had ambitious diversity targets across multiple under represented groups for both the board and senior management.

Of those companies that did set targets, the results of target outcomes were mixed.

Meeting diversity targets taken in our sample of 100 companies



"A significant number of companies do not have any diversity targets for either the board or senior management, while a slightly lower number of companies have targets for both."

However, it was disappointing to see that 37% of companies did not appear to have any voluntary diversity targets. In addition, while some companies attempted to demonstrate the effectiveness of their approach by having a female board representative above the Hampton-Alexander target, others did not appear to have any evidence to justify their decisions to not have any diversity targets. Those which attempted to justify this approach said that it was a deliberate decision due to their policy of recruiting "on merit".

Delta Alpha Psi (DAP), advisors to the Parker Review, while exploring reasons behind companies opting not to have voluntary diversity targets, state that reporting would be much more aligned to organisations' values if there was a better understanding of the value of diversity and the myths regarding the nature of meritocracy.

"Positioning organisations as meritocracies implies that organisations operate in environments of social equality. Meritocracy may well be a value and a goal, but it is not a current reality. The practice of committing to greater diversity whilst reassuring stakeholders that the firm appoints on merit is unhelpful as it perpetuates a number of myths", including that *"meritocracy and diversity are values that are 'at odds' with one another and cannot both be achieved simultaneously."*

Delta Alpha Psi

DAP recommends that organisations should recognise their shortcomings with respect to diversifying their boards, leadership teams, and workforces, and report on actions taken, commitments, and proposed solutions without the caveat of meritocracy.

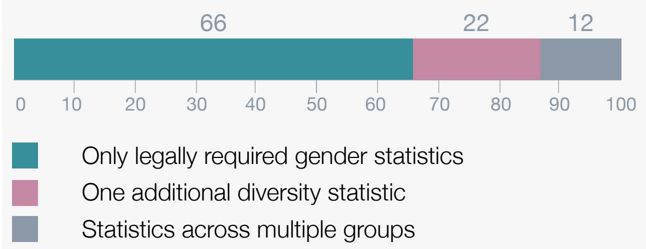
The FRC is concerned that in too many cases, those shortlisted for the interview are not drawn from a sufficiently wide talent pool. To increase diversity and deliver effective meritocratic appointments, companies must consider candidates from sufficiently diverse backgrounds.

FRC Financial Reporting Council

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

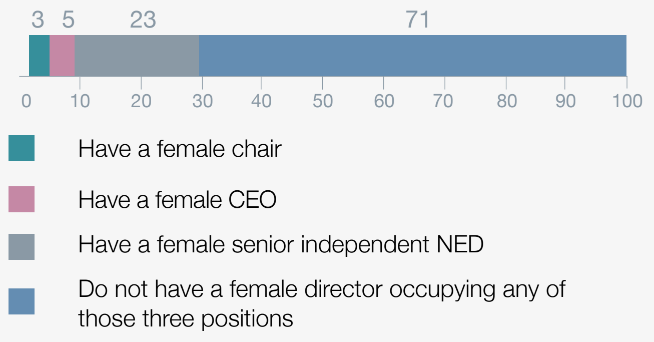
Diversity representation

Diversity statistics are an important way of monitoring the effectiveness of diversity policies as well as progress against diversity targets. Given the importance of the Hampton-Alexander and Parker reviews, the level of disclosure about diversity statistics is key.



After gender, the second and third most commonly disclosed diversity groups were ethnicity and age respectively, with a handful of companies disclosing other characteristics such as sexual orientation.

We also examined the diversity of company talent pipelines in general. The vast majority of companies, (96%), disclosed information about their female pipeline, but far fewer companies disclosed their ethnicity pipeline, and many companies only disclosed their senior management figures.



Only 20 companies in our sample explicitly mention the Parker Review as one of their targets. This is concerning as the Parker Review recommends FTSE100 boards to have at least one director from an ethnic minority background by 2021.

As this target was just over a year away at the time that these annual reports were published, we expected to see all FTSE100 companies in our sample reporting on their progress towards this target.

"Based on our research, it appears that for many companies, diversity extends to gender representation only, and is predominantly driven by external targets."

The FRC recently commissioned London Business School and SQW to examine the evidence for links between diversity in FTSE350 board membership, boardroom dynamics and company performance. This research will be completed in 2021.

KEY MESSAGE

Diversity both in the boardroom and the talent pipeline can improve the decision-making process in companies through offering rigorous debate and different perspectives than the company has previously had.

Some companies have facilitated the establishment of support networks e.g., women returning from maternity leave, military veterans, and LGBTQ+ individuals. However, in most cases, it was not clear how this support translated into career development and promotion.

The FRC has also commissioned work by The Good Side to examine the barriers and challenges LQBTQ+ people face in progressing to senior leadership positions; how senior leaders have overcome those obstacles; and any good practices or procedures that enable LQBTQ+ progression.

This research complements the FRC's own research into diversity reporting considered in this report. Both found that very few companies have published their data on LGBTQ+ representation and we encourage companies to report regularly and transparently on all of their diversity data, targets, and progress.

The key findings and recommendations, which can be applied to many minority groups, can be found *here*.

In summary, companies are urged to:
Embed inclusive practices
Develop policies which protect everyone from discrimination
Capture individual insight and experiences and act on these when necessary
Offer training
Have senior sponsors or mentors policy
Build partnerships with other stakeholders

We encourage companies to publicise their diversity policies and practices more clearly, set appropriate targets across multiple areas of diversity, describe their progress against those targets in more detail, and include both senior management alongside boards when setting these targets to create a more diverse talent pipeline.

KEY MESSAGE

Perhaps most importantly, companies should show visible evidence that they 'walk the talk' on inclusion through collecting, tracking and transparently reporting on employee data and company progress over time.

REMUNERATION

Principle P of the Code states that: *"Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success. Executive remuneration should be aligned to company purpose and values, and be clearly linked to the successful delivery of the company's long-term strategy".*

We found that overall, the remuneration picture is mixed, with improvements in reporting on workforce pay, discretion, and Provision 40, but disappointing in relation to KPIs, pension contributions, and workforce engagement.

Alongside our own review, the FRC has commissioned a research project in partnership with Portsmouth University (to be published in early 2021) to examine the remuneration policies of FTSE350 companies which updated their policies in 2020. The purpose of the research is both to determine the impact of the Code on remuneration policies and to assess shareholder dissent to those policies through votes at AGMs.

The Portsmouth University's interim research offers a quantitative assessment of the extent of disclosure of remuneration policies in FTSE350 annual reports. Our review, on the other hand, assesses the effectiveness of company remuneration reporting in respect of the Code. We will refer to the interim findings of Portsmouth's research throughout this section of the report.

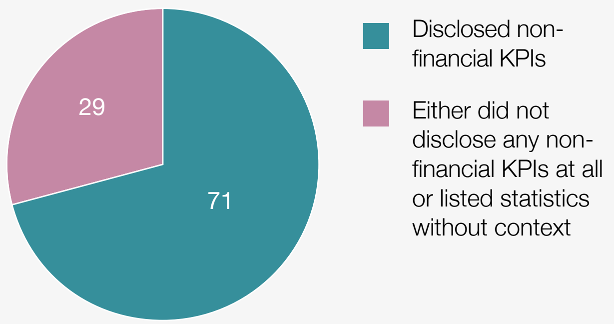
Key interim findings of the Portsmouth University research include:

- The Code has increased the extent of the disclosure against Provisions and Principles related to remuneration policies
- Remuneration committees appear to meet the required objectives of the new Code

KPIs

In our previous review, we noted an increase in the use of non-financial KPIs both for remuneration and more widely. Our research confirmed that this is still the case, as shown below:

Disclosure of non-financial KPIs



Explanation of non-financial KPIs

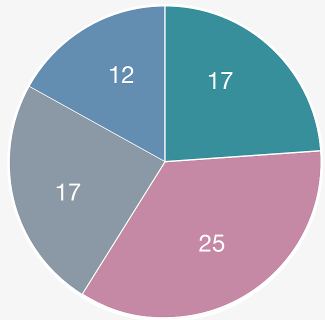


Chart refers to the 71% of companies that disclosed non-financial KPIs.

- Disclosed non-financial KPIs, but did not explain how they were designed, why they chose them, or their link to strategy
- Explained one of either design, choice, or strategy relating to their non-financial KPIs
- Explained two of design, choice, and strategy relating to their non-financial KPIs
- Explained all three of design, choice, and strategy relating to their non-financial KPIs

We were pleased that well over half of companies directly link non-financial KPIs to their remuneration measures. It was also encouraging to find that many companies in our FTSE350 sample, and to a lesser extent the SmallCap, had identified environmental areas as non-financial KPIs.

> "Some companies had gone beyond the government's guidelines to report on remuneration linked to the achievement of sustainability and climate change targets as key part of their governance."

43% of companies used specific non-financial KPIs in either their annual bonuses, long-term incentive plans (LTIPs), or both, with varying percentages and reassuringly weightings, while 30% specified only vague personal or strategic objectives. 27% did not link any non-financial KPIs to their remuneration at all.

A number of companies in our FTSE350 sample also identified meeting their commitments on climate change as a standalone non-financial KPI and provided a clear explanation of how they measure the KPI and why they intend to use specific environmental factors as measurements of their performance.

KEY MESSAGE

In line with the responsibility of the board for narrative reporting, companies should be providing a valid explanation of the relevance of each non-financial KPI in the context of the resilience of their business model to related risks.

While it is positive to see that many companies have included non-financial KPIs in their remuneration measures, we would encourage those companies that have not done so to consider their inclusion. For those companies that did not specify personal/strategic objectives, we would encourage them to detail the specific objectives they are measuring against. Reassuringly, Portsmouth University's interim findings indicate an improvement in the clarity and use of non-financial KPIs in annual reports for remuneration.

It is important to understand the methodology behind KPIs as their role is crucial in ensuring transparency for investors in measuring the performance of companies. The selection of metrics matters because they help to paint an accurate picture for shareholders to make investment decisions. Using misleading or 'cherry-picked' KPIs without providing any supporting information, (such as disclosing customer satisfaction scores without explaining their background and context), can have the opposite effect.

The most important aspect for KPIs is that they should be clearly linked to the company's strategy and are reflective of how a company is fulfilling its targets, goals, and purpose. We encourage companies to consider these three elements when including KPIs in future annual reports.

Workforce pay

While the Code focuses predominantly on remuneration for executive directors, it also emphasises the importance of boards both understanding and taking account of workforce pay and policies when considering company culture and remuneration. Consequently, our research looked at the degree to which companies had commented on workforce pay.

83% of companies reported on workforce pay, covering a pay comparison between the CEO and a group of employees as well as CEO pay ratio disclosures. This is primarily due to *recent changes* in the law which require companies to compare the salary, benefits, and bonus elements of the CEO with a comparator employee group.

> Provision 33 of the Code states that the RemCo has the responsibility for the remuneration policy for executive directors, reviewing workforce remuneration, and aligning incentives and rewards with company culture.

Portsmouth University also found that reporting related to Provision 33 significantly increased this year compared to those annual reports published in 2017.

Discretion

Section 5 of the Code describes the role of the remuneration committee in setting, overseeing, and applying discretion to executive remuneration.

Our research found that a clear majority of companies provided a full explanation of their Remuneration Committee (RemCo) discretionary powers, specifically around malus/clawback, bonuses, and LTIPs. In many cases, companies explained when they had exercised such discretion and why. Circumstances outlined where discretion was exercised included company performance and share price.

Examples of how discretion was exercised include:

- Lowering bonus outturns
- Not paying bonuses
- Deferring bonuses into shares
- Lowering LTIP payouts
- Lapsing LTIP awards entirely
- Reducing maximum future opportunity for LTIPs
- Increasing LTIP awards
- Cancelling scheduled pay rises for senior executives

Portsmouth University's interim research also found that the number of companies with remuneration policies enabling the use of discretion to override formulaic outcomes, both upwards and downwards, increased by 20%, compared to remuneration policies in 2017.

A minority of companies provided only partial explanations of their RemCo's discretionary powers, leaving out bonuses or LTIPs, while a small number did not provide sufficient information about either. Given their importance to stakeholders such as investors, customers and suppliers, companies should be describing what discretionary powers they have over all pay elements.

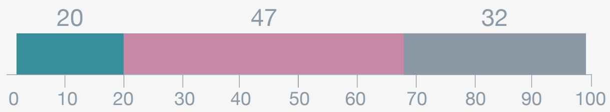
FRC Financial Reporting Council

FRC expects remuneration policies to elaborate on their RemCo discretionary powers. If existing remuneration policies do not currently include those controls, they should be strengthened.

Pension contributions

Executive pension contributions which are not in line with those received by the rest of the workforce have become increasingly contentious, with many companies facing shareholder dissent. We continue to see companies unifying their pension contributions levels, particularly those that have reviewed their remuneration policies this year.

Unfortunately, our research discovered that a majority of companies have not yet aligned the pension contributions of all their executive directors with their workforce.



Did not state anything about aligning their pension contributions with the workforce

Would align their pension contributions on a specific date or omitted information about ether their exec./workforce levels.

Had aligned all their exec director pension contributions with the workforce

It is concerning that some declined to disclose the workforce pension contribution rate. We also found that 43 companies claimed full compliance with the Code which includes Provision 38 (pension contribution alignment) in their corporate governance statements but did not in fact demonstrate compliance with this Provision.

While 32% of companies had aligned all their executive director pension contributions with the workforce, this is far less than we were expecting.

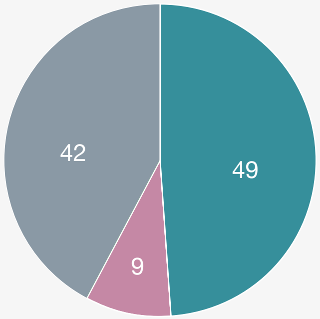
FRC Financial Reporting Council

FRC expects all companies to move to the full alignment of pension contributions as soon as possible. We also expect, along with investors, those companies which still have not addressed this issue to provide a clear and specific rationale and to define a timeline by when this will be rectified.

Until then, those companies must disclose this non-compliance in the governance statement.

Provision 40

Reporting against Provision 40



- Addressed the six elements of Provision 40 in an effective manner or addressed them in a moderate amount of detail. In terms of offering transparency, many of these companies clearly explained how they had addressed each element of the Provision, which is in line with Provision 41
- Partially addressed some elements of Provision 40, choosing to focus on areas such as clarity and simplicity, but neglecting to disclose how the other elements had been considered
- Paid lip service to the Provision by repeating the wording from the Code within their report, but did not describe what they did to fulfil it

Provision 40 of the Code states that: "*When determining executive director remuneration policy and practices, the Remuneration Committee should address the following*":

- Clarity
- Simplicity
- Risk
- Predictability
- Proportionality
- Alignment to culture

Portsmouth University's interim research found that the extent of disclosure in annual reports regarding each element of Provision 40 improved significantly.

Unfortunately, 42% of companies failed to address all the elements of Provision 40. Many companies revised their remuneration policies this year in line with the remuneration policy cycle, and we would have expected these companies to, at the very least, acknowledge the existence of the Provision in their updated policies and explain how they propose to report on these matters in the future.

FRC expects to see clear descriptions of how each element of the Provision has been accounted for when determining the remuneration policy for the next reporting cycle.

C. STAKEHOLDER ENGAGEMENT

Stakeholder engagement issues were expanded within the Code in line with the emphasis placed on s.172 reporting. We acknowledge that companies have been engaging with a wide range of stakeholders and have some good practices in place. Companies should be using these engagements to gain greater insight into the views of their stakeholders and to assess how these views and ideas can help inform strategy. Meeting the new and evolving needs of key stakeholders is essential for a company's sustainable success.

Provision 5 of the Code states that: "*The board should understand the views of the company's other key stakeholders and describe in the annual report how their interests and the matters set out in section 172 of the Companies Act 2006 have been considered in board discussions and decision-making.*"

Our monitoring looked not only at s.172 statements but also at how the s.172 factors have been applied across the strategic report.

KEY MESSAGE

Companies are failing to provide sufficient information for investors and broader stakeholders in their s.172 statements. This is in line with *Grant Thornton's recent finding* that just 38% of FTSE350 companies provided detailed disclosure.

BOARD ENGAGEMENT WITH STAKEHOLDERS AND STEPS TAKEN TO UNDERSTAND STAKEHOLDER VIEWS

We encourage companies to provide detailed s.172 statements with examples of key decisions relating to each stakeholder group. Cross-references should be used to direct the reader to more information, and companies should not simply provide a list of cross-references to various parts of the strategic report.

Principle D of the Code states that the board should ensure effective engagement with, and encourage participation from, its stakeholders.

IDENTIFYING STAKEHOLDERS AND ISSUES

- Identify key stakeholders and explain how stakeholders affect the development and implementation of strategy
- Identify key concerns for each stakeholder group. This should ideally be informed by stakeholder feedback and reflect your stakeholders' evolving needs

ENGAGING WITH STAKEHOLDERS

- Report on the outcomes of engagements and why key decisions were taken in light of that engagement
- Do not equate outcomes with processes
- Reporting on one-sided engagements driven by the company pays lip service to the Code and does not amount to meaningful engagement

UNDERSTANDING STAKEHOLDER VIEWS

- Explain how particular engagements enabled the company to better understand the needs and views of stakeholders
- Explain how stakeholder feedback helped inform decisions
- Address future implications and planned actions arising from feedback received and impacts of decisions

IDENTIFYING STAKEHOLDERS AND ISSUES

FRC Financial Reporting Council

FRC expects companies to identify their key stakeholders and explain their relevance in the context of their strategy. Companies should also be identifying key issues relating to each group.

Almost all companies in our sample identified their key stakeholders and reported on why they engage with each group, which is commendable. However, it appears that many companies engaged with their stakeholders in an ad-hoc manner and it was often unclear why they have decided to engage with some of their key stakeholders and not others.

A better approach was observed where the company distinguished between those stakeholders that impact the company and those which are impacted by the company. Reporting was further enhanced where the company clearly linked each stakeholder group and relevant issues to its corporate purpose and strategic objective.

The FRC Lab issued its '*Hints and Tips*' for S.172 reporting and will publish a further report in the coming month.

KEY MESSAGE

Whilst many companies identified the issues pertaining to each stakeholder group, in the majority of cases, companies listed the relevant issues but did not provide specific examples of engagement on each of these issues.

A number of companies also linked each stakeholder group to the specific company values that the company is guided by when interacting with each stakeholder group.

When accompanied by relevant outcomes of stakeholder engagements throughout the year (e.g., the initiation of public health awareness campaigns or entered into partnerships to develop training in a particular field), 'operationalising' the company's values in this way is an effective method of demonstrating the integration of company values throughout the business and its decision-making processes.

Boards should be asking, and reporting on, how any changes to their business model or strategy in recent years may impact each stakeholder group.

FRC Financial Reporting Council

FRC expects companies to both report on how the company has engaged with its key stakeholders and on the steps it has taken to understand the views of their stakeholders, in line with Provision 5 of the Code.

ENGAGING WITH STAKEHOLDERS

Contextualising stakeholder engagement within business strategy was often achieved by appropriate signposting to the relevant part of the Annual Report, for example to information on relevant KPIs, case studies and risks for each stakeholder group.

"Although the vast majority of companies reported on some form of engagement with stakeholders, many are still failing to report on the outcomes of these engagements."

"Failure to embrace stakeholder governance could be the most significant risk factor, outside of liquidity, facing most businesses over the next ten years."

Board Intelligence[2]

[2] Board Intelligence, *Navigating the New World of Stakeholder Governance (2020)*

Even where companies did report on outcomes, these were couched in general terms. For example, after describing their methods of stakeholder engagement, some companies referred to outcomes such as ‘good relationship with suppliers’ or ‘improved efficiency’. In other cases, companies referred to ‘outcomes’ which were, in reality, processes.

EXAMPLE

One company stated that its Investor Relations team provided the board with regular feedback on investors’ views and key market issues, without going into any detail about what kind of feedback they had received nor the key market issues.

We found, generally, that companies are not reporting on the effectiveness of their stakeholder engagements and how those have contributed to the companies’ long-term success.

UNDERSTANDING STAKEHOLDER VIEWS

FRC Financial Reporting Council

FRC expects companies to take action to understand the views and needs of their stakeholders and report on such engagements. Engagements should promote a dialogue between stakeholders and the company.

Although almost all companies report on some form of stakeholder engagement, what a company refers to as ‘engagement’ is often a one-sided exercise, such as providing presentations or visits to supplier/customer sites. While these activities certainly have the capacity to become meaningful engagements, companies rarely demonstrated how these have enabled them to better understand the needs and views of their stakeholders.

> “Even where companies have yet to response to a feedback, they should be stating how and when they intend to take action in respond to that feedback.”

Of the companies that have detailed the ways in which they collected stakeholder views, only a few companies report on how that feedback has helped inform their decisions. Better reporting practice was observed where the company explained clearly:

- How they engaged with the relevant stakeholders;
- The specific feedback they received; and
- The action they have taken in response to those stakeholder views

EXAMPLE

For example, one company in the financial services sector reported that it received feedback from a number of sources (its annual survey, real-time client experience survey and third-party surveys that benchmark its performance against competitors) which told them that clients felt that the company should simplify its processes and make better use of digital technology. The company also took into account the increasing demand for sustainable finance products and a number of specific examples of digital platforms in specific areas of the business and in different countries which have enhanced client experience in the past. The company then listed the various examples of action taken in response to the feedback it had received, including improvements in the design of their digital platforms.

Measuring the performance of stakeholder engagements

FRC Financial Reporting Council

FRC expects companies to report a coherent narrative on their approach to measuring the performance of their engagement strategies.

Although stakeholder relationships are difficult to measure, the disclosure of stakeholder engagement performance metrics shows a recognition of stakeholders as a source of differentiation and risk and can help companies achieve their strategic objectives.

Only a small number of companies within our sample provided details of key metrics or signposted to information explaining how they had measured the success of engagements with each stakeholder group.

Of those companies that did provide performance metrics, there were variations in the metrics used to measure the performance of engagement methods. Where companies used just one metric or provided only metrics which related directly to financial performance (such as number of payments made to suppliers on time) the outcome was far less satisfactory.

A more comprehensive and accurate representation of the performance of stakeholder engagements was achieved where the company utilised a combination of performance metrics.

For example, when reporting on customer engagement, instead of using simple metric such as 'number of new customers', some companies used customer satisfaction surveys as a measurement of customer engagement in addition to the number of complaints as a KPI. Methods of measuring stakeholder engagement which relate to stakeholder perception are better as they provide greater insight into the potential risks and opportunities relating to each stakeholder group.

The company's narrative should also describe how information relating to each metric is passed to the board and how often the board assesses each metric. Reporting was further enhanced where the company stated the weighting of each metric (e.g., 30% of performance) against its weighted performance outcome (e.g., 22%).

FRC Financial Reporting Council

FRC expects 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.

By acknowledging their failures and demonstrating elements of their strategy which will improve performance, companies can effectively demonstrate the resilience of their business model.

Considerations for reporting on stakeholder engagement:

Do

- Use metrics that provide insight into risks and opportunities (e.g., stakeholder feedback)
- Report on performance weightings and weighted performance outcomes
- Report on difficulties as well as positives
- Explain why trade-offs were necessary in the short term

Don't

- Use simple performance metrics (e.g., number of supplier payments made on time)
- Focus on metrics relating to financial performance

Reporting on Key Decisions

FRC Financial Reporting Council

FRC expects companies to report on how the board has reached key decisions and the likely impact of those decisions, including how it has taken account of the company's stakeholders in doing so.

We also found that many companies (and particularly larger companies) report on decisions which do not, to any significant degree, impact stakeholders beyond shareholders and/or employees.

KEY MESSAGE

Whilst most companies reported on at least one principal decision that impacted its stakeholders, these were often routine decisions which did not involve difficult stakeholder trade-offs.

As such, reported 'principal' decisions were often routine decisions which typically occur on a yearly basis (e.g., remuneration decisions, pension plans, capital allocation) but do not significantly impact wider society.

Considerations for reporting on key decisions:

Do

- Provide examples of key decisions where the company has taken stakeholder interests into account
- Report on the specific risks and opportunities to the company and each impacted stakeholder group
- Explain the contribution of each principal decision to the company's long term success

Don't

- Confine decisions to routine decisions which do not involve the need to make difficult stakeholder trade-offs
- Use boilerplate language when reporting on key decisions

Our findings align with a [recent report by Board Intelligence] which found that 57% of boards say their biggest stakeholder governance challenge is a strong focus on one or two stakeholder groups, with not enough time spent on others.

KEY MESSAGE

Within principal decision disclosures, there were also huge variations in the level of detail provided and level of analysis. Boilerplate reporting on principal decisions was common.

We welcome reporting on decisions which involve the need to make difficult stakeholder trade-offs. Examples included: the sale of the business in a particular country; a new partnership; building of a new site in a certain location; restructuring to transform the company's e-commerce capabilities; and the acquisition of a digital platform.

EXAMPLE

Many companies reported that they had "*balanced the needs of their key stakeholder groups*" in coming to a key decision, "*they considered the risks and benefits of the proposal*", or that "*feedback from stakeholders helped the board arrive at the most appropriate decision*", without providing any further detail about the interests of each stakeholder group and any specific benefits/risks that would result from the company's principal decision(s).

Reporting was better where companies were specific about which stakeholders would be impacted and information taken into account in coming to that principal decision.

One company, for example, reported on the decision-making process that led to their new diversity and inclusion policy:

EXAMPLE

The company recognised that such a policy would help the company achieve its aim of recruiting a more diverse workforce, which in turn would better reflect the diverse customer base of the Company. The company also considered the impact of the decision on specific customer contracts and the fact that the new D&I policy would align with the values of key customers.

That company also reported on their consideration of a number of studies that demonstrated that companies with greater diversity in leadership positions were more likely to outperform their national industry median on EBITDA margin, whilst companies with the least diverse leadership for both gender and ethnic/cultural diversity were less likely to achieve above-average profitability.

Transparency was further enhanced where the company reported on the risks and opportunities related to the decision, any due diligence carried out, and the process by which the board received the appropriate information relating to relevant stakeholder groups (e.g., where the board consulted the Chief Risk Officer).

"Much of the reporting was boilerplate and/ or vague in nature, with some companies stating merely that the views of stakeholders were "*considered in the normal cycle of board meetings.*""

Concerningly, the majority of companies who did report on their principal decisions, did not make any statement on the contribution of those decisions to the company's long-term success.

This is in line with *Grant Thornton's finding* that only 12 companies (4%) in the FTSE350 illustrate the long-term impact of board decisions in the context of stakeholder considerations.

EXAMPLE

A number of companies in our sample used vague statements such as "*the decision led to positive results for all key stakeholders*" and/or "*the board continues to monitor its success*".

FRC Financial Reporting Council

FRC expects 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 figures (e.g., the decision generated X new jobs, increased shares by X amount, generated X new customers in market Y) or case studies.

TOP TIP

Include prompts on stakeholders and Section 172 duties in templates for board agendas, papers and minutes as reminders for both the board and management.

Board oversight of stakeholder decisions

FRC Financial Reporting Council

FRC expects 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.

We found that only a very small minority reported on these aspects and when they did, these largely focused only on information relating to the workforce and/or shareholders.

Transparency was enhanced where the company reported on not only how the board engaged directly with shareholders (e.g., visits, Q&As), but also where they stated who, or which department, is specifically responsible within the company for engaging with certain stakeholder groups and escalating information relating to those stakeholders to the board (e.g., CEO, Investor Relations team, HR department, Health & Safety, Legal team).

A small number of companies are disclosing the training received by directors to help them fulfil their duty under s.172, including training on key stakeholder issues (e.g., bespoke inductions, training and masterclasses on specific ESG issues).

A number of companies reported on their requirement that all papers submitted to the board for decision include a checklist of these factors, stating, firstly, whether or not the factor is a relevant factor in taking the decision; and secondly, where there is a relevant factor to be considered, a short description of the issue or reference to the section of the paper where the factor is discussed. These are elements of reporting that we expect to see more of next year.

Reporting on mechanisms for stakeholders to raise issues independently

Having a mechanism for stakeholders to raise issues independently helps strengthen the continual dialogue between the company and its stakeholders.

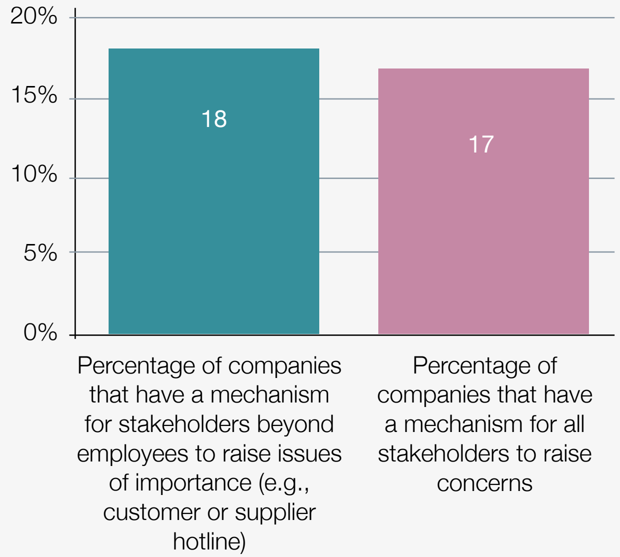
KEY MESSAGE

Although almost all companies report on some form of stakeholder engagement, engagement beyond the workforce is almost invariably driven by the companies themselves.

The majority of companies in our sample did not report on a mechanism for stakeholders to raise issues of importance independently. Where companies did have such a mechanism, these were largely limited to employee whistleblowing processes.

A minority of companies reported on complaints, grievances or 'raising concerns' platforms for all stakeholders.

No. of companies that report on mechanisms for stakeholders to raise issues independently



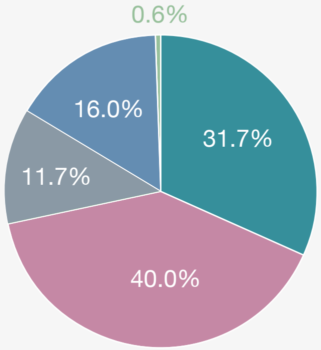
However, there were variations of level of detail provided, particularly in respect of the effectiveness of complaints/ grievances mechanisms.

TOP TIP

Explain clearly the purpose of stakeholder platform and provided an overview of its performance for the year. This could include the number of complaints received, investigated and resolved.

WORKFORCE FOCUS

Most popular mechanisms of including employee representation on company boards



- Did not adopt any of the three options
- Chose to appoint a NED
- Chose an advisory panel
- Chose a NED + Advisory panel
- Workforce director

The chart includes 280 companies in the FTSE350. Investments trusts with no employees and firms with fewer than 50 employees were discounted.[3]

Under Provision 5 of the Code, processes are required for the board to understand the views of the company's workforce and describe in the annual report how their interests have been considered in board discussions and decision making.[4]

Our analysis suggests that the reporting in this area is wide-ranging, with many companies explaining the different approaches used to tackle engagement with the workforce. Popular ways of engaging included the use of an employee survey, town halls and site visits by members of the board.

Four companies within our sample of 100 did not comply with one of the suggested mechanisms or an alternative listed under the Provision. While the majority disclosed their choice of mechanism or alternative, it was still unclear why the method selected was considered most effective for the company.

The same concerns are also reflected in the workforce engagement research project which was commissioned by the FRC and is being conducted by the Involvement and Participation Association (IPA), in partnership with the Royal Holloway University of London (RHUL). Although the report will not be published until early 2021, we have some interim findings which we will refer to in this report.

As part of the disclose related to the mechanism used we expected companies to report that the decision was made following some degree of discussion with the workforce. However, in the majority of cases, we found almost no reference to employee discussion/participation in making the decision.

It is important to note that in some disclosures there remained a degree of difficulty in identifying whether a method chosen was one of the three suggested mechanisms or an alternative arrangement.

FRC Financial Reporting Council

FRC expects further clarity to ensure that investors and stakeholders are aware of how companies engage with their workforce.

3 Data was obtained from the Involvement and Participation Association in partnership with Royal Holloway University of London

4 The use of 'workforce' is for Code purposes and not meant to align with legal definitions of workforce, employee, worker or similar.

Recurring themes from our analysis are set out below:

Non-executive Director	Workforce advisory panel	Alternative arrangements	Workforce Director
The majority of companies highlighted that this was the most appropriate method. However, information on the NED's role tends to be ambiguous and limited in some cases.	Compared to the information provided for the roles of the NEDs, this mechanism provided a more robust and structured process for obtaining employee views.	The majority of companies refer to having either too small or too large workforce as the reason why they have not adopted one of the three mechanisms listed under Provision 5.	Only two companies within our sample used this approach, therefore it is insufficient to draw conclusions from this method.
There appears to be a reliance on looking at the results of staff surveys and the use of site visits led by the NED to ensure employee voices are heard at board level.	Difficulty in establishing how the activities of the panel have impacted board decision making. In some cases, the panel is used for the board to explain decisions already taken.	Whilst some stated that their existing practices are adequate, many suggest that they are enhancing their current engagement processes, but do not provide any additional information on how it will be delivered.	
We noted a lack of substantive information on the decisions/ outcomes as a consequence of the NED's activity.	Some companies have adopted a hybrid model with a designated NED who chairs the panel. Such an arrangement allows for two-way communication between employees and the board.	Some companies highlight the importance of all NEDs engaging with the workforce to understand the workforce views, however, the majority of the firms in this group appear to be reliant on the use of an annual engagement survey. Occasionally, this form of engagement is supplemented with the use of Q&A sessions and informal interactions.	
Reports did not on the whole set what was required of NED's to succeed in the role, and we were left with a feeling that it was up to them to work out how to engage.	Many companies noted that these panels had only just been set up.		

Alternative arrangements

Companies highlighted the challenges of using one of the three workforce engagement mechanisms suggested in the Code, and stated that their existing methods are adequate – but not always with a reason why the current method of engagement is effective.

Many companies noted the challenges in obtaining views from a global workforce across multiple countries which necessitated the need for multiple engagement methods suitable for individual jurisdictions, whilst companies with fewer employees highlighted that their employees have regular access to senior staff through meetings and ‘informal events’ and therefore a mechanism listed under Provision 5 was not suitable.

> “Many companies did not mention why their existing activities are effective in understanding the views of the company workforce, in line with the Code at Provision 5.”

Alternative arrangements reported by companies not choosing one of the suggested methods included relying on the information from the annual employee engagement survey and informal activities, such as Q&A sessions, lunch with board members and the use of blogs and videos on the company’s intranet. It was generally not apparent from these explanations how any issues raised affected board decision making.

The better reports detailed any well-established and effective formal mechanism of engagement, such as meetings involving the chief human resources officer or the chief executive; alongside the workforce and trade union representatives, and the use of anonymous reporting hotlines through which concerns can be brought to the board’s attention.

A minority of companies suggested that plans were being made to enhance their current engagement methods. For example, that to meet the expectations of the Code, one company has decided to involve one or two NEDs in town hall meetings.

However, there were instances in which companies did not to provide details of how methods have been enhanced and simply provided boilerplate language;

EXAMPLE

One company stated that the board has “*.... dedicated considerable time during the year to oversee implementation of a robust culture framework and ensuring employee voices are heard in the boardroom*”.

Overall, our analysis highlights that this approach tends to provide weaker responses as to why such arrangements are effective.

FRC Financial Reporting Council

FRC expects companies to fully explain why their method of employee engagement is effective. This can be reported through examples of discussions in relation to the impact of the engagement on decision making.

Non-Executive Director

Appointing a NED to engage with the workforce was the most common mechanism used. This also correlates with the findings of IPA and RHUL in which over 112 companies in the FTSE350 chose this approach. In some cases, the role of designated NED expanded to two or three individuals to ensure accessibility in each of the company’s respective regions. One company within our sample highlighted that, due to having over 80,000 employees across 40 countries, a workforce NED was insufficient and the role should be undertaken by the corporate responsibility committee.

Companies that chose the NED approach often highlighted that it offered the director the opportunity to get insight into employee views throughout the company and share them with the board. However, very few companies reported why this arrangement was effective, for example, it was not clear if a report from the NED was a standing item on the board agenda, or alternatively what criteria the NED used to raise matters to the whole board.

This is further evident from the IPA and RHUL research which found that one in five companies described an existing NED as simply being 'approached and asked to take on the role' without reference to a wider board discussion on why they were considered to be the right candidate for this position.

Companies also did not report adequately on what is expected of a workforce NED. In almost all cases it appeared to be that driving the work forward was left to individuals and no little direction given on time to allocate to this activity. To ensure that a Workforce NED is effective, expectations should be set out prior to someone accepting the role.

TOP TIP

Defining the role of the workforce NED:

- Set out the board's expectations
- Agree on what activities the NED should undertake e.g., host specific engagement events, chair a working group
- Consider whether additional training is needed
- Consider how the role might be supported by HR or internal audit
- Define how often the NED should report to the board
- Define how the NED should report – formal agenda Item or other methods
- Discuss the kinds of issues that should be brought to the board and which should be dealt with by committee or executive
- How the role will add value to current engagement activities

FRC Financial Reporting Council

FRC expects companies to adopt an effective method of workforce engagement in order to deliver meaningful and regular dialogue with the workforce and aim to strengthen the employee voice in the boardroom. Such dialogue needs to be explained clearly and effectively for the Code Provision to be met.

The reported activities of NEDs differed between each company but included site visits, lunches, participating in town hall meetings and employee focus groups, all of which allowed employees to raise their views directly to the representative director. However, it was not always clear whether these kind of interactions were ad hoc or focused, and if or how the views reached other board members. Better engagement will be achieved when the workforce is able to consider issues in advance and there is a specific focus to such interactions.

There was also a substantial reliance on the annual employee engagement survey and site visits to different parts of the business. The IPA and RHUL research discovered that out of the 61% of companies that responded to their survey stating that they had a designated NED, the NED was most commonly asked to consider the results of staff surveys (81%) and attend site visits which is undertaken by 84% of designated NEDS.

In some cases, the NED is simply required to complement the survey process whilst the human resource function reports findings to the board. When reporting on such matters, it would be useful to determine exactly what value is added by the NED.

Although our concerns regarding the use of surveys as the only way to engage have been dealt with elsewhere in the report (see our analysis on *culture*), we would also like to draw attention to the comments highlighted in the *Guidance on Board Effectiveness* which expressed that while the annual survey can be a useful source of information, it is not sufficient on its own as an indicator of workforce views.

FRC Financial Reporting Council

FRC expects reporting to clearly set out the impact of the involvement of the NED on workforce engagement.

Advisory panel

KEY MESSAGE

Our analysis highlighted that elements of good practice are evident in this area and signs of advanced development and structure were prevalent when a workforce advisory panel was the chosen method. A formal structured approach was relatively common and evidence of a direct two-way communication system were present in many reports.

Structured approaches can also enhance effectiveness as the workforce will be more confident that their views will be heard by the board. However, we are yet to see whether such activities stemming from the panel have influenced board decision making, partially due to the fact that many of the panels at the time of reporting had only recently been set up.

Some companies provided examples of initiatives they are committed to carrying out as a result of a panel, such as including greater access to training and opportunities to further develop the reward strategy. However, we would welcome more clarity on whether training courses for the panel members are provided and if gender, ethnicity and age are considered in their selection and appointment to ensure there is a fair representation of the wider workforce. In the survey conducted by IPA and RHUL, they noted that only a third of the advisory panels were fully elected by the workforce, with the remaining two-thirds being described as a combination of elected and appointed.

Some companies opted for a hybrid mechanism which combines a designated NED with an advisory panel.

EXAMPLE

One company made the following observation about making the NED the chair of its panel:

"...provided the board with a better understanding of the views of the employees and greater clarity on the culture of the company."

In such cases, the NED tends to discuss the results of the survey with the panel and the themes arising from such discussion are shared with the board. Chairs of the panel can also be invited to board meetings, and around 25% of firms that responded to the survey by IPA and RHUL sent written reports from their advisory panel to be presented at board meetings.

Overall, whilst many companies highlight that their mechanism allows for two-way engagement, we are yet to see whether activities arising from panels have impacted board decision making in any way.

Workforce director

Only two firms within our sample employed worker directors meaning there is insufficient evidence to draw conclusions from this method. However, the companies that did adopt this method highlighted that they appointed two workforce directors in order to get direct views from the workforce. Information on training and support was provided and there were indications to suggest that the workforce directors took part in board discussions on all issues that were presented to the board.

However, neither report explained in sufficient detail how workforce views had been obtained.

We would encourage other companies to consider either this option or other ways in which workforce representatives could attend the board to offer views and feedback from the workforce.

Overview of outcomes

It is important to ensure that the approach to workforce engagement delivers meaningful and regular dialogue with the workforce and evidence is provided within the report to show that such dialogue is brought to the board's attention.

We were surprised at the lack of discussion with the workforce as to what would be the most effective way to engage with them.

FRC Financial Reporting Council

FRC expects outcomes from either form of 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.

Remuneration committee workforce engagement

For the first time, the Code explicitly set out that remuneration committees should engage with their workforce. It describes two main strands to such engagement – Provisions 33 and 41.

Provision 33 of the Code states that the RemCo should take the workforce's remuneration considerations into account when setting the remuneration policy for executive directors.

Provision 41 states that the annual report should describe the work of the RemCo, including: *"what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company pay policy."*

Our review last year noted that very few RemCos reported on their workforce engagement in relation to executive remuneration, but the majority acknowledged that they would address this area in 2019.

Many companies stated in their annual reports that they had taken workforce remuneration, workforce-related policies, and the alignment of incentives and rewards into account when setting policy for executive director remuneration under Provision 33. However, few companies provided further detail. Examples of common reporting included: Engaging through briefing and guides; the employee champion providing information to or sitting on the RemCo; and collecting information as part of staff surveys.

These engagements were predominantly led by the company and did not appear to allow much, if any, room for a response from the workforce. It was quite often unclear how such one-way engagement resulted in the RemCo taking the workforce into account when setting the remuneration policy.

However, there is a key difference between Provisions 33 and 41. Provision 33 focuses on how companies factored their workforce's circumstances into setting the remuneration policy. Provision 41, on the other hand, examines the discussions between the workforce and the RemCo regarding the policy, any feedback that the RemCo received, and any actions that it took in response to such feedback.

When we considered the application of Provision 41, we were unable to find any annual reports that described any feedback that was received from employees by the RemCo, and any consequent follow-up actions. Some companies did report that this was an area that they were still working on and would report on next year. However, we found that some companies that had claimed full compliance with the Code were not, in fact, in compliance with this part of Provision 41.

When reporting against Provisions 33 and 41, RemCo should offer additional clarity on the matters they have taken into account in relation to the workforce's remuneration policies and incentives when setting the remuneration policy for executives.

KEY MESSAGE

RemCo should also engage with their workforce meaningfully, ensuring there is a two-way dialogue. Good practice would be to separate engagement on executive remuneration policy from other workforce engagements to ensure a focused discussion.

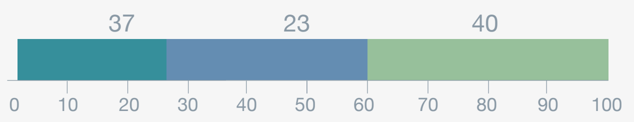
FRC Financial Reporting Council

FRC expects to see an improvement in companies reporting the steps that they have taken to engage their employees on their remuneration policies.

SHAREHOLDER FOCUS

To review to what extent companies are being responsive to shareholder concerns, we used the Investment Association's *Public Register* which tracks significant opposition by shareholders to a resolution, or any resolution, withdrawn before a shareholder vote at listed companies.

Our analysis of companies which were due to submit their six-month update after the shareholder meeting by 31 October, as per Provision 4 of the Code, revealed that 40% of companies did not make any announcement. This inaction is deeply concerning as it highlights a further area od non-compliance of the Code and indicates a lack of regard for significant shareholder concerns.



By looking at companies within our sample which received 20% or more votes 'Against', and as such were listed on the Public Register, 40% of them faced shareholder dissent purely due to remuneration concerns, whether relating to remuneration policy, report or proposed share scheme.

"Within our sample of companies that received 20% or more votes 'Against' on remuneration grounds, 56% have previously received significant opposition by shareholders relating to the same resolution, some more than once, which is a red flag."

While we recognise that not all issues can be resolved immediately, we would expect companies to at least demonstrate their active engagement with shareholders, and other stakeholders, with a view to resolving any contentious points, not simply to discharge their duty.

Unfortunately engagement too often resembles an information campaign, rather than a discussion. For example, 67% of companies within our sample encountering significant opposition by shareholders due to remuneration issues, appear not to have addressed shareholder concerns at all. Such a high number is particularly worrying considering the concerns related to, among other things: overcomplexity of certain remuneration schemes; disproportionate salary increases for top executives; RemCo discretion; post-employment shareholding requirements; and pension entitlements – all points clearly addressed by the Code.

Responsiveness to the views of shareholders and wider stakeholders is one of the key requirements of the Code and s.172. It should stem from the company's culture and be underpinned by integrity, transparency and accountability – all crucial elements of effective corporate governance.

FRC Financial Reporting Council

FRC expects 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 specified timeframe.

Grant Thornton's recent report reflected our findings, stating that just 10% of companies in their FTSE350 sample specified actions taken as a result of information collected from shareholders.

SUPPLIER FOCUS

KEY MESSAGE

We were disappointed that more companies did not report on channels of engagement with suppliers and their importance as a source of risk. Failures and concerns within the supply chain will impact the success of the company, even if only in the short term.

We found that meaningful engagement with suppliers, or reporting on supplier engagement with outcomes, was very rare. Indeed, in their recent research, Board Intelligence found that just over one third of FTSE350 companies saw a clear connection between their suppliers and their financial performance.

We found that engagement with suppliers was usually limited to supplier polices and codes of conduct and did not involve two-way communication. Simply because a company has produced a code of conduct does not mean suppliers are actively engaging with it.

Whilst a few companies reported on a general 'hotline' for stakeholder concerns, there was little detail of the effectiveness of these in terms of supplier engagement. Similarly, some companies referenced supplier surveys without providing any indication of how feedback from these engagements informed decision making.

> "Engaging meaningful with suppliers is not simply about being a good corporate citizen, but also about discharging directors' duties under s.172 and mitigating risk in company supply chains."

Whilst carrying out our research, two issues relating to suppliers merit particular attention:

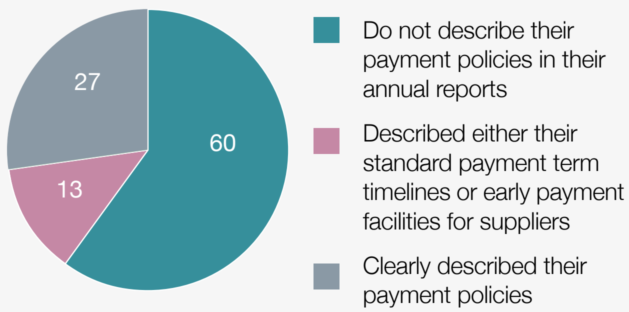
Payments to Suppliers

The issue of late payments to suppliers is a longstanding one. The effects range from causing suppliers to experience financial difficulties to unnecessary business failure.

In our review last year, we noted that reporting on supplier payments would be one way to demonstrate having regard to those matters referred to in section 172.

We were therefore expecting more companies to report on this element of engagement, evidencing a discussion at board level on payment policies or reporting that a company is a signatory to the governments Prompt Payment Code (PPC). It is an effective way of demonstrating how a company works with, and considers issues of importance to, its suppliers.

Reporting on payment policies



Within those companies that did describe their payment policies, 92% did not discuss them at the board-level, which is disappointing given their reputational, strategic, and s.172 importance.

Furthermore, only 11% of our sample were signatories to the PPC, with one company reporting it had been reinstated following a suspension. Roughly half of these were FTSE100 and FTSE250 respectively.

KEY MESSAGE

Boards should review their prompt payment policies on a regular basis and have mechanisms in place for being alerted to problems with payment expectations.

Modern Slavery

It was disconcerting that although many companies made a reference to the Modern Slavery Act, very few mentioned it in their s.172 statement and only a small minority of companies had engaged with their suppliers on the topic. The issue of modern slavery was often described solely through the lens of employee engagement, with companies failing to address the supply chain dimension.

Of those who did report on supplier engagement on this issue, good practice was seen where the company reported not only on the process/actions taken to engage their suppliers (e.g., enhanced due diligence; checked publishing of Modern Slavery Statements) but also on the outcomes of those engagements (e.g., discontinued business; received assurances).

In response to the COVID-19 pandemic, a number of companies have started to pay closer attention to their supply chains. Many have made commitments to improving their visibility and introduced processes to ensure that the board is kept informed about any impacts on suppliers. This is something we will look at for next year.

SOCIETY FOCUS

Environment

Although the Code does not include any specific Provision on environmental issues, a number of the Code's Principles cover matters relating to the environment, including the requirements to assess and manage the company's risks, the board's responsibility for narrative reporting and for engagement with wider stakeholders.

As such, we would expect almost all Premium listed companies to consider the impacts of climate change on their business model and report on the actions they are taking to mitigate climate-related risks and ensure resilience and long-term success.

In November 2020 the FRC published its *Climate Thematic*, a cross-organisational project which aimed to assess current responses by companies to climate change and to set expectations for future reporting. Along with the Thematic, the FRC issued a statement signaling its support for additional reporting in this area:

FRC review concludes that corporate reporting needs to improve to meet the expectations of investors and other users on the urgent issue of climate change.

FRC supports the introduction of global standards on non-financial reporting, but, as an interim step, encourages public interest entities to report against the Task Force on Climate-related Financial Disclosures' recommended disclosures and the Sustainability Accounting Standards Board metrics for their sector.

As part of the Climate Thematic we considered 60 companies from our wider sample.

KEY MESSAGE

While many companies are disclosing approaches to climate governance it was often unclear how consideration of climate-related issues inform key decisions or the business model or strategy. This consideration was even less obvious amongst smaller cap companies.

We were pleased to see that many companies are reporting that action on climate change is essential for their long-term success. Many businesses have pledged to becoming 'net zero' in line with the UK Government's target to decarbonise the economy by 2050 and/or aligned their strategy with the goals set out in the Paris Agreement.

Others reported on the process by which climate risks and opportunities are reviewed. Whilst a number of companies have one named director responsible for climate-related issues, some others report that climate risks are the responsibility of the whole board or relevant committee.

We recognise that there is no one-size-fits all approach to climate governance and companies are encouraged to carefully consider which kind of climate governance structure is most appropriate for their business model.

KEY MESSAGE

Many companies have clear governance structures in place for the identification and management of climate related risk, but it was often unclear whether climate considerations had been given sufficient attention on board agendas, as few companies went into detail regarding any key decisions the relevant individuals or bodies have made.

For the few small cap companies assessed, we were disappointed to find that that there was very little reporting on climate change governance.

For a more detailed analysis of our climate-related governance findings, see pp11-46 of the corporate reporting section of FRC *Climate Thematic*, where you can find information on the following issues:

- TCFD Disclosure
- Small Cap Reporting
- Risks and Opportunities
- Impact of Business on Environment
- Environmental KPIS
- S.172
- Stakeholder engagement

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FRC expects companies to report how climate and environmental issues are considered at board level and the impact this has on decision making, taking into account any reporting against TCFD and SASB.

Communities

Whilst many companies listed communities as a key stakeholder, they often failed to provide examples of specific community engagements and rarely reported on issues discussed with community members beyond the workforce. Some companies vaguely commented on having a positive impact on a community but did not elucidate further.

KEY MESSAGE

Companies should be reporting on the steps taken to ascertain the views of all relevant stakeholders and describe what action they have taken to better meet the needs of their community.

Community engagement seemed largely to consist in donations to local charities, for example local schools or hospitals, and did not involve active engagement by the company with members of the community.

EXAMPLE

There were, however, some instances of good reporting within our sample. When reporting on community engagement, for example, one company reported that employees asked for clarity and consistency in the company's approach to charitable giving so that they could make recommendations for deserving causes that could be helped either financially or with volunteering efforts. The company responded by launching a new charitable giving programme, comprising information on 'company match' donations, how to seek assistance with local charity support, and an expansion of their 'Volunteer Time Off' employee programme into its Asia-Pacific community.

5. CONCLUSION

As we stressed in the introduction to the 2018 Code: "*Successful and sustainable businesses underpin our economy and society by providing employment and creating prosperity*", with effective corporate governance being an important enabler. Unfortunately, the outcomes of our monitoring suggest that many companies are still more focused on the process than on meaningful reporting.

The Code should not be perceived purely as a compliance exercise. It is designed to help boards look at company policies and practices through the lens of corporate governance best practice, assess what works well and what could work better, and use the flexibility offered by the Code to change, where needed. Over time this will improve the resilience and long-term success of the business. As such, we discourage companies from a tick-box approach to reporting on the Code, and instead urge them to embrace the aims of the Principles.

The strongest and most insightful reporting came from companies that described not only the initiatives that were introduced and processes that were followed, but also discussed their outcomes and what impact they had on the business. From risk review, through board evaluation to stakeholder engagement, measuring and reporting on impact means moving away from the boilerplate statements towards meaningful reporting. Giving more emphasis to the impact, while not disregarding thorough process, will also help companies better assess the effectiveness of their governance and generate better company performance and outcomes for shareholders and stakeholders.

With a plethora of Environmental, Social and Governance (ESG) issues rising in prominence and attracting greater government and public attention, ignoring best practice guidance generates greater risk. On the occasions when boards choose to depart from the Code, they need to explain more clearly why they chose to do so and how the alternative arrangements are in the best interests of the business and its stakeholders. To help those companies that are struggling with the application of the Code, and those that claim compliance without fully doing so, The FRC will be taking steps to engage with them to better understand the basis of the chosen approach.

The pandemic has forced many companies to reconsider their purpose, strategy and relationships with their stakeholders. Those companies that were better aligned with expectations of the Code and s.172 of the Companies Act 2006, were more equipped to face those challenges. Those that demonstrated a healthier corporate culture and better stakeholder engagement showed better resilience. This is something that stakeholders will be carefully looking at when 2021 annual reports are published.

The year ahead brings even more challenges. Boards will need to ask some of the hardest questions, ensuring that the varied risks associated with Brexit, COVID-19 and Climate Change are effectively managed and mitigated in company operations and strategy. Over the next year we will be carefully monitoring how companies are reporting on the impact of risks which have manifested themselves and how boards are responding in terms of improving their governance.

With growing focus on the social issues, we will review how directors are discharging their s.172 duty, in particular the quality of stakeholder engagements, the extent to which they have informed board decisions and how effectively companies are responding to concerns raised.

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