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COMPANY LAW COMMITTEE RESPONSE TO FINANCIAL REPORTING COUNCIL CONSULTATION ON EFFECTIVE COMPANY STEWARDSHIP - ENHANCING CORPORATE REPORTING AND AUDIT

The City of London Law Society (CLLS) represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees and in this case the response has been prepared by a working party of the CLLS Company Law Committee comprising senior and specialist corporate lawyers.

We welcome the opportunity to comment on the FRC's consideration of narrative reporting, the ways in which the integrity of a company's Annual Report may be assured and the other issues discussed in its paper on Effective Company Stewardship. With the publication of *The Plan for Growth* issued on 23 March 2011 by HM Treasury and the Department for Business, Innovation & Skills, and the Department's response on narrative reporting, we look forward to working together with the FRC and BIS towards the goal of simplified narrative reporting.

The FRC paper does not ask specific questions and so our response is made by reference to the key recommendations it contains and other key points and comments made within the paper.

1. **Introduction**

1.1 **Purpose**

We understand the Introduction to say that the ability of shareholders to exercise effective stewardship of companies depends on "the provision of robust and reliable information by companies and on audit assurance of that information". We agree with that.

We also agree with the aim set out in the Introduction of achieving:

> "Higher quality narrative reporting, particularly on business strategy and risk management."

We take this to be the overriding objective. The proposals in the paper should be assessed by reference to their contribution to delivery of this objective.

However, we question the assumption that appears in two of the other aims set out in the paper that greater transparency regarding processes is helpful in delivering this overriding objective. Specifically, we note the following aims:

- "greater transparency of the way that Audit Committees discharge their responsibilities …"

- "more information about the audit process …"

As a general proposition, we think requirements for disclosure about process tend to lead to formulaic, boilerplate disclosures that add little or nothing to the substantive disclosure. At the same time, disclosures of this kind tend to dilute the responsibility of the party concerned (the directors or the auditors) for the substantive disclosures they are required to make. This approach shifts responsibility for judgments on adequacy of the process described to the user of the report. We question whether investors and other users would think that desirable.

1.2 **Evidence**

While we welcome a number of the proposals in the paper, we are concerned at the lack of evidence showing that investors and other users of Annual Reports share the concerns expressed in the paper and will find its proposals of real practical use. We think it is essential that there should be a good empirical basis to support the introduction of additional obligations on companies and their directors and auditors.

The introduction to the paper suggests that it is timely to ask whether the recent financial crisis exposed shortcomings which are relevant to all large companies, not just those in financial services. There is no further discussion of this question and no evidence is adduced on the point. We agree that this is a relevant question but we also see a danger in assuming that the problems faced by banks and other financial institutions in 2008-9 and the lessons learned from that experience necessarily "read across" to other kinds of companies. We suggest therefore that this question requires a more thorough analysis and consultation before new requirements of general application are adopted.

1.3 **Cost**

We would also wish to see more information on the added cost for companies implied by these proposals, beyond the simple statement in chapter 6 of the paper that the FRC believes the benefits will outweigh the costs.

2. **Are these proposals over-prescriptive?**

The paper says that its proposals build on existing foundations. The FRC does not view those proposals as over-prescriptive, but it welcomes views on the point. We respond below in relation to particular proposals, but as a general point we believe that the FRC's aims of better and more informative narrative reporting and assurance of the integrity of Annual Reports can be best achieved through:

- peer pressure;

- better engagement by investors and other stakeholders; and

- clearer guidance,

and not by mandatory regulation. Good narrative reporting and trust in a company's Annual Report cannot be legislated for; rather, they can be fostered and encouraged by other "softer" measures.

As a general observation, we believe narrative reporting has developed and improved greatly over recent years and only in part because of legislative intervention. That development should be allowed to continue as guided by the requirements of investors and other stakeholders, and with more regulation only where it is justified by clear evidence of the benefits which will result.

In this context, we welcome the Government's commitment in *The Plan for Growth* that it

> "will materially simplify narrative reporting for quoted companies to make it clearer and more focussed",

with the additional suggestion of improving non-regulatory guidance (paragraphs 2.147-2.148).

3. Narrative reporting

3.1 The Annual Report should communicate high quality and relevant narrative and financial information to the market.

That statement is, of course, accepted. The paper recognises that some narrative reports are "exemplary" (page 8) and it would clearly be desirable if all reports achieved the same standard. But such excellence cannot be legislated for and will only be achieved on a voluntary basis as a result of the "soft" factors such as peer pressure, investor and other stakeholder engagement with companies and good practical guidance.

The paper notes the increasing length of Annual Reports and Accounts[1] and suggests that companies need to shorten them (page 9). Increased length is inevitable as more requirements are imposed by regulation and legislation. In that context, we note the paper's proposals for fuller reports by Audit Committees and expanded audit reports and the new Corporate Governance Code requirement to describe business models. There is, therefore, a tension between the demands of some for more disclosure and the competing pressure for reporting to be more accessible and comprehensible. We do not believe there is a "one size fits all" solution to this dichotomy. The answer must, we think, lie in better feedback to those who write annual reports from those who use them, indicating what is useful and what is not, coupled with practical guidance that helps those faced with the challenge of writing to achieve the desired standards.

The paper urges a decrease in the use of "legalistic boilerplate". We also note that the chief executive of the FRC has said that "companies need to stop producing boilerplate text prepared by their lawyers to minimise their liabilities"[2]. We agree there can be a tendency for companies to produce standardised, formulaic responses when faced with formulaic requirements. We also agree that is undesirable. It is probably most often seen in the drafting of risk factors. The paper refers to the activity of the FRRP in this area, and we note its press release on 1 February 2011 in relation to risk reporting.

This is an area that would benefit from a detailed review involving regulators, companies, their advisers and shareholders which might cover:

- best practice in risk reporting;
- the interaction of periodic reporting of risks with prospectus risk factors;
- the reasonable boundaries of disclosures on risk mitigation;
- the reasons companies adopt defensive and boilerplate risk reporting (a proper understanding of which is necessary before effective measures can be adopted to discourage its use).

[1] To take one example, the Barclays PLC 2009 Report was 166 pages. The recently published 2010 Report has grown to 288 pages, of which there are 77 pages on risk management, six for the Directors' Report, 17 for the Corporate Governance Report and 18 pages for the Remuneration Report.
[2] Speech by Stephen Haddrill, 10 February 2011.

Such a review would also usefully examine the extent to which it is appropriate to draw parallels between risk management and risk disclosure for financial institutions (learning the lessons of the financial crisis) and risk management and risk disclosure by non-financial companies. We are not convinced that those parallels are self-evident and believe this needs a proper examination.

The paper does not explain what statutory and regulatory requirements dictate how and where companies provide information, though it says those requirements need to be amended. We do not see the statutory and regulatory requirements as prescriptive as to form or order of information. We agree that companies should be left to make their own decisions on this. We assume, therefore, that the sequence of disclosures set out in footnote 4 is not intended to be prescriptive.

3.2 **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 directors' report for a financial year, which includes the business review, must be approved by a company's board and, if it does not comply with the requirements of the Companies Act 2006, every director who knew that it did not comply, or was reckless as to whether it complied, and who failed to take reasonable steps to secure compliance, is guilty of an offence which may be punished by a fine (s. 419, Companies Act 2006).

Directors also have a responsibility:

- to ensure that the business review contains a "fair review of the company's business" (s.417(3)(a), Companies Act 2006); and

- not to approve financial statements unless they are satisfied they give a true and fair view (s.393(1), Companies Act 2006).

In addition, for listed companies:

- the Disclosure and Transparency Rules require a responsibility statement from directors in respect of its financial statements (that they give a true and fair view) and the management report (that it includes a fair review) (DTR4.1.12);

- a company must take reasonable care to ensure that any information it notifies to a Regulated Information Service (which may include the financial statements and Annual Report) is not misleading, false or deceptive and does not omit anything likely to affect the import of the information (Listing Rule 1.3.3R);

- the same obligation is imposed by DTR 1.3.4R in respect of information published under the Disclosure and Transparency Rules;

- a company may be liable to an investor where a director knew a statement in published information (which may include the financial statements and Annual Report) to be untrue or misleading or was reckless as to that fact, or where the omission of information is a dishonest concealment of a material fact (s.90A and Schedule 10A, Financial Services and Markets Act 2000)

- Main Principle C1 of the UK Corporate Governance Code requires a board to present a balanced and understandable assessment of the company's position and prospects in its financial and business reporting.

The significance of the paper's proposal therefore seems to be that:

- it requires the Annual Report to be <u>viewed as a whole</u>;

- the report must provide a "fair and balanced" report on [the directors'] stewardship of the business.

We are not sure whether this proposal is intended to make a material change to the nature of the obligations described above. If not, then we suggest it is unhelpful to have a new formulation. If it is, the FRC should explain what the additional obligation entails and why that additional obligation is necessary.

The paper accepts that this proposal should not be advanced by regulation and chapter six of the paper does not include legislative proposals on this point. Instead, it is proposed that a framework for the Annual Report should be established through a Narrative Reporting Standard issued by the ASB. That Standard would set out principles for the preparation of the Annual Report and establish the responsibility of directors for ensuring that it is balanced and fair.

The BIS consultation in its paper, *The Future of Narrative Reporting* (August 2010), asked whether a statutory reporting standard would help to improve the quality of reporting. Our response to this was that a statutorily imposed standard would be too prescriptive and would risk stifling innovation in, and the continuing development of, good narrative reporting. There is a subjective element to good narrative reporting which cannot be prescribed by regulation. The more the contents of the Annual Report are dictated by regulation, the greater the risk that they come to resemble full prospectus-style descriptions of a company's business and comprise boilerplate disclosures. We do not believe that would be to the advantage of investors or other stakeholders.

We assume that a Narrative Reporting Standard would operate within the existing framework for narrative reporting (the business review required by s.417, Companies Act 2006 and the management report required for listed companies under DTR4). This is important as it will ensure that liability for the Annual Report should be as set out in section 419, Companies Act 2006 described above (and see also our comments in section 7 below on the safe harbour regime in s.463 of the Act).

3.3 **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.**

This is an example of the emphasis placed in the paper on disclosure of systems and processes and we question whether this kind of disclosure is of real use or interest to the reader. Such a requirement lends itself to boilerplate disclosures and will tend to be repetitive from year to year. We query whether this is really something that is being asked for by investors or other users of company reports or that they will find useful. Rather, a reader of an Annual Report needs to know that such systems are in place and that the directors believe them to be adequate. The FSA's Listing Principles already require listed companies to take reasonable steps to establish and maintain adequate procedures, systems and controls to enable the company to comply with its obligations, which include obligations to provide financial information and announce price-sensitive information. A requirement for a detailed description of those systems seems unnecessary and impractical.

In any event, we doubt whether the provision of more information of this type really achieves its desired objective. The more disclosure there is about internal management systems, the more the responsibility for assessing the adequacy of those systems passes to investors and other users of the report. Should those systems prove inadequate, the directors may seek to hide behind the full disclosure they made as to what they had put in place. That does not seem to us to serve the interests of users.

Of the specific items to be included in the required disclosure, only "the extent and frequency with which the effectiveness of the [internal reporting] system is tested" would provide useful information to users of the report. We do not understand what is contemplated by disclosure of "the effectiveness of the external assurance arrangements". Does this refer to the testing of the effectiveness of the audit that is suggested as part of the Audit Committee report? If this is a new obligation to express a view on the audit, we wonder what it adds.

If the intention is to improve the standards of the controls companies have in place for reporting relevant information, we think this needs to be done in a different way, for example by guidance as to what the controls should take account of and the sorts of information that should be provided. This might be done by expanding Section C of the UK Corporate Governance Code and by means of the audit committee's terms of reference. In some cases, the systems are satisfactory but are not in practice operated in a satisfactory fashion.

3.4 **Companies should take advantage of technological developments to increase the accessibility of the Annual Report and its components.**

We support the adoption of technologies that facilitate easy access to the information in Annual Reports. We understand how technology may allow easier comparison of financial information, but not how it may be applied to narrative reporting.

The paper seems to suggest that shareholders should lose the option to require a printed copy of the Annual Report and Accounts. We are surprised at that, given our understanding that some shareholders prefer to receive a printed copy. The current system allows companies to operate on the basis that shareholders must opt-in to receiving printed copies of the full Report and Accounts (rather than a summary financial statement alone) and that seems to us to represent a reasonable approach. If this proposal is to be taken forward, perhaps some research should be undertaken to identify how many shareholders prefer to receive a printed copy and why.

4. **Assuring integrity**

4.1 **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)**

As an initial point, it is not strictly correct to say that the Audit Committee has responsibility for the integrity of the Annual Report. This is a responsibility shared collectively by the full board and all directors have a potential liability for the Report. It is not helpful to suggest that other directors are relieved of that responsibility. The Audit Committee has a particular responsibility to <u>monitor</u> the integrity of the Annual Report (see the UK Corporate Governance Code, C3.2 and DTR 7.1.3R).

We note that there is currently no overt requirement for a separate report by the Audit Committee, although it is common practice to include one (and section C3 of the UK Corporate Governance Code requires the Annual Report to describe the work of the committee and DTR 7.1.5R requires a statement by a listed company disclosing which body carries out the function of the committee and how it is composed). We think it should be left to companies to decide how to deal with the disclosures required in relation to matters that are within the remit of the Audit Committee. Note also that, as with the Annual Report, these matters remain the responsibility of the full unitary board and the responsibility of all directors should not be diluted by requiring a separate report from the Audit Committee. The Remuneration Report is a responsibility of the whole board although its preparation is generally led by the Remuneration Committee. We suggest a similar approach would be appropriate if it is considered necessary to require a separate report in relation to matters dealt with by the Audit Committee.

Again, this proposal is an example of an emphasis on disclosure of process and not substance and we question its utility. For example, it is suggested that the Audit Committee should report on the steps taken to assess the effectiveness of the audit. Footnote 10 sets out the steps that an Audit Committee should pursue to achieve that end. We envisage that all Audit Committees would recite in their report that they had taken those steps. What value is obtained by the user of the report from that recitation? If it is agreed that Audit Committees should take these steps, it would be more effective to include that as part of the Corporate Governance Code so that it could be dealt with through the usual comply or explain process.

Our comments on the specific matters proposed to be covered in an Audit Committee report are as follows:

- key areas of sensitivity or risk: while we agree that there is value in requiring disclosure of key accounting policies and the key judgments made to implement those policies, those are matters for the whole board and should not be an Audit Committee disclosure;

- matters of material significance not otherwise disclosed: we do not think this is necessary or useful. We have set out above our view on whether it is helpful to impose a new obligation to ensure the Annual Report as a whole is "fair and balanced". If that new obligation is adopted and the auditors raise an issue with the Audit Committee that the directors who are members of the committee consider requires disclosure, they will be under an obligation to ensure that it is so disclosed. There is no necessity, therefore, for a separate disclosure by the Audit Committee.

- effectiveness of the audit: as explained above, we do not believe this would lead to useful additional disclosure;

- non-audit policies: this disclosure is already required (UK Corporate Governance Code, C3.7);

- process for appointment of auditors: as indicated in 5 below, we think this disclosure may be useful;

- dialogue with investors: we do not support this as a requirement as it suggests that discussion of audit issues with selected investors is usual and acceptable. An informal and confidential dialogue may be appropriate in certain instances, but the knowledge that a discussion would be publicly disclosed would inevitably inhibit a free expression of views and so detract from its usefulness.

It is not clear where these requirements might appear or how they would be imposed. There are no legislative changes proposed in chapter six of the paper. To the extent these proposals are pursued, we think they would be better included in the UK Corporate Governance Code, rather than legislation.

We also query how much of what is proposed in the paper in relation to an Audit Committee might also apply to a Risk Committee established by a company to take over some of the responsibilities previously held by the Audit Committee.

4.2 A quality audit of the financial statements

We have no comment on the proposal for enhanced standards for the reporting by auditors to Audit Committees.

4.3 Auditors who are independent of their client, acting without fear of dismissal for being challenging

We have no comment to make under this heading.

4.4 **Co-operation between regulators and auditors**

While the enhanced dialogue between financial regulators (Bank of England, FSA) and auditors is justified as a reaction to the financial crisis, it does not necessarily follow that there should be a parallel requirement as regards non-financial companies and other regulators. Any proposal to extend this approach should be justified by identification of the problem that is thought to exist and which it is suggested could be overcome by such a dialogue.

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

We do not agree. The appointment, re-appointment and removal of the external auditors is the responsibility of the full board, subject to shareholder approval. It is for the Audit Committee to make recommendations to the full board. As the paper notes, it is appropriate for independent non-executive directors who comprise the Audit Committee to oversee the process. If there is a widely held perception that decisions on auditors' appointment and their remuneration are made by "management" or are not sufficiently rigorous, there may be a case for a report to shareholders on the process followed and the reasons for the decision (although we expect such disclosures would end up being formulaic and not very informative).

We do not agree with the suggested alternative of a discussion with "principal shareholders". In our view it is inappropriate to give "principal shareholders" a special status in this way. It may be the case that in some circumstances an Audit Committee may seek the views of certain shareholders, but the Committee should accept responsibility to <u>all</u> shareholders for its recommendation and the formal role of shareholders should be confined to the vote given to them at the company's AGM.

6. **The growing strength of audit committees in holding management and auditors to account should be reinforced through 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.**

The paper seems to envisage a regime in which the auditors make an enhanced report to the Audit Committee on the factors they have relied on in exercising their professional judgment in the course of the audit and in giving their audit opinion; the Audit Committee then report in the Annual Report on how they have discharged their responsibilities, including their oversight of the audit process; and the auditors conclude by reporting on the completeness and reasonableness of the Audit Committee's report.

We accept that there can be benefits in the auditors reporting on the Audit Committee report, as this will act as a discipline on what the report contains. We are, however, concerned that a requirement for the auditors to state that the Audit Committee report is "complete" will encourage the inclusion of unnecessary detail and so lead to much longer reports. And for there to be any certainty as to what a "complete" Audit Committee report might contain, there will have to be much greater prescription as to its contents. We would expect to comment further on this point if and when any new requirement is formulated.

As a more general point, the test for these requirements must be whether they really add value for an investor or other reader of an Annual Report. Investors are well served by the simple assurance provided by the established audit opinion. In suggesting that the audit opinion is nothing more than a pro-forma statement, the paper has missed the virtue of that simplicity which is that it confirms to shareholders what they expect from an audit.

The paper also proposes that the auditors should be required to identify any matters in the Annual Report which they believe are "incorrect or inconsistent" with the information in the financial statements or which they obtained during the course of the audit. We query whether this formulation can work. In particular:

- there is no materiality qualification (of the kind implicit in the "true and fair" opinion). Is that practical? What additional costs will be required for such an opinion to be given?

- "incorrect" is the wrong test for forward looking statements, for which one would expect a "reasonableness" standard. But we would strongly resist any requirement that auditors should give an opinion of that kind.

We note that the existing Companies Act requirement is for the auditors to give an opinion that information in the Directors' Report is consistent with the financial statements and we do not believe that there is a need for that obligation to be expanded.

The recent trend has been to adopt rules that facilitate open and transparent narrative reporting. Introducing an onerous audit requirement will significantly reverse that trend. It would inevitably have a "chilling" effect and lead to reports that are more defensive and less useful to users.

7. Safe harbour

We welcome the recognition on page 18 of the paper that directors should enjoy a safe harbour in respect of forward looking statements. However, in our view, no change is required as the liability regime effectively already provides such a safe harbour. Section 463, Companies Act 2006 provides that a director is only liable to the company for any loss it suffers as a result of any untrue or misleading statement in -

- the Directors' Report,

- the Remuneration Report or

- material derived from those reports in summary financial statements,

or because of the omission of anything required to be included in such reports, if the director knew the statement to be untrue or misleading or was reckless as to whether it was untrue or misleading, or if he knew the omission was a dishonest concealment of a material fact.

While directors may be liable to the company for such knowledge or recklessness, the section excludes liability to any other party, including shareholders, resulting from reliance on information contained in such reports.

Companies can (and many do) make sure that all of their narrative reporting is brought within the Directors Report and therefore benefits from this safe harbour. If it is thought desirable to extend the safe harbour to cover information wherever it may be included in the Annual Report (for example, the Chairman's statement), regardless of whether it may be deemed to be part of the Directors' Report, we would support that change.

Note also that s.90A and Schedule 10A, Financial Services and Markets Act 2000, referred to in section 3.2 above, provide a similar safe harbour in respect of all information published via a Regulated Information Service.

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

We accept that, to the extent these proposals go ahead, the responsibilities of the FRRP and the AIU should be extended as described.

We are unclear what is proposed by the suggestion on page 19 of the paper for a review in the event of a corporate failure and the requirement for legislation identified in chapter six to allow for an investigation to be carried out in the event of such a failure. We would welcome more detail on such proposals, including the expected costs and who would bear these.

9. **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.**

While we would welcome such a group and the opportunity to play a part in it, we believe general consultations such as this one should continue to play a major part in developing and testing policy and proposals from regulators and government. With responses to consultations being publicly available, there is a transparency as to who has said what and where ideas have come from which such a group may lack.

Similarly, with a financial reporting lab, all papers and policy proposals should be published and consulted on, with appropriate impact assessments, to ensure transparency.

10. **To whom will these proposals apply?**

The paper says that the FRC will consult further, as its proposals develop, as to the companies to which they will apply. The alternatives mentioned are: all listed companies, those in the FTSE 350 or some other grouping such as those having systemic significance.

We will respond to that consultation at the appropriate time, but in the meantime note that:

- "all listed companies" would include those with a standard listing which do not have to follow the UK Corporate Governance Code;
- companies come in and out of the FTSE 350 and so a company may be subject to different standards of regulation at different times; and
- other entities of systemic significance may differ from listed companies in not having a body of shareholders who would benefit from these proposals.