Financial Reporting Council

ANNUAL REVIEW OF THE UK CORPORATE GOVERNANCE CODE

JANUARY 2020

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Executive Summary

This report has two purposes: to give an assessment of corporate governance in the UK by considering the quality of reporting against the 2016 UK Corporate Governance Code (2016 Code); and to comment on any 'early adoption' by FTSE 100 companies of the 2018 UK Corporate Governance Code (2018 Code). In commenting on 'early adoption', the FRC sets out its expectations for companies reporting on the 2018 Code.

There were a number of factors that informed our review of corporate governance during 2017-18 which resulted in the 2018 Code. These included: a continuing lack of trust in business, high profile corporate failures, lingering concerns that companies gave little thought to long-term sustainability; and, more generally, the impact of companies on wider society.

The past few years have seen a continuing debate about the purpose of capital markets and the role of companies and investors in solving – as opposed to contributing to – economic, environmental, and societal problems. The FRC has actively led and participated in that debate, made substantial changes to the UK Corporate Governance Code, the UK Stewardship Code, and introduced new principles of corporate governance for large private companies (the Wates Principles). These changes broaden the scope of governance and stewardship, and in particular address how the actors in capital markets interact with a wider set of stakeholders to deliver sustainable value and benefit the economy, environment and wider society.

We found that while the need for this broader approach is generally accepted, reporting on its practical aspects needs much further development to demonstrate its effectiveness. We wish to see a much greater focus on the activities and outcomes of implementing the Principles of the 2018 Code, particularly on the board's effectiveness and decision-making, and how this has led to sustainable benefits for shareholders and wider stakeholders.

Continued corporate failures also raise concerns around board effectiveness in considering and reporting on risks to their long-term sustainability. In light of this, we will be reviewing our *Guidance on Risk Management, Internal Controls and Related Financial and Business Reporting*.

It became apparent during our review that many companies simply concentrated on achieving strict compliance with the Provisions, and that this approach gave little insight into governance practices. The majority of companies declared themselves fully Code compliant; however, many annual reports lacked information on the outcomes of governance policies and practices, including any areas for future improvement.

The 2018 Code reaffirms the importance of applying the Principles in a manner that shareholders can evaluate.[1] Effectively applying the Principles is much more valuable than a 'tick box' approach. It requires demonstrating the actions a company has taken and how these link to their strategy and purpose. The language used in the 2018 Code supports this. There are many instances where companies are asked to explain the impact of their actions, such as in relation to stakeholder and employee engagement, and progress against diversity outcomes.

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1 See LR 9.8.6, Listing Rules Handbook, Financial Conduct Authority

The Code has always offered companies the ability to explain because we recognise that all companies are different, and it is not always suitable or appropriate for a company to comply with a Provision. Companies should think carefully about simply stating that they comply with the Provisions, and instead provide examples that would offer a clearer insight into their governance practices. Distinctive reporting of a high quality has an important role to play in both differentiating the approaches companies take and providing confidence to investors.

We welcome the efforts made by companies who reported against a number of new 2018 Code Provisions in order to prepare the ground for the coming year. We were pleased to see that there were pockets of good reporting against the 2018 Code. However, there is significant room for improvement in 2020.

Reporting against the 2016 Code

Although the focus of future reporting now moves to the 2018 Code, our review of compliance with the 2016 Code found that the overall quality of reporting is unchanged. However, there are areas of reporting where improvements identified will still be relevant under the 2018 Code: in the disclosure of explanations and reporting of actions taken when there has been a significant vote against AGM resolutions (20% and above).

Early adoption of the 2018 Code

A new Code was published in July 2018 and applies to premium listed companies for accounting years beginning on or after 1 January 2019. Therefore, reporting will be part of the annual reports published in 2020. However, many listed companies noted in their annual reports published in 2019 the actions that they were planning to take in preparation for full reporting. In some cases, they stated early adoption of some elements of the 2018 Code.

The FRC has examined the annual reports of FTSE 100 companies with December 2018 and March 2019 year ends, which covers 82 entities. Almost all acknowledged the new Code, and many welcomed the changes made. Some aspects of the 2018 Code have caused companies to consider what actions they need to take to ensure that they have processes in place to both apply the Principles and report against the Provisions.

In relation to early adoption of the 2018 Code, the quality of reporting was mixed. Corporate culture and workforce engagement were the most frequently discussed areas. We also noted that many companies would be proposing new remuneration policies to their 2020 AGMs. Therefore, the 2018 Code changes to remuneration committee oversight will become evident in this year's reports.

We have focused on the FTSE 100 as they have traditionally been early Code adopters. For the FTSE 250, we have considered the findings from other reviews published this year and are pleased to note that on the whole, these companies have also engaged positively with the changes to the 2018 Code.

We did not consider the application of the Principles in our review of this year's reports, but will do so when looking at the reports published this year.

This review of early adoption has been complemented by work carried out by the FRC's Financial Reporting Lab (the Lab) about how companies might meet the needs of investors on the reporting of workforce-related issues. The Lab's findings will be published shortly.

2016 Code Compliance

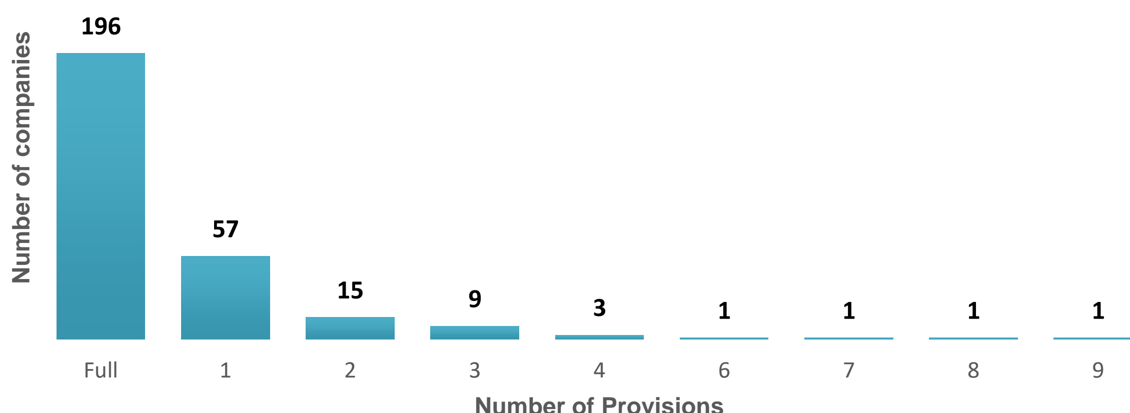
This section of the report covers the application of the 2016 edition of the UK Corporate Governance Code over the last year and provides an assessment of the quality of reporting on corporate governance. Details on early adoption of the key Principles and Provisions in the 2018 Code are covered in the next section.

Full strict compliance has never been the aim, nor has it reflected the spirit, of the Code due to the 'comply or explain' approach on the Provisions. Detailed and comprehensive explanations offer the reader a greater insight into how the company operates. We view good quality explanations as an effective way to achieve compliance with the Code.

Overall compliance rates

We have reviewed a selection of third-party research on the 2016 Code, all of which excludes investment trust companies as they are able to follow the AIC Code of Corporate Governance. Grant Thornton's annual survey found that declared compliance with the 2016 Code remains high. Of the 288 non-investment companies reviewed, 73% claim full compliance, and 95% report that they were either complying with all, or all but one or two, of its 54 Provisions.[2] These figures are consistent with last year. Table A shows both the number of companies who declare full compliance and those who depart from the Code, by number of Provisions.

Table A: Compliance with the Provisions of the 2016 Code



Source: Practical Law What's Market database. Data as at 31 October 2019.

Table B lists the top ten areas of explanations for the 2016 Code. This year, Provision B.1.2 (at least half the board, excluding the chair, should be independent) and A.3.1 (where the chair did not, on appointment, meet the independence criteria set out in the Code or where the CEO goes on to be chair) were the Provisions least complied with. The FRC's assessment of the quality of the explanations given is discussed below.

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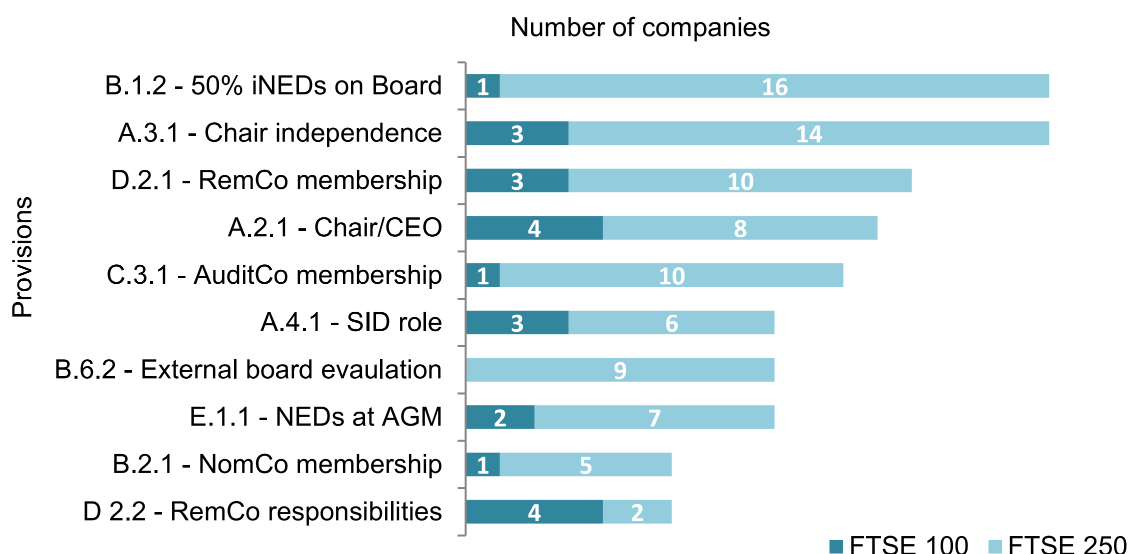
2 Corporate Governance Review 2019; Grant Thornton; November 2019.

Table B: Top ten areas of non-compliance with the 2016 Code requiring explanation, as reported by FTSE 350 companies in their 2018/2019 annual report



Source: Practical Law What's Market database. Data as at 31 October 2019.

Data compiled by Minerva Analytics on behalf of the FRC shows that, with respect to board and committee composition, compliance levels among companies on the FTSE Small Cap and Fledgling indices remain on par with those of larger companies.[3]

Table C: Compliance with selected Provisions of the UK Corporate Governance Code

Code Provision	FTSE 350 companies		Smaller companies	
	2019	2018	2019	2018
A.2.1 – Separate chairman and CEO	99%	99%	99%	99%
B.1.2 – Met minimum provisions for number of independent NEDs	96%	97%	86%	90%
B.2.1 – Met minimum provisions for nomination committee composition	99%	99%	96%	97%
C.3.1 – Met minimum provisions for audit committee composition	97%	98%	95%	93%
D.2.1 – Met minimum provisions for remuneration committee composition	95%	97%	89%	87%

Source: Minerva Analytics (date range 1 August 2018 – 31 August 2019)

Note: The 2016 Code has different requirements for FTSE 350 and smaller companies regarding the minimum number of independent directors and minimum requirements for board and committee composition

Explanations

Given that the principle of 'comply or explain' provides flexibility for companies to depart from a Provision, it is important that a clear explanation is provided so that shareholders can assess whether they are content with the governance arrangements that the company has put in place.

[3] Minerva Analytics looked at a sample of 342 from the FTSE 350 Index, 265 from the Small Cap Index, and 8 from the Fledgling Index.

The 2016 Code contains guidance on 'comply or explain', which describes the features of a meaningful explanation. This is to provide a benchmark for companies when providing explanations and for shareholders when assessing them. An explanation should set out the background, provide a clear rationale for the action being taken, and describe any mitigating activities. In addition, where departure from a Provision is intended to be limited in time, an explanation should indicate when this is expected to end.

Investors agree with our view that a company is compliant if it chooses to depart from one or more Provisions, but **only** where ample explanation is provided. These best practice explanations include company specific context, historical background, and information on what mitigating actions have been taken to address any additional risk. It is important that the company explains how its alternative approach is consistent with the spirit of the Provision it is departing from and whether it is time limited. Explanations should be sufficiently clear to be convincing and understandable to all shareholders without the need to contact the company.

We have reviewed in detail the explanations for the following 2016 Code Provisions: A.2.1 – where the roles of the chair and CEO have been combined; A.3.1 – where the chairman is not independent on appointment or they were previously the company's CEO, and B.1.2 – where less than half the board, excluding the chair, comprises of independent non-executive directors. We expect companies to take note of our views on these for future reporting.

Explanations where companies have a combined chair and CEO (A.2.1)

There are 12 companies in the FTSE 350 with one individual as both chair and CEO. In eight cases, this was explained as a temporary arrangement, with the majority of cases arising from one of the roles becoming vacant sooner than expected. An effective example of disclosure was provided by a company that had a three-month gap between the CEO leaving and the new one joining, so the roles were merged. Although a temporary measure, the company recognised the importance of having robust governance arrangements and revised the framework of delegated authorities during this interim period to ensure that no individual had unfettered powers of decision-making.

There were four companies where the combination of the two roles was open-ended, i.e. no time limit was mentioned in their explanations. Of these, two failed to offer any obvious rationale or mitigating arrangements. The other two were better as they did provide details on how various mitigations had been put in place to ensure that the lack of separation of responsibilities was either overseen or that some aspects were carried out by others.

Explanations where the chair did not, on appointment, meet the independence criteria set out in the Code or where the CEO goes on to be chair (A.3.1)

There were 17 FTSE 350 companies that provided an explanation in relation to this Provision. The majority of those related to the chair not being independent on appointment (consistent with the criteria in Provision B.1.1). However, there were also instances of a chief executive who had gone on to become chair. Neither situation is considered best practice by the Code. Poorer quality explanations simply repeated the Code Provision and did not disclose why this arrangement was considered acceptable by the company.

The better explanations were informative about why the situation had occurred, and particularly included commentary on mitigating actions. These included: strengthening the role of the deputy chair and/or senior independent director, an indication that major shareholders had either been met ahead of the board changes, and/or that regular engagement had continued to ensure they were still comfortable with the situation.

Explanations where less than half the board, excluding the chair, comprises independent non-executive directors (B.1.2)

All but two of the 17 companies came from the FTSE 250, and there were four who were newly listed. 12 have since returned to full compliance with this Provision.

The overall quality of explanations here was average or poor, with the latter examples coming mainly from those who have continued to not comply with this Provision for many years. It is unsatisfactory that these companies do not offer an insight into why their board is effective and whether their shareholders are supportive. Explanations offer a unique opportunity to demonstrate why non-compliance is right for that company.

It is equally concerning that the most common reason given was the loss of a director, often at relatively short notice, which led to an imbalance of the board. This points to a need for improvements in succession planning so that the time taken to replace a director can be kept to a minimum. In such cases, companies should as part of their explanation cross-refer to an effective succession plan.

The few better-quality explanations gave more information on the rationale for the balance of the board and explained that the board had considered how the current composition was still able to help support the company.

Relations with shareholders

The 2016 Code includes (in Provision E.2.2) the need for companies to explain, when publishing meeting results, how they intend to engage with shareholders when a significant percentage of them have voted against a resolution. The purpose is to encourage companies to describe the process they will take to assess the concerns of shareholders while setting out how they intend to respond to those concerns, albeit reporting on these may occur at different times. The 2018 Code defines ‘significant’ as 20% or more.

Since this Provision was first introduced in 2014, the Investment Association (the IA) has started hosting (from December 2017) a Public Register of votes against of 20% or more. Using this data, Table D shows the voting results for the AGMs held in 2019 which had significant shareholder opposition of 20% or more. 2019 has been a quieter AGM season for the FTSE 350, with fewer high dissent resolutions and fewer defeated resolutions. Despite a quieter AGM season, executive pay and director elections remain areas of investor focus.

Table D: Significant Minority Voting at FTSE 350 AGMs

Resolution Type	Number of resolutions with 20%+ votes against	
	2019	*2018*
Audit & Reporting	2	1
Director Elections	31	56
Issue of Shares & Pre-emption Rights	18	23
Remuneration – Policy	8	22
Remuneration – Report	30	32
Shareholder Rights	1	8
Political Activity	3	2
TOTALS	**93**	**144**

Source: The IA Public Register and Minerva Analytics; Date range 1 January to 30 September 2019

These 93 resolutions relate to 57 companies, and all have at least indicated in their AGM results that they have received a significant vote against. However, we are concerned that there are several 'repeat offenders' – companies who appeared on the Public Register for two consecutive years. The bulk of resolutions are remuneration related; of the companies at which shareholders expressed concerns over remuneration in 2019, nine were on the list the previous year. This suggests these companies have not responded effectively to shareholder concerns.

Given the need for companies to be more transparent about the actions they have taken to engage with shareholders, we expect improvements over the coming year in relation to the increased disclosure required by 2018 Code's Provision 4, i.e. providing an update six months after the shareholder meeting. The annual report should then provide a final summary on the impact the feedback has had on the decisions the board has taken and any actions or resolutions now proposed.

In 2019, five resolutions proposed by management were defeated, and 16 were withdrawn; this compares to 10 defeated resolutions and 12 withdrawn resolutions in 2018. The defeated resolutions consisted of three share issue authorities, one authority to call a general meeting with not less than 14 days' notice, and one remuneration report.

Both versions of the Code require that only votes against a resolution are counted. Nevertheless, we are aware that some investors see a purposeful 'abstain' as a valid way to signal dissent to a resolution, which if disregarded will likely lead to a vote against the following year. Based on Minerva Analytics' dissent voting data, resolutions on director elections and remuneration still dominate. The GC100 and Investor Group's remuneration reporting guidance suggests companies consider viewing abstentions in combination with votes against as an indication of a low level of support that the company may wish to comment on and address. The FRC expects companies to view all types of votes (including abstentions) when considering whether there has been any significant minority dissent to a resolution, thereby allowing them to engage with shareholders appropriately.

Risk management and internal control

Since 2014 companies have been expected to consider how solvency, liquidity, or other risks may impact the long-term viability of the business. In identifying the risks and uncertainties a company faces, directors should consider a range of factors. These include operational and financial considerations and risks in the broader environment in which it operates, such as cyber security and climate change.

Most FTSE 350 companies identified risks and showed how these had changed from the previous year. Not all companies explained the reason for the change, nor did they express how risks were mitigated. PwC's review stated that while, '77% of companies indicated how each risk had moved in the year, only 27% indicated whether any principal risk had been introduced or removed during the most recent assessment, but others may have changed without explaining they have done so'.[4]

Brexit remained a risk for almost all companies, and cyber security/attacks continued to be a matter of concern for many. While there was evidence that companies are linking risk to their strategy, companies should provide additional explanations of the impact of all risks being realised on future strategy.

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[4] Annual Review of Corporate Reporting in the FTSE 350 2018/19, PwC, July 2019

Companies should assess their prospects and the resilience of the business model over a longer period – this is often referred to as the viability statement. Since the introduction of this Provision in 2014, reporting against it has not produced the future insights we envisaged.

Most companies consider viability over a three-year period, often in line with their business planning cycle. Following a project on *Risk and Viability Reporting* by the Lab, we expected more companies to follow the two stage approach this report recommended. Companies should consider and report on their longer-term prospects, taking into account the company's current position and principal risks, and **then** state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their viability assessment.

There was an increase in companies that used scenario analysis and testing to support their viability statements. This type of analysis offers companies the opportunity to consider different mitigating activities in response to key risks. Grant Thornton found that, '44% of the FTSE 350 give little insight into how they assess long-term viability, including scenarios considered, and how these link back to principal risks'.

It is unsatisfactory that reporting of viability has not improved and we strongly suggest that companies take time to consider the Lab report to assist future reporting.

Both reviews by Sir John Kingman and Sir Donald Brydon made recommendations[5] in relation to the viability statement. Work is ongoing on the former, which will include updating our *Guidance on Risk Management, Internal Controls and Related Financial and Business Reporting*, and will now include consideration of the recently published Brydon review.

[5] Sir John Kingman recommended that, *'viability statements should be reviewed and reformed with a view to making them more effective. If they cannot be made more effective, serious consideration should be given to abolishing them'*. Sir Donald Brydon recommended, *'that the board should make a Resilience Statement that incorporates, enhances and builds on the current Going Concern and Viability Statements'*.

Early Adoption of the 2018 Code

The 2018 Code gives companies the ability to consider how they have applied the Code, and whether a simple statement of compliance provides the information that investors and stakeholders need to evaluate the quality of governance. Therefore, when reporting against the 2018 Code, companies should offer more insight into the impact and outcomes their governance has had on their long-term success.

Purpose

Principle B of the 2018 Code states that, 'the board should establish the company's purpose, values, and strategy, and satisfy itself that these and its culture are aligned'.

Around half of our sampled FTSE 100 companies provided purpose statements. However, the quality of these varied greatly. There was a tendency to conflate mission and vision with purpose; normally, mission and vision rely on a company's purpose to provide the reasons behind their goals.

Too many companies substituted what appeared to be a slogan or marketing line for their purpose or restricted it to achieving shareholder returns and profit. This approach is not acceptable for the 2018 Code. Reporting in these ways suggests that many companies have not fully considered purpose and its importance in relation to culture and strategy, nor have they sufficiently considered the views of stakeholders in their purpose statements.

There were some companies who, when articulating purpose, clearly described their unique contribution to the market they operate in, their stakeholders, and society at large. The best reporting described purpose by considering it alongside culture and strategy in a way that demonstrated the company had thought about purpose effectively.

The Lab issued a report in 2018, *Business model reporting; Risk and viability reporting – Where are we now?* which considered company purpose, and they found that, 'it can impact credibility when the purpose stated is difficult to connect with the business model disclosed'.

The Lab report also explained that, 'investors are supportive of purpose statements that communicate what the company does and why it does it'. The report provides some examples of purpose statements by FTSE 100 companies that not only received a positive response from some investors but clearly described how stakeholder value is created.

We expect companies to have further considered their purpose and values during 2019, which should lead to significant improvements in disclosure in this area when companies next report.

Culture

The 2018 Code built on the report the FRC and its partners published in 2016: *Corporate Culture and the Role of Boards*. We are encouraged that company culture is something that many boards are taking seriously. Chair statements mentioned the importance of culture and explained that as part of their considerations of the 2018 Code, they had decided that additional work would be required throughout 2019. This includes setting the tone from the top and achieving buy-in from management and employees. We expect to see the outcomes of these deliberations during 2020.

The FRC recognises that leading and maintaining the right culture for a company requires long-term commitment by the board. It was disappointing that only a small number of boards disclosed that they already receive reports on culture to aid discussions, especially as the importance of corporate culture was raised by the FRC more than three years ago. Moreover, only a few reported that it had a specific agenda item on alignment of culture with values and strategy. The lack of this level of discussion at board level perhaps links back to some of the poorer articulations or company purpose discussed earlier.

Some companies reported on behaviours and referred to requirements within their Code of Conduct. We did not review these Codes of Conduct; however, we would like companies to consider whether these are seen by employees as a set of rules to follow rather than aspirations that achieve a healthy culture. Annual reports should demonstrate that such Codes of Conduct articulate the values the company wish to foster in both leaders and employees and in doing so defines appropriate behaviours.

In some cases, boards either had a committee or planned to delegate to a committee the role of leading on culture. In these cases, this responsibility was often combined with other issues such as sustainability or health and safety. Reports should demonstrate the value and effectiveness of this approach to achieving the desired outcome.

A handful of companies included culture as a key risk; these companies recognised the importance of ensuring the right culture to retain staff, engage with stakeholders effectively, and respond to requests for information from investors. Linking culture to diversity was popular in some reports, but it should not be seen as a single metric to determine an effective culture.

Overall, there was limited discussion of assessing and monitoring culture. Of those that did, the main tool used appeared to be employee engagement surveys, with the main metric being completion rates of such surveys. While these are beneficial, they only provide a snapshot of information and should not be used in isolation.

One company did report on some of the less positive feedback received as a result of a survey, and went on to explain how the board had dealt with the concerns raised. This approach demonstrates company commitment to its survey and values and that it acts on the views expressed. Others tended to focus on the positive responses of any survey and failed to demonstrate any consideration of concerns raised.

Very few companies cited more than three metrics used to monitor and assess culture. Linking different sources of information together will help companies better understand their culture. There was little evidence to suggest that companies saw a role for internal audit in the assessment and/or monitoring of culture. The internal audit function can provide an independent and objective assessment of the company's operations.

More information on ways that companies can assess and monitor culture can be found in the *Guidance on Board Effectiveness*. We would expect that work on assessing and monitoring culture has been further considered during 2019 and look forward to seeing more details.

Workforce Engagement

The methods of workforce engagement were the subject of consultations by both the Government and the FRC. Our analysis of the FTSE 100 showed that this area continues to be one that companies are carefully considering, with around half commenting on their current engagement with the workforce or detailing their preparation ahead of full reporting in 2020.

The reporting on current approaches to engagement was wide-ranging, with companies explaining that many different approaches were used, from staff surveys and employee AGMs to inviting employees to attend board meetings to discuss specific issues.

Several companies explained that they were taking the opportunity to consider how to build on activities already in place, and to decide whether to introduce further methods. Some companies were very clear that they felt their current methods were strong, and that they would continue with their current approach when reporting the following year.

Some companies have stated which method they will use for engagement with workforce. However, it is not clear from this year's reporting how much thought was given to the effectiveness of the method chosen. There was little analysis of whether the likely method for engagement was the best one for the company to ensure that boards were made aware of key issues raised by the workforce. It was also unclear whether the board were able to feed back their views and decisions once made.

Several companies reported that site visits were a good way to increase engagement by Non-Executive Directors (NEDs). However, there was limited disclosure of how the information gleaned from such visits was fed into wider board discussion and whether it impacted on future strategy, culture, risk or other such matters. Site visits should be an opportunity to understand how matters at the heart of the 2018 Code are impacting on the workforce. For example, are the desired culture, values, and behaviours being displayed? Does the workforce feel safe to speak out? Does the workforce feel that the company supports diversity?

Some companies explained the actions they are taking to engage their international workforce, mindful that one approach may not always be appropriate in all locations. Many companies were also keen to ensure that their workforce was involved in the process of proposing individuals to roles which improved engagement. In a number of cases, employees had taken part in elections to roles such as sitting on committees or panels, which ensured wider buy-in.

Practical Law's *What's Market practice?* report notes that 171 FTSE 350 companies included a statement on which workforce engagement method they have adopted or will adopt; having a designated NED was the most popular choice (at c.60%).[6] From our review of the FTSE 100 the designated NED was either leading a new committee or attending an employee advisory panel to help better understand what mattered to the workforce. There was limited discussion of how information would flow to the board or which matters would be selected for review.

When we analyse reports in 2020, we will be looking to determine how effective engagement with the workforce has been. The 2018 Code is clear at Provision 5: 'the board should understand the views of the company's other key stakeholders and describe in the annual report how their interests… **have been considered in board discussions and decision making**'. 2020 reports should make it clear how the methods used have achieved the objective of this Provision and include details or real examples of what a company has done to consider and if appropriate take forward matters raised by the workforce.

Section 172 Reporting

The 2018 Code links engagement with stakeholders with reporting on s.172 of the Companies Act 2006, now required by The Companies (Miscellaneous Reporting) Regulations 2018.

It is ultimately for companies to determine how the annual report flows and to what extent cross-referencing is used. The legal requirement is for a s.172 statement to be incorporated within the Strategic Report, but more detail may be appropriate in the governance section.

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6 Annual reporting and AGMs 2019, What's Market practice?, Practical Law, November 2019

Most companies we reviewed identified their key stakeholders, reported on their engagement with communities and their work on sustainability, detailed engagement with specific events, or offered support across a community. Many also highlighted the use of customer satisfaction surveys to gather stakeholder data.

There was limited discussion of the issues that were important to or raised by stakeholders, and consequently to what extent boards had considered these and the impact they had made to strategy. We found one company that noted its prompt payment ratio as part of a disclosure in relation to relationships with suppliers. This is an example of demonstrating having regard to other matters set out in s.172.

Our findings are in line with others, such as EY, which commented in its report that boards should clearly establish the strategic issues on which they wish to obtain stakeholder input and feedback.[7] Reporting must cover the concerns raised by stakeholders, how companies have understood the issues, and how they have thought carefully about how these impact on the long-term success of the company.

Chair Tenure

Provision 19 sets for the first time a maximum nine-year length of tenure for the chair. As this is from their first appointment to the board, the Code includes some flexibility to deal with an existing NED who has been appointed chair. The Provision permits a limited extension to the term of the chair beyond nine years if they are already a board member and the appointment supports the company's succession plan and diversity policy.

When the Code was published in July 2018, there were 28 chairs in FTSE 100 with tenures of nine years and over; for the FTSE 250, it was 73.[8] Table E shows the current position (length of tenure has been rounded up to full years), and it appears that change is underway. Provision 19 was designed to prompt greater refreshment of boards and bring succession planning to the fore. However, it is concerning that there are c.18 chairs that have been on the board for 18 years or more. We would expect these companies to set out their rationale for this situation and their proposals for the future composition of their boards.

Table E: FTSE 350 Chair Tenure (9 years plus)

Length of tenure on board (yrs)	Number of chairs	
	FTSE 100	FTSE 250
9	3	5
10	3	10
11	8	2
12	1	7
13	4	2
14	1	5
15-20	3	11
21-30	1	3
31+	1	4
TOTALS	**25**	**49**

Source: Practical Law What's Market and BoardEx databases; Data as at 31 October 2019.

[7] Annual reporting in 2018/19: Engaging stakeholders, restoring trust, EY, September 2019
[8] Minerva Analytics, July 2018

Succession Planning

Most companies simply noted that the role of the nominations committee was to keep appointments under consideration. The reports we reviewed lacked detail on succession planning, with many companies focussing more on their appointment process (including usage of external recruitment agencies) rather than providing information on how they plan for the various types of succession that exist. Some did set out development plans for current board members and progression plans for those looking to move to board level, but this was not something that most companies reported. Several companies only highlighted succession planning as an outcome of an external board evaluation in terms of an area to improve, including linkage to increasing diversity.

We also reviewed 40 AGM notices to determine how companies were justifying the re-election of board members to their shareholders. Provision 18 of the 2018 Code states that, 'the board should set out in the papers accompanying the resolutions to elect each director the specific reasons why their contribution is, and continues to be, important to the company's long-term sustainable success'.

Around half of the AGM notices we looked at simply listed the biographies of each individual, referred to the annual report, or said nothing about how they contribute to long-term success. The more informative notices had detailed biographies and briefly explained why each director should be re-elected. The best clearly outlined the reasons for an individual's re-election, specifically linking their contributions to company strategy, risks, or similar key issues referenced in the annual report. This level of information is new for the 2018 Code, and we expect more companies to consider this Provision in detail for this year's AGM notices.

Diversity

Almost all the annual reports we considered stated that the company had a diversity and inclusion policy, and included statistics for females at board level and senior management levels. Some companies chose to include elements of the policy within the annual report while others signposted the reader to the full policy on their website.

It was not always clear whether there were targets related to diversity at board and senior management level, and if so, what actions were being taken to achieve these targets or wider objectives. This is something we will look more closely at as Provision 23 requires companies to describe, 'the policy on diversity and inclusion, its objectives and linkage to company strategy, how it has been implemented, and progress on achieving the objectives'. We expected more companies to be reporting against objectives following the publication in September 2018 of the FRC's *Board Diversity Reporting* paper, which explained that reporting against objectives could be improved.

That said, a few companies did explain that elements of CEO remuneration packages were linked to diversity or a KPI had been introduced to deal with diversity matters. Others disclosed the use of specific panels that recommended actions to improve diversity.

In terms of diversity links to succession planning, a few companies reported that they only accepted gender balanced long lists from executive search companies, or only worked with companies who followed Codes of Conduct concerning ethnic and/or gender diversity.

There was limited reporting of diversity beyond gender. While several FTSE 100 companies did comment on ethnic diversity and included plans and targets to improve this area (often in line with the Parker recommendations)[9] only one or two reported on their approach to age,

[9] A Report into the Ethnic Diversity of UK Boards, October 2017

disability, and/or LGBT+ diversity. We expect to see an increase in more detailed commentary on all aspects of diversity in future disclosures.

Remuneration

Principle P of the 2018 Code states that, 'remuneration policies and practices should be designed to support strategy and promote long-term sustainable success. Executive remuneration should be aligned to company purpose and culture and be clearly linked to the successful delivery of the company's long-term strategy'.

All sampled companies used financial KPIs to measure their annual bonus and LTIP awards. There is some movement towards the use of additional non-financial metrics, such as diversity, culture and health and safety targets. Better practice examples included strategic or individual non-financial KPIs that align with long-term horizons and specified the use of vesting periods for incentives. The FRC encourages the inclusion of these non-financial metrics as a valuable measurement to achieve long-term success. Investors should support the introduction of more non-financial KPIs of this nature.

Our review examined the extent to which companies considered the wider workforce in terms of executive remuneration. Provision 33 states that the remuneration committee, 'should review workforce remuneration and related policies, and the alignment of incentives and reward with culture, taking into account when setting the policy for executive director remuneration'. This is a major shift, and a clear majority of companies sampled have yet to provide any information in their annual reports about engagement.

The 2018 Code asks remuneration committees to report on their engagement with the company's workforce. Very few committees have reported early on this matter; of those that did comment, a handful explained that they engage with the workforce through dedicated forums. The majority acknowledge that this was an area that would be considered further during 2019. This year's annual reports should offer much more detail on both the way in which remuneration committees have engaged with the workforce, and importantly the effect of this engagement. Future reporting will give us an insight into both how workforce pay influences pay policy, and how any new pay policies are communicated to the workforce.

For the first time, the 2018 Code expected remuneration committees to report on their use of discretion to override formulaic outcomes from existing remuneration policies or schemes. A clear majority of our sample discussed the remuneration committee's discretionary powers and how these could be applied in a wider context, such as granting good leaver status, modifying performance measures, and granting loss of office payments. Most explained the exact circumstances in which they would exercise discretion, and a handful outlined how they already had, which ranged from reducing salary to applying malus/clawback to bonuses.

Provision 37 of the 2018 Code states that remuneration schemes and policies, '…should also include provisions that would enable the company to recover and/or withhold sums or share awards, and specify the circumstances in which it would be appropriate to do so'. Most companies reviewed mention having malus/clawback policies, with some degree of information on the circumstances in which they would exercise them. The best among these note how long executive directors would be subject to such policies. A minority, however, are yet to disclose their arrangements. Having malus/clawback provisions are vital for remuneration committees in terms of exercising their oversight duties, so we encourage those companies that have not yet published full details to do so.

Provision 38 of the 2018 Code states that, 'the pension contribution rates for executive directors, or payments in lieu, should be aligned with those available to the workforce'. Our analysis shows that many FTSE 100 companies have adopted this Provision early for new

appointments. For current executive directors, this was unlikely to be an immediate change due to contractual obligations.

We are aware that investor pressure has had a positive impact on the early adoption of this Provision, and that their attention is now focussed on current executive pension contributions so that these are brought into alignment with the workforce as soon as possible.

Some companies have outlined their pension contribution rates, but have not explained how they will align them with their workforce or what their workforce's contribution rate is; others are yet to disclose the pension contribution rates of their executive directors or their workforce. Given many remuneration policies are up for shareholder approval in 2020, we expect more change here.

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