THE INVESTMENT ASSOCIATION

SHAREHOLDER PRIORITIES FOR 2023

Supporting Long-Term Value in UK Listed Companies

February 2023

Contents

About the IA

The Investment Association is the trade body that represents UK investment managers, whose 270 members collectively manage over £10 trillion on behalf of clients. Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorized investment funds, pension funds and stocks & shares ISAs. The UK is the second largest investment management centre in the world and manages 37% of European assets.

Investment Association (IA) members hold in aggregate, one third of the value of UK publicly listed companies. We use this collective voice to influence company behaviour and hold businesses to account. More information can be viewed on our website.

About IVIS

The Investment Association's Institutional Voting Information Service (IVIS) is a voting research service which analyses FTSE All Share and FTSE Fledging companies against the IA's investee company guidelines, the UK Corporate Governance Code and best practice.

IVIS does not provide voting recommendations and instead assists shareholders to make informed voting decisions by highlighting issues or concerns prior to voting. Each IVIS report is issued with a colour top: Blue, Amber or Red. A Blue top indicates no areas of material concern while an Amber top raises awareness of areas which require a significant shareholder judgement. A Red top is IVIS' strongest level of concern and used to highlight a breach of best practice or our guidelines.

Introduction

Investment managers invest on behalf of millions of savers in the UK and around the world, working to deliver long-term returns to meet savers' investment needs. To achieve this, investment managers work as stewards of the companies they invest in to ensure they are positioned to deliver long-term value.

In 2020, the IA set out four Shareholder Priorities, which the IA members had identified as critical drivers of long-term value for companies. These issues were responding to climate change, diversity, audit quality and stakeholder voice. For each issue, the IA set out the importance to shareholders and how they drive long-term value creation, and the approach IVIS would take on each issue.

Investors have generally been pleased with the progress that companies have made in responding to these issues to date. The landscape has continued to evolve significantly since 2020, and IA members note that the way in which these themes have developed has created some important issues and challenges for corporates to consider.

IA members have considered whether to amend or expand these priorities for 2023. Maintaining these priorities has had the benefit of allowing the dialogue and approach from companies on these issues to mature and evolve. Investors believe that these issues still remain important in driving long-term value creation for shareholders, and that there is still more that could be done to drive further improvements.

Nonetheless, investors recognise that risks are not static and there are additional emerging risks and macroeconomic challenges that could have an impact on long-term shareholder value. The impact of the invasion of Ukraine, the knock-on impact on energy prices, and resultant inflationary environment have led to immense pressure on the resilience of the world's economy and an increase in the cost of living, which disproportionately impacts those at the lower end of the income distribution scale. These issues have helped to catapult social inequalities and the need for a 'just' transition to the forefront of investors' minds.

This challenging economic environment means that now more than ever there is a need for good governance including experienced non-executive directors on the Board, with the right information and ability to make the best long-term decisions for stakeholders and shareholders. This good governance also requires boards to monitor emerging risks, such as biodiversity loss.

Biodiversity and climate change are strongly interlinked, a changing climate threatens natural ecosystems, and nature loss amplifies climate change by reducing the ability of ecosystems to store carbon. Tackling both is an essential part of achieving net-zero emissions. According to the World Economic Forum, with more than half of the global Gross Domestic Product (GDP) depending on nature, a significant number of companies could face operational and financial risks as a result of collapsing ecosystems.

As a starting point, companies are encouraged to start reporting against the Taskforce on Nature-related Financial Disclosures (TNFD) to help them:

(i) assess their nature-related risks and opportunities, (including whether they are contributing to, or vulnerable from biodiversity loss);
(ii) assess those over different forward-looking scenarios; and
(iii) quantify the financial impacts.

However, the IA has retained the existing four Shareholder Priorities for 2023. In reviewing these Priorities for 2023, the IA conducted a review of 276 companies with year-ends starting after 13/12/2021 and have held an AGM by 31/07/2022.

This paper sets out:

- Progress against each priority based on an analysis of the 2022 AGM Season
- Investor expectations for the 2023 AGM season; and
- The IVIS approach to assessing companies against these expectations in 2023.

IVIS will monitor companies with year-ends starting on or after 31 December 2022 against the approach set out in this document.

Responding to Climate Change

2022 EXPECTATIONS AND IVIS APPROACH

In 2022, IVIS amber topped all commercial companies that did not make disclosures consistent with all four pillars of the TCFD framework: Governance, Strategy, Risk Management and Metrics and Targets. Previously IVIS amber topped companies in “high-risk sectors” as defined by TCFD that did not report against all four pillars of TCFD.

2022 AGM SEASON REVIEW

We have continued to see an increase in the quality and comprehensiveness of TCFD reporting, largely due to new rules for Premium listed issuers to make TCFD-aligned disclosures on a comply or explain basis. This was affirmed by the FRC's latest Thematic Review on climate-related disclosures within Premium listed entities.

The IA has found that 98.8% of FTSE 100 companies made disclosures consistent with all four pillars of TCFD in comparison to 88% in 2021. The one FTSE 100 company that was amber topped in 2022 noted that it was working on a ‘significant project on its approach to carbon reduction and climate change’. In 2022, improvements in reporting were made against the strategy pillar, with 100% of companies analysed providing disclosure on this. While most companies are describing their material climate-related risks and opportunities, fewer were able to disclose the impact on the company’s strategy (for example through considering the impact of climate-related scenario analysis) and only 68% were able to describe the impact on the company’s approach to capital management. Improvements were also seen against the risk management pillar with 100% of companies analysed by IVIS in 2022 now integrating climate change into their risk management processes.

2023 INVESTOR EXPECTATIONS

Investors welcome the work of the International Sustainability Standards Board (ISSB) in developing a consistent and comparable global baseline for sustainability-related disclosures. These standards will draw heavily from the TCFD and SASB standards. Where they have not already done so, companies should consider supplementing existing TCFD disclosures with the SASB sector-specific metrics.

The IA and its members have been encouraged by the number of companies reporting against all four pillars of TCFD. However, further improvements could be made on the following climate-related disclosures:

Metrics and Targets

IVIS currently assess whether a company discloses climate-related metrics and targets including whether:

- the company has disclosed an emissions reduction target and the timeframe for achieving these targets; and
- the company has committed to align its business model/operations with the Paris Agreement and explained how this can be achieved.

In 2022, 98.8% of companies in the FTSE 100 made disclosures on metrics and targets in comparison to 93% in 2021. While this is positive, investors would like to see companies focus on disclosing:

- The frameworks and methodologies used for setting targets and measuring progress;
- The targets which have been set over the short, medium, and long term; and
- The progress against targets to date and explaining whether it is in line with expectations.

Disclosing credible and robust metrics and targets helps provide investors with quantifiable information to identify, manage and track a company's exposure to climate-related risk and opportunities. Without this information, it is difficult for investors to assess how climate-related risk will affect the performance of the company, and consequently any resultant impact on long-term shareholder value.

Scenario Analysis

Consistent with the recommended disclosures under the Strategy pillar of TCFD, IVIS currently asks whether companies make specific reference to the impact of climate-related risks and opportunities in their approach to capital management. In 2022, 67.9% companies made reference to this in comparison to 60.5% companies analysed in 2021. However, some members have noted that there are significant omissions and variations in the approaches taken to climate-related reporting on scenario analysis by FTSE 100 companies. For example, on the level of detail on the impact of the scenario analysis and how this informs future financial planning and the company strategy.

Better disclosures on scenario analysis would provide investors with the comfort that a company's management is actively seeking to understand risks and manage the impact that climate change will have by embedding the outcomes of scenario analysis within its business model and strategy. For IA members, the ability to create sustainable value on behalf of savers is affected by how well companies manage these impacts. The importance of this was recognised by the ISSB, who have confirmed that companies will be required to use climate-related scenario analysis to inform resilience analysis. However, members recognise that there are still challenges involved with the complexity of scientific modelling, the multi-faceted nature of the consequences of each climate scenario and the longer-term timeframes within which climate-related risks manifest.

In the interim, investors would welcome greater disclosure on the process and governance of scenario analysis, including:

(i) how climate scenario analysis impacts the company’s business model and strategy; and
(ii) any changes the Board has made to the business model and strategy as a result of the outcomes of scenario analysis.

Transition Plans

As more companies set ambitious targets to reach net-zero by 2050 or sooner, investors expect climate pledges to be operationalised through robust plans on how companies will transition towards a low-carbon economy. Transition plans play a key role in enabling investors to assess the progress of investee companies on the path to net-zero, which in turn will inform more sustainable capital allocation decisions. Under the TCFD requirements in the Listing Rules, companies are already encouraged to produce transition plans. The IA is a member of the Transition Plan Taskforce (TPT), which has been established by the UK Government to develop the gold standard for private sector climate transition plans. The IA supports the need for a sector-neutral framework that will help standardise reporting. The TPT is currently consulting on a draft version of its framework. Whilst we await the final output of the TPT, IA members expect companies who have set interim net-zero targets to start producing Transition Plans against the TCFD supporting guidance on Metrics, Targets and Transition Plans, alongside the emerging interpretive guidance on a sector-neutral framework from the TPT.

2023 IVIS APPROACH

In 2023, IVIS will continue to Amber top all commercial companies that do not make disclosures against all four pillars of TCFD.

Metrics and Targets

Alongside the existing question on metrics and targets, IVIS will monitor the following additional questions:

- Has the company disclosed the framework or methodologies used to set these targets?
- Over what time periods have the targets been set?
- Has the company included narrative disclosures on the achievement of these targets?

Scenario Analysis

In addition to asking companies whether they make specific reference to the impact of climate-related risks and opportunities in their approach to capital management, IVIS will ask the following question:

- Has the company disclosed how the results of the company’s scenario analysis have impacted its business model and strategy?

Accounting for Climate Change

2022 EXPECTATIONS AND IVIS APPROACH

Investors expected directors to be able to affirm that the financial impacts of climate change had been adequately reflected in the company's financial accounts. Directors were also asked to consider the relevance of both physical and transition risks arising from interventions designed to align with the Paris Agreement when preparing and signing off the Annual Report and Accounts. The external auditor was asked to set out how they had assessed the risks arising from climate change when assessing the accounts.

In 2022, IVIS monitored whether companies had made a statement that the directors had considered the relevance of climate and transition risks associated with the transition to net-zero, when preparing and signing off on the company accounts. IVIS also noted instances where auditors had highlighted material climate-related risks in their Key Audit Matters as part of the auditor's report.

2022 AGM SEASON REVIEW

While we observed a sizable increase in the number of companies making such statements and incorporating the financial impact of climate-related matters into the company's accounts, the proportion across the FTSE 100 is still quite low, with 51.8% making a statement in 2022, in comparison to 14.8% in 2021. Even where companies had incorporated the financial impact of climate-change into their accounts, the Audit Committee rarely made a statement to confirm this. This failed to meet the specific expectations as set out in the Shareholder Priorities.

A further report from Carbon Tracker this year notes that 98% of multi-national companies responsible for up to 80% of GHG emissions do not sufficiently provide evidence that their financial statements include the impact of climate-related matters. This includes forward-looking assumptions on climate-related scenario analysis in the notes to the accounts.

2023 INVESTOR EXPECTATIONS

When companies don't take climate-related matters into account, their financial statements may include overstated assets, understated liabilities and overstated profits. Many asset and liability values rely on forward-looking assumptions. While the development of globally harmonised sustainability-related disclosure standards under the ISSB could encourage accounting standard setters to facilitate additional forward-looking financial statement disclosures, investors still expect directors to provide a statement on whether they have assessed climate and transition risk when signing off the accounts. Where relevant companies should refer to IIGCC's paper on Investor Expectations for Paris-aligned Accounts. Furthermore, entities should ensure consistency between information communicated in the financial statements and the information communicated to stakeholders outside the financial statements, such as in press releases, investor updates and disclosures in other parts of the annual report.

2023 IVIS APPROACH

IVIS will continue to monitor whether companies have made a statement that the directors had considered the relevance of climate and transition risks associated with the transition to net-zero, when preparing and signing off on the company accounts.

Audit Quality

2022 EXPECTATIONS AND IVIS APPROACH

The IA continued to expect companies to demonstrate how they have judged the quality of the audit they have received. This included a statement from the Audit Committee on whether they believe the auditor has provided a high-quality audit, including through challenging management's judgments and assertions and exercising professional scepticism.

IVIS monitored whether the Audit Committee had demonstrated how it assessed the quality of the audit and how it has challenged management's judgements.

2022 AGM SEASON REVIEW

In 2022, 8% of FTSE 100 companies were able to adequately demonstrate how they had assessed the quality of the audit, including how the auditor demonstrated professional scepticism and challenged management's assumptions where necessary. This was in comparison to 20% in 2021. IVIS noted that this drop came as a result of companies failing to adequately demonstrate how they had reported against each aspect of the question.

More encouragingly, 53% of Audit Committees were able to demonstrate how they had challenged management's judgments and what had happened as a result. This was an increase from 45% in 2021.

2023 EXPECTATIONS

Investors continue to rely on the financial information presented in a company's annual report and accounts to assess the quality and robustness of the audit and in turn make well-informed investment decisions. To this end, investors agree that the foundational aspects of a high-quality audit continue to relate to how the Audit Committee has judged the quality of the audit, including through an assessment of the auditor's ability to exercise professional scepticism and challenge when performing audits and assessing management's judgements and estimates.

Enhancing the consistency and quality of professional judgment exercised by auditors will help investors make better informed investment decisions based on the underlying financial performance of the company, as well as hold management and the Board to account. To this end, auditors should consider the FRC's Professional Judgement Guidance in supporting greater consistency on the judgements made on an audit.

IVIS APPROACH

For 2023, IVIS will separate the existing question into three parts to enable companies to provide targeted disclosures on:

- how the Audit Committee has assessed the quality of the audit;
- how the auditor has demonstrated professional scepticism; and
- how the auditor has challenged management's assumptions where necessary.

Companies may choose to provide case studies to help illustrate these points.

Diversity

2022 EXPECTATIONS AND IVIS APPROACH

IA members welcomed the changes made to the FCA's Listing Rules to incorporate additional diversity reporting and diversity targets on a comply or explain basis, and the alignment with the FTSE Women Leaders Review. Members expected companies to be able to articulate the approach they were taking to meet the new FTSE Women Leaders targets over time.

2022 AGM SEASON REVIEW

Gender Diversity

IVIS increased its thresholds for colour tops on gender diversity for 2022 to the following levels:

Red top FTSE 350 companies where women represent:

- 33.0% or less of the Board
- 28.0% or less of the Executive Committee and their direct reports

Amber top FTSE Small Cap companies where women represent:

- 25.0% or less of the Board
- 25.0% or less of the Executive Committee

In 2022, 14% of companies in the FTSE 100 were red topped for a lack of gender diversity at the board level—this remains unchanged from 2021. Of the 14% in 2022, 4 companies were also red topped in 2021. Encouragingly, the number of companies red topped In the FTSE 250 for a lack of gender diversity at the board level has decreased from 36% in 2021 to 17% in 2022. This also aligns with data from the 2022 FTSE Women Leaders Review, with 77% of boards in the FTSE 250 having met or exceeded the target to have at least 33.0% of women on the Board, and 92 companies now have 40% or more women on their Board.

The current IVIS colour-top targets remain below the 2025 targets of the FTSE Women Leaders Review, and those within the FCA's diversity disclosure Listing Rules of 40% female representation across the Board.

In 2022 22% of companies in the FTSE 100 were red topped for a lack of gender diversity at the Executive Committee and their direct reports level, in comparison to 17% in 2021. 10 companies were red topped in both 2021 and 2022.

Ethnic Diversity

IVIS took the following approach to ethnic diversity for 2022:

- Red top FTSE 100 companies that have not met the Parker Review target of one director from a minority ethnic group.
- Amber top FTSE 250 companies that do not disclose either the ethnic diversity of their board or a credible action plan to achieve the Parker Review targets by 2024.

In 2022, 7 companies in the FTSE 100 were red topped for failing to meet the Parker Review target, and 73% of companies in the FTSE 100 disclosed the percentage of Board members that come from an ethnic minority background.

11% of companies in the FTSE 250 were amber topped for failing to disclose the ethnic diversity of their Board, or how they plan to achieve the Parker Review targets.

2023 EXPECTATIONS AND IVIS APPROACH

Gender Diversity

For 2023, IVIS will increase its existing diversity targets by 2% which is aligned with the ambition to hit the FTSE Women Leaders Women on Board targets by 2025:

Red top FTSE 350 companies where women represent:

- 35.0% or less of the Board
- 30.0% or less of the Executive Committee and their direct reports

Given the level of gender diversity on small cap boards, IVIS will maintain its approach to Red topping FTSE Small Cap companies where women represent:

- 25.0% or less of the Board
- 25.0% or less of the Executive Committee

IVIS will also assess whether companies are meeting the new Listing Rule requirement for companies to disclose on a comply or explain basis whether one of the four senior positions on the Board (Chair, SID, CEO or Finance Director) is held by a female. At this stage, IVIS will not colour top on this issue.

Investors are generally pleased with the progress that companies have made in trying to tackle the lack of diversity at the board level. However, investors are equally interested in whether the drive for diversity is reflected across the wider workforce, and will increasingly be examining Gender Pay Gap data, and any voluntary reporting on the Ethnicity Pay Gap in order to ascertain this.

Ethnic Diversity

Investors continue to promote the Change the Race Ratio, as a business-led peer group. All signatories are committed to change and making progress in transparency, inclusion, action and accountability, which helps to provide a mechanism for improving ethnic diversity both at senior leadership levels and throughout the company.

IVIS is not changing its approach to Ethnic Diversity for 2023, it will:

- Red top FTSE 100 companies that have not met the Parker Review target of one director from a minority ethnic group.
- Amber top FTSE 250 companies that do not disclose either the ethnic diversity of their board or a credible action plan to achieve the Parker Review targets by 2024.

Stakeholder Engagement

2022 EXPECTATIONS AND IVIS APPROACH

Investors continued to expect companies and their boards to:

- Identify and disclose their material stakeholders;
- Decide on the most appropriate mechanism to engage with those stakeholders;
- Clearly articulate how their views have been informed and impacted their decision making; and
- Report back to shareholders and stakeholders on the engagement, the views heard and how they have impacted on board decision making.

2022 AGM SEASON REVIEW

In 2022, the IVIS approach has been to highlight in which section of the Annual Report Covid-related stakeholder engagement disclosures have been made by companies. Investors have generally been pleased with the approach that companies have taken in managing their wider stakeholders through the pandemic.

2023 EXPECTATIONS

Investors recognise that there has been a growth in the number of issues (particularly related to sustainability) that companies are now required to consider and make disclosures on. It is therefore imperative that Boards remain well-informed and have access to the right information in order to make the best long-term decisions. Part of this process will require Boards to continue to foster constructive relations and dialogue with key stakeholders to inform strategic, long-term decision making. Failing to do so could create reputational risks which have a knock-on consequence for the long-term performance of the company.

Investors were generally pleased with the way that Boards responded to the needs of various stakeholders through the pandemic. For 2023, companies should continue this good practice by extending the focus on engagement, supporting and communicating with stakeholders through the cost-of-living crisis. Company disclosures should include the impact of the increases to the cost-of-living and the inflationary pressures in the economy on employees (particularly lower paid employees), consumers including vulnerable customers, and suppliers. Investors will expect Boards to demonstrate how they have reflected the views of their stakeholders in key boardroom decision making.

IVIS APPROACH

IVIS will monitor and highlight areas of the Annual Report which reflect engagement with stakeholders on the cost-of-living crisis.

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