



The Hundred Group
of Finance Directors

Investor Relations and Markets Committee

Mr Stephen Haddrill
Chief Executive
Financial Reporting Council
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

By email: effectivestewardship@frc.org.uk

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Dear Stephen

Effective Company Stewardship Enhancing Corporate Reporting and Audit

We welcome the opportunity to comment on the paper *Effective Company Stewardship Enhancing Corporate Reporting and Audit* published by the Financial Reporting Council (FRC) in January 2011.

Who we are

The Hundred Group is a non-political, not-for-profit organisation which represents the finance directors of the UK's largest companies, with membership drawn mainly, but not entirely, from the constituents of the FTSE100 Index. Our aim is to contribute positively to the development of UK and International policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the view of The Hundred Group of Finance Directors as a whole, they are not necessarily those of our individual members or their respective employers.

Our views

We welcome the consultation by the FRC and the opportunity to respond on these issues. We support the objectives of the FRC to review aspects of stewardship in the UK. In particular we echo the views expressed by the FRC concerning the importance of the UK's vibrant capital markets and the pivotal role that they have played in helping non-financial companies come through the global recession better than many expected.

However, in a number of areas, we are not convinced that the FRC have identified sufficiently the case for change. In the FRC's own words 'we have established no circumstance where financial statements were materially misstated: rather corporate and financial reporting was overtaken by exceptional market conditions....Audit, by itself could not have prevented the collapse of the credit markets. That could only have been achieved if action had been taken by others responsible for macro economic affairs and prudential regulation'. In this respect, we question whether the recommendations within the report would, if in force in 2007/8, have assisted in avoiding or reducing the problems then encountered.

We have stated in a number of our recent consultation responses our view that Corporate Governance in the non-financial sector has been shown to be effective and resilient in the face of financial turmoil. We support the FRC's position that more could be done to effectively promote and explain the role of the Board and the operation of the Audit Committee, in particular to emphasise the strength of the corporate governance system in operation.

However, we do not see significant advantage in increasing the scope of the audit report over the 'front half', narrative sections of the financial statements, and caution against the risk of increased boilerplate disclosure within already extensive financial statements, particularly in light of the FRC's statement above.

We would support, however, a review of the effectiveness of financial statements in communicating with investors and other stakeholders. We are concerned over the recent trend for a number of bodies to lobby for increased disclosure within financial statements on a range of different information: Greater financial disclosure appears to be seen as the panacea to a number of current stakeholder concerns. In our view a holistic review of corporate reporting should be undertaken by one UK body, combining recent consultations by the FRC, the anticipated release of the FRC's 'cutting clutter' report, DBIS's consultations on Narrative Reporting and EC consultation responses on non-financial information within the financial statements. In addition such a review should consider the range of tools that are available to companies when communicating with stakeholders, including websites and analyst presentations. As the FRC has highlighted, there has been little, if any, fault found with financial reporting during the financial crisis, and yet something was clearly 'missing'. It is likely that reporting of risk, in a way which communicates to shareholders the risk they are taking in their investment decision, specific to the company in question, should play a role in that improvement. In our view, identifying this aspect should be the area of focus for change.

Finally, we support the proposal to increase the scope of the FRC to cover all aspects of financial reporting, including in certain circumstances, narrative reporting, provided it does not simply lead to greater volume and reduced clarity of financial reporting. Where, however, there appears to be a clear disparity between the numbers being reported and the fortunes of the company, or where significant deviations in key performance indicators from prior year remain unexplained by the directors, we believe it would be appropriate for the FRRP to question this.

Please feel free to contact me if you wish to discuss our comments on the proposals.

Yours sincerely



Robin Freestone

Chairman

The Hundred Group – Investor Relations and Markets Committee

APPENDIX: Comments on main FRC proposals and recommendations

Chapter One: Introduction

We welcome the views set out by the FRC in the introduction to the paper, and support its overall objective.

As recognised in the Paper, the current stewardship model for business has enabled enterprises to raise debt and equity in capital markets and that this has played a key strategic role in permitting companies to weather the recent financial crisis.

We support the need to identify where issues have arisen in stewardship matters and to appropriately respond to weaknesses. In our opinion the recent crisis has confirmed the strength of UK stewardship and corporate governance for the vast majority of non-financial service companies. We therefore support a proportionate and pragmatic response to the crisis.

We support the FRC's view that the stewardship of corporate assets from Boards through to investors is dependent on the provision of robust, reliable information by companies to investors and on audit assurance of that information. However this information must also be clearly focused and represent, transparently, underlying business performance; there is a growing danger that excessive information makes it impossible for investors and other parties to identify the aspects of financial reporting which are the most important.

We support the aims of the FRC to see high quality narrative reporting on strategy and risk management and to improve reader understanding of the role of the Audit Committee within the corporate governance framework. We are also supportive of considering the most effective way of communicating with investors to provide information in the most user friendly format possible.

We note the FRC's commitment to consult on the application of the proposals to all listed companies or those in the FTSE350. As a representative group of large business we do not express a view as to the extent that the proposals should be drawn across this group, but do urge the FRC to ensure proportionate application of proposals and that wider application beyond listed companies would be inappropriate.

Chapter Two: Key Recommendations

We detail our comments on these below.

Chapter Three: Narrative reporting

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

Recommendation 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.

We agree that the Annual Report should present a fair and balanced report of the directors' stewardship and that the Annual Report is the responsibility of the Board. However, we consider that these matters are already satisfactorily addressed in UK company legislation and regulation, supported by the UK Corporate Governance Code and, most importantly, are already fully understood and undertaken by FTSE 100 Company directors.

The statutory Business Review requires directors to provide a fair review of their company's business, including disclosure of the principal risks and uncertainties, and a balanced and comprehensive analysis of the performance of the business. Directors are responsible under the Companies Act 2006 for presenting annual accounts that show a 'true and fair' view, and,

among other things, for providing a business review that gives a balanced and comprehensive analysis of the development, performance and position of the company's business. Financial Statements prepared under International Financial Reporting Standards (IFRS) are intended to allow capital providers to assess 'how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources'. As such we believe that the major elements of this recommendation are already in place, and that further rules are unnecessary. The emphasis should be on driving up standards, so that more companies achieve the standards already met by companies that are already acknowledged to be very good reporters. We also note that sanctions and remedies already exist to pursue companies and boards who fall down on their obligations.

We are not of the opinion that it is necessary to have a formal or mandatory Narrative Reporting Standard and consider that the replacement of the statutory OFR by the Business Review in the Companies Act 2006 provides sufficient mandatory disclosure requirements and an appropriate framework for narrative reporting.

Recommendation 2: Directors should describe 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.

We acknowledge the comment that it is not possible for senior management of larger companies to have detailed, personal knowledge of all the activities of their business, including all the risks arising from those activities. Business, and indeed investing, by definition involves a degree of risk and it is not possible for Companies or shareholders to mitigate that risk entirely and show a return on capital. Accordingly directors use reporting systems/processes that will ensure that they are given appropriate, relevant information about the business; to understand the risks it runs; how these risks are changing (and being mitigated) and to enable them to discharge their stewardship responsibilities to shareholders.

However we are not convinced that significant change in reporting obligations is required. The Listing Rules already require listed companies with a Premium listing to have "adequate procedures, systems and controls to enable it to comply with its obligations" under LR7 (Principle 2), and the Companies Act 2006 contains requirements for maintenance of proper accounting records

If necessary, some boards may be content to provide a flavour of the processes they adopt in carrying out their functions, perhaps on their website, as a voluntary matter if they wish to do so. This could also be part of the engagement process with shareholders if they wish to have further information or assurance on any of these matters. However, directors are already accountable for the accuracy, completeness and balance of information provided in the annual report. We support the need to ensure that risks reported are specific to the organisation, and not boiler-plate.

We are concerned that requirements from the FRC to disclose details of processes to ensure accuracy of information may lead to an increase in boiler-plate disclosures which will be uninformative to investors who already understand that such appropriate controls exist.

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

We agree that the internet offers a powerful channel for the communication of corporate information and note the current requirement for quoted companies to maintain a website and to publish their annual reports and financial statements there (Companies Act 2006 Section 430). In our experience, the use of websites to communicate with our stakeholders is a more vibrant, dynamic, user friendly, tailored channel to reach out and tell a company's story. It also allows for increased timeliness and responsiveness of communications.

We also endorse improvements in the quality, and quantity, of online reporting. We do not consider that proposals to maintain information online necessarily remove the requirement for information to be kept proportionate. Cluttering up online websites is just as detrimental as cluttering up hard copies of financial statements.

We note that some shareholders, private shareholders in particular, would still welcome a printed copy, so it may be premature to fully de-regulate this requirement now.

Chapter Four: Assuring Integrity

Investors need to have confidence in the integrity of the narrative and financial information they receive in the Annual report.

We concur with the opinions set out by the FRC that integrity of information provided to investors is key to the effective operation of the capital market and the reflection that financial information and disclosures continue to grow in complexity.

We strongly support the statement that 'to be useful, disclosure must be tailored to the position of the particular company, and must not descend into boilerplate'. In our view, boiler-plate can be reduced by increased tailoring to the specific circumstances of a company – in reducing less pertinent and relevant disclosure requirements, and in accepting that judgements over relevance must be performed on a company specific level.

Confidence in corporate reporting should be reinforced by a more effective and transparent assurance regime that involves:

A quality audit of the financial statements

The FRC states that the financial crisis has given rise to considerable concern about the role and value of audit in relation to the financial services sector. However the FRC also states that they have established no circumstances where financial statements have been materially misstated within the financial crisis. In our view this vindicates the integrity of the financial statements and implies that there was sufficient scepticism shown by auditors. There is however a case that disclosures of risks facing a company need to be better communicated.

In our opinion we do not consider that the FRC has established a robust 'case for change' concerning assurance if there has been no material misstatement within the financial statements of most organisations.

Whilst we support the fact that auditors must be appropriately sceptical in their approach and select appropriate audit evidence to corroborate statements made by management, we would not endorse an approach that assumed that material error exists until proven otherwise: In the vast majority of Companies, it is management's clear intention to present financial statements which present a true and fair view.

We note the FRC's proposals for enhanced reporting to the Audit Committee, which we assume refers to the auditor's private report to the Audit Committee. In practice we note that the topics included by the FRC are commonly reported to the Audit Committee by the auditors, and that effectively operating Audit Committees should be requesting this information if it is not provided. We support formalisation of this requirement.

We would also caution that the value of the relationship between the auditors and the Audit Committee is predicated on open, robust and challenging dialogue. We would not support any proposals that would put this dialogue at risk: For example requirements to disclose details of discussions held on key accounting areas. Disclosure requirements should be helpful to stakeholders to improve their understanding but this must be balanced with

caution, so as not to change behaviours and truncate the very discussions that underpin the value of the relationships within the corporate governance structure.

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

We have previously responded to the APB's consultation on Ethical Standards and have been broadly supportive of the proposals in the recently reissued standards.

Co-operation between regulators and auditors

We agree that effective two-way dialogue between regulators and external auditors is critical in regulated sectors and in particular we support recent developments with the Bank of England and the FSA in the financial services sector. However, we are not convinced that any case has been convincingly made for widening these arrangements to other sectors.

Recommendation 3: Fuller reports by Audit Committees explaining how they have discharged responsibilities for the integrity of the Annual Report and other aspects of their remit (such as their oversight of the external process and the appointment of the external auditors)

We concur with the FRC's position that the role of the Audit Committee may not be fully understood and that more should be done to explain the workings and focus of the Audit Committee during the past financial year. However, we also stress the importance of the whole Board in operating effective corporate governance. The Annual Report, must, in our opinion, be owned by the full board and clearly identified as such. The role of the Audit Committee serves to strengthen corporate governance and should be understood in the context of the role of a single, unitary board.

We are concerned that the proposals to increase disclosures over the role and remit of the Audit Committee could lead purely to increased lengths of financial reports without improved clarity, as these are topics which could easily increase boilerplate disclosures which in turn are of limited use to investors.

Recommendation 3: An expanded Audit Report which 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.

Auditors already review the narrative elements of the Annual Report, including the Audit Committee report, to ensure that it is consistent with the information contained in the audited financial statements. We consider that this is a sufficient requirement and that further comment specifically on the report of the Audit Committee would have no further value.

We do not support the proposal that auditors be required to comment on the completeness and reasonableness of the Audit Committee Report. This will lead to further audit processes, higher audit fees and may delay annual reports being issued. In addition we are concerned that the requirement for auditors to opine on sections of the narrative reporting could lead to significant 'unintended consequences'. The ability of management to speak with one 'voice', to tell the story of the company and its governance should not be undervalued. Such proposals could well jeopardise this ability and lead to a decrease in management interpretation and insight within Annual Reports.

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

The existing UK Corporate Governance Code and associated guidance already provides for audit committees to report on their process for recommending their choice of audit firm to shareholders in considering the Resolution at the AGM. In addition, existing sections 489-491 Companies Act 2006 set out the law on appointment of auditors of public companies.

Shareholders may appoint, or vote against the appointment of, auditors by ordinary resolution at an accounts meeting (defined in section 437(3) Companies Act 2006).

Boards can also expect to discuss this, and their policy on putting the Audit out to tender, as part of their engagement process with major shareholders.

The fact is that much upheaval and little gain arises from a change of auditors, and whilst audit committees and the board will always keep the performance of the audit firm under review, the fact that a recommendation is made to re-appoint an audit firm, does not mean that such a process has not been undertaken, but merely indicates that they have seen no justification to change firms. We are strongly against any rules requiring mandatory audit firm rotation.

It is also the case that audit independence is underpinned by regular rotation of the audit partners and members of the audit team, as provided by Ethical Standards, which is our preferred approach.

Safe Harbour

We support the need for a safe harbour, if the FRC proposals are taken forward.

We note that the existing safe harbour for directors in respect of the Business Review and other reporting is set out in Section 463 Companies Act 2006, and that this is based on a test of lack of knowledge or recklessness by a director of any errors or omissions.

Chapter Five: Fostering Quality Improvements

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

We are not convinced that the recommendation that the FRC has a mandate to review to ascertain whether further investigations or regulatory actions are needed in instances of future 'corporate failure' is appropriate or necessary. There already exist powers available under various pieces of legislation such as the Companies Act 2006, Insolvency Act 2006 which provide for further investigations, regulatory action and even disciplinary action if there is a public interest concern in a case. The suggestion of providing an enhanced role for the FRC in this respect seems to be adding an additional layer of review at additional cost, so we would not support an automatic review, e.g. by the FRRP or AADB, whenever there is a corporate failure.

We would support the extension of the role of the FRRP over narrative reporting in certain circumstances, albeit narrative reporting is a much more judgemental area than those usually overseen by this body. However, where there is clearly a disparity between numbers being reported and the explanation of those numbers, or significant omission of appropriate explanation, such that the fairness or balance of reporting is open to question, it would be appropriate for such areas to be questioned by the appropriate body. However, there can be no 'checklist' of disclosures which can provide a regulator with assurance that all the appropriate disclosures have been made; indeed this can only be performed by a body that understands the business, which makes the auditors best placed to conclude on this area.

The concept of a 'financial reporting lab' where new financial reporting models and concepts could be explored, tested and trialled without liability is a good suggestion provided that it can be achieved within a cost effective, and accountable, framework.

Chapter Six: The legislative and cost implications of the proposals in the consultation paper

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Chapter Six: The legislative and cost implications of the proposals in the consultation paper

As explained above, we consider that the substance of many of the FRC proposals in the Discussion Paper are already adequately addressed in existing legal requirements, supported by the UK Corporate Governance Code.

In addition we are concerned that the cost analysis indicated by the FRC has limited detail and so it is inappropriate for us to comment at the moment on the cost / benefit of the implementation of the recommendations. Any consideration of costs must also include an estimate of the impact of changing regulation on the costs of preparers, and auditors, and the increased costs of dealing with their regulators on such issues.

Recommendation 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.

The FRC have consistently demonstrated that they are already in a very good position to determine market developments and international initiatives in corporate reporting and the role of assurance and promoting best practice.

In general we believe market participants groups to be a good idea only if such groups do not limit the due process of the consultation process. We feel that such groups work best in times of extreme crisis when a 'temperature' needs to be taken quickly and efficiently.