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Dear Stephen

Effective Company Stewardship: Enhancing Corporate Reporting and Audit

I am writing in response to the discussion paper published by the FRC in January 2011.

The 100 Group of Finance Directors has today written in response to the discussion paper, and I would like to add my support to the views expressed in that response. In addition to supporting the 100 Group response, I wish to add particular emphasis to some of the points raised.

Objective

As the discussion paper notes, "the financial crisis and global recession posed unprecedented stress on companies", but that "companies in the non-financial sectors came through the global recession better than expected given its speed and depth". The FRC has "established no circumstances where financial statements were materially misstated: rather corporate and financial reporting was overtaken by exceptional market conditions" and that "during the financial crisis the analyses that were considered reasonable at the time the report and accounts were finalised became rapidly obsolete as markets deteriorated, and the requirements of the listing regime that are intended to ensure the markets are kept properly informed of such developments proved inadequate to address the exceptional circumstances that arose. Audit, by itself, could not have prevented the collapse of the credit markets. That could only have been achieved if action had been taken by those responsible for macro-economic affairs and prudential regulation."

The financial services sector clearly has its own particular issues that need to be/are being addressed to reduce the risk of a rerun of the financial crisis. In respect of the non-financial sectors, the evidence strongly suggests that UK corporate governance (including corporate reporting and audit), having been severely tested by the financial crisis, has been found to be robust. The FRC clearly has this in mind in presenting its proposals. There is however always the danger that this gets lost in the process of fleshing out amendments to regulations.

The introduction to the paper says that the FRC wants "to see the examples set by the best in corporate reporting adopted across the market". This sounds like a worthy goal. It will be a good test of the FRC's proposals as they are developed from this discussion paper to see whether the recommendations that follow will result in more onerous requirements on those exemplars.

Recommendation 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.

This is a requirement of Section 417 of the Companies Act 2006. Chapter 3 states that "too many Annual Reports do not cover all of the necessary topics sufficiently well to constitute an adequate report on the board's stewardship of the company". This would appear to be a matter of enforcement not regulation.

Whilst the Recommendation in Chapter 2 refers to the Annual Report "*viewed as a whole*", in Chapter 3, the paper states "Directors should be responsible for ensuring that *each element* of an Annual Report, as well as the Annual Report in aggregate, should meet the test of being balanced and fair". Requiring *each element* to be balanced and fair seems unrealistic, and counter-productive if every element becomes couched with qualification.

Best practice guidance as to what might be included in an Annual Report has to be useful. It is not clear however that a Narrative Reporting Standard issued by the ASB is the right mechanism for providing that guidance, particularly if followed by more onerous audit requirements than suggested by the comments in Chapter 4.

Recommendation 2: Directors should describe 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.

Descriptions of the steps taken will most likely become boiler-plate. Also, it is unlikely directors can ever "ensure" that information is reliable. What they can do is review the effectiveness of the internal control systems. This they currently do and report on under the Code.

Recommendation 3: Fuller reports by Audit Committees explaining how they have discharged responsibilities for the integrity of the Annual Report and other aspects of their remit (such as their oversight of the external process and the appointment of the external auditors)

Companies are required under the Code to publish a report from the Audit Committee. It is unclear what is proposed by the use of the word "fuller" in relation to these reports. This is an important point, particularly if the auditors are to comment on the completeness of the report. (There is already a requirement for the Annual Report to include disclosure on critical judgements and key sources of estimation uncertainty in the preparation of the financial statements.)

It is important that discussions between Audit Committees and auditors are carried out in an environment where things can be freely said and debated. Imposing a reporting requirement around such discussions is likely to have the effect of restricting them. The FRC should not promote an environment whereby discussions are conducted in a stressed and potentially adversarial environment.

I would also suggest that it is more important that investors are reassured that such discussions have taken place in an open and frank environment than to know the details of the discussions themselves. Audit Committees, management and auditors have the detailed knowledge of the issues concerned and the time and responsibility to address them and reach appropriate decisions. To invite second guessing on issues could create undue uncertainty and volatility which cannot be in the best interests of the orderly stewardship of companies and of investors.

I refer to my earlier suggested test of whether or not any new requirement would oblige those companies with the best reporting practices to disclose more detail than currently.

Recommendation 3: 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.

Auditors are already required under ISA700 to read all of the information published with financial statements and to report if there are apparent mis-statements or material inconsistencies with the financial statements. The audit opinion already addresses whether the information in the directors' report is consistent with the accounts as a matter of company law. A revision to the Auditing Standards therefore seems unnecessary.

The paper suggests a requirement that the report by auditors to the Audit Committee include, at a minimum, the auditors' views on "the effectiveness of the company's controls". Any proposals in this respect should make it clear that the intention is that the views to be given are those that arise from the conduct of the normal audit work and that no extension to scope is envisaged in meeting this requirement.

Chapter 4 states that "under current company law and standards, the auditor amongst other things addresses: (i) whether the financial statements present a true and fair view of the financial health of a company." Please note that auditors are not required to opine on the financial health of a company but on the financial statements.

I would be happy to discuss any aspects of this response further.

Yours sincerely

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