Review of Corporate Governance Reporting

Financial Reporting Council

November 2021

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1. Foreword

Sir Jonathan Thompson
CEO, Financial Reporting Council

The last 18 months have been unprecedented. Each of us, on a personal and professional basis, has had to deal with uncertainty and change in how we live our lives. In such times, how companies are governed and managed assumes much greater importance. Policies and procedures must be robust, up to the challenge and flexible to the circumstances, and boards need to make decisions that take account of short and long-term considerations and risk.

In tough economic times regulators need to be conscious of costs to business; the UK Corporate Governance Code (the Code) offers a proportionate framework for companies to comply with their governance obligations and the Financial Conduct Authority (FCA) Listing Rules.

In the Code, companies and directors have a solid governance foundation on which to rise to the recent challenges. Its Principles and Provisions provide clear direction, and the 'comply or explain' principle offers flexibility for directors to make decisions that reflect company circumstances. Demonstrating effective corporate governance builds trust that is necessary to attract investment and support capital formation.

This annual review considers the clarity and quality of reporting on the Code, including the transparency and integrity of board decision-making, and how the company demonstrates accountability to investors and wider stakeholders.

I'm pleased to say that overall we continue to see improved reporting – particularly when taking into account the testing circumstances we have lived through – but unfortunately expectations we set out in last year's report remain unfulfilled.

We saw some good quality reporting on stakeholder engagement, audit and in some areas of risk, but board appointments, succession planning and diversity reporting remains weak. And in too many cases reporting has not provided insight into the actions and outcomes of governance, which provides investors and wider stakeholders with confidence that company leadership is addressing the material governance issues that the company is facing.

In turn, we expect asset managers and owners to demonstrate the quality of their stewardship, through reporting on the Stewardship Code. We recently announced the successful applicants to the Code. Good governance and good stewardship should go hand in hand.

The best governance reporting offers transparency that goes beyond broad-brush declarations and sets out clearly and concisely how the Principles of the Code were applied and the nature of compliance with the Provisions of the Code. We continue to highlight such good practice.

As we emerge from the pandemic, company leaderships will need to deliver change that builds on the good examples of governance that this report showcases, and pursue policies on environmental and social issues that will deliver long-term benefits for the company, the economy and society as a whole.

As the FRC transitions to ARGA we will continue to work with companies to deliver the highest standards of practice and reporting, going beyond declarations of intent or boilerplate comments but clearly demonstrating the impact of actions.

2. Executive Summary

This is the second year that the FRC has reviewed how UK premium listed companies have reported on their application of the 2018 UK Corporate Governance Code. Our analysis last year gave us a benchmark on the quality of reporting against the Code. This year we have once more assessed a random sample of 100 FTSE 350 and Small Cap companies.

Since our last review, published in November 2020, we have published three research reports: **Changes in remuneration reporting following the UK Corporate Governance Code 2018, Workforce Engagement and the UK Code: A Review of Company Reporting and Practice** and **Board Diversity and Effectiveness in FTSE 350 Companies**. Each of these makes suggestions for improved reporting on activities and outcomes.

The COVID-19 pandemic has had a substantial impact on company governance. It required an increased number of board/committee meetings, the introduction of different approaches to stakeholder engagement and provoked significant developments in employee health and wellbeing.

Many companies have reported that these will continue into the future, due to the importance of supporting and engaging with employees, and acting on feedback.

One of our major concerns last year was that companies were failing to disclose non-compliance with the Code. As a result we issued **Improving the quality of 'comply or explain' reporting**. This guidance confirmed that the comply or explain approach supports non-compliance when accompanied with an effective explanation. This year we expected an increase in the number of disclosures of non-compliance. However, there is still room for improvement in relation to the quality of explanations.

Unfortunately, as last year, we continue to see the use of boilerplate or declaratory statements. These statements are seldom substantiated by actions or examples, and therefore do not offer insight into company governance.

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

Diversity and inclusion and succession planning at board-level and through the pipeline continue to remain a concern. There is often a lack of cohesion between policies and succession plans.

There continues to be minimal information on how diversity and inclusion policies and objectives link to company strategy. This view is supported by the generally poor reporting by nominations committees on succession planning. Typical reporting in this area consists of reporting on processes.

The pandemic served as a reminder of the importance of risk management. All companies reported that they had reviewed their systems. However, in a year where we expected to see changes made very few commented on how they reviewed the effectiveness of their systems, this is an issue that has been raised as part of the audit consultation.

While most companies confirmed that their remuneration arrangements support company's strategy, only some of them explained how. Very few companies explained how remuneration aligns with company purpose and values.

In challenging circumstances many remuneration committees used discretion to change remuneration outcomes in line with company performance and shareholder and stakeholder experience. Interestingly, we found a few instances where discretion was not used despite dividend cancellation, staff redundancies and/or furloughing the workforce.

Our Approach to Improvement

This review sets out our expectations across the five areas of the Code. In each we set out our general conclusion, areas where reporting could be improved and examples of good practice along with expectations. On that basis this review provides a balance between our assessment and promoting good practice to provide support to further improve governance and reporting.

3. Reporting Expectations

Last year we said that effective reporting should be underpinned by the principles of transparency, clarity and integrity.

Key Message:

Good reporting is characterised by clear and consistent explanations, supported by real-life examples of application and cross-referencing between related initiatives and sections.

To support improved reporting we have reiterated our expectations of last year and, where relevant, introduced new expectations to support findings of this year's assessments.

- Greater attention to the alignment between reported good governance and company practices and policies, strategy and business models.
- Increased focus on assessing and monitoring culture by using different methods and metrics.
- Better reporting of succession planning, and how this links to assuring the make-up of the board and delivering diverse challenge.
- Improved reporting on outcomes and actions, rather than declarations or statements of intent without detail.
- Increased focus on assessing and ensuring the effectiveness of the risk management and internal control systems.
- Better explanation of how executive remuneration is aligned to a company's purpose, values and strategy.

We also ask companies to be clear about:

- Departures from Provisions and provide a detailed explanation.
- Engagement with shareholders and the workforce in relation to remuneration, and the impact on remuneration policy and outcomes.
- The impact of engagement with stakeholders, including any areas where the company failed to meet targets.
- The impact of engagement with stakeholders, including shareholders, on decision-making, strategy and long-term success.
- Explaining diversity policies with objectives and targets and demonstrating their connection to company strategy.
- The relationship and level of oversight between the board and committees.

4. Main Findings

A. Code Compliance

The Code recognises that there is no single path to achieving effective corporate governance for all companies and that a single approach does not necessarily apply to all companies. We have therefore continuously encouraged companies to make use of the 'comply or explain' nature of the Code's Provisions, but this must be supported by clear and relevant explanations. As we transition to ARGA we expect to have more powers to take action against those companies that fail to apply the Principles of the Code or when departing from the Provision do not offer an effective explanation.

Compliance statement

Almost all companies included a compliance statement in the corporate governance section of their annual report. The structure of this statement differed. Some companies gave a general overview of how they applied the Code's Principles, usually by signposting to other areas of the report. Others simply confirmed that they had applied the Principles and complied (or not) with the Provisions. Some of the companies that disclosed non-compliance provided the explanation in the statement, whereas others signposted to other pages of the report.

Some of the compliance statements did not reference the Principles, focusing solely on compliance with the Provisions. The FCA's Listing Rules require companies to confirm in their annual report that they have applied the Principles of the Code and explain how they have done so. We found that a clear structure of a compliance statement was provided by those companies that included:

1. A statement of how the company has applied the Principles. Better reporters signposted to other parts of the annual report that showed how these have been applied.

2. A statement of whether the company has: a) fully complied with all elements of the Provisions of the Code throughout the whole financial year; or b) has departed from any of the Provisions of the Code (whether throughout the whole financial year or part of it), citing any Provisions that they have not complied with and state where in the report the explanation can be found.

In terms of clarity, we noted a slight improvement from last year, with more companies being explicit in the compliance statement which Provisions they have not complied with. Nevertheless, we found instances where companies confirmed they had not complied with all the Provisions of the Code but did not name these Provisions or offer further information.

We expect companies to make departures clear by naming the Provision(s) in the compliance statement, followed by an explanation, or signposting to where the explanation could be found.

Example

'The Company has applied all the Principles, and complied with all Provisions of the Code, except for Provision 9, an explanation for which is provided on page X of this annual report.'

Compliance with the Code

Last year many companies failed to declare non-compliance with Provision 38. This year we were pleased to see that compliance with this Provision increased, and for those companies that have yet to align their pensions, 43% declared non-compliance, compared with last year's figure of 16%. However, this still leaves a significant number of companies yet to report effectively on this Provision.

Other Provisions of the Code for which we detected undisclosed non-compliance were Provisions 4, 5, 9, 19, 24, 26, 28, 32, 36 and 41 (not an exhaustive list). We have previously emphasised the importance of being clear about the Provisions of the Code that have not been complied with.

Regrettably, too many companies continue not to be transparent about their compliance with the Code, thereby misleading the reader. Our expectations remain:

> Financial Reporting Council
>
> **The FRC expects** companies to report in a clear and transparent way any non-compliance with any Provisions of the Code.

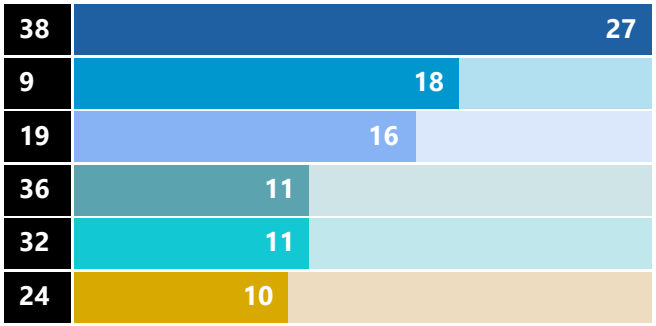
We found an increase in non-compliance with the Code this year compared with last year. From the explanations provided, we found only a small minority of companies linking their non-compliance to the COVID-19 pandemic. One example was a company that disclosed non-compliance with Provision 19, stating that travel and face-to-face meeting restrictions being put in place in the UK resulted in their succession process taking longer to implement than was originally expected.

The largest increase in non-compliance, other than Provision 38, was with Provisions 24 and 32, which relate to the composition of the audit and remuneration committees.

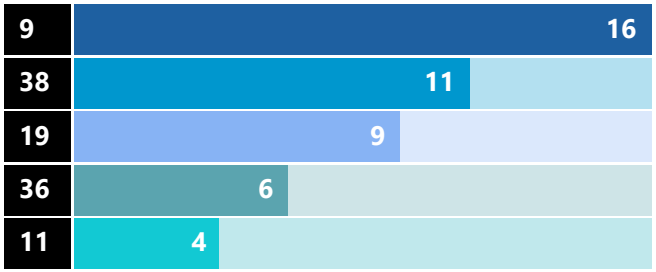
Provisions with the highest levels of non-compliance:

- **Provision 38**
  Alignment of pension contributions
- **Provision 9**
  Chair independent on appointment
- **Provision 19**
  Chair remaining in post beyond nine years
- **Provision 36**
  Post-employment shareholding requirement
- **Provision 32**
  Remuneration committee composition
- **Provision 24**
  Audit committee composition

No. companies that declared non-compliance by Provision this year



No. companies that declared non-compliance by Provision last year



Explanations

Again, we were disappointed that the quality of explanations provided for non-compliance this year has not significantly improved. Most explanations lack supporting information or use boilerplate language.

A good explanation should include the following elements:

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

We found that Provisions 36 and 38, the Provisions with the highest rate of undisclosed non-compliance, were also the ones where most companies failed to provide an effective explanation.

We understand that the reason for companies not having their pensions aligned is likely to be due to contractual obligations; however, if this is the case, it should be explained in the annual report.

Interestingly we found a few companies that explained that the reason for receiving more than 20% of votes against their remuneration policy was because of the lack of pensions alignment. We also found companies that stated that during their engagement with investors, one of the issues raised by them was the lack of a post-employment shareholding requirement.

These comments demonstrate the importance investors place on these Provisions. It is therefore in the companies' interests to give a detailed and meaningful explanation.

A better explanation for Provision 38 is:

Example

'At the time of the introduction of the new Code, the Company had already signed a contract with the CEO that entitled them to a pension equal to 25% of their annual salary. This is higher than the pensions available to the workforce, which are currently set at 10% of the annual salary. Therefore, since the introduction of Provision 38, the company has been non-compliant with it for the above reason.

However, despite the contractual obligations, the remuneration committee has discussed this issue with the CEO and an agreement has been reached whereby a phased reduction by 5% every year of the CEO's pension will be implemented. The CEO's pension will be fully aligned with the workforce by 1 January 2023. The committee has engaged with the shareholders and explained the reasons why the company has not been able to comply with Provision 38 and assured them that they will be fully compliant by 2023.'

Companies should provide explanations even when:

- Non-compliance during the year was temporary and the company has since come into full compliance; or
- It will comply in the following year or the near future.

We also found a few cases where non-compliance is continuous, but the explanations for this tended to provide less insight. This was particularly the case when disclosing non-compliance with Provisions 9 and 19. Under Provision 9, where the roles of the chair and chief executive were carried out by the same individual, many companies noted that sufficient separation of responsibilities was in place but provided little to no insight about the nature of the checks and balances in place. Further information on chair independence and tenure can be viewed on page 33 and 34.

FRC Financial Reporting Council

The FRC expects companies to provide a clear and meaningful explanation for any departures from the Code.

Companies should improve their reporting on non-compliance by being more transparent and providing informative explanations. Please see our **report** on how to improve reporting in this area.

B. Leadership

This section of our review addresses the issues set out in section one of the Code. We have considered company culture, including purpose and values as they relate to strategy.

This section also deals with shareholder and stakeholder engagement. Both of these areas were substantially affected by the COVID-19 pandemic, but we were pleased to see that a number of companies made changes to their engagement processes that they intend to continue.

Culture, purpose and values

Principle B states: *'The board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned. All directors must act with integrity, led by example and promote the desired culture.'*

Quality of reporting

We were pleased to see that the overall quality has improved. Several companies in our sample restated their values and purpose statements, as they were adjusting their strategies and business models in response to the challenges posed by the pandemic. Other factors, such as regulatory changes and investor engagement, have undoubtedly also played a part.

Most companies described their culture by referring to their organisational purpose, values and behaviours – with different degrees of detail. As a change from last year, more companies are putting the workforce at the centre of culture reporting, including related policies and practices.

As for the corporate purpose, as stated in last year's review it should be simple to understand and act as a reference point for decision-making. It may contain the following elements:

- Why the company exists
- What the company does
- In what market the company operates
- What the company is seeking to achieve
- How the company will achieve it

While the majority improved their purpose statement some companies continue to confuse it with vision and mission statements, and operational descriptions. We also saw examples of purpose statements being limited to a marketing slogan, with very limited supporting information.

Examples of better purpose statements:

Example

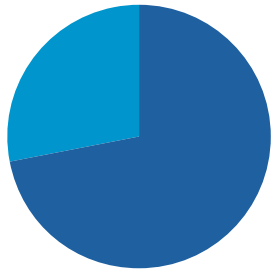
'Our purpose is to drive a shift to mass transit by providing safe, reliable and great value services on clean and green vehicles.'

'We deploy finance responsibly to support people and businesses, acting with empathy and integrity, championing innovation and sustainability, for the common good and the long term.'

All companies referred to their organisational values but unfortunately not all clearly disclosed them. Reporting was particularly effective where:

- They were clearly displayed in one place, often framed/boxed;
- Narrative was provided – with supporting information;
- They were linked to desired behaviours, sometimes also other factors;
- Practical examples of application were given.

Disclosure of organisational values (%)



72 Clear disclosure

28 Referred to values put didn't disclose them

Clear and insightful purpose and values statements are also helpful as they can serve as a guide for stakeholders on how the company operates, creating a sense of direction and reducing conduct risk. We expect companies to pay greater attention to the clarity and consistency of explanations, providing real-life examples of application and cross-referencing between related elements.

Alignment

Financial Reporting Council

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

Only a few companies in our sample attempted to connect all four elements set out in our expectation, with most statements being largely declaratory in nature and without examples of application. Instead, the majority discussed individual elements or linked them with one other element, most commonly linking culture with values.

Key Message:

Despite reiterating in last year's report that we expect companies to improve in this area, reporting on the alignment between culture, purpose, values and strategy remains largely unsatisfactory.

Example of reporting on the alignment of different elements:

Example

'The Board sets the strategy for the Group to align with our purpose. In implementing this, the Board ensures the Group is suitably resourced to deliver on its strategic objectives through a culture that drives the right behaviours. The Board receives regular reports that allows it to assess culture within the Group, to ensure it is aligned with strategy and ultimately our purpose.'

Companies should be aiming to join the dots – not only between culture, purpose, values and strategy, but also between different culture-related activities across the organisation. By doing so, companies should be better equipped to:

- Analyse data outputs by putting them into context;
- Spot trends – both risks and opportunities;
- Create impactful actions/strategies;
- Achieve synergy between different functions;
- Embed desired behaviours among their stakeholders;
- Tell their story/report on their activities in a meaningful way.

These connections are an indicator of organisational maturity in understanding each of those areas – individually and in combination, e.g., their impact on the organisational resilience and integrated reporting. It distinguishes those companies that genuinely recognise the value of a positive working culture and organisational purpose and values, from those that only pay lip service to it, which still appears to be the case for the majority of companies.

Practical approaches

According to our findings from this year's research, directors appear to be promoting desired organisational culture through multiple routes. Some of the most common approaches that we observed include:

- 'Tone from the top', including role modelling and board evaluation;
- Alignment with purpose, values, strategy and desired behaviours;
- Risk management/risk culture;
- Code of conduct/ethics and compliance mechanisms;
- Learning and development, including mandatory training;
- Health and safety, including hygiene, wellbeing and mental health;
- Equality, diversity and inclusion, including gender, ethnic and racial;
- Workforce engagement;
- Performance management and remuneration policy, including for executive directors;
- Recruitment and talent development;
- External stakeholder relations/management.

To understand the extent of embedding across the organisation, Provision 2 of the Code urges companies to assess and monitor culture. Last year we commented on poor performance in this area, and unfortunately this doesn't seem to have improved.

Key Message:

While almost all companies provided some evidence of the review process of their culture-related activities, reporting lacked structure and consistency of approach. Most of those that did explicitly report on their culture assessment/monitoring and/or embedding unfortunately provided limited evidence of any link between different workstreams or a feedback loop.

Despite little progress in this area, a few examples of compliance with Provision 2 stood out. Some of the most insightful reporting included:

- Designated section/table that clearly outlined the approach;
- Culture framework that is rooted in policies and practices, and mapped across different functions within the organisation;
- Consistent and regular review process, based on engagement;
- Disclosure of outcomes of the review and how they informed board decisions – emphasis on impact rather than process;
- Systematic assurance of the process and findings;
- Balanced discussion, including both achievements and challenges.

FRC Financial Reporting Council

The 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.

There is no single correct approach to culture assessment and monitoring. It should be a combination of quantitative and qualitative methods and be company-specific. Yet again, this year's research shows that staff surveys tend to be dominant, and sometimes the only approach used to review culture. There also appears to be an increase in frequency of surveying the workforce, largely due to the pandemic, with many companies opting for more regular 'pulse surveys' that supplement or sometimes even replace the annual review.

Direct engagement routes have been affected by the pandemic too, with many companies increasing the use of technology to reflect changing patterns and methods of working. While it is understood that virtual engagement is only a temporary solution, some companies believe that this has helped their boards and leaders to connect more directly and regularly with the workforce.

While most companies didn't discuss culture embedding explicitly, several explained how their positive working culture, purpose and values were demonstrated through individual role modelling and revised corporate strategies.

The FRC recently engaged with 134 companies, industry bodies and advisory firms, outlining different approaches to organisational culture. The key findings, related to assessment, monitoring and embedding, include the following:

- It is not necessary to start from a blank page – existing frameworks, tools and methods can often be adapted and joined up to assess and monitor culture.
- Assessment and monitoring of culture are important, but without clear and timely follow-up actions and feedback to workers and other stakeholders, companies can be accused of ''culture washing'', leading to the loss of trust – the biggest barrier to the positive culture.

Further, the report will recognise the crucial role of stakeholder engagement and ambassadorship/culture champions in ensuring the review process is insightful and effective, which was also evident in the reporting of several companies in our sample.

We have observed some additional examples of qualitative and quantitative metrics to monitor and assess culture:

- Leadership and board diversity, and effectiveness review;
- Employee representative interactions and feedback;
- Workforce engagement mechanisms and frequency;
- Staff perception surveys and follow-up actions – impact review;
- CEO pay ratio;
- Introduction of culture-oriented, measurable indicators into executive and mid-management pay award schemes;
- Number of resolved grievances;
- Talent succession statistics;
- ED&I data, including gender and ethnic pay gap;
- Number of internal/external culture audits, including M&A related;
- ESG data;
- Engagement of trade unions/number of industrial actions;
- Customer satisfaction survey and community engagement.

While the general increase in reporting on culture, purpose and values has been noticed, companies are urged to give greater attention to the following:

- Reporting on the alignment between culture, purpose, values and strategy, supported by real-life examples;
- Joining the dots between different culture-related initiatives across the organisation to put data into context;
- Providing information on how stakeholder feedback influenced board decisions;
- Reporting on the impact, not only the process;
- Reviewing their culture cyclically and consistently;
- Ensuring transparent, insightful and connected, yet concise, reporting on culture assessment, monitoring, embedding and assurance.

Shareholder engagement

In line with Principle D, the board should ensure effective engagement with company shareholders. While almost all companies have reported on their engagement efforts, largely due to increased reporting on s.172 requirements and the pandemic, a number of disclosures are lacking specific examples.

The dialogue

In last year's review, we expressed our concern that shareholder engagement too often resembled an information campaign, rather than a discussion. To address this, we stated that meaningful engagement needs to be based on timely, open and inclusive two-way communication.

FRC Financial Reporting Council

The 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 a specified timeframe.

Seeking input from investors from across the spectrum – beyond the top few largest holders – was reported by almost three-quarters of companies, which is encouraging. However, this was not always followed by disclosure on how the views sought informed board decisions. For example, of those companies that received 20% or more votes against a resolution at the previous year's AGM, most did not discuss actions or provide their rationale following further engagement.

The most common topics where the impact of investor engagement on board decisions has been discussed related to executive remuneration, holding of a hybrid or virtual-only AGM and the pay out of a final dividend, with the latter two linked to the pandemic.

Seeking engagement

Provision 3 of the Code urges the chair and committee chairs to seek engagement with shareholders. The chair should also ensure '*that the board as a whole has a clear understanding of the views of shareholders*'.

Reporting in this area was inconsistent. Only a third of companies discussed their chair's engagement activity. Pandemic-related emergency arrangements and company resilience were some of the most commonly addressed issues. A majority of companies either did not report on their chair's regular engagement with shareholders or the reporting was indirect and/or declaratory in nature – by the reference to the chair's remit of responsibilities, without providing any examples.

Equally, only one-third of organisations explicitly discussed how the chair ensured that the board as a whole has a clear understanding of shareholder views, other than attending the AGM. Another third of companies did not address this point at all, with the remaining group mostly referring to other forms of engagement, such as executive briefings, investor relations and broker briefings.

Encouragingly, most companies reported on engagement by committee chairs. While this is welcomed, the reporting was generally limited to engagement by the remuneration committee chair – often when a new remuneration policy required shareholder approval.

Less detail was provided in relation to audit and nomination committee chairs engaging with companies. Bearing in mind our finding of a general improvement in engagement with wider stakeholders, it is disappointing that this has not extended to chairs of these committees engaging with shareholders.

Those that reported insightfully on Provision 3 provided:

- A clear schedule of meetings between the chair and shareholders and those between each committee chair and shareholders;
- An outline of issues covered and any follow-up actions;
- Explicit information on how the chair ensured that the board as a whole has a clear understanding on investor views, and how those views have influenced board decisions.

20% votes against resolutions

Some companies explained that their engagement reach was enhanced thanks to greater use of virtual meetings, thereby enabling them to encourage more shareholders to engage. This is a positive change. However, this increased participation is not always reflected in companies' taking any received feedback into consideration.

Key Message:

In the last year's review, we said that if a company had previously received 20% or more votes 'Against' at the AGM relating to the same resolution, this is a red flag for investors as it may indicate that the board is not addressing their concerns.

In line with Provision 4 of the Code, companies that receive significant shareholder dissent should be outlining actions they intend to take to rectify it and publishing an update on how they are addressing concerns raised no later than six months after the vote.

Once again, analysis of the Public Register, which is maintained by the Investment Association (IA), indicates that a proportion of companies in our sample – a third this year – that received 20% or more votes 'Against' at their AGM, have not updated the register. This included either their Statement in Results, Update Statement, or both, even after more than six months have passed.

Financial Reporting Council

The FRC expects companies to address their shareholders' concerns formally and publicly, and in a timely manner.

In terms of the quality of statements, many of them are still boilerplate. Declarations such as: 'The views of the shareholder are well known to the board' or 'Prior to the AGM, the board engaged with the shareholders and understood that the reasons for their dissent is the increase of the CEO's remuneration' are neither insightful nor addressing the intention of Provision 4.

To help companies write better update statements, the IA issued guidance.

Example of a better update statement:

Example

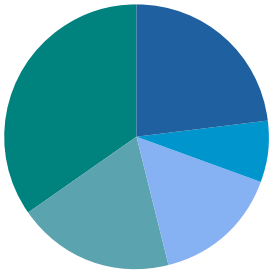
'At the 2020 AGM, the resolution to approve the remuneration policy was approved by 70% of shareholders. The committee engaged extensively with shareholders who voted against and as a result of feedback the board recognises that a significant factor for votes against the policy related to disparity between the executive pension contribution and the pension contribution available to the workforce.

The executive pension contribution is the result of a contractual arrangement. To address shareholders' expectations, the remuneration committee and the executives have agreed to a phased reduction to the executive pension contribution level over the next four years, at the end of which the pensions would be fully aligned with those of the workforce. All the new directors appointed will receive a pension at the same rate as that available to the workforce.'

Provision 4 of the Code also urges boards to provide a final summary in their annual report *"on what impact the feedback has had on the decisions the board has taken and any actions or resolutions now proposed"*.

Overall, most companies in our sample that received 20% or more votes 'Against' at their last AGM, did not sufficiently address their shareholders' concerns in the following year's annual report.

Quality of disclosure in annual reports following the 20% vote



6	Did not refer to dissent in their next year's annual report
2	Only acknowledged the dissent
4	Only confirmed further engagement
5	Disclosed feedback received following further engagement
9	Explained follow-up actions

Key Message:

Companies that fail to report on the impact of received feedback and repeatedly disregard the need to understand reasons for voting, risk disenfranchising their shareholders and jeopardising their access to the capital.

For example, if shareholders have voted against the chair's re-election, due to concerns about their independence, it is not adequate to state that the nomination committee has evaluated it and concluded that they remain effective and independent. To demonstrate that the board took investor views into account, reporting should also include a detailed explanation of the process undertaken by the nomination committee to evaluate the chair's independence – not just a declaratory statement – followed by seeking further input from shareholders on the approach taken.

Better reporting for the purposes of Provision 4 that we observed included:

- An explanation of what engagement has taken place since the AGM;
- A description of the feedback that the board has received from shareholders;
- An explanation of how the received views impacted board decisions;
- Any follow-up actions or resolutions taken or proposed.

The FRC intends to look more closely at shareholder engagement and votes 'Against' in the coming year.

Remuneration engagement

Remuneration remains a significant issue for shareholders. However, 10% of companies in our sample did not report on their shareholder engagement on remuneration. Of those that did report only 31 companies gave details of the feedback received from shareholders and the impact this had on remuneration arrangements.

The annual report should describe actual engagement with shareholders by the board or remuneration committee and not simply provide declaratory statements such as "The Committee regularly consults major shareholder on remuneration matters". To comply with Provision 41, there should be a description of the impact the engagement has had on the policy and outcomes.

Better reporters in this area explained:

1. What remuneration issues were discussed;
2. What was the feedback received from shareholders;
3. What impact, if any, such feedback had on remuneration policy and outcomes.

One company explained that the reason for not engaging with shareholders during the year was due to the company not implementing a new policy that year. For the purposes of provisions 40 and 41, shareholder engagement should be proactive and take place during the reporting year even if the remuneration policy was agreed in the previous years.

Engagement with shareholders should also include wider remuneration matters including the amount of pay, use of discretion by the remuneration committee, choice of performance metrics and so on. The committee should understand and take into account shareholders' views when making decision on these matters. A description of the engagement, issues discussed, views expressed and any changes to remuneration as a result, should be included in the annual report.

Stakeholder engagement

Companies will engage with a variety of stakeholders – this section of the report looks at some of those interactions. We have set out an engagement cycle that companies can apply to their engagement activities.

Engagement Cycle

Engagement inputs

- **Who:** Who is responsible for engagement at company-level and who passes relevant information to the board?
- **What:** What are the methods of engagement?
- **Why:** Why are we engaging? For example, the purpose of each engagement, including the parts of business strategy engagement seeks to drive.
- **Where:** Where is the engagement taking place? For example, by geography/product range/business unit.

Engagement outputs

- The feedback gathered from those engagements, including information on how different stakeholders are affected by the company's operations and activities.
- Key issues identified by stakeholder materiality assessments.
- Data for metrics used to measure effectiveness of engagement.

Engagement benefits and outcomes

- **Stakeholder outcomes:** tangible benefits to stakeholder groups.
- **Business outcomes:** how a particular decision/course of action following engagement contributed or will contribute to the company's long-term success. This may be presented in reporting on principal decisions and relate to, for example, reputational improvements, improvement in processes or operations, development of product range, or expansion of market.
- Performance reported via metrics supported by narrative, including any areas where the company has underperformed and how it seeks to address this.

Principle D *of the Code states that in order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from, these parties.*

FRC Financial Reporting Council

The 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 and identification of any issues discussed.

Workforce engagement

Two companies in our sample did not comply with Provision 5 of the 2018 Code. One company stated *'the board's approach was not anticipated by Provision 5'* and therefore highlighted that its approach to workforce engagement was not compliant with this Provision.

Last year, we highlighted that in some disclosures there remained a degree of ambiguity in identifying whether the engagement method chosen was one of the three suggested mechanisms or an alternative arrangement. While it is encouraging to see an improvement in reporting and compliance, three companies within our sample did not provide definitive disclosures on the method used to engage with the workforce.

FRC Financial Reporting Council

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

Alternative arrangements

Last year we saw that alternative arrangements were popular for many companies. This year 22 companies reported using these, but nine did not provide an explanation of the effectiveness of their arrangement.

In early 2021 we released the report **Improving the quality of 'comply or explain' reporting**, which is intended to help companies on how to achieve good quality explanations when departing from the Code. To comply with the second element of Provision 5 we stated the following:

2. Workforce engagement

In addition to the above, to comply with Provision 5, companies should engage with the workforce using one of the engagement methods prescribed by this Provision, or a combination of them:

- *a director appointed from the workforce*
- *a formal workforce advisory panel*
- *a designated non-executive director*

Companies can also report compliance with this element of this Provision if they have not chosen one of the methods above but have implemented alternative arrangements. Such alternative arrangements need to be fully explained, including addressing why they are considered effective.

As highlighted last year, the FRC expects companies to fully explain why their method of employee engagement is effective. While an alternative approach to workforce engagement complies with the Code, an explanation of the effectiveness of the approach should be provided. This can be reported through examples of discussions in relation to the impact of the engagement on decision-making.

Example

'… and ensures that the Board has access to the views of the workforce, regardless of their location, and provides meaningful information and data that the Board can use when considering the impact of the strategic decisions on employees. Additionally, the chosen mechanisms allow all directors to engage directly with a wider cross-section of the global workforce and provide opportunity for meaningful dialogue. The Board considers these views and the potential impacts on the workforce when it makes key decisions.'

COVID-19 impact on alternative arrangements

Popular methods such as site visits and physical town halls were postponed. As a result, many companies created solutions and facilitated engagement activities virtually, moving to virtual town halls and increasing communication via the company's intranet page or email.

It was also encouraging to see that many companies also escalated their engagement efforts with the use of pulse surveys to gather employee sentiment. These surveys were particularly useful when seeking views on wellbeing and workforce health initiatives implemented by the company during the period.

Last year we commented that site visits were one of the most used forms of engagement, but it was not always clear how effective this approach was, whether the engagement was structured and if it had a clear objective. We hope that some of the new innovative approaches introduced this year by companies will lead to more appropriate use of different methods to meet company circumstances.

Designated non-executive directors

Our analysis continued to show that this continues to be the most popular approach. Again, similarly to last year, it was not always clear as to why a specific NED was chosen. Nor was it always clear what exactly was expected of them. The role of the NED was often clearer when it was accompanied with a workforce advisory panel. Similar findings were also discovered in our commissioned workforce engagement report, which discovered that half of the NEDs had 'no previous experience of working in workforce engagement'. Further details on the findings of this report can be viewed here.

Last year, we shared helpful tips on 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 matters should be dealt with by committee or executive
- How the role will add value to current engagement activities

Key Message:

It would be useful to disclose the expectations the company has for designated NEDs when they take on the role of working with the workforce. This would help determine the impact the designated NED has made.

In-person engagement conducted by NEDs has dropped due to the pandemic, and companies reported that they proceeded with virtual arrangements. One company in our sample noted the challenges it had faced:

Example

'The COVID-19 pandemic, and the resulting limitations on our operations and travel, stifled our otherwise well integrated approach to engagement within the Company and between the Board and workforce. We have implemented a number of e-initiatives to increase remote engagement, however, we have not fully recovered the loss of our organic approach to engagement.'

This level of transparency is good practice and can be enhanced with the addition of actions on how to retain an effective approach to engagement in the future.

However, there were still a number of companies that explained engagement had changed as a result of the pandemic, but did not always explain how the NEDs' existing engagement had been tailored to fit in with any new ways of engagement.

Our analysis found that when the NED was engaging without the support of an advisory panel or similar it was not always clear what the outcomes and actions of the engagement were. Many companies provided a list of issues discussed, but seldom went further to explain the impact of this.

The survey results obtained by IPA and RHUL in our commissioned workforce engagement report paints a picture of firms' approaches under this selected mechanism. As highlighted in our previous report, it would suggest that many firms consider the combination of the designated NED, site visits and an annual survey as the most effective method of obtaining views of the workforce.

How does your designated non-executive director consult with the workforce and seek their opinions? [Select all that apply]					
Site visits	84%	Looking at the result of staff surveys	81%	Consultation with HR who collect the views of the workforce indirectly	65%
Meetings with employee representatives through a staff forum or advisory panel	60%	Holding their own consultation meetings directly with groups of frontline staff	53%	Consultation with line managers who collect the views of the workforce indirectly	16%
Meetings with trade union representatives	16%	They have not yet carried out any work to consult with the workforce or seek their opinions	2%	Other	7%

The COVID-19 pandemic was an unprecedented event; nevertheless, we encourage companies to assess the difficulties experienced in obtaining workforce views and work towards improving current methods to gathering views. One company within our sample has shown evidence of this, by creating a programme of workforce engagement initiatives throughout the year. This was considered so successful that they will likely be added to the board's regular engagement activities.

Advisory panels

Last year, we highlighted that workforce advisory panels offered a more structured approach and better two-way communication. It was encouraging to see that most panels were able to continue in a virtual format.

In last year's report, we highlighted that we were yet to see whether such activities from the panel have influenced board decision-making. This, of course, was partially due to the fact that many of the panels had only recently been set up.

The majority appear to meet at least twice a year; however, a small minority of companies held more. One company noted that its '*... global employee forum, chaired by two non-executive directors, met four times throughout 2020. Despite the challenges presented by COVID-19*'.

It is helpful to the reader to understand on what basis the frequency of meetings is decided and whether changes are made as a result of external or internal factors.

This year, we were pleased to see many companies had highlighted the outcome of the engagements under this mechanism, many of which were used as a vehicle to obtain staff views on the COVID-19 response implemented by the company. One company in our sample noted how it reflected on employee feedback:

Example

'The Board reflected on colleague and customer feedback on the Company's response to COVID-19 at Board meetings In order to keep our colleagues safe, Board meetings were held virtually to adhere to governmental restrictions and the wellbeing of store and home-working colleagues was discussed through feedback from the Great Place to Work National Group.'

Workforce directors

Six companies within our sample employed worker directors, two of whom were appointed after the introduction of the Code. The role of the worker director differs between each company. One, for example, had an employee director on its group board before the revised Code was introduced and had worker directors on the majority of its operating companies' boards since the founding of the company. Another in our sample appointed two employee directors shortly after the new Code came into effect. Despite the differences in approach to this method, all six companies had similar objectives: bringing the employee perspective and/or the voice of their employees directly to the board.

As stated in our previous review, we continue to 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.

Our commissioned report, conducted by the IPA and RHUL, provides further insight into this method, beyond annual reports, looking at why other FTSE 350 firms have not adopted this method, and in addition provides an interesting perspective from two worker directors who were interviewed.

Overview of outcomes

Overall, our analysis shows that the pandemic prompted many companies to engage more frequently with their employees, mostly focusing on employee wellbeing and flexibility issues concerning employees working from home.

Examples

'... to understand how colleagues were feeling during the COVID-19 pandemic, with a specific focus on wellbeing, working remotely and work/life balance...'

Examples

'We were able to continue to conduct and review the various cultural and engagement surveys as we have done in prior years. In addition, we reviewed specific pulse surveys conducted by executive management to determine how our people were coping during the pandemic, particularly those who were working from home.'

It is encouraging to see that during a time of crisis many companies solicited employee views more regularly on issues of high importance. This method of engagement allowed for the organisation to respond to concerns in a much shorter timeframe. As a result, many employees were able to gain access to important IT equipment and company wellbeing programmes.

In our previous report we noted the following expectation:

FRC Financial Reporting Council

The 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.

Many of the employee mechanisms have been in place since the Code came into effect in January 2019. As required under Provision 5, in the next review we will be paying much closer attention to companies that have begun to assess their engagement mechanisms to ensure that they are continually effective.

Remuneration committee workforce engagement

Provision 40 asks companies to effectively engage with the workforce to discuss their remuneration arrangements. In our Improving the quality of 'comply or explain' reporting publication we explained that 'effective engagement' for the purpose of this Provision means two-way dialogue. Twenty-three companies confirmed that they engaged with the workforce to discuss remuneration, through either the designated NED, the workforce advisory panel, or members of the remuneration committee. We were pleased to see that companies have directly engaged with the workforce on remuneration. However, only two companies reported on the issues discussed and/or feedback received.

Provision 41 of the Code asks companies to explain *'what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company pay policy'*. Such engagement could be a two-way direct engagement or one-way. Two companies stated that they communicated information about remuneration to the workforce using a communication video or internal newsletter. This is a good starting point and could be further improved by explaining how the workforce is able to ask questions or seek additional information to help understand complex procedures.

These two Provisions appear to be an area of confusion for many companies. Forty-five of the companies in our sample explained within their remuneration report their methods of engagement and/or how the board engages with the workforce generally but did not report explicitly how they discussed remuneration. Sometimes this information was duplicated from earlier sections of the annual report that highlighted its workforce engagement activities.

To comply with Provision 40 in terms of workforce engagement	To comply with Provision 41 in terms of workforce engagement
• Two-way engagement with the workforce during the reporting year • Specifically discuss the company's remuneration arrangements • Opportunity for the workforce to ask questions or raise issues • Explain this engagement and the outcome from it in the annual report	• Two-way or one-way (such as a communications video, report, newsletter) engagement during the reporting year • Explain to the workforce how executive remuneration aligns with wider company pay policy • Describe this in the annual report

Stakeholder engagement

We were pleased to find that many boards have developed consistent and robust procedures for receiving information throughout the pandemic, with many companies reporting on more frequent board meetings and more thoughtful consideration of stakeholder needs.

We found the majority of board engagement to be indirect, including updates from various divisions in different units and geographies and reports on health and safety, customer demand, market conditions, operations and supply chains.

It was particularly encouraging to see a number of companies including a 'forward-looking' segment within their s.172 and stakeholder engagement reporting, setting out their engagement strategies for the following year, including any changes or improvements to methods and governance processes.

Stakeholder engagement issues and feedback

Key Message:

While there was a higher level of reporting on issues discussed with employees in s.172 reporting, particularly in relation to COVID-19, engagement and consultation with broader stakeholders was limited.

Where a company has reported on engagements throughout the year, we expect them to describe (i) the engagement methods used, (ii) the feedback gathered from those engagements, and (iii) the action taken or to be taken or how that information informed decisions at board-level.

We were disappointed to find a lack of strategic narrative around stakeholder issues identified in s.172 statements and stakeholder engagement sections. It was still common for companies to identify 'key issues' for each key stakeholder group without explaining whether these were issues that had been discussed with stakeholders or had emerged from a formal assessment.

We did, however, find some instances of effective reporting where companies cross-referenced to stakeholder materiality assessments and matrix in their s.172 statements. These generally consisted of stakeholder surveys and impact analyses, and clearly showed what issues are important to the company's key stakeholder groups over the short, medium and long-term.

As referred to in the FRC Lab Report on Stakeholders and s.172 Reporting, this kind of reporting is particularly useful to investors, who can then better understand the significance of the stakeholder group to the company's long-term success and issues that present sources of both risk and opportunity to the business.

Reporting on stakeholder materiality assessments was particularly effective where the company articulated clearly:

1. Who approved the materiality assessment/matrix;
2. How materiality assessment was conducted and which teams were involved;
3. Whether stakeholders were consulted and methods of engagement used;
4. How results were actioned throughout the organisation;
5. How outcomes were reported back to the board;
6. How results were reported to internal and external stakeholders.

We saw some companies draw expertise from throughout the organisation, helping promote a holistic approach to addressing stakeholder needs and promote consistency between those interests and the long-term success of the company.

Some companies also reported on establishing workshops and bodies such as stakeholder advisory panels to gain a better understanding of their stakeholders' changing expectations and improve their response. Such panels included external topic experts with senior internal decision-makers to sense-check, challenge and provide direction against key non-financial topics such as culture, ESG, climate change, ED&I, and digital transformation issues. In some cases, these bodies provided input to either the materiality process, or the development of targets or actions emerging from the assessment.

Example

One company reported that its process for determining material stakeholder issues involves consultation, analysis and approval. The process was led by a third party and incorporated both in-depth interviews with a range of internal and external stakeholders, along with desktop research. Following the stakeholder interviews, a third party-led validation workshop took place where subject matter experts from across the Group were asked to validate and prioritise the matters identified as most material to the company.

The final materiality list was then approved by the Group's leadership and the board. The company

helpfully provided a table clearly showing the matters identified as material to its stakeholders and business, including a detailed description of each issue along with the elements of strategy they relate to (e.g. portfolio, innovation and people issues), as well as how value creation was affected (e.g. by health and safety, environment, sociopolitical or financial implications).

Engagement outcomes

Financial Reporting Council

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

The importance of reporting on the outcomes of engagement was something we highlighted in last year's review. This year, this aspect of reporting was usually addressed within principal decisions reporting or in the company's stakeholder engagement section.

We were pleased to find that 69% of companies reported on the outcomes of their engagements. However, much of the reporting is boilerplate or unclear as to whether achievements were the result of active engagement.

Financial Reporting Council

The 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 key metrics supported by narrative or case studies.

We found that, although the number of companies reporting on engagement 'outcomes' has increased dramatically since last year, the quality of reporting in this area was often poor. Many companies provided generic stakeholder outcomes (*e.g. 'created employment opportunities' or 'continued to provide an excellent service'*) without explaining whether such outcomes were the result of action taken in response to specific engagements or how these factors helped the company succeed in the long-term.

Reporting was best where the company demonstrated a direct link between specific engagements and the tangible outcomes/benefits for the stakeholder group and the company. One company, for example, reported that it had established an online platform for suppliers to raise concerns after a poor supplier satisfaction survey score, resulting in smoother and more frequent communication between parties, enhanced opportunity for innovation and improved supplier satisfaction scores.

Integrating stakeholder issues into board decision-making

Key Message:

We found increased reporting on ESG issues in principle decisions, with a majority of companies reporting on their response to COVID-19 in at least one of their principal decisions. Other issues discussed included culture, purpose and values, climate-related decisions and ED&I agendas.

Different reporting approaches

While the quality of principal decisions reporting has improved significantly, most companies lag behind the best market practice.

This year we found, broadly, that reporting on the integration of stakeholder issues in board decision-making can be categorised into two types:

1. Reporting by individual stakeholder groups, providing a list of board-level decisions that affect/ may affect particular stakeholder groups; and
2. More integrated reporting that accounts for overlaps and trade-offs between key stakeholder interests.

Although both approaches provide insight into the impact of the business on its stakeholders, the first approach does not clearly account for any conflicting stakeholder needs or difficult trade-offs that had to be made. Reporting on these factors demonstrates to investors how the company has considered its stakeholder interests in a holistic manner and articulates clearly the corporate thought process.

While only 39% of companies provided clear and comprehensive principal decision reporting, we found that the quality and depth of principal decision reporting this year has improved. We were pleased to find companies taking account of some or all of the factors below:

- Any associated potential risks & opportunities to company and/or stakeholders impacted by potential courses of action;
- Feedback received from engagement and action taken in response;
- Use of external evidence and advice to support decisions;
- How such evidence and data was used to drive strategy;
- Any overlaps in stakeholder interests and difficult trade-offs made.

It is also worth noting that although some companies provided metrics by which they measure the effectiveness of stakeholder engagement and relationships, in general, companies are not reporting on how such indicators have been considered in board-level decision-making.

Key Message:

Many more companies are reporting on the impact of key stakeholder decisions on the company's long-term success. However, boilerplate reporting continues to dilute the quality of information for investors.

We were encouraged that 65% of companies that reported on board-level stakeholder decisions described how the particular decision/course of action contributed to the company's long-term success. The better reporters linked key decisions and engagement to specific long-term factors, including key competitive trends and disruptions, technology capability and climate change considerations. We were also encouraged to see some companies linking their engagements and key decisions to tangible achievements; for example, being recognised and ranked by external benchmarking and standard-setting bodies.

FRC Financial Reporting Council

The 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.

Much of the reporting focused on short-term decisions to protect stakeholders throughout the pandemic. In this context, while almost all companies reported on the challenges related to COVID-19, very few reported on areas where they failed to meet targets or how such decisions may impact the company in the longer term.

Key Message:

Reporting on targets not met can build trust with investors and stakeholders and provides an opportunity for companies to demonstrate the resilience of their business model.

This was a missed opportunity for companies to demonstrate legitimacy in their board's decision-making processes and build trust through enhanced transparency. We nevertheless found some examples of good reporting in this area. One company described a multi-step process to address an area in which it was underperforming:

Example

The company described:

1. How the board identified the area where the company was underperforming and recognised a need for change and/or establishment of strategy;
2. How they reviewed policies and practices and who was responsible for review;
3. How they sought views from stakeholders on the relevant issue and who was responsible;
4. How they developed proposals in response to stakeholder views (including targets and metrics over the short, medium and longer term) and how these were reported both internally and externally;
5. How they tested their proposed approach and strategy by engaged stakeholders, many the same as before but also broader stakeholders to determine whether strategy was aligned with stakeholder expectations;
6. What refinements they made to their proposals based on feedback received;
7. How they reported back to stakeholders, including investors.

Supplier focus

Over half of companies that identified their suppliers as a key stakeholder group reported on their governance structure and/or processes in place to address supplier issues. In some companies, compliance and ethics/ sustainability committees are responsible for oversight of ethical issues associated with suppliers.

A number also reported on updates to the board from their audit and risk committee on supplier issues and the internal auditing of ethical business processes. We found, however, that this reporting lacked detail and companies are failing to provide sufficient information on board-level decisions relating to suppliers.

Supplier engagement methods: One-sided or dialogue?

Many companies recognised how their suppliers have been impacted by COVID-19, with a significant number explaining their board's response to protect suppliers. This included reporting on enhanced and new methods of engagement and working with suppliers to reduce risks and ensure continuity of supply.

Many companies reported that engagement with suppliers was carried out more frequently, often daily. One company reported that it developed a COVID-19 information website for suppliers to share protocols and information to help keep them running safely.

Key Message:

Sixty-three per cent of companies that identified suppliers as a key stakeholder group reported on engagement with suppliers that was either one-sided or unclear if suppliers had the opportunity to have their views heard.

A number of reporters used language such as 'cooperated' and 'collaborated' to describe one-sided exercises of engagement such as external reporting on policies and supplier codes of conduct. Others reported that they had had 'meetings with suppliers' or 'worked closely' with suppliers without providing information relating to the purpose of those engagements or whether suppliers had the opportunity to raise any concerns.

Some also reported on board-level engagement with suppliers at external events such as the World Economic Forum. However, in most cases, it was unclear the level of participation or any insights gained.

The forms of engagement reported on ranged from process-focused methods of seeking assurance to engagement that offered real opportunities for both parties to discuss material issues:

Suppliers: Engagement methods

- Board oversight/approval of supplier code of conduct;
- Board oversight/approval of Modern Slavery Statement;
- Supplier ethical/human rights/ethical sourcing risk assessment;
- Suppliers' sustainability ratings by external providers;
- Due diligence assessments;
- Audits and inspections of suppliers;
- Periodic performance/commercial reviews;
- Corporate responsibility and ethics reporting;
- Review and approval of significant orders/contracts by board.

Suppliers: Dialogue-driven engagement methods

Key Message:

Only 37% of companies that identified their suppliers as a key stakeholder group reported on a clear dialogue between that group and the company.

While it is good practice to undertake due diligence and assurance checks with suppliers, it is important that companies also seek the views of their suppliers to inform and improve decision-making in line with Provision 5. In this context, we were pleased to find some companies report on dialogue-driven engagement methods, including:

- Meetings with suppliers at the outset of the relationship to agree on performance metrics and ensure continual monitoring of performance; supplier questionnaires and satisfaction surveys/ stakeholder materiality surveys;
- Board-to-board meetings with suppliers;
- Supplier whistleblowing hotline, with all issues tracked and monitored by board;
- Listening groups for suppliers hosted by the chair and reported to the board;
- Worker voice programme, expanded to hear directly from factory workers in supply chain;
- 360° feedback programme with key suppliers, providing insight into the supplier experience and ensuring continual improvement;
- Creation of supplier forums to discuss health, safety and environmental issues and to share best practice on an ongoing basis.

Example

One company demonstrated a thoughtful and strategic approach to supplier engagement, taking account of supplier views and demonstrating its response:

The company reported that engagement with suppliers focused on ensuring continuity of supply of products in the face of increased demand and the potential for disrupted supply chains due to COVID-19. As supply and demand stabilised, it recognised that engagement could be rebalanced to include strategic opportunities.

The company explained feedback from suppliers that they understood the long-term strategy enables them to invest appropriately in their businesses. It then chose to hold a conference, enabling engagement on its product technical and responsible sourcing strategy and raw material and packaging targets.

In response to feedback from the conference, the company reported that it is developing a cross-functional balanced scorecard for assessing capability and establishing medium-term supplier strategies, enabling it to segment its supplier base for optimal working relationships. It is also developing a tiered plan for meeting and engagement to enable both transactional and strategic topics to be discussed with suppliers throughout the year.

Companies reported on engaging suppliers to find solutions and seek opportunities on a range of issues, including:

- Sustainability strategies;
- COVID-19 mitigation measures, including cash flows and health and safety standards;
- Technology infrastructure;
- Climate change-related issues such as innovation in sustainable packaging;
- Developing plans to minimise any disruptions arising from brexit and contingency planning;
- Building capability and expertise, particularly design and technical expertise.

We were particularly encouraged to find a number of companies reporting on how engagement methods and issues differed strategically across product ranges and geographies, taking account of any risks associated with particular supplier relationships and how these are mitigated. The most effective reporters linked engagement efforts and specific supplier trading relationships to risks quantified in potential reductions in turnover. In determining the importance of different supplier relationships to the company's success, we encourage companies to use risk-based profiling as an effective method of ensuring all suppliers receive the relevant level of engagement.

Example

One company reported that a specialist supply chain auditor helps provide independent assurance to both the company and its suppliers that the standards and values that they have agreed on are being met. Where this is not the case, it reported that it assists its suppliers in developing remediation plans for implementation to help develop compliance in required areas.

The company's suppliers are then given the opportunity post-audit, through the completion of a survey, to provide feedback on whether they believed the audit was effective, fair and how, in their view, it could be improved. The high-level results of related audits are reviewed by the board, with the outcomes of the audit and effectiveness review reported in its annual report.

Supplier engagement outcomes and benefits

Key Message:

Sixty-four per cent of companies that identified its suppliers as a key stakeholder group reported on a link between their engagement with suppliers and business outcomes.

Companies reported that supplier engagement is integral to their success, yielding various benefits, including:

- Ensuring a resilient supply chain;
- Sharing knowledge and expertise to find solutions and opportunities for innovation;
- Developing responsible business strategies and achieving continuous sustainable development;
- Meeting shared targets for growth and development;
- Strengthening transparency of strategic objectives, particularly environmental and social objectives, by setting fair and clear expectations;
- Reducing risk, including reputational risk, and enhancing opportunities for other stakeholder groups such as communities.

In general, however, companies stopped short of providing company-specific factors when reporting on the outcomes of engagement or the impact of supplier engagement on the company's success.

For example, many companies identified '*differentiation*', '*cost efficiencies*' or '*meeting global supply chain standards*' as a corporate benefit of engaging with suppliers. However, this was seldom supported by narrative that explained meaning or context. In other cases, some stated that they monitored progress of supplier engagement, but did not report on metrics were used and how these helped inform decisions.

Reporting on outcomes of engagement was most informative where the company quantified its achievements through metrics and linked back to the strategic value of specific suppliers and to the company. Some companies referred to innovations in particular product ranges, for example, as an outcome of engagement with specific suppliers. Another reported how the board monitors key accreditations in core geographies to ensure they remain relevant to technology partners and customers.

We were particularly pleased to find some companies demonstrating their efforts to ensure continual improvement of engagement processes and outcomes relating to suppliers. For example, one company reported on its annual survey for key suppliers, which allows them to understand if actions taken following previously received feedback has improved its supplier relationship management. Another reported on 'key benefits' as a result of engagement, including the percentage of high-risk production sites that had an ethical audit in the past year, and a comparative analysis with previous years.

Reporting was most effective when the company linked these improvements to specific engagements and provided examples that demonstrated rigour in its process and effectiveness review. Some improvements made in response to supplier engagement included improving the procurement process, updating plans, enhancing innovation opportunities and improved adherences to supplier charter.

Supplier metrics

% of supplier payments within agreed terms
% of suppliers adhering to supplier charter
% of suppliers completing external sustainability assessments
Supplier diversity profiles
Supplier relationship management feedback score
External industry recognitions
Innovations and solutions
Risk metrics in different geographies/product ranges/supplier relationships
Customer value perception

Modern slavery

This year, we worked with the Department of Accounting and Finance at Lancaster University, which researched modern slavery ('MS') reporting to determine the extent to which companies are including modern slavery as part of their duty to consider the interests of their stakeholders in their annual report. The research also included a review of reporting on MS governance, policies, and due diligence in Modern Slavery Statements against a framework developed by the Business & Human Rights Resource Centre (BHRRC).[1] In conducting the research, Lancaster used the same random sample as our annual review.

Modern Slavery reporting in annual reports

In terms of governance, it was found that 42% of companies discussed, to some extent, the person/department/committee(s) responsible for overseeing MS in their annual report, with just under a third of these reporting on internal controls linked to these committees/departments. Only 19% referred to KPIs or other non-financial performance indicators relating to MS. In terms of risk, just 15% of companies reported, to some extent, on their assessment of risks relating specifically to MS in their annual reports, compared to 72% disclosing this within their Modern Slavery Statement (although half of the latter were only partial disclosures).

A mere 13% of companies explicitly discussed board-level decisions relating to MS in their annual report with just 2% referring to the long-term impact of MS-related issues on their business. Nine per cent of companies provided evidence in their s.172 statement that they had engaged their stakeholders on the topic, while only 2% reported on how any gathered views had helped inform board decisions. The evidence suggests that MS considerations appear to be relatively low on the agenda of most boards.

Overall, reporting on MS in annual reports was largely descriptive and superficial, and only 14% of companies provided a direct link (URL) to their MS statement for more coherent reporting. We were disappointed that most companies did not use the opportunity to cross-refer to their MS statement within their annual report.

Modern Slavery Statements

Reporting on engagement with suppliers in MS statements was generally limited. Only 27% of companies disclosed how they work with suppliers to improve their labour rights practices, with only a quarter of those providing a comprehensive disclosure. Engagement with workers in supply chains on MS was even less common, with 23% of companies reporting that they engage directly with workers in their supply chain. It is therefore unsurprising that only 16% of companies reported that they expect their suppliers to establish a mechanism(s) for workers to raise complaints or concerns (including about human rights issues) and communicate their expectation to their suppliers.

In terms of policies, 84% of companies were found to have made a disclosure about how their internal policies relate to MS, but less than half of these were comprehensive disclosures. The quality of information was often poor, with many companies opting for general or boilerplate statements rather than providing information about issues such as policies on withholding wages or imposing recruitment fees.

In the area of due diligence, 73% per cent of companies reported on how they monitor suppliers on MS (e.g. audits, site visits). However, less than half of these were considered comprehensive disclosures with many failing to provide information on the outcomes of the monitoring processes. Eight per cent of companies require first-tier suppliers to cascade the company's human rights and MS standards down their own supply chains, whilst 59% discussed specific actions that that they will take in the coming financial year to address MS issues.

Companies' assessments of their MS policy effectiveness were found to be the most opaque area of MS reporting, with 57% of companies failing to disclose any KPIs or other methods used to measure the effectiveness of efforts to address MS risks.

Overall, the low quality of reporting on Modern Slavery by companies is concerning. Although the lack of disclosure may not necessarily reflect a lack of action, we encourage companies to build trust with investors and wider stakeholders by explaining how they are combatting Modern Slavery in their supply chains.

1 The methodology captures variations in the quality of reporting using a three-part scale (no disclosure, partial disclosure, comprehensive disclosure) and has already been used as an effective tool for assessing the reporting of premium listed companies on MS. Our review focused on the areas of disclosure pertinent to the responsibilities of companies under the Code.

Communities

We were pleased that 75% of companies identified communities as a key stakeholder.

Assessing the impact of a company's operations and activities on communities

Key Message:

Although companies are identifying issues important to their communities, the vast majority are not articulating the actual or potential impact to local communities as a result of their business operations.

Common issues companies identified as important to their communities included climate change and bio-diversity, response to COVID-19, compliance and anti-corruption, labour and human rights, and health and safety. Others linked their impact on communities to a commitment to paying their fair share of tax in the jurisdictions in which they operate.

We were disappointed to find, however, a lack of narrative around how community issues were identified or how the key issues identified relate to the company's impact on those communities and/or the company's financial performance.

For example, almost all companies that identified communities as a key stakeholder referred to climate-related issues as important to their communities, yet very few provided information on which part of their operations and activities such issues arise from, or how those matters impact specific communities in which the company operates or serves.

Reporting was best where the company was specific in describing which communities were impacted by their operations and activities (including, for example, by region and business unit) and how those communities may be impacted (e.g. by flooding risk in the supply chain due to expansion of operations or risk to community health from Scope 3 emissions).

We also found a lack of strategic narrative around methods of community engagement, with the large majority of reporting unclear on the reasons the company used certain engagement methods or donated to a particular cause instead of others.

Financial Reporting Council

The FRC expects more information and transparency on why the board approved community initiatives or programmes, and how these align with strategy.

In the few instances of better practice, companies reported on positioning their employees strategically around a local cause that supports their strategic objectives and partnering with charitable organisations aligned with their purpose and values.

We also found some companies reporting on the alignment of community engagement to carbon-offsetting strategies and specific ED&I objectives. In light of the Code's emphasis on corporate culture, we were also encouraged to find a number of companies linking their reasons for engaging to their corporate culture and values.

The methods of engagement and the desired outcome should aim to align with, and where necessary mitigate, the impacts and risks posed by business operations and activities on the communities in which they operate or serve.

Community engagement methods: one-sided or dialogue?

Key Message:

Reporting on community engagement focuses almost entirely on good news stories and philanthropic giving, with little reporting on any challenges encountered or negative impacts as a result of business operations and activities.

Last year, we urged companies to ensure a continual dialogue with their communities for mutually beneficial relationships. We were therefore disappointed to find that only 18% of companies that identified communities as a key stakeholder group reported on a clear dialogue between that group and the company. Where companies did claim an active dialogue with their communities, this was often not substantiated by examples of engagement.

Some 58% of companies that identified communities as a key stakeholder group reported on engagement with communities that was either one-sided or unclear if communities had the opportunity to have their views heard.

In the cases of better practice, we were pleased to see companies engaging with local communities throughout their project development stage to identify and mitigate any actual and potential adverse impacts, and ways in which projects can bring benefits to local communities. One company also reported on 'sustainability masterclasses' to raise awareness of and seek feedback on its the new sustainability strategy, with feedback provided to the board via sustainability updates.

We were also encouraged to see one company report on the role of their 'community champions', who have undertaken an extensive listening programme with community stakeholders to better understand priorities and needs locally. This enabled detailed local community plans to be developed.

Some companies carried out community/ environmental and social impact assessments for particular projects, which identified both benefits that the project would bring communities and any mitigating measures to prevent any negative impact. While such assessments were primarily carried out in high-risk industries, this is perhaps something that other sectors could benefit from.

Integrating community considerations into board-level decision-making

Some 58% of companies that identified its community as a key stakeholder group reported on governance structures in place to address community issues. However, companies are not providing sufficient information on board-level decisions relating to communities.

Companies reported on various processes and practices in place to help their boards integrate community issues into decision-making, including:

- Board approval of investment, community programmes and donations;
- Training undertaken by board and audit and risk committee members on climate change reporting;
- Updates on collaborative initiatives and international forums, e.g. the World Business Council for Sustainable Development and Task Force for Climate-related Financial Disclosures (TCFD);
- Updates to the board on stakeholder engagement activities, stakeholder materiality analysis and research conducted by different business functions;
- Executive board member on a social diversity impact board, led by independent experts and reporting directly to the Group board;
- Direct board engagement in various geographies on geopolitical and social issues influencing regions in which the company operates;
- Reports to board on community metrics/outcomes of engagement.

As expected, a number of companies had also established new processes in response to COVID-19. In particular, we found reporting on board oversight of initiatives supporting communities throughout the pandemic, including health and wellbeing provision, regular updates on infection rates in communities and discussion on how to best support stakeholders, and immunologist updates on the impact of the pandemic on communities in different geographies, to provide insight into the changing needs of community members.

Key Message:

The vast majority of companies reported that community issues fall within the remit of general sustainability/ESG/compliance committees. However, companies' reporting could be improved by offering more information on how boards assure themselves that these governance structures are sufficient to meet community needs.

Of those that did report on the consideration of community issues and impacts at board or committee level, decisions included topics such as pathways to carbon neutrality, moving operations to a different site, acquisitions and the development of community grievance mechanisms.

Community engagement outcomes and benefits

Of the companies that identified communities as a key stakeholder, 51% linked engagement with their communities to their performance and business outcomes.

We were pleased to find an increase in companies reporting on a direct link between their responsiveness to community needs and their business performance. This stemmed from various corporate benefits of community engagement, including:

- Building trust and support which, in turn, wins goodwill and maintains the company's reputation and social licence to operate;
- Being a source of employee motivation and team morale and develops sense of achievement and purpose in their day-to-day work;
- Increases in workforce loyalty and result in a more resilient and better performing business.

Companies used a number of metrics when reporting on community outcomes including number of investments in a cause, total sum donated to a charity, number of employees volunteering in community initiatives, number or percentage of products supplied (e.g. medical equipment), number of employment opportunities created, or rise in the number of girls' access to education.

The vast majority of reporting on outcomes of community engagement remained generic and boilerplate. While this is likely to be a reflection of the challenges in identifying and articulating specific objectives for community engagement and the impact that engagement and business activities have on local communities, we did find some innovative reporting in this area.

Example

One company reported on monitoring the short and long-term benefits of engagement by asking beneficiaries to report on their progress, sharing feedback on the company's website. The company also reported that it surveys employee volunteers to understand the impact of the programme on their personal development and how it affects the way they feel about working for the company.

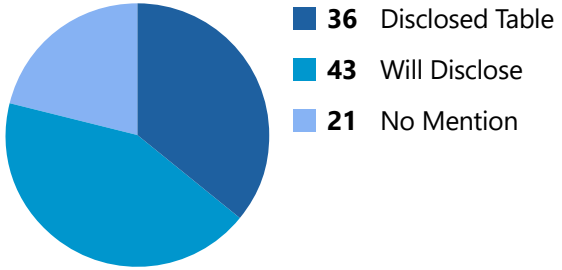
Climate reporting

Last year we looked at governance as part of the wider FRC thematic on climate. This year we have narrowed the scope as many companies prepare to report against the requirements of TCFD.

We were pleased to see that many companies are preparing the ground to ensure that they will be complaint with the new FCA Listing Rule. The majority of companies had taken time to acknowledge the work of the task force and had said that reporting in line with the recommendations would start next year.

We found 36% of companies have already provided full TCFD Disclosure Tables. We also found that 43 commented that they plan to disclose.

No. of Companies that have created a TCFD Table



Companies will need to establish and use a solid framework of measures for discussing climate-related issues with the board.

From our review, 21 firms did not report any steps that they had taken to prepare for assessing these issues at a board or committee level.

Companies that reported well on this included a discussion of how the board oversees climate-related risks, as well as other committees and initiatives involved in the decision-making process. Including these matters within the annual report would have helped investors analyse how well prepared companies are for the introduction of the new requirements.

The disclosure of targets and metrics is a central pillar to the TCFD Disclosures. Many firms are still unwilling to disclose targets and metrics outside of mandated carbon dioxide emissions. We recommend that firms try to expand their climate reporting outside of these standards. Companies included additional reporting outside of CO2 emissions including

- Science-based targets
- Setting net zero targets
- Percentage of renewable energy used
- Reduction in water usage

General reporting

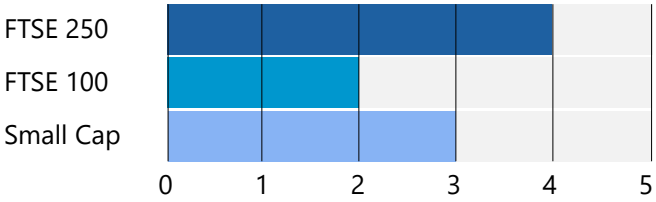
We were surprised by the low level of reporting on climate-related issues by some companies. One company in our sample described climate change as 'not currently considered to be an emerging or a principal risk for the Group'. We consider that climate change should be seen as a risk for all companies, regardless of their sector or size.

Key Message:

It is important for companies to undertake the work to assess the level of climate-related risk and determine what governance arrangements should be put in place. The degree of oversight and assurance will only be clear after a full assessment and be different for all companies.

It was concerning to see an albeit small but surprising group of nine firms that reported neither board-level discussions on environmental issues nor disclosure of climate targets and metrics outside of mandated CO2 emissions. These included three small cap firms, four FTSE 250 firms and two FTSE 100 firms.

No. of Companies that disclose neither Board Arrangements or Targets or Metrics



Despite this, the companies that excelled in this area have used a variety of metrics, comparing their metrics between years and allowing for a discussion of how progress has been made in this area.

Some firms are still defaulting to the use of vague language to discuss how emission reductions are going to be achieved. An example is:

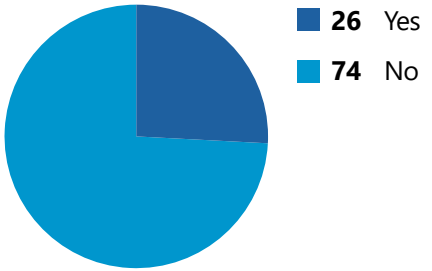
> 'We will harness our leading industry knowledge to support the retrofitting of our social housing stock to contribute to the UK meeting its target and to allow our residents to live in decent and future fit properties.'

This is an important statement about what the company wants to achieve, but we were unable to find any of the actions the company planned to take to achieve this change and, importantly, how that might impact on the company over the coming years.

In last year's report, we said: *'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.'*

Once again, discussion of board room decision-making on climate issues was generally vague. In addition, very few companies have effectively reported on the level of expertise or knowledge at board or senior management level to help companies navigate the complexities of the issue.

Number of companies disclosing climate expertise on boards



On a positive note some companies have introduced climate committees, but there is little clarity on the levels of expertise and understanding of climate issues of those who attend the committees. This may be a matter for future succession plans.

An example of good reporting describing who in the company is involved in climate change:

Example

'The chief executive has lead responsibility for climate-related issues, including at board-level. The Board sets the Group strategy direction and, when setting strategic objectives, it considers all material influencing factors including those relating to climate change. The Group Executive Committee (GEC) implements the Group strategy set by the Board and drives climate-related performance programmes across the organisation. The Chief Sustainability Officer advises the Board, GEC, Group Risk Committee and Business Units on climate-related matters.'

Some companies have limited their reporting to recycling and reduction of plastics. These are good initial steps but we urge companies to go further, for example, and in the future they will need to discuss Scope 1-3 emissions.

Climate change and risk

Risk management is an essential pillar in TCFD reporting. Due to the unique characteristics of climate change risks, it is important that companies consider the characteristics of these risks and how further warming of the planet will impact facilities and operations, supply and distribution chains, employees and customers.

Companies should identify and incorporate climate-related risks. For companies where climate-related risks have not traditionally been a prior consideration, it is important that an understanding of climate change concepts and impacts is present across the company.

In this year's sample of reporting, the FRC reviewed how companies talk about climate-related risks. This was dealt with in different ways:

- 33 companies had identified climate change as a principle risk;
- 20 companies identified climate change as an emerging risk;
- 4 of these companies identified climate change as both a principle and emerging risk.

In addition:

- 14 companies explained how climate change had affected other risks.
- 1 company had discussed all the elements set out above: identifying how climate change was both a principle and emerging risk as well as discussing how climate change affected other risks to the company.

In total, 62 companies within the review discussed climate change as a risk. Even though this year's sample of companies differs from last year, in percentage terms there has been a near 50% improvement in the number of firms that have reported climate change as a risk, from 42 in 2020 to 62 in 2021.

C. Division of Responsibilities and Board Composition

Many of matters dealt with in this section are the responsibility of the nominations committee. This committee should play a pivotal role in ensuring that there is an effective board, assessing the skills and knowledge requirements of the board in the medium to long term and setting out plans for diversity and inclusion at both board-level and in the pipeline. These are important matters, but the reporting of these issues continues to leave room for improvement.

Our analysis found many declaratory statements such as 'diversity is important' or 'succession planning is a priority'. However, this section of our report demonstrates that these declarations were left unsupported in many of the reports we assessed.

Chair independence

Chair independence

Provision 9 of the Code recommends that the chair should be independent on appointment. Last year we noted that this Provision had the highest level of non-compliance, and this year 18 companies reported non-compliance. Reasons for this included the combination of the chair and chief executive role, or the chair representing a significant shareholder.

The Code states that the roles of the chair and the chief executive should not be exercised by the same individual. Eight of the 18 companies stated that the roles of the chair and chief executive were carried out by the same individual. However, not all explanations were of a high quality.

Chair and CEO roles

Many companies explained that there was sufficient separation of responsibilities on the roles undertaken by the executive chair and that the nomination committee kept arrangements under review. However, details of the methods used, or actions taken to ensure effective separation were not provided in almost all reports.

Poor transparency here brings into question how the executive chair role is kept under review and in what circumstances any change would be made to the individual's existing role, or that of others, to achieve independent challenge.

Where the chair assumed an interim arrangement as an executive chair, a much clearer explanation of the rationale was provided. This usually included background detail as to why the chair was not considered independent, the reasons why the chair was best suited for the role and the timescale in which the company intended to comply.

Providing better explanations

Provision 10 sets out the circumstances to assess independence. Last year we produced the following key message:

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.

Where the company board proposes that the chair and the chief executive roles should be exercised by the same individual, the FRC expects the company to consult its major shareholders ahead of the appointment, provide reasons for the approach and publish those reasons on the company website. Efforts should be made to provide further detail in the annual report on the method used to ensure that there is sufficient and effective separation between the role of a chief executive and the role of a chair.

Our Improving the quality of 'comply or explain' reporting publication provides further insight on how to tackle an explanation when a company declares it is not compliant with Provision 9:

1. Explain why the chair was not independent when they were first appointed on the board.
2. The rationale should include the reasons why retaining the chair is beneficial for the company and its stakeholders, including the skills, experience and any other factors considered. It should also cover the reasons why a new independent chair may not offer the same or better skill set than the current chair.
3. Companies should consider the risks of having a non-independent chair.
4. State whether the company has plans in place to comply with this departure.
5. The reasons why the chair is not independent should be genuine and it should be visible that it is the right approach to take.

Chair tenure

Our analysis found 16 companies where the chair remained in post beyond nine years from the date of their first appointment to the board. The chair is pivotal in creating the conditions for overall board effectiveness, which also includes setting high governance standards. Long-term tenure can lead to a higher risk of complacency and group-think. Last year we stated:

'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 are regularly refreshed.'

Our analysis demonstrates that there are a number of companies that have no plans to change the chair even though the incumbent has been in place well beyond nine years. In these situations, it is often unclear what mitigating actions are in place to support both effective challenge and diversity of thought.

Some companies did offer better explanations.

Example

'In 2018, we highlighted that the chair's tenure had been discussed at numerous shareholder engagements. It was disclosed that shareholders were supportive of the extension of his tenure to the 2021 AGM … Retaining the chair on the Board until the 2021 AGM was right for the business. Doing so has facilitated a more effective phasing of his succession, particularly given the existing slate of director tenure at the time of the Code's issuance, with three directors nearing their ninth year of service. Earlier departure would have been disruptive and could have left a significant deficiency in the Board's corporate knowledge. He has done this while coaching other, particularly new, non-executive directors on the intricacies and nuances of the business…'

The explanation above provided a clear rationale for extended tenure, the timeline for the extension and noted that the chair's extension would facilitate a more effective phasing of succession. Even though this is a detailed explanation there should be a connection to the work of the nominations committee and the organisations' succession plans. Effective succession planning should pre-empt situations, for example ensuring that the chair and a senior independent director (SID) are not likely to leave the board in close proximity to each other. The explanation would have been further enhanced if it explained how the nominations committee would avoid situations like this in the future.

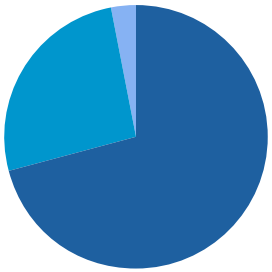
Last year we also highlighted that, as a result of the COVID-19 pandemic, we expected several companies to ask their chairs and NEDs to remain in post beyond the nine-year rule. Three of the 16 companies that declared non-compliance highlighted the pandemic as one of the reasons to extend the tenure of the chair. We understand that an extension during times of disruption and uncertainty can be important to ensure the long-term success of a company, and it is encouraging to see that one of the three companies highlighted that it had discussed this potential scenario with its largest shareholders, whose responses were supportive.

Diversity

Diversity policies

Last year we looked at how many companies described their diversity policies in their annual reports, if a link to the policy on their website was provided and whether it identified whom the diversity policies apply to.

This year we found that 71 companies stated they had a board diversity policy or a diversity policy that extends to the board.



71 Companies with a board diversity policy or a diversity policy that extends to the board

26 Companies that did not indicate that it had a board diversity policy

3 Unclear

However, some companies failed either to provide a link to the policy or include extracts from the policy in the annual report; therefore it was not possible to determine which elements of such a policy were aimed at the board, senior management or the talent pipeline.

Financial Reporting Council

The FRC expects companies to either describe their diversity policies in full in their annual report or summarise them and link to the full document on their website to enable easy access.

Last year, both the FRC and the FCA commented on the lack of transparency on both diversity planning and objective setting to improve diversity at board and senior levels. Following this, the FCA published its Diversity and Inclusion on company boards and executive committees consultation with the aim of promoting greater diversity and inclusion on company boards over time.

We advise companies to be clear about their board and workforce diversity policies. Effective policies should include objectives and targets and link to company strategy, along with actions taken to implement the policy and progress on achieving objectives. These elements form part of the reporting requirements in Provision 23.

In our Improving the quality of 'comply or explain' reporting publication we noted that many companies do not report on each element of this Provision, but continue to claim compliance. If a company has not commented on all points under this Provision, it cannot claim full compliance.

Although many companies have diversity policies in place, the weakest area in reporting against Provision 23 was explaining how the policy and objectives linked to company strategy. One company, however, highlighted its diversity and inclusion strategy, which is underpinned by its five colleague networks. The strategy includes three key pillars and, under each pillar, further information is provided on the initiatives and actions taken to create a more and diverse and inclusive culture. One pillar, for example, is labelled 'Embed inclusion in everything we do', which includes having inclusive people policies.

Diversity targets

This year we found that more than 70% of our sample disclosed diversity targets. However, like last year, these were predominantly related to gender, and the majority aligned with the Hampton-Alexander review targets. For those companies that set ethnicity targets, they were primarily in line with the Parker Review.

This year we paid closer attention to companies' progress on the Parker Review. The review set targets that each FTSE 100 board appoints at least one director of colour by 2021; and for FTSE 250 boards the timeline is 2024.

Twenty-seven of the 35 FTSE 100 companies within our sample did meet the recommended Parker target at the time of publication of their annual report (we note that the numbers may now be different). Of the eight FTSE 100 firms that had not yet met the target, three explained that they were set to meet this target by the end of 2021. Unfortunately, five companies did not provide any comments on the progress they were making towards the target.

Encouragingly, 15 FTSE 250 firms reported that they had met or exceeded the Parker recommendation in advance of the 2024 target. As we come to the end of 2021, there is now an opportunity for nominations committees of FTSE 250 companies that have not yet achieved this target to consider their current recruitment and selection processes and assess whether they require changes to their succession plans to enable them to meet the target on time.

Investors are now stepping up pressure on companies to increase ethnic diversity on boards. The IA's Shareholder Priorities for 2021 notes that its corporate governance research service, the Institutional Voting Information Service (IVIS), has highlighted that it will amber top FTSE 350 companies if they do not disclose the ethnic diversity of their board or a credible action plan to achieve the Parker Review targets. We encourage companies that do not have credible action plans to take action now to avoid being placed under the investors' spotlight.

For those companies that did not set out either policies, objectives or targets, we often found boilerplate statements explaining that they were committed to ensuring that they have an '*inclusive and diverse culture across the group*', but significantly these declaratory statements were not followed by setting out actions the company was taking or planned to take to achieve an inclusive or diverse culture, or indeed an inclusive or diverse workforce, senior management or board. In the majority of cases, such statements did not translate into an increase in diversity in senior positions.

Conversely, it was good to see that a handful of companies did not mention Hampton-Alexander or Parker, but they had achieved both targets and had policies and targets in place to go beyond the externally driven targets. This approach is positive and demonstrates that companies have understood the benefits diversity could bring to their organisation.

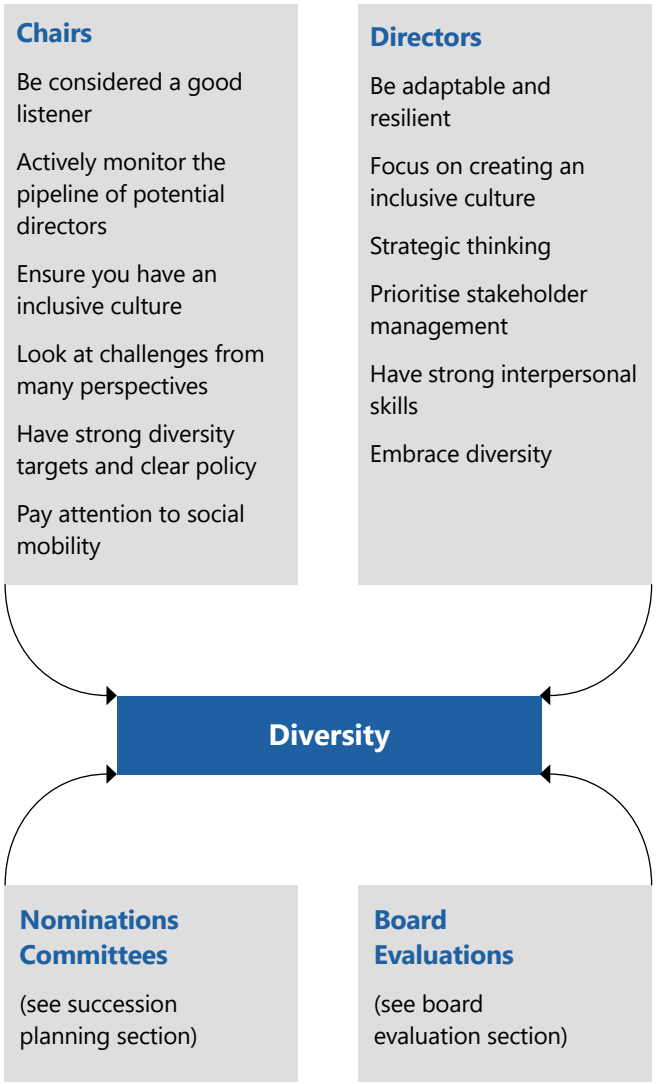
Some of the initiatives used to drive diversity and inclusion across the organisations included:

- reviewing whether opportunities for progression and development are equally available to those of different backgrounds;
- appointing a chief diversity officer to lead on diversity initiatives relating to the workforce;
- updating HR practices to accumulate diversity statistics to track the progression of individuals within the company;
- tracking and reporting against the diversity policy to the board;
- use of ED&I councils or committees;
- setting a strategy with clear goals and milestones;
- use of mentoring programmes;
- use of specialist recruitment consultants;
- targets for graduate recruitment.

A number of companies supported their disclosures on ED&I by reporting that they had joined a diversity and inclusion independent accreditation scheme or charter schemes. These approaches enhance oversight of ED&I strategies. One example is the National Equality Standard (NES), which sets clear equality, diversity and inclusion criteria against which companies are independently assessed. Another is the Women in Finance Charter, which is a commitment by signatory firms to work together to build a more balanced and fairer financial services industry.

Our joint publication with London Business School, Board Diversity and Effectiveness in FTSE350 Companies, published earlier this year, found that diverse boards can lead to better corporate culture.

The report highlights how different roles and functions can contribute to improving diversity and inclusion at companies.



The FRC encourages companies to take into account the requirements of Principle J of the 2018 Code:

'Both appointments and succession plans should be based on merit and objective criteria and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths.'

As noted last year the FRC continues to be concerned that, in too many cases, those shortlisted for interview are not drawn from a sufficiently wide talent pool to achieve diverse longlists and shortlists. Several companies continued to state that their appointments are made based on 'merit' without reporting on any activities to encourage diverse candidates to apply, or request executive search firms to cast their net widely.

Companies should take the expectation below into consideration.

Financial Reporting Council

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

Succession planning

Following last year's review, we noted the following expectation:

Financial Reporting Council

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

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

A year on, we continue to see little improvement in this area. The reports we reviewed continued to provide minimal insight into company succession planning. Many companies only described the process used in relation to appointments. There was little or no discussion on why the process was effective in ensuring the best candidates for the role could be found.

Similarly, disclosures did not discuss how the nomination committee had assessed the skills required for the board, when recruitment would begin, and how plans would change if recruitment timelines changed. This relatively low level of disclosure raised questions about not only board recruitment, but how companies' methods support the development of a diverse pipeline. A small number of companies did try to offer more clarity about their processes, particularly when referring to their appointment processes of a new director. Below are two examples of such practices.

Example

One company provided details on the appointment of a new chair for the board, which included stage 1 to 5 steps on the appointment process and disclosed the gender diversity of the longlist and shortlist of candidates who were running for the role.

Example

Another outlined a step-by-step approach to recruiting and inducting non-executive directors and provided further insight under each step. It highlighted that the chair leads the committee, working with the general counsel and company secretary to develop a candidate specification using a talent and expertise matrix, which was also illustrated in its report.

Insight into the formal appointment of directors is welcomed. Not only is it in line with one of the four elements of Provision 23 but it also ensures that companies have taken into account the requirements of Principle J:

'Appointments to the board should be subject to a formal, rigorous and transparent procedure…'

Other reports provided minimal insight into succession planning, more commonly, companies within our sample would simply note that:

'Search firms are appointed to secure a strong and diverse list of candidates.'

Reports seldom explained why the recruitment consultant was a good fit for the company; for example, whether the firm was experienced in a particular sector or if it had strong experience in obtaining a required skill set.

Some companies would at most simply note that they use external consultancy firms that were signatories to the voluntary code of conduct. Such information is useful; however, should be enhanced with additional information on how the succession plan delivers an effective and diverse board with the appropriate skills, knowledge and levels of challenge. This low level of disclosure is very disappointing given that so many of the companies stated that succession planning is considered a major area of focus for the nominations committee.

Key Message:

Succession plans should be written down, regularly reviewed and updated as the needs of the board and the make-up of the company evolves. They should be linked closely to talent pipelines and diversity and inclusion plans. Consideration should also be given to how planning arrangements are operated across short, medium and long-term planning.

We encourage companies to take into account the table we created in our previous review:

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

It should be remembered that the formalisation of a strong succession plan has several benefits. It can identify potential gaps in particular areas and outline a course of action. Publishing a plan can set out clear, fully defined roles as well as policies and practices guiding companies towards long-term growth and success.

Nomination committees

Our joint diversity publication with the London Business School highlighted the board's responsibility to drive inclusion and noted that the board should recognise that diversity without inclusion is unlikely to encourage new talent to the board. The report also highlighted actions the nomination committees can take to encourage diversity, including ensuring that the nomination committee is itself diverse and has a clear mandate to work with search firms that access talent from wide and diverse pools. Here are some of the recommended actions shared in the report:

Nominations Committees
Choose a diverse search firm and provide a clear mandate
Manage the pipeline of diverse talent
Set clear diversity targets and report regularly
Use a skills assessment to recruit directors
Invest time and energy into making diverse appointments
Ensure that the nominations committee itself is diverse

Effective succession planning enables boards to make the best decision for the company in the event of planned or unplanned transitions; therefore the nomination committee must continue to conduct a proactive process

of planning and assessment. Nomination committees should also acknowledge the growing recognition that boards with an appropriate mix of age, experience and backgrounds tend to foster better debate and decision-making and less group-think. We hope to see more thoughtful succession planning in the next reporting phase.

Board evaluation

As noted, earlier in the report the effects of the pandemic have resulted in many companies moving away from their usual approach this year. This year eight companies within our sample either deferred their external evaluations or did not conduct an evaluation at all. Explanations were wide-ranging, some companies highlighted extensive changes to the board meant it was better to schedule an evaluation in the next financial year, while others stated that they deferred their external evaluation due to the additional work arising from the pandemic. An example is provided below:

Example

'…to ensure the Board and its committees were able to focus on their usual work as well as the significant additional work of responding to the challenges created by the Covid-19 pandemic, and to contribute to critical cost savings, the Board deferred its scheduled external performance evaluation in 2020 and instead carried out a third consecutive internal evaluation.'

Another company noted the limitations and disadvantages an external board review would have and provided four bullet-pointed reasons for the deferral:

Example

- 'creating a distraction at a time when the Board and executive teams were in the midst of a crisis and dealing with pressing priorities;
- the likelihood of participants struggling to devote the time, and to give thoughtful consideration, to a review of Board and Committee performance given that their focus would inevitably be on crisis management issues;
- the risk that input and contribution from participants would be less useful and insightful if interviews needed to be conducted by videoconference rather than in person; and
- a risk of not getting full value and real insights from the exercise.'

While the FRC understands the difficult circumstances experienced during the pandemic we would like to reiterate the benefits of having an external evaluation. Provision 21 states:

'There should be a formal and rigorous annual evaluation of the performance of the board, its committees, the chair and individual directors. The chair should consider having a regular externally facilitated board evaluation. In FTSE 350 companies this should happen at least every three years. The external evaluator should be identified in the annual report and a statement made about any other connection it has with the company or individual directors.'

In January 2021, The Chartered Governance Institute UK & Ireland released the findings of its review into the effectiveness of independent board evaluation in the UK listed sector. Alongside the report, the Institute published guidance for listed companies when reporting on their annual board performance review, designed to assist companies with their reporting obligations under the 2018 Code. Companies should acknowledge and take on board such guidance materials and use it as a tool to improve their disclosures. Although this report has yet to be commented on by the Government, it contains useful advice for companies.

Reporting approaches

This year our analysis highlighted that several companies added questions/topics specifically addressing the board's responses and governance in the face of the COVID-19 pandemic Principle L is relevant here:

'Annual evaluation of the board should consider its composition, diversity and how effectively members work together to achieve objectives…'

Our analysis showed that over half our sample used a survey/questionnaire to measure the effectiveness of the board for its internal or external evaluation. In some cases, this was supplemented with interviews and document reviews. In our last review, we reminded companies that the Guidance on Board Effectiveness states that questionnaire-based external evaluations are unlikely to get underneath the dynamics in the boardroom. While we understand that this approach was best suited due to the effects of the pandemic, we hope to see companies consider a much more rigorous process for their next evaluation.

Reporting on actions and outcomes arising out of board evaluations is mixed. Like last year when referring to outcomes, most companies noted that '*the review concluded that the Board is operating effectively.*' Some companies that included COVID-19 responses as part of their evaluation used the following terminology '*the board is considered to have performed well through the pandemic.*' To accompany this some companies shared examples of areas that were praised in their review, this usually included points on the chair's performance and the wealth of experience on the board.

When analysing actions from findings of previous board evaluations several companies focused on areas for improvement, for example, company culture, and described what measures had been implemented by the board during the year. It was also encouraging to see some companies acknowledging difficulties with administering some of the actions:

Example

'In 2020, progress was planned, and in some respects made, on each of these matters, but disruption due to the demands of the pandemic has made it difficult to achieve all the progress we would have liked. For example, we experienced increased pressure on the Board's time and agendas, which often had to be revised at short notice to deal with urgent pandemic-related matters.'

This is an honest approach to reporting which we support. This approach is helpful to the reader and we hope to see whether evaluations in the coming year note actions that could be taken to mitigate shocks in the future.

We recognise that some findings of the board evaluation and recommendations for actions are too sensitive to disclose in the annual report. Nevertheless, companies should aim to describe aspects of the board's performance where have concluded there is a need for improvement. Actions arising from the evaluation should be disclosed and a timetable for completing them should be given.

Attributes, skills, and experience for boardrooms of the future

Our report on Board Diversity and Effectiveness in FTSE350 companies, asked 71 directors what skills would be required in the boardroom of the future, the extract below synthesises their response:

Having looked at the impact of diversity on board dynamics, we then asked our sample of directors what skills will be needed in the diverse boardrooms of the future. The top five include adaptability and resilience, strategic thinking, stakeholder engagement, interpersonal skills and embracing diversity. Their answers are revealing in that they reflect a) the need for change with adaptability and resilience topping the list, b) realism in that 'dealing with diversity' is high on the list and c) reassuring with classic skills such as strategic thinking and financial skills scoring highly.

We recommend that both companies and board evaluators consider these comments when considering the effectiveness of boards.

D. Audit, Risk and Internal Controls

Audit

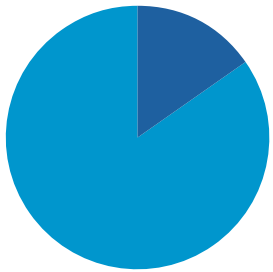
This year, we found that overall there was good reporting on the significant issues that the audit committee had considered relating to financial statements. However, when considering tenure and tendering of external audit the picture was mixed.

Provision 26 of the UK Code states that, an annual report must provide: *'...information on the length of tenure of the current audit firm, when a tender was last conducted and advance notice of any retendering plans'.*

In many cases it was not clear exactly how long the audit partner or firm had been working with the company.

One company had failed to disclose both when the last tender was conducted and the tenure. Twenty-six companies failed to disclose either the date of tender or length of tenure. Four companies had retained the same audit firm for over 20 years, with three of them failing to disclose when the last tender was conducted.

No. of companies not declaring on Tender or Tenure



It is important that companies disclose the date of both tender and tenure as there may be a lag between the tender date and the start of a contract.

Financial Reporting Council

The FRC expects companies to report fully and clearly on both the tender process and tenure for the external auditor.

Principle M *of the Code states: 'The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions and satisfy itself on the integrity of financial and narrative statements.'*

We also took the opportunity to consider how well reports explained how the committee assessed the independence and effectiveness of the external audit process.

Effectiveness of external audit

The reporting ranged from details of the processes undertaken to assesses both independence and effectiveness to boilerplate statements for one of both of the elements. The most common method for assessing a company's effectiveness was the use of a questionnaire, which can be effective but should be supported by other methods. The best quality of reporting set out a clearly outlined process for assessment of effectiveness; this included the types of meetings held, appropriate levels of challenge and regular feedback from committee members and senior management covering the following issues:

- Review and execution of the audit plan, including identified significant risks and monitoring changes in response to new issues or changing circumstances;
- Reviewing the planned audit hours of each component, including hours by audit area and on IT controls;
- Reviewing the audit scope with the lead audit engagement partner to ensure adequate coverage of full-scope audit components over the Group's operations;
- The relevant skills and experience of the audit partner and team and relevant knowledge;
- Formal reports presented to the audit committee.

Twelve per cent of companies did not report on the effectiveness of the external audit, while others offered a generalised statement along the following lines:

'The committee also reviewed effectiveness, which involved assessment of the auditor by the committee and key executives; and confirmation that the auditor meets minimum standards of qualification, independence, expertise, effectiveness, and communication.'

Disclosures should include:

- What actions are taken to do this? Who is involved and what are the outcomes?
- Discussions with who?
- On what matters?
- How often?

Assessment of independence

Eleven per cent of companies gave no explanation of their assessment of the independence of the external auditor. We also found that four companies solely relied on the letter from the auditor that stated they were independent. The letter is a useful document but only one tool to ensure high levels of governance. Other companies included additional checks of independence including:

- Consideration of whether the auditor was exercising an appropriate level of scepticism;
- Evaluation of all the relationships between the external auditors and the Group, including compliance with the Group's policy on the employment of former employees of the external auditors, to determine whether these impaired, or appeared to impair, the auditors' independence;
- Review compliance against the policy on the provision of non-audit services by the external auditors;
- Reviewed details of the non-audit services.

Eight per cent of firms gave no assessment of how non-audit service independence was safeguarded where the external auditor provided non-audit services. Outside of general statements about compliance with the FRC's Ethical Standard, little detail was given. The strongest quality of reporting included:

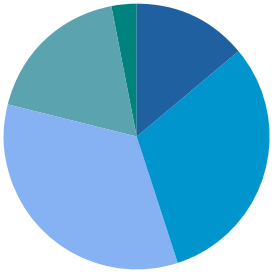
- A review of the effective level of sign-off on non-prohibited audit services above a certain threshold;
- A discussion of the firm's non-audit policy and the approval of any changes to it;
- An assessment of any potential threats to independence or objectivity of the auditor.

In some of the reporting we note above, it may be questionable to what extent committees are meeting their legal obligations in respect of independence.

Risk and internal controls

Risk management procedures

Risk management procedures should demonstrate a company's approach to identifying, assessing and mitigating internal and external risks. The quality of reporting on risk management procedures from companies in our sample was mixed.



- **14** Specific and detailed explanation
- **31** Good level of information, but could be more detailed and/or specific
- **34** Generic or boilerplate information
- **18** Basic and little information
- **3** No information on risk management procedures

Effective reporting should provide detailed and specific explanation of the company's risk governance and processes.

Governance of risk – who and what

The FRC Lab's recent Risks, Uncertainties, Opportunities and Scenarios Report stated that explaining 'who' is responsible for 'what' in the context of risk management is useful to illustrate accountability for, and management of, different risks within a company. The majority of companies provided some level of insight on their governance structures, with 15 providing detailed and specific disclosures. These include, for example (not an exhaustive list):

Who

- The board
- Senior management
- Audit committee
- Other committees (e.g. risk, compliance, sustainability)
- Internal audit

What

- Establish risk appetite
- Review and approve Group policies and procedures to manage risk
- Design and maintain the risk management framework
- Own and manage risk on a day-to-day basis
- Coordinate risk identification, reporting and governance activity

Processes – how and when

While the majority of companies reported on their structures, fewer reported on processes. Simply explaining the risk governance and responsibilities does not give the full picture of how the company manages risk. The FRC Lab's report states that 'understanding who and what is being monitored is only truly useful in the context of how the process is undertaken'. An effective overview of risk procedures came from those companies that, in addition to risk governance, also provided a good explanation of their risk-related processes, for example:

How

- How different groups with risk-related responsibilities interact, discuss and share information between one another
- How the company maintains its risk register, including how it decides to add risks to the register
- How the company conducts risk assessments and reviews
- How different issues and factors are considered when determining risks (e.g. internal or external)
- How the company determines mitigating actions

When

- Frequency of board/committee meetings to discuss risk-related issues
- Frequency of reporting and interaction between each group
- Frequency of risk assessments and reviews
- Frequency of reviewing and amending the risk register

Better reporting came from those companies that, in addition to their overall processes, provided insight of activities during the year; for example, when the board or committees met during the year and what was discussed, or how any new risks were added to the register and so on.

FRC Financial Reporting Council

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

Monitoring risk management and internal control systems

Challenging conditions during the year – COVID-19, along with other external factors – have emphasised the need for effective risk management and internal control systems. Last year demonstrated that risks could emerge quickly and have very serious impacts. It has served as a reminder of the need to regularly monitor risk management and internal control systems to ensure that they are fit for purpose. We are aware that many companies have reformed their risk management systems in response to the COVID-19 pandemic. Some annual reports provided insight into the changes companies made to their systems during the year, with a few companies going even further by explaining their planned actions for the year ahead. However, many companies, while acknowledging the difficulties arising from COVID-19, did not describe any changes they had made or planned to make to adapt their systems.

The annual report should describe any actions taken during the year to improve or change the risk management and internal controls systems. This demonstrates that the board is taking active steps to monitor these. As we have stated before: 'Reporting these changes externally allows investors and stakeholders to gauge how responsive and agile a company can be when facing difficult situations in the future.'

Reviewing the effectiveness of the risk management and internal control systems

Review process

All the companies confirmed that they annually review their risk management and internal controls systems. While most provided some level of insight into how they have done so during the year, 27 companies did not go beyond confirming that the board, or the audit committee, on the board's behalf, had reviewed the effectiveness of their systems. Such confirmation statements are not enough for compliance with the Code, which requires companies to report on that review in the annual report, but also do not provide transparency on board activities to ensure effectiveness of these systems. Reporting should include a detailed description of the whole process that the board or the committee has undertaken to do this.

Outcome of the review

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

Some companies provided simple statements such as 'actions have been or are being taken to remedy any significant failings or weaknesses identified', without explaining the process for reaching such assumptions. Thirty-two other companies, including some of those that provided details of how they reviewed their systems, did not comment on outcomes of the review.

What is missing?

- Stating that 'the board has reviewed the effectiveness of the company's risk management and internal controls systems' but not explaining how.
- Stating the outcome, e.g. 'the board is satisfied that these systems are effective' but not explaining how the review process is carried out.
- Explaining how the review process has been carried out, but not describing the outcome from it.
- Stating that 'weaknesses or inefficiencies were identified', but not explaining what these were and what actions have been or will be taken to address them.
- Stating that 'actions have been taken to remedy any weaknesses or inefficiencies', but not explaining what weaknesses or inefficiencies were identified.

Effective reporting should provide good quality information, not just declaratory statements. It should show investors and others how the board has reviewed and ensured that the company's risk management and internal control systems remain effective and adequate.

Filling the gaps – What should good reporting look like?

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

Key Message:

The COVID-19 pandemic has demonstrated the importance of having robust, resilient and agile risk management and internal control systems. The review of these systems should ensure that they are effective and able to identify and rapidly respond to both short-term and long-term risks and uncertainties.

Risk appetite

Our monitoring found a lack of explanation of how the board determines the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives. The majority of the companies confirmed the board's responsibility for setting the risk appetite of the company; however, many of them did not provide any further discussion.

In addition to how the board sets the risk appetite, the annual report should also provide an overview of how this applies to different risk categories. A few companies explained the level of tolerance they have for certain categories; for example, risks related to strategy, operations, or regulation.

Example

Our risk appetite has been defined and agreed by the Board and helps frame decision-making in determining how best to manage each of our principal risks. Our summary risk appetite in relation to different categories of risk is outlined below:

- Operational – The company has a low appetite for taking risks that may result to significant disruption of the company's operations. We will carefully evaluate the level of operational risk we are prepared to take. We seek to minimise the risks from unforeseen operational failures in both our business and our service providers and have suitable mechanisms in place to identify issues and take necessary actions to minimise losses.

Better reporting came from those companies that explained the extent of tolerance they have for each of its principal risks. This demonstrates that the company has a complete understanding of its risk appetite and the extent of risk it can absorb while pursuing its objectives. It also provides investors with a better insight into how principal risks affect a company's operations and strategy.

Example

Principal risk – credit risk
The Company has a moderate appetite for credit risk. As part of our strategic priorities we are rebalancing our lending mix, increasing the proportion of unsecured lending, which will lead to an increased level of credit risk. Our tolerance for credit loss has been set within our ability to meet our capital requirements, but also reflects the increased level of risks associated with COVID-19. Our metrics, and how we monitor them, will allow for informed decisions and meaningful risk management action to take place to ensure our capital and other resources are adequate in order to achieve our long-term strategic objectives.

FRC Financial Reporting Council

The FRC expects companies to explain:

1) the process of how the board has determined the company's risk appetite; and
2) the risk appetite for each of the company's principal risks.

Principal risks

Risk description and mitigating actions
All companies provided a description of their principal risks and corresponding mitigating actions. We state in our Guidance on Risk Management that 'the descriptions of the principal risks and uncertainties should be sufficiently specific that a shareholder can understand why they are important to the company'. We were pleased to see that many companies provided specific descriptions from which it was clear why those risks were considered material to the company, as well as providing detailed explanations of their mitigating actions.

Impact and likelihood
The Code states that, when determining their principal risks, companies should consider the potential impact and probability of the related events or circumstances. When describing their principal risks, companies should refer to the potential impact that each of those risks could have on the company's business and operations and the likelihood of occurring.

Sixty-seven companies indicated the impact that their principal risks have on their business and operations, with some of them giving specific explanations. While we are pleased that companies referred to the impact of principal risks, many companies simply provided shortcut words or symbols, for example stating that the impact was high, low or medium – without explanation of the meaning and/or impact of being rated at one of the levels. Better and more meaningful reporting came from those companies that explained clearly how the risks would potentially impact them.

Many companies also provided heat maps that gave a concise picture of all the principal risks identified by the company in terms of both impact and likelihood.

Developments during the year
When reporting on principal risks, companies should disclose any developments during the year, such as events that took place, changes in the macroeconomic environment or changes in financial figures (e.g. an increase in borrowing). Many companies provided some information on developments during the year, particularly those related to COVID-19. Describing recent events or activities in the annual report demonstrates that the company is consistently monitoring and assessing principal risks, as well as providing a wider insight into how each risk could affect the company.

If a principal risk was on the company's risk register in the previous year, the annual report should explain what happened during the year and how or whether this risk had changed from the previous one. Some companies indicated how their risks had changed from the previous year using symbols, for example using arrows such as in the figure below. We found that providing arrows to demonstrate changes in risk, without further explanation, is not very helpful and does not allow users to understand how and why the risk, its impact and likelihood had changed.

Better reporting came from those companies that explained specifically not only developments during the year, but also how the risk (e.g. impact, likelihood) had changed from the previous year. If any principal risk was removed from the register, the annual report should explain what caused this.

Example

Explaining developments during the reporting year and changes from previous year

1. What happened during the year?
   There was a change of currency during the year with the dollar strengthening against some of the company's main trading currencies, causing losses on translation.

2. What changed from the previous year?
   There has been a greater level of volatility in dollar exchange rates against the company's main trading currencies during the financial year, caused in part by the impact of the COVID-19 pandemic and by continued uncertainty related to the EU exit.

We were also pleased to see that some companies explained steps undertaken during the year to mitigate their principal risks, with a few companies going even further to explain any planned actions for the future. Disclosing actual mitigating actions undertaken during the year shows that companies are not just using boilerplate statements but are actually taking active steps to manage risks.

Example

Information and IT risk Mitigation actions in 2020

- Created the position of chief information security officer to strengthen IT security controls
- IT system, cyber and end-user security controls improved to ensure employees had the capability to work from home during the pandemic, while minimising security, unauthorised access, and data leakage risks

Future actions

- Improve IT security structure, process and procedures
- Monitor and improve information security controls to reduce the risk of data leakage or unauthorised access
- Implement new tooling to help increase data security and reduce the possibility of data leakage
- Implement additional security controls for end-user computing devices to reduce the possibility of ransomware or virus attacks
- Enhance security over corporate domains and cloud governance to reduce risk of unauthorised access and data loss

Link to strategy

Good reporting on principal risks should provide a link to the strategy of the company. We were pleased to see that 64 companies indicated in some way how their principal risks were linked to their strategy. Nevertheless, many of those companies did this by simply providing symbols that cross-reference to boilerplate words such as below.

Link to strategy 1. Innovation | 2. Growth | 3. Efficiency

This does not give much insight, unless those words are given specific meaning within the strategy or business plan to show how the principal risk is linked to the business strategy and how it affects it. A better way to demonstrate links to strategy came from those companies that either cross-referenced to the company's KPIs in the strategic report or explained this link in the description of risks.

Effective reporting of principal risks

- Provide a specific and detailed description of principal risks
- Explain the potential impact
- Indicate the likelihood of the risk occurring
- Describe any developments during the reporting year
- Explain any changes from the previous year, including what caused the change
- Explain how risks are linked to the strategy of the company
- Explain the risk tolerance that the company has for each of the risks
- Provide a specific and detailed description of mitigating actions, including any activities undertaken during the year and/or planned ahead

Emerging risks

Twenty-six companies did not confirm explicitly that the board had carried out an assessment of their emerging risks during the reporting year. While the majority of these companies stated that they regularly or annually reviewed emerging risks, it was not clear if they had done so during the reporting year. To comply with the Code, companies should confirm that such assessment has been carried out during the reporting year. This could include horizon-scanning activities or consideration of risks that are emerging in new markets.

The Code then requires companies to disclose in the annual report, 'What procedures are in place to identify emerging risks, and an explanation of how these are being managed or mitigated'. Companies should have procedures in place to monitor risks whose nature is uncertain and are difficult to predict and quantify in terms of impact and likelihood. The COVID-19 pandemic is a prime example of the importance of being prepared for all eventualities. It demonstrates the necessity of having procedures in place to identify and mitigate emerging risks before they turn into principal risks. Companies should explain these procedures in the annual report, as a separate section or a sub-section to its general risk management procedures.

It is possible that following an assessment, no new emerging risks may be identified. However, if there are, it is helpful to describe these in the annual report. While the nature of emerging risks is more uncertain and unpredictable, companies should aim to provide the same level of detail as they do for their principal risks.

Key Message:

Companies should ensure that procedures are in place to identify and mitigate emerging risks before they materialise.

E. Remuneration

Most companies have remuneration structures for executive directors that are typically made up of base salaries, benefits, pensions, and variable remuneration usually split into an annual bonus and a long-term incentive plan (LTIP) that are subject to achievement of specific performance metrics. Companies seem to generally favour the use of financial metrics for their LTIPs. On the other hand, annual bonuses are more varied and usually involve a mix of both financial measures, such as profit, sales or cashflow, as well as non-financial strategic or sustainable measures, such as delivery of special projects (e.g. digitalisation, takeover, increase in innovation, etc), customer satisfaction, employee engagement, environment, and so on.

***Principle P**. 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*

Strategy

In line with Principle P, remuneration committees should focus on the link between remuneration and strategy. The choice of performance metrics is crucial to this and should be explained clearly in the remuneration report. All companies stated that their remuneration structures support their company's strategy. However, only 44 provided an explanation of how their chosen performance measures for annual bonuses and/or LTIPs supported their strategy, and only six provided specific information.

The annual report should explain the rationale for each performance metric, weighing and target achievement, referring to the company's strategy and KPIs. Investors and others should be able to understand why a chosen metric is important and how it benefits the company.

Example

One company explained how having a cash flow metric included in the LTIP motivates longer-term cash flow generation and balance sheet strength. It also signposted to the strategic report, where cash flow is described as one of company's KPIs.

We were pleased to see that a few companies linked their remuneration performance metrics directly to their KPIs reported in the strategic report, and we urge other companies to consider doing so as it demonstrates a direct link between their strategy and chosen metrics.

Eighty companies used non-financial performance metrics that support specific strategic and sustainable objectives. While 30 companies explained these well, 18 gave a one-line statement, such as 'customer satisfaction' or 'employee engagement', without explaining what these entail. A good description of non-financial performance metrics should explain not only the strategic rationale, but also performance conditions.

An example of better reporting is set out below.

Example

One company explained how 'customer satisfaction' was used as a performance metric in order to increase the quality of service. They then explained how this metric could be achieved, setting out and explaining the performance targets such as an increase in the Net Promoter Score and a reduction in the number of customer complaints.

We recognise that companies will sometimes use performance metrics that they consider too commercially sensitive to disclose in the report. However, they should still explain how these support the company's strategy, as well as performance conditions and assessment, following the period of measurement and achievement.

Key Message:

Reporting should assure investors that the chosen performance metrics incentivise executives to pursue the company's strategic objectives.

Long-term strategy and sustainable success

While many companies stated that their remuneration was aligned to long-term investors' interests, fewer companies stated that it was linked to the successful delivery of the company's long-term strategy, and very few explained how.

We found most companies are using total shareholder return (TSR) and earnings per share (EPS) as performance metrics for their LTIPs, as well as many of them using return on capital employed (ROCE) and return on invested capital ROIC. However, we found it difficult to find examples of companies linking these measures to their long-term strategy.

Only 21 companies had non-financial metrics in their LTIPs. We were surprised that only five companies had environmental or social performance metrics, particularly considering that many of them discussed in detail environmental and social issues as part of their strategy, and the high number of companies that disclosed climate change as a principal or emerging risk.

Key Message:

While equity-based metrics may effectively align the interests of executives with those of the shareholders, remuneration committees should consider including long-term strategic objectives, as well as environmental and sustainability performance metrics on their LTIPs.

Remuneration structures, particularly long-term elements, should promote long-term sustainable success, which in addition to company's profits and shareholder value should also consider impact on wider stakeholders. A mix of financial and non-financial performance metrics support the financial, strategic and sustainable objectives of the company.

FRC Financial Reporting Council

The FRC expects companies to explain in their annual reports how their chosen performance metrics:

- support company's strategic objectives;
- are linked to the successful delivery of long-term strategy;
- promote long-term sustainable success.

Alignment with purpose and values

We were disappointed with the quality of reporting about alignment of executive remuneration with a company's purpose and values. Only 33 companies referred to this, with the majority of these companies simply providing a declaratory statement to confirm alignment. (see examples below). This type of statement does not explain how it is designed to do this and what the benefits will be.

Example

Our remuneration framework has been designed to support our values and purpose.

Incentive schemes are constantly reviewed to ensure they remain consistent with company's purpose and values.

Companies should provide specific explanations, by referring directly to the company's purpose and values. For example, if a company's purpose includes to 'provide new, innovative products', the annual report should explain how remuneration is linked to this purpose, such as having performance measures that incentivise innovation and a new range of products. If one of a company's values is related to safety, it should explain how remuneration promotes the safety of employees; for example, having health and safety, wellbeing or other relevant performance metrics as part of the bonus or LTIP.

FRC Financial Reporting Council

The FRC expects companies to improve reporting on how remuneration is aligned to company's purpose and values.

Remuneration structures

Most companies rely on benchmarking market practices and remuneration consultants in designing their pay structures. Many annual reports specifically state that the reason certain elements or provisions are included in their remuneration policy is to follow certain market practices. Our Guidance on Board Effectiveness emphasises the importance of avoiding designing pay structures based solely on benchmarking to the market, or the advice of consultants, and that there must be a strong and clear relationship between remuneration and performance.

Discretion

Discretionary powers of the remuneration committee

In last year's review, we emphasised the importance of explaining the remuneration committee's discretionary powers in the annual report. We were pleased to see that most companies specified in their annual reports instances when the remuneration committee could exercise its discretion, and nearly 40% provided specific and detailed descriptions. Nevertheless, we also found six companies that did not explain these at all.
We expect all companies to describe their remuneration committee's discretionary powers in each annual report. Investors and other stakeholders need to understand under what circumstances executive remuneration could be altered and be assured that the final remuneration outcomes are appropriate.

Use of discretion by the remuneration committee

We found 51 companies whose remuneration committee had used its discretionary powers to cancel or reduce the amount of bonus or LTIP awarded, despite the performance targets being partially or fully met. With few exceptions, the reason for use of discretion was due to the impact of COVID-19.

We were pleased to see that the majority of the companies explained well how and why the remuneration committee did or did not use its discretionary powers during the year.

The best reports explained company performance, the impact of COVID-19 upon shareholders, the workforce and other stakeholders, as well as executives' performance during the period. They also stated whether the performance metrics for the bonus or LTIP had been achieved. They then explained how all these factors balanced out and whether any bonuses or long-term incentives were warranted to be paid, taking account of company and individual performance, and wider circumstances.

The best explanations included not only those where discretion was used to account for the impact from COVID-19, but also some that explained well why the committee did not see it necessary to use its discretionary powers. We are pleased to see that many remuneration committees are utilising their discretionary powers effectively and explaining these in the annual report.

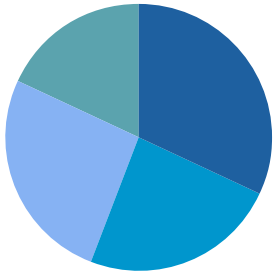
However, a few companies took a different approach, awarding partial or full annual bonuses (despite the company cancelling dividends, furloughing workforce or making redundancies) without further explanation of how they had considered company performance, or shareholder and workforce experience. Principle P of the Code states that when determining remuneration outcomes, the remuneration committee should take into account company and individual performance, and wider circumstances. Companies are expected to consider all factors when determining final pay outcomes and explain them in the annual report.

FRC Financial Reporting Council

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

Provision 40

In last year's report, we stated that we expect to see clear descriptions of how each element of the Provision 40 has been accounted for when determining the remuneration policy. We were pleased to see that reporting in this area has somewhat improved, with more companies than last year reporting on how they addressed these elements. Nevertheless, we found that many companies have provided either brief or generic information. See pie chart below:



- **32** Did not address the elements of Provision 40
- **24** Briefly explained
- **26** Explained in more detail, but still generic and/or boilerplate
- **18** Gave specific examples

Companies should provide specific descriptions, which should include examples, of how the remuneration committee has addressed these factors, see example below:

Example

Clarity (first point of Provision 40)

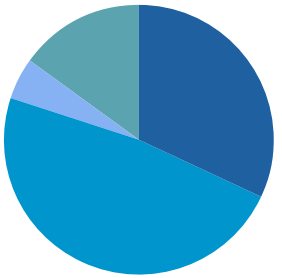
- The committee ensured clarity by explaining how the remuneration structure and performance metrics supported the company's strategy and aligned with purpose and values in the remuneration policy section of the report.
- Remuneration arrangements were transparent because the nature and weighting of executive directors' annual bonus targets and LTIP performance measures were disclosed in advance in the previous year's annual report.
- During the year the remuneration committee engaged with both shareholders and the workforce to discuss remuneration policy and took their views into account, as stated in the remuneration policy section of the report.

Companies are expected to give similar examples for each of the factors in Provision 40: clarity, simplicity, risk, predictability, proportionality and alignment to culture.

Pensions

In last year's report, we emphasised the importance of aligning executive pensions with those of the workforce. We outlined our expectation for companies to align pensions as soon as possible, and for those that had not yet done so to provide a clear and specific rationale and define a timeline by when this would be rectified.

We were disappointed to see that reporting in this area has not improved significantly, despite our expectations in last year's review and our **Improving the quality of 'comply or explain' reporting** report.



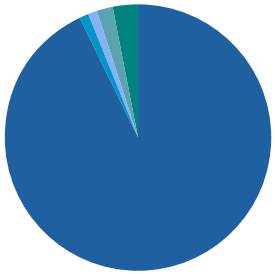
- **32** Companies have aligned their pensions
- **48** Companies stated when these would be aligned
- **5** Stated that they will in the future, but gave no indicative timetable
- **15** Did not report on this

There does not appear to be a significant change in the percentage of companies that have aligned their pensions. We were disappointed to see that 15 companies did not state anything about aligning their pension contributions with the workforce, whereas five others stated that they would do so at some point in the future but did not provide a specific timeline.

We were also disappointed to see that only three companies in our sample gave an explanation for why their pensions are not aligned yet, despite the FRC advising companies to do so in two separate reports released in the past 12 months. Our expectations for reporting in this area have not changed.

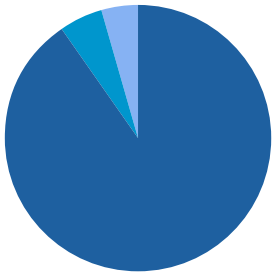
Recover and withdraw provisions (Malus/clawbacks)

All the companies in our sample, with few exceptions, reported the inclusion of recover and/or withhold provisions in their remuneration policies. We found no instance of companies using such provisions during the year.



- **93** Companies – both malus and clawback provisions
- **1** Only malus provisions
- **1** Only clawback provisions
- **2** No malus or clawback provisions
- **3** Did not state

Of the 95 companies which had either malus, clawback, or both provisions, we considered whether these applied to the bonus, LTIP or both.



- **86** Companies – provisions for both bonus and LTIP
- **5** Provisions only for bonus
- **4** Provisions only for LTIP

Twenty-five companies did not specify the circumstances under which recover or withhold provisions apply. One of the companies signposted to its 2019 annual report for details on these provisions, whereas another one pointed to the full remuneration policy on its website. Companies should be transparent and clearly disclose in their annual report the circumstances when recover and withhold provisions apply. Investors and others should be able to easily understand the circumstances under which directors would be held accountable for certain actions and/or would not be awarded unwarranted remuneration.

The most common circumstances specified by the companies in our sample (not a definitive list):

Circumstance	Number of companies	% of those disclosing circumstances
Material misstatement in the company's accounts	69	99%
Misconduct (including fraud)	64	91%
Payment based on an error, inaccurate or misleading information	58	83%
Reputational damage	53	76%
Corporate Failure	31	44%
Failure of risk management	24	34%
Financial loss/deterioration	16	23%
Breach of health and safety standards/regulations	6	9%
Contravention of company values	4	6%
Other	27	39%

These are similar to those circumstances specified by the Government's consultation paper, Restoring trust in audit and corporate governance, with the exception of the final one below.

- Material misstatement of results or an error in performance calculations
- Material failure of risk management and internal controls
- Misconduct
- Conduct leading to financial loss
- Reputational damage
- Unreasonable failure to protect the interests of employees and customers

Companies may wish to consider adding as a circumstance for the use of malus and/or clawback provisions unexpected events out of company's control which could significantly affect the company, its shareholders, its workforce and other material stakeholders (such as the COVID-19 pandemic).

5. Conclusion

This report, like last year, identified areas where governance reporting can be improved. Disappointingly, there are a number of areas where the same issues persist.

Last year we said that we would look more closely at how directors are discharging their s.172 duties – the quality of stakeholder engagements and the extent to which they have informed board decisions. This year we have commented on the improved reporting across stakeholder engagement. However, there is still room for improvement in relation to suppliers, communities and modern slavery reporting.

The improved reporting is welcomed; however, as with almost all areas of reporting assessed there is room for improved disclosure on impact and outcomes. Only when companies assess the effectiveness of their governance can real improvements be made, taking account of the wide range of stakeholders who are impacted by companies.

We were pleased to see that environment and climate issues are being integrated into board decisions. As new regulations come into effect we expect companies to improve governance of these matters and explain how they impact strategy and financial planning.

This year we saw more reporting of non-compliance against specific Provisions of the Code – we welcome the move away from treating the Code as a compliance exercise. Next year we would like to see a similar improvement in explanations, with more information about the reason for departures along with any support offered by shareholders.

Nominations committees appear to receive less focus within the annual report than audit or remuneration committees. We would like to draw attention to their importance as their work is central to ensuring that the board is adequately resources and effective.

Unfortunately, the reporting by these committees on board effectiveness, succession planning and diversity is often process-driven and ambiguous in terms of targets and achievements, with little detail of long-term plans. Next year we will be looking for improved quality of reporting.

With the recent announcement of investor signatories to the UK Stewardship Code, in next year's annual reports we look forward to improvements in the quality of disclosures from companies about their engagement with investors, especially following votes against resolutions and issues material to the sustainable success of the company.

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