Shareholder engagement and corporate reporting at a crossroads

February 2014
Will company boards, investors and auditors embrace new corporate governance changes so as to maximise the benefits to shareholders? Or could a lack of engagement lead the UK further down the path of more prescriptive regulation?

In the wake of the financial crisis, many measures were put in place with the aim of enhancing corporate governance, stewardship and reporting. The Financial Reporting Council (FRC) introduced the world's first code on stewardship in 2010. The UK Corporate Governance Code has also been enhanced (most recently in September 2012) to encourage more useful disclosures e.g., a confirmation by the board that the entire annual report and accounts is fair, balanced and understandable, and the significant issues the audit committee considered in relation to the financial statements.

But codes and reporting can only go so far in driving good governance. To make it really work, engagement, dialogue and challenge between company boards and shareholders are vital. The 'Shareholder Spring' in 2012 was marked by a wave of investor activism over board room pay and incentives. Remuneration will likely continue to occupy investors’ stewardship efforts in the near term especially given the legislative introduction of binding votes on remuneration policy to hold directors to account. However, this has created pressure on what is already limited investor resource. This means there is a risk that broader issues of strategy and governance are squeezed out. Investors we speak with have described this hopefully as a short term ‘bandwidth’ problem and that in future years they will return to engaging on broader governance matters.

What do investors want to engage on?

Investors, as shareholders of the companies we audit, are one of EY’s key stakeholder groups. We are focussing increasingly on conversations with them to make sure we understand their views on corporate governance, corporate reporting, audit, assurance and other capital market issues. We do this through meetings with individual institutions, conversations with trade bodies and other groups and also at EY held events; most recently our Dialogue with Investors session in November 2013 at which we hosted institutional investors.

Feedback we get from investors during these discussions indicates that a good corporate governance presentation by a company goes beyond remuneration and addresses matters like board composition and effectiveness, strategy, risks and opportunities, not to mention audit. This view is endorsed in the Report of the Collective Engagement Working Group,¹ which recommends: ‘Major listed companies should hold an annual strategy meeting for institutional investors, outside the results cycle, where investors and company executives can link governance to the company’s long-term strategy without the focus on short-term results.’

Some institutional investors have also suggested to us that governance matters should be covered in analyst presentations, alongside a discussion on performance. A short “audit and assurance” section where matters covered in the new style audit committee and auditor’s reports could be included.

The quality of explanations has also been emphasised to us. As one investor put it, “Boards should have the courage of their convictions – if they believe they have good reasons for diverging from a Corporate Governance Code requirement, they should explain them clearly.”

¹ This report was published in December 2013 by the Investment Management Association on behalf of the Collective Engagement Working Group. The Working Group was formed in response to the Kay Review on equity markets and long-term decision making. Its objective was to identify how institutional investors might be able to work collectively in their engagement with listed companies to improve both sustainable, long-term company performance and overall returns to end savers.
New governance reporting

Annual reports of listed companies will now include a range of new or enhanced governance related disclosures particularly in the audit committee, remuneration and auditor reports. Quoted companies are also required under statute to disclose their business model and strategy and provide gender diversity data.

Boards are being held to account by being asked to provide fair, balanced and understandable reports and greater transparency on their executive remuneration policies and how these link to the company’s strategy, as well as the issues considered by the audit committee in relation to the financial statements.

The audit ‘black box’ has also been opened; a development that we welcome. Auditor’s reports will now contain a fuller description of how the audit was conducted; giving far more insight to shareholders than the historical binary pass/fail model we have all been used to.

This greater transparency is likely to create new opportunities and challenges for companies, investors and auditors in the coming reporting season. It is also worth noting that this places private/smaller investors on a more equal footing with institutional investors.

Examples of the types of questions investors could ask about new corporate reporting – and for which company boards should prepare – are provided in the Appendix.

Andrew Hobbs from EY’s Corporate Governance team says, “The new reporting provides new hooks for investors to use in their discussions with companies. When we have explored these new disclosures with investors, it has been interesting to see them realise that the information not only tells them something new about the financial statements and the audit, but in so doing it tells them about the company and its business issues.”

Corporate boards: do you fully understand the questions investors could now ask you, enabled by new and enhanced ARA disclosures?

Investors: how will you further fulfil your stewardship role by interrogating the enhanced/new information available to you – on issues such as audit quality and effectiveness, the auditor’s work and significant issues in the financial statements?

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2 The key enhanced or new disclosures in the ARAs of listed companies include:

- Confirmation by the board that the ARA is fair, balanced and understandable and provides the information necessary for shareholders to assess the company’s performance, business model and strategy.
- A separate section of the ARA will need to include disclosures by the audit committee on:
  - Significant issues it considered in relation to the financial statements
  - How it assessed the effectiveness of the external audit process
  - Its approach to the appointment and tenure of the auditor
  - How independence and objectivity are safeguarded if the auditor provides non-audit services
- New regulations require directors’ remuneration reports to contain a policy report and an annual report on remuneration detailing directors’ pay in the reporting period, introduced by a statement from the remuneration committee chair.
- Auditor’s reports will:
  - Provide an overview of the scope of the audit
  - Describe the risks that had the greatest effect on the overall audit strategy, the allocation of resources in the audit, directing the efforts of the engagement team
  - Explain how materiality was applied in planning and performing the audit

In addition, auditors will report by exception, where the board’s statement on whether the ARA is fair, balanced and understandable does not accord with the auditor’s knowledge, and where the significant issues disclosed by the audit committee do not appropriately address matters communicated by the auditor.
Looking to the future

The key question is whether the new information will be used.

Ken Williamson emphasises that, “Shareholders need to show companies they are using the new information. If they don’t, companies are more likely to go down a boilerplate route over time and/or regulators could perceive that governance and disclosure frameworks need further adjustment.”

“And indeed hard-wired regulation appears to becoming de rigueur – the binding vote on remuneration policy and the potential advisory vote on audit committee reports show the direction of travel. However, good engagement and dialogue must precede any vote – and there shouldn’t be any surprises at that stage.” says Mala Shah-Coulon.

As stated in a report of the Investor Stewardship Working Party, “Stewardship involves more than just voting. Effective stewardship is about well-chosen engagement.”

Further out ...

Regulators will be watching what happens in the current reporting season with interest in regards to corporate reporting and investor engagement. In its Plan and Budget 2013-2016 the FRC says it will ‘gather evidence about the effectiveness of our existing codes and standards relating to stewardship and how the concept should inform the development of corporate reporting and audit in future.’

We also wait to see if the UK Competition Commission’s recommendation for an advisory vote on audit committee reports is implemented. If it is, investors will have further work – formulating a voting policy and implementing it before actually voting – at a time when there is already pressure on investor resources.

This could lead to investors making more use of proxy agencies. This is a community which has also seen the spotlight shone upon it in recent times. Whilst currently unregulated, the European Commission has included transparency requirements on proxy advisers in the amendments to the Shareholder Rights Directive. The proxy industry has taken the bull by the horns. In late 2013 it published for comment draft Best Practice Principles in an effort to self-regulate. Some commentators have questioned the sufficiency of the principles and in particular some have suggested that the community has become so influential in the functioning of the capital markets that there needs to be independent monitoring of the advisers.

No one can deny that the UK has strong foundations in governance and stewardship, yet these developments point towards boards and investors having to “up their game” even further on how they engage with each other to achieve long term success. In this regard, we are encouraged to see a joint report by Tomorrow’s Company and Standard Life Investments Building the Momentum for Effective Investor Stewardship, published in January 2014. It suggests a number of practical recommendations for both companies and investors, which build on the success of the UK Stewardship Code and seek to raise the bar from compliance to excellence.

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1 2020 Stewardship – Improving the quality of investor stewardship a report by the Investor Stewardship Working Party which is a group of six institutional investors supported by Tomorrow’s Company.
Continuing the debate

Our November 2013 investor dialogue event was the first in a new series aimed at providing investors with more insight on how we fulfil our public interest audit role, whilst offering them additional tools to help them engage with investee companies on reporting and auditing matters. We also discussed other issues and concerns of importance to investors.

If you would like to share your comments on the topics raised in this publication, or if you are an investor and would like to attend one of our dialogue events, please get in touch or call your usual EY contact.

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Appendix
Enhanced ARA disclosures could enable investors to ask detailed questions on many corporate governance matters. Some examples follow:

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<th>New disclosures</th>
<th>Potential questions investors could ask</th>
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| Significant issues considered by the AC in relation to the financial statements | ▶ How did the AC determine the issues that were significant and warranted disclosure in its report?  
▶ What are the quantitative and qualitative thresholds for determining whether an issue is significant?  
▶ What is the relationship between the issues the AC considers significant and the audit risks that the auditor highlights in its report? Can any difference be explained?  
▶ How did the AC and board determine what was commercially sensitive when deciding on what significant issues to report?  
▶ Your disclosures do not make it clear HOW you addressed the significant issues; can you explain? |
| How the AC assessed the effectiveness of the external audit process? | ▶ What are the key factors the AC took into account when assessing the effectiveness of the audit process?  
▶ When the AC assessed the effectiveness of the audit process, what did it learn about how: i) the auditor; ii) management; and iii) the AC contributed to the effectiveness?  
▶ What actions arose for: i) the auditor; ii) management; and iii) the AC as a result of the AC’s assessment of the effectiveness of the audit process?  
▶ How did you satisfy yourself about the scepticism of the audit team?  
▶ (If the company is intending to tender its external audit) How will the outcomes of your assessment inform your tender process? |
| Independence* | ▶ Can you explain how your independence policy operates in practice?  
▶ How do you satisfy yourselves that the non-audit services are best provided by your auditor whilst maintaining independence?  
▶ We see that your auditor was paid £x in relation to a project to undertake (transaction advisory services). Can you explain what safeguards the auditors implemented to protect their independence? How did you satisfy yourself that the threats they identified, as well as the safeguards, were appropriate? |
| Tenure and tendering | ▶ Given the disclosure in the AC report about the auditor’s tenure period, what are your intentions regarding putting the audit out to tender, and what is the timetable?  
▶ Have you thought about your objectives for an audit tender? What are they? How have you made this clear to all audit firms?  
▶ We feel that your business is going through a period of significant change. What are your views on whether this could prevent a smooth tender?  
▶ How important are the level of audit fees in an audit tender situation?  
▶ How are you creating relationships with other audit firms to give you a good choice of auditors?  
▶ How will you allow time for audit firms invited to the tender to withdraw from their non-audit activities so they can attain an independent status for audit purposes?  
▶ What will the audit committee do to ensure that it takes primary responsibility for running the audit tender process, and for recommending the appointment of the external auditor? |
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| **Fair, balanced and understandable** | ► What are the key changes you made to your annual report and accounts (ARA) to make it fair, balanced and understandable?  
► (If the AC was asked to provide the board with advice) What did the AC do to provide the board with advice that the ARA is fair, balanced and understandable?  
► Did the AC rely on any other sources of assurance to determine that the ARA is fair, balanced and understandable, and to provide advice to the board? |
| **Business model** | ► It is not clear from your disclosure how the company creates and sustains value in the long term. Can you explain? |
| **Diversity** | ► What is the link between the gender diversity disclosures in the Strategic Report, and how the board/executive management are managing succession at senior levels in the organisation?  
► Is there a link between the board’s policy on diversity, any measurable objectives it has set (UK Corporate Governance Code requirement) and the gender disclosures in the Strategic Report? (In particular, where gender diversity is low at senior manager level). |
| **How auditor applied the concept of materiality when planning and performing the audit?** | ► Why is the materiality used by your auditor much greater/lower than that used by the auditor of company X, which has a similar scale of operations and market capitalisation?  
► How does the auditor’s materiality compare with the AC’s and management’s threshold for determining whether an issue is significant?  
► Did management adjust all the audit differences that the auditor reported? If not, why?  
► What are the main reasons for the errors found by the auditor? Are there any underlying control weaknesses and what is management doing about them?  
► What errors/differences did the auditor report to the audit committee below the threshold that had been agreed? |
| **Scope of the audit** | ► What debate did the AC have with the auditor over its scope and materiality?  
► Are you satisfied that the auditor’s approach addresses the key risks?  
► For the locations outside the auditor’s scope of work, what process and controls do management have to ensure that whilst they may be immaterial from an audit perspective, there are no big risks present?  
► How did the AC get assurance that the lead auditor had a sufficient handle over issues at key locations?  
► What was the extent of the group auditors’ involvement in the work performed by local audit teams?  
► The audit fee has decreased compared with last year’s fee. In light of this, can the AC explain how it satisfied itself that the overall level of work performed by the auditor was sufficient to identify material misstatements and to ensure that audit quality was not compromised? |
| **Risks that had the greatest effect on audit strategy, allocation of resources and directing the team’s efforts** | ► How have the risks changed from last year and why?  
► How did the auditor validate with you whether the risks it had identified were the same ones the AC was also concerned about?  
► What is the relationship between the issues the AC considers to be significant, and the audit risks that the auditor highlights in its report? Can any difference be explained?  
► Did the auditor raise any concerns regarding key judgements made by management? What was the nature of those concerns? |

*Required previously under the 2010 UK Corporate Governance Code*  
‘Previously required on a ‘comply or explain’ basis under the UK Corporate Governance Code, now a statutory disclosure for quoted companies.'
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