

# Moving away from 'comply or else'

## KPMG Board Leadership Centre

The FRC recently published their updates to the [UK Corporate Governance Code](#) and with it reiterated their stance on 'comply or explain'. The Code does not set out a rigid set of rules and recognises that one approach does not necessarily suit all companies. While the concept is seen as one that must be protected by investors and companies alike, it has also attracted much attention with many voicing that it had become a 'comply or else' regime. So how do we move away from this and use the full breadth of what 'comply or explain' can offer and provide companies with the flexibility they need?

### What happens in practice?

The FRC's [2023 Annual Review of Corporate Governance Reporting](#) found that well over 50% of companies departed from one or more provisions of the Code. While it could be seen as encouraging that companies choose to only comply with those provisions that are most suitable to their circumstances, the FRC found that in most cases there was either no explanation or an unsatisfactory one. Most departures relate to the alignment of executive pensions with the workforce (provision 28). Other Code departures typically include the Chair's tenure limit and the Chair's independence requirements.

### How did we end up with 'comply or else'?

For a long-time, there have been those that have argued that institutional shareholders are driven by their own structures to force companies to comply. Of course, companies do have a responsibility to uphold the highest standards of corporate governance – but this doesn't necessarily mean compliance with every Code provision.

Looking more widely, there is no doubt that investor behaviour has a big role to play in ensuring the success of the 'comply or explain' framework, but companies that allow themselves to be pushed into a one-size-fits-all framework, will have to take some responsibility. The battle will be lost before the first shot is fired if companies seek compliance for compliance's sake. This will not be good for boards, business, or shareholders.

### What needs to change?

Boards should choose not to comply with those provisions that they genuinely believe will not be conducive to the business itself. Generally, those companies that have chosen non-compliance have done so without fear of unreasonable shareholder backlash. Hopefully there is no reason to believe that this situation cannot continue – providing non-compliance is properly explained and evaluated objectively.

It is, however, a two-way process. Investors are often criticised by the corporate community for interpreting non-compliance as failure, but they would argue that they can't do anything else when most 'explanations' continue to lack detail specific to companies' circumstances.

It is not sufficient to simply disclose that a course of action has been taken because it is 'appropriate to the company's circumstances'. There may be many valid reasons to depart from the Code, but these must be explained fully – after all, if boards make conscious decisions in the interests of their company's members, then they should ensure they articulate their reasoning to those very same people.

Only when corporates make proper disclosure can they criticise investors for taking an unwarranted, and unhelpful, box ticking approach. However, this does not mean that the investor community doesn't have to look closely at its own responsibilities.

'Comply or explain' will not work in an environment where investors are simply telling companies to comply. The principle requires the commitment of institutional shareholders to devote the time necessary to assess each company's explanation.

### What makes a good explanation?

The FRC published in 2022 their guide on [What Makes a Good Annual Report and Accounts](#). Set against a backdrop of materiality, the publication outlines the 4Cs of effective communication:

- Company specific
- Clear, concise, and understandable
- Clutter free and relevant
- Comparable

The FRC's 2021 publication on [Improving the quality of 'comply or explain' reporting](#) is also a great resource. It provides examples of good explanations for departures from the Code and states that these should:

- Set the context
- Give a convincing rationale for the approach being taken
- Consider any risks and describe any mitigating actions
- Set out when the company intends to comply (timescales)
- Be understandable and persuasive

## What is happening with the stewardship code?

In the FRC's policy update in November 2023, Richard Moriarty, the FRC's CEO, noted that during the consultation on the UK Corporate Governance Code, concerns about aspects of the UK Stewardship Code were raised. Following the publication of the Corporate Governance Code, their next priority will be to start to engage with stakeholders on how best to review the Stewardship Code, which sets the standard for how investors oversee the companies in which they invest. An important piece which hopefully will drive better collaboration and unity between boards and shareholders.

## Transparency is key

If the 'comply or explain' framework is to continue to be successful, it must have the 'buy-in' of both the investor and corporate community. Boards must explain their governance procedures in an open and transparent way and not be pressured into Code compliance when it is not in the best interests of the company. The quality of the explanation is key – there needs to be a persuasive reason why they have decided not to comply, and they have to explain this clearly. Likewise, investors must ensure they interpret governance disclosures in an enlightened and objective manner. At the end of the day, simple, open and transparent communication is the key.

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