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Accountants &
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Our ref: NK/tc

31 March 2011

Dear Mr Haddrill

Effective Company Stewardship: Enhancing Corporate Reporting and Audit

PKF (UK) LLP is a national firm of accountants and business advisers who specialise in advising growing and entrepreneurial businesses, AIM and fully listed companies, and public and not-for-profit organisations. We have more than 1,500 partners and staff operating from 23 offices around the United Kingdom. The firm is one of the nine major audit firms in the United Kingdom subject to regular review by the Audit Inspection Unit, part of the Professional Oversight Board.

We welcome the opportunity to respond to the proposals set out in this consultation paper.

Whilst we support the FRC in its efforts to ensure the UK remains at the forefront of Company Reporting and Audit we would note that the European Commission Green Paper on audit policy is likely to result in significant changes to corporate reporting in the coming years. We are of the opinion that potential developments in the European arena need to be taken into consideration when progressing these proposals as any UK changes will need to reflect developments in European legislation. Nevertheless we welcome your consultation paper for providing a basis for discussing possible developments in this area.

Current economic conditions require that all legislation and reporting requirements should aid not hinder growth in the UK economy both in absolute terms and relative to the rest of Europe. We are concerned that any additional regulatory burden, however small, should not disadvantage UK companies. To that extent, we do not consider any new UK corporate reporting requirements should go further than that mandated for other European countries as part of Commission's current project. Therefore, whilst we see this consultation as useful for developing ideas for the European wide debate we do not think it should lead to additional requirements beyond those resulting from any new European legislation that emerges over the coming months and years. This would appear to be consistent with the UK Government's current thinking in relation to smaller entities.

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We also consider that any additional requirements must be proportionate and respond to the needs of users of the corporate reports. The paper includes little evidence that users of corporate reports are demanding change – we would urge the FRC to ensure the views of the users of accounts are vigorously sought. Any analysis of users' needs should also consider the size and complexity of the reporting companies. In addition the cost/benefit discussion included at the end of the consultation paper appears to be qualitative in nature only and we would expect further work to be done in this area before any proposals are finalised.

1. Directors should take full responsibility for ensuring that an Annual Report, viewed as a whole, provides a fair and balanced report on their stewardship of the business.

Page 10 of the paper states that the Annual Report should explain "the company's business, strategy and prospects and the risks and uncertainties involved in the course being pursued."

In our view, such an explanation is already required by the Companies Act 2006 ("the Act") to be included in the enhanced business review in the Directors' Report. If this is not being provided this is a failure of enforcement not a failure in the legislative requirements.

The ASB analysis of compliance with the Act referenced on page 8 is difficult to understand. On the one hand it shows low levels of non-compliance but on the other hand it shows high incidence of reporting "falling short". We are concerned that the current corporate reporting is being judged against unclear or subjective criteria – are companies in a position to judge in what respect the reports are "falling short"? We are concerned that the FRC is "gold-plating" the current legislative requirements in order to meet its own definition of good corporate reporting.

If there is a failure in enforcement, it is not clear how the proposals would address this. Simply expanding the notion of fair and balanced report to other narrative sections might only expound such a failure. We are concerned that the expanded audit report is implicitly intended to address such failures as discussed further in our response to recommendation 3 below.

Page 10 also asserts that the Annual Report should not be "promotional in nature" without further justification or explanation. The Annual Report, in practice, is the main form of communication with all shareholders and it would be naïve to expect, for example, a Chairman's statement not to include some element of company promotion and aspiration. Furthermore, we believe that users of the accounts understand this and interpret such statements accordingly.

If the enhanced business review is comprehensive and balanced then it is unlikely that the Chairman's statement, or similar, would be so one-sided or optimistic as to provide a misleading and inconsistent view when compared to the contents of the Directors' Report and auditors would bring such obvious inconsistencies to the directors' attention. The paper does not provide any evidence to support an assertion that the narrative reporting outside the Directors' Report generally contradicts the view presented therein.

Therefore, we do not consider extension of the regulatory requirements in this way will add to the clarity of the narrative reports when seen as a whole and may have unforeseen consequences. Possible reactions to such changes could be the provision of less useful information, more "boiler-plating" and greater repetition if the contents of the enhanced business review are simply repeated elsewhere. We would note that the FRRP was encouraging companies, in its 2010 Annual Report, to "cut the clutter" and avoid repetition in the Annual Report where possible.

2. Directors should describe in more detail the steps that they take to ensure:

- **the reliability of the information on which the management of a company, and therefore directors' stewardship of the company, is based; and**
- **transparency about the activities of the business and any associated risks.**

In our view there is the potential for such a requirement to only encourage the provision of bland boiler-plate descriptions of internal processes that will be repeated from year to year extending the length of and clutter in the Annual Report for little discernable benefit. We find little difference between this proposal and the current requirement to describe the systems of internal control on which management rely – the proposal should be expanded upon so that the enhancements the FRC are proposing are clearer.

We would also note that the stated need for such systems is predicated on there being significant distance between the Board of Directors and operational matters and decision making. Such a distance does not exist in many smaller listed and publicly traded companies.

3. The growing strength of Audit Committees in holding management and auditors to account should be reinforced by greater transparency through:

- **fuller reports by Audit Committees explaining, in particular, how they discharged their responsibilities for the integrity of the Annual Report and other aspects of their remit (such as their oversight of the external audit process and appointment of external auditors); and**
- **an expanded audit report that:**
    - **includes a separate new section on the completeness and reasonableness of the Audit Committee report; and**
    - **identifies any matters in the Annual Report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit.**

As with the disclosures proposed in respect of recommendation 2 above, we are concerned that the description of Audit Committee processes will not add value to users of the accounts. There is the potential for the process to stay the same from year to year and boiler plate disclosures will ensue.

We consider users would see value in disclosures explaining the specific issues considered by the Audit Committee in discharging their oversight responsibilities in the current year. For example, the significant risks of material misstatement identified by them and their auditors, the specific areas of judgement and estimates they reviewed and assessed and matters of financial reporting and disclosure that required additional consideration be it due to their complexity or subjectivity.

Any requirement to expand the scope of the audit and the areas over which assurance is given will not be without additional costs to the company. The FRC should ensure that any additional costs are outweighed by the benefits to users of the additional assurance provided.

The Audit Committee is itself part of the corporate governance framework intended to provide independent assurance to investors that the financial reporting and auditing process is robust. To require auditors to provide an explicit opinion that the Audit Committee report is complete and reasonable is to imply that assurance is needed over the operation of an assurance process. The implication is that the Audit Committee, whose primary responsibilities include the facilitation of the external audit process, should be subject to that very process. The FRC should take great care in developing requirements that might subtly, but importantly, alter the nature of a key relationship and a cornerstone of an effective and efficient audit.

As discussed in our response to recommendation 1, if the FRC perceive a failure to implement the requirements of the Companies Act in respect of the enhanced business review then the paper should explicitly set out the FRC's intended approach to enforcing it. We are concerned that the second expansion to the audit report may be interpreted as providing assurance that the narrative reports are fair and balanced. For example, the reference on page 18 to safe harbours for auditors giving assurance on forward looking statements would imply a much broader scope for the opinion than implied in the recommendation itself. If this is not the intention, then the limitation of any opinion must be explicitly stated to ensure no expectation gap is created.

Auditors are already required under International Standards of Auditing (UK and Ireland) 705 and 706 to consider if the narrative reports include any inconsistencies with the financial statements and any impacts this might have on the audit report. They must also consider their responses to material misstatements they become aware of when reviewing for inconsistencies. However, in order to provide an explicit opinion of the kind envisaged in the recommendation additional audit work and hence costs will be incurred. This proposal should be subject to an impact analysis that reflects the benefits users would perceive from any additional assurance.
There are a number of other issues discussed in respect of auditors which do not form part of the recommendations. We have the following observations to make in this regard.

On page 13 it is asserted that, where appropriate, auditors should provide disclosures on the systems in place and the processes followed to ensure the reliability of financial statements but there is no indication of what these disclosures are or when the auditor should provide them. Auditors are required to apply detailed auditing standards and are subject to strict regulatory monitoring to ensure they comply with them. We do not believe there is added value in the auditor further explaining the audit process, especially if the Audit Committee report is expanded in line with recommendation 1.

We are concerned by some of the potential implications of the discussion on audit quality in light of the financial crisis on pages 13 *et seq*. On the one hand the FRC have established no circumstances where financial statements were materially misstated, but on the other asserts that audit work would have been more effective if auditors had shown more scepticism. Others have already challenged the FRC and the AIU to provide evidence that auditors are not applying sufficient professional scepticism but, as far as we are aware this has not been forthcoming. By repeating the view that audits are not of appropriate quality in this regard, despite the accounts not being materially misstated, the FRC undermines public confidence in those financial statements.

Companies should take advantage of technological developments to increase the accessibility of the Annual Report and its components

We agree that technological developments could be exploited to increase the accessibility of the Annual Report and it components. However, careful consideration needs to be given to the requirements of all users as some shareholders may still wish to receive printed copies of financial statements.

Similarly the benefits to be achieved through the use of XBRL may be limited to a relatively small group of interested parties e.g. investment analysts, as opposed to individual shareholders.

There should be greater investor involvement in the process by which auditors are appointed.

We agree with the principle of greater investor involvement in the appointment of auditors by investors in large listed companies where systematic risks are identified. However, we have some concerns regarding the suggestion that specific discussions should take place with a number of "principal investors" as this potentially provides different investor groups with access to different information. In the first instance we consider that Audit Committees should be charged with providing greater transparency over the audit relationship, such as the process for re-tendering, length of tenure, time elapsed since performance of last tender etc.

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The FRC's responsibilities should be developed to enable it to support and oversee the effective implementation of its proposals.

Any expansion of the FRC's responsibilities should be focussed on areas of public interest where the costs of monitoring and the costs of compliance do not outweigh the benefit to investors, users and the public at large and reflects the expressed needs of the users of accounts.

The FRC should establish a market participants group to advise it on market developments and international initiatives in the area of corporate reporting and the role of assurance and on promoting best practice.

There is insufficient detail on the nature, function and constitution of such a body set out in the paper to allow us to properly assess its efficacy. However, we would stress that any group be sufficiently broad in the profile of its members to ensure the views of all stakeholders are reflected. In particular, we would assert that it should include those involved with, investing in and advising all sizes of company that may be impacted by projects under its remit.

We would be happy to discuss our comments further should you have any questions.

Yours sincerely

Nicole Kissun

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