Corporate Governance Behaviour Review 2015

Quoted Companies Alliance
& UHY Hacker Young

Good governance demonstrates sound stewardship.

Our third annual Corporate Governance Behaviour Review has demonstrated that the reporting landscape continues to evolve, albeit slowly. Reporting generally within the small and mid-size quoted company community is under scrutiny from the regulator, with the FRC's ongoing three year project seeking to bring about improvements in the quality of reporting by companies.

We again benchmarked the corporate governance disclosures made by 100 randomly selected small and mid-size quoted companies taken from the Main List, AIM and ISDX and compared these against the minimum disclosures set out in the Quoted Companies Alliance Corporate Governance Code for Small and Mid-Size Quoted Companies (the QCA Code).

As in prior years, we shared the results of our findings with a group of institutional investors at a roundtable discussion and have drawn on their feedback and comments to identify the top five reporting tips for companies, together with some easy reporting wins.

The QCA Code is designed to help quoted companies put into practice appropriate corporate governance arrangements and to enable them to explain their corporate governance ethos to shareholders. Good corporate governance reporting is a means by which company directors can demonstrate the quality and effectiveness of their stewardship of the business, its assets and the company's strategy for sustainable long-term growth.

Investors have consistently told us that for small and mid-size quoted companies, the annual report is key, and often the only effective and reliable means of communication. It is important, therefore, that management does not treat the reporting opportunity as one of simply compliance. Companies should view this as an opportunity to set the tone and to attract and influence shareholders.

Our annual review of governance disclosures seeks to help those charged with governance to improve the communication of their arrangements by highlighting the aspects of significant interest to investors, and also to provide them with the prompt to ask the question: 'how well do we communicate that aspect of our governance arrangements?'. The reporting process allows companies the opportunity to build a level of trust between the company and its key stakeholders, which is enhanced through clear and concise explanations of the arrangements in place and why those are appropriate for the company.

The top five governance reporting tips

- Make the 'boring' information more interesting
- Focus on the bumps in the road ahead
- Ensure that there is consistency
- Tell your company's story
- Link strategy and corporate governance

Helping you prosper

EXECUTIVE SUMMARY

The challenge of linking governance and strategy

What has remained most apparent across the three years of this review is that companies do not seem to be effectively linking governance with strategy in their annual report. We do not yet know whether they struggle to achieve this or simply do not consider it to be important. If companies do not think it important, they do not tend to provide any narrative as to why: this is disappointing and we are currently reaching out to the corporate community to better understand their views on this.

Improved signposting

The good news is that over the course of the last three years there has been a notable improvement in the manner of presentation. This year it was much easier to find companies' corporate governance disclosures and generally there is much better signposting within the annual report and the website.

Making life easier for investors and easy wins

Just because an item of information is routine or is readily available from other public sources, it does not mean that investors do not find it helpful for it to be included within the annual report.

It is also rare for a single reader at an investment house to review a complete annual report from cover to cover on a single occasion (the document is usually carved up between the fund management and governance teams). The annual report is almost invariably the first source anyone at the investment house will go to when considering a company, so we have identified the 'easy wins' that we recommend should be included, below.

The annual report as the shop window

Small and mid-size quoted companies regularly say that they struggle to attract investor interest and, most notably, analyst coverage. There is an extent to which this is a simple matter of market forces. However, companies should use their annual report as an opportunity to pique the interest of their current and prospective investors. Even the smallest company must work on the basis that its investors read the document.

Investors tell us that they are more likely to be well disposed to the company if they read powerful and interesting narrative in the annual report, which contains all of the relevant information.

At the very least, the process of producing a high quality annual report builds trust between the company and its investors – especially independent and private investors who provide much of the liquidity in small and mid-size quoted company shares. These investors do not get the opportunity to meet companies as regularly as institutional investors and so companies should ensure that their annual reports explain their governance arrangements to this audience clearly.

Small and mid-size quoted companies have a particular opportunity because of their size. Larger companies often struggle to ensure that the narrative in their annual reports is in the voice of the chairman, audit committee chairman, etc. However, the annual report of a small and mid-size quoted company tends to be produced largely by key management rather than the marketing team or an external consultant. The benefit of this is that the voice of key individuals can come across strongly, which investors welcome.

The narrative reports should be written in a manner which conveys the life and energy of the company and allows directors to describe personally the key elements of the company's story within that year. Narratives should go on to explain the substance of the arrangement, not simply identify it.

The evolving narrative

New entrants to the market may have immature governance structures. More deeply–rooted companies should develop increasingly solid governance structures as they grow. Investors like to see year-on-year progression and, most importantly, to read a narrative that explains what has changed, for example why one risk that was very important in the last year is no longer considered material in the latest year under review.

Easy reporting wins

Meeting and attendance records

(Disclosures 13 and 14) – include the number of meetings, rather than just saying 'the board met a number of times throughout the year'.

Results of shareholder voting

(Disclosure 30) – include more detail on the votes received by proxy in the company announcements post annual general meeting on the website.

Independent directors

(Disclosure 10) – explain the deeper narrative as to why any particular director sits on the board; what specific skills, quality and experience he or she brings to the company; and how his or her skills complement the skills and experience of other board members.

OUR TOP FIVE GOVERNANCE REPORTING TIPS

Make the 'boring' information more interesting

The annual report includes a significant amount of information, some of which seems routine and not particularly important or revealing. However, investors tell us that they often look to see if this information is in a report or on a company website and, if it is not there, they wonder why it has been omitted. We have found that the number of companies providing details on the number of board meetings (Disclosures 13 and 14 of the QCA Code), information received by the board and its committees (Disclosure 19), a description of the roles of directors (Disclosure 21) and the shareholder votes received by proxy (Disclosure 30) has been falling. Many companies stated that they had board meetings during the year, but did not give the number of meetings. Many also said that the resolutions at their AGM were passed, but then did not set out the details.

> Tip one - focus on improving the quality of the routine or 'boring' information that is required in the annual reports and accounts or on a company's website. For example, add more detail about why a particular director is on the board and what skills and experience he or she adds to the board, rather than just rehashing his or her biography.

Focus on the bumps in the road ahead

Risk disclosures in the annual report are important to investors. They indicate that companies have thought about what issues may arise in the years ahead that would have a material impact on a company's growth and thus shareholder value. However, risk disclosures are often lengthy and cluttered with general risks (i.e. the market could go up or down). Whilst the majority of companies in this sample have made risk disclosures (Disclosures 15 and 16), investors tell us that rarely is there a rich discussion of risks in the annual report.

> Tip two - focus on trying to make a synopsis of the key risks, how the company plans to manage them, and how its approach to risk management links into other aspects of the company (i.e. strategy, key performance indicators and corporate governance).

Ensure there is consistency

Whilst companies should approach writing the annual report with a fresh sheet of paper each year, it is vital that they are delivering a message that is consistent with the previous year – or at least explaining why it is now different. For example, investors have told us that they often notice that risks change year-on-year and that companies do not always explain why a certain risk is no longer problematic or highlighted in the annual report. Companies should show their workings and ensure that they explain why something is important or why something has come out of the report, or is no longer relevant. Whilst some companies may think that they would just explain this to investors in conversation, private investors, who provide much needed liquidity to small and mid-size quoted companies, are not privy to these discussions.

> Tip three - ensure consistency within the company's reports and explain clearly what the company is doing and how it is protecting and enhancing shareholder value.

Tell your company's story

Investors do not want to see boilerplate text. They want to read statements that are unique to a company and that express that company's distinctive character. For example, Tim Martin, Chairman of JD Wetherspoons, wrote a 2015 Chairman's report which was fiercely critical of many aspects of the UK approach to corporate governance. Whilst investors may not agree with the sentiments expressed, the statements made were clear. A large number of investors read the report and this revealed valuable information about the company. It was clear that the chairman was considering how the company should apply or not apply certain aspects of governance.

> Tip four - the message from investors is be honest and truthful in drafting your company's report. In general, focus on the 'explain' aspect of corporate governance, rather than just blind compliance. Investors want to know what you do and why you do it. Even if your company complies with certain aspects of a code, you should be trying to explain why that approach is best for the company.

Link strategy and corporate governance

This continues to feature as a disclosure (Disclosure 3) that small and mid-size quoted companies struggle with. The problem lies in their inability to provide information in a manner which gives the investor insight into what the company is aiming to achieve in its strategy and how its governance arrangements support that strategy.

We found that many of the disclosures about which code a company applies, how it applies it and how its governance arrangements link to strategy are filled with generic language. One phrase that particularly stands out is that a code is applied 'in so far as applicable for a company of this size and nature'. It is unclear what this phrase means and companies seem to use it instead of specifically stating what code elements are not appropriate or workable for a company of its size and nature. Companies should strive to avoid empty statements and to provide precise, specific and informative explanations of what they do with regards to governance.

Everyone accepts that linking corporate governance to strategy is difficult, but investors continue to tell us that this is a key disclosure for them.

> Tip five - the chairmen should be managing boards to not only help develop good governance, but also to help companies clearly articulate how their approach supports their plans for sustainable long-term growth in shareholder value. A good starting point is to focus on producing a clear synopsis of the business model. If a company has described its business model clearly to investors, then it should be easier to define how its governance links to strategy. Issues to focus on include:
>
> - How your company's strategy is relevant to its business
> - How your company's strategy and its corporate governance arrangements benefit shareholders.

OUR ANALYSIS

This section details our measure of corporate governance behaviour by showing the percentage of the sample that included the minimum disclosures of the QCA Code.

CHAIRMAN'S GOVERNANCE REPORT

No	Disclosure	2015	2014	2013
1	The narrative reporting of the company should include a report by the Chairman of how the QCA Code is applied.	21%	14%	10%
2	There was reference to 'the Code' (unspecified).	47%	69%	71%
3	The report should include how such application supports the company's long term success and strategy for growth.	7%	1%	3%

AUDIT COMMITTEE REPORT

No	Disclosure	2015	2014	2013
4	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.	41%	36%	20%
5	There should be an explanation to shareholders of how audit objectivity and independence is safeguarded, particularly if the auditor provides significant non-audit services.	37%	35%	31%
6	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.	30%	28%	17%

REMUNERATION COMMITTEE REPORT

No	Disclosure	2015	2014	2013
7	A remuneration committee report should explain how the company's remuneration policy and practice align with the company's strategy.	55%	61%	68%

DETAILS OF DIRECTORS

No	Disclosure	2015	2014	2013
8	The identity of all the directors, their roles and committee memberships must be disclosed.	94%	79%	93%

RELEVANT SKILLS AND EXPERIENCE

No	Disclosure	2015	2014	2013
9	The relevant skills and experience that the executive and non-executive directors bring to the board should be described.	92%	73%	91%

INDEPENDENT DIRECTORS

No	Disclosure	2015	2014	2013
10	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.	30%	33%	43%

> Even though writing the annual report can feel like a routine exercise, it is important to do it well because investors want to read this often vital information in one place.

Tim Goodman, Hermes Equity Ownership Services

COMMITTEES

No	Disclosure	2015	2014	2013
11	There should be a brief description of the work of each board committee and its role.	94%	75%	95%
12	Committee responsibility and accountability should be explained.	75%	67%	87%

MEETINGS AND ATTENDANCE RECORDS

No	Disclosure	2015	2014	2013
13	There should be disclosure of the number of meetings during the year of the board and of the committees.	47%	57%	70%
14	The attendance records of each director should be provided.	44%	51%	67%

RISK MANAGEMENT AND INTERNAL CONTROL

No	Disclosure	2015	2014	2013
15	There should be a summary of the systems of risk management and internal control and the uncertainties facing the business.	84%	89%	73%
16	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.	63%	51%	38%

PERFORMANCE EVALUATION

No	Disclosure	2015	2014	2013
17	There should be a description of the performance evaluation procedures for each director, the whole board and each committee focusing on their objectives and outcomes.	34%	27%	14%
18	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.	11%	10%	2%

INFORMATION SUMMARY

No	Disclosure	2015	2014	2013
19	There should be a summary of information received by the board and by individual committees.	3%	2%	5%

SUMMARY OF STRATEGY

No	Disclosure	2015	2014	2013
20	There should be a clear articulation of the strategy of the company.	92%	41%	56%

Amongst the things that good annual reports do is cross-reference related information between different parts of the report and accounts. A key challenge for companies is to present the business, contextualise it and explain its progress in an accessible and meaningful way.

Iain Richards, Columbia Threadneedle Investments

DESCRIPTION OF ROLES

No	Disclosure	2015	2014	2013
21	There should be a description of the roles and responsibilities of the chairman, chief executive and, if applicable, the senior independent director.	30%	48%	65%

MATTERS RESERVED FOR THE BOARD

No	Disclosure	2015	2014	2013
22	There should be a list of the types of decisions reserved for the board.	46%	39%	32%

NON-EXECUTIVE APPOINTMENT TERMS

No	Disclosure	2015	2014	2013
23	Terms and conditions of appointment of non-executive directors should be stated.	20%	4%	12%

TERMS OF REFERENCE: AUDIT AND REMUNERATION COMMITTEES

No	Disclosure	2015	2014	2013
24	Terms of reference of the audit committee and the remuneration committee should be included.	35%	42%	41%

TERMS OF REFERENCE: NOMINATION COMMITTEE

No	Disclosure	2015	2014	2013
25	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.	30%	33%	29%

ROLE OF EXTERNAL AND INTERNAL ADVISORS

No	Disclosure	2015	2014	2013
26	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.	12%	4%	6%

PUBLISHED MATERIAL

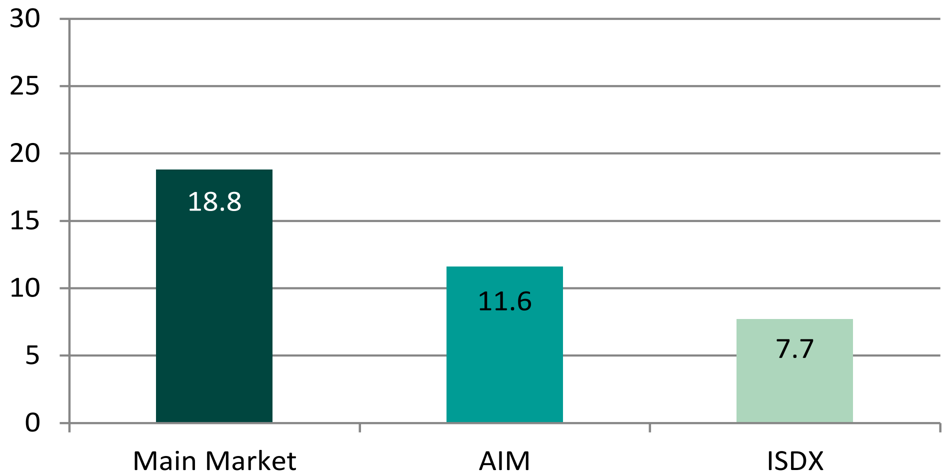
No	Disclosure	2015	2014	2013
27	The annual report and other governance-related material should be on the website.	99%	100%	98%
28	Notices of all general meetings over the last three years should be on the website.	58%	53%	63%

RESULTS OF SHAREHOLDER VOTING

No	Disclosure	2015	2014	2013
29	Voting decisions should be posted on the company website.	54%	33%	65%
30	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 reposted as soon as practical after the meeting. Where votes are conducted on a poll, the actual votes, including votes withheld or abstentions, should be reposted as soon as practical after the poll.	14%	18%	65%

> Companies should focus on delivering an annual report with life and energy in it.
>
> Paul Lee, Aberdeen Asset Management

AVERAGE NUMBER OF CORPORATE GOVERNANCE DISCLOSURES



Market	Number of companies in the sample	Average number of disclosures	Minimum number of disclosures	Maximum number of disclosures
Main Market companies	32	18.8	7	26
AIM companies	65	11.6	5	25
ISDX companies	3	7.7	5	13

METHODOLOGY

The analysis was conducted on 100 annual reports and accounts and the corporate websites of 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 in July and August 2015. Note that the sample of companies analysed in prior years is different to those analysed in 2015.

UHY Hacker Young assessed these annual reports and accounts and governance disclosures on their corporate websites against the minimum disclosures of the Quoted Companies Alliance Corporate Governance Code for Small and Mid-Size Quoted Companies 2013.

The assessment was completed on a straightforward binary measure: did the company disclose the requirement or not. We have not sought to judge the qualitative nature of the disclosure.

We would like to thank those investors that provided invaluable feedback on this project and Edward Craft, Partner at Wedlake Bell and Chairman of the Quoted Companies Alliance Corporate Governance Expert Group.

Tim Ward
Chief Executive
Quoted Companies Alliance
6 Kinghorn Street
London
EC1A 7HW
+44 (0)207 600 3745
www.theqca.com

Colin Jones
Head of Audit
UHY Hacker Young
Quadrant House
4 Thomas More Square
London
E1W 1YW
+44 (0)207 216 4600
www.uhy-uk.com