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By e-mail: effectivestewardship@frc.org.uk

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Dear Mr Haddrill

Effective Company Stewardship – Enhancing Corporate Reporting and Audit

We appreciate the opportunity to respond to this important consultation document issued by the Financial Reporting Council (FRC).

We agree with the spirit and overall direction of the FRC's recommendations on narrative reporting and enhanced directors' responsibilities. We also very much welcome the proposals on more expansive reporting by audit committees. We believe these will help improve the transparency to investors and other users of financial information of the scope, processes and decision-making around the external audit.

Encouraging an environment of innovation in corporate reporting is important. We support the initiative to create a 'financial reporting lab' where new innovations in corporate reporting can be developed and tested. We urge the FRC not only to sponsor and oversee the lab, but to regard it as an integral part of its activities – a place where new proposals can be trialled before being introduced on a wide-scale basis.

However, while these recommendations are welcome, we believe that more fundamental changes are needed if annual reports are to become more coherent, accessible and reliable reports on the directors' stewardship of the business.

In our view, we are at a turning point in the development of corporate reporting. Without a change in mindset and direction, we will move further towards what many already regard as a compliance-driven document, with greater standardisation around a growing but not

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coherent set of required elements. We have the opportunity to stop this trend by steering towards a model that emphasises clear, fair and balanced reporting of strategy, the business model, risks and financial reporting – while at the same time allowing companies to innovate and customise the model to their circumstances.

There is an opportunity to put corporate reporting on a different and enhanced footing – with more factually-based narrative and greater reliability – and consistent with a model where all stakeholders are actively engaged in stewardship and acknowledge their responsibilities (for example under the Stewardship Code). To achieve that aim, we consider that work should continue in the following areas:

- *Comprehensively re-examining the whole corporate reporting model* and how that model, which has been assembled piecemeal over time, can be made more consistent and streamlined. This re-examination should be demand-driven – guided by what investors need. The FRC should first work to secure an improved UK model and then use that as a platform to lead the international debate as this will ultimately need to be discussed internationally given the extent of cross-border market activity.
- *Moving to an integrated reporting model.* The debate has already started and an International Integrated Reporting Committee (IIRC) has been established. We believe these developments are important signals regarding the direction of travel of reporting. The FRC should help ensure that the UK is at the forefront of the debate.
- *Re-calibrating the audit model* to respond to these new demands and to recognise the growing importance of narrative reporting.

Such a reassessment of the whole model will take time and may necessitate changes to law and other requirements. In the meantime, we consider that there is scope for the FRC to facilitate incremental improvements in current reporting practices that will help move us towards a 'fair and balanced' corporate reporting model.

Our specific recommendations for such improvements, together with our views on each of the matters raised in the consultation document, are set out in the accompanying Annex.

We would be delighted to discuss our views further with you. If you have any questions in the meantime regarding this letter, please contact Pauline Wallace (+44 207 804 1293) or Graham Gilmour (+44 207 804 2297).

Yours sincerely

PricewaterhouseCoopers LLP

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ANNEX 1

Detailed responses to the Recommendations

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 welcome the focus on the Annual Report as a complete document. Corporate reporting is a critical part of good governance and effective stewardship. The paper is a useful reminder that issues around governance, the business model and risk are as important to a company's long-term sustainability as its financial performance. With the right flow of information - which focuses on the substance of business activity – investors and other users' understanding of business will be enhanced.

The current reporting model is complex. Today's annual report comprises many different and overlapping elements that have accumulated over time - from company law, accounting standards, listing requirements, voluntary codes, and custom and practice. As a consequence, the annual report as a whole has not been designed from the outset to be a 'fair and balanced report on stewardship' in the manner envisaged by the FRC's recommendation.

We are also concerned at the increasing gap between regulatory demands and the information needs of the capital markets and, more importantly, the information used by management to run the company and exercise their stewardship responsibility.

This recommendation would establish a clearer responsibility for consistency and flow between the front and back parts of the annual report. But, as explained in our covering letter, we think that more fundamental changes are needed to achieve the ambition of more factually-based and reliable narrative reporting with a clear linkage to the substance of the business and its risks. More 'bolt on' amendments to the current model are not the answer.

In our covering letter we suggest a number of actions that should continue in order to change the direction of the reporting model. Recognising that this will be a long-term project, we set out below areas where there is scope for the FRC to facilitate more immediate incremental improvements in current reporting practices that will help move us towards a 'fair and balanced' corporate reporting model.

Our recommendations for more immediate improvements to the reporting model

- *Review the current reporting requirements and practice* for examples of where they might be reduced, simplified or consolidated to avoid duplication of information.
- *Move standing data* from the annual report to the company's website and, where appropriate, require it to be updated on a real-time basis. (Examples of such standing data include information on the board of directors, governance structure, the terms of reference of committees, aspects of remuneration and corporate responsibility information and other statutory information.)

- *Improve the navigation through the annual report.* There should be encouragement to consider better the needs of the audience, how the information is arranged and where it should be reported in order to present the critical areas of business activity - with a focus on what is strategically important and material to the understandability of how the business is run.
- *Encourage more concise summaries.* Companies could for example produce a short executive summary in the annual report which can be read in 20 minutes, which provides the board's high-level overview of the business and its performance and a route map to all other elements of information reported. This could encourage a more cohesive and streamlined process that leverages the content from other sources (eg analyst presentations and preliminary announcement).
- *Foster an environment of innovation in reporting.* The FRC could provide guidance that de-emphasises the historical structure of annual reports (directors' report, business review, governance section, financial statements, etc) and *where* information is located in the report, and gives instead more attention to its overall cohesion, quality, accessibility and understandability.

The strategic tone for these developments needs to be set by an appropriate body such as the FRC or its Accounting Standards Board. The financial reporting lab proposed in the paper – which we fully support (see our response to Recommendation 7) – could help with experimentation and development in some of the areas listed above.

2. Directors should describe in more detail the steps that they take to ensure:
- **the reliability of the information on which the management of a company, and therefore directors' stewardship of the company, is based; and**
- **transparency about the activities of the business and any associated risks.**

We agree that directors should acknowledge their stewardship responsibilities in these areas, but we think that this would best be achieved by the directors giving a relatively short and clear statement. We do not agree that more descriptions of the *process* or 'steps' by which directors have ensured the reliability of the information are necessarily helpful.

What is needed, as discussed in our response to Recommendation 1, is a substantive change in the quality of the reporting of the business model and risks. A narrative description of the *process* by which the directors have ensured the reliability and transparency of the information is likely to quickly become 'boilerplate' disclosure. In our view, users are unlikely to regard it as enhancing their understanding of the company's business model and risks.

As explained above there is a need for a more coherent picture of strategy, business model, the board's appetite for risk, the key areas of risk, funding, and performance in annual reports (where narrative, financial and non-financial information are brought together). For example, it makes little sense to have different elements that explain how a company is funded spread across various parts of the annual report. This may be an area where the financial reporting lab could help to develop and pilot new reporting templates.

As an example, we welcome the FRC's recently announced initiative to set up the Panel of Inquiry led by Lord Sharman to identify, in the light of the credit crisis, lessons for companies and auditors addressing going concern and liquidity risks. We look forward to an opportunity to contribute evidence and views, based on our experience, to the Panel.

We would support the inclusion of a fuller going concern statement in annual reports, setting out the key responsibilities and sensitivities, and providing a clearer explanation to readers of what the going concern assumption underpinning the annual accounts means (and does not mean).

3. The growing strength of Audit Committees in holding management and auditors to account should be reinforced by greater transparency through:

- **fuller reports by Audit Committees explaining, in particular, how they discharged their responsibilities for the integrity of the Annual Report and other aspects of their remit (such as their oversight of the external audit process and appointment of the external auditors); and**
- **an expanded audit report that:**
- **includes a separate new section on the completeness and reasonableness of the Audit Committee report; and**
- **identifies any matters in the Annual Report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit.**

We fully agree with the notion of more expansive reporting by audit committees, and have been active in promoting that concept to our clients.

In October 2010, we proposed a five-point plan of actions to improve the reporting and audit models. Central to that plan is improving the transparency of the scope, processes and decision making in an audit. As auditors, we are mindful of the need to better explain to stakeholders what an audit is and what we do. But changing the audit and reporting standards around the statutory audit will inevitably take time. The most immediate way to consider giving more information is through the audit committee's governance report, where there is greater discretion over its content.

We have been active with our own clients in promoting the idea of using the audit committee's report to describe in more detail the risks of misstatement and key areas of judgment in the financial statements and the principal subjects of discussion with the external auditors. (We attach, in Annex 2, an illustrative example of how such enhanced reporting by the audit committee might look which we have discussed with our clients).

The financial reporting laboratory proposed elsewhere in the FRC's consultation document could be used to help develop and pilot such reporting. The recommendation that auditors should include a separate new section in the audit report on the completeness and reasonableness of the audit committee report is one that we believe should be explored, while recognising that developments in audit committee reporting should come first. As practice evolves and as the proposals are further developed, they should be examined to make sure there are no unintended consequences.

We support the growing strength of audit committees and, as discussed, we support the FRC's recommendations to reinforce their role. However, stewardship ultimately rests with the board as a whole. Consequently it will be useful for the FRC and stakeholders to consider also the wider subject of the audit committee's interaction with the board of directors as a whole. Much of the detailed inquiry around corporate and financial reporting and audit matters is today concentrated in a particular part of the board structure. As this part is strengthened further, the FRC should consider how the audit committee relates to the whole board, including what elements of the committee's deliberations are important to the board's overall stewardship.

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

We agree. Corporate reporting should keep pace with developments in communications and technology. We particularly welcome the broad encouragement to companies to make their annual reports searchable on the web. Ensuring that companies publish an easily searchable report in PDF or similar format might be the simplest and most effective step that the FRC could promote in this area. We also support FRC encouraging an environment of innovation, fostering the development of other tools to make corporate reporting information available to users in different media formats.

In our view, initiatives by the FRC to promote technological developments in reporting are welcome, provided that they:

- Are consistent with solutions being used for other regulatory filings of business information.
- Start with appropriate limited-scale trials, possibly involving the financial reporting laboratory suggested elsewhere in the consultation document, so that lessons can be learned before wider roll-out.
- Do not over-complicate the preparation process. (For example in relation to XBRL, it might be appropriate to begin with a very limited taxonomy of common items that investors will find particularly useful to search.)

The HMRC requirement for companies to use XBRL for tax filing will commence in 2011 and further initiatives by Companies House connected with electronic filing have been signalled. We recommend that the FRC ensure that, from the point of view of preparers, there is a clear joined-up approach to regulatory requirements for business information.

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

We agree. We support the first of the two options suggested in the paper for achieving this.

In our view, the key issue is for the audit committee, made up of independent non-executives appointed by the shareholders, to recommend the appointment of the auditors to the board. In this role the committee acts as representatives of the shareholders, who have the opportunity to ratify the appointment subsequently. We believe the audit committee provides an important mechanism to separate the appointment of auditors from undue management influence, and we are not aware of any evidence that this safeguard is not working.

The FRC's paper proposes two possible actions that audit committees could take to reinforce their decisions regarding the appointment of auditors. Of these, we believe the first option – that the committee should report on the process by which it reached its recommendation to appoint or reappoint the external auditors and the reasons for the recommendation – is the more appropriate. This would fit well as part of the fuller reports to shareholders by audit committees suggested in Recommendation 3.

The second option, which involves discussion with a number of principal investors, could result in a limited category of shareholders being seen to have an influence on appointment decisions at the expense of other shareholders.

Nevertheless, while we believe appointment decisions should rest with the audit committee, we encourage greater dialogue between investors and audit committees.

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

We consider that any proposals that would affect the scope of the FRC's powers should be further elaborated and carefully assessed, taking into account the need to have appropriate accountability to complement any extension of responsibilities and powers. Any changes to the FRC's current responsibilities should be the subject of formal public consultation processes, including a full impact analysis.

In particular, we think there is already a framework in place to allow regulatory investigations to be conducted in the case of corporate failure. It is not clear to us how any review conducted by the FRC of a company's governance, accounting and audit in those circumstances would fit with the existing investigative processes of other agencies. Any proposals to improve the method of analysing corporate failures should be based on an understanding of the current system and why changes are needed.

7. The FRC should establish a market participants group to advise it on market developments and international initiatives in the area of corporate reporting and the role of assurance and on promoting best practice.

We fully support this recommendation.

We support the idea of a market participants group to give advice and input on developments in corporate reporting, but in order for the group to be effective its mandate needs to be clearly defined. An appropriate mix of skills and experience relative to the mandate should be represented on the group. The group should be a collaborative effort with input from companies, investors, auditors and the FRC itself.

We also fully support the initiative to create a 'financial reporting lab' where new innovations in corporate reporting and assurance could be developed. It is important that the system encourages and rewards innovation undertaken in the name of increased transparency, such as the creation of pilot schemes or sites where companies are encouraged to experiment with their reporting in a 'safe environment' outside of the existing regulatory reporting model.

The priorities of the lab and its work agenda should be largely market-driven by companies and investors. In order to be successful, the lab will need to have clear terms of reference, a steering committee comprising representatives from the key stakeholder groups, and be appropriately resourced and supported in its work.

The FRC should sponsor and provide oversight of the lab's activities and should use the lab to encourage a broad scope of experimentation (for example streamlining the front-end of the annual report, improving back-end disclosures, integrating front to back, reviewing the effectiveness of remuneration reports and governance statements, and enhancing disclosures around business models and risks). There should be channels of feedback that allow developments to be shared with the market. The lab would also provide evidence with which to support any broader reporting changes, in advance of any proposals for legislative change.

We also encourage the FRC not to limit itself in the scope of the lab's work to the 'paper' annual report. It could also consider the flow of company information into preliminary announcements. As noted in our response to Recommendation 4, the lab could also be used to trial new technological advances in reporting such as reports in XBRL format.

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ANNEX 2

ILLUSTRATIVE EXTRACT FROM AUDIT COMMITTEE REPORT FOR XYZ PLC

External Audit

During the year, we:

- Reviewed the effectiveness and independence of the Group's statutory auditor; we are satisfied that the auditor provides effective independent challenge to management;
- Approved the re-appointment, remuneration, and engagement letter with the Group statutory auditor; and
- Considered the provision of non-audit services by the Group statutory auditor. Further details on this can be found on page X below.

We also discussed the planning, conduct and conclusions of the external audit as it proceeded as explained below.

We approved the auditor's group audit plan after discussion with them. They identified the following risks of misstatement of the Group's financial statements which they judged to be significant:

- Impairment of the goodwill arising on the acquisition last year of ABC S.A. which is based in Greece, following the deterioration of the economic conditions in that country.
- Revenue recognition particularly in the long-term contacts business where management assumptions and estimates are necessary.
- The realisable value of the accounts receivable from DEF Inc is dependent upon the outcome of pending litigation in the US courts.
- The Group's ultimate tax liability to UK tax in relation to the transfer of goods between members of the Group is subject to continuing negotiation with HMRC.
- The potential for breakdown in the internal controls of our recently established businesses in Eastern Europe which are growing very strongly.

We also had a discussion with the auditors of the risks of fraud in the Group.

The auditors explained to us the programme of work they planned to undertake to address these and the other risks they had identified to ensure that these risks did not lead to a material misstatement of the financial statements. Where they thought it would be effective to do so, this work included the evaluation and testing of the Group's own internal controls. They also explained where they planned to obtain direct external evidence.

We discussed these issues with them at the time of their review of the half-year summary financial statements and again at the conclusion of their audit of the financial statements for the year. As they concluded their audit, they explained to us:

- The work they had done to test management's evaluation of the value of the goodwill arising on the acquisition of ABC S.A. and why they were satisfied with the adequacy of the impairment provision made by management based on our current assessment of that business and the Greek economy.

- They had reviewed the Group's application of its accounting policy for the capitalisation of pre-contract costs whereby a threshold of £x is applied before any costs are capitalised.

- The work they had done to test management's assumptions and estimates in relation to revenue recognition in the long-term contracts business and how they had satisfied themselves that these were reasonable.

- The results of their testing of the controls in our Eastern European businesses and the issues they had found there. As described on page XX, a rectification programme is now underway to bring these controls up to the Group's standard. The auditors also explained the other procedures they had carried out, using independent external evidence to ensure that that had been no misstatement of the financial statements as result of these difficulties.

As discussed on page XX our litigation with DEF Inc and our discussion with HMRC concluded before the year-end. The auditors informed us that they were satisfied that these financial statements appropriately properly reflect those outcomes.

The auditors also reported to us the misstatements that they had found in the course of their work and we confirmed that there no such material items remaining unadjusted in these financial statements.