14 January 2011

Mr Stephen Haddrill
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Dear Mr Haddrill,

I would like to respond to your invitation to provide feedback on the consultation paper on 'Effective Company Stewardship'.

My contribution is purely in a personal capacity. However, as background, I have extensive experience at board level and on Audit Committees over the last 15 years. Currently I am Chairman of the Audit Committee for two UK listed companies, Aegis Group plc and Quintain Estates and Development PLC, and Group Chairman of a privately held company. Previously I was CFO for 10 years of a FTSE-100 company and have served as Audit Committee Chairman on two other listed companies, Mitchells & Butlers plc (after its significant derivative loss) and Northern Rock plc (after its liquidity issues). On the other side, I am also a frequent professional user of company financial information as an industrial adviser to private equity.

Firstly I would like to welcome the paper, your raising the issues involved and the consultation that you have initiated. These are important issues that deserve careful consideration. I have broken down my responses into a few areas;

OVERALL OBJECTIVE OF THE PAPER

The consultation states that the objective is ‘to reduce the likelihood that the message [of the role of risk in the recent financial crisis] will be forgotten… by increasing transparency in the way that directors report on their activities, including their management of risk’. However there is no analysis that shows that *lack of transparency* was indeed a significant factor in allowing the crisis to develop. The key factor actually appears to have been the inability of executives and directors in both financial institutions and regulators to understand the complex derivatives and their interrelatedness. The evidence suggests that the problem was not lack of transparency in reporting externally, but a failure by management to understand the full implications of what they were doing.

To put it the other way, are we confident that had this consultation paper been in force over the last few years, it would have materially contributed to directors, investors or regulators understanding the looming crisis earlier? Sadly, I would suggest that the answer is no. I would propose that more effort should be put into understanding why so many people failed to understand the risks and how we can ensure that directors and regulators are able to exercise an informed oversight in future.

My recommendation is for more research, and then more training on the results, for both directors and regulators. This would tackle the basic problem at its root. It would also provide a better understanding as to what should be communicated by boards to stakeholders to increase transparency. This may not be popular as it lacks the simple solution of a little more regulation and quick wins, but then if the answer were so simple, perhaps we wouldn't have got ourselves into such a major crisis after all.

The paper does suggest that in future a review might be carried out into a corporate failure to learn lessons, but surely many such reviews have already taken place and to what effect? The paper goes on to say that such reviews would 'ascertain whether further investigations or regulatory actions are necessary'. Here is precisely the problem. If you have a review to apportion blame and arm regulators, the report becomes mired in legal requirements and all parties protecting their positions. If you want a report that really identifies what lessons can be learnt, it has to be prepared confidentially and without being able to be used in any disciplinary action.

THE ANNUAL REPORT

The consultation paper says that '…Annual Reports…are the mechanism by which management report on the stewardship of the company and its assets to investors and other users. Annual Reports provide the underpinning to other communications by companies…'. For most investors, the interim and final results announcements are the prime communicators of performance. The latter will include part of the subsequently produced Annual Report, but this emphasises that focus on the Annual Report as the central or prime communication is misplaced.

The consultation rightly condemns Annual Reports for having too much boiler plate language, but then asks for more disclosure that will lead to more, not less, such language. It is inevitable that where there is regulation on disclosure then companies will comply in a conservative, least risk manner.

The consultation argues that 'Companies should provide information in a userfriendly and accessible manner'. This is said with scarcely a blush in that it is precisely the regulators' insistence on complex, sometimes Byzantine accounting and disclosure that has the opposite effect! Suggesting that this could be achieved simply by permitting companies to decide how and where they provide particular information in an Annual Report, and to stop producing printed reports is a surprising conclusion. For investors, knowing that they can find a particular piece of information in a certain section is actually helpful. Of course for an online report, where and in which order a piece of information is kept is much less important, as they are not necessarily linear and are readily searchable.

In what way does allowing companies to stop printing annual reports makes information more 'user-friendly and accessible'? For many investors, myself included, it is much easier to look through a printed book than scan through a hundred pages of computer screens; not to mention the ease of annotating a printed document. Aside from the savings from a print run – offset no doubt by investors having to print the documents themselves – what benefit would actually be achieved by this proposal? Many online annual reports are in fact digitised versions of the printed version anyway. The effort that goes into authoring text, checking numbers, proofreading, and photography are equally needed for online as well as for printed reports.

The proposal would have the effect of depriving many investors of their preferred form of communication at an insignificant overall economic saving. Reducing the amount of complex information and boiler plate statements would have a significant saving in overhead as well as actually increasing the accessibility of Annual Reports. Perhaps at least some disclosure could be required only in online form, and thus removed from the standard (printed) annual report?

One key lesson of the ‘digital economy’ is not that people want everything online, but that they demand information in a variety of ways to suit their lifestyle. This is why, for example Argos, which has online, ipad, iphone and telephone ordering, hasn’t withdrawn its costly printed catalogue.

INCREASING TRANSPARENCY

Surprisingly, the consultation paper makes only a passing reference to analyst presentations as a source of information. However, when an investor wants to understand a listed company’s performance they are likely to want to tap into that company’s interaction with analysts. There have been major advances in this area in recent years. Many analyst presentations are now webcast both live and recorded for later download. Some companies allow anyone to dial in to listen to trading updates or analyst briefings on major events. Best practice now is for these also to be available on the web. One of the most valuable elements of this form of communication is that directors have to face unscripted questions from informed sceptics. It is becoming an increasingly important source of information to hear – and better to see as well – directors’ responses to these searching questions.

It’s worth recalling that a key stage in the revelation of Enron’s problems came during an analysts’ call in which an analyst, Richard Grubman, put it to the CEO, Jeffrey Skilling; *“You're the only financial institution that can't produce a balance sheet or cash flow statement with their earnings”.* Skilling’s exasperated response showed how right the analyst was, and the fact that this was recorded ensured its public notoriety.

It is precisely because these interactions are not dictated in detail by a regulator and not scripted that makes them so valuable. Improving transparency and understanding would however be greatly enhanced by ensuring that these calls and presentations are always made available to all investors online both contemporaneously and later on demand.

REPORTS FROM AUDITORS

The consultation paper recommends that auditors provide a report to audit committees covering; the effectiveness of the company’s controls; materiality; accounting policies; valuations; and any other material matters. These comments are exactly what most audit committees would already expect to see from their auditors, so this can only be seen as formalising best practice. However there is a danger that when they become mandated, the auditors, led by legal advice, will feel they have to do more work to achieve that same assurance, inevitably inflating audit fees and possibly reducing their value.

REPORTS FROM AUDIT COMMITTEES

The consultation paper proposes a longer report from the Audit Committee on areas such as; risk; accounting policies; oversight of the effectiveness of the audit; and why they recommend the appointment of a particular auditor. Unfortunately this has the feel of more boiler plate language. What does the paper expect Audit Committees to write here? I suggest that the only effect of this is that Audit Committees will switch time from actually doing the work to negotiating how they describe their activities in the Annual Report.

If Auditors then report on the Audit Committee report, we shall have gone full circle. Again, what do the authors really expect auditors to write here?

SUMMARY

I would recommend that;

1. A thorough review is held into recent financial failures that looks at issues such as executive and director understanding of complex financial instruments and overall business risk. It should be held confidentially and without any public allocation of blame, to get at the truth and develop recommendations that would cover not only governance matters, but more importantly the appreciation and evaluation of business risk.

2. Companies should still be required to circulate printed annual reports at least to those shareholders who request them.

3. Some disclosure, particularly boiler plate statements, should be required only in the online Annual Report, leaving the printed version shorter and clearer.

4. Listed Companies should be required to webcast all analyst conference calls and presentations. These should available live, in recorded on-demand form and in a transcript.

5. Further additional regulatory proposals addressing perceived failures causing the recent financial crisis should be tested against whether they would have assisted in avoiding that situation.

Yours sincerely

Simon Laffin