



FINANCIAL REPORTING COUNCIL

WHAT CONSTITUTES AN EXPLANATION UNDER 'COMPLY OR EXPLAIN'?

REPORT OF DISCUSSIONS BETWEEN COMPANIES AND INVESTORS

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Introduction

Through the concept of 'comply or explain' the UK has successfully promoted high standards of corporate governance over many years. This has led to widespread improvements in practice. For example, there is now near universal acceptance of the desirability of separating the role of chairman and chief executive which was common when the Cadbury Code was introduced in 1992. Thanks to the Code, fully independent audit committees were the norm in the UK market well before the EU introduced a statutory requirement on listed companies to have an audit committee with at least one independent director.

However the current governance debate in Europe has raised questions about the operation of 'comply or explain'. A research project carried out for the European Commission in 2009 raised doubts about the level of monitoring of statements made by companies on their compliance with governance codes and on the quality of their explanations for non-compliance. An informal examination of a representative sample of some 60 UK annual reports by the FRC indicates that, in the UK, explanations are indeed sometimes rather perfunctory. They can come across as an assertion of difference rather than a full explanation of why the company in question has chosen to deviate from agreed best practice.

It should be noted that this is true only in a minority of cases. In its latest annual survey, Grant Thornton finds that 50 per cent of FTSE350 companies report full compliance with the UK Corporate Governance Code. Two thirds of those who do not comply explain with a meaningful level of detail, while one third explain but with less detail. In no case did a company that failed to comply with a provision of the Code fail to provide any explanation at all.

Looked at from another perspective, Grant Thornton found that most instances of non-compliance relate to only one or two provisions of the Code, so that, overall, the FTSE 350 comply with 96 per cent of the aggregate Code provisions that apply to them. This is a strong result, and it would be difficult to conclude that the compliance cost of more formal regulation could be justified simply to raise the figure by a mere four percentage points.

On the other hand a very few egregious or notorious deviations can undermine support for the whole concept of 'comply or explain'. For that reason and, particularly given the debate in Europe about the future of 'comply or explain', the FRC felt it was timely to bring together those who make explanations and those to whom they are addressed in order to compare notes about what each side understands by the word explanation.

The aim was to ensure that, where companies do choose to explain, that explanation is as full as is necessary to meet the expectations of shareholders. Aiming for such a standard should also help companies, since the stronger the explanation, the less likely it is to be rejected by shareholders adopting a box-ticking approach.

With the support of the London Business School, the FRC thus held two discussion meetings between senior investors and companies in December 2011. This paper is a report of those discussions. The FRC believes it should help the UK market to develop further the effectiveness of the 'comply or explain' concept. The consensus it contains should also reinforce our argument in Brussels that the right way to address current corporate governance challenges is to make the existing system work better rather than to introduce new prescriptive regulation. As indicated in its recent report on the impact of its two codes, the FRC is considering whether to reflect the outcomes of these discussions in the revised UK Corporate Governance Code on which it will consult later in the year.

We are particularly grateful to the LBS for hosting the discussion and to Paul Coombes, the Chairman of its Centre for Corporate Governance, for moderating the discussion.

Background

Both the UK Disclosure and Listing Rules and the Corporate Governance Code itself set out some clear expectations of how explanations should be approached. There are two main messages, one relating to the status of the principles as contrasted with the provisions of the Code and the other to the expectation that explanations will indeed be meaningful.

Under the FSA's disclosure rules (DTR7.2.3R), an issuer must include a corporate governance statement in its directors' report. This must say which corporate governance code the issuer is subject to and explain what parts of the code it departs from and the reasons for doing so to the extent that it departs from the code. If it has decided not to apply any provisions of the code, it must "explain its reasons for that decision."

Thus, under the FSA's Listing Rules (LR9.8.6) a listed company must state how it has applied the main principles of the code "in a manner that would enable shareholders to evaluate how the principles have been applied." The company must state if it has complied with all the relevant provisions of the code or not. If not, it must set out which provisions it has not complied with, the period for which it did not comply and the company's reasons for non-compliance.

In its introductory section on 'comply or explain', the FRC's Governance Code refers to the Listing Rule requirement on companies to apply the main principles of the Codes. It then continues (Para 3): "an alternative to following a provision may be justified in particular circumstances if good governance can be achieved by other means. A condition of doing so is that the reasons for it should be explained clearly and carefully to shareholders, who may wish to discuss the position with the company and whose voting intentions may be influenced as a result. In providing an explanation, the company should aim to illustrate how its actual practices are both consistent with the principle to which the particular provision relates and contribute to good governance."

In its recent Green Paper on corporate governance, the European Commission invited views on a proposal (Para 3.2) for making corporate governance statements regulated information within the meaning of the Transparency Directive. This would mean that regulators rather than shareholders would have the task of deciding whether an explanation was sufficiently complete. The FRC believes strongly that explanations are directed to shareholders and it is up to them to decide whether to accept or reject explanations. For this to work, the market needs to develop and maintain a clear understanding of what constitutes an explanation. If regulators have a role it should be in support of shareholders rather than as a substitute for them

The Green Paper itself goes some way to offering a definition. It cites (Para 3.1) the Swedish code requirement on companies to "state clearly which code rules [they have] not complied with, explain the reasons for each case of non-compliance and describe the solution [they have] adopted instead." It asks whether this could be a model for the EU as a whole. Arguably, however, the UK Code already goes further than this, as described above.

A critical question is what exactly is meant by the word reason. It might, for example, be possible for a company to argue that the reason why it has combined the role of chairman and chief executive was simply that the board considered this was the right thing for the company. That would be a reason in a technical sense, though the UK Governance Code still demands that companies in this position should explain how they have applied the principle that there should be a clear division of responsibilities at the head of the company and that no individual has unfettered powers of decision.

The Listing Rules and the Governance Code do thus call for substantive explanations. The Grant Thornton research referred to above suggests that the majority of explanations are substantive, but a substantial minority are not.

The purpose of the discussion groups was to encourage a greater understanding that would reduce the incidence of insubstantial explanations and bolster the operation of the 'comply or explain' approach. Such an understanding could also obviate the need for regulatory interference in the content of explanations and ensure that explanations continue to be directed to shareholders who provide capital and bear residual risk. It could also help newly-listed and smaller companies who are contemplating the need for an explanation for the first time.

Defining explanations

(i) Context

There was general agreement that the quality of explanations could be improved in some cases, but the context was the overall approach to governance reporting, including in companies which were fully compliant with all the provisions of the Code. The starting point should thus be an improvement in the general quality of disclosure around corporate governance and a clear articulation by each company of how its governance arrangements support its business model.

Companies which offer a coherent explanation of their corporate governance approach are more likely to find that their explanation is readily acceptable when they do choose to deviate from a particular provision of the Code.

Most participants agreed that an understanding of the whole governance framework was important, even when a company was fully compliant. This was not a question of more disclosure but of better quality disclosure. One participant said it would help if the Governance Code was clearer about the purpose of corporate governance. Another said this was not simply a matter of compliance with a set of rules for its own sake, but of setting a framework which enabled the company to perform well in its chosen market.

Another said that the market was increasingly looking for a holistic statement from the chairman about how the company was being run. This trend had become apparent over the past couple of years and was a welcome one. However, the Grant Thornton findings show that over half of companies in the FTSE350 do not discuss governance at all in their chairman's report. Of those that do disclosures are typically limited to board movements with only 10 per cent providing insights into how key features of leadership and board effectiveness are achieved in practice. Participants agreed that the 'comply or explain' concept is more about mind-set and culture than box-ticking. There was no absolutely right answer. One participant called for honesty, transparency and clarity combined with brevity. Another said the obligation to explain rests as heavily on those who are doing well as on those who are doing badly. Good governance should lead to a return on capital that is higher than its cost. It was critical to remember the connection between governance and performance.

(ii) Explanations

There was a general recognition that explanations - and corporate governance reporting generally - should be specific to the company's position, not generic or off-the-shelf.

Explanations should also apply to deviations from the provisions of the Code, not to deviations from its main principles, which companies are expected to apply.

One participant said there should be no doubt that shareholders expect and prefer compliance with the Code, though this includes meaningful explanations, defined as a full explanation as to “how and why.”

Three elements were proposed for a meaningful explanation. It should set the context and historical background, should give a convincing rationale for the action it was taking, and describe mitigating action to address any additional risk and to maintain conformity with the relevant principle. Also the explanation should indicate whether the deviation from the Code’s provisions was limited in time and when the company intended to return to conformity with the Code’s provisions.

There was agreement that explanations should be understandable as well as persuasive. One participant said explanations should be relevant, specific and sufficiently informative, providing enough information to those shareholders who could not simply pick up the phone and talk to the company. Another said the ideal was to have an explanation which did not require a follow-up meeting. Others stressed the importance of explanations as the basis for dialogue, although the two objectives are not mutually exclusive since not all shareholders will react in the same way.

Participants suggested that shareholders, through one or more of their trade associations, might produce an annual report giving examples of what constituted good or bad explanations. This should be useful for companies, though there was recognition that the initiative for this should come from the market rather than from the FRC.

(iii) Obstacles

Some corporate participants warned of obstacles to greater disclosure. These included constraints on companies with listings in the US and the risk of litigation that might arise if, for example, companies gave a detailed description of the outcome of their board evaluation. Others mentioned worries about the reaction of the media and other stakeholders, such as non-governmental organisations. Both corporate and investor participants expressed concern about the apparent influence of the proxy advisors.

One corporate participant said concern about stakeholder reaction created a need to be clear to whom annual reports were directed. Many companies might feel comfortable with less rather than more disclosure. However, one investor said that active investors, in particular, place a great deal of faith in companies that can show they have thought about their governance arrangements and give cogent reasons for any deviation from the provisions of the Code. Another shareholder said that not all companies faced adverse media publicity. He cited the case of one company which did not have a permanent chairman but rotated the position among members of its board. This had not attracted media coverage because the company concerned was not a household name. The key to addressing these situations was engagement. This would engender trust and, when trust was there, an explanation was more likely to be accepted.

While participants recognised the difficulties facing some companies on disclosure, the general view, summed up by one participant, was that the process of explanation should involve recognition of a full audience of stakeholders but had to be directed primarily to shareholders. Dialogue with shareholders and an articulation of the governance arrangements could help address these issues.

From the shareholder perspective, a number of participants also mentioned the need for trust, particularly when boards were making judgements about independence. One corporate participant said that boards were not by-and-large malevolent towards shareholders, but both companies and shareholders had difficulty with issues that were subjective. Investors did not always understand the dynamics of boards and this sometimes made the latter unnecessarily defensive. Another corporate participant said there were few blatant abusers and explanations had been improving in recent years. One investor agreed with this though he said there were still information gaps. Another said investors should not be satisfied with just reading a governance statement. The issue was about dialogue. This was critical, even though investors did have to prioritise.

Conclusions

The meetings agreed that an important priority was to ensure that corporate governance statements laid out the company's approach to governance in the context of its business model. The Chair could play an important role in this and Chair's statements were not yet as full as they might be. Getting this right mattered as much as improving the quality of specific explanations. If shareholders felt that the company had thought carefully about governance, there would be higher levels of trust and explanations for any specific deviations that might arise were more likely to be acceptable. This meant that the quality of disclosure was important even when companies were complying with all the provisions of the Code.

As far as the latter were concerned, there was agreement that explanations should be full and include reference to context and coherent rationale. They should explain how the company is fulfilling the relevant principle of the Code and also whether deviation from its provisions is time limited. Ideally explanations should be sufficiently full to meet the needs of those shareholders who could not simply call up the company and ask for information, but larger shareholders also saw them as the foundation for further dialogue that should engender trust. At a practical level companies mentioned the real constraints arising from conflicting requirements in different jurisdictions and which might result in litigation. Examples were reporting on risk and board evaluations. These problems may bear further scrutiny by policy-makers and regulators but there was still merit in maximising the use of disclosure and dialogue to engender trust.

Shareholders were clear that a company was still in compliance with the code if it chose to deviate from one or more of its provisions and made a full and ample explanation. All participants agreed that companies had to deliver on the main principles, which were not negotiable. However, the principles were expressed in general terms which allowed some latitude in their implementation. This was a great resilient strength and one that participants agreed we should cling to it. Used properly, the Code-based 'comply or explain' approach can deliver greater transparency and confidence than formal regulation which is purely a matter of compliance.



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