FRC Paper on
Effective Stewardship
Comments from R A Collinge FCA

Chapter 1 Introduction

Aims of the paper

1.1 Page 5; Understanding of risk

The paper suggests that "companies in all sectors still get into trouble apparently because of failures" (Page 5 Para 3) to understand the risks they are taking on. The suggested solution is to "increase transparency in the way that directors report." This fundamental statement is questionable.

Does it imply that failures to understand risk by directors will be avoided by telling more? Should not the question here be how it can happen that directors do not understand the businesses for which they are responsible? If a director does not understand what his or her company is doing they should not be there.

Companies will always fail as mistakes are made and circumstances change. It is naïve to think that more "transparency" will avoid this.

1.2 The aim is to:

1.2.1 See "high quality narrative reporting". Desirable but one wonders what reporting qualifies as high quality.

1.2.2 Have more widespread recognition of the importance of audit committees. By whom is such recognition missing?

1.2.3 Have greater transparency with regard to how audit committees ensure the "integrity" of the annual report. It is not clear what an annual report without integrity might constitute. What does this mean?

1.2.4 The auditors are quite rightly responsible for their audit opinion. The audit committee should not have a role in deciding on that opinion.

More information about the audit process could be useful if it is real and not just standard wording which will be the likely outcome.

A broadening of the scope of the auditor's responsibilities will need vary careful consideration of the skills required and the costs and potential benefits.

1.2.5 More accessible annual reports must be a good thing. Stopping printing them would do the reverse.

1.3 The last paragraph (page 5) suggests that a regulatory framework that eliminates the risk of failure is undesirable. It is, of course, also impossible.

Chapter 2 Key Recommendations (page 6)

2.1 Annual report:

There does not appear to be a comprehensive definition of what should appear in an "Annual Report". The directors must take collective responsibility for any such report even though parts may be signed by individual directors. Surely this is the current position and would constitute no change?

2.2 Reliability and Transparency:

It is not clear what will be reported as to the reliability of information. It is surprising that this should be needed. It implies that some boards may have information which is not reliable. The result will, most likely be that again some standard wording will evolve as no board will want to do other than report that its information is reliable. The information about the business activities is prescribed in various Accounting Standards. What is being asked for here?

2.3 Audit Committees:
Additional explanation of what these committees do could be useful.
2.4 The audit report is not the responsibility of audit committees. If the auditors are to report on the audit committee report this will be a very circular process and it is difficult to see its value.
Ensuring that the whole of the Annual Report is consistent and fairly stated is important. If this idea is to be pursued then some careful thought will have to be put in to define the extent to which this should go.
2.5Annual report accessibility:
This is clearly sense. Eliminating printed reports is not.
2.6 Auditor appointment:
Shareholder committees should be formed which would have the supervision of this process as one of their responsibilities.
2.7 FRC responsibilities.
What is involved in any extension of FRC powers is not explained. As a general rule regulatory supervision should not be increased. Shareholders should be as able to judge for themseves what is needed and will also be more effective than regulators.
2.8 Market participants group.
If such is formed it should include private shareholders or their representatives as well as fund managers etc.

Chapter Three: Narrative Reporting

3.1 FRC believes that regulation is required to ensure “relevant" information (page 7)
A clear understanding of the activities of a company and the associated risks of those activities is clearly important for its shareholders and potential investors. It however is not clear that regulation will be an effective way to achieve this end. FRC calls for “high quality” narrative reporting but does not attempt to define what this is, probably because it would be almost impossible to do so. If therefore there can be no standard against which to measure how would regulation work? What, if any would the penalties be for failing to achieve, in the view of that regulator, a “high standard”? What rights of appeal would there be if penalties were enforced? How could anyone judge whether a “high standard” had been achieved?
A better route might be to encourage investors to demand and companies to produce what they jointly regard as being of a “high standard”. It must be in the interests of both, that what is produced, increases shareholder and investor confidence in the company.

3.2 FRC suggests the annual report no longer be made available in print form.
This seems to run contrary to the general trend of trying to assist shareholders. Accounts are far easier to read in printed form and a printed copy should be the norm with a chance for shareholders to opt out if they so wish.

3.3 FRC repeats on page 10 some comments about narrative reporting.

3.3.1 The points made above stand. There are great difficulties of definition given that every company is different and there will be many different views as to what is “fair and balanced”. The FRC goes on to suggest that regulation may not be appropriate havng suggested (3.1above) on page 9 that it would. They now appear to be recognising the real problems of regulation in this area as commented upon.

3.3.2 The paper later goes on to try to teach directors what they need to do in order to be able to run their companies properly for their shareholders. This has the implication that FRC believes that some directors do not properly understand the businesses they run - a very worrying implication. The belief may sadly be true and has been commented on in the points made in connection with chapter 1. FRC seems here to be accepting that its suggested solution of "increasing transparency" will not, of its own, solve the problem.

The suggested disclosures (page11) are clearly things which the directors should have at their fingertips. As the FRC suggest, reporting on them in a way "accessible to users" (does this mean "comprehensible to users"?) will be a considerable challenge. Standardised wording will appear as no company will want to appear any less thorough than another.

3.3.3 Technology and Annual Reports. (Page11)
Clearly the easier these are to read, follow and understand the better. There is no good argument for transferring the cost of printing from the company to the shareholder.

Chapter 4: Assuring integrity.

FRC here adduces some very doubtful arguments.
4.1 Page 12 last para: the very strange statement is made that since computers are "processing transactions and allocating sales proceeds in accordance with accounting requirements numerical issues are less problematic."
4.1.1 It is self evident that computers handle data according to the manner in which they are programmed. How does the involvement of computers, of itself, reduce problems with "numerical issues"?
4.1.2 By "allocating sales proceeds" is the FRC referring to revenue recognition problems as few accounting standards prescribe how costs are to be allocated?
4.1.3 Many an observer would argue that numerical problems have been at the heart of recent company failures. Many would argue that more prudent accounting might have reduced the severity of the set back which has affected the banks, in particular, and the economy as a whole.
4.1.4 Overall one is concerned by the basic attitude of this paragraph as it appear to have been badly thought through and reduces one's confidence in the document as a whole.

4.2 Page 13 first para.
4.2.1 FRC continues with this theme that we no longer need to worry about the numbers. It asserts that the value of accounts has been enhanced by the move to market values rather than costs.
Many would disagree with this view. FRC admits that "significantly greater judgement "is required for accounts prepared on the basis of values rather than costs. That "judgement" can otherwise be stated as greater subjectivity, greater uncertainty, greater scope for what is called "aggressive earnings management", and fewer grounds for the auditors to be able to counter management valuations.
There is also reference to the increased complexity of accounting standards. It is also arguable that this has been in itself a major hindrance to shareholders and probably to directors in trying to understand the accounts.
4.3.1 Page3 second para
This paragraph again makes some very doubtful assertions in arguing that the "reliability" of financial statements is now more dependant on a series of listed factors identified by bullet points.

4.3.2 The first factor listed is the effectiveness of monitoring systems and associated risks. Such monitoring has always been central to the ability to produce reliable financial statements.
4.3.3 As suggested above the moves to market values have almost certainly reduced the reliability of such statements.
4.3.4 Again reliability has always depended on the quality of the external audit. That's what auditors are for.
4.4.4 The final bullet point refers to "all responsible" for the financial statements. Has the FRC forgotten that it is the directors of a company who are responsible for them? If so this is a fairly fundamental mistake by the FRC.

4.5 Page 13 Last para and page 14 first para.
The FRC continues to make highly questionable assertions.
4.5.1 It claims that there are no circumstances where financial statements were materially misstated. In fact it can be demonstrated that at least one bank paid almost certainly illegal dividends because of failures, inter alia, to prudently provide for bad debts. The FRC will argue that the recognition of bad debts should only happen on what is called the "incurred" basis as required by an international accounting standard. In fact it is strongly arguable that this standard does not comply with UK law as it fails to allow, indeed it forbids, the assessment of bad debts on the basis of what is "likely" (SI 2008/209 Schedule7) to be incurred.
This specific point is irrespective of the doubts held by many as to basis on which bank accounts were prepared given their failure to make prudent provisions. It was from the "profits" struck on this imprudent basis that bankers' bonuses were, and are being paid.
4.5.2 FRC asserts that the collapse of credit markets could only have been prevented by action taken "by those responsible for macro economic affairs and prudential regulation". (page 14 first para)
This again is very debatable. Had bank managements taken a more prudent view, had boards of directors fully understood the risks they were taking in financial derivatives, had managements not had the incentive of enormous bonuses calculated on, in many cases, false profits, had the debt rating agencies not moved from acting for buyers and lenders to acting for sellers and had accounting standards not prevented prudent accounting then it is most likely that the worries which caused the collapse of credit markets would not have arisen. Many groups of individuals were involved, not just regulators however inadequate they may have proved.
The FRC seems to be arguing that there is no need for more fundamental reform so long as directors tell people more of what they are doing. This position influences what views it holds preventing some of the real causes of recent problems to be addressed. This is a worrisome characteristic of this paper.
4.5.3 Audit (page 14 para 2 et seq)
FRC then goes on to discuss audits. It seeks "increased auditor scepticism when assessing material assumptions and estimates" clearly implying that such scepticism has not been adequate.
This is surprising as it has just suggested that no financial statements were materially misstated. Appropriate scepticism has always been necessary in an audit and if the scepticism was inadequate it would follow that any financial statements which were not considered with adequate scepticism could well have contained "material misstatements".

4.5.4 “The right environment”
FRC briefly mentions the need for the “right environment” to exist between auditors and management. This may be shorthand for attempting to reconcile the inevitable drive the auditor has to be and to remain on good terms with the management, with the need for scepticism. The auditor does not want to lose the job. This is central to the preparedness of auditors to disagree with management when they feel it necessary. It is a very difficult area which FRC seems to recognise but then skims over
4.5.5 Greater transparency
.FRC suggests that the assessments made by auditors should be open to “effective challenge by the audit committee and investors”. It is the assessments made by <u>management</u> that should be challenged by the audit committee firstly, on behalf of the whole board who have the final responsibility.
FRC suggest that, as a minimum, the list of factors used by auditors in making their assessments should be reported to the Audit Committee (last para on page14) not apparently to the world at large as is implied by the word “investors” in the paragraph above.
The disclosure of these factors (bullet points on page 15) may well have advantages in helping audit committees to appreciate what may well be views contrary to those of management.

4.6 Auditor independence (page 15)
FRC recognises the potential for conflicts of interest here. It suggests that Audit committees get more involved in the use of auditors for non audit work.
A better solution would be the use of shareholder committees of which this would be one of their tasks.

4.7 Co-operation between auditors and regulators.(page 15)
FRC wants more of this. It is not clear what would be gained from this. The job of running the company should remain with the directors and involving regulators dilutes that responsibility. Care would have to be taken to ensure that the auditor’s sole responsibility, i.e. to the shareholders, is not endangered by working with a regulator with other obligations.

4.8 Reports by Audit Committees (page 16)
It is pleasing here to see the FRC recognises the fact that the directors (and per FRC the management) are “exclusively responsible for the management of a company”. The FRC seemed previously uncertain on this point. (See 4.4.4 above)
It suggests that the Audit Committee report to the shareholders on various matters. (Bullet points on pages 16 and 17). These appear in the main to be reasonable.
Dealing with auditor reappointment and the supply of non-audit services should however be the remit of a shareholder committee rather than the audit committee.
FRC suggests that the audit committee may have had dialogue with investors in relation to audit issues. It is difficult to understand what this suggestion is meant to cover.

4.9 An expanded audit report (page 17)
FRC suggests that disclosing the various assumptions used by the auditors in coming to their view on the financial statements could be helpful. (para3 of this section Page 17). It does not specify how this should be done. The proposal raises a number of potential problems as such disclosures may well trouble auditors in regard to potential professional liability claims.

4.9.1 FRC goes on to suggest that the auditors then report on a report by the audit committee. This appears to be overkill, potentially expensive and unnecessary.
4.9.2 FRC further suggests that the auditors should consider the whole of the Annual Report and comment on whether it is consistent with the financial statements. This seems reasonable and logical.

5.1 Auditor appointment:
FRC suggests greater involvement by shareholders in the audit committee appointment of auditors. This they think could be done either by further reporting or by the involvement of principal investors.
It is suggested that a better way to deal with this would be to have a shareholder committee elected by the shareholders and which would specifically include private shareholders along with representatives of the institutions.

6.0 Fostering Quality Improvements
FRC here has two key suggestions
6.1 “Developing” FRC’s responsibilities
Bureaucracies, by their nature, always seek to extend their powers. Whether the FRC should have extra powers after any new guidance is agreed should be decided then with due scepticism as to its benefits.
6.2 Market Participants Group
Users of annual reports should be able to influence how they are developed. Users include private shareholders whose interests should be represented on any body of users of annual reports.

7 Conclusions
7.1.FRC appears to believe that Effective Company Stewardship can largely be obtained by greater “ transparency” for which it presumably means greater disclosure. Some of this may be valid but such additional disclosure will only further lengthen and complicate annual reports.
7.2 FRC’s analysis of the cause of recent problems appears flawed and has driven it to seek therefore inappropriate remedies..
7.3 FRC appears occasionally uncertain as to responsibility for stewardship and seems to be keen to spread this responsibility around despite its comments referred to in 4.8 above.
7.4 Sadly FRC appears to have ignored the needs of private investors and should be encouraged to address such needs.
7.5 Effective company stewardship is clearly crucial and has always been an obligation of directors. The most effective pressure on directors to ensure this will come from active shareholders prepared to drive for such stewardship and not just sell the shares they are holding for the benefit of others when they are unhappy. It is because this short-termism of institutions contrasts with the tendency of private shareholders to invest for the long term that the influence of private shareholders on stewardship should be enhanced rather than ignored.

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