

Reflections on corporate governance issues – the purpose of company reports.

The following article was written by Ian McDonald Wood. Ian runs his own business, FutureValue, which specialises in assessing standards of corporate governance. One of FutureValue's main beliefs is that there is a strong link between high standards of corporate governance in businesses and the levels of shareholder value that they create over the medium to long term. FutureValue's analysis of corporate governance standards is based on information contained in the annual report – information which is in the public



domain and available to anyone who cares to seek it out. Over a number of years the Company has devised a comprehensive set of metrics which it uses to make its assessments.

Ian regularly posts blogs on the FutureValue website. Members can read these and view a summary analysis of FutureValue's assessment of corporate governance performance for FTSE100 companies by going to: www.futurevalue.co.uk

Ian's article (below) prompts some interesting thoughts for shareholders.

Re-focusing corporate reporting

by Ian McDonald Wood

A core pillar of UK corporate governance is the pivotal role that shareholders play in supervising both the performance of Boards and the enforcement of their rights as owners of the company. That is why corporate reporting addresses shareholders to enable them in this role. But do shareholders remain the right primary audience for Annual Reports? The globalisation of equity investment driven by digital technology has changed radically the shareholding profile of UK-listed public companies over the last decade. Altered composition and reduced duration of share ownership have eroded a mainstay of the joint stock company concept – the effective separation of ownership and management where shareholders oversee the performance of their executive. Arguably, corporate governance needs to evolve faster and more radically than the outgoing Government envisaged if the UK is to retain its vaunted role as a global leader in corporate governance. The options and most suitable course of action may not be desirable to all parties.

The FRC maintains unequivocally that: "*The overriding objective of the strategic report is to provide information for shareholders ...*". Much of reporting regulation and legislation of the last two decades has been aimed at stimulating this. Indeed, the most recent BEIS Committee Report on Corporate Governance (5/4/2017) foresees considerable evolution of corporate governance, yet still sees a central role for shareholders as enforcers of that governance, supported by a more effective, better resourced regulator. Yet the proportion of active shareholders in UK companies prepared to engage with their respective Boards dwindles at an alarming pace. While BEIS has acknowledged this reality in its recent report, using data confirmed also by other expert commentators, it has recoiled from any truly radical solution.

The statistics are various and all point in the same direction. BEIS reports that institutional shareholders are tending to have more diverse portfolios with small shareholdings in many companies. Chris Hodge in his authoritative paper on the Future of Governance (ICSA) adds some colour to this. UK pension funds and insurance companies owned just 10% of UK equities in 2014, down from more than 50% in the early 1990s. He adds that the UK equity market is much less important to UK investors than it used to be with the majority of UK shares held by institutions outside the UK. The speed of this reduction is remarkable, as represented in figures from the Investment Association whose members, Chris says, hold and manage only 13% of their assets invested in UK equities in 2016, down from 25% as recently as 2007. Over a similar period the percentage of assets allocated by defined benefit pension schemes to UK equities fell from 32% to 10%.

Not only is the proportion of UK equities held by UK investors diminishing rapidly, the duration for which these dwindling percentages are held is also contracting. The average period for which shares are held today is only 6 months – it was reportedly 6 years in 1950. This rapid decline in UK equity holdings relates to individual investors as well. Around 10% of equities are held by individuals today where it was more than 50% fifty years ago, although one suspects individual investors remain more likely to hold for the longer term.

Can it be right then for UK corporate governance to continue to rely on shareholders as the overseers and enforcers? BEIS quotes Andy Haldane of the Bank of England who talks of: “*a more dispersed and disinterested ownership structure*” with what he refers to as “*ownerless*” companies. It is small wonder then that executive pay has got out of control if there is no longer either adequate check or balance on this burning issue by way of engaged ownership.

So, why retain shareholders as the primary audience of corporate reporting? The answer is probably because the only two other options are less than palatable while at the same time challenging. The first option is more stringent legislation that moves away from a principles based reporting framework, with its ‘comply or explain’ philosophy, to a rules-based approach. Here Government and its regulator would take over fully as the enforcers of good behaviour by Boards and the corporate executive. Who would this serve and what value would there be to investors in purely compliant reporting that will ultimately observe merely the letter of the law? The second option is to give the oversight and enforcement role to a broader group of stakeholders of which shareholders are *primus inter pares*. BEIS recognises the role of stakeholder advisory panels as being “*a useful forum in which meaningful collaboration, consultation and dialogue with all stakeholders can take place*” and wants to see companies report on how they engage with the various parties, but seems to shrink from any more enshrined enforcement role. If the UK is to retain its vaunted role as a leader in corporate governance Government and its regulator will need to think and act more radically. Corporate reporting will need to re-focus accordingly.

by Ian McDonald Wood