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Governance *in brief*
The Investment Association looks to boost UK productivity through enhanced investor engagement

Headlines

- More attention needs to be paid to the alignment of company board and investor incentives with the long-term investment needs of the economy. For productivity to improve, businesses and investors need to be able to invest for the long term.
- Long-term capital efficiency is the foundation for a company's productivity, profitability and success – corporate reporting should focus more than it currently does on capital management (including human capital management).
- Quarterly reporting should cease as it focuses on short term performance – but through purposeful dialogue shareholders can demonstrate support for capital spend that will boost productivity or challenge companies compromising productivity improvement through poor capital management.
- There is insufficient annual reporting on human capital of companies, including leadership, culture and workforce.

Background

In July 2015, the Chancellor published "Fixing the Foundations: Creating a more prosperous nation". This was a comprehensive plan setting the agenda for the whole of Government over the current Parliament with an aim to reverse the UK's long-term productivity problem. The Investment Association (IA) welcomed this and has now developed a framework for how investors can contribute to productivity improvements with long-term investment.

The five investor productivity principles

1) **Enhance company reporting for efficient capital allocation:** through investment and analytical expertise, the investment industry will seek to identify and finance those companies contributing to productive growth in the economy.

2) **Enhance investor stewardship and engagement:** the investment industry will engage with companies to help them achieve sustainable value creation over the long term and support investments in improved productivity.

3) **Simplify behavioural incentives and the investment chain:** the investment industry will work to ensure that the agreed incentives and governance of the investment chain ensure a clear alignment with clients' long-term investment objectives.

4) **Develop efficient and diverse capital markets:** as key capital market participants, the investment industry has a key role in the development of asset classes and the efficient functioning of capital markets.

5) **Overcome tax and regulatory impediments to the provision of long-term finance:** the investment industry should contribute to the debate on the tax and regulatory impediments to investment so as to ensure the right long-term outcomes for clients.

This Governance *in brief* focuses on the issues and proposed actions for the first of these two principles and provides a brief overview of the other three.

Enhance company reporting for efficient capital allocation

When making investment decisions, annual reports are an important source of information for investors. The Action Plan makes it clear that ideally annual reports should provide a real understanding of a business and its drivers, its financial strength, as well as the quality of management and their decisions. Investors have real concerns about the quality of reporting on long-term strategy and capital management. There are a number of elements to these concerns:

Lack of clarity on companies' management of capital

Disclosures do not allow investors to assess the effectiveness of capital allocation strategies. The measurement of return on invested capital is difficult and there is no articulation of the company's overall capital management policy and practice. Investors would welcome more meaningful commentary on future expenditure plans, how these will improve the business and how the plans are linked to strategy and will support productivity over the long-term.

ACTION: the IA will develop proposals for the articulation and measurement of the long-term drivers of productivity and key performance indicators. The IA will issue Long-Term Reporting Guidance which will set out investors' views on how to re-focus reporting on the longer-term strategic drivers of performance.

Quarterly reporting is seen as a distraction from focus on the long-term

The Action Plan expresses concern that quarterly reporting can distort management behaviour by channelling its focus on short-term fluctuations in performance, resulting in the risk of senior management increasingly focusing on managing the market rather than the business. There have been examples where management has delayed investment in R&D and capex if they believe it will stop them achieving short term performance targets and meeting market guidance.

ACTION: the IA will publish a position statement calling for companies to cease quarterly reporting. Any companies that continue reporting quarterly will be asked to explain why they do so and how it is relevant to their long-term strategy.

Insufficient reporting on human capital management

A key driver of improving corporate productivity is a company's workforce and whether the workforce is deployed efficiently, including the development of skills and competencies. Investors would like to see reporting on how a company manages its workforce within their investment decision-making process. Without this, an important factor for improving company productivity is neither being reported on by companies nor sufficiently integrated into analysis by investors.

ACTION: the IA will work with other stakeholders to outline the approach to company reporting of human capital management which would be most beneficial to investors.

Enhance investor stewardship and engagement

There continues to be a disproportionate amount of engagement time spent on executive remuneration at the expense of a focus on wider fundamental factors. The IA's 2015 report on 'Adherence to the FRC's Stewardship Code' showed that the issues that respondents considered the most important were (in order of importance):

- Corporate performance
- Board leadership
- Culture and strategy
- Board and committee composition
- Remuneration

It is felt that the Stewardship Code's principles do not make a sufficiently explicit connection between shareholder engagement and promoting medium- to long-term value and capital efficiency. There remains a disproportionate focus on AGM-related governance matters at the expense of companies' strategy for long-term, sustainable value creation.

ACTION: the IA will develop a set of guidelines, the Stewardship Reporting Framework, to assist members when they publicly report on their stewardship activities. The IA will also seek wider support and financing for the work of the Investor Forum.

Simplify behavioural incentives and the investment chain

There is a need to ensure that the relationship between asset owners and investment managers is governed in a way that does not inadvertently embed a short-term focus. In particular, there is a risk that mandates or Statements of Investment Principles inadvertently embed a short-term approach as a result of the manner and frequency of how performance is assessed.

In September 2015, the IA announced the establishment of an independent working group to consider the current structures of executive remuneration in the UK to address the belief that current structures are too complex and can lead to perverse incentives. Poorly structured remuneration arrangements can act as a disincentive to invest in capital expenditure and R&D. They can also provide a perverse incentive to favour short term outcomes over longer-term value creation. The working group will bring forward proposals in early summer 2016.

Develop efficient and diverse capital markets

To stimulate UK productivity growth, companies must be able to access the finance they need to invest in new technology and growth. This requires an investment environment that supports efficient and diverse capital, and protects the interests of investors. More can be done to improve the flow of institutional funds into other asset classes issued by both large and smaller companies.

Overcome tax and regulatory impediments to the provision of long-term finance

Regulatory and tax developments play an important part in shaping the asset allocation strategies of institutional investors. At present, the tax system continues to incentivise businesses to use debt rather than equity finance. On the investor side there is a concern that solvency regulation is inadvertently impeding long-term asset allocation strategies.

For further information

The full Productivity Action Plan can be found here: **http://www.theinvestmentassociation.org/media-centre/productivity-action-plan/**

Deloitte View

- We applaud the focus on long term wealth creation through this focus on productivity.
- We agree that efficient and effective capital management is a key component of the success and sustainability of a company over the longer-term and support steps to improve reporting in this area. At present reporting on the success of company investment decisions is opaque.
- We agree that reporting on leadership, culture and workforce, the human capital of a company, can be significantly improved.
- We are supportive of removing the obligation for UK publicly-listed companies to report on a quarterly basis. We commented to this effect to the FCA in August 2014.

Contacts and feedback

Deloitte's market leading Human Capital practice advises on reward strategy, organisation design, systems evaluation and implementation.

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The Deloitte Academy

Located in Stonecutter Court (EC4A 4TR), the Deloitte Academy has been designed to provide support and guidance to boards, committees and individual directors through a series of briefings and bespoke training. The briefings and training workshops help directors stay up to date with the changing regulatory environment and to meet their everyday business challenges. They also provide directors with the opportunity to discuss and debate matters with their peers.

Membership of the Deloitte Academy is principally for board directors of the FTSE 350.

For further details about the Deloitte Academy including membership enquiries, please email **enquiries@deloitteacademy.co.uk**.

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