QUOTED COMPANIES ALLIANCE

UHY Hacker Young
Chartered Accountants

Corporate governance behaviour review

Quoted Companies Alliance & UHY Hacker Young

Good corporate governance can bring a great deal of value to a company by helping it raise finance and preserve capital.

This report on corporate governance behaviour will help quoted company directors to communicate with investors better. We do not expect every box to be ticked and neither do investors. Rather, investors want to see companies improving their corporate behaviour as they grow.

The Quoted Companies Alliance worked in partnership with Top 20 UK accountancy firm, UHY Hacker Young, to produce this report which details our analysis of corporate governance behaviour.

We benchmarked corporate governance disclosures made by small and mid-size quoted companies against the Quoted Companies Alliance Corporate Governance Code for Small and Mid-Size Quoted Companies 2013 (the 2013 QCA Code). The main objective of the analysis was to compare the disclosures made against the minimum disclosures set out in the 2013 QCA Code.

Our review looked at 100 small and mid-size quoted companies across a range of sectors and London markets. While levels of behaviour varied across the differing disclosure requirements, the results highlighted some obvious areas of improvement for the majority.

We shared the results of our analysis with a group of institutional investors at a round table forum and have drawn on this feedback in determining the top five governance reporting tips.

One of the overriding indications is that boards must become more effective in articulating how and why decisions link strategy, governance and the proper management of risk.

Speed Read...

Snapshot of the key messages

- Boards need to improve on telling shareholders why the decisions they make are in the best interests of the company as a whole
- Investors want companies to focus on what is important and move beyond the comfort of boilerplate and cut-and-paste disclosures
- Companies should view the annual report and accounts as the 'shop window'
- Companies need to make it easier for investors to come to their conclusions

EXECUTIVE SUMMARY

FOCUS ON WHAT IS IMPORTANT

The annual report and accounts represents the story of the board's stewardship of the company to a broad audience. The published accounts are an important advertisement that will hit the news wires, often giving small and mid-size quoted companies more airtime and media coverage than for the rest of the year combined.

Companies should be bold enough to focus on what is important through their reporting, rather than falling into a mode of cut-and-paste where false comfort is taken from boilerplate disclosure and other clutter. "This is what we said last year" should not be the starting point for any of your narrative.

NEED FOR BETTER LINKAGE BETWEEN STRATEGY, GOVERNANCE AND RISK

The clearest conclusion from our review is that, almost universally, small and mid-size quoted companies need to work harder to create a more effective link between the narrative on strategy and the proceedings within the boardroom. The manner in which the board and, in particular, the chairman ensures that the governance structures of the business are linked into its strategy for long-term success is vital. There is a significant body of evidence that boards do indeed relate governance to strategy, but it seems that boards are not yet building this into the corporate narrative as effectively as they might, for example, by providing a detailed account of the significant issues considered by the audit committee and how these issues have been addressed.

A key objective of good corporate governance is to better align risk, governance and corporate strategy. Boardrooms have changed a lot over the last decade and will continue to do so. Greater focus on the duties of directors and the need for those directors to open up their subjective judgements to the views of shareholders represents a major shift of emphasis. An 'open' board engages in a regular and open manner with shareholders. It has fewer places to hide than a more closed board where underlying debate and analysis is kept tightly controlled.

USING THE REPORTING CYCLE AS AN OPPORTUNITY TO PUT A GOOD STORY FORWARD

Companies should use the interim statement to lay the ground for the annual report and accounts and to advise of any changes in accounting policy or presentation and the reasons for this. Investors do not like to receive bad news, and to receive bad news as a surprise is even less desirable.

Companies invest a lot of money in the presentation of financial and narrative reports and in obtaining assurance thereon. It is important that this is treated as an investment which should deliver some added value to your company. Despite the ever increasing speed of communication and diversity of media, the annual report and accounts is an invaluable tool to set out all that is currently of relevance to a company, its shareholders and those whom it seeks to attract as either shareholders, suppliers or customers, in a single document.

Investors emphasise that the annual report and accounts remains a vital source of information throughout the year. While the annual report and accounts may not be read cover-to-cover, it remains an essential single source of reference information, which will also appear in other communications (eg. a company's website). The key for your company is to ensure consistency across all media. Your company should use all of its published documents to display your corporate style and culture.

Subject to legal and accounting requirements, you should focus on how your company might be able to improve the presentation of the key elements of the annual report and accounts and the narrative upon which investors will focus. Deliver the message to investors in a clear and confident manner and do not try to hide bad news in the detail. Indeed, the Financial Reporting Council and the Department for Business, Innovation and Skills are encouraging companies to be more innovative in presentation.

BOARD EVALUATION CAN HELP IMPROVE GOVERNANCE

Our analysis has demonstrated that small and mid-size quoted companies remain reluctant to embrace the benefits which can be brought about through effective board evaluation.

> "Setting and reiterating the strategy are key. Investors can tell a lot of reports are just a template and full of boilerplate disclosures. Companies could do more to sell themselves."
>
> **Judith MacKenzie, Downing LLP**

We do not yet appear to have arrived at the point where boardrooms are sufficiently open to neither be threatened by evaluation, nor deeply sceptical of the board evaluation process. Accordingly, descriptions of the evaluation process and the resulting benefits remain light and require further focus, especially as investors want more information on this.

IN SUMMARY

Companies invest a lot of time and effort into producing reports which meet regulatory requirements and deliver a good narrative as to the operations of the business. However, more needs to be done to link disclosures (both financial and narrative) to corporate strategy and for companies to better present their good work. Boardrooms need to become bolder in using the annual report and accounts (and, indeed, the interim financial statements) to advise shareholders and the wider community of stakeholders as to how and why the company does what it does.

Edward Craft
Corporate Partner at Wedlake Bell LLP, Chairman of the Corporate Governance Expert Group of the Quoted Companies Alliance

OUR COMMENTARY

We found that there is a variable level of disclosure when compared to the suggested minimum disclosures in the 2013 QCA Code. Some aspects are communicated extremely effectively whilst other aspects have significant room for improvement. Ultimately, we want companies to improve the communication of their corporate governance behaviours.

Companies may be compliant with certain aspects of any given corporate governance code, but they need to address how they articulate that compliance within their published communications to their investors and other stakeholders – explaining what they do and why they do it. For example, in many instances, information historically expected to be found within the annual report and accounts was found to be merely signposted to information on the company's website. We considered such instances to be compliant in nature, provided the link was clear to the reader of the financial statements.

Areas of good disclosure

Most of the companies that we analysed provided their annual report and accounts and other governance related materials on their websites. They also disclosed brief descriptions of the work of each board committee and its role.

Many companies also disclosed information on the identity of all directors, their roles and committee memberships, together with information on their relevant skills and expertise, both for executives and non-executives.

There is further strong disclosure in terms of highlighting the responsibilities and accountability of each committee.

Weakest areas of disclosure

The weakest area of disclosure is the inclusion of a summary on how evaluation procedures have evolved from previous years, the result of the evaluation and the action taken or planned as a result.

During our discussions with institutional investors following our analysis of companies' disclosures, they indicated that reporting information on such evaluations and, perhaps more pertinently, the actions to be taken provided valuable insights for them in their assessment of a company, its prospects and its credibility.

> "The most important disclosure is to establish the operational effectiveness of the Audit Committee, Remuneration Committee and Nomination Committee."
>
> James Thorne, Threadneedle Investments

Another weak area was the lack of a clear articulation of how the application of a company's corporate governance structures and behaviour would support the company's long-term success and its strategy for growth. Of the companies reviewed only 3% included appropriate narrative to provide this information to the readers of the annual report and accounts.

Only 5% of companies were found to provide a summary of information received by boards and by individual committees. Institutional investors have indicated that such information would enhance their understanding by providing a reference point for the type and quality of information presented to board members as they reach critical decisions on the company's operations and strategy.

The 2013 QCA Code requests an explanation of the role of any external advisors to the board or its committees and any internal advisory responsibilities, including that of the company secretary. Where the company secretary is also a director, an explanation should be provided. We found that only 6% of our sample provided such explanations. Investors again indicated the value of such information to them.

Importantly, investors told us that they see a potential conflict in the situation where the company secretary was also a director.

The knowledge that boards are making their decisions based on sound, independent and objective advice can enhance the company's credibility for being able to deliver on its future strategy.

The 2013 QCA Code requests that the terms and conditions of appointment of non-executive directors should be stated. We found that only 12% of our sample disclosed this and, out of those that did communicate such information, they did so within the annual report and accounts rather than on the company's website.

Another aspect of significance to investors where improvement could be made includes an explanation to shareholders of how audit objectivity and independence is safeguarded, particularly if the auditor provides significant non-audit services.

In addition, providing a clear explanation of how risks align with the strategy of the company and how the strategy links to the key performance indicators, the remuneration policies and corporate responsibility activities, are seen as highly valued aspects.

The top five governance reporting tips

1. **Focus on what is important**
   Companies should think about what messages they want to convey in the annual report and accounts and use it as an opportunity to sell their company's story.
2. **Explain what you do**
   Investors do not necessarily want blind compliance and box-ticking – they want to understand what governance structures and process you have and why.
3. **Link your company's strategy, governance and risk**
   Everyone accepts that this is difficult to do, but it is important to investors that companies try to articulate this clearly.
4. **Use the reporting cycle to tell a story**
   Write in your company's voice and tone; don't hide the bad news; and deliver your company's messages in a clear and confident manner.
5. **Board evaluation can help your company improve its governance**
   Board evaluation and disclosures on this can help demonstrate to investors a process of continuous improvement.

OUR ANALYSIS

This section details our measure of corporate governance behaviour by showing the percentage of the sample that included the minimum disclosure requirement.

KEY:
We have coded the results according to the percentage observed:

- Less than 25%
- Between 25% and 50%
- Between 50% and 75%
- Between 75% and 100%

> The quality of disclosure on the individuals on the board is generally poor. We want to know why directors are on the board in the first place. More information about board members is always helpful.

Antony Marsden,
Henderson Global Investors

ANNUAL REPORT AND ACCOUNTS

Chairman's governance report

The narrative reporting of the company should include a report by the Chairman of how the QCA Code is applied.

There was reference to a 'Code' (although not always specifically defined):

81%

The report should include how such application supports the company's long term success and its strategy for growth:

3%

Audit committee report

An audit committee report should explain the major tasks undertaken and demonstrate an independent oversight of both management and external auditors.

It should include details of the significant issues considered by the committee in relation to the financial statements and how these issues were addressed:

20%

There should be an explanation to shareholders of how audit objectivity and independence is safeguarded, particularly if the auditor provides significant non-audit services:

31%

The audit committee also acts as the committee focused on risk if there is no designated risk committee and, as such, the committee should indicate how this role has been undertaken:

17%

Remuneration committee report

A remuneration committee report should explain how the company's remuneration policy and practice align with the company's strategy:

68%

Details of directors

The identity of all the directors, their roles and committee memberships must be disclosed:

93%

Relevant skills and experience

The relevant skills and experience that the executive and non-executive directors bring to the board should be described:

91%

Independent directors

Those directors considered to be independent should be identified. The reasons for their independence should be explained and particular attention given to circumstances where the status of independence may be impaired:

43%

Committees

There should be a brief description of the work of each board committee and its role:

95%

Committee responsibility and accountability should be explained:

87%

Meetings and attendance records

There should be disclosure of the number of meetings during the year of the board and of the committees:

70%

The attendance records of each director should be provided:

67%

Risk management and internal control

There should be a summary of the systems of risk management and internal control and the uncertainties facing the business:

73%

An explanation should be provided of how risks align with the strategy of the company, as well as linking into key performance indicators, remuneration policies and corporate responsibility activities:

38%

Performance evaluation

There should be a description of the performance evaluation procedures for each of the directors, the whole board and each committee focusing on their objectives and outcomes:

14%

Include a summary of how evaluation procedures have evolved from the previous years, the result of the evaluation and action taken or planned as a result:

2%

> *Invest some time and money into improving your electronic communications, especially websites.*
>
> Nathan Leclercq, Aviva Investors

WEBSITES

Should include:

Information summary

A summary of information received by the board and by individual committees:

5%

Summary of strategy

A clear articulation of the strategy of the company:

56%

Description of roles

A description of the roles and responsibilities of the chairman, chief executive and, if applicable, the senior independent director:

65%

Matters reserved for the board

A list of the types of decisions reserved for the board:

32%

Non-executive appointment terms

A statement of the terms and conditions of appointment of non-executive directors:

12%

Terms of reference

Terms of reference of the audit committee and the remuneration committee:

41%

Where there is a nomination committee, the terms of reference of the nomination committee should be included. If there is no separate nomination committee, there should be an explanation of the processes by which the whole board determines nomination and senior appointment matters:

29%

Role of external and internal advisors

An explanation should be given of the role of any external advisors to the board or its committees (in particular, the remuneration committee) and any internal advisory responsibilities, such as the roles performed by the company secretary and the senior independent director in advising and supporting the chairman. Where the company secretary is also a director, the company should provide an explanation for this:

6%

Published material

Annual Report and other governance related materials:

98%

Published material

Notices of all general meetings over the last three years:

63%

Voting decisions:

65%

Where votes at a general meeting are by show of hands, the votes by proxy received by the company, including abstentions or votes withheld, should be reported as soon as practical after the meeting. Where votes are conducted on a poll, the actual votes, including votes withheld or abstentions, should be reported as soon as practical after the poll:

65%

METHODOLOGY

The analysis was conducted across 100 small and mid-size companies with equity securities admitted to trading on a London market (the Main Market of the London Stock Exchange, AIM and the ISDX Growth Market) across all sectors.

UHY assessed the sampled annual reports, accounts and company websites against the minimum disclosures as set out in the Quoted Companies Alliance Corporate Governance Code for Small and Mid-Size Quoted Companies 2013.

The conclusions of this exercise were then presented to a round table meeting in late 2013 with seven institutional investors and other interested parties who then provided feedback and insight into the aspects they consider to be significant.

The annual report and accounts would naturally have been produced largely prior to the issue of the updated 2013 QCA Code. However, the tracking of the newly issued code was considered to be a better benchmark for measurement, particularly as it is a barometer of current best practice.

The assessment was completed on a straightforward binary measure; did the company disclose the requirement or not. As an initial report, we did not seek to judge the qualitative nature of the compliance.

Since this work has been carried out, the London Stock Exchange has proposed a change to the AIM Rules, which, if adopted, will require each company to formerly disclose which corporate governance code it applies and the extent to which it does so. In the expectation that this change will come into effect, companies with securities admitted to trading on AIM will need to better evidence their corporate governance behaviours and compliance.

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