

Conversation with investors

Audit Committee Institute
part of the KPMG Board Leadership Centre



A conversation with investors – Thursday 8 February 2018

At our conversation with investors, FTSE350 audit committee chairs discussed a number of issues with Jeannette Andrews (LGIM) and Paul Lee (Aberdeen Standard Investments). We look at the four main areas covered:

Dialogue & communication

- The audit committee is increasingly important to investors, and two-way communication is vital. Audit committee chairs (and Senior Independent Directors) are being increasingly involved in Chairman/Investor meetings.
- There is recognition that, historically, the audit committee may have been the 'forgotten' or 'Cinderella' committee, but that view is changing. Investors (and audit committee chairs) are keen to break down any barriers and build better relationships. To make best use of time, it may often make sense to combine such a meeting with other planned discussions.
- The improvement in audit committee reporting is helping to foster relationships – it gives the investor community something to 'bite on' and ask questions around. Some audit committees are taking particular care to ensure that their reporting provides more hooks in this respect. The FRC Audit and Assurance Lab publication *Audit Committee Reporting* explores how investor confidence in audit is enhanced by external reporting and provides good examples of audit committee reporting.
- Audit committee reports (and, more widely, the annual report) may be better understood if the language used is aimed at readers who are often time poor and unlikely to be technical experts.

Usefulness of the Annual Report

- The Annual Report is a key communication tool – not just for the audited numbers but also to help readers gain a broader understanding of specific indicators critical to a company and its operations. Company-specific information is favoured over 'boiler plate' disclosure.

- Specifically, audit committee reports (including the personalised introduction from the audit committee chair) are an opportunity to show where, and how, the audit committee is challenging management assumptions.
- The audit committee chair's introduction to the audit committee report can also provide, in particular, an opportunity to create a balance between what is required (compliance) and what is helpful to add colour. Currently – driven by the recommendations within the FRC's *Guidance on Audit Committees* – some areas are covered better than others. For example, the committee's oversight of external audit is generally covered in much greater depth than the committee's oversight of the internal audit function.
- The value of the extended audit report to investors was noted.
- Questions arose as to whether Annual Reports are read, but there was general agreement that the information contained within them was useful to the investor community even if they are not always read 'cover to cover'.
- Inclusion of non-GAAP measures within the Annual Report was not considered an issue *per se* – though it was noted that it can be frustrating for the investor community – and a cause of diminishing investor confidence in management – where different definitions are used for the same KPIs year-on-year.
- Non-GAAP measures can usefully articulate how management run the business but there is also a need to understand why such measures are being used and how they are reconciled back to the GAAP numbers. If the use of non-GAAP measures cannot be clearly articulated then that in itself can be very telling.

- The audit committee have an important role in the oversight of non-GAAP measures and KPIs; ensuring they are robust and comparable, and assumptions remain appropriate. It is better to have fewer and more robust KPIs.
- Audit committee chairs need to take the lead in drafting their statement - not just reacting to a draft prepared by others.

Viability statements

- Investors welcome the viability statement, but it is important that the statement is underpinned by a robust risk assessment and strategic planning process that addresses *inter alia* the full gamut of risks threatening an organisation. Non-financial risks and value drivers should be reflected in the viability statement.
- Viability statements require a positive assertion as to ongoing viability – which for many presents a natural disincentive to asserting viability over a long period. Organisations may benefit from better use of the risk section to discuss in more detail the threats to sustainability and, in particular, those risks outside the board's control.
- Viability periods may vary dramatically from one industry to another, but investors want assurance that boards are looking long-term even if the disclosed viability period is relatively short.
- Viability periods can also change from year-to-year. Companies need to be realistic and reflect the particular circumstances of the organisation. For example, for companies with a defined regulatory regime/ franchise/contract period it may be appropriate to craft the viability statement around the contract terms and adjust as time passes.
- Investors understand that companies with US listings in particular may be guarded about their approach to the viability statement due to the particular legal environment.
- Risk evaluation and reverse stress-testing approaches used in financial services may be useful tools that other organisations could employ.
- Kitchen-sinking of risks remains a concern, innovative disclosure is needed to demonstrate that "not all risks are created equal".

Audit tendering and rotation

- While investors and audit committee chairs recognise the benefits brought about by regular audit tendering and rotation, some audit committee chairs noted that compliance with the new rules can leave the largest global companies feeling they have less choice of auditor than before. This is not what was intended by the legislation.
- There is an increasing acceptance that an organisation might have to appoint an audit firm who also audit a competitor. Audit firms need strength and depth (in terms of audit teams) in order to manage this - or appropriate cooling-off periods for audit partners and senior audit professionals.

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