



Association of British Insurers

Comply or Explain

Investor expectations and
current practices

December 2012



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Summary

As the UK market reviews the recent revisions to the UK Corporate Governance Code, it is easy to forget the progress that has been made since the inception of the Cadbury Report 20 years ago. The UK's principles-based approach has achieved significant improvements in corporate governance standards over this time.

However, ABI members have increasingly conveyed concerns that, in too many cases, 'comply or explain' disclosures fail to meet investor requirements. It is worrying if major institutional investors lose confidence in this element of company disclosure. Ultimately, this may damage confidence in UK corporate governance and affect shareholder value.

The success of this model relies on good quality explanations by companies and a fully engaged shareholder base. If shareholders are not sufficiently engaged, they may not be able to challenge companies effectively. Similarly, if companies are not clear in their explanations, they run the risk of being poorly understood by investors. Therefore, it remains an important responsibility for both companies and investor practitioners to consider how to improve the operation of 'comply or explain'.

Earlier this year, the Financial Reporting Council (FRC) convened two meetings between companies and investors to discuss these issues. Although the meetings revealed clear unison over the benefits of the 'comply or explain' system, companies indicated that further clarity from investors on what constitutes a good explanation would be beneficial. For this reason, the ABI initiated a project to formalise investors' views, highlight best practice and review a sample of company disclosures to gauge current standards.

The ABI has developed six key criteria to assist companies in preparing Code explanations. These have been designed with the intention of providing investors with the information necessary to consider whether the alternative approach a company has chosen in particular circumstances remains aligned with their interests. These should not be viewed as a rigid set of rules that provide a new set of requirements for companies to follow. The intention is simple: to improve the operation of the UK principles-based system – underpinned by 'comply or explain' – for the mutual benefit of companies and investors.

In summary, the criteria are:

- 1. Company specific context and historical background**
- 2. Convincing and understandable rationale**
- 3. Mitigating action to address any additional risk**
- 4. Time-bound**
- 5. Specify deviations from the provisions as well as from main principles**
- 6. Explain how the alternative is consistent with the Code principles and contributes to the objective of good governance**

The ABI reviewed a sample of Code explanations based on these criteria to understand the current quality of explanations and to highlight best practice and areas requiring improvement. Many company disclosures are failing to meet investor needs:

- **38% of the explanations detailed the company specific context and historical background;**
- **27% provided a convincing and understanding rationale;**
- **25% indicated whether the Code breach was time-bound;**
- **20% described mitigating actions taken to address any additional risk;**
- **25% explained how the alternative was consistent with the principles and contributed to good governance; and**
- **16% met none of the criteria.**

We were encouraged to find that the increasing use of a Chairman's introduction to the corporate governance section is having a positive influence on the quality of reporting:

- **Companies with a Chairman's introduction scored on average 56% higher on the number of criteria met than those without.**

Key Recommendations & Conclusions

- ABI members strongly support the role of Code explanations. We attach as much importance to good quality explanations as to basic compliance with Code provisions.
- It is important for companies to consider carefully and articulate both why they have complied with and deviated from the Code: in a sense, a move towards 'apply and explain'.
- Where companies deviate from the Code, they are strongly encouraged to explain in detail the reasons. Current Code explanations are not meeting investors' current expectations and are some way from meeting the new Code explanation requirements coming into effect shortly.
- The increasing trend towards Chairmen providing introductory corporate governance statements is positive. Those companies with Chairmen's statements were correlated with better corporate governance disclosures in the wider sense. Chairmen should therefore be encouraged to provide introductory statements.
- Investors must adopt a more active approach to overseeing and scrutinising Code explanations. This should also help broaden the nature of engagement and increase focus on a wider range of corporate governance risks.
- Although we accept that smaller capitalised companies face a bigger burden meeting high standards of corporate governance, we particularly encourage them to make improvements in their Code explanations. They may well have good reasons for departing from the Code given the nascent development of their business or uniqueness of products or services. They would derive significant benefit from enhancing disclosures to improve investor understanding.

Introduction

As the UK market reviews the recent changes to the UK Corporate Governance Code, it is easy to forget the progress that has been made since the inception of the Cadbury Report 20 years ago. The UK's principles-based approach – underpinned by the 'comply or explain' system of accountability – has achieved a quiet transformation in corporate governance standards. Other markets have also recognised the benefits of the 'comply or explain' system: it has been exported across many developed and developing markets.

The ABI believes it is no coincidence that these improvements have been achieved under a principles-based approach. Under the relationship between shareholders as principals, and managers as agents, accountability is exerted by the providers of capital, rather than regulators. As companies compete for the supply of capital, they are more likely to aspire to improvements in corporate governance.

This elicits competition for the mantle of 'best in class', rather than a 'rush to the bottom', perhaps more likely under regulated minimum standards. This flexibility enables companies to adapt their governance practices to the specific nature and challenges inherent in their business model. Companies and investors can then take account of important variables, such as size, ownership structure and sectorial differences: built to measure rather than one-size fits all. Explaining this properly is an essential part of demonstrating to investors why a company's governance approach supports its business model and is aligned with shareholder interests.

Improving corporate governance contributes to lowering investment risk and therefore increasing shareholder confidence. It is therefore part of the virtuous circle that contributes to lowering the cost of, and increasing the access to, capital in UK markets.

For investors to retain confidence in this system, company explanations must be sufficiently detailed for investors to make informed judgements on the merits of different corporate governance models. If explanations are opaque or simply not provided, then investors will not be able to consider why divergences from the Code are consistent with their interests and, consequently, companies may be, perhaps unnecessarily, viewed as high-risk. Over time, poor disclosure may undermine the effective operation of 'comply or explain' and companies will (generally) be afforded less flexibility.

This has partly been explored under the UK Stewardship Code, but must also be considered in the context of guidance in the Corporate Governance Code and by investors formalising their expectations of Code explanations. Our members have increasingly conveyed concerns that Code explanations are not meeting investor requirements. Too often they are unable to make informed judgements over the merits of unconventional governance arrangements. It is worrying if major institutional investors lose confidence in companies' governance disclosures in this important area. This may damage confidence in UK corporate governance and ultimately affect shareholder value.



Doubts raised in Europe

The current debate in Europe has raised questions about the suitability of the 'comply or explain' framework. A research project¹ carried out on behalf of the European Commission in 2009 raised concerns over the level of monitoring of company compliance statements and on the quality of explanations for non-compliance. Citing the 2009 Paper in 2011, the Commission invited views on the effectiveness of 'comply or explain'. In its Green Paper² on corporate governance, the Commission proposed (Para 3.2) making corporate governance statements "regulated information" within the meaning of the Transparency Directive.

This would represent a fundamental shift away from the prevailing system of shareholder-based oversight: regulators rather than shareholders would have the task of deciding whether an explanation was sufficient. The ABI believes this would represent a retrograde step towards compliance-driven disclosure and may undermine the role of shareholders in corporate control and oversight. Importantly, therefore, the obligation to demonstrate the effectiveness of the system of 'comply or explain' sits squarely with investors and companies.

FRC Code Explanations Debate

Partly in response to this proposal, the Financial Reporting Council (FRC) convened two roundtable discussions for companies and investors to share views on the current quality of explanations.

The meetings revealed clear unison over the benefits of the 'comply or explain' system and that the relationship between shareholders and companies should continue to govern its operation. However, investors observed that explanations too often failed to provide them with sufficient justification for departures from the Code. At the same time, companies indicated that further clarity from investors on what constitutes a good explanation would be mutually beneficial. For this reason, the ABI initiated a project to formalise investors' views and to review a sample of company disclosures to gauge current standards.

The project had the following objectives:

- **Outline the criteria that an explanation should cover to facilitate better understanding between investors and companies and meet investor expectations;**
- **Outline why the criteria are considered important by investors and highlight best practice under each criterion, so companies have a clear basis upon which to compare their practices and consider areas where they can improve; and**
- **Examine the extent to which companies' current explanations meet these criteria.**

¹ Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States. 2009. http://ec.europa.eu/internal_market/company/docs/ecgforum/studies/comply-or-explain-090923_en.pdf

² Green Paper: The EU Corporate Governance Framework. 2011. http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf

What do investors want from Code explanations?

We have developed six criteria to assist companies in preparing Code explanations. These have been designed with the intention of providing investors with the information necessary to consider whether the alternative approach chosen by a company remains aligned with their interests.

These should not be viewed as a rigid set of rules that must be abided by by every company and for every explanation. The intention is not to supplant the Code with new and more detailed requirements to follow, but simply to help improve the operation of the UK principles-based system – underpinned by 'comply or explain'.

We accept that some of the criteria will on occasion be more or less important depending on circumstances. If a CEO is appointed combined Chairman and CEO, this combination of roles will require a comprehensive and detailed explanation. However, if the nomination committee did not meet during the year, simply because the Board had recently undertaken significant appointments in line with a long-standing succession plan, then this explanation would not necessarily need to meet all of the criteria.

We also accept that sometimes there are obstacles to detailed explanations. More often than not, this can relate to personal sensitivities, in which case, a concerted effort to give a meaningful oral explanation to shareholders takes on added importance. However, a meaningful written explanation should still be provided. We are not persuaded by the argument that more detailed disclosure necessarily implies increased litigation risk or adverse media publicity. As we demonstrate below, many companies are already giving cogent explanations and the evidence suggests that these companies are more likely to achieve support from actively engaged investors.

The six criteria are designed to be considered by companies not only as a means to improve disclosure but also to form an indicative agenda that can be used for meetings with shareholders. In this sense, they can also be used by shareholders when considering the merits of a departure from the Code.

Consistent with the UK Corporate Governance Code revisions

Many ABI members participated in the FRC roundtable discussions that had informed the February 2012 report³ 'What constitutes an explanation under 'comply or explain'. These meetings and the report informed the thought process in finalising the explanations criteria.

At the time the ABI was finalising views on the criteria, the FRC had begun consulting on changes to the UK Corporate Governance Code. The FRC consultation considered whether the Code should require a fuller explanation by companies when describing departures from the Code.

They proposed to set out the specific characteristics of an informative explanation in the Preface to the Code. The following wording (in bold) was proposed as an extension to paragraph 3 of the guidance section for 'Comply or Explain':

"It is recognised that an alternative to following a provision may be justified in particular circumstances if good governance can be achieved by other means. A condition of doing so is that the reasons for it should be explained clearly and carefully to shareholders, who may wish to discuss the position with the company and whose voting intentions may be influenced as a result. In providing an explanation, the company should aim to illustrate how its actual practices are consistent with the principle to which the particular provision relates, and contribute to good governance **and promote delivery of business objectives. It should set out the background, provide a clear rationale for the action it is taking, and describe any mitigating actions taken to address any additional risk and maintain conformity with the relevant principle. The explanation should indicate whether the deviation from the Code's provisions is limited in time and, if so, when the company intends to return to conformity with the Code's provisions.**"

This wording was carried forward into the amended and final version of the September 2012 Code. The criteria that were adopted are therefore consistent with the new FRC Corporate Governance Code guidance on Code explanations. Therefore, as well as assessing the extent company disclosures meet investor expectations, the report also provides insight into areas that may need improvement in order for companies to be in line with the new Code guidance on explanations.

³ Financial Reporting Council. What constitutes an explanation under 'comply or explain'? Report of discussions between companies and investors. February 2012. <http://www.frc.org.uk/getattachment/590dd61a-d3b1-4a2e-a214-90f17453fa24/What-constitutes-an-explanation-under-comply-or-explain.aspx>

Code Explanations Criteria

We outline in greater detail why we consider each of the criteria to be important and illustrate this by referring to specific extracts of best-practice examples of company disclosures. We also highlight how different criteria are met to show how they combine effectively as part of one explanation.

1. Company specific context and historical background

The starting point for any company should be to consider the context in which it is making its governance decisions: what are the business specific reasons – whether because of the unique characteristics of the business model, strategy or ownership structure – that means it is in shareholders' long-term interests to take a different approach from that set out in the Code? Too often, companies fail to make this connection.

Normally, the business context is affected by particular historical developments, whether corporate governance changes or milestones in a company's development. Both will have typically led the company to a particular model of governance. The business context and historical background set the scene for investors to consider how the alternative approach remains aligned with shareholder interests and contributes to better business outcomes.

This is one of the most important criteria and will be relevant in almost all examples of departures from the Code.

Example of best practice:

One example of a company that meets this criterion is SABMiller Plc.

During the last reporting period, the company sought to appoint its current Chief Executive to the role of combined Chairman and Chief Executive. This is perhaps one of the most high-profile departures from the Code, given the amplified risk it is considered to cause by shareholders. The incumbent Chairman explained the criteria under which the board had approached the succession process:

"In selecting my successor, the board carefully considered the requirements of the job in the context of the group's size and geographic spread. We agreed that the new Chairman must be able to provide stability and continuity, must understand both the global brewing industry and the particular challenges of the emerging markets in which we operate, must be familiar with our ways of working and able to enhance our corporate culture and operational performance and must be competent to oversee the completion of the business capability programme currently under way."

Preceding the formal reporting of this, the company had presented these issues in more detail in meetings with shareholders. It also explained the decision in the context of the overall succession plan. The company had already identified its long-term replacement CEO and clarified the need for a staged handover of responsibilities given the global complexities of the business.

"The decision to appoint Dr Clark as Chief Operating Officer to facilitate a staged handover of responsibilities recognises the complexities of our global business and our many significant external relationships and partnerships."

Finally, in respect of a different explanation SABMiller Plc made during the year, it also make a clear link back to the specific nature of the company, in this case the relationship agreement in place with its largest shareholder.

"The board applied all of the principles and provisions of the Code throughout the year ended 31 March 2012, except that the audit committee did not consist solely of independent directors. Under our relationship agreement, as approved by shareholders in 2002 and in 2005, Altria Group, Inc. (Altria) has the right to nominate a director to the audit committee, and has nominated Mr Devitre, whom the board does not consider to be an independent director for the purposes of the Code. The board nevertheless considers that the composition of the audit committee remains appropriate, given Altria's interest as the company's largest shareholder, and is satisfied that, having regard to the experience and background in financial matters of Mr Devitre, as a former chief financial officer of Altria, the independence and effectiveness of the audit committee in discharging its functions in terms of the Code continue to be considerably enhanced and not in the least compromised."

2. Convincing and understandable rationale

It is important that a company justifies why the governance decision taken is proportionate in the light of the context already provided. Investors will be looking for a cogent description of the link between the business-specific context and the governance model employed. While this criterion is more subjective, the burden is with the company to persuade investors that it has reached a proportionate outcome.

Example of best practice:

One example of a company that meets this criterion is SOCO International plc.

The company has a number of long-standing non-executive directors who do not meet one of the parameters of independence set out in the Code. The Chairman addressed the issue directly as part of his introduction to the corporate governance section.

"The independence of Directors was identified as a matter against which the external facilitator would apply particular scrutiny. The facilitator reported that each Director expressed, in confidence, the strong belief in the continued independence of their fellow Directors. This included, in particular, the Board's long tenured Directors, who are believed to bring a valuable quality and effectiveness to the Board as a whole. The Board embraces the underlying principles of the Code provisions regarding tenure and refreshing of the Board, and seeks to strike an appropriate balance between continuity of experience and succession. The findings of the externally facilitated Board evaluation confirmed the Board's previously stated position concerning independence, in that an individual's independence cannot be determined arbitrarily on the basis of a set period of time, or by a set period of concurrent tenure with an Executive Director."

Reference to how the external evaluation of the board scrutinised the independence of the directors also, to some extent, serves as a safeguard for investors. In this sense, the explanation provides a form of mitigating action against the additional risk of weakened independence.

The explanation then goes into more detail about the specific nature of the company, providing comments relevant to the 'context criterion'.

"Each of the Non-Executive Directors' tenure has run concurrently with the Company's Executive Directors, both of whom have been in office from the Company's initial listing. The Company manages a portfolio of long term, complex projects and benefits from long serving Directors with detailed knowledge of the Company's operations and with the proven commitment, experience and competence to effectively advise and oversee the Company's management on behalf of shareholders. The Company seeks to ensure its Directors are focused on a long term approach, and does not impose fixed term limits as this would result in a loss of experience and knowledge without assurance of increased independence. Accordingly, the Board's assessment of independence is of prime importance to ensure that retention of experience does not result in a failure to retain a sufficient contingent of independent Directors."

The specific tests applied to determine independence were then outlined.

"The independence of each Non-Executive Director is assessed at least annually. Independence was additionally identified as a matter for increased scrutiny in the externally facilitated Board evaluation, as described more fully in the Nominations Committee report. To be identified as independent a Director must be determined independent in character and judgement and free from any relationships or circumstances which are likely to affect, or could appear to affect, their judgement including in particular those set out in the Code. Particular scrutiny is applied in assessing the continued independence of Directors having served over nine years, with attention to ensuring that interactions with Executive Directors have not in any way eroded their independence and that their allegiance remains clearly aligned with shareholders. Board refreshment and tenure are considered together, and weighed for relevant benefit in the foreseeable circumstances, given further that the Board should not be enlarged to a size that is unwieldy."



The full explanation then set out how the company applied these tests in reviewing the independence of each of the non-executive directors during the year.

3. Mitigating action to address any additional risk

With the exception of explanations for major changes to the nature of the Chairman's role, this criterion was the least satisfactorily fulfilled. This is disappointing. Even if a departure from the Code is put into context and is understandable, investors expect a company to have considered necessary steps to mitigate any amplified risk.

There are some provisions of the Code where this criterion will be less relevant. However, we would still urge companies to go through a process of contemplating whether mitigation measures are appropriate and, if not considered necessary, to explain why.

Examples of best practice:

One example of a company that meets this criterion is Micro Focus International plc.

During a challenging period for the company in 2011, the CEO left and the then Chairman became executive Chairman. The company's explanation clearly set out the actions it had taken to counter concerns over a concentration of influence in one individual.

"In order to mitigate any potential concerns over the combined role, David Maloney was also appointed as Deputy Chairman on 14 April 2011 and continues to perform his role as Senior Independent Director. Following Kevin Loosemore's appointment as Executive Chairman and David Maloney's appointment as Deputy Chairman, the terms of reference for each role have been agreed by the board and can be viewed on <http://investors.microfocus.com/corporate-governance>."

It also detailed the division of responsibilities operated by the board and the majority of independent directors, serving as a further safeguard for shareholders.

"Kevin Loosemore leads the board and the Company in its relationships with all stakeholders and customers. He is responsible for all aspects of executive management including business strategy and its successful achievement. He is also responsible for chairing board and general meetings, facilitating the effective contribution of non-executive directors, ensuring effective communication with shareholders and upholding the highest standards of integrity and probity.

David Maloney chairs the nomination committee and is therefore responsible for succession planning. He leads on governance issues, including the annual review of board effectiveness, and acts as an intermediary, if necessary, between non-executive directors and the Executive Chairman and between the Company and shareholders. The board also has a clear majority of independent directors, with four out of six directors being fully independent."

The SABMiller Plc example is also relevant here. The disclosure also reviewed the options that were considered by way of mitigation before going on to set out the arrangements put in place to deal with the increased concentration of decision making.

"The board also considered carefully whether it would be appropriate to appoint an interim chairman for 12 months before Mr Mackay becomes non-executive chairman but concluded this would not be in the best interests of the company or its shareholders as it would not provide the appropriate continuity of strategic direction and oversight that the group requires."

"Any risk of an over-concentration of decision making powers in one person will be mitigated by the formal appointment of Mr Manser as Deputy Chairman, the fact that Mr Mackay's appointment as Executive Chairman is for a pre-determined and limited period of one year, and the proposed appointment of Dr Clark as a third executive director. It is also the board's intention now to begin the process of recruiting a new independent non-executive director, with the expectation that in due course he or she could become the senior independent director in succession to Mr Manser."

This part of the explanation could be equally relevant to the criterion below, that, where appropriate, an explanation be time-bound. It is also helpful if the question of whether a Code departure should be limited in time is considered in the context of risk mitigation.

4. Time-bound

Investors expect companies to consider whether certain Code departures should only be in place for a limited period of time. There are of course some departures where, by virtue of their nature and the previous explanations provided, the company does not consider it appropriate to be bound by a time limitation. In such circumstances, companies should review this periodically.

Example of best practice:

One example of a company that meets this criterion is Workspace Group plc.

The audit committee chairman had served more than nine years on the board but, due to radical changes to the board during the year, the company needed to retain continuity. However, in deciding to maintain the current composition the company set out a defined time-period for the departure from the Code.

"Following our AGM this year, Bernard Cragg will have served as a Board Director for nine years. The Board recognises that his tenure will have reached a threshold at which, his independence could be called into question. Considering the radical changes to the Board which have occurred over the past year, the Board is mindful of ensuring that a certain level of continuity is maintained. Indeed, if Bernard were to retire we would have only one Non-Executive Director with more than one year's experience of the Company. With this in mind and given the importance of the experience and skills required to perform the role of Chair of the Audit Committee and Senior Independent Director, Bernard will remain as a Board Director until the Annual General Meeting in 2014."

5. Specify deviations from the provisions as well as main principles

Companies often fail to link their explanation specifically to the relevant Code provision or the company appears uncertain whether they have in fact departed from a Code provision. This may demonstrate that the company has not considered sufficiently how a provision supports the main principles under the Code. This is linked into the final criterion below and we would encourage companies to think of the two together.

When explaining a departure from a Code provision, companies should give an explanation of how the alternative remains consistent with the main principle and contributes to the fundamental objective of good governance.

Example of best practice:

Bwin Party Digital Entertainment plc provides a good example of being direct in respect of the provisions that have been departed from. The link to the main principles is also highlighted.

"In particular, it did not comply in the following areas: 1 Less than half the Board are determined to be independent. This matter is addressed below on page 71. 2 The membership of the Audit Committee. However this was rectified on 31 March 2011 with the completion of the merger with bwin (see page 75). 3 The membership of the Remuneration Committee. However this was rectified on 31 March 2011 with the completion of the merger with bwin (see page 81). 4 In relation to various legacy share plans: a) the performance-related elements of certain Executive Directors' remuneration (see page 91); b) executive share options being offered at a discount (see page 91); and c) certain Non-Executive Directors holding share options (see page 91).

The explanations for these deviations and the actions that have already been taken or will be taken in an appropriate timeframe to remedy them are set out in this section."

6. Explain how the alternative is consistent with the Code principles and contributes to the objective of good governance

We encourage companies to consider this consideration as an underlying principle for all governance reporting. It is also linked to providing a convincing explanation, as investors will assess whether the alternative arrangements remain aligned with the main principles and fulfil the underlying objective of good governance.

Example of best practice:

One example of a company that meets this criterion is Smith & Nephew plc.

Before setting out the specific areas the company has departed from the Code, the explanation described the broader benefits derived from independence in the boardroom. This makes a clear link to the underlying objective of good governance. It also made the connection to the benefit of long-serving directors, which led into a more specific description of the departures from the Code.

"We value the independence of our Non-Executive Directors. It is important that the Chief Executive Officer and the Chief Financial Officer are challenged in the Boardroom, leading to wider debate and better proposals and decisions. This leads to an improved articulation of strategy and enhanced assessment of risk and opportunities. This can only be done effectively if the Non-Executive members of the Board are prepared to ask the difficult questions, to insist on sound responses and to spend time understanding the key drivers and challenges faced by the Group. Our Non-Executive Directors do this both at formal Board meetings and, on occasion, between meetings. We value the longevity of our long-serving members, who have a deep understanding of the Group. However, we are also mindful of our need to plan for the future and the need to refresh our Board structure. We shall continue to look for new Non-Executive Directors to ensure that we have a balanced Board with the capabilities fit for taking us into the future and its new challenges."

In addition, the explanation described key priorities of the board when considering its composition in the future. In doing so, it made a connection between departing non-executives and the areas the board would focus on when appointing a new non-executive director.

"Now that Olivier Bohuon has settled into his new role and we are beginning to implement our new strategy, we are in a position to analyse the appropriate Board balance and structure for the future. We know that we will need different skills and experiences and, in particular, we would like to have a greater representation from Emerging Markets, which is a key Strategic Priority for us. The appointment of Ajay Piramal at the beginning of 2012 goes some way towards achieving this. Rolf Stomberg has served on the Board for 14 years and will be retiring from the Board following this year's Annual General Meeting. We are continuing to look for suitable Non-Executive Directors and, in due course, other longer serving Directors will step down."

How well are Code explanations meeting investor requirements?

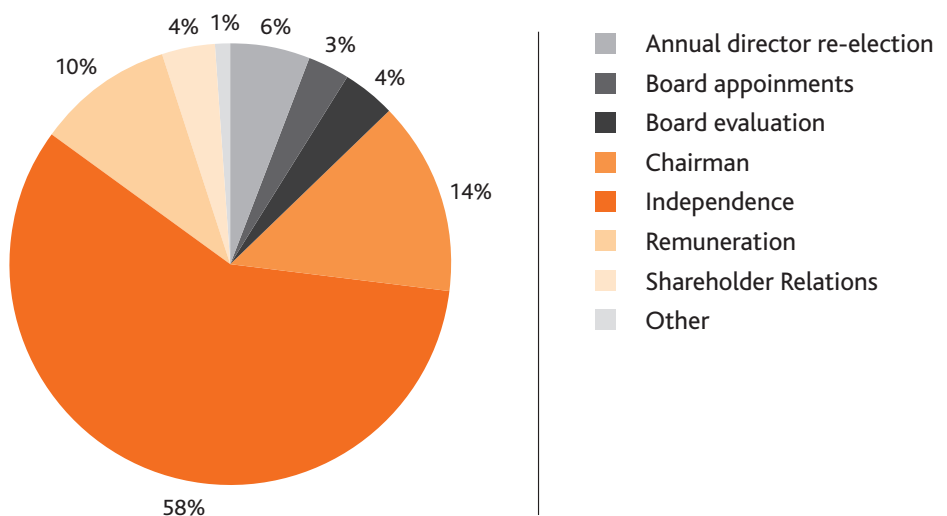
We examined the extent to which companies' current explanations meet the Code explanation criteria.

From the ABI Institutional Voting and Information Service (IVIS) database, we identified 128 companies from the FTSE All Share that had departed from the UK Corporate Governance Code during the 2011/12 reporting season. In total, these companies had made 212 explanations.

To enable comparison between different types of Code explanations, the total sample was then divided into a Code Categories Framework (see Appendix). This grouped together similar types of explanations.

The explanations were then assessed against each of the criteria. Each assessment was then subject to further verification for accuracy and consistency. Explanations identified as best practice were then subject to further cross-checking for consistency.

Split by type of Code deviation



Key Findings

38%

of the explanations detailed the company-specific context and historical background

27%

provided a convincing and understanding rationale

25%

indicated whether the Code breach was time-bound

20%

described mitigating actions taken to address any additional risk

21%

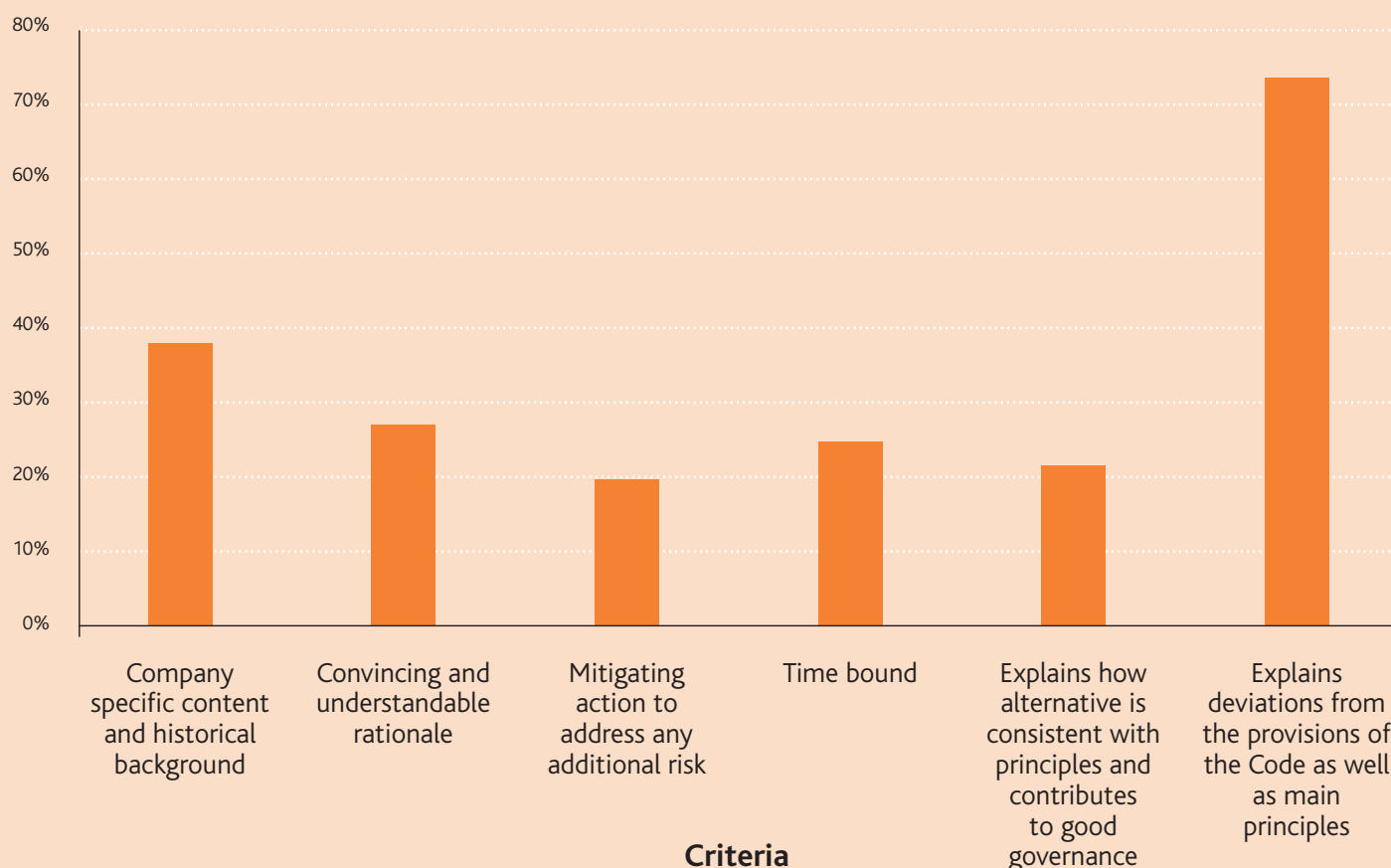
explained how the alternative approach taken was consistent with the principles and contributed to good governance

17%

met none of the criteria

Total Sample Findings

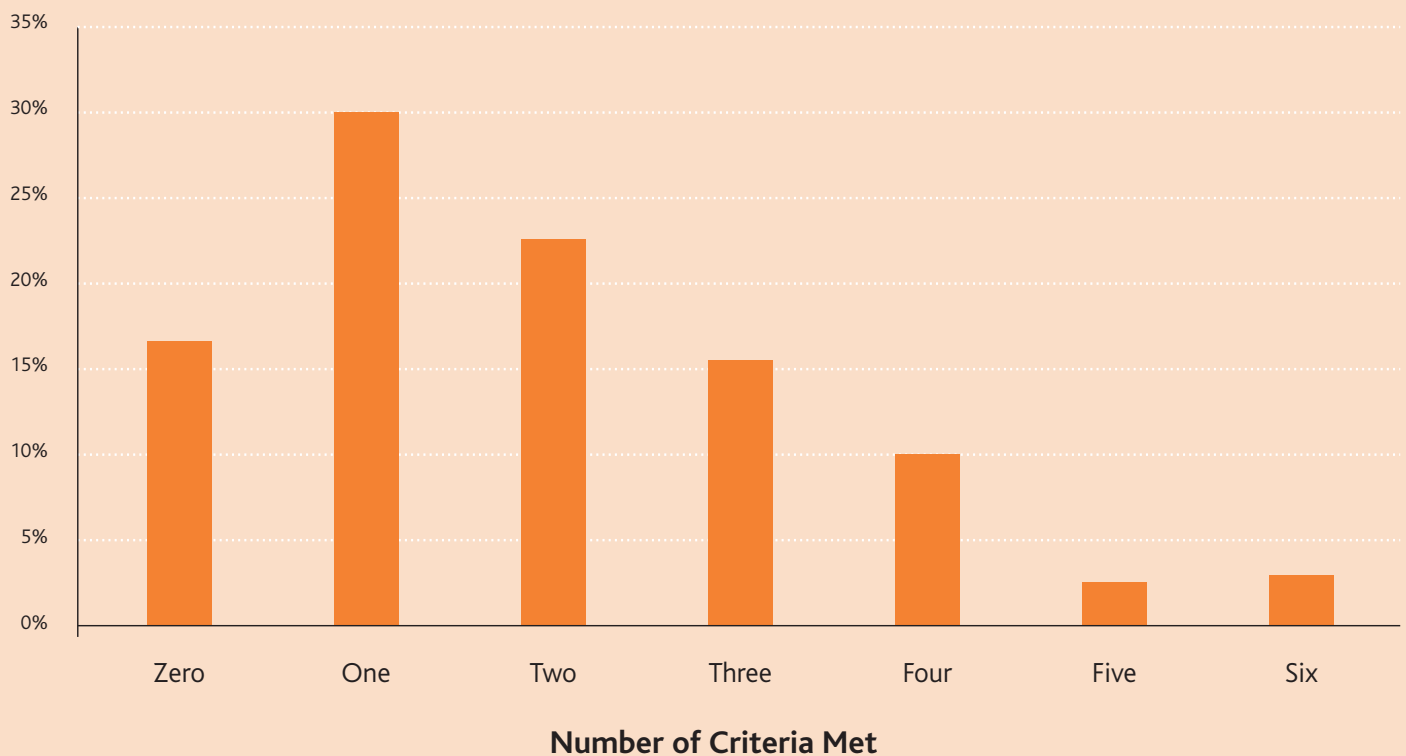
Individual Criteria Conformity: Total Explanations Sample



Many of the current Code explanations are not meeting investor requirements. 16.5% of explanations failed to meet any of the six criteria. Of the major groupings in the findings, just over 50% of the sample met 1 or 2 criteria and 25.5% met 3 or 4 criteria. Only 5.5% of the sample is currently close to, or meeting, investor requirements for explanations.

The criterion met by companies most was that explanations should refer specifically to the Code provisions as well as to the main principle. This should be largely uncontroversial. However, only a small proportion of the companies' explanations (21%) then linked their specific provision explanation back to the main principle and good governance.

Distribution of criteria met per explanation: Total Explanations Sample

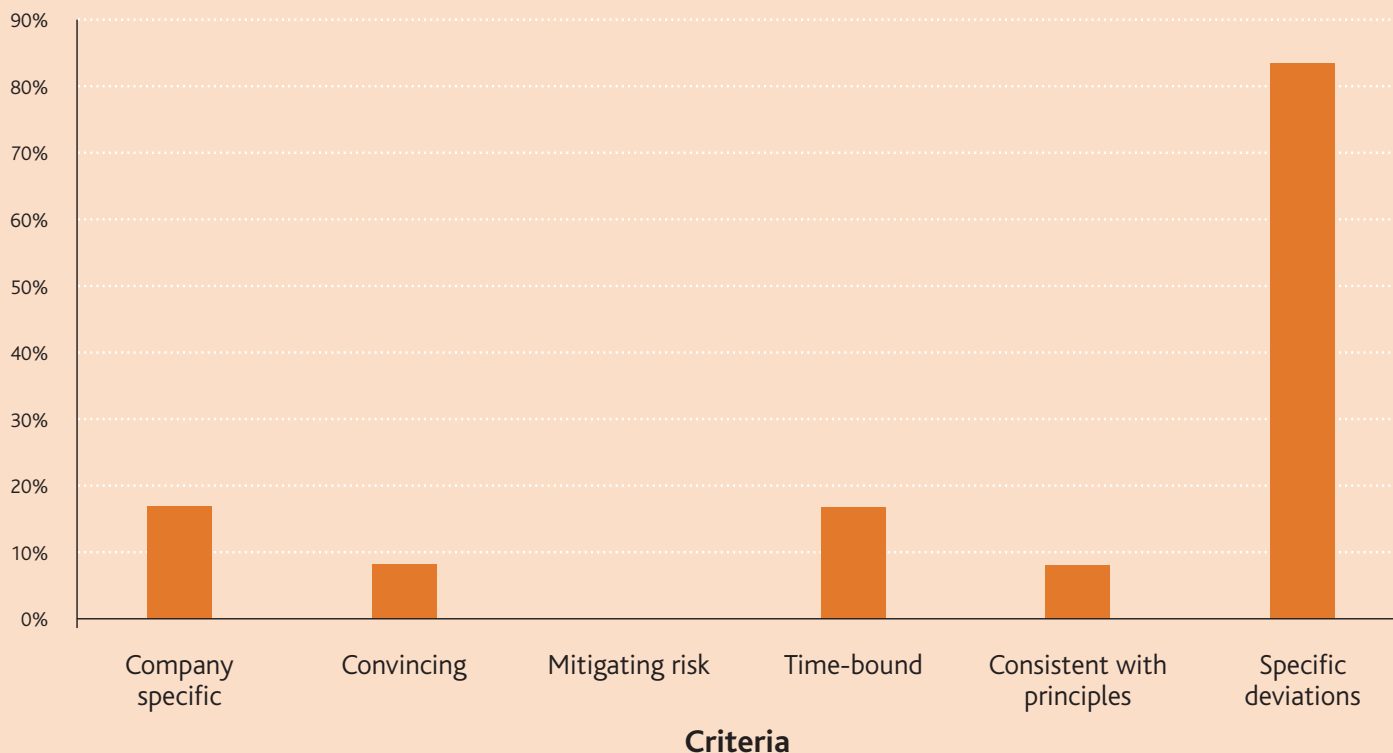


Significantly more explanations were found to be “company specific” than “convincing and understandable”, which would appear to indicate that, although an explanation had given a business context, investors still found the Code deviation to be disproportionate given the circumstances. This suggests that companies may be struggling to articulate the link between their business model and their governance model.

We had expected a smaller proportion of companies to link their explanations to mitigating additional risk, because some Code provisions may not present a meaningful amount of amplified risk. However, we would expect this link to be required in more than 19.5% of the explanations. Investors expect companies to at least review periodically whether mitigation actions are necessary.

Individual Categories Findings

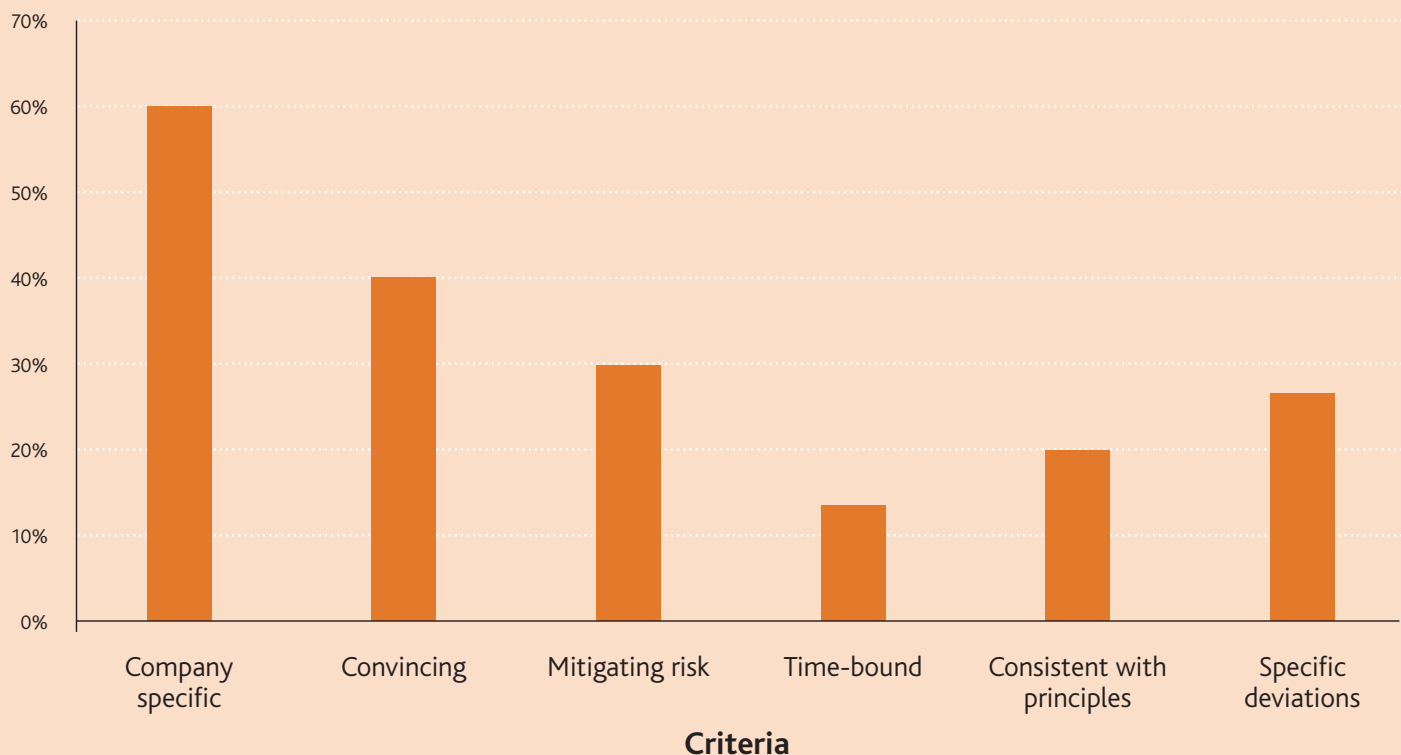
Percentage Criteria Met: Annual Director Re-election



Although this Code provision was introduced recently, it has been widely adopted by companies. The explanations accounted for only 6% of the total sample. Those companies not adopting annual director re-election are increasingly unusual and therefore adds to the need to explain an alternative approach effectively. Those companies that offered

a time-bound aspect to their explanations were in all cases committing to implementing the provision the following year or on a phased basis. Given this, these companies did not explain further. This lowered the number of companies explaining opposition to the requirement on the basis of disagreeing with the principle or for business specific reasons.

Percentage Criteria Met: Chairman Related



At 14% of the total sample, Chairmen-related Code explanations represented the second most common category.

For the first three criteria, companies scored markedly above average, indicating that more companies realise the added importance of background context and risk mitigation where there are fundamental changes to the role of chairmen. Explanations generally provided the company context and historical background, scoring 58% higher than the total sample average. Similarly, for providing a convincing and understandable rationale and mitigating action, Chairmen-related explanations scored 48% and 53% respectively above the total sample average. However, concerns remain that many explanations failed to meet the first three criteria for matters that are fundamental to board effectiveness.

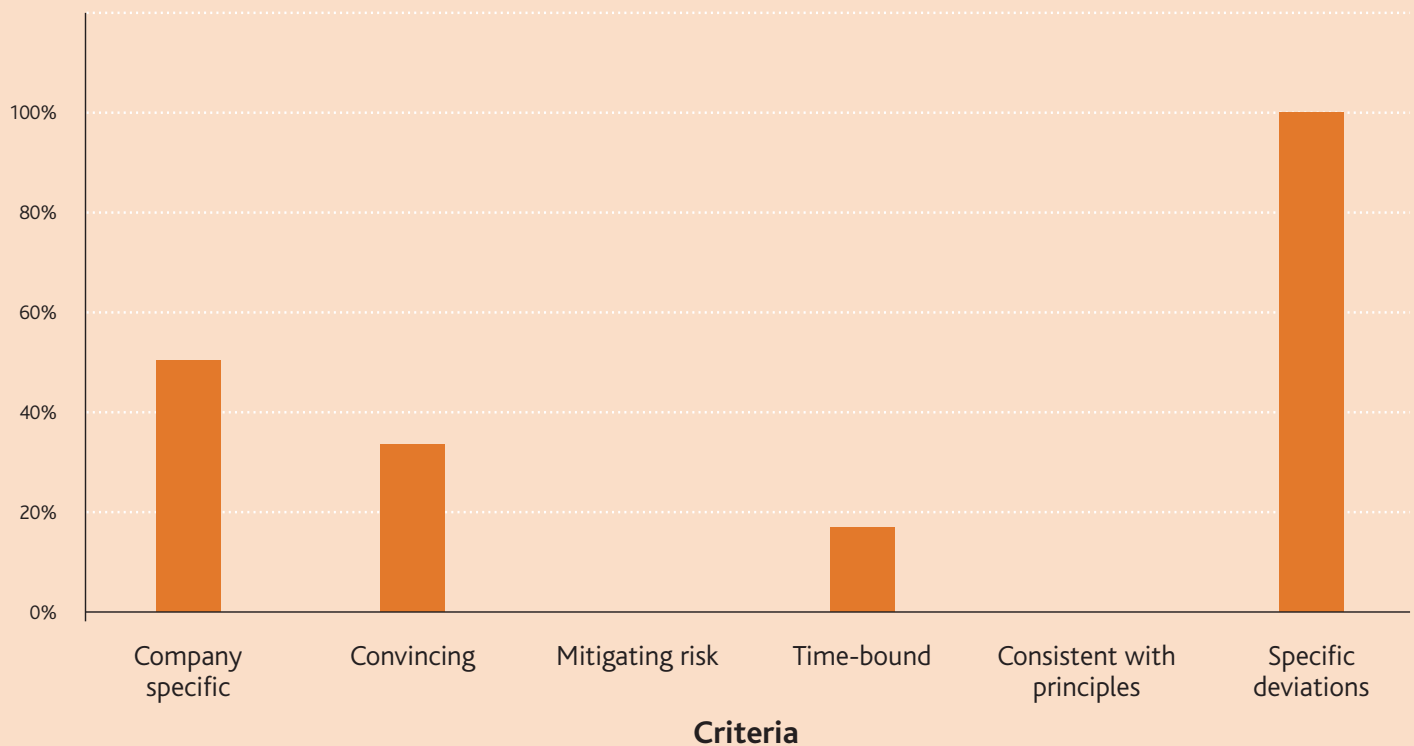
For the remaining three criteria, explanations scored below the total sample average. Given the likely changes to the board decision-making process as a result of having an executive Chairman or joint CEO/Chairman, investors attach

particular importance to understanding how the alternative approach is consistent with the main principles and contributes to good governance. Only 20% of the explanations successfully met this criterion. It was also disappointing that this category was the lowest scoring for the last criterion: that specific reference is given to the provision that had been departed from. Only 26% of these explanations did so, compared to the 73% total sample average.

Although explanations for Chairmen-related Code breaches were generally detailed, many explanations followed a *de minimis* approach, for example:

"The Executive Chairman does not meet the provision that the role of Chairman and Chief Executive should not be exercised by the same individual (A.2 and A.2.1). To ensure that there is a clear balance of power and authority within the Company, there is a clear division of duties between the Executive Chairman and the Independent Non Executive Deputy Chairman."

Percentage Criteria Met: Board Appointments

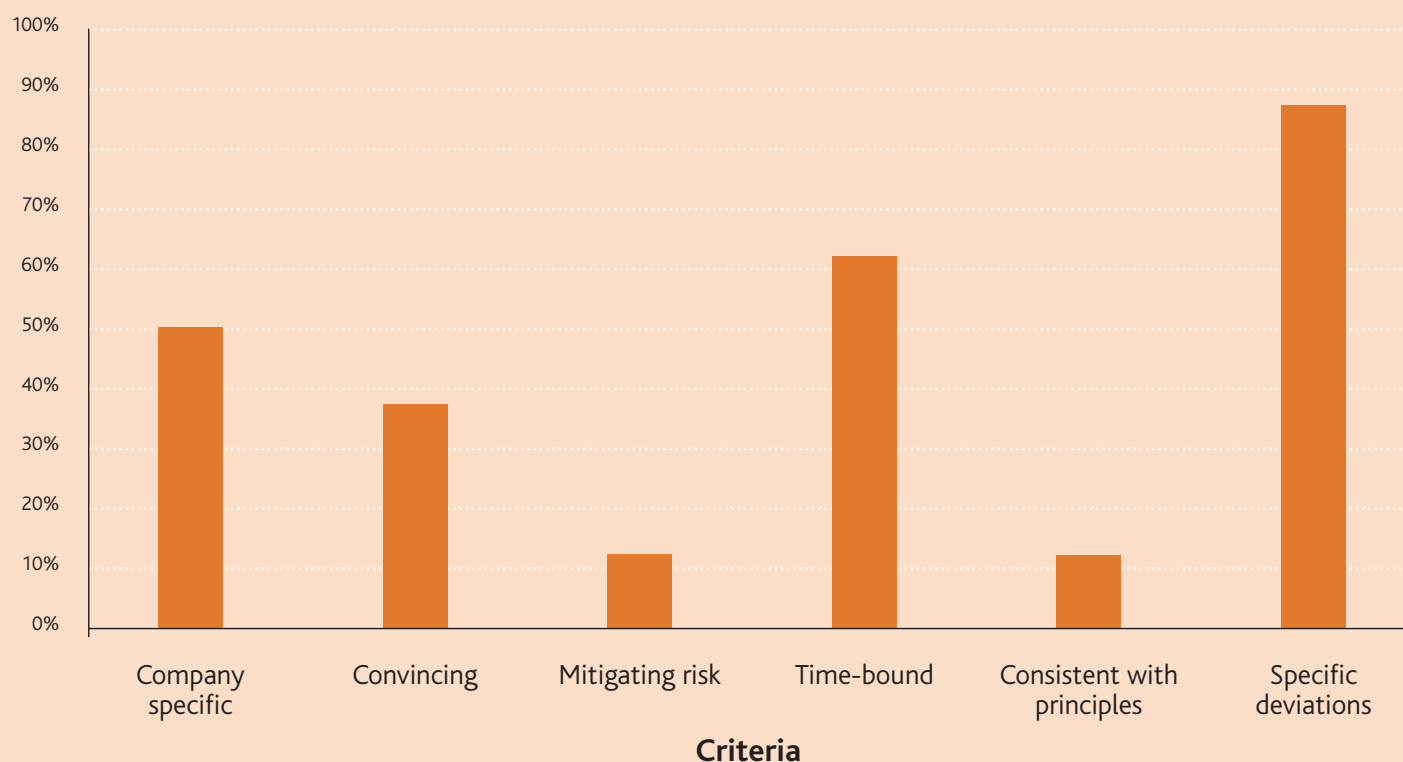


These explanations represented only 3% of the total sample. An above-average 50% provided a detailed company specific context and historical background. However, although the 'convincing and understandable' criterion finding was also above average, it was some way below the 'company context' criterion. Again, this may indicate that the chosen alternative was not considered proportionate in the light of the specific circumstances at the company.

Several of the explanations related to companies that had in place relationship agreements with large or controlling shareholders that had determined the appointments. Although these explanations gave good detail over the

reasons and historical background to such agreements, they often failed to extend to the other criteria. For example, no explanation made the link to mitigating additional risk or to how the deviation contributed to good governance. Other explanations were for quite specific reasons, such as the company re-domiciling and re-appointing the same board without undertaking the usual nomination process. Incomplete explanations were those that made a brief reference to the nomination committee not meeting during the year. In such circumstances, shareholders would still expect to understand why long-term succession planning, or other areas such as performance appraisal, were not considered during the year.

Percentage Criteria Met: Board Evaluation



Explanations scored above average for provisions relating to board evaluation. Broadly speaking, companies explained the benefits of external and internal board evaluation satisfactorily. If a company had not undertaken an evaluation during the year, reasons were normally provided and commitments to return to full compliance by a specific time. Hence, this category scored the highest across the total sample for meeting the time-bound criterion. This might also help explain why explanations scored below average on “mitigating actions” and “consistency with the main principle and good governance”. As companies were aligned with the benefits of the evaluation and were, more often than not, returning to full compliance the following year, they saw no real need to give a wider explanation.

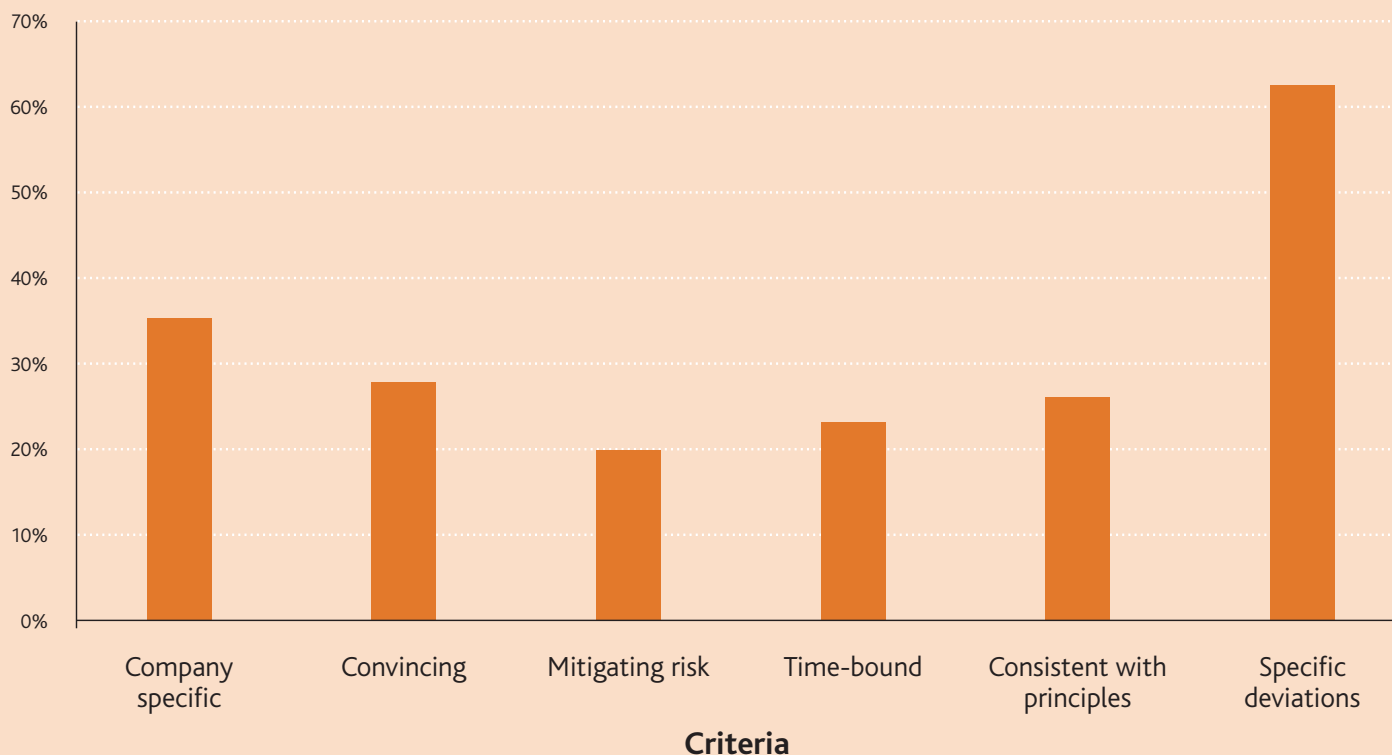
One company had concluded that, for the current year, the market for external evaluation remained nascent with too

few practitioners. Although the company could see potential benefits in the process, it had decided to continue with an internal evaluation and monitor developments in the market closely. The company stipulated when it would reassess this position.

Another company appeared to position its decision not to undertake an external evaluation as a permanent policy and, here, investors would expect an explanation to give an account covering all of the criteria. Unfortunately, this explanation was limited to the following extract:

“The Board has determined to continue to conduct evaluation internally by means of a questionnaire, rather than through contracting external consultants every three years. The process is refreshed regularly and has proved valuable in driving the Board’s agenda.”

Percentage Criteria Met: Independence



This category had by far the most Code explanations, at 58% of the total sample. The findings correlate closely with the average.

We did, however, find a significant divergence within this category. For example, some companies went into considerable detail over the tests they had applied to consider their designation of independence for a particular director. The majority of these explanations were for situations where, notwithstanding some evidence to the contrary, the board still considered a director to be independent or, for example, a director's tenure had exceeded nine years.

Many company explanations gave only a cursory explanation of their approach. For example:

"The company has complied with the relevant provisions set out in the Code throughout the year with the exception of the following areas of the Code that have not been implemented: (i) the audit committee includes one non-executive director who is not considered to be independent."

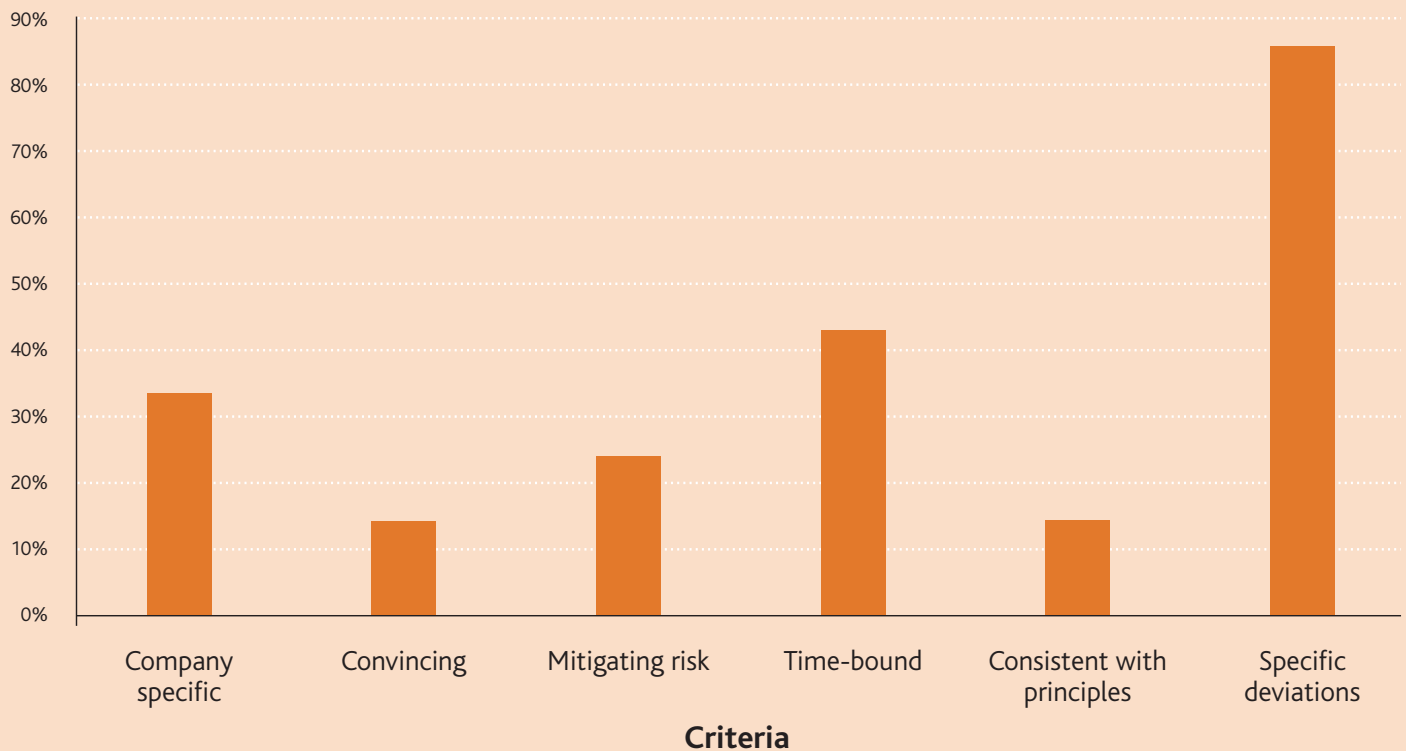
Or:

"The Code suggests a remuneration committee should comprise at least three independent non-executive directors in addition to the Chairman of the Board, however, the Board continues to consider the current composition of the Committee to be effective, efficient and appropriate to the Company's needs."

This category was found to have the most examples of companies that failed to give any explanation whatsoever, despite clear reasons to suggest non-independence. For example, several companies had awarded performance-related remuneration to non-executive directors but had not commented on the effect this might have had on the directors' independence.

Good explanations in this category made detailed links to the wider context of succession planning and continuity of expertise and experience on the board. Good explanations also linked effectively to the process they had undertaken for their external evaluations, for example, that they had asked their external evaluator to provide an enhanced assessment of independence during the process.

Percentage Criteria Met: Remuneration

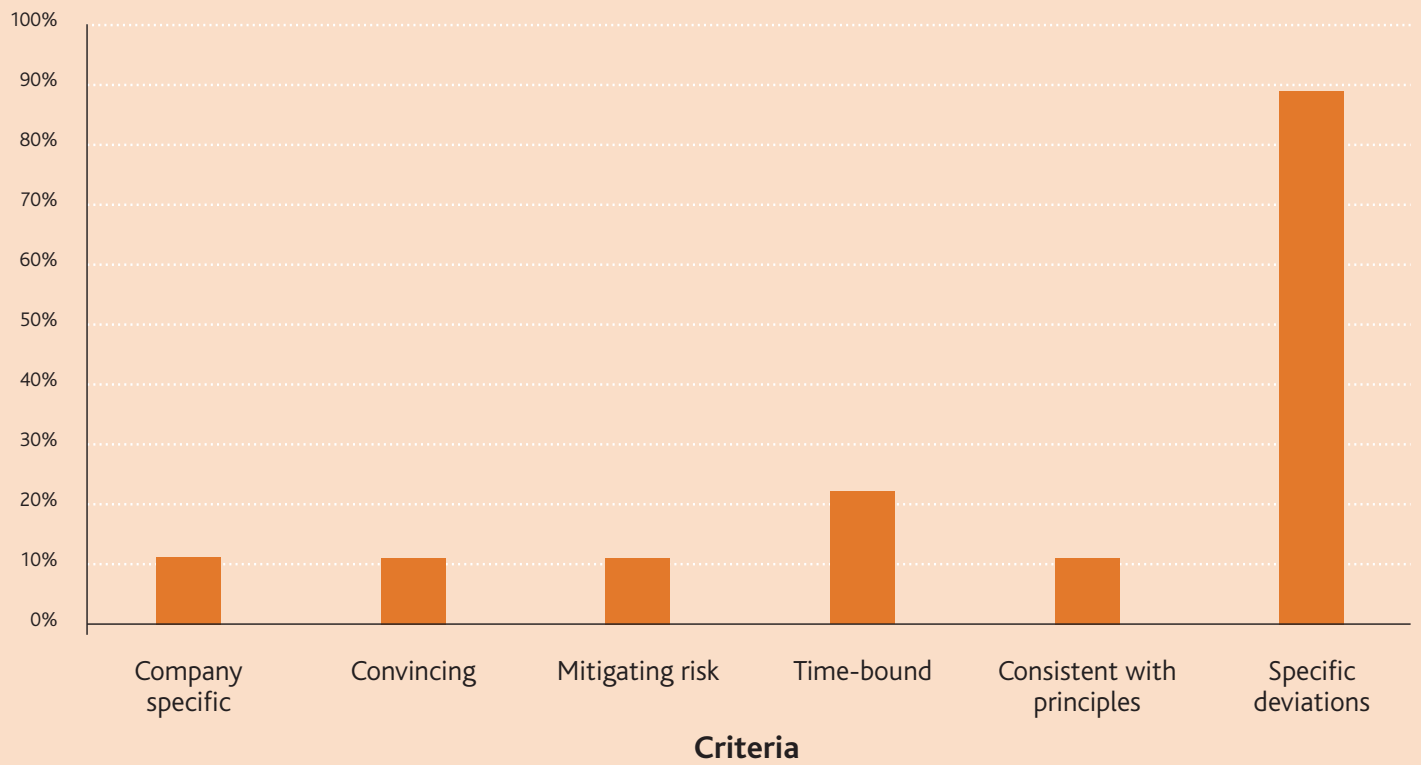


Explanations relating to remuneration provisions scored below average compared to the total sample. Many were reported on in a way that was uncoordinated with the corporate governance section and few went beyond reference to the provision within the remuneration report. Often the Code deviations were one-off in nature, which could explain the above average-score for the time-bound criterion. Several related to discretionary share option awards to non-executive directors. However, 42% of these explanations related to executive service contracts exceeding 12 month notice periods where many had been in place for an extended period of time. Despite the long-standing deviation from the Code, many companies failed to provide meaningful explanations.

Some companies referred to having provided more complete disclosures in previous years. From an investor perspective, this is considered inadequate.

The "company context" criterion did not link well to the "convincing and understandable" criterion, which may indicate that investors found the ultimate remuneration decisions to be disproportionate. Finally, this category scored markedly below the total sample average for "consistency with principles and contributes to good governance". This is disappointing as remuneration decisions are a key component of good governance.

Percentage Criteria Met: Shareholder Relations



Role of Chairman's introduction proving positive

A key re-orientation of the Code following the financial crisis was to emphasise the importance of the chairman's role in ensuring an effective board. In 2010, when the Combined Code became the UK Corporate Governance Code, a notable amendment was the introduction of a section exclusively focusing on 'Leadership'.

This introduced a new main principle specifically emphasising the importance of the Chairman: "The Chairman is responsible for leadership of the board and ensuring its effectiveness

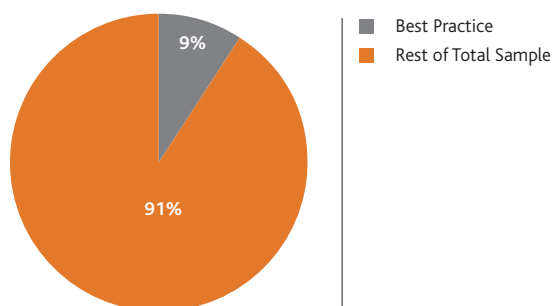
on all aspects of its role." A new section in the Preface encouraged chairmen to report personally in their annual statements how the principles relating to the role and effectiveness of the board (in Sections A and B of the Code) have been applied. The ABI was a strong supporter of this re-orientation during the consultation process.

The result of the change has been unequivocally positive for those companies following the Code Preface guidance:

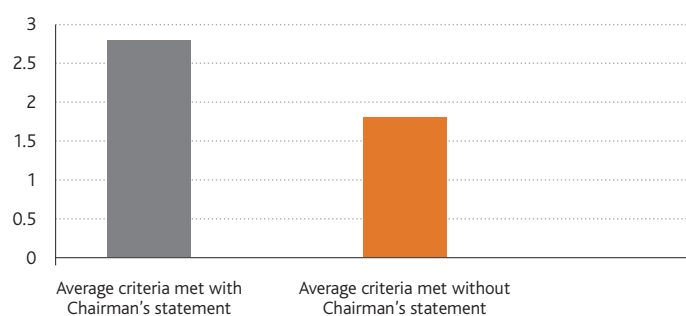
55.5%

Companies with a Chairman's introduction scored on average 55.5% higher on the number of criteria met than those without.

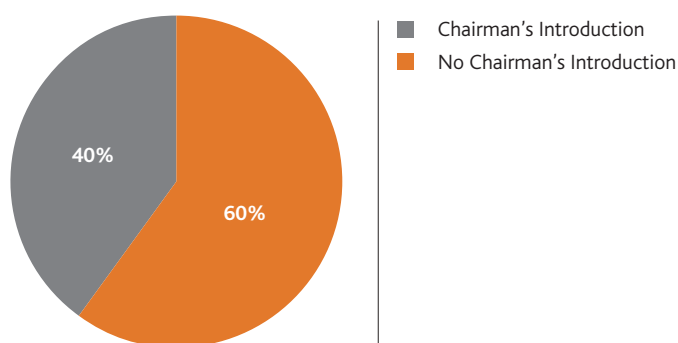
Identifying Best-Practice



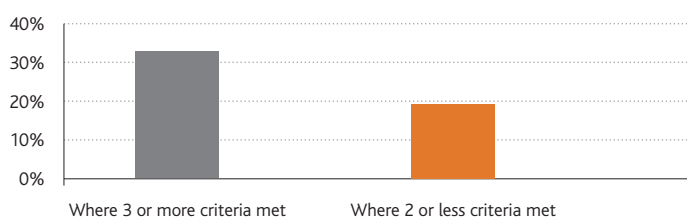
Role of Chairman's Statement



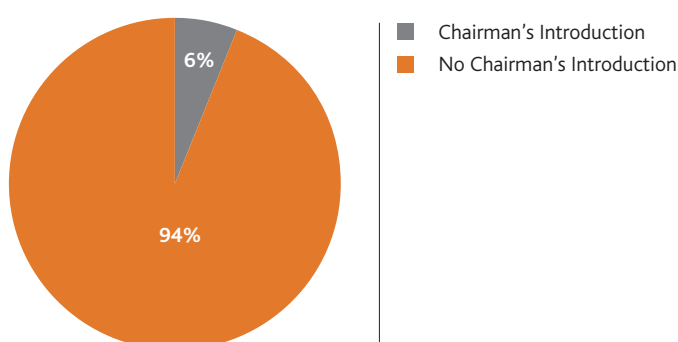
Best-Practice Sample



Chairman's Statement in Total Sample



Non Best-Practice Sample



Conclusion

These findings endorse the decision of the FRC to clarify and strengthen the explanations guidance under the newly published September 2012 Corporate Governance Code.

The ABI welcomes this change and believes that, if followed effectively by companies, it will help to meet the requirements of investors. This should have a positive effect on the operation of 'comply or explain' and help provide more transparent governance disclosures.

However, this report demonstrates that many company Code explanations fail to meet the requirements of institutional investors.

Both companies and investors agree on the benefits of the 'comply or explain' system. They must work together to preserve the UK's leadership position by improving its operation in the market. Unless there are improvements, the UK market remains at risk of having its principles-based approach displaced by mandatory, compliance-based European regulation.

Whilst early indications are that the UK Stewardship Code has led to an increase in the number of investors engaging with companies, the findings of this report underline the importance of retaining focus on the wider concept of stewardship, rather than the traditionally narrow range of issues limited for the AGM season. This was encapsulated in the updated and broadened definition of stewardship in the newly amended Stewardship Code⁵.

Wider stewardship can be exercised by exerting more scrutiny over the quality of companies' corporate governance disclosures and, more specifically, their Code explanations – contributing to improving corporate governance reporting and practices.

ABI members indicated that companies generally provide more complete oral explanations of Code deviations to major shareholders during engagement meetings, compared to the more limited annual report disclosures. Although this type of dialogue is to be supported, it should not derogate from the need for clear written disclosures:

- **larger institutional investors can have a greater engagement burden and consequently be more inclined to focus on companies viewed as in some way problematic. This means they may not always be available for this type of dialogue**
- **equally, smaller investors may not have sufficient voice to access company representatives or in-house resources.**

Poor quality written explanations may therefore:

- **deny the wider market of information considered important by investors to understand companies' corporate governance structures**
- **give the impression to the European Commission that the system of comply or explain is not fit for purpose**
- **expose companies to the 'box-ticking' approaches of investors more reliant on proxy advisers.**

⁵ <http://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx>

However, good quality explanations:

- **are more likely to foster the aspirational nature of a voluntary, principles-based approach**
- **facilitate flexibility in governance arrangements: as more investors understand better how deviations support a business, they are more likely to support differing approaches**
- **have a positive influence on the contest for the mantle of best-in-class.**

A clear positive from the findings is the beneficial role Chairmen's introductions are having on corporate governance disclosures. Not only they appear to give investors a clearer picture of the steps taken by boards to operate governance effectively but also, by providing fuller context, are more likely to lead investors to accept situations when a company chooses to explain rather than to comply.

Personal reporting on governance by Chairmen may considerably help overcoming the detrimental effect of "boiler-plate" which is so often the preferred and easy option in sensitive areas.

Smaller cap companies appear more likely to make poor quality disclosures even though many smaller companies may have more business-specific reasons as to why alternatives to the Code provisions may be suitable and in shareholders' interests. Improved explanations by these companies could have a significant impact on how the market perceives their business model and governance structure.

Key Recommendations & Conclusions

- ABI members strongly support the role of Code explanations and attach as much importance to the role of good quality explanations as they do to basic compliance with Code provisions.
- It is important for companies to consider carefully and articulate both why they have complied with and deviated from the Code: in a sense, a move towards 'apply and explain'.
- Where companies deviate from the Code, they are strongly encouraged to explain in detail the reasons. Current Code explanations are not meeting investors' expectations and are some way away from meeting the new Code explanation requirements coming into effect shortly.
- On the quality of explanations. The increasing trend towards Chairmen providing introductory corporate governance statements has had a positive influence. Those companies with Chairmen's statements were also correlated with better corporate governance disclosures more generally. Chairmen should be encouraged to provide introductory statements.
- Investors should adopt a more active approach to overseeing and scrutinising companies' Code explanations. This should also help broaden the nature of stewardship engagement and increase focus on a wider range of corporate governance risks.
- Although we accept that smaller capitalised companies face a bigger burden meeting high standards of corporate governance, we particularly encourage them to make improvements in their Code explanations. They often have good reasons for departing from the Code given the nascent development of their business or uniqueness of products or services. They could derive significant benefit from enhancing disclosures to improve investor understanding.

Appendix

Code Categories Framework

Chairman Related	Independence	Board appointments	Shareholder Relations	Remuneration Related	Board Evaluation	Annual Director Re-election	Other
CEO to Chairman	Independence of the Board	No external search agency used	Not all Directors attended the AGM	Bonuses being pensionable	No formal annual Board evaluation	No Annual Director Re-election	No Audit Committee whistleblowing policy
Chairman non-Independent upon appointment	Independence of Committees	No Nomination Committee	Chairman of the Audit Committee excused from the AGM	No incentive plan maximum award	No external board evaluation every three years		No recent and relevant financial experience on Audit Committee
Combined CEO and Chairman	Independence of the Senior Independent Director	No specified Terms of Appointment	No Senior Independent Director	Executive Directors' remuneration from other sources			
Executive Chairman		No Nomination Committee meetings		Option Grants to NEDs			
Executive Director to Chairman				No performance conditions attached to majority of equity based awards			
The responsibilities of the Chairman not being set out in writing				Executive contracts notice period exceeding one year			

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