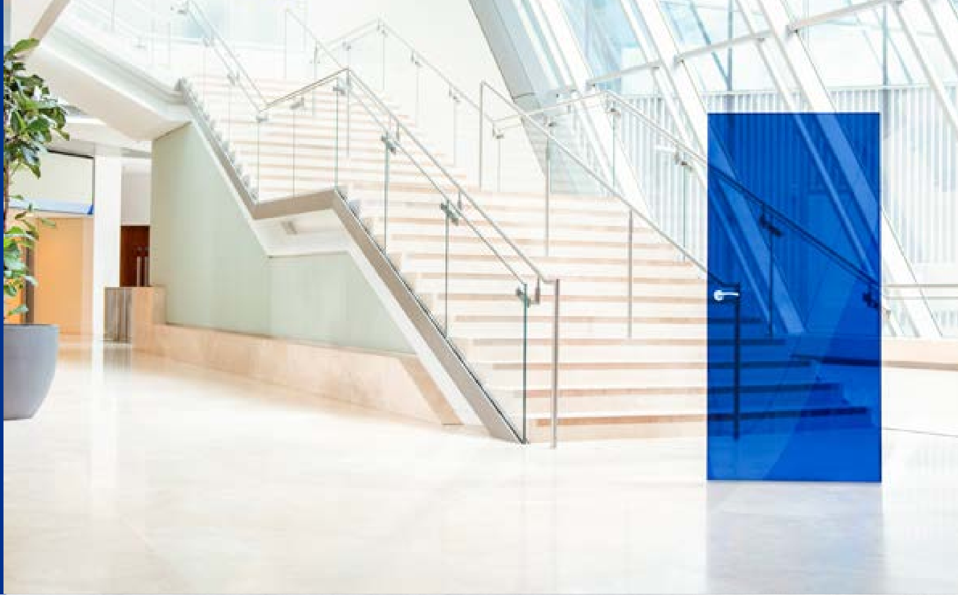
A conversation with Edward Bonham Carter

KPMG Audit Committee Institute



With investor engagement high on the agenda, Edward Bonham Carter - one time investment analyst and now Vice Chair of Jupiter Fund Management and non-executive director at Land Securities Group and ITV - joined a meeting of our FTSE100 Audit and Risk Committee Chairs group to provide an investor perspective on the challenges faced by audit committees and corporate boards.

It's a perennial issue that boards, along with audit committees and their chairs, find it difficult to achieve the right level of engagement with their investors and owners. Outside a crisis scenario, it is usually a challenge for all parties to find the time, however good their intentions may be.

So how can this be addressed effectively, particularly with COVID-19 creating so many challenges and issues for companies across the spectrum? Better dialogue and a longer-term view, rather than merely a short-term focus, are needed more than ever.

Edward Bonham Carter agrees that engagement can be problematic. A fund manager may commonly have 40-60 holdings and should ideally meet company management and, separately, the chairman once a year. That's already a heavy schedule, and doesn't leave much time for additional discussions with the audit committee and remuneration committee chairs. Then, from the company side, there is the issue that the ideal scenario is to have a dialogue both with the investment and the corporate governance sides at a fund manager. A proxy agent may also have been appointed, complicating matters still further.

Trying to ensure that investment and governance discussions happen together as part of the same process has obvious advantages – not least in balancing longer-term perspectives with short-term performance.

New engagement models

Recognising that AGMs don't provide an effective forum for detailed engagement with institutional investors, could companies add an 'institutional AGM' to their shareholder engagement activities as a forum for meeting with their most significant shareholders to discuss a range of issues including governance, audit matters, key risks, alternative KPIs, ESG and more.

Such exercises have been trialled by some companies and seen to be a worthwhile exercise – although it requires a time and commitment on both sides.

One attendee noted, "*some investors say they simply don't have the time to read audit committee reports. So what's the point in producing them?*" However, the hope is that audit committee reports will receive the attention they deserve and engagement will rise over time. With the risk agenda so relevant to the investment agenda, there is a strong logic to healthy communication and understanding between investors and audit committee chairs.

One attendee made the point that it is 'surprising' audit committee chairs are not actually required to have in-depth conversations with investors. This is arguably needed more than ever, not only because of the pandemic but more generally because annual reports have become increasingly technical and difficult to understand – despite the best efforts of preparers.

Dividends

Many businesses have revisited their dividends policy as a result of the pandemic – whether that be due to uncertainties around the sustainability of realised profits or reputational issues. The pandemic has also highlighted some companies' low margin of error around solvency and liquidity; and raised questions as to the balance between distributions to shareholders and investment in the business. Nevertheless, cancelling or reducing dividends is a delicate matter to 'sell' to investors and can prompt worries about the impact on share price.

In the early days of the pandemic, investors were generally sympathetic to changes in dividends – but will this continue to hold true? It is an area where, as Edward put it, "*boards need to show leadership*" – taking shareholder views into account but ultimately operating in the long-term interests of the business.

Sustainability over the mid- to long-term must be ensured, and a degree of flexibility built in so as to be able to respond to any future changes in trading circumstances and performance. It is critical to resist the perhaps natural human tendency to over-promise.

One attendee raised the US practice of paying out relatively small regular (annual) dividends, supplemented by 'super dividends' when profits have built up. This is not a practice that has been as widely adopted in the UK to date, but with COVID-19 leading to a re-evaluation of policy, it may become more popular.

ESG to the fore

The pandemic has shone a light on the 'S' and the 'G' with ESG. But what does good look like, both from a company and investor point of view?

Edward made the point that we are all at the start of the journey – in the "*partial light*". Asset managers and owners need to devote an increasing amount of time to understanding what is important to boards and audit committees around the whole ESG agenda and in particular how they are approaching measurement and milestones. In the 'E' sphere especially, milestones are important – but again, there is a danger in over-promising. Targets should be stretching but realistic. What's more, with CEO tenures commonly 5-7 years, there is the prospect of leaders announcing ambitious future targets safe in the knowledge that these will become their successor's responsibility to deliver on.

One attendee argued that businesses may be advised to hold off from rushing to announcing targets and spend more time – perhaps the coming 2-3 years - on detailed analysis and discussions with investors. Frameworks and common standards should have become clearer by then. Some organisations, however, may not feel they can wait that long.

Some investors are taking active stances of their own – particularly around the ESG agenda. At least one large investment house has trained its fund managers on ESG-related issues, and on how companies should be embedding such issues into their strategy and decision-making.

What is 'culture'?

Many facets of good corporate governance come down to culture – but as Edward argued, culture across a large organisation in particular can be hard to gauge. Can the culture be uniform across an entire enterprise spanning multiple divisions and countries? It is something that goes beyond key metrics in Annual Reports. But, as hard as it is to define, culture is a key driver within an organisation's approach to governance, sustainability and risk. This is why it remains essential for corporate (and audit committee) reporting to bring cultural dynamics to life in a meaningful and measurable way.

The bid test...

Ultimately, the real test of the significance of the ESG agenda will be when a bid - agreed or hostile - is made for an organisation. Do investors take ESG factors into account or simply look at the premium being offered? In Edward's view, "*this will be one of the key tests of the stakeholder capitalism we're building.*"

Overall, there was a sense that we are in the 'foothills' of better engagement and that there are encouraging signs that things are moving in the right direction.

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