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Dear Mr. Rughoobur,

Re: Draft Plan and Budget and Levy Proposals 2017/18

We are writing as a group of long-term institutional investors and the UK Shareholders Association to comment on the FRC's proposed priorities and work programme for 2017/19. Our response identifies three areas on which we believe the FRC should focus in support of its mission to "promote high quality corporate governance and reporting to foster investment": enhancement of accounting standards to ensure consistency with the UK's capital maintenance regime; addressing the disconnect between company reporting rules and companies' present lack of disclosure of climate-related risks; and resolving conflicts of interest which may impede the effective fulfilment of its duties.

1. Accounting standards

Reliable accounts are paramount to underpin robust accountability

We support the FRC's ambition to "encourage companies to produce the trustworthy information necessary for informed investment decisions; and to encourage trustworthy behaviour by directors and professionals". However, as we have previously set out as a group and individually, we believe that the UK's system of accounting and audit has been undermined over recent years by the introduction of International Financial Reporting Standards (IFRS) for listed entities in 2005, and by an overly permissive audit system. Without a robust and demonstrably independent accounting and audit system, financial markets cannot function efficiently and there is no mechanism for ensuring accountability of executives.

The most vital ingredient in a healthy financial market is an accounting and audit system that ensures full transparency and promotes effective stewardship, such that the providers of capital can monitor whether their capital has been protected, and whether management teams have delivered enduring value[1].

The problem: a flawed accounting and audit system in the UK

[1] The centrality of accounts in delivering effective governance could not have been made clearer by Sir Adrian Cadbury in his seminal work in 1992 "The Financial aspects of Corporate Governance". This report led to the creation of the UK's Corporate Governance Code.

The problem is that the UK's system of governance is today being undermined by: 1) systemic flaws in the accounting framework brought in under the IFRS in 2005, and 2) an inadequately independent and robust audit system.

Taken together these problems have weakened our system of corporate governance such that it is no longer a problem of a few rotten apples, but a systemic failure of accountability. In addition to excessive risk-taking by UK banks prior to the financial crisis, there is growing evidence that not all is well with companies' disclosures to shareholders. Over the past two years we have seen a growing number of FTSE-listed companies admit to having paid illegal dividends due to their failure to properly disclose in their accounts that they had sufficient reserves to make distributions[2].

What is going wrong with accounting?

In order to protect capital, Company Law requires that it is not over-stated
For investors to be confident that they are not putting good money after bad, they need to know what portion of a company's profit has been realised, and what portion has not. Understanding the level of realised profit is important to judging the reliability of a business's income stream. It is also a key ingredient in determining a company's true capital strength and ability to pay dividends.

For these reasons, Company Law includes a number of provisions that make up our 'capital maintenance regime'. The core pillars of this are a prohibition on directors making distributions (dividends, share buybacks) out of capital; supplemented by clear rules that the published accounts provide visibility around what capital is, and what is not available for distribution (Part 23, CA2006). Supporting regulations to the Companies Act further outline that the accounts must be prudent to ensure that capital and performance are not overstated. The regulations require that: 1) foreseeable liabilities and losses are properly accounted for (and deducted from distributable reserves); and 2) unrealised gains are excluded (as these are not a reliable form of income)[3].

Where accounts achieve this legal test they can then be described as providing a "true and fair view" in law[4].

IFRS is not consistent with Company Law
The problem is that IFRS is explicitly drawn up outside of national company law frameworks. The International Accounting Standards Board (IASB) is intended to be independent to protect the integrity of the standards. However, it is this 'independence' which has allowed IFRS to become disconnected from UK and EU (and perhaps other jurisdictions') company law frameworks. IFRS is not intended to deliver capital protection, nor to ensure companies meet solvency tests. They have a goal merely to be "useful for users", which is

[2] See for instance Manifest's summary https://blog.manifest.co.uk/next-forced-to-call-shareholder-meeting-following-technical-breach-of-companies-act/

[3] The Large and Medium sized companies and groups (Accounts & Reports) Regulations 2008 (Part 2); and also EC's 4th Directive Article 31(1)(c).

[4] Companies Act, Part 15, Ch. 4. See also case law linking the true and fair view requirement to capital maintenance and prudent accounting. We believe the FRC's two papers on the "true and fair view" standard misrepresent the statutory requirement (see below for a fuller discussion of this point).

not consistent with the UK's legal standard. It is interesting to note that this much woollier goal acts to weaken accountability of the preparers of accounts and the auditors to shareholders and creditors.

In line with their different goal, IFRS does not prioritise prudence as an accounting principle, but favours 'neutrality'. The result is evident in a number of standards. Most notably, under IFRS mark-to-market gains on trading assets on companies' balance sheets are treated as 'profit', and contribute to 'capital', even though they are unrealised. Moreover, mark-to-market gains in 'available for sale' assets contribute directly to capital. In an upward moving market, this results in overstated profit and capital versus what would be permitted under Company Law.

This is exactly what we saw in banks prior to the financial crisis, and these 'numbers' triggered large bonuses for executives and continued (and excessive) lending. Added to this, banks were required by IFRS to ignore expected losses in their loan books. Again, this inflated 'profits' in the short term, prolonging the boom. The damaging role played by accounts was highlighted by the G20, the Financial Stability Board, the Bank of England, European Central Bank, a number of respected MPs and UK MEPs amongst others. Almost a decade after the financial crisis the accounting standards that contributed to the problems in the banks have not been properly addressed.

And the problem of imprudent accounting affects all sectors, not just banks. Whether we are looking at pension liabilities, tax liabilities or foreseeable losses from climate-regulation, it is vital that companies apply a prudent mind-set in drawing up their accounts.

The problem is widely understood, but strangely persists

The disconnect between UK company law protections for investors and creditors and IFRS has been acknowledged by the accounting profession and the FRC. Indeed, the accounting profession offers guidance to members on how to calculate distributable reserves to enable directors to meet their legal obligations[5]. When IFRS was introduced in the European Union, KPMG published a paper for the European Commission on how it was not aligned with company law, and the implications for distributions[6].

Despite wide acknowledgement that IFRS will deviate from Company Law, for some unclear reason companies are not consistently publishing the adjustments to their IFRS accounts to permit shareholders and others to see their realised profit, or their distributable capital. We believe that the FRC's guidance has contributed to this situation.

The FRC's guidance on the "true and fair view" must be reviewed

As early as 2011, the FRC provided guidance to UK companies that, except in "extremely rare circumstances", IFRS accounts will meet the legal "true and fair view" test[7]. The FRC's papers on this were backed by a legal opinion from Michael Moore QC (2008). A

[5] Please see the Institute of Chartered Accountant for England and Wales (ICAEW) has provided "Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Companies Act 2006" (TECH 02/10), which is currently being updated.

[6] KPMG, 2006, "Feasibility study on an alternative to the capital maintenance regime established by the Second Company Law Directive 77/91/EEC of 13 December 1976 and an examination of the impact on profit distribution of the new EU-accounting regime"

[7] FRC, "True and Fair", July 2011.

group of investors contested this conclusion, believing that Michael Moore was not independent due to his close involvement in providing guidance to the accounting profession on related matters. Three investors and the UK Shareholders' Association submitted a separate independent legal opinion from George Bompas QC to the Parliamentary Commission on Banking Standards in 2012. Instead of undertaking a review of the matter, and seeking independent counsel, the FRC referred back to Moore QC and reiterated this interpretation in an updated true and fair view paper in 2014. A subsequent Opinion from George Bompas QC in 2015 describes the FRC and Michael Moore's logic as 'defective'.

No formal review has been taken by the FRC to clarify the matter. This has led to questions from concerned parties including the House of Lords' Economic Affairs Committee. Most recently the FRC responded to questions from Lord Hollick about ongoing uncertainty over the legal position in a letter from the Chief Executive Stephen Haddrill in December 2016 that "*the Companies Act does not require the publication of information on realised profits or distributable reserves in the Annual Report*". And yet the requirement in the Companies Act 2006 could hardly be clearer, as copied below (with our emphasis added):

836 Justification of distribution by reference to relevant accounts

(1) *Whether a distribution may be made by a company without contravening this Part is determined <u>by reference to the following items as stated in the relevant accounts</u>—*
    a. *profits, losses, assets and liabilities;*
    b. *provisions of the following kinds—*
        i. *where the relevant accounts are Companies Act accounts, provisions of a kind specified for the purposes of this subsection by regulations under section 396;*
        ii. *where the relevant accounts are IAS accounts, provisions of any kind;*
    c. *share capital and reserves (including undistributable reserves).*

The FRC maintains that, this requirement does not require "the <u>separate</u> disclosure of a figure for distributable profits".

But if distributable profits and reserves are not disclosed, then this suggests companies have a separate set of accounts for directors to refer to in fulfilling this obligation. However, Company Law – under Section 498(2)(b) – prohibits companies having two sets of books. So the notion that there is no requirement to publish distributable reserves and profits is – in our view – impossible to maintain.

Of course, as already noted, there are very good reasons why the law requires that the distributable numbers to be published. Investors (and creditors) need to have a prudent view of performance and capital to be reassured their capital is safe, and to monitor executives' realised performance.

The fact that investors are not routinely provided with disclosures by companies on their distributable profits and reserves is a grave matter. Worse still, the problem appears to extend to directors not keeping a record of their distributable reserves. Recent announcements by a number of FTSE 350 companies that they had inadvertently paid illegal dividends, in some cases over many years, should be a wake-up call.

The House of Lords, Parliamentary Committee on Banking Standards, prudential regulators and many others have called for action to tackle the concerns we raise here. We have also raised these concerns in our submission to the Government's Green Paper on Corporate Governance.

Thankfully, we believe the solutions are straightforward because they are underpinned by our existing system of Company Law. Additionally, because post-Brexit the UK will not be subject to the International Accounting Standards (IAS) Regulation, under which defective standards have been adopted, there will be no impediment to abandoning parts of the IFRS system and applying a better standard. This will enable UK accounts to fulfil the shareholder and creditor protection requirements of Company Law which are also essential to a stable banking system.

The FRC should respond to the two Opinions of George Bompas QC by undertaking a truly independent, formal review into this matter.

Methodology for asset impairment provisions

For insurers there is a recognised body of knowledge and practice, and a near-universal professional (actuarial in this case) sign-off of the technical provisions. For banks, for whom the analogous uncertainty and estimation challenge relates to future asset impairment, there is no comparative requirement for a professional sign off. Having an individual take responsibility in the way that happens in insurance (witness the recent decisions by the FRC in the RSA Ireland case) would surely protect the public interest and better implement the requirements of Company Law. Given that the systemic risk that banks present to society dwarfs that presented by insurers, this seems to be a significant gap, and we would recommend that this matter be placed firmly on the FRC's agenda for the coming year.

2. Climate risks should be reported under existing rules

In consulting on its priorities for 2017/18, the FRC notes that "there are significant challenges facing society as a whole"; not least among these is the threat that climate change poses to economies around the world. Individual companies are, to varying degrees, exposed to climate-related changes and their resilience will depend on the early recognition of related risks and foreseeable losses. Yet few companies adequately communicate the climate-related risks they face. Addressing the disconnect between existing company reporting rules and the lack of disclosure of climate risks should be high on the FRC's list of priorities.

Under Company Law, publicly-listed entities in the UK are obliged to disclose forward-looking "principal risks and uncertainties" (s414C (2) (b) Companies Act 2006) and provide "a fair review of the company's business" including the "main trends and factors likely to affect the future development, performance and position" of the business as part of the strategic report provided by directors (s414C (7) (a) CA 2006)[8]. In addition, since October 2015 the UK requires that companies provide long-term viability statements that address long-term risks to solvency. Finally, as already highlighted above, the financial accounts that management present to shareholders are expected to provide a reliable and prudent – i.e. not over-stated – view of current performance and capital. Prudence demands that foreseeable losses and liabilities are accounted for as long as they can be measured.

These two company reporting requirements - disclosures of future risks and uncertainties and financial accounts - underpin responsible capital stewardship and confidence in markets. They provide the information investors, creditors and other stakeholders need to determine the current capital strength of a business; to evaluate the performance of the executive team in delivering value over time; and to offer a basis for making an informed judgment about future prospects.

At the very least, for companies where the risks are potentially material, disclosures should include a discussion of future risks and uncertainties facing the business, and how the Board is managing them. For companies where impairments or losses are likely, the Board should ensure financial statements present a prudent view of capital and performance.

3. Resolution of perceived conflicts of interest

Our final comment is on the FRC's stated priority to enhance the speed and effectiveness of its enforcement role. It is our view that the FRC is excessively influenced by the accounting profession, both through its own staff, advisors and its Board, but also through the audit industry's determined lobbying. Despite being repeatedly highlighted as a problem (e.g. by the UK Competition Commission in its 2013-14 investigation), we do not feel these conflicts are being adequately managed.

In our view, the excessive influence of the accounting profession has resulted in a lack of action on the aforementioned matter of proper accounting, as well as a reluctance to sanction audit firms in general. Aside from our and other investors' efforts to have the issue of faulty accounts investigated properly, the FRC has also failed to adequately respond to the House of Lords' Economic Affairs Committee and the Parliamentary Commission on Banking Standards, which have both independently called for further reviews of the accounting system.

In its report into the collapse of HBOS in July 2016, the Treasury Select Committee identified similar frustrations around the lack of robust oversight by the FRC:

> *"The Financial Reporting Council (FRC) decided not to investigate the auditing of HBOS in 2013, well before the completion of the final HBOS report. This was a serious mistake. The process by which it reached its decision suggests a lack of curiosity and diligence. These failures are all the more concerning given the scale of the problems at HBOS, and the clear public interest at stake. It is extraordinarily*

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[8] In the EU, the Transparency Directive (2004/109/EC) and Accounting Directive (2013/34/EU) set out requirements for public entities to publish a management report each year. This report should include a "description of principal risks and uncertainties" and financial and non-financial information necessary to provide a "fair review of the development and performance" of the company.

unhelpful that the FRC has taken so long and has belatedly reconsidered its position, only after considerable pressure from Parliament and the Treasury Committee. Following its preliminary inquiries, the FRC has now finally commenced an investigation into the auditing of HBOS.

"The auditing of HBOS is the one major element of the HBOS affair that has yet to be subject to adequate scrutiny. The Committee will expect the FRC to undertake an extremely thorough analysis of the HBOS case. Regardless of the outcome of the FRC's investigation process, it is likely that the Committee will want to consider its work and regulatory approach in more detail. The investigation announced on 27 June 2016 is better late than never. But the very tardy response by the FRC appears to be as inexplicable as it is unacceptable."

Even if there is no conflict within the FRC, there is the impression that it takes the side of the audit profession rather than actively addressing governance issues. It is clearly problematic if there are perceived conflicts and governance questions about the body responsible for governance.

To ensure robust independence and proper checks and balances, we believe that the FRC's duties should be split between, on the one hand the promotion of high quality standard setting for corporate reporting and auditing, and on the other, the oversight of the accounting, auditing and actuarial professions, including their implementation of the accounting standards and consistency with Company Law. In both cases, governance structures need to ensure diverse perspectives and independence from the accounting profession.

We hope our comments above are helpful. We would be happy to clarify any of the points above, if this would be useful.

Yours sincerely

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