

## Amendments to AAF 01/06 Stewardship Supplement and summary of consultation responses

### Introduction

ICAEW Audit and Assurance Faculty issued in October 2010 the exposure draft of the Stewardship Supplement to AAF 01/06 *Assurance reports on internal controls of service organisations made available to third parties*<sup>1</sup> with a view to assist asset managers to obtain an independent assurance report on their compliance with the UK Stewardship Code (the Code). The Code was issued by the Financial Reporting Council (FRC) in July 2010 to enhance the quality of engagement between institutional investors and companies they invest in to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities.<sup>2</sup>

Principle 7 of the Code states that institutional investors should report periodically on their stewardship and voting activities and in the associated guidance that:

*Those that sign up to this Code should consider obtaining an independent audit opinion on their engagement and voting processes having regard to the standards in AAF 01/06 [ICAEW technical Release Assurance reports on internal controls of service organisations made available to third parties] . . . The existence of such assurance certification should be publicly disclosed.”*

The draft Supplement contemplates that assurance reporting on the UK Stewardship Code would as a minimum address the policies and processes relating to the application of Principles 1, 2, 6 and 7 of the Code and the related disclosures and whether these have been fairly described. Assurance reporting is not at present envisaged in relation to Principles 3, 4 and 5 of the Code as they are currently not considered ‘objectively verifiable’. The assurance opinion does not extend to design suitability or the effectiveness of the process implementation.

The draft Supplement intends to facilitate asset managers’ adoption of the Code and obtaining an assurance report on fairness of description in the first instance and widening the scope of reporting to cover design suitability and process implementation as good practices develop. A stakeholder panel, including users, preparers, reporting accountants and other interested parties participated in the development of the draft Supplement.

Consultation on the Stewardship Supplement was carried out between October 2010 and January 2011.

Five responses were received, including , two from the investment community, two from accountancy firms and one other. A complete list of respondents is at Annex A. Individual responses are available in Annex B of this paper.

This paper considers the comments on the proposed Stewardship Supplement and AAF 01/06 working group’s responses. AAF 01/06 working group and the stakeholder panel met on 16 March 2011 to consider the responses. The meeting included three asset managers, three end investors (including members of the National Association of Pension Funds), six reporting accountants and the representatives of the Investment Management Association, the Association of British Insurers, the Auditing Practices Board and the Chartered Institute of Public Finance and Accountancy.

---

<sup>1</sup> AAF 01/06 is available from: <http://www.icaew.com/en/technical/audit-and-assurance/assurance/technical-release-aaf-01-06>.

<sup>2</sup> For the background, see the background section of the Stewardship Supplement (Appendix 9 to AAF 01/06).

## Overall summary

All respondents were generally supportive of the issuance of guidance on the basis that:

*Independent assurance is important in adding credibility to the public disclosures made by asset managers on their compliance with the Code (Railpen Investments)*

*Confidence in the institutional investment community and the Stewardship Code will be bolstered if reliable mechanisms are available to provide assurance to interested parties as to the quality of application of the Stewardship Code by institutional investors. (Governance for Owners)*

All respondents were also supportive of the approach taken to use AAF 01/06 as a framework for assurance reporting on the investors' compliance with the Code.

*It is correct to build upon the existing well established AAF 01/06 framework and its predecessor which are now quite widely adopted on a voluntary basis in the investment industry and which we already rely on as part of the process of holding our external investment managers and custodians to account (Railpen Investments)*

However, all respondents had concerns that the proposed scope of the draft Supplement being limited, in particular in terms of the coverage of the Code. Three thought that the narrowed scope is acceptable for the time being while one thought that the guidance could be adapted to enable reporting on design suitability and operating effectiveness.

*We disagree with the proposal to limit assurance reporting to Principles 1, 2, 6 and 7 of the Stewardship Code because we believe that Principles 3, 4 and 5 go to the heart of effective application of the Code. Further, we believe it is possible to objectively verify descriptions by institutional investors of their application of Principles 3, 4 and 5 (Governance for Owners)*

*We concur that the scope of the assurance report should be limited to Principles 1, 2, 6 and 7. . .in their current form. . . However, limiting the scope of the assurance report to only part of the Code may be perceived by those that seek compliance with the Code, and independent assurance on that compliance, as reducing its value (KPMG)*

One respondent raised concerns as to subjective words such as 'robust (Principle 2)' and 'clear (Principle 6)' in the Code and three respondent called for greater clarity to the criteria and one expected subject matter expertise from those who carry out assurance reporting.

Notwithstanding these comments, all respondents supported the review of the Stewardship Supplement as practice evolves.

## Responses to questions

Question/summary of key points	Comments	Outcome
<p>Q1 Is it reasonable that the elements of the Code covered by the reporting accountants' assurance report are limited to Principles 1, 2, 6 and 7? If not, which Principles should be included within the scope of the report and why?</p>	<p>Three of the respondents thought that the proposed scope is reasonable as a tentative arrangement at present.</p> <p>However, all respondents stated concerns about the limited scope of assurance reporting for Stewardship Code including communication need and relative importance of Principles 3, 4, 5 that are currently excluded from the scope.</p> <p><i>'(W)e believe that Principles 3,4 and 5 go to the heart of effective application of the Code. Further we believe it is possible to objectively verify descriptions by institutional investors of their application of Principles 3,4 and 5. For instance, some institutional investors have in place criteria and procedures to help identify companies with which they will enter into active dialogue (Principle 3) and determine when to escalate their engagement action (Principle 4). With respect to Principle 5, given that institutional investors are expected to develop a policy on collective engagement, assurance reporting could focus on the extent to which such policy is followed.'</i> (Governance for Owners)</p> <p><i>'We believe the ability of reporting accountants to objectively verify application of Stewardship Code principles would be strengthened if institutional investors are encouraged to provide specific and detailed information relating to their voting and engagement policies.'</i> (Governance for Owners)</p> <p><i>'Although we agree that . . . it is harder to deal with the more inherent uncertainties in relation to principles 3, 4 and 5. . . however, we would hope that over time fund managers will improve their reporting and description of controls over these areas so that they become more amenable to independent assurance and hence objectively verifiable.'</i> (Railpen Investments)</p> <p><i>'(L)imiting the scope of the assurance report to only part of the Code may be perceived by those that seek compliance with the Code, and independent assurance on that compliance, as reducing its value. Therefore the limitation on</i></p>	<p>Keep the scope as it is for the time being with an explanation of how it compares with AAF 01/06 as a whole in the background section of the Supplement. Monitor practice in this area and assess the need for revision in the light of developing practice.</p>

	<p><i>the scope of independent assurance should be explained to the prospective users of the assurance report. . .in both the management report and the assurance provider’s report’ (KPMG)</i></p> <p><i>‘We have some concerns over the narrower scope of reporting for Stewardship Code purposes compared to other areas of reporting under AAF 01/06. Particularly we believe care will need to be taken in making these difference clear for users, both in the AAF and in the reports(s) themselves’ (Deloitte.)</i></p> <p>One respondent expressed concerns about the subjective elements of Principles 2 and 6.</p> <p><i>‘Principle 2. . . is only partially verifiable due to the subjective nature of what constitutes “robust”. Assurance can be given only on the public disclosure. Alternatively, should the guidance in the Stewardship Code be rephrased to contain specific objectives, then these might form a sufficient basis for assurance over the effectiveness of the design and operation of controls.</i></p> <p><i>‘Principle 6 requires that “Institutional investors should have a clear policy on voting and on disclosure of voting activity”. . . We note that whether the policy is “clear” also has a significant subjective aspect and so is not capable of being the subject matter of an assurance report. . . It should be explained within the guidance that the scope of the assurance report is constrained to the application of the policy (i.e. the disclosure of voting) and not the subjective area as to whether the policy itself is considered “clear”. Alternatively should the guidance in the Stewardship Code be rephrased to contain specific objectives, then these might form a sufficient basis for assurance over the effectiveness of the design and operation of controls.’ (KPMG)</i></p>	
<p>Q2 Is it reasonable to limit the scope of the reporting accountants’ conclusion to fair description thereby excluding any reference to the design suitability or</p>	<p>All respondents generally supported the proposal as a reasonable and pragmatic solution at present, but endorsed extending the scope of assurance reporting on design suitability and operating effectiveness for the benefit of users.</p> <p>Two respondents commented that the criteria would be one of the hurdles.</p>	<p>Keep the scope as it is for the time being with an explanation of how it compares with AAF 01/06 as a whole in the background section of the Supplement.</p>

<p>the effectiveness of the process implementation? If not, what should be the minimum scope of the assurance conclusion?</p>	<p><i>'We would also note that there appears to be a tension between the completeness criterion that will be used to assess fairness of Stewardship Code application descriptions and Stewardship Code guidance that institutional investors that manage several types of funds make only one statement. Our concern is that . . . some institutions may be led to believe that broadly-worded statements of policy would suffice, thereby complicating the task of the reporting accountant.'</i> (Governance for Owners)</p> <p><i>'An opinion on. . . the design and operating effectiveness of those controls to achieve/demonstrate compliance with the Code would provide significantly better value to recipients of the assurance report. Such a change would require greater clarity as to the criteria to be used in relation to any of the Principles being assured.'</i> (KPMG)</p>	<p>Monitor practice in this area and assess the need for revision in the light of developing practice.</p>
<p>Q3 Are the procedures described in relation to reporting accountants' procedures reasonable, and if not, what other procedures should be included?</p>	<p>All respondents considered that the procedures described are reasonable pending on the comments made in Q1 and 2.</p> <p>However, an investor commented that the review of written documents won't be sufficient to provide reporting accountants with an understanding of the effectiveness to voting and engagement activities as it depends on how policies and procedures are applied in practice:</p> <p><i>'(W)e would encourage reporting accountants to devote a substantial portion of their time to performing walk-throughs of the relevant processes and, where feasible, observing voting and engagement activities (or meetings of decision-making bodies relating thereto) in real-time.'</i> (Governance for Owners)</p>	<p>There are practical challenges to observation procedures in the context of stewardship processes, but walkthroughs and observation procedures are already included. Therefore no changes have been made in this area.</p>
<p>Q4 Would you be interested in obtaining an assurance conclusion on the design suitability and effectiveness of the process implementation in the application of the Code?</p>	<p>Please see the analysis under Q2.</p>	<p>Please refer to Q2.</p>

Other comments on the consultation document

<p>Evolving nature of Stewardship assurance</p>	<p><i>‘We. . . welcome the observation that the Supplement is issued on an interim basis with a view to incorporating good practice that is expected to evolve over time. We believe that it is correct to build upon the existing well established AAF 01/06 framework and its predecessor which are now quite widely adopted on a voluntary basis in the investment industry and which we already rely on as part of the process of holding our external investment managers and custodians to account.’</i> (Railpen Investments)</p> <p><i>‘We would support the elements of AAF 01/06 relating to the UK Stewardship Code being kept under review as reporting on the Code develops. In particular, if not driven by quicker change, the elements of AAF 01/06 relating to the UK Stewardship Code should be reviewed within two years of implementation and consideration given to whether the other Principles of the Code could be covered and the form of reporting accountant’s opinion brought in line with other AAF 01/06 reports.’</i> (Deloitte.)</p>	<p>Keep the scope as it is for the time being with an explanation of how it compares with AAF 01/06 as a whole in the background section of the Supplement. Monitor practice in this area and assess the need for revision in the light of developing practice.</p>
<p>Responsibilities of the reporting accountants</p>	<p><i>‘The proposed draft report does not specify in the responsibilities section who the issuer is responsible to when expressing the opinion/conclusion – possible wording could be “Our responsibility is to express our conclusions to [the Company]/[engaging party] on the findings of our work referred to below.” This would also be consistent with the approach taken on other AAF 1/06 reports.’</i> (KPMG)</p>	<p>Add: ‘. . . and report this to the directors.’</p>
<p>Scope of work/basis of work</p>	<p><i>‘There is currently no sub-heading for this; all of this detail is under the sub-heading of “responsibilities”. We suggest that a sub-heading should be added.’</i> (KPMG)</p>	<p>No change suggested as this is in line with the new report in Appendix 8</p>
<p>References to ISAE 3000</p>	<p><i>‘The full title of the standard should be referred to: “We conducted our work in accordance with International Standard on Assurance Engagements 3000: Assurance Engagements other than Audits or Reviews of Historical Information, issued by the International Auditing and Assurance Standards Board.”</i></p> <p><i>‘We suggest that the following phrase (or similar) should be used: “We planned and performed our work to obtain all the information and explanations that we considered necessary</i></p>	<p>No change as two documents (ISAE 3000 and AAF 01/06) are referred to in the Supplement.</p> <p>No change suggested as this is in line with the new report in Appendix</p>

	<p><i>to provide sufficient evidence for us to be able to give reasonable assurance as to ...”, in place of the wording in the draft report, which refers to ISAE 3000 requiring that we “plan and perform our procedures to obtain reasonable assurance...”. The standard does not in fact require this, as it also covers limited assurance engagements. In addition, the draft wording refers only to the reporting accountant obtaining reasonable assurance, as opposed to giving reasonable assurance.</i></p> <p><i>‘ISAE 3000 refers to the expression of a conclusion rather than an opinion and in our view this terminology should be used in the report sub-heading before the conclusion (albeit that the conclusion commences with “In our opinion...”’.</i></p> <p><i>(KPMG)</i></p>	8.
--	---	----

Annex A

List of respondents

Investors

Governance for Owners

Railpen Investments

Accountants

Deloitte.

KPMG

Other

Chris Yates Smith/ESG Technical Standards

Annex B

Responses received are attached as below.

Investors  
Governance for Owners  
Railpen Investments

Accountants  
Deloitte.  
KPMG

Other  
Chris Yates Smith/ESG Technical Standards