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Audit committee reporting to shareholders in 2016

EY is pleased to present this fifth report on the topic of audit committee reporting based on the EY Center for Board Matters (CBM) review of audit committee-related proxy disclosures by Fortune 100 companies.[1] As in past years, our research shows that companies are continuing to supplement mandatory disclosures with additional voluntary information. Through this publication, EY seeks to promote public discussion about audit committee communications with stakeholders, which has been the subject of investor and regulatory interest in recent years.

Audit committees have a key role in overseeing the integrity of financial reporting. Nevertheless, relatively little information is required to be disclosed by US public companies about the audit committee's important work. Since our first publication in this series, which covered 2012 audit committee-related proxy disclosures, we have described efforts by investors, regulators and other stakeholders to seek increased audit-related disclosures, as well as the resulting voluntary disclosures to respond to this interest.[2]

Over 2015 to 2016, US regulators have placed a spotlight on audit-related disclosures and financial reporting more generally. The US Securities and Exchange Commission (SEC) and the US Public Company Accounting Oversight Board (PCAOB) have both taken action to consider the possibility of requiring new disclosures relating to the audit. SEC representatives also have used speeches to urge companies and audit committees to increase disclosures in this area voluntarily. While additional disclosure requirements for audit committees are not expected in the near term, regulators continue to monitor developments in this area. This report seeks to help shed light on the evolving audit-related disclosure landscape.

Context

Public company audit committees are responsible for overseeing financial reporting, including the external audit. Under US securities laws, audit committees are "directly responsible for the appointment, compensation, retention and oversight" of the external auditor[3] and must include a report in annual proxy statements about their work. This audit committee report, however, currently must affirm only that the committee carried out certain specific responsibilities related to communications with the external auditor, and this requirement has not changed since 1999.[4] In recent years, a variety of groups have brought attention to the relative lack of

US regulators have placed a spotlight on audit-related disclosures and financial reporting more generally.

information available about the audit committee and the audit, including their view that this area of disclosure may not have kept up with the needs of investors and other proxy statement users. These groups include pension funds, asset managers, investors, corporate governance groups, and domestic and foreign regulators. As efforts to seek additional information have continued, there has been a steady increase in voluntary audit-related disclosures.[5]

Over the last year, the SEC has taken a series of actions to consider whether and how to improve transparency around audit committees, audits and financial reporting more generally. The combined effect of these activities has been to increase engagement by issuers, audit firms, investors and other stakeholders in discussions about the current state of financial reporting-related disclosure as well as how it should change.

SEC concept release

In July 2015, the SEC issued its Concept Release on Possible Revisions to Audit Committee Disclosures, which solicited views on whether there should be greater transparency around the work of audit committees, and if so, how best to achieve it. The concept release focused specifically on transparency relating to the audit committee's oversight of the auditor.

Responses from commenters

The concept release drew comments from a variety of capital market participants, including audit committees, public company executives, investors, business and legal associations, academics, and audit firms.[6]

- Commenters representing board members, corporate management and auditors generally advised against new, more prescriptive SEC-required disclosures. Many were supportive, however, of voluntary disclosures by issuers and audit committees and provided views on the disclosures they thought would be most helpful to investors. These commenters suggested that companies would be more likely to provide more meaningful disclosures if allowed to disclose information voluntarily in response to investor interest and the company's particular circumstances. Mandatory requirements could result in boilerplate disclosures.
- A majority of the investors that provided comments took a different view, however, and supported mandatory disclosures. Among the reasons provided for preferring required disclosures was that investors typically do not have enough information with which to assess the audit committee under the current disclosure regime, which already allows voluntary disclosures. In addition, required disclosures would allow for greater comparability among companies.
- Commenters from multiple categories noted that one benefit of increased audit committee disclosures, whether required or voluntary, would be enhanced confidence in audit committees, as these disclosures would allow them to demonstrate their alignment with shareholders, as well as explain the breadth and depth of their activities, which currently may not be widely known or appreciated.

Since issuing the Concept Release, the SEC has not taken additional regulatory action on audit committee disclosures. SEC Chair Mary Jo White and SEC staff have said that voluntary disclosures will be monitored, however, and have urged audit committees to provide more such disclosures.

SEC focus on audit committee responsibilities

Over the past year, Chair White and SEC staff have used speeches to remind audit committees of their oversight responsibilities.[7] They also have emphasized the responsibility of audit committees in particular areas, such as involvement in discussions between auditors and management on internal control over financial reporting, implementation of new accounting standards and use of non-GAAP measures.[8]

In addition to the SEC focus, the PCAOB is exploring providing greater transparency around the audit to investors and other stakeholders. One of these initiatives is the reproposed standard to revise the auditor's report.[9] Among other things, the reproposal would require auditors to provide information about critical audit matters, which would inform investors

53% of companies disclosed that the audit committee considered the impact of changing auditors when assessing whether to retain the current auditor.

about areas of the financial statements that involved especially challenging, subjective or complex auditor judgment.[10] In addition, the PCAOB finalized a standard in late 2015 to require auditors to disclose on a new Form AP the name of the lead engagement partner as well as the other audit firms that participated in an audit.[11]

Findings

Our analysis of the 2016 proxy statements of Fortune 100 companies indicates that voluntary audit-related disclosures continue to trend upward in a number of areas.[12] Specifically, the CBM data for this review is based on the 78 companies on the 2016 Fortune 100 list that filed proxy statements each year from 2012 to 2016 for annual meetings through August 15, 2016 (i.e., it excludes companies that have not yet held their 2016 annual meeting).[13] Below are highlights from our research:

- The percentage of companies that disclosed factors considered by the audit committee when assessing the qualifications and work quality of the external auditor increased to 50%, up from 42% in 2015. In 2012, only 17% of audit committees disclosed this information.
- Another significant increase was in disclosures stating that the audit committee believed that the choice of external auditor was in the best interests of the company or the shareholders. In 2016, 73% of companies disclosed such information; in 2015, this percentage was 63%. In 2012, only 3% of companies made this disclosure.
- The audit committees of 82% of the companies explicitly stated that they are responsible for the appointment, compensation and oversight of the external auditor; in 2012, only 42% of audit committees provided such disclosures.
- 31% of companies provided information about the reasons for changes in fees paid to the external auditor compared to 21% the previous year. Reasons provided in these disclosures include one-time events, such as a merger or acquisition. Under current SEC rules, companies are required to disclose fees paid to the external auditor, divided into the following categories: audit, audit-related, tax and all other fees.[14] They are not, however, required to discuss the reasons why these fees have increased or decreased. From 2012 to 2016, the percentage of companies disclosing information to explain changes in audit fees rose from 9% to 31%.
- Additional CBM research examined the disclosures of the subset of studied companies (43) that had changes in audit fees of +/- 5% or more compared to the previous year. Out of these 43 companies, roughly 20% provided explanatory disclosures regarding the change in audit fees. Fourteen companies had fee increases of 5% or more, out of which 8 companies disclosed the reasons for the increases. 14 of the 43 companies had fee decreases of 5% or more, out of which only one company provided an explanatory disclosure.
- Companies disclosing that the audit committee considered the impact of changing auditors when assessing whether to retain the current auditor increased 6 percentage points over 2015 to 53%. In 2012, this disclosure was made by 3% of the Fortune 100 companies.
- Over the past five years, the number of companies disclosing that the audit committee was involved in the selection of the lead audit partner has grown dramatically, up to 73% in 2016. In 2015, 67% of companies disclosed this information, while in 2012, only 1% of companies did so.
- In addition, 51% of companies disclosed that they have three or more financial experts on their audit committees, up from 47% in 2015 and 36% in 2012.[15]

Summary: trends in audit committee disclosure

Category	Topic	2016 % of total	2015 % of total	2014 % of total	2013 % of total	2012 % of total
Disclosures in the audit committee report	Statement that the audit committee is independent	58%	58%	55%	51%	54%
	Name of the audit firm is included in the audit committee report	76%	74%	74%	76%	76%
Audit committee composition	Audit committees with 1 financial expert (FE)	26%	24%	28%	26%	28%
	Audit committees with 2 FEs	23%	28%	31%	51%	36%
	Audit committees with 3 or more FEs	51%	47%	41%	23%	36%
Audit committee responsibilities re: external auditor	Explicit statement that the audit committee is responsible for appointment, compensation and oversight of external auditor	82%	81%	68%	55%	42%
Identification of topics discussed	Topics discussed by the audit committee and external auditor	6%	8%	6%	8%	8%
Fees paid to the external auditor	Statement that the audit committee considers non-audit fees/services when assessing auditor independence	81%	82%	79%	79%	14%
	Statement that the audit committee is responsible for fee negotiations	29%	26%	17%	9%	0%
	Explanation provided for change in audit fees paid to external auditor	31%	21%	19%	14%	9%
Assessment of the external auditor	Disclosure of factors used in the audit committee's assessment of the external auditor's qualifications and work quality	50%	42%	33%	19%	17%
	Statement that audit committee is involved in lead audit partner selection	73%	67%	49%	17%	1%
	Disclosure of the year the lead audit partner was appointed	13%	12%	8%	3%	3%
	Statement that choice of external auditor is in best interests of company and/or shareholders	73%	63%	49%	22%	3%
Tenure of the external auditor	Disclosure of the length of the external auditor tenure	63%	62%	51%	29%	24%
	Statement that the audit committee considers the impact of changing auditors when assessing whether to retain the current external auditor	53%	47%	33%	17%	3%
Accessibility of audit committee charters from proxy statements	Link goes directly to the charter	12%	15%	15%	10%	8%
	Company main website	37%	40%	40%	41%	45%
	Company site for investor relations	24%	24%	26%	26%	24%
	Company site for corporate governance matters	27%	21%	19%	23%	23%

Reviewed companies had an average of 2.9 financial experts.

Reviewed companies indicated that the audit committee raised certain topics with their external auditors other than those required by regulations; these included the testing and evaluation of internal controls, enterprise risk management, cybersecurity and other information technology matters, subsidiaries and accounts, tax, and legal matters.

Most companies provide an explanation for the types of services included within each fee category. The companies highlighted here explain the circumstances for the change.

Reviewed companies indicated that audit committees based these assessments on criteria such as the independence and integrity of the external auditor and its controls and procedures; performance and qualifications, including expertise on the company and global reach relative to the company's business; quality and effectiveness of the external auditor's personnel and communications; appropriateness of fees; length of tenure and benefits of a longer tenure; and PCAOB reports on firm and peers.

Endnotes

1 See *Audit committee reporting to shareholders: going beyond the minimum* (February 2013), *Audit committee reporting to shareholders 2013 proxy season update* (September 2013), *Let's talk: governance — audit committee reporting to shareholders* (August 2014) and *Auditing committee reporting to shareholders in 2015* (September 2015).

2 EY also has several publications examining audit committee-related disclosure trends in other countries, most recently in *Enhancing audit committee transparency: EY's review of 2015 disclosures*.

3 17 CFR §240.10A-3(b)(2).

4 Item 407(d) of Regulation S-K (17 CFR §240.407(d)).

5 In addition to the EY publications in footnote 1, see also the Center for Audit Quality's *Audit Committee Transparency Barometer* (November 2015), which showed trends of enhanced voluntary audit committee-related disclosures among companies in the Standard & Poor's Composite 1500 index.

6 See generally the responses to the SEC's concept release.

7 See, e.g., Chair White's speech at the AICPA conference, supra note 4.

8 See, e.g., "Remarks before the 12th Annual Life Sciences Accounting and Reporting Congress," James V. Schnurr, Chief Accountant, Office of the Chief Accountant, March 22, 2016.

9 PCAOB *Proposed Auditing Standard – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, May 11, 2016.

10 The exact definition contained in the reproposal is: "A critical audit matter is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment." (P. A1-7 of the reproposal.) Supra note 8.

11 PCAOB standard *Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards*, December 15, 2015. This standard will take effect for auditor's reports issued after January 31, 2017 for the lead engagement partner name and June 30, 2017 for the names of other auditors that participated in the audit.

12 The data for this report was gathered through the Center for Board Matters' proprietary corporate governance database, which collects and analyzes data for more than 3,000 US public companies. See the Center for Board Matters website.

13 In our previous publications on this topic, the data was based on the Fortune 100 list for that year (e.g., the 2015 Audit Committee Reporting to Shareholders had data based on the 2015 Fortune 100 companies). Since the Fortune 100 changes slightly from year to year, some of the percentages in this publication differ slightly from previous publications.

14 Item 9 of 17 CFR §240.14a-101 (Schedule 14A. Information required in a proxy statement).

15 Companies are not required to have financial experts on their audit committees, but must disclose whether they have one. There is no requirement to disclose whether additional audit committee members qualify as a financial expert. Item 407(d)(5) of Regulation S-K (17 CFR §240.407(d)(5)).

Four takeaways from proxy season 2016

Active — not just activist — institutional investors are reshaping the corporate governance landscape and challenging how boards think about fundamental issues such as strategy, risk, capital allocation and board composition. Large asset managers are increasingly outspoken on governance expectations and urging companies to think long term — and also making clear that they view corporate governance not as a compliance exercise but as an ownership responsibility tied to investment value and risk mitigation.

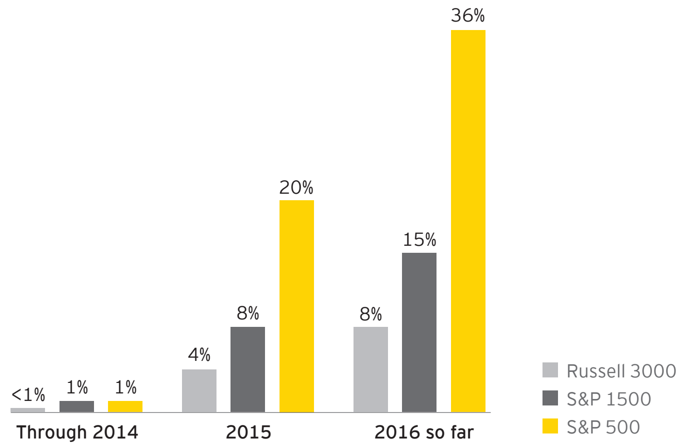
Companies are responding to investor demands for increased board accountability and transparency. They are enhancing communications with investors to share the board's message on governance and strategy and highlight director qualifications and board responsiveness to investor concerns. Against this backdrop of increased company-shareholder engagement and evolving disclosure practices, investor support for directors and company pay programs remains high.

This report is based on EY Center for Board Matters' proprietary corporate governance database, ongoing conversations with investors and directors, and insights from EY's Corporate Governance Dialogue series, which convenes key governance influencers to discuss developments impacting the governance landscape.[1]

1) Adoption of proxy access is accelerating across the market

Proxy access, a provision that companies fought against for decades, has now been adopted by more than a third of Standard & Poor's (S&P) 500 companies within a two-year span, driven largely by the submission of shareholder proposals calling for the reform. Around 60% of almost 200 companies that received proxy access shareholder proposals for 2016 annual meetings adopted proxy access bylaws before the proposal even went to a vote. Most companies with proxy access (81%) have adopted the following key provisions: a group of up to 20 investors that have collectively held at least 3% of the outstanding stock for at least three years may nominate up to 20%–25% of the board (in some cases, providing for at least two nominees).

More than 240 companies with proxy access bylaws by index



Proxy statements continue to evolve from compliance documents to communication tools.

What this means for boards

Pressure on companies to adopt proxy access is likely to increase. Also, at a significant – and increasing – number of companies, investors now have a new tool for holding their representatives on boards accountable. Actions to consider:

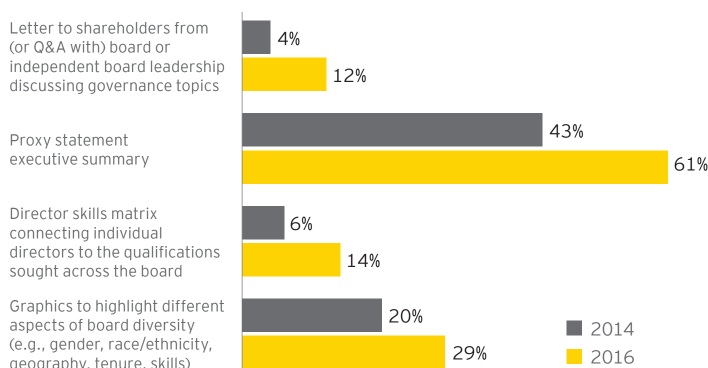
- Proactively raise the topic with key shareholders to better understand their views on proxy access, including around preferred terms (e.g., shareholders' ability to work as a group and the number of board seats that may be filled)
- Confirm that communications around board composition make clear how the skill sets of individual directors are aligned with the company's strategy and risk oversight efforts, and discuss the board's assessment, refreshment and nomination processes

2) Companies continue to enhance investor communications

Proxy statements continue to evolve from compliance documents to communication tools that serve as an extension of corporate engagement efforts and a formal record of the board's priorities and governance philosophy. Effective proxy statements are improving readability through enhanced formatting and graphics, demonstrating board engagement and effectiveness, and addressing key interests of institutional investors.

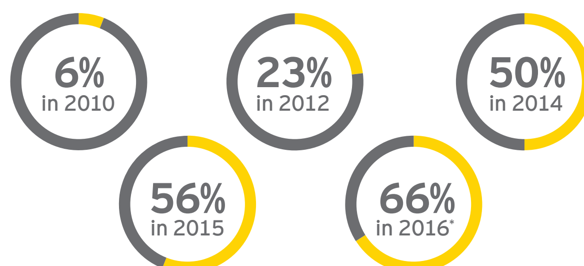
Company-investor engagement on governance topics – and disclosure of these efforts in the proxy statement – also continues to grow. While executive compensation remains a primary engagement driver, companies disclosed a variety of other topics that were part of those conversations, including proxy access, strategy, performance, board composition, board leadership, board assessments, director tenure, sustainability practices, risk oversight and capital allocation. And directors are getting involved: among the 287 S&P 500 companies that disclosed engagement this year, 24% disclosed that board members were involved (most often the lead director or compensation committee chair), up from 18% last year.

S&P 500 proxy disclosure trends*



** Percentages for 2016 based on 436 proxy statements for S&P 500 companies available as of June 10, 2016.*

S&P 500 companies that disclose engaging with investors*



What this means for boards

Proxy disclosures are an efficient way to take the company's targeted governance message to a broad audience of investors and other stakeholders. Through direct engagement, companies are better positioned to proactively respond to investor concerns and have effective investor communications and secure investor support. Actions to consider:

- Use the proxy statement to directly address investors, e.g., through a letter from the board or a committee, a Q&A with the lead director or a link to director video interviews
- Incorporate investor insights into governance decisions and communications

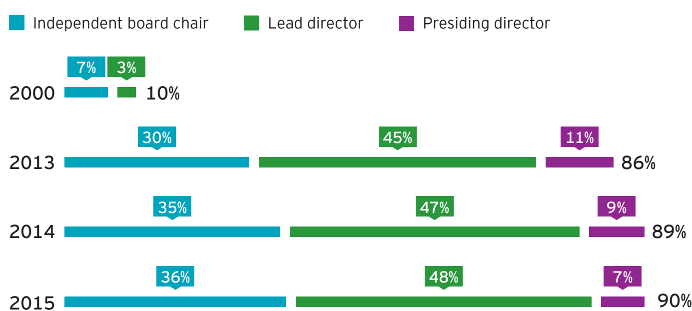
3) Board composition remains a key focus – with director tenure and board leadership coming under increased investor scrutiny

Investors evaluate board composition using a number of different lenses (e.g., skill set and subject-matter experience relevant to industry, strategy and risk; diversity, specifically including gender, race and ethnicity; independence). Some investors are now particularly focused on director tenure and the board's approach to refreshment and succession planning. Notably, several influential investors have recently adopted proxy voting policies that take tenure into account.[2]

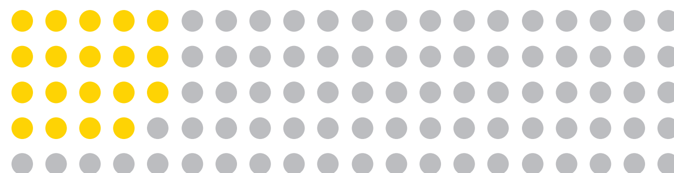
Some investors view tenure as a measurement of the relevance of director experience. Indeed, expertise may become stale over time as a director becomes further removed from the professional qualifications underlying his or her recruitment to the board. Some investors also believe lengthy tenure may compromise board independence. Other considerations include the need for gradual board and committee turnover and the fact that board refreshment is critical to recruiting new skills aligned with the company's evolving strategy – and creating opportunities to enhance board diversity.

Some investors are also paying closer attention to board leadership. They seek assurances that boards have empowered and effective independent leaders with well-defined responsibilities and relevant personal strengths and qualifications.[3] For some, there is no substitute for an independent chair, but others find lead directors to be sufficient. While having an independent board leader has become standard practice, there continues to be a lack of consensus over the preferred structure among companies, and the relatively stagnant support for independent chair shareholder proposals (hovering around 30% over the past four years) may reflect that.

Evolving independent board leadership practices at S&P 1500 companies



S&P 1500

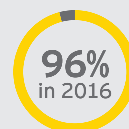


19% of S&P 1500 directorships are held by individuals who are 68 or older and have served on the board for 10 years or more. That's up from 14% in 2010, and almost all (93%) of these seats are held by men.

Strong investor support for directors and executive pay programs

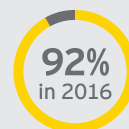
Despite increased investor scrutiny of directors' qualifications and tenure, support for director elections continues to rise. Only around 0.2% of directors have failed to get majority support so far this year, down from 0.3% in 2015.

Average support for 2016 board nominees



Similarly, investors are giving directors high marks on one of their key responsibilities: compensating executives. So far, only 2% of all say-on-pay proposals voted on this year have received less than majority support – that is just 24 proposals out of 1,484.[4]

Average support for say-on-pay proposals



*Percentages for 2016 based on 436 proxy statements for S&P 500 companies available as of June 10, 2016.

What this means for boards

Boards' record of refreshment, assessment process and leadership structures are under increased scrutiny. As some investors weigh their options for encouraging regular, thoughtful board refreshment, it underscores the value in companies enhancing their communications in these areas. Actions to consider:

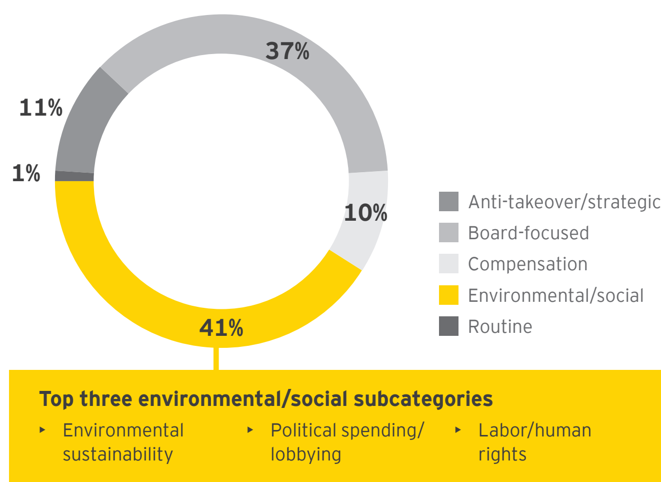
- Discuss board refreshment, assessment and leadership during engagement conversations with shareholders (and consider making directors available as appropriate), and enhance proxy disclosures related to these topics
- Include proxy statement graphics highlighting the board's diversity of tenure (25% of S&P 500 companies have done so this year) and letters from (or Q&As with) the lead independent director or independent chair, demonstrating the depth of their role (6% of S&P 500 companies have done so this year)

4) Shareholder proposal submissions remain high, driven by push for proxy access and environmental sustainability

Shareholder proposal submissions generally remain high. We are tracking around 890 shareholder proposals submitted for meetings through June 30, 2016, which is close to what we tracked over the same period last year. This sustained high level of proposals is largely driven by the campaign for proxy access and a continued push for increased transparency and accountability around environmental sustainability practices. Some key takeaways include:

- Environmental and social topics remain in the lead among proposal categories, but board-related proposals have increased with the expansion of the campaign for proxy access. This year, 37% of shareholder proposal submissions are board-related, up from 28% in 2015.
- The most submitted shareholder proposal topic again this year was proxy access. Shareholder proposals on this topic average close to majority support — and usually fall under that mark only when the target company has already adopted proxy access by the time the proposal goes to a vote or management is submitting a counterproposal to adopt proxy access. The proposal averages 59% when excluding such companies.
- Environmental considerations appear to be moving further into the mainstream,[5] and some proxy votes to date may reflect that shift. Average support for proposals on climate risk have jumped from 7% in 2011 to 28% so far this year, including a proposal at an oil and gas company that nearly received majority support with 49% of the votes cast. In addition, there have been two environmental sustainability-related proposals so far this year to receive majority votes: one seeking a sustainability report, including greenhouse gas emissions reduction goals, and another seeking a report on the company's monitoring and managing of methane emissions.
- The percentage of shareholder proposals withdrawn before going to a vote is 26%, which is consistent with recent years.

Shareholder proposal submissions by proposal category, 2016



Most common shareholder proposals submitted in 2016

Proposal	Average support to date	Proposals submitted	Proposals withdrawn
Adopt/amend proxy access	49%	186	37%
Review/report on lobbying activities	24%	56	23%
Appoint independent board chair	30%	55	15%
Review/report on political spending	28%	46	30%
Address human rights	7%	39	28%
Report on sustainability	28%	33	33%
Limit post-employment executive pay	27%	33	27%
Review/report on greenhouse gas emissions	25%	31	35%
Increase/report on board diversity	32%	27	67%

Shareholder proposals receiving highest average vote support in 2016

Proposal	2011 average support	2016 average support to date
Adopt majority vote to elect directors	60%	68%
Eliminate supermajority vote	59%	61%
Adopt/amend proxy access	n/a	49%
Allow shareholders to act by written consent	52%	41%
Allow shareholders to call special meeting	43%	39%

Endnotes

1 All data is from EY's proprietary corporate governance database, which covers more than 3,000 companies listed in the US. For additional timely governance data, see EY's Corporate Governance by the Numbers. Shareholder proposal data is based on meetings through June 30, 2016. Vote results for 2016 are available for meetings through May 31, 2016. All other data is full year.

2 See statements from State Street Global Advisors, February 2015; CalPERS, March 14, 2016; and Legal & General Investment Management, February 21, 2016.

3 See statement from State Street Global Advisors, February 2016.

4 See EY's Corporate Governance by the Numbers for more data on director elections and say-on-pay proposals.

5 See 2016 proxy season preview: a focus on the long term.

Questions for the board to consider:

- Is your board prepared to integrate conversations about long-term strategy with conversations about governance — and are key directors prepared to take part in shareholder engagement?
- Does your board know key shareholders' views on proxy access and the company's governance practices?
- How is your board verifying that director qualifications align with the company's risks and opportunities going forward? And that regular refreshment brings in current expertise and increases board diversity?
- How does your board's leadership structure improve board effectiveness?
- Is your company optimizing the proxy statement as an investor communications tool? Are there ways to enhance communications around board leadership, director qualifications, board succession planning and assessments?
- How is the board overseeing environmental and social risk and value drivers? Are environmental and social considerations integrated into the company's long-term strategy — and is the company communicating that to investors?

Buybacks vs. backlash

The board's role in weighing the pros and cons of stock repurchases

Cash may be king, but over the long post-2008 recovery, liquid capital on balance sheets has swelled to the point that corporations and their boards feel serious pressure from markets and shareholders over what to do with it. In the fourth quarter of 2015, non-financial S&P 500 companies reported cash holdings — including short-term investments — totaling $1.77 trillion, the highest quarterly level in 10 years. Since the beginning of 2009, when S&P 500 companies reported cash stockpiles of about $750 billion, that figure has more than doubled.

These cash holdings were widely dispersed on both a company and industry level. While the companies that comprise the S&P 500 Industrials Index led the way with a combined $13.2 billion surplus, sectors as diverse as health care ($5.3 billion), telecom ($4.5 billion) and energy ($3.9 billion) all face the same problem: what to do with the excess cash on their balance sheets.

As the 2016 proxy season approached, attitudinal data relevant to this cash question was released by the EY Center for Board Matters. Conducting interviews with more than 50 institutional investors, advisors and investor associations, EY gathered insights into investor priorities and heard many investors express concern over whether buybacks are the best strategy for long-term value creation. Investors said they expect directors to carefully oversee capital allocation decisions, and they want to better understand why capital used for stock repurchases is not better off invested in human capital, innovation and other long-term strategies.

Scrutiny of the practice has become fairly intense of late. Critics point to the first quarter of 2015, when companies in the S&P 500 index returned more money to shareholders than they earned. The anti-buyback voices consider the practice to be symptomatic of a short-term mindset, one likely to harm business operations in the long run.

The pro-buyback counterpoint is perhaps most loudly voiced by activist shareholders. In 2015, 70 activist investor campaigns sought buybacks or higher dividends at S&P 500 companies — a 37% increase year-over-year — and 31 of those campaigns were successful. Both figures were record highs since the analytics firm FactSet began tracking this data in 2005.

Even more noteworthy is the success of activist shareholders. At the 10 companies that got the most out of their buyback purchases — as measured by the difference between their average stock price and their average buyback price — the buyback discount ranged from 12% to more than 26%.

For boards, the challenge is to oversee capital allocation decisions with an eye toward the long term.

Time frame priorities

Finding a balance between near-term and long-range priorities is the ongoing challenge for public companies, requiring nuanced judgment at the top and careful oversight by directors.

Institutional investors participating in the EY report cited the importance of having the "right mix of directors, with a depth of diverse skills and backgrounds, in place to oversee long-term strategies and risk management." One benefit of having this optimal mix of board directors would involve "how a company manages — and how the board oversees — the company's environmental and social impacts." Surveyed investors called performance in this area "integral to whether the company is being run well for the long term."

An investor who takes the long-term view may feel positive about share repurchase programs when the cash balance is sky-high, but there appear to be few promising investments in the core operation or in mergers and acquisitions (M&A). Investors may also prefer share repurchases late in periods of significant M&A activity, when companies are more likely to overpay for the businesses acquired. Both situations require vigilant directors who are asking the tough questions about proposed capital allocation strategies.

Corporate decisions around buybacks are also judged in light of what sector peers are doing. Last year, when a fixed-capital expenditures rose 23.5% in the consumer discretionary category, any firm in that space that made only modest capital outlays while ramping up distributions and buyback programs would be an outlier as to its capital allocation approach.

Ultimately, the underlying subject is how a given company and its board are perceived. Stock price, over an extended period, is one obvious way perception gets expressed — and repurchase efforts can affect that. However, absent the signaling that comes from technical analysis or the belief that a stock is undervalued, buybacks don't necessarily create new value.

Repurchasing shares (to either cancel them or stow them in the treasury) has the effect of dressing up quarterly earnings reports: having fewer shares lifts the key earnings-per-share (EPS) metric, giving a perhaps-contrived boost to the profitability story. Buyback programs also address the dilution issue that arises as top executives exercise their stock options. Because the shares executives acquire are newly issued, a repurchase by the company of open-market stock provides a way to reset the number of shares outstanding and positively impact EPS, although some companies do adjust for this.

Management bonuses linked to share price or EPS may also be positively affected by repurchase programs, contributing to some investors' views that executive bonuses must be reined in. In the EY Center for Board Matters report, executive compensation made the top three shareholder-proposal categories. Included are shareholder proposals asking compensation committees to adjust executive pay metrics to exclude the impact of stock buybacks.

In February, an open letter penned by BlackRock's Larry Fink, the CEO of the world's largest investor with $4.6 trillion in assets, illustrated how the mood of institutional investors has shifted. Addressing the leadership at US and European companies, Fink supported the return of excess cash to shareholders, but not at the expense of value-creating investment, decrying today's "culture of quarterly earnings hysteria" and warning of the risks of focusing on near-term profit over long-term value. Fink also earned plaudits for encouraging all CEOs to lay out an annual strategic framework for value creation and to explicitly affirm that their boards have reviewed those plans.

The short-term viewpoint and stock buybacks begin to look like yesterday's strategy, at a point when higher aims and a broader view of value are emerging. For its proponents, the likely hope is that there will be cash on hand to fund that vision going forward. For boards, the challenge is to oversee capital allocation decisions with an eye toward the long term.

More insights

Access additional information, including the following, at **ey.com/boardmatters**:

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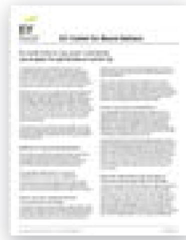

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