CORPORATE GOVERNANCE BEHAVIOUR REVIEW 2017

Long-debated corporate governance reforms have finally been put in place to boost public trust in businesses. Our fifth annual review identifies key ways directors can improve their annual reporting to connect with their shareholders and bridge the trust impasse.

OUR TOP FIVE TIPS

- Describe the link between strategy and corporate governance more effectively and explain the work of the board on both fronts.
- Provide detail on the board performance evaluation procedures.
- Tell your company's story, avoiding boilerplate disclosures.
- Include a single total remuneration figure for each director within a remuneration report.
- Explain the role of each director to give a full picture of the skills and experience of the board.

As in previous years, we have benchmarked the corporate governance disclosures made from a random selection of 100 small and mid-size quoted companies taken from the Main List, AIM and NEX Exchange, 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). The results of our analysis were discussed with a group of institutional investors at a roundtable event. Their thoughts, comments and feedback have helped us develop this year's top five recommendations for companies looking to improve their corporate governance disclosures.

The QCA Code is structured in a way which enables quoted companies to adopt corporate governance arrangements appropriate to the particular needs of each company. In order to do this, companies are expected to provide clear explanations that convey the approach and ethos of their own arrangements. Effective corporate governance reporting is only achieved when investors can gain a clear understanding of the governance arrangements in place together with the rationale behind such decisions and an understanding of the culture established by the board of directors. With this information, investors can appreciate how the company's strategy is conceived, managed and implemented throughout the business.

The two key themes which have risen to the top of the corporate governance agenda in 2017 are executive pay and board diversity, consistent with the public pressure which the government is also now reflecting. New legislation will require all listed companies to disclose the ratio of CEO pay to the average pay of a company's UK (not worldwide) workforce, and new measures will seek to ensure the employee and shareholder voice is heard in the board room. Listed companies with significant shareholder opposition to executive pay packages will have their names set out on a new public register, intended to sharpen the focus on those companies who need to be held to account.

The Financial Reporting Council (FRC) is currently undertaking a fundamental review of the Corporate Governance Code, which will take into account the government's reforms announced on 29 August 2017. Remuneration committees will be required to accept greater responsibility for demonstrating how pay and incentives align across the company, and to outline how decisions on executive pay reflect company policy and its strategic objectives. To encourage boards to develop diversity, the FRC is considering how to improve guidance in order to achieve this aim. The government intends to bring legislative reforms into effect by June 2018. A voluntary code for large private businesses will also be introduced.

Despite the resulting public outcry, the government has said that it will not currently be acting on two key recommendations from the Department of Business Energy & Industrial Strategy (BEIS) Parliamentary Committee in relation to diversity issues, namely that by May 2020 at least half of all new appointments in all listed companies should be women, and all FTSE 100 companies should be required, by legislation, to publish their workforce data, broken down by ethnicity and pay band. The government's preferred approach is a target of 33% of board members to be women by 2020 and to allow a voluntary approach to diversity reporting by ethnicity.

Pay and diversity come together in the new gender pay gap regulations, which came into force on 5 April 2017. These require all employers with more than 250 employees to publish gender pay gap statistics (the difference between the average pay for men and the average pay for women) on their website before 4 April 2018. It is important to note that gender pay reporting is different to equal pay. Equal pay deals with the (unlawful) pay differences between men and women who carry out similar jobs or work of equal value. The gender pay gap shows the difference in the average pay between all men and women in a workforce, and hence does not take account of the proportion of men and women performing different functions.

OUR TOP FIVE GOVERNANCE REPORTING RECOMMENDATIONS

1. Demonstrate clear links between strategy and corporate governance

As we have found in the preceding four years, one of the hardest things for small and mid-size quoted companies to do is to offer investors the necessary insight to understand how their strategy links with, and is supported by, their governance arrangements. The generic language used in many of the disclosures continues to contribute to this problem. Whilst investors acknowledge that linking corporate governance to strategy is a challenge, they continue to tell us that this is a key disclosure. They want to see a clear articulation of strategy (Disclosure 20 of the QCA Code) and an explanation of how the application of their chosen corporate governance code supports the company's long-term success and strategy for growth (Disclosure 3 of the QCA Code). Ensuring that a company's corporate governance structures and processes are appropriate, and that they help to deliver long term growth and shareholder value, is of fundamental importance to investors.

A good starting point is to focus on producing a clear depiction of the company's business model. If a company has described this clearly to investors, it should be easier to define how its governance links to its strategy. Companies should focus on how its strategy relates to its business model; and how its strategy and its corporate governance arrangements benefit shareholders in the long term. Companies should also void empty statements and provide specific and informative explanations of what they do with regards to governance.

2. Avoid boilerplate disclosures

With the increasingly limited availability of investment research and other independent commentary, the annual report and accounts are often the only source of primary information available to stakeholders. It represents a vital first impression. It is essential that sufficient time and resources are dedicated to producing a report with a clear and concise narrative around the company's activities over the past reporting period. The key performance indicators (KPIs), the description of the business model and the company's strategy and its implementation must be set out transparently.

A well-performing company articulates the business story and the company's ambition and purpose; this will enhance engagement with all interested parties. Focusing the narrative and explanations on the areas that are critical to the business provides a better understanding of the issues faced and manages expectations of future performance.

Investors want to read statements that are unique to a company and that express the company's distinctive character. The direct message from investors is be honest and truthful in drafting your company's report.

Companies should 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 also explain why that approach is best for the company. Reports should be forward-looking and explain what has changed from the previous year and what the key challenges are coming up in the next year. Most importantly, they do not try to hide non-compliance with a governance code – investors prefer companies to highlight this and explain what they do instead. Indeed hiding non-compliance goes against the principles of comply and explain.

Investors can tell when companies have copied standard-wording in their disclosures. They read hundreds of annual reports each year so they quickly recognise statements lifted from other reports.

3. Evaluation of board performance

An effective board evaluates its own performance on a regular basis. Effective companies tell shareholders the outcome of any assessment or the objectives they have set as a result of the process. They clearly set out the criteria for board performance and how how this is measured. The knowledge that there is a culture of engagement and challenge within the boardroom environment, along with a commitment to seek continual improvement, reassures shareholders.

Investors also want to know how the procedures around performance evaluation have evolved, that a plan of action for improvement has been identified, how it has progressed, and whether it was successful.

Disclosures on board evaluation provide a good opportunity to illustrate the culture within the business, and demonstrate how that culture influences the behaviours of all those involved with the company. The impact and value of such disclosures in establishing confidence and trust should not be underestimated.

Investors want to see companies assessing the quality of directors and ensuring that boards have the appropriate balance of skills within the team. Small and mid-size quoted companies should demonstrate the benefits of board evaluation (Disclosures 17 and 18 of the QCA Code), explaining the performance procedures, including the frequency and result of the evaluation and any action taken.

4. Include a renumeration report

There is increasing concern at the level of CEO pay and the disparity with the pay of the average employee.

Shareholders want to understand the links between the company's strategy, its performance, and how executives are being incentivised and rewarded for executing the strategy well.

Investors want frank, open contact so that they can see how the company's objectives are being achieved and how the directors are being remunerated. Clarity and transparency in matters of remuneration are important foundations upon which trust between companies and shareholders is built. Establishing well-structured remuneration arrangements indicates good governance - but this can only be fully appreciated if the arrangements are articulated effectively to all shareholders.

The regulations governing the remuneration-related disclosures are extensive, particularly for listed companies. Since 2013 the Companies Act 2006 requires a quoted company to prepare a detailed directors' remuneration report for each financial year. Although AIM and NEX Exchange are not subject to these regulations, many investors now expect to see this information. However, the optional nature does lead to a lack of comparability and unnecessary concern from an investor perspective. It is important to ensure that consideration is given to the materiality and proportionality of the disclosures and the particular needs of your shareholders.

Crucially, the objective of any disclosure is to ensure a proper understanding of the nature and amounts involved. The reader must be able to appreciate the connection between the company's strategy and performance and how executives are being rewarded for their contribution to any successes (Disclosure 6 of the QCA Code). Preparers of accounts should also consider the practical approach to good remuneration disclosures, detailed in the QCA Remuneration Committee Guide.

The board should ensure that the remuneration report sets how how the policy links to the company's strategic objectives and KPIs, and demonstrates that the amounts paid are reasonable in terms of the value created. In particular, for an annual bonus scheme, information about how bonuses are determined based on the company's performance and individual targets should be easy to identify. Similarly, for share plans, details of financial targets should be provided. Investors tell us that for full transparency on remuneration, information is best presented in a tabular format showing a single total remuneration figure for each director, analysed between salary, benefits, bonus, pension and share plans (value of awards).

5. Ensure that board roles are adequately described

Companies usually highlight each director on the board and include a biography in the annual report and accounts. However, investors are particularly interested in the board structure and why each director is on the board – namely the specific skills he or she brings to the team (Disclosure 9 of the QCA Code). It cannot be assumed that people can figure this out from a biography. There should be a clear distinction between executive and non-executive directors and clarity as to whether the chair is executive or non-executive. The roles of each individual director should also be clear – for example, CEO or CFO, as this helps investors determine whether the board has the appropriate balance of skills and experience.

Effective chairs oversee the board to not only help develop good governance, but also to ensure the board's approach supports the plan for sustainable long-term growth in shareholder value. Such chairs are seen to be independent and competent to challenge the CEO and CFO. Investors also see sector knowledge as being important, as an understanding of how the business operates enables the chairman to challenge the executive more effectively.

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.

*when assessing item one, we have excluded Main List companies given that they are required to adopt the UK Code, therefore, cannot adopt the QCA Code. However, we have included item two to indicate companies that reference compliance with a corporate governance code.

Investors want to understand the basis of the remuneration policy and performance measures, and how those are aligned with the company's strategic objectives.

Those companies which do not make adequate disclosures can find it difficult to attract investment.

Charlotte Cuthbertson
Miton Group

CHAIRMAN'S GOVERNANCE REPORT

No	Disclosure	2017	2016	2015	2014	2013
1	The narrative reporting of the company should include a report by the Chairman of how the QCA Code is applied (see note*).	50%	26%	31%	22%	20%
2	There was reference to the application of a corporate governance code.	93%	82%	68%	83%	81%
3	The report should include how such application supports the company's long term success and strategy for growth.	9%	4%	7%	1%	3%

AUDIT COMMITTEE REPORT

No	Disclosure	2017	2016	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.	45%	53%	41%	36%	20%
	It should include details of the significant issues considered by the committee in relation to the financial statements and how these issues were addressed.	34%	48%	32%	-	-
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.	36%	49%	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.	37%	43%	30%	28%	17%

REMUNERATION COMMITTEE REPORT

No	Disclosure	2017	2016	2015	2014	2013
7	A remuneration committee report should explain how the company's remuneration policy and practice align with the company's strategy.	54%	68%	55%	61%	68%

DETAILS OF DIRECTORS

No	Disclosure	2017	2016	2015	2014	2013
8	The identity of all the directors, their roles and committee memberships must be disclosed.	87%	93%	94%	79%	93%

RELEVANT SKILLS AND EXPERIENCE

No	Disclosure	2017	2016	2015	2014	2013
9	The relevant skills and experience that the executive and non-executive directors bring to the board should be described.	98%	99%	92%	73%	91%

Small cap companies do not need to conduct board evaluation on an annual basis, every three years will suffice.

Daniel Jarman, BMO Global Asset Management

INDEPENDENT DIRECTORS

No	Disclosure	2017	2016	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.	18%	19%	30%	33%	43%

COMMITTEES

No	Disclosure	2017	2016	2015	2014	2013
11	There should be a brief description of the work of each board committee and its role.	94%	92%	94%	75%	95%
12	Committee responsibility and accountability should be explained.	77%	73%	75%	67%	87%

MEETINGS AND ATTENDANCE RECORDS

No	Disclosure	2017	2016	2015	2014	2013
13	There should be disclosure of the number of meetings during the year of the board and of the committees.	55%	77%	47%	57%	70%
14	The attendance records of each director should be provided.	44%	69%	44%	51%	67%

Investors welcome a company which can clearly describe what the Board is doing and how it is adding value to the success of the company.

Nick Hawthorn Downing LLP

RISK MANAGEMENT AND INTERNAL CONTROL

No	Disclosure	2017	2016	2015	2014	2013
15	There should be a summary of the systems of risk management and internal control and the uncertainties facing the business.	89%	91%	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.	72%	50%	63%	51%	38%

PERFORMANCE EVALUATION

No	Disclosure	2017	2016	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.	22%	44%	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.	9%	3%	11%	10%	2%

INFORMATION SUMMARY

No	Disclosure	2017	2016	2015	2014	2013
19	There should be a summary of information received by the board and by individual committees.	14%	5%	3%	2%	5%

It is important that certain pieces of information within an annual report are clearly signposted.

It doesn't need to be a long report to meet the criteria, just thoughtfully prepared.

Will Pomroy
Hermes Investment
Management Limited

SUMMARY OF STRATEGY

No	Disclosure	2017	2016	2015	2014	2013
20	There should be a clear articulation of the strategy of the company.	95%	87%	92%	41%	56%

DESCRIPTION OF ROLES

No	Disclosure	2017	2016	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.	39%	33%	30%	48%	65%

MATTERS RESERVED FOR THE BOARD

No	Disclosure	2017	2016	2015	2014	2013
22	There should be a list of the types of decisions reserved for the board.	43%	38%	46%	39%	32%

NON-EXECUTIVE APPOINTMENT TERMS

No	Disclosure	2017	2016	2015	2014	2013
23	Terms and conditions of appointment of non-executive directors should be stated.	28%	23%	20%	4%	12%

TERMS OF REFERENCE: AUDIT AND REMUNERATION COMMITTEES

No	Disclosure	2017	2016	2015	2014	2013
24	Terms of reference of the audit committee and the remuneration committee should be included.	43%	46%	35%	42%	41%

TERMS OF REFERENCE: NOMINATION COMMITTEE

No	Disclosure	2017	2016	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.	29%	40%	30%	33%	29%

ROLE OF EXTERNAL AND INTERNAL ADVISORS

No	Disclosure	2017	2016	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.	10%	11%	12%	4%	6%

Many fund managers have been pushing for companies to develop their board structures. One individual with unfettered power can prove damaging.

Charles Henderson
Invesco Asset Management Limited

PUBLISHED MATERIAL

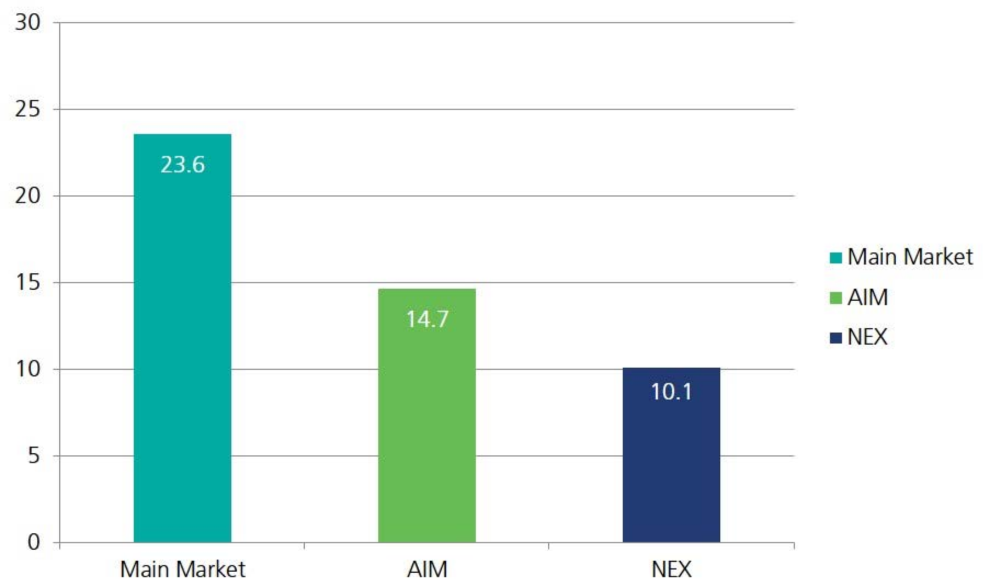
No	Disclosure	2017	2016	2015	2014	2013
27	The annual report and other governance-related material should be on the website.	100%	100%	99%	100%	98%
28	Notices of all general meetings over the last three years should be on the website.	87%	49%	58%	53%	63%

RESULTS OF SHAREHOLDER VOTING

No	Disclosure	2017	2016	2015	2014	2013
29	Voting decisions should be posted on the company website.	70%	37%	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. Whtyttyere votes are conducted on a poll, the actual votes, including votes withheld or abstentions, should be reposted as soon as practical after the poll.	4%	27%	14%	18%	65%

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	16	23.6	6	28
AIM companies	67	14.7	6	25
ISDX companies	17	10.1	6	25



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 2016. Note that the sample of companies analysed in prior years is different to those analysed in 2016.

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.

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