Update on the new QCA Corporate Governance Code

What do AIM companies need to know in light of the Rule 26 change?

June 2018

Introduction

In April 2018, the Quoted Companies Alliance (QCA) published an updated version of its Code (the new QCA Code). The QCA Code provides UK small and mid-sized companies with a corporate governance framework that may be more appropriate for many AIM companies than the UK Corporate Governance Code, for premium-listed companies.

The new QCA Code is shorter than its 2013 predecessor with fewer principles (10 down from 12), and includes step-by-step guidance on how to apply them. While at a glance this implies that the new QCA Code has fewer requirements than the prior version the majority of the previous principles have been consolidated into the new principles.

The new QCA Code highlights the need for communication with stakeholders to build and develop trust. It calls for a more detailed chair's corporate governance statement and clear signposting to what is disclosed in the annual report and on the company's website. It emphasises the importance of long-term value, shareholder engagement, risk management, culture, board composition and effectiveness.

The publication of the new QCA Code is timely. From 28 September 2018 the AIM Rule 26 change; requiring AIM companies to provide details of a recognised corporate governance code, comes into force. This will mean AIM companies will need to explain how they comply with, and where they depart from, their chosen code.

How will AIM companies find complying with the new QCA Code?

While under Rule 26 AIM companies can choose to comply with any recognised Code, we anticipate that the majority will choose to adopt the QCA Code. The quality of AIM company annual reporting is currently variable with some reports being similar in quality to FTSE 250 reports and others being much more basic in both style and substance. Many AIM companies reference compliance with either the QCA Code or the UK Corporate Governance Code at a very high level e.g., "we comply with the UK Corporate Governance Code/QCA Code where relevant for a company of our size", with little explanation provided. For these companies, Rule 26 represents a significant shift. The change will require more preparation, not only in terms of reporting, but in some cases to organisational and governance processes.

For the majority of AIM companies who currently do not comply with any code in a meaningful way, the new QCA Code provides a suitable framework. There are also opportunities to be found for companies in providing more detail about their business, for example investors (current and potential) will be able to access more information on AIM companies and their governance.

Practical steps a company needs to take to comply with the Rule 26 change

The company will need to determine which Code they will chose to comply with

Compare the current state of governance processes and disclosures with those required under the Code

Determine what gaps need to be filled or whether the company is comfortable disclosing non-compliance

Disclose what Code the company complies with and where they depart (where relevant) by 28 September 2018

The winds of change

Many of the changes made to the QCA Code mirror changes being made to the UK Corporate Governance Code (as consulted on by the FRC). In particular the new QCA Code's emphasis on long-term value, stakeholder engagement, culture and significant votes against resolutions align with the update to the Code. This, coupled with new secondary legislation, which will also require disclosures in relation to large private companies' corporate governance, will lead to an increase in standards across many different types of companies (listed, AIM and large private).

Emphasising long-term value creation

The new focus on promoting long-term value asks companies go beyond describing their products and corporate structures to explaining how they intend to deliver shareholder value in the medium to long-term.

Companies will also be required to explain the company's business model and strategy. This will bring companies complying with the new QCA Code more in line with quoted companies who are required to disclose a business model. As part of our annual review of FTSE350 annual reports we have found many companies struggle to clearly articulate their business model. We encourage companies complying with the new QCA Code to read the acid test in '*Annual reporting in 2016/17; broad perspective, clear focus*' which highlights what questions a business model disclosure should answer.

Promoting stakeholder engagement

Wider stakeholder engagement is a prominent new theme. The new QCA Code emphasises that long-term success depends on engagement with stakeholder groups both internal (workforce) and external (suppliers, customers, regulators and others). There are new required disclosures on the feedback from stakeholders and actions taken as a result of these, as well as asking companies to outline the key resources and relationships in the business model.

Risk management

There is a shift in focus from reporting on risk processes and policies to actions and outcomes. The previous disclosure requirement to summarise the systems of risk management and internal controls has now been extended to also require companies to explain how the board obtains assurance that the risk management and related control systems in place are effective. Companies are also encouraged to consider their extended business, including its supply chain. Some companies will already have these controls in place, for others they will need to put these in place before making the disclosures.

Culture

Given the increased focus on culture in recent years it is no surprise that culture has been included as a new principle. "Promote a corporate culture that is based on ethical values and behaviours" (2018 QCA Code, Principle 8, pg 14). Companies will need to explain how their culture is consistent with their objectives, strategy, business model, how the principal risks are managed and what the board does to monitor and assess culture. EY's report on '*Governing culture*' includes practical considerations for boards.

Significant votes against

Another similarity to the revised UK Corporate Governance Code is a new requirement for companies to disclose where a significant proportion of votes (i.e. 20% and above) have been cast against a resolution at a general meeting. The company should include an explanation of what actions it intends to take to understand the reasons behind that vote result, and, where appropriate, any different action it has taken, or will take, as a result.

Importance of communication

Communication is a vital component in building trust and the new QCA Code highlights the importance of dialogue with both shareholders and other stakeholders on how the company is governed.

Disclosing compliance with the QCA Code is primarily through the Chair's statement. It should explain how the Code is applied, how the application of the Code supports the company's medium to long-term success and outline any areas where the governance departs from the expectations in the QCA Code. They also need to provide an overview of any governance matters that have arisen during the year. This is in addition to the website disclosure required under Rule 26 of the AIM rules.

The new QCA Code focuses on signposting and this is particularly important given disclosures may be on either the website or the annual report (the QCA Code provides recommended locations but companies can ultimately choose where is most appropriate for them on each disclosure). It is advised that companies have clear signposting by way of an index on their website indicating where certain information can be found.

Conclusion

Whilst a recent survey of fund managers by the QCA and Peel Hunt found that investors are confident that corporate governance in smaller companies has improved, adherence to leading practice remains varied. We hope the new QCA Code will steer companies toward improving their corporate governance and reporting and that companies will find opportunities within these new requirements.

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