The UK Shareholders' Association's response to the Financial Reporting Council on Effective Company Stewardship Enhancing Corporate Reporting and Audit

The Requirements of Company Reports

1. It is noticeable that there are several instances where the need for *"a fair and balanced"* annual report is stated, but only one where the word *"accurate"* appears and none at all where the requirements of the Companies Act are mentioned. Private investors have suffered from too many instances of company reports subsequently found to be misleading to make the assumption that those requirements are known and understood, so all relevant regulatory documents should refer to them, particularly sections 393 and 417. The word *"coherent"* appears once, but the need for *lucidity* might be thought even more important yet it is not mentioned.

2. A similar comment can be made about the absence of any explicit reference to a company's performance (eg in the second key point on page 7). Stewardship is for a purpose and that too is defined in the Companies Act, section 417. As it is the directors' duty to report on how they *"have performed their... duty to promote the success of the company,"* the concern expressed in paragraph 2 of page 10 surely needs qualification. It is more important that the owners of the business can see what has been done in their name than that they should be worried that the directors might also be promoting the company.

3. We comment on the *"ever increasing content of annual reports and accounts"* below, but in the same footnote that refers to this in the consultation document, on page 9, the FRC has suggested a sequence for that content. We welcome the somewhat muted proposal that there should be a standard, because the recent fashion has been to present key information in different places and so make it more difficult to find. Even so, we must take exception to the idea that *"Performance against key performance indicators"* should feature as low as seventh on the list: much greater prominence is required than this, coupled with the introduction of some mandatory elements, such as debt.

4. It is the FRC's belief that, *"An informed investor should not be surprised"* by anything appearing in a published annual report. Because of RNS requirements this is to be expected, but it would be unfortunate if this assertion by the FRC were to be used by company directors to withhold information from an annual report because it had not already been published elsewhere. Private investors already have experience of the law of unintended consequences – directors justifying their failure to do something helpful to those investors' interests because they have been put under pressure to give priority to others' – so this is not an unrealistic fear. The greater fear of all investors is surely that something will appear after an annual report has been published which then negates something in that report: this is what enhanced corporate reporting should prevent.

5. On page 13, second paragraph, the FRC appears to introduce the concept that responsibility for the financial statements extends beyond a company's directors, but this is not what the Companies Act states. The proposals that audit committees should more actively review the work of the external auditors seem more likely to fudge responsibility than improve accountability, especially as they would introduce a circularity that might simply result in mutual support. In its questionable use of the undefined term *"safe harbour"* on page 18, the FRC appears to be favouring a concept not found in the Companies Act and one that seems unlikely to improve the position of a company's owners. It is only outward facing accountability to those owners that will improve things, as we propose below.

6. The consultation document does not make reference to the consultation on narrative reporting conducted by the Department for Business Innovation & Skills last autumn, to which the UK Shareholders' Association responded. We would have expected the conclusions of that study to be relevant, so their absence seems to be a flaw.

The Role of Private Shareholders

7. The private investor who has personally chosen to put his or her own savings into a company's shares is the perfect stakeholder. Nobody else stands to lose so much if the company fails to perform satisfactorily, or fails altogether. He or she gets no reward for failure. Yet the FRC persistently ignores the role he and she can play in calling company directors to account. To prepare a consultation document without taking into account the individual investor's perspective is a serious omission.

8. The private investor is the only *"participant"* who stands, so to speak, outside the circle. Yet there are no FRC recommendations that he or she be consulted. This group has been progressively marginalised. The one remaining link with their investment is the annual report, so for them its content, its reliability and (unless they individually *choose* to read it on screen) their physical possession of it, are all fundamental to safeguarding that investment. Annual reports should be written with them in mind.

9. For this group of investors, the *"ever increasing content of annual reports and accounts"* may be counter-productive. It is not from this group that demands have come to increase the size of reports and it is not self-evident that their interests have been served by that phenomenon.

10. Because the private investor stands outside the circle, he or she is able to ask the awkward questions, in public, at the AGM. They often do, but it is almost unheard of for an institutional investor's representative to do this. The importance of the AGM cannot be overstated, but for a number of reasons this element of ensuring good corporate governance is underused and the abolition of printed annual reports would simply reduce its value even further, to the detriment of director accountability.

11. The consultation document appears to dismiss early on those with their own money at stake, by rather glibly stating, on page 4, that, *"....many individual investors and pensioners... often expect fund managers to act on their behalf..."* But what choice do they have? Those whose money is in pension funds may not even be told when the shares which have been bought with their savings are lent to another fund manager in order to be sold short and thus potentially depress the ultimate value of their pensions. Such money, collectively, may constitute the largest shareholding(s) in a company, yet whether those fund managers do *"act on... behalf"* of those whose money it is is very much a hit or miss affair. The FRC is laudably trying to remedy that with its new Stewardship Code, but this will never work as satisfactorily as giving a greater voice to individual investors themselves, who may be presumed to have similar interests whether their shares are directly or indirectly held.

12. To reinforce this point, we draw attention to the vast private shareholdings in nominee accounts. These are held only beneficially, because the law gives legal ownership to the nominee account provider, who doesn't even have the nominal fiduciary responsibility of a pension fund or unit trust manager. These investors are separated from their investments and very often have no choice in the matter. Part 9 of the Companies Act 2006 made a low-status provision for *"information rights"*, but even this is almost a dead letter, so the Financial Reporting Council's exertions are wasted on a vast swath of investors, whose nominee account providers don't even give the information that an annual report has been published.

13. Nominee account users should be fully enfranchised. Until the law is changed, they should all be given information rights and the right to attend company AGMs. If the FRC were to apply pressure in this direction, it might well achieve more *"effective company stewardship"* than by adding to the *"ever increasing content of annual reports and accounts"*. The more ordinary shareholders with their own money at stake who attend company AGMs, the greater will be director accountability.

14. As things stand, the UK Shareholders' Association Ltd is the only democratic body able to represent private shareholders, which is what we have always striven to do. We therefore formally request to be included in the proposed *"market participants group"* and any other advisory group to be established by the FRC which affects private shareholder investments.

15. We also request that the FRC begins publishing the names of companies whose annual reports are found wanting by the Accounting Standards Board. To find, on page 8 of a consultation document which proposes adding to the already lengthy list of content requirements for annual reports, that 10% of companies are already *"non-compliant"* and as many as 42% are *"falling short"*, strongly suggests that a more vigorous approach is required. This is the kind of information that private investors would use to challenge directors at AGMs and that would be a more constructive step towards improving annual reports than adding to their content.

16. It is only at meetings of company owners (a word that is strikingly absent from the consultation document) that the improvements flagged at the top of page 9 in the consultation document can be demanded. It is the owners' right to make such demands, making use of the valuable help provided by the FRC, with those demands coming even more legitimately from the true owners rather than from representative owners such as fund managers.

The Role of Auditor

17. The FRC is seeking to place additional responsibilities on auditors, but private investors are more concerned at auditors' failure to do what is already required, of which there have been too many instances in recent times and by no means all affecting financial service companies. We emphatically would not regard *"an expanded audit report"* as being *"the final piece of the jigsaw"*, nor do we think the term *"users"* as at all appropriate in this context (top of page 17). The correct term is <u>owners</u>.

18. We have made representations before to the FRC about the looseness with which it describes the auditor's role. This plays to the interests of the audit profession, which does its best to escape the responsibility laid down for it in section 495 of the Companies Act 2006, which begins, *"A company's auditor must make a report to the company's members...."* Directors may of course be numbered among those members, but in the great majority of public companies they will be in a minority and the job of the auditor is to carry out checks on behalf of all the owners, not a select few. A closer relationship with the directors, such as the FRC is proposing, won't necessarily improve scrutiny on behalf of the owners and might even inhibit it.

19. The FRC admits, on page 13, that *"significantly greater judgement"* is required for accounts prepared on the basis of values rather than costs. That inevitably means greater subjectivity, hence greater uncertainty, greater scope for aggressive earnings management and fewer grounds for auditors to counter management valuations. The increasing complexity of accounts, which may well present problems for directors, is certain to be a major hindrance to shareholders and this requires greater auditor independence not less, regardless of whether there is to be *"a broadening of the scope of the auditor's responsibilities"* (page 5).

20. We do not agree with the claims made at the end of page 13 and top of page 14. We have advice that it can be demonstrated that at least one bank almost certainly paid illegal dividends because of failure, inter alia, to make prudent provision for bad debts, if UK law on the matter were to prevail rather than an international accounting standard. Furthermore, had bank managements taken a more prudential view of matters, had boards of directors properly understood the risks they were taking in financial derivatives, had there not been the incentive of enormous bonuses to be based on insufficiently questioned profits, had the debt rating agencies not moved from acting for buyers and lenders to acting for sellers and had the appropriateness of accounting standards not been taken for granted, much of the financial crisis would not have arisen. After all, it arose within companies; it wasn't imposed from outside. Original responsibility lay with company directors and auditors failed to protect the owners.

21. It is fervently to be hoped that the FRC's belief, stated in the second paragraph on page 14, that audit practice can be improved will prove valid, but it is our belief that this is much more likely to come from making auditors properly accountable to shareholders than by extending their role. When something isn't being done well enough, it isn't obvious that adding to it will make it better.

Accountability of Auditors

22. The UK Shareholders' Association has previously made representations to the FRC about its wish to see the establishment of private shareholders' committees for publicly quoted companies. We also made such representations to the Walker Enquiry which were commented on favourably by Sir David Walker. The FRC has shown no interest to-date in this proposal, but we observe here that such committees would be an excellent way of calling auditors to account. Unless there is such a mechanism in shareholders' hands, human nature dictates that auditors will see themselves as principally responsible to boards of directors, despite what the Companies Act states.

23. The FRC's consultation document does not go so far as to propose that auditors' reports to members should cover the deficiencies revealed on page 8, but it is only if a company's owners can be sure that auditors really are reporting to them and not to the management that a change in behaviour can be expected. Simply extending the auditor's role will produce more of the same and potentially more obfuscation of the things that really matter to owners.

24. The FRC's paper does suggest that, *"There should be greater investor involvement in the process by which auditors are appointed,"* but it isn't clear how this is to be achieved. If it simply means behind the scenes discussions between a limited number of large investors and an even more limited number of auditing firms, this is unlikely to produce any benefit to owners.

25. The FRC's laudable desire for more *"auditor scepticism"* seems hardly likely to be achieved by asking audit committees of directors to look for this, when the scepticism to be sought will be of the accounts to which the audit committee has already, presumably, given its approval. Human nature can only be pushed so far.

26. The FRC comes closer to the mark on page 14, where it is suggested, *"Such scepticism would be enhanced by greater transparency, with the assessments being open to effective challenge.... by investors."* We say *"hear, hear"* to this, but how to achieve it? The FRC doesn't say.

27. Private shareholders want auditors to accept that their duty to owners is much greater than to the managers. This is something they show reluctance to do. They do not always attend AGMs. They are reluctant to answer shareholders' questions when present. They seek defence against owners' enquiries by claiming to report to owners only as a body and as owners can't ask questions as a body this is a perfect defence. Auditors should be *obliged* to answer questions from owners, no matter how small their holdings, both at the AGM and in correspondence.

28. We have no idea whether auditors already answer questions put by major shareholders, but the latter have other opportunities for enquiries. In the absence of private shareholder committees, as we have been seeking, auditors must be made to answer questions from any shareholder – especially at, but not limited to, each AGM.

29. The FRC is proposing a greater role for itself and associated bodies. This is spelled out at the end of page 15 and expanded on page 21. This may result in some benefit for company owners, but nothing will be so effective as giving more power to company owners themselves. Adding more and more oversight by third parties, no matter how well intentioned and whether enforced by regulatory edict or not, is likely simply to distance stewardship further from ownership and leave the real owners increasingly impotent. This is not the way to go.

    - The job of running a company should remain with its directors; involving regulators dilutes that responsibility.

    - Care must be taken to ensure that the auditor's sole legal responsibility – that is, to the members, the owners – is not endangered by imposing regulatory requirements with different objectives.

    - Owners' interests must be paramount – and that includes all private investors, however their shares are held.

The Essential Nature of Printed Annual Reports

30. We are unimpressed by the reason given by the FRC for dispensing with the requirement for printed annual reports. It is one thing to *"take advantage of technological developments to increase the accessibility of the annual report..."* (page 6), but it is quite another to force those for whom these reports are intended to use technology just to gain access. There is nothing more *"user-friendly"* (page 9) than to receive a report in the post, requiring no more effort than to open the envelope and no cost at all to the recipient, who can take it to read and study anywhere without the need for equipment -- even to the meeting where it is due to be approved.

31. We note that the task of sending information in printed form to its owners is considered, by the Financial Reporting Council no less, to be *"a drain on (a company's) resources"* which it thinks can be better deployed, yet the FRC has produced no objective evidence to show that this will improve directors' accountability for their stewardship. The UK Shareholders' Association is not hostile to use of developing technology, but this should *add* to what is available to shareholders, not be a substitute. To use the FRC's own term, it may "*increase... accessibility*", but this will only be for some and should not be at the expense of others.

32. The UK Shareholders' Association thoroughly agrees with the FRC's conclusion that there is substantial scope for improvement in the quality of information given in annual reports. This was reflected in our response last October to the BIS consultation on the future of narrative reporting, already referred to above. This is likely to be of greatest benefit to those who read reports in hard copy form. the particular value of technology on the other hand, as suggested on page 11, is to facilitate the process of searching for information, which is different. Technology seems more designed to assist investors who take little interest in the actual management of companies, unlike those we represent, but rather those who move money around based solely on comparative numbers.

33. It is appropriate to observe that annual reports are increasingly produced for a wide community of so-called stakeholders, rather than being focused on the share holding and dealing public. As they have been increased inordinately in length over the last decade to serve such a variety of stakeholders, it is difficult to believe that they are now read in their entirety by more than a very few decision-taking investors, an outcome which might be regarded as counter-productive. Migration to electronic copy would exacerbate the situation, because there is no equivalence in readability between soft and hard copy. This is a problem being hinted at in the consultation document, but not addressed.

34. It seems to us bizarre to be suggesting, in the same sentence on page 11, that use of *"common reporting languages such as XBRL... would facilitate engagement"* while asserting that abolition of the requirement for printed reports would do the same. It may seem sarcastic to say so, but we wonder how XBRL would meet the requirement expressed by staff writer Tony Jackson of the Financial Times, for annual reports and accounts to *"alert the owners to contingent risks and liabilities – unexploded bombs which might go off beyond the reporting date."* He was writing in May 2009 about BT's *"collapse into loss"* the previous week, because of *"a legally binding deal struck with the BT pension fund trustees more than two years ago."* This is presumably the kind of information the FRC wants to see more plainly revealed in annual reports, but of a nature unlikely to be revealed by a computer search.

35. On page 17, the FRC states, *"It would not be appropriate to dictate by detailed regulation the information to be provided to meet users' needs.... because some users will attach importance to particular information. Nor would it be appropriate to dictate by whom such information should be provided."* Why then does the FRC consider that it is appropriate to dictate the means by which that information is to be provided? The way the recommendation to do away with printed reports comes across is that, in its desire to add to the quantity of information provided, the FRC has encountered resistance on cost grounds and this is why it proposes jettisoning the printed annual report, yet this is without evidence to show that printed reports have become superfluous.

36. Despite all the advantages in using technology to give assistance to undefined *"users"*, some of those users will actually be owners, whose interests as owners ought to come before those whose job it is to produce reports to account for their stewardship. There is no substitute for a printed document when a reader wants to refer rapidly from one page to another, compare related items, make comparisons with previous years and perhaps make notes in the margins in preparation for the AGM or correspondence with an officer, or simply keep it readily to hand. It is all very well to read a book from one end to another on a Kindle, but a very different matter to go to an AGM where there may be a requirement to jump from one section to another to follow the proceedings. The annual report is the principal basis on which to call directors to account and its availability should not be reduced.

37. We have been made aware of a letter that Baroness Hogg wrote to Mrs Theresa Villiers MP on 31 January. A key sentence in that letter says *"Questions have also been raised as to whether some of the material in annual reports could not more effectively be posted on a company's website…"*. Removing *"some of the material"* to a website is very different from eliminating the requirement to produce printed reports altogether. Permitting some of the routine, non-fundamental material to be produced only on the website could be acceptable if it were carefully defined to exclude anything which members might want to refer to or discuss at the AGM, or which might affect their retention of the shares or readiness to invest further.

38. In referring to cost, the FRC appears to assume that all *"users"* will be content to read and retain reports online only. This is certainly counter to our experience and we would be surprised if that were not the case elsewhere too. It is far more expensive and consuming of resources for printing to be undertaken individually in homes and offices than for one set of copies to be produced centrally. This observation and others, with all of which we agree, were made in an excellent article in The Daily Telegraph on January 14 2011 by John Owens, a former deputy director-general of the CBI. We are also aware of the letter to sent to the FRC by Michael Johnson, chief executive of the British Printing Industries Federation, saying much the same thing and based on professional knowledge.

39. We would like the FRC to do more than simply drop its proposal to abolish the requirement for printed annual reports. We would like it to regulate, or at least seek to influence, the way in which companies are able to withdraw the automatic despatch of annual reports to shareholders. This seems to be largely left to registrars to control, but responsibility ought to lie firmly with the company itself. The widespread, although not universal, presumption that reports have to be requested (rather than the opposite presumption) is unfavourable to the interests of private shareholders, but even more so is the practice of asking for confirmation of this at intervals: this ought to be stopped, or at least a minimum five year interval imposed.

END