



Financial Reporting Council

Improving the quality of 'comply or explain' reporting

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Introduction

The UK Corporate Governance Code has set a framework for good governance for over thirty years. During this period, it has been copied all over the world as a leader in offering companies a flexible framework for undertaking and reporting their governance activities.

The Code sets out high level principles for companies to follow in a way that suits their maturity and business model and alongside this sets more specific provisions to support the principles.

Over time we have noticed that this flexible framework has, by some stakeholders, been turned into a compliance exercise, from which companies feel they cannot depart. This was not, nor is it now, the basis on which the Code was introduced. The principles are to be applied, and the provisions either followed, or an alternative approach explained within the spirit of the Code – demonstrating good governance practice. It is important to emphasise that an explanation is, in our view, evidence of better governance than tick box compliance, especially in a case where a Code provision doesn't suit a company's circumstances.

The Code allows a company to demonstrate the oversight and accountability of the board and its committees and illustrate how governance practices set the company up for success in managing those risks that have to be managed and mitigated, whilst also maximising opportunities. This is important in helping companies in their capital formation on financial markets.

Applying the principles

The principles are simple and high level, allowing companies a large amount of discretion and flexibility when applying these to their structures and circumstances. They present good governance practices, such as the general responsibilities of the board, board committees and individual directors. The simple nature of the principles means that all companies should be able to apply them and set out how this have been done noting any highlights or issues of importance.

When explaining how the principles are applied, the focus of reporting is on the board's activities and decisions. Annual reports often describe the work of senior management or other units within the company, however, it is the board who has responsibility for the company's governance, therefore, reporting against the principles should reflect this.

In addition, explanations should demonstrate actions and outcomes, not just policies and procedures. Outcomes will take different forms depending on the principle. For example, when explaining the application of Principle D (board's engagement with shareholders and stakeholders), the annual report could describe what impact, if any, such engagement has had on the board's discussions and decision-making.

Provisions

The Code recognises that all companies are different and often they are able to demonstrate good governance without following all the provisions. Companies should embrace the flexibility offered by the provisions, and choose governance arrangements most suitable to their circumstances, while clearly explaining any departures from the Code.

Demonstrating good governance and high-quality reporting through offering explanations is preferable to 'tick-box' compliance. Striving to declare strict compliance with the Code often leads to boilerplate language, and ineffective reporting that lacks substance and information about governance outcomes, and does not reflect the way in which the company operates.

Shareholders, proxy advisors and other stakeholders should not expect or favour strict compliance over effective governance that meets the spirit of the Code. It is more important that they consider the explanation provided by the company and evaluate whether the alternative governance arrangement is more suitable and effective for the company.

Shareholders and advisors are encouraged to take into account departures from the Code positively in their voting policies and build in flexibility to consider the alternative arrangement chosen by the company and the explanation provided, especially where this is transparent and informative. They can use these policies when engaging with the company and when making voting decisions.

In addition to departures from the Code which are chosen by a company because it suits their particular circumstances, sometimes a shorter-term departure from the Code is unavoidable: for example, if a director resigns without advance notice, leaving the board with less than half of the board made up of independent non-executive directors. Companies should use the flexibility offered by the Code to adjust their governance to their changing circumstances in both the short and long term.

Transparency

When a company does depart from a provision it is important that they are transparent about this in their reporting and include an explanation. In our reviews, we have found several companies that reported full compliance with the Code, that on further investigation had not disclosed and explained a clear departure from one or more provisions of the Code.

Such discrepancies can call into question the other information within the annual report and leave the reader wondering what else is not accurate in the report. It is, therefore, essential that companies are transparent about any departures from the Code so that investors and wider stakeholders can assess a company's approach to governance.

Clarity

It is important to offer clarity when following the Code. Companies should state they have:

- a) fully complied with all elements of the provisions of the Code; or
- b) departed from any of the provisions of the Code, citing any provisions that they have provided and explanation for, and state where in the report the explanation can be found.

Introducing ambiguity into the reporting is not helpful. For example:

“Other than where expressly stated below, throughout the financial year, the company complied in full with all relevant provisions of the Code.”

“The Board is committed to the highest standards of corporate governance and, except as set out below, the Board has complied with and intends to continue to comply with the requirements of the UK Corporate Governance Code.”

If either of the above statements were followed with a list of provisions that were not complied with, the report would offer clarity, but in many cases the reader has to search through the annual report to a section that says ‘we did not comply with provision x’.

Companies should make departures clear by naming the provision(s). For example:

“Throughout the financial year ended 31 December 2019, the company fully complied with all the provisions of the Code, except for provision 9 and we have provided a full explanation.”

This should then be followed by an explanation for the departure, either as part of the compliance statement, or signposting to another page of the annual report, where the reader can easily find it.

Clear and meaningful explanations for departures from the Code

Explanations are key to the Code’s ‘comply or explain’ nature. A meaningful explanation for a departure shows that an alternative arrangement is more appropriate and beneficial in upholding high governance standards. This allows investors and other stakeholders to consider whether the quality of the explanation achieves effective governance of the company even though there is a departure from the Code. It also demonstrates confidence that the company is taking governance seriously.

A good explanation demonstrates that a departure is justified given the company's specific circumstances. It should:



Set the context and background. This makes it easier for a reader of the annual report to understand the departure when the company explicitly names the Provision that they have not complied with. A good and effective explanation starts with describing the circumstances, state the reasons why they are not complying or are unable to comply.



Give a convincing rationale for the approach being taken. Companies should set out the alternative arrangement that they have chosen and state the reason(s) why they have chosen it. This should be easy and straightforward if departure from the Code is unavoidable, such as in the example mentioned above, a director resigning without advance notice. For explanations when a departure is indefinite, more detail is likely to be helpful. For example, if the company decides to keep the chair in their position for longer than nine years, a strong rationale would include clear reasons and the criteria used to evaluate it.



Consider any risks and describe any mitigating actions. Companies should consider whether departing from the Code and following an alternative approach contains any risks. They should state if there are any actual risks (if any) arising from this approach. If the directors consider that there is no or negligible risk, companies it is good practice to state any potential risks that might arise in the future followed by an explanation of any actions that they have taken or will be taking to mitigate such risks. For example, the loss of independent directors could reduce challenge to board decision-making and leave effective control of the company with a small number of individuals.



Set out whether the company intends to comply (and when). A good explanation should indicate whether departure is limited in time or is indefinite. When companies have not complied with a provision only for part of the accounting year, it is important to set out the time that they were unable to do so. When a departure extends beyond the full accounting year, a good explanation would give an estimate of when the company plans to comply with the provision. When departure is indefinite, it is helpful to state this and explain whether there could be any future factors or circumstances that would give them a reason to review.



Explanations should be understandable and persuasive. Considering all the above elements, companies should ensure that their explanation is understandable and persuasive. It should be written in plain language that is easy to understand and leaves no room for ambiguity, providing enough level of detail so that investors and stakeholders fully understand and evaluate why the company has not complied with a provision and what the chosen alternative entails.

These five criteria are intended as a helpful checklist for the drafting of explanations. It is for companies to decide the extent to which each of the five criteria needs to be addressed after considering their particular circumstances.

It is always beneficial to consult with shareholders, and it is a good addition to an explanation to state that shareholders are supportive of the departure.

Example of a good explanation – **Rolls-Royce**, non-compliance with Provision 32:

We are very sorry that Ruth Cairnie stepped down from the Board at the end of 2019 to allow her more time to focus on her other commitments, following her appointment as chair of Babcock International Group PLC. Following Ruth's departure, Irene Dorner was appointed as Chairman of the Remuneration Committee, with effect from 1 January 2020. While we note the Code requirement that remuneration committee chairs should have served on a remuneration committee for at least 12 months prior to their appointment, we have every confidence that Irene has the appropriate experience and skills to carry out the role. She formally joined the Remuneration Committee on 1 August 2019. Irene is Employee Champion on the Board, a role she has held for three years. Her role on the Audit Committee over the last four years gives her excellent insights into the financial performance measures and targets for the long and short-term incentive schemes. She has also attended six Remuneration Committee meetings since joining the Board and is therefore familiar with the discussions and workings of the Committee. Irene also has experience of HR

in her executive career having spent two years as general manager, human resources for a UK unionised workforce of 55,000 at HSBC. Irene joined Ruth to consult with shareholders on the remuneration policy that will be voted on by shareholders at the 2020 AGM and both attended the joint briefing during the year on wider workforce engagement (see page 86). Irene stepped down from the Audit Committee in December 2019.



They set the background and explain the reason for non-compliance.



The timescale is clear.



They give a convincing rationale of the approach taken, by explaining the alternative approach and why that is effective.



They consider any risks and describe their mitigating actions.



The explanation is understandable and persuasive.

Summary

When explaining how the company has applied the principles of the Code, it is important to provide reporting that demonstrates how the board has discharged its responsibilities, the outcomes from these and how the governance contributes to the overall success of the company.

For companies to demonstrate a robust appraisal of their governance, they should offer transparency in terms of both their application of the principles and reporting against the provisions. This can only be effective if the report avoids boilerplate language and individual companies explain how they have applied the code to their individual circumstances. This transparent approach should be welcomed by investors, service providers, regulators and wider stakeholders.

Appendix A – Explanation for non-compliance with Provision 9

Provision 9 of the Code has continuously been one of the provisions with the highest departure rate from companies in the samples used for our annual reviews of corporate governance reporting. We have found that explanations given by companies for a departure from this Provision are often vague and lacking information. The examples below are excerpts from annual reports of explanations for departure from Provision 9.

“The Board confirms that it fully complied with the Code, with the exception of the independence of the Board Chair upon appointment which was fully explained and justified at the time of appointment.”

“The Board continues to support the appointment of the Chairman to retain their skills and experience and ensure continuity of service for customers.”

“The Non-Executive Directors have determined that [the Chair] continues to lead the Board effectively.”

For a departure from this Provision, we would expect to see fuller explanations that include the following:



Set the background. Explain why the chair was not independent when they were first appointed on the board.



Give a convincing rationale for the approach being taken. The rationale should include the reasons why retaining the chair is beneficial for the company and its stakeholders, including the skills, experience and any other factors considered. It should also cover the reasons why a new independent chair may not offer the same or better skillset than the current chair, bearing in mind that Principle F of the Code states that “...they should demonstrate objective judgement throughout their tenure” and Principle K states that “Consideration should be given to the length of service of the board as a whole and membership regularly refreshed”.



Consider any risks and describe any mitigating actions. Companies should consider the risks of having a non-independent chair, for example, the impact on board effectiveness or board dynamics, and the actions that the board has taken to mitigate this.



Set out when the company intends to comply (timescales). State whether the company has plans in place to comply with this departure, for example describing the process for succession planning; or explaining the reasons for the chair remaining in post without setting a timeframe for a replacement.



The explanation should be understandable and persuasive. The reasons why the chair is not independent should be genuine and it should be visible that it is the right approach to take. A good explanation should provide a convincing argument that shows that, on balance, the benefits of retaining a non-independent chair outweigh the benefits of appointing a new independent chair.

Appendix B – Following the Audit Committees and the External Audit: Minimum Standard

Provision 25 of the Code outlines the Audit Committee's role and responsibilities covered by the Code, which now include following the [Audit Committee and the External Audit: Minimum Standard \(the Minimum Standard\)](#). This is further supported by Provision 26, which states that the annual report should cover the matters set out in the Minimum Standard.

To comply with these two Provisions, the Audit Committee should either follow the Minimum Standard or implement those points specified in the Minimum Standard relevant for the company. The annual report should make clear which points have been followed, and which have not. Reporting in this way would constitute compliance with the Code. As Provision 26 asks that the annual report covers matters set out in the Minimum Standard, companies have the opportunity to describe how they have followed it, including which aspects of the Standard were not implemented and the reasons behind these decisions.

If the Audit Committee chooses not to follow the Standard at all (e.g. not implementing any of the points), it should disclose a departure from both Provisions 25 and 26. This disclosure should be accompanied by a clear explanation to provide stakeholders with context regarding this decision.



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