



**The Quoted
Companies Alliance**

01 July 2010
Edward Beale, *Chartered Secretary*

Governance for smaller firms: Operational know-how - Edward Beale examines reasons why smaller quoted companies shouldn't ignore corporate governance.

For me, corporate governance is the means by which the organization (corporate) is managed (governed) in order to achieve its objectives. So perhaps we could say that corporate governance really means 'what the board does', but that it is not the day-to-day operational management of the company by the executive management team. All companies will therefore have some form of corporate governance, even if they do not call it that. If there were no corporate governance, there could be no business. The common misconception is that corporate governance is all about policing and value protection, but it is not. Corporate governance is much more than this; it is about value creation, as well as value protection.

Value creation

It is the value creating aspects of corporate governance that are often overlooked. This is all about getting the basics right, which can be achieved by taking the following steps:

- Having a good strategy, good management and adequate funding to deliver the plan;
 - Identifying the risks and opportunities;
 - Controlling those risks and maximizing your advantage from the opportunities;
 - Ensuring that the management team's skills and experience are relevant to implementing your strategy;
- and
- Motivating management to deliver, over timescales that are relevant to shareholders.

There is nothing new here, but these are all fundamental parts of corporate governance.

None of this information should be new to shareholders either. All this information should already be encapsulated in a good annual report.

Value protection

Value protection is all about having in place a suitable system of internal controls over the entire spectrum of risks that the business is exposed to, be they risks associated with development or execution of strategy, risks associated with management performance, or risks associated with funding. These risks need to be identified from a shareholder's perspective and include the risk that you do not take maximum advantage of opportunities, as well as more obvious risks such as management keeping more than their fair share of cash generated and, as a result, shareholders receiving an unequal return on investment.

Non-executive directors

Value protection is where non-executive directors (NEDs) have their traditional role. In forming nomination, audit and remuneration committees they can carry out a monitoring role. But this is only part of their role. They should also be able to contribute to the setting of strategy, use their contacts to help execute the strategy, mentor management and draw upon their experience of implementing effective solutions elsewhere, so that the company is not always starting from scratch.

If you want the NEDs to only 'tick the boxes' and otherwise sit quietly in the corner looking decorative (or not as the case may be), then they are an expensive compliance cost. However, wisely selected and used to the full, they can provide a cheap form of consultancy as well as fulfilling a value protection role.

How does this add value?

For a company to achieve its maximum value, not only does it have to have a good strategy in place and show success in the execution of that strategy, its investors also need to believe that it is well run. By ensuring that this is the case the financial rewards arising from this strategy are maximised and will flow through to the investors. This maximisation of value is achieved through convincing investors that the company is well run.

Convincing investors, as we well know, can be difficult. The usual methods are written reports and regular meetings, results presentations or AGMs. From the investor's perspective there needs to be a continuity of message through all communication streams.

A separate corporate governance report, no matter how well written, is not going to be convincing unless it is supported by all other written communications, and what the directors do and say.

The best way to convince investors is face-to-face. If investors trust directors and believe that directors are acting with the shareholders' best interest at the forefront of their minds, then they will always be willing to support those directors, even if their actions are flying in the face of what everyone says is 'best' corporate governance practice.

The importance of trust

If directors do not want to be tied up in regulation or continually questioned about corporate governance practices, they have to take the time to build up trust with investors.

The background problem that we have to continue to deal with is that past breaches of trust have led to a build up of regulation, which we all have to comply with. This volume of regulation will only continue to grow unless we can persuade investors that it is not necessary, and the way to do that is to focus on building trust with investors.

This will require a significant investment in time. Key to this is the chairman. The chairman is the person who has responsibility for running the board and investors need to believe that they can trust the chairman to run the board well. So the chairman needs to take every opportunity to meet investors, be it analyst's briefings or visits, results presentations, AGMs or other events. At these events, investors need to see that the personal dynamics between the members of the board are appropriate, that the chairman is in charge but that they do not stray into the chief executive's turf and that the board works well as a team. NEDs are also an important element of building trust with investors. Opportunities need to be created for NEDs to meet shareholders and establish their credibility.

This is especially important in small companies, where the NED may not have the same name recognition with investors as those of larger companies. The appearance of independence helps shareholders trust NEDs. My golden rule here is to follow the money. How much money do the NED and those connected to the NED receive from the company? For example, if a FTSE 100 audit committee chair is paid £150,000

a year plus expenses my nose says that this person cannot continue to be independent, and so should cease to chair the audit committee.

Conversely, a major long-term shareholder may be an independent NED, if his or her director's fees are reasonable and the individual does not receive any rewards other than those that are equally available to all other shareholders.

Engagement is a two way street

In the same way that some companies find it difficult to make sufficient time available to engage fully with shareholders, many shareholders find it difficult to engage with companies as fully as companies would like. In these situations, rather than giving up on attempts to engage, companies need to retain the moral high ground and keep trying, no matter how many re-buffs they receive.

The Institutional Shareholders Committee (ISC) has a guide to help investors with their engagement. This is being reviewed at present by the FRC and will lead to some updated guidance later in the year.

The evolution of guidance

The FSA has in the past prescribed that all listed companies apply the Combined Code on Corporate Governance, published by the FRC. This Code has developed into a worthy document, which, having been added to over the years, has now evolved into an extensive shopping list of sensible business structures and processes associated with corporate governance.

The 2008 update included, for the first time, a mention in the preamble of the purpose of corporate governance, which it saw as being to 'facilitate efficient, effective and entrepreneurial management that can deliver growth in shareholder value over the longer term', although this has now changed in the 2010 update to: 'facilitate effective, entrepreneurial and prudent management that can deliver the long term success of the company'.

In 2005, the Quoted Companies Alliance (QCA) saw how unwieldy the Code had become and identified a lack of suitable guidance for companies traded on AIM. Accordingly it devised its Corporate Governance Guidelines for AIM Companies, which have since become the de facto standard for AIM companies. The QCAs AIM Guidelines identified the purpose of corporate governance as: to 'ensure that the company is managed in an efficient, effective and entrepreneurial manner for the benefit of all shareholders over the longer term', which was surprisingly similar to the definition adopted by the FRC some three years later. The QCAs AIM Guidelines set out to present corporate governance in a much more user friendly way, focusing on outcomes as opposed to a shopping list of structures and processes.

It selected the most important structures and processes from the then Combined Code and set them against the purpose of corporate governance, so that readers could see at a glance why those structures or processes were considered to be important. If a company has different structures or processes to those recommended, this structure makes it easier for them to explain how the purpose of corporate governance is being achieved, despite the different approach.

Changes

There have been a number of changes in 2010. The FSA brought out changes to the Listing Rules and introduced the concept of premium and standard listings. All premium-listed companies are now required to state how they apply the main principles of the Code (no exemptions are allowed). They must also demonstrate that they have complied with the provisions of the Code, or explain their reasons for not doing so. Standard listed corporate governance reporting on the Code or on a different set of guidance.

With effect from 1 July 2010 the Combined Code replaces the UK Corporate Governance Code. While the body of the new Code is in effect no more than a facelift of the old Combined Code, the new introductory sections contain valuable material on the softer aspects of corporate governance.

The main body of the new Code introduces yet more new structures and processes, to an extent driven by the recommendations of the Walker Review. Despite the emphasis in the preface to the Code of the chairman becoming involved in corporate governance reporting, this increasing list of principles and compulsory disclosures may well lead to the continuation of boiler plate corporate governance reports.

In my view, the new Code could have been substantially improved by allocating some space to a discussion of the purpose of corporate governance. The QCA argued strongly during the recent consultation on the Code that it needed to be redesigned to achieve a better balance between value creation and value protection.

The QCA is now in the process of replacing its Corporate Governance Guidelines for AIM Companies with a new publication, due out this summer, which will provide corporate governance guidelines for all quoted companies other than Premium Listed companies (who are required by the FSA to apply the Code). Coming back to the original question of the reasons why smaller quoted companies shouldn't ignore corporate governance; the simple answer is because corporate governance is really shorthand for what the board does. The only way for smaller quoted companies to ignore corporate governance is for their boards to do nothing. If you accept this definition of corporate governance, which the Governance Code does, then you need to substantially rethink how you structure corporate governance reports, so that they address the purpose of corporate governance.

In reporting corporate governance you should avoid the trap that the Code has fallen into and ensure a proper balance between value creation and value protection.

Looking forward, if we are to minimize future corporate governance regulation, or even roll back the tide, we (directors and investors) need to improve the level of trust. It is the absence of trust that drives increased regulation.

ABOUT THE AUTHOR

Edward Beale is Chief Executive of City Group Plc, a business helping smaller quoted companies with the extra tasks that arise because their shares are publicly traded. He is also the Chairman of the Corporate Governance Committee of the Quoted Companies Alliance, a member of the Accounting Standards Board of the Financial Reporting Council and non executive director of a number of smaller quoted and private companies.

Final report

Good quality reports are an essential part of getting the UK's 'comply or explain' based approach to corporate governance to work. When preparing corporate governance reports the tendency is to go through the main and supporting principles in turn and comment about each one.

While such a report is a compliance department's joy, as it just needs to tick off each paragraph in the corporate governance report against the next item on the checklist, it does not address the users' needs. Users need to understand how the company is being run to facilitate effective, entrepreneurial and prudent management that can deliver the long term success of the company'.

Corporate governance reports need to be drawn up to answer this question: They need to discuss how 'effective' management is achieved as well as 'entrepreneurial management' and 'prudent management'. They need to identify what constitutes long-term success and explain how that can be achieved.

This requires a totally different structure of corporate governance reports compared to the standard reports that have been produced to date.

To produce a high quality corporate governance report, companies need to think about which of the main principles and supporting principles contribute towards 'effective', 'entrepreneurial' or 'prudent' management, as well as how they drive long term success. They also need to consider how the compulsory disclosures contribute towards the purpose of corporate governance