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Mr Stephen Haddrill
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Dear Stephen

Effective Company Stewardship – Enhancing Corporate Reporting and Audit

I am writing to comment on the above discussion paper on behalf of Railpen Investments, the investment monitoring arm of the Railways Pension Trustee Company Limited, the corporate trustee of the UK railway pension funds with approximately £18 billion of assets under management and 350,000 beneficiaries. In addition to the brief general observations in this letter, we would like to add our detailed comments, as set out in the attached appendix, on your specific recommendations.

As a major institutional investor and asset owner, we have a long standing interest in effective stewardship and corporate reporting. We therefore welcome this consultation which is very timely in view of other recent consultations on related aspects of audit and corporate reporting conducted by various official bodies including the European Commission and the UK Government to which we have submitted considered responses.

We believe that external audit is a major pillar of good governance. In our view, audit should provide assurance to shareholders on the stewardship of the businesses that they own and thus play an important role in ensuring confidence in the companies themselves and the wider capital markets. The overriding requirement for auditors must be to report on whether the financial statements show an unencumbered true and fair view and this should remain the bedrock of assurance.

We also agree that 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. The primary reporting responsibility on these matters rest with management whether in the financial reporting itself or in the narrative reporting. The audit committee also has a major role in such disclosure. However, we consider that the auditor needs to look at the audit committee's report in reaching an opinion on the true and fair view.

We consider that audit committees have a pivotal role in this process and would like to stress the pressing need to improve audit committee reports which are often weak in substantive disclosure and tend to deal with the scope of the committee rather than underlying substantive issues. We believe that minimum standards of audit committee reporting need to be established. In this context we support the enhanced disclosure guidelines for boards and others which were developed in 2009 by the Global Auditor Investor Dialogue (see www.enhanceddisclosure.org for the full text) which we have publicly endorsed as a founding member of the Dialogue.

I would add that I served on the Future of Assurance Working Group established by the Institute of Chartered Accountants of Scotland which recently published its report on "The Future of Assurance" in December 2010 which calls for the duties of company auditors, directors and non-executives to evolve in order to provide greater transparency and accountability to shareholders and others with a number of specific recommendations. It is welcome to see that some of the ICAS recommendations have been taken up by the FRC in its own discussion paper, particularly in relation to encouraging boards to prepare an annual report that tells a coherent story of the business and to urge audit committees to report more meaningfully.

It is generally accepted that the annual report should be a tangible expression of the discharge of corporate stewardship by management and it follows that it should communicate high quality and relevant narrative and financial information to the market. Although this precept is rarely, if ever, challenged openly in principle by preparers, actual practice often falls well short and too much disclosure is boilerplate and uninformative to investors and other users.

We share the Accounting Standards Board's concern about immaterial clutter which was well expressed in its review of narrative reporting and in "Rising to the Challenge" in October 2009. This has been rein forced in the ASB's very recent consultation paper on "Cutting Clutte r" published on 6 April 2011 which stresses behavioural aspects and makes several helpful practical suggestions to which we intend to respond in a separate submission.

We very much agree with the ASB's findings in recent years that reporting on risk and business strategy by too many companies generally falls well short of best practice. This suggests that reports have not concentrated on important issues notwithstanding their increasing length. We also agree that those involved in regulating, reviewing, preparing and using annual reports may need to change their behaviours in order to remove clutter and improve corporate reporting.

It may be possible to stimulate this by encouraging companies to explain how they measure and record the materiality of issues of potential importance to the business. In addition, it is not always evident from the output how the internal scrutiny provided by audit committees behind the scenes and the assurance provided by the external audit process have enhanced corporate stewardship. We agree that it would be helpful in this regard to encourage greater transparency in relation to the way in which audit committees discharge their responsibilities on the integrity of the annual report.

We also concur with the FRC's view that the linkage between the front and back ends of the annual report and accounts needs to be improved. In this regard we favour the concept of more joined up reporting and support the Prince of Wales' Accounting for Sustainability Trust's initiative to set up the International Integrated Reporting Committee (IIRC) and I currently serve on the IIRC Working Group which is drafting a consultative framework document for publication later this year.

We also wish to make the point that improved technology may well assist better reporting but with some caveats. We note that XBRL is being rolled out by regulators in some jurisdictions and whilst it is not necessarily the full answer, there may be lessons to learn. Web-based technology is still developing and will enable companies to report more coherently whilst providing links to standing data. However, it must be remembered that this is essentially an information retrieval process to aid judgement and not a substitute for judgement itself. Investors still need properly presented accounts and narrative reports that provide context for the figures.

We agree that greater investor involvement in the appointment of the external auditor would be appropriate in some cases. At present, investors merely ratify the appointment of the auditor at the Annual General Meeting and are not involved in the selection process. Whilst the directors' control over this matter may have the potential to cause a conflict, the existence of the shareholder vote, and in many cases an independent audit committee whose role is to oversee the selection process, should provide, at least in principle, some key checks and balances.

However, we feel there should be more transparency as to the process followed and the frequency with which the audit is tendered. This needs to be better addressed in audit committee reports.

In a minority of cases it may be important to obtain the views and input of shareholders directly or indirectly particularly on an unexpected development. If vacancies arise for whatever reason, audit committee chairmen should expect that major shareholders will wish to be informed of the reasons and consulted as appropriate.

In this context we would draw attention to the recent case of the change of auditors at Tui Travel plc in which the company circulated a letter from the outgoing auditor but did not make any public attempt to justify the appointment of the successor firm in its formal communications with shareholders. We would suggest that the APB and other relevant bodies look at this case carefully to see what if any lessons can be learned from this example.

The FRC should also look at other approaches to make the auditor more obviously accountable to shareholders. In our detailed comments in the attached Appendix we have referred to examples of recent legislative changes in Australia that are intended to make auditors more directly answerable to shareholders that may be worth examining in the UK context.

In summary, we consider that the FRC discussion paper takes forward the debate on how to encourage effective company stewardship further with a number of helpful observations and recommendations. The FRC is well placed to encourage the market to enhance the stewardship role of boards and audit committees through corporate reporting and audit. We hope that market led best practice will be largely sufficient but recognise that the authorities need to keep a watching brief. In this regard, we welcome the expanded role of the FRC's Financial Reporting Review Panel to include narrative reporting and we hope that this is developed further. We also welcome the recommendation to set up a Market Participants Group which in our view needs to include investor and asset owner representatives.

I hope that these comments are helpful. Please contact me if they need clarification or you feel that we can otherwise be of assistance. In the meanwhile, we look forward to participating in the subsequent phases of this consultation exercise.

Yours sincerely

Frank Curtiss
Head of Corporate Governance

enc: Detailed response to Discussion Paper Recommendations

RPMI Railpen Comments on FRC Discussion Paper Recommendations on "Effective Company Stewardship – Enhancing Corporate Reporting and Audit"

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.**

Yes, we agree that 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. The primary reporting responsibility on these matters ultimately rests with management whether in the financial reporting itself or in the narrative reporting.

It follows that this should be in the company's own voice rather than in uninformative boilerplate. We are encouraged that some companies, although still very much in the minority, do manage to achieve this and this has been recognised by the Hermes ICSA Transparency in Governance Awards and similar voluntary initiatives which have helped to drive up standards over the last few years.

We believe that in addition to the board, the audit committee also has a major role in ensuring the integrity of such disclosure and the external auditor in turn has an assurance role to perform on this. We consider that the auditor needs to look at the audit committee's report in reaching an opinion on the true and fair view. The overriding requirement for auditors must be to report on whether the financial statements show an unencumbered true and fair view and this should remain the bedrock of assurance. However, it is helpful for the auditor to look at whether the annual report is fair and balanced as part of the process. Please see our further remarks in answer to recommendation 3 below on the fuller ramifications for the audit report.

We also concur with the FRC's view that the linkage between the front and back ends of the annual report and accounts needs to be improved. We consider that statute can provide a framework and that standard setters and regulators can provide helpful guidance but we urge the authorities not to follow an overly prescriptive approach which runs the risk of encouraging more rather than less boilerplate reporting.

In this regard we favour the concept of more joined up reporting and support the Prince of Wales' Accounting for Sustainability Trust's initiative in setting up the International Integrated Reporting Committee (IIRC). We look forward to the IIRC's comprehensive discussion paper on integrated reporting which will be published for public consultation in June 2011.

In our view, the International Financial Reporting Standards (IFRS) Practice Statement on Management Commentary published by the IASB in 2010 is a significant step in the attempt to promote best practice with adequate rigour in terms of disclosure on risk and business strategy supported by appropriate metrics and key performance indicators. We hope that Management Commentary will gain prompt acceptance globally as we see great merit in its use as an anchor document for any integrated reporting framework and we acknowledge the very definite intention to link the financial statements with the key non-financial information.

We would also commend the Institute of Chartered Accountants of Scotland's report on "The Future of Assurance" published in December 2010 which makes a number of helpful recommendations specifically in the context of UK corporate stewardship. These include calls for the duties of company auditors, directors and non-executives to evolve in order to provide greater transparency and accountability to shareholders and others with a number of specific recommendations. It is welcome to see that some of the ICAS recommendations have been

taken up by the FRC in its own discussion paper, particularly in relation to encouraging boards to prepare an annual report that tells a coherent story of the business and to urge audit committees to report more meaningfully.

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**.

Yes, we agree that more detail is needed on how the board ensures the reliability on which the management of a company, and therefore directors' stewardship of the company, is based and this should be explained in the annual report and as appropriate in the audit committee report. Better communication is essential.

We also concur that current reporting on business strategy and risk by companies is often seriously inadequate which makes it much harder for investors to assess the adequacy of stewardship. This has been well substantiated by the ASB and the FRRP in their own work in this area in recent years and we support these attempts to reduce clutter and encourage proper focus.

These findings suggest that corporate reports have not concentrated on important issues notwithstanding their increasing length and vindicates the FRC's recent introduction of the new business model disclosure requirement in the UK Corporate Governance Code in 2010 in view of the inadequate explanations on strategy and business models.

We also see merit in the ICAS suggestion in their response to the Discussion to amend the FRC Stewardship Code to encourage investors to engage with their portfolio companies on the quality of reporting and the assurance provided on that reporting, given the assumption that shareholders are, and should be, willing to engage with companies in relation to the audit process.

We also agree that those involved in regulating, reviewing, preparing and using annual reports may need to change their behaviours in order to remove clutter and improve corporate reporting. We welcome this emphasis in the ASB's latest consultation paper on "Cutting Clutter" published on 6 April 2011 which stresses behavioural aspects and makes several helpful practical suggestions.

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.**

Fuller Audit Committee Reports

We agree that there is a pressing need to improve audit committee reports which are often weak in substantive disclosure and tend to deal with the scope of the committee rather than underlying substantive issues. Greater transparency will be very helpful as the judgements made and processes followed during the preparation of the accounts and their audit are largely opaque to investors.

We believe that minimum standards of audit committee reporting need to be established. In this context we support the enhanced disclosure guidelines for boards and others developed in 2009 by the Global Auditor Investor Dialogue (please see www.enhanceddisclosure.org for the full text) which we have publicly endorsed as a founding member of the Dialogue. These include:

- what steps the audit committee took to satisfy itself that the risk and control processes are effective;
- the significant assumptions for determining fair values, particularly mark to model;
- the factors considered when endorsing material write downs and impairments;
- the work to ensure material securitisations and off balance sheet liabilities are disclosed; and
- how often the external and internal auditors are evaluated and the key conclusions.

These broadly follow the proposals for audit committee reporting in the FRC's own paper and it should be noted that the Global Auditor Investor Dialogue is to review them shortly. In particular we feel that the audit committee should report more fully on the conduct of the audit as proposed in the paper and report on the nature of any dialogue with investors. It should also give its major investors the opportunity to highlight any areas they would like covered during the audit. However, it is important that the auditor then forms an opinion and reports on the completeness of the audit committee's report.

We also feel that audit committees need to provide far more detail on the audit appointment and we agree with the recommendations in the ICAS paper on the Future of Assurance on a comply or explain approach to re-tendering an appointment. We agree that the audit committee should disclose:

- The date the audit firm was first appointed as the external auditor;
- The date the external audit appointment was last subject to a full tendering process;
- The policy on the expected timescale after which the company would normally expect to re-tender the audit appointment;
- Where the auditor has been subject to the normal annual review of effectiveness – the process by which the audit committee concluded that the external audit was effective or otherwise and the conclusions of that review;
- Where the auditor has been subject to the extended 5 yearly review process –the process by which the audit committee concluded that the external auditor was effective or otherwise, in particular how it engaged with the shareholders during this process; and the conclusions of that review process;
- The reason for any decision to re-tender the audit other than simply compliance with the policy;
- The circumstances of any resignation or dismissal of the external auditor before the end of their term.

We also believe it would be helpful in relation to the external audit process for the audit committee report to give some indication of the details of the key areas discussed between the audit committee and the external auditor during the audit process, including the main areas of audit challenge.

Expanded Audit Report

We are support the FRC's proposal for an expanded audit report that includes a 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 in the financial statements or obtained in the course of their audit. The existing audit opinion is essentially a binary opinion which gives little detail of the underlying work and this proposal will give users greater comfort that the audit committee report and the annual report as whole are sufficiently comprehensive and cover the range of matters that the auditor has to consider in reaching an audit opinion.

We believe that external audit is a major pillar of good governance. In our view, audit should provide assurance to shareholders on the stewardship of the businesses that they own and thus play an important role in ensuring confidence in the companies themselves and the wider capital markets. The overriding requirement for auditors must be to report on whether the financial statements show an unencumbered true and fair view and this should remain the bedrock of assurance. It follows that we consider that the auditor needs to look at the audit committee's report in reaching an opinion on the true and fair view of the financial statements as a whole and whether the audit committee's report is fair and balanced.

We believe that this opinion is understandable to the user and provides the desired assurance that the annual report is not subject to "spin" by management. We hope that this additional assurance can be delivered without significantly increasing the workload of the external auditors by drawing on their existing knowledge and understanding of the business.

However, we acknowledge that it may be hard to indicate the level of conservatism in any absolute sense in separate disclosures though clearly this is a factor that needs to be weighed in its totality in arriving at the opinion concerning a true and fair view. Some relevant disclosures though may emerge in key issues discussed between auditors and audit committees.

Auditor scepticism

We believe that objectivity, integrity and independence are vital in ensuring the effectiveness and efficiency of audits. We share the concern of others including the regulatory authorities that in some cases audit firms seek to obtain evidence that supports the judgements of their clients. We believe that auditors should seek to challenge management, rather than gathering prescribed data for the purposes of supporting management's assertions. Audit firms should employ processes which ensure consistency of their key judgements and findings across clients, rather than implementing specific processes to satisfy the requirements of specific clients.

Non-audit services

We agree that the provision of non-audit services should be carefully monitored both by the ASB and investors. We are not in favour of a blanket ban on non-audit work but consider that companies and audit committees need to do a better job in justifying non-audit work.

Disclosure may well be compliant in the strict legal sense but is all too often poor and uninformative.

The audit committee should keep the nature and extent of such services under regular review, seeking to balance the maintenance of objectivity and value for money. In addition, in the annual report there needs to be full disclosure of the value of any non-audit fees with a clear breakdown between the types of services received, with tax compliance services differentiated from tax advisory services and non-statutory acquisition related services separated from statutory services.

Cooperation between regulators and auditors

Some form of consultation and communication between auditors and regulators is helpful to investors and is in any event in the public interest. We are therefore supportive of the development of procedures and practices to facilitate dialogue between supervisors, regulators and audit firms.

Safe Harbours

We note the observation that the proposals in the Discussion Paper may result in additional requirements on directors, officers and auditors of companies and that this may lead to calls for some form of "safe harbour". Whilst not unsympathetic, we feel this needs to be very carefully considered and we urge the FRC and the other relevant authorities to proceed with caution to avoid weakening the chain of accountability and the standard of care owed to investors.

4. Companies should take advantage of technological developments to increase the accessibility of the annual report and its components.

We agree in principle that improved technology may well assist better reporting but with some caveats. We note that XBRL is being rolled out by regulators in some jurisdictions and whilst it is not necessarily the full answer, there may be lessons to learn. Web-based technology is still developing and will enable companies to report more coherently whilst providing links to standing data. However, it must be remembered that this is essentially an information retrieval process to aid judgement and not a substitute for judgement itself. Investors still need properly presented accounts and narrative reports that provide context for the figures.

We would certainly encourage companies to develop and maintain user-friendly websites. Nearly all major UK companies have websites but the ease of navigation and the quality of information can vary. Regulation can prescribe the content and format of the disclosure of certain information but it is up to investors and companies and other stakeholders to make sure that websites are well designed and entirely fit for purpose. This is another example of where behavioural change can potentially make a significant difference.

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

We agree that greater investor involvement in the appointment of the external auditor would be appropriate in some cases. At present, investors merely ratify the appointment of the auditor at the Annual General Meeting and are not involved in the selection process. Whilst the directors' control over this matter may have the potential to cause a conflict, the existence

of the shareholder vote, and in many cases an independent audit committee whose role is to oversee the selection process, should provide, at least in principle, some key checks and balances.

However, we feel there should be more transparency as to the process followed and the frequency with which the audit is tendered. This needs to be better addressed in audit committee reports.

In a minority of cases it may be important to obtain the views and input of shareholders directly or indirectly particularly on an unexpected development. If vacancies arise for whatever reason, audit committee chairmen should expect that major shareholders will wish to be informed of the reasons and consulted as appropriate.

In this context we would draw attention to the recent case of the change of auditors at Tui Travel plc in 2010/11. The company circulated a resignation letter from the outgoing auditor but did not make any public attempt to justify the appointment of the successor firm in its formal communications with shareholders. We would suggest that the APB and other relevant bodies look at this case carefully to see what, if any, lessons can be learned from this example.

The FRC should also look at other approaches in other jurisdictions to make the auditor more obviously accountable to shareholders. We would draw particular attention to the requirement in Australia, where the law requires auditors of listed companies to attend AGMs[1] and there is an explicit right for shareholders to pose oral questions[2] on the conduct of the audit, the content of the audit report, accounting policies and auditor independence. Shareholders can also put written questions to auditors before AGMs via the company, but only on the conduct of the audit and the content of the audit report[3]. This provides a process for all shareholders, and not just those in attendance at the AGM, to ask questions of the auditor.

As a significant institutional investor in the Australian equities market, we feel that these provisions are in principle helpful in reinforcing the accountability of the auditor to shareholders and in our interests. The Australian legislation has been in force for around six years and offers a helpful live case study for regulators in other jurisdictions.

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

We hope that market led best practice will be largely sufficient but recognise that the authorities need to keep a watching brief. In this regard, we welcome in principle the expanded role of the FRC's Financial Reporting Review Panel to include narrative reporting.

We also support the extension of the AIU's role to include an assessment of how external auditors review the narrative contents of the accounts. We understand that auditors already have various obligations under auditing standards to comment on statements in the audit committee report and elsewhere that may not properly and fairly convey the facts. The Auditing Practices Board must be given sufficient powers, to the extent that it does not already have them, to make the auditor attestation provisions work effectively in practice.

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[1] Section 250RA Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Act 2004, commonly called CLERP 9

2 Ibid Section 250T

3 Ibid Section 250PA

7. 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.

We support the recommendation to set up a Market Participants Group which in our view needs to include investor trade bodies and asset owner representatives with expertise in these areas as well as preparers, auditors and regulators.

We also welcome the proposal to create a 'financial reporting lab' where new financial reporting models and concepts could be explored, tested and trialled (without liability) to enable greater innovation in the market. We think this is a useful suggestion and hope that it also extends to assurance as well as the preparation of accounts.

We accept that companies are understandably reluctant to provide alternative statements of their results on different accounting bases as it could take significant management time and require considerable care in meeting regulatory requirements on disclosures to market participants. On the other hand, users will find it useful to assess the practical implications and value of what are often very theoretical proposals from the IASB and other standard setters. Carefully controlled experimentation under 'financial reporting lab' conditions could well provide the right environment for progress and meaningful innovation.

We note that there are existing initiatives underway elsewhere on narrative and other types of non-financial reporting. These include the work of the European Laboratory on Valuing non-financial performance (further details at www.investorvalue.org) with the active involvement of companies and stakeholder organisations led by Telecom Italia and Lloyds Banking Group, and facilitated by CSR Europe. We suggest that the FRC keeps a watching brief on this and similar initiatives.

We would also draw attention to a global pilot integrated reporting exercise to be launched by the International Integrated Reporting Committee with a tentative sample of 50 companies in different regions in September 2011 for a two year reporting cycle. The objective of the IIRC pilot is to give companies the opportunity to test and provide feedback on the development of the integrated reporting framework.