LAPFF Response to FRC Consultation on *Effective Company Stewardship Enhancing Financial Reporting and Audit*, 31 March 2011

Summary of consultation

- The FRC (which is an accounting regulator as well as a corporate governance regulator) has issued a consultation paper on 'Effective Company Stewardship: enhancing corporate reporting and audit'[1]. This is due to questions from politicians about the audits of banks which failed having presented accounts with unqualified audit opinions.
- The core issue of relevance within the remit of the FRC is the shift to accounting standards ("IFRS") in 2005 which omit stewardship as an accounting and hence auditing outcome. The FRC then replicated very serious errors in IFRS into "UK GAAP".
- With IFRS; capital, pay and dividends can all be based on unreliable and dysfunctional numbers. That is the antithesis of stewardship. The nub of the issue is that IFRS is not a creditor protection model of accounting and audit. Creditor and shareholder protection is dependent on accounting standards identifying losses. IFRS can actively cover up losses.
- Because the shareholder model of corporate governance is set to function on the basis of reliable audited accounts for Annual General Meetings, any distortion of capital and profit, undermines the ability to assess, not only true business position and performance, but the conduct of the AGM itself. The accounts can therefore be a misleading "manifesto" for shareholder purposes as well as legitimising imprudent value destructive behaviour.
- However this FRC consultation skirts around the accounting issue to the extent of denying a problem with accounting and audit and the key role that played in the banking crisis. The FRC seems to be using the consultation to deflect attention from its effectiveness as a regulator.

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[1] **Effective Company Stewardship: enhancing corporate reporting and audit, FRC January 2011, http://www.frc.org.uk/press/pub2485.html**

- The consultation is very weak on detail and the situation is fluid:
  - the FRC has - since this consultation - had to set up an emergency Committee of Enquiry due to “going concern” problems endemic in the banks.
  - some of the proposals in this document are not consistent with the law, or the principle of unitary boards in the Combined Code.
  - members of the Economic Affairs Committee of the House of Lords are concerned that the FRC had been captured by the Big 4 accounting firms, and that the FRC had “dropped the ball”. That committee should report this month.
  - the former head of public policy at PWC, who is also a past president of the Institute of Chartered Accountants in England and Wales has said public that IFRS were not fit for purpose, and that problem remained unaddressed (Peter Wyman, to Sunday Telegraph, 13th March 2011.).

Recommendation

- The FRC needs to come up with coherent and consistent set of proposals, to address problems with accounting standards, not piecemeal symptoms, which in so doing may create unintended consequences in the wider corporate governance system.
- The FRC has moved considerably from the Cadbury Committee position, which was entitled “The financial aspects of corporate governance”, and has instead brushed over the role played by accounting.

INTRODUCTION - THE FRC APPEARS TO BE CONFUSING CORPORATE GOVERNANCE AT A FUNDAMENTAL LEVEL

LAPFF is perturbed, given that this is a consultation from a corporate governance and accountancy regulator, that there is:

- absolutely no reference to the core function of statutory accounts for Annual General Meetings, or the requisite standard of accounts required in law for that function that stand up on a going concern basis,

- confusion in the document about the corporate governance regime that applies in both law and the FRC's own Combined Code, in respect of the roles of directors and the auditors and who is accountable to whom.

- a clear avoidance of discussing problems with accounting standards, despite it being particularly relevant in the context of annual accounts of banks, and of the accounts that were also used in prospectuses for capital raisings by banks.

Overall, the consultation paper contains several inaccuracies and irrelevancies. LAPFF notes that the FRC has the remit to ensure "confidence in financial reporting". It is difficult to see that this has been a satisfied outcome in the case of certain banks.

It would be wrong to make hasty changes to the corporate governance regime due to the unintended consequences of the radical changes that took place within the accounting standards regime.

This response is structured as follows:

1) the role of audited accounts in stewardship, the AGM and class rights,

2) banks and problems with their accounts,

3) capital and going concern, and problems with International Accounting Standards,

4) conclusions and comments,

5) answers to specific questions

1. STEWARDSHIP, ANNUAL REPORT AND ACCOUNTS, ANNUAL GENERAL MEETINGS AND CLASS RIGHTS

Audited annual accounts are prepared in order to properly discharge the business of the Annual General Meeting, thereby a “stewardship” purpose.

Not only do audited accounts provide information, but properly prepared accounts are essential to resolve various conflicts of interest in a business in first instance. These conflicts are:

- the principal/agent problem between the providers of capital (debt and equity) and the managers of it.
- the conflicts that exist between the different providers of capital, as shareholders have liability for loss, limited to their capital invested and retained reserves, creditors will then bear the remaining losses.

Because managers may make losses, or even make off with the capital, shareholders and creditors have an interest in properly audited accounts, which show whether a business is sound or not. As shareholders bear losses first, properly audited accounts that identify losses to shareholders as a class also help to protect creditors.

The proper functioning of the AGM is essential to proper shareholder oversight of companies, and that requires the presentation to it of reliable audited accounts.

Against that practical and legal yardstick there are some significant omissions and contradictions in the “Effective Company Stewardship” consultation.

The reliability of audited accounts, going concern and the AGM cycle

Unless AGMs were to turn into an active discussion about potential faults in accounts, it must be taken as read that the audited accounts are accurate. Unless they state the contrary, they are prepared on a going concern basis, and that means for a year from when the accounts are signed. The going concern opinion is sufficiently prospective to be assumed to be valid up to the period immediately prior to the next AGM.

The statutory basis of the audit is very clearly set out in case law:

> *It is the auditors’ function to ensure, so far as possible, that the financial information as to the company’s affairs prepared by the directors accurately reflects the company’s position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company’s affairs and to exercise their collective*

powers to reward or control or remove those to whom that conduct has been confided.

Case Law, Caparo, House of Lords 1990 (Also see ICAEW Audit Quality Forum, March 2006)

LAPPF is disappointed that there is no mention in the document of the role of accounts in the context of the proper functioning of financial governance and corporate governance.

The FRC consultation seems to be very different from the position of the Cadbury Committee; they recognised the proper governance and accountability flow from having proper financial reporting auditing. The FRC seems to have developed a process of corporate governance for reporting which gives inadequate outcomes due to defects in accounting standards, i.e. the tail is wagging the dog.

2. BANKS AND PROBLEMS WITH THEIR ACCOUNTS

LAPFF notes that several banks that collapsed did so well within the 1 year going concern period. Given that, and given the objectives of the statutory purpose of the audit, the statement on page 13 of the "Effective Company Stewardship" document seems somewhat complacent.

> *"we have established no circumstances where financial statements were materially misstated: rather corporate and financial reporting was overtaken by exceptional market conditions". ("Effective Company Stewardship" page 13), and:*
>
> *"There were no audit failures during the financial crisis. Nevertheless the accounting and auditing system did not do as much as was expected by people in terms of informing them".* **FRC Chief Executive, Accountancy Magazine, 1 March 2010**

But banks did not collapse due to "exceptional market conditions"; those that collapsed did so because they had already made bad loans some time earlier which the accounts did not reflect.

The "exceptional market conditions" were credit and equity markets identifying what the accounts were not showing, the scale of the bad loans. It was not market conditions that were including loans at values far higher than their recoverable amounts in banks' balance sheets. "Market conditions" in 2008 did not put the bad loans onto the books of HBOS in 2006 and 2007 that were overvalued in their accounts.

> *"Actually, if we'd had more conservative accounting then the profits and the equity of the banks would have been lower, the bonuses wouldn't have been so big; they wouldn't have loaned out so much more money. I am intrigued that when HBOS was taken over by Lloyds that, of their £432 billion loan book, Lloyds said £186 billion of that was not business that they would've wished to do. It would have been helpful, maybe it did happen, if whoever was auditing HBOS had said, "Your loan book seems to us to be rather different from the loan books that we're finding in other banks".* **David Pitt-Watson, Hermes, Evidence to the House of Lords Economic Affairs Committee, January 2011.**

Of the £186bn, £30bn (16.1%) were bad loans that needed to be written off: a sum that was several times the capital of HBOS plc and of the its banking entity, Bank of Scotland plc, which also produced audited accounts.

The going concern auditing standard

The FRC assertion "we have established no circumstances where financial statements were materially misstated" seems to depend on what the FRC means by a “misstatement”, and what is “material” and by reference to what criteria of correctness.

LAPFF notes that the FRC’s own **auditing** standard, ISA 570 does in fact cover asset values deteriorating as part of the going concern assessment:

> ISA 570 – UK and Ireland – “Going concern”, states:
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> *Examples of events or conditions, which may give rise to business risks, that individually or collectively may cast significant doubt about the going concern assumption are set out below:*
>
> > *substantial operating losses or significant deterioration in the value of assets used to generate cash flows.*

There clearly <u>was</u> a problem with the audited accounts of some banks, measured against the FRC’s own going concern criteria, unless, the FRC is stating that compliance with accounting standards protects auditors even if the statutory objective, including the going concern test is not met.

Two examples of demonstrably unreliable accounts which should have led to qualified opinions:

1. HBOS, accounts signed, 26th February 2008, with dividend declared, to be approved at AGM on 29th April 2008. Dividend then cancelled before AGM. Then rights issue announced at AGM. Rights issue then largely fails (left with underwriters). Then further capital raising backed by government. Then acquisition by Lloyds TSB. Then asset protection scheme needed by Lloyds, largely for HBOS loans.

   Losses since those accounts were signed off have been in excess of £40bn, four time greater than the last stated capital and reserves of the bank at 31 December 2007.

2. Bradford & Bingley, accounts signed, 12th February, 2008, with dividend declared to be approved at AGM on 22nd April 2008. On 14th April company denies it needs a rights issue. Rights issue then announced on 14th May 2008.

Rights issue fails. Private equity placing fails. Private placing with certain institutional investors instead. Bank nationalised September 2008.

The FRC document is not consistent with the EU position on the same subject

In our response to the EU Green Paper on audit, we noted that the EU Commission was far less categorical that there was not audit failure.

> *“Current practice would seem to indicate that the “reasonable assurance” referred to above is less targeted at ensuring that the financial statements*

give a true and fair view and more geared to ensuring that the financial statements are prepared in accordance with the applicable financial reporting framework."

EU Commission Green Paper para 6 page 2.

The EU is clearly saying that there is more emphasis on compliance with standards than delivering a satisfactory outcome.

3. CAPITAL AND GOING CONCERN AND PROBLEMS WITH ACCOUNTING STANDARDS

Accounts are prepared on a going concern basis, unless the break up basis applies, in which case that position must be properly addressed in the accounts.

A common definition of going concern is "*the ability to meet debts as they fall due*". However, that is not wholly correct. Members can decide to wind up a company solvently, creditors still get paid. However, the accounts must be prepared on a non-going concern basis. The non-going concern basis merely includes break-up costs.

In any limited liability company there is a tipping point where shareholders go from having a positive interest in the company, to a position where they do not. Shareholders will not rationally refinance if their interest in a company is negligible. It is better to earn future profits elsewhere. Shareholder support is the critical factor in a company being a going concern or not.

Assurance on whether a company is viable as a going concern is key to the AGM being conducted properly.

It is of fundamental importance to what the FRC does - to encourage the right kind of stewardship - that shareholders as a class can have confidence that if audited accounts show that the shareholders have a positive interest in company (capital and reserves), they do so in fact.

However, it is clear from the FRC's document on capital disclosures (December 2010) that the IFRS (International Finance Reporting Standards/International Accounting Standards) accounting model is not addressing capital properly. LAPFF notes that there is a systemic philosophical problem with the way in which IFRS has been scoped. It is set to exclude matters relating to capital.

Evidence of problems with accounting standards

Deloitte also says in a technical bulletin, that accounting standards were a significant factor, not merely in unreliable accounts, but driving harmful behaviour:

> *Many bodies including regulators and governments felt that banks' losses were being recognised too late due to the "incurred loss" impairment models where losses are only recognised once certain triggers are hit. It has been suggested that this approach encouraged aggressive lending practices and helped to drive down the cost of credit with high levels of interest income being booked in the good times. When actual losses occurred, many institutions did not have provisions built up and, in many cases, had insufficient reserves to soak up such losses.* ***Deloitte February 2010 – Reforming impairment and amortised cost***
> *http://www.deloitte.com/assets/Dcom-*

UnitedKingdom/Local%20Assets/Documents/Services/Audit/UK Audit Reforming impairmentandamortisedcost.pdf

The newly appointed Governor of the Central Bank of Ireland is also addressing the same issue, problems in accounting standards:

"I have already railed elsewhere against the backward-looking loan-loss provisioning practices encouraged by International Financial Reporting Standards (IFRS) and still all too pervasive in the reporting by most of the Irish banks. I find it unsatisfactory that expected losses in many parts of the portfolio are clearly higher than the provisions already taken, because I fear that this evident and in some cases explicit discrepancy may awaken doubts in the minds of investors as to the relevance of other aspects of the reported accounts". **Patrick Honohan, Governor of the Central Bank of Ireland, November 2010**

IFRS (International Financial Reporting Standards) is not a stewardship model, for class rights, it has divisive objectives

LAPFF notes that IFRS has the following attributes that mean that standards are not being set on a stewardship model:

- IFRS sets the purpose of accounts for the subjective attribute to be "useful for users". That is not only subjective but untargeted. "Users" may have selfish needs, e.g., hedge sell-side analysts, or fund managers. It is the body of members (the capital as a class) that has an objective need of stewardship,

- the IFRS model expects "users" to be sophisticated to interpret complexity in IFRS accounts. It is thus even more of a divisive model, by design,

- IFRS were and are still being set on the basis:

  - that it is not the purpose of IFRS accounts to gives assurance as to the capital solvency of companies,

  - remuneration is not a matter for which IFRS accounts are required to be reliable; yet shareholders approve remuneration based on the performance in the accounts,

- IFRS left out losses to book them as they actually arrive as specific defaults (rather than transparently making provisions at the point the risk is first borne by the company) as some users have purportedly said that this is "more useful". However this has been catastrophic in banks. The impact is that shareholders have not been shown the true capital in the banking companies or banking groups that they have been invested in, The fundamental basis for IFRS is not consistent with:

- the AGM as the controlling mechanism over companies, for which **shareholders as a class** require reliable and transparent accounts,
- the accounts giving assurance to the shareholders that the company they are invested in is in fact solvent, from which all other parties can gain assurance,
- the fundamental principle of going concern. It is difficult to see how that test can be met if the accounts do not reflect the true capital.

Shareholders cannot respond in any informed manner if the audited accounts do not show the truth. It is likely that the truth is only deduced – eventually – by the speculative/short end of the market.

LAPPF notes that there are some clear non-sequiturs in FRC thinking from the recommendations made in this consultation paper. On the one hand the FRC is praising the efficacy of audit committees in dealing with auditors (Q3) on the other the FRC is suggesting more involvement of shareholders in appointing auditors (Q5). If the former is indeed correct, it is difficult to see why the latter has been suggested

4. CONCLUSION

It would have made for a more meaningful consultation if the FRC could have been open and straightforward about problems with accounting standards (IFRS) and banks in particular.

The FRRP and ASB has tried to address the matter in its paper from December 2010 on capital disclosures. However, it has only needed to do that because the accounting standards have left it out.

It does seem a possibility that one reason that the FRC framework is not delivering as law intends, is that there have been forces within the FRC with the objective of muddying the legal framework that applies to auditors. While there are some very strong functions within the FRC, for example the FRRP, the AIU and the Governance Code team, the key problem seems to lie in the standard setting arena.

The FRC needs to come up with coherent and consistent set of proposals, to address problems with accounting standards, not dealing piecemeal with symptoms of that.

5. ANSWERS TO SPECIFIC QUESTIONS

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.

This is positive to the extent it is putting rigour into information that is currently neither in the Directors' report nor the Accounts. There is currently a requirement that auditors must ensure that what is in the Directors' Report is consistent with what is in the Accounts.

However, this can however, be read as the directors taking on stewardship responsibilities that are implicit in the auditors and directors duties **in respect of the audited accounts,** which is a stewardship function shared by the directors <u>and</u> auditors. The Institute of Chartered Accountants of Scotland document "The Future of Assurance" is clearer in outcome without having the directors "trumping" the auditors' responsibility.

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,**

It should go without saying, that the directors have to take big decisions, such as whether the company has the resources to make dividend payments by using the numbers in the audited accounts. That is part of the statutory function of accounts. The audit confirms not only the capital, but the existence of assets, such as cash. In the Parmalat case the accounts showed not only false capital but false cash of Euro 1bn.

A company has its own macro-prudential and micro-prudential systems. It is not feasible for directors to make certain decisions based on ad hoc internal information only. Directors, for example, do not seek independent confirmation of bank balances; auditors do.

If accounts are not reliable enough to affirm the key decisions of directors in discharging their stewardship obligations, it is difficult to see how they can be of any use for shareholders discharging theirs.

The FRC seems to be justifying that audited external accounts (directors) could be "unreliable" whilst management accounts (management) could somehow be "reliable". Is the FRC stating that "two sets of books exist?" There seems to be a subtle confusion of duties going on in what the FRC is saying.

Shareholders put capital in, share-capital based on audited public information, and receive and approve dividends based on audit public information.

Again, the FRC proposal seems to be requiring directors saying more, due to deficiencies in the published accounts. The issue should not be "the steps they take" to show risks, it should be a given that they are showing the risks properly.

It would have been helpful if the FRC could refer to existing statutory duties in the Companies Act by specific reference to statute. For example directors' and auditors' existing duties under Section 386 (proper records and financial control).

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 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 inconsistent with the information contained in the financial statements or obtained in the course of their audit.**

This introductory statement is legally confused. It is not the function of audit committees to "hold the auditors to account" or to "hold management to account". In law the shareholders hold the directors and the auditors to account.

The FRC position does not concur with the position of the Cadbury Committee, which was for the audit committee to assist the discharge of the duties of the unitary board. The FRC statement reads more like the function of a German Supervisory board where the law is entirely different.

The audit committee report should stand on its own. If the auditors are signing off that the accounts give a true and fair view, having the auditors commenting on the audit committee report would appear to be a potential distraction from focussing on that duty. It is creating a circularity.

The expanded audit report to cover matters inconsistent between matters in the Annual Report and the Accounts, would seem unnecessary, if what is proposed is merely applying the same rigour to the Chairman's statement and the Financial Review, as that which already applies to the Director's report. Anything else would seem to give scope for auditors to charge for more work.

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

The annual report and accounts should continue to exist in paper form.

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

This would appear to be a non-sequitur with the statement in Q3. If Audit Committees have been the strength that Q3 claims, it would seem superfluous to require more investor involvement.

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

The FRRP should primarily focus on the numbers. It has been very effective in that function. What the document describes as "the narrative content" can be so subjective, it is difficult to see how that can be regulated. The same applies to the AIU's consideration. Audited accounts should contain reliable and incisive number and words. The concept of "narrative" seems to be open to things that are not at all incisive, and could substantially undermine the effectiveness of the FRRP and AIU. The problem is the accounting standards.

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.

Accounts exist to deal with the conflicts of interest between the providers of capital and the manager, between different classes of capital providers (creditors vs equity) and ultimately the general public interest, such as that a company is not in fact a Ponzi scheme (taking in creditors/shareholders money with no return).

Different "market participants" may have different selfish aims and objectives and may be conflicted with those of the company itself. It is perfectly possible to make money out of trading shares on the basis of poor financial reporting.

Parliament has set the legal framework for establishing what the framework is and who has what "role". The term "role of assurance" could be a way of using an ad hoc, non-transparent group to undermine the function and rigour of the audit that Parliament has set out.

The FRC should be delivering to the statutory requirement of accounts of sufficient quality to discharge the business of the AGM properly. A “market participants group” would seem to confuse the matter even more.