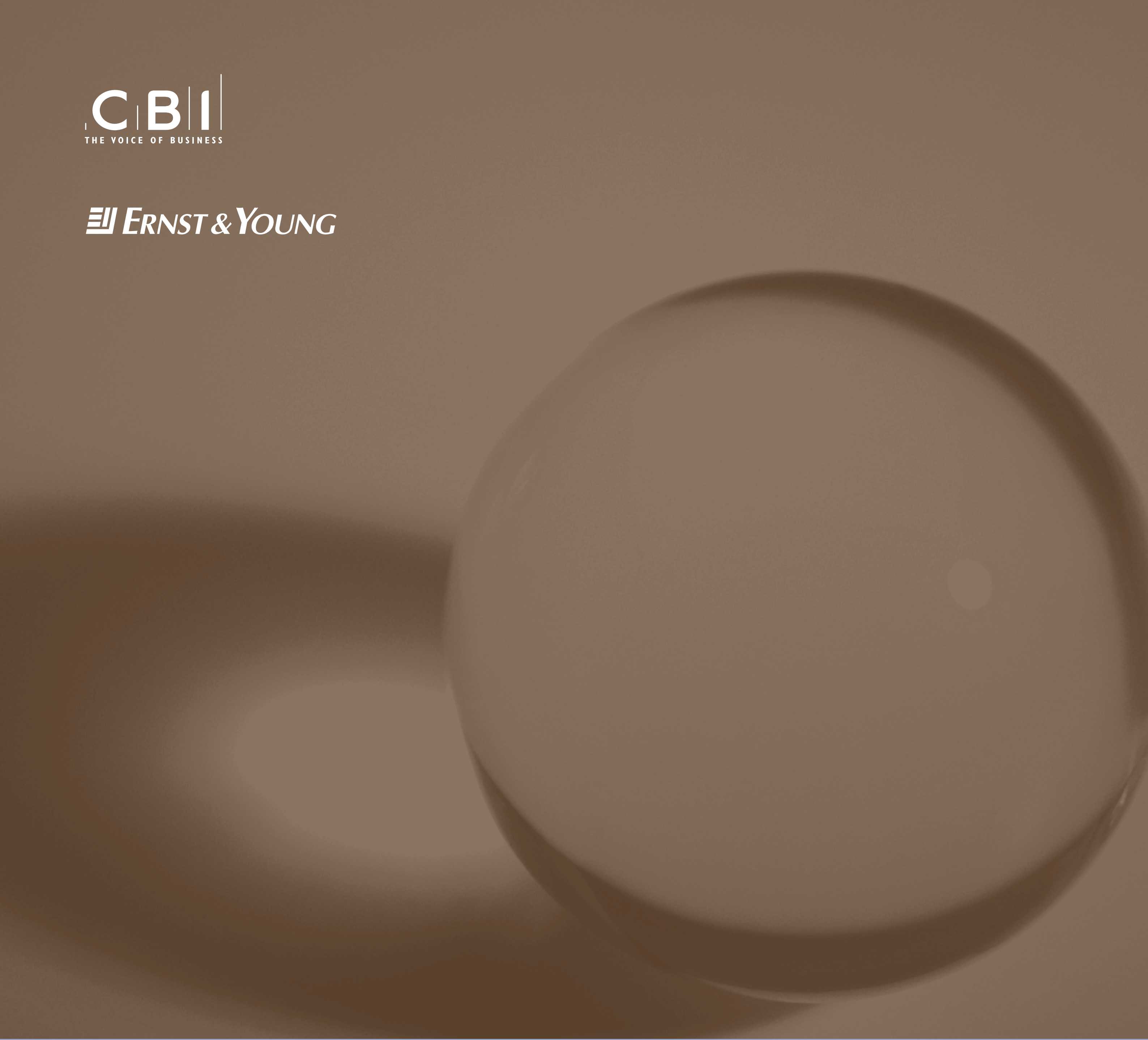

Telling a Good Story?

Meeting with Bill Knight and David Lindsell, Chairman and Deputy Chairman of the Financial Reporting Review Panel

Paper prepared for the Audit Committee Chair Forum

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The Audit Committee Chair Forum (ACCF) is convened by the CBI and Ernst & Young and is facilitated by Cranfield University.

The Forum comprises a select group of audit committee chairs from the UK's leading companies. Our aim is twofold, namely:

- to influence the direction of regulation as it impacts audit committees, and
- to act as a vehicle to develop points of view and best practice.

The Forum provides an opportunity to contribute to the debate, influence its direction and improve the performance of audit committees.

The Forum is currently chaired jointly by Richard Wilson, Senior Partner at Ernst & Young, and Helen Alexander, President of the CBI.

This is the eleventh paper produced by the ACCF. Previous papers include:

- The role and function of the Audit Committee
- The drivers of audit quality
- What is an effective audit and how can you tell?
- Audit Committee regulation: 'Financial literacy' – what does it mean?
- Audit Committee communication: What is said, why, how and to whom?
- The role of the Audit Committee in risk management
- The role of the Audit Committee regarding non-audited information
- The Audit Committee and the credit crunch
- Risk management in a cost-cutting environment
- A Conversation with a Regulator: Meeting with Paul Boyle, Chief Executive of the Financial Reporting Council

To obtain copies or learn more about the ACCF please contact the Forum Secretary, Caroline Das-Monfrais at the CBI, ***caroline.dasmonfrais@cbi.org.uk***

Executive summary

- The Panel's role is to ensure that company accounts comply with the Companies Act and accounting standards. In doing this, it reviews the accounts of about 300 listed and larger companies every year.
- Questions are only asked of companies if the reviewer, who will have hands-on experience of financial statements, believes that a treatment is unclear or misleading, or wrong. The Panel does not go on "fishing expeditions".
- The Panel reviews only published financial information; it will not 'pre-clear' proposed treatments for companies.
- The focus of the Panel is on the presentation of the information, not the judgements and valuations that underlie the published numbers. No attempt is made to second-guess the directors and auditors on matters of judgement.
- Company accounts and narrative reporting should be clear, and present a picture of the business that is understandable to an intelligent and informed reader. The growing complexity of financial reports has made this more difficult.
- The business review should include a discussion of the principal risks and uncertainties faced by a company. Often, this becomes a comprehensive listing of potential risks, with insufficient indication of priorities. The Panel encourages companies to be more discerning about what they report and how they report it.
- The Panel operates with fewer people than its international counterparts, and with a much lighter touch. Nonetheless, there was much discussion about whether its means are cost-effective and its outcomes are value-adding.

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Introduction

This paper reflects the discussions at a meeting of the Audit Committee Chair Forum (ACCF) held on 8th June 2009, which was addressed by Mr Bill Knight and Mr David Lindsell, respectively the Chairman and Deputy Chairman of the Financial Reporting Review Panel ("FRRP" or "the Panel").

The meeting was attended by 11 chairs of the audit committees of leading companies, two representatives of the CBI, and four partners from Ernst & Young.

The Financial Reporting Review Panel

> *"I've been impressed over the last five years at the standard of accounting and the way people conduct their business." (FRRP)*

> *"The 2008 financial statements of banks are significantly more transparent than 2007. Partly as a result of our efforts, I believe." (FRRP)*

The Panel was established in 1990 as part the Financial Reporting Council. Its role is to ensure that companies' accounts and financial and other reports comply with the law and relevant reporting requirements. Since 2006 this has included a review of directors' reports. Although in theory it covers all companies, the Panel's main focus is on the accounts of listed and larger companies.

The Panel is a relatively small body. As well as the Chairman and two Deputy Chairmen there are about half a dozen staff and a group of volunteer members, all of whom have extensive hands-on experience as preparers or auditors of financial statements.[1]

The way in which the Panel approaches its work is set out in detail in its Operating Procedures. A brief outline of its procedures for reviewing reports issued under the Companies Act 2006 is included as Appendix 1.

1 *A list of Panel members is available at http://www.frc.org.uk/frrp/about/board.cfm*

The Panel's approach

What the Panel does

"Have a look at those accounts and see if they tell the story" (FRRP)

In any year the financial reports of approximately 300 companies are selected for review. Some of these are selected by the Panel, using risk-based criteria such as sector, company-specific activity, and governance record. Others are reviewed following complaints received by the Panel about a particular company's presentation, which is then investigated. Complainants' identities are never disclosed by the Panel, which encourages users of accounts to contact it with their concerns.

"Complaints, unfortunately, are quite low." (FRRP)

Only if the initial reviewer sees a potential question is the matter is pursued further; this applies to approximately one third of the reviews. Appendix 2 gives details of the Panel's activity during 2006/07.

Unlike the equivalent bodies in other countries (e.g. the SEC in the United States) the Panel does not go on "fishing expeditions". Any questions asked of the companies are specific, and relate to a matter in the annual report that appears to be non-compliant.

Box 1 sets out the Panel's explanation of its role and powers.

Box 1 – About the Panel

The Panel seeks to ensure that the annual accounts of public companies and large private companies comply with the requirements of the Companies Act 2006 and applicable accounting standards.

The Panel can ask directors to explain apparent departures from the requirements. If the Panel is not satisfied by the directors' explanations it aims to persuade the directors to adopt a more appropriate accounting treatment. The directors may then voluntarily withdraw their accounts and replace them with revised accounts that correct the matters in error. Depending on the circumstances, the Panel may accept another form of remedial action - for example, correction of the comparative figures in the next set of annual financial statements. Failing voluntary correction, the Panel can exercise its powers to secure the necessary revision of the accounts through a court order.

http://www.frc.org.uk/frrp/about/

The FRRP is regarded by many companies as a deterrent, discouraging them from publishing financial reports which could be regarded as unclear, misleading or factually incorrect. Its value or contribution to the capital markets is generally viewed in this way, as a means of prevention rather than cure.

On average, about 80% of the Panel's initial queries to individual companies are answered satisfactorily. In the remaining 20% of cases, the Panel requests a correction or a re-issue of the information. If a company chooses not to cooperate, the Panel's ultimate sanction is a referral to the Court to obtain a revision of the accounts; this has never been needed.

One problem faced by the Panel is the long timescale between a company's year end and the Panel's review. Although preliminary statements may be made relatively quickly, the published accounts reviewed by the Panel will be received several months after the year end. Add to that the time taken for the review, and for any questions to be answered, and one can see why it is often more appropriate to make a correction in the subsequent period's report rather than re-issuing the one under review. The Panel is looking to accelerate the publication of its annual activity reports.

An aspect of company reports which raises many Panel questions is the business review. Although its purpose is to explain the business, and its principal risks and uncertainties for the year ahead (see Box 2), the Panel believes there is scope for most companies to improve the content and presentation of their reviews.

Box 2 – The Business Review in the Directors' Report

(2) The purpose of the business review is to inform members of the company and help them assess how the directors have performed their duty to promote the success of the company.

(3) The business review must contain:
  (a) a fair review of the company's business, and
  (b) a description of the principal risks and uncertainties facing the company.

(6) The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include:
  (a) analysis using financial key performance indicators, and
  (b) where appropriate, analysis using other key performance indicators.

Extracted from s.417, Companies Act 2006

The FRRP representatives and several of the audit committee chairs expressed the view that in many companies the business reviews do not tell a coherent story. Written by lawyers, they set out a long list of possible business risks with the aim of avoiding any future litigation from someone claiming that they were misled by an omission. This does not clarify the business model to the reader.

> *"People should say what the business model is – where they make their money. And sometimes, you can't tell." (FRRP)*

If the underlying business model is not clear from the published report and accounts, the Panel will pursue the matter with the aim of getting, as one of the audit committee chairs phrased it, "simple, honest statements around performance and outlook" of the business.

Of course, not all of the Panel's questions relate to the narrative of the business review. Many arise from the detail of the financial accounts and notes. Here, in addition to compliance with the standards and regulations, the Panel is looking for a presentation that makes sense to an intelligent and informed reader.

"If we didn't understand it, we say to ourselves it normally means the ordinary reader wouldn't understand it." (FRRP)

"I don't see why someone should be an oil and gas specialist to understand an oil and gas company's accounts." (FRRP)

Overall, the Panel takes a 'light touch' approach, like much of the rest of the UK's principles-based governance regime. The aim is to determine the drivers of poor reporting, and to eliminate these for the future rather than to act in an adversarial manner against companies.

For example, in December 2008 the Panel announced its intention to review impairment disclosures, and notified a number of listed companies in advance that their accounts would be subject to this review. Although this approach was a departure for the FRRP, the aim was to encourage higher standards of reporting. The audit committee chairs expressed their support and appreciation for the Panel's constructive approach towards this issue.

What the Panel doesn't do

"If the underlying accounting in all sorts of areas was poor, the Review Panel would not pick it up. Because we do not re-audit." (FRRP)

"… we do not substitute our judgement for that of the directors and auditors." (FRRP)

The fact that a set of financial statements is apparently in compliance with reporting regulations does not mean that it is 'right'. Any informed reader is very aware of the judgements and assumptions that underlie the numbers that are presented. The Panel has no information beyond that disclosed in the financial statements, and makes no attempt to second-guess the company's directors and auditors about those judgements.

Although it does not criticise companies with the benefit of hindsight about economic events, in some recent cases the Panel has argued that the risk disclosures in companies' business reviews should have included more information about the impact of the credit crunch and recession, as these are matters which could and should have been considered at the time the accounts were being prepared.

The Panel's work is concerned with the presentation of the financial report and accounts. However, it does not operate any system of 'pre-clearance' for companies wishing to seek advice on a particular presentation. Being a very small body of people, there is no capacity for such pre-clearance. Accordingly, the Panel reviews the information once it has been published, not before.

Financial Reporting Standards

"It's a Standards problem." [2]

"The Panel may or may not create an unnecessary burden, but the standard-setters are creating the overhead."

Inevitably in a discussion about financial statements, much of the conversation related to the financial reporting standards. It was generally agreed that financial reporting has become ever more complex, and financial statements are more difficult to understand, both for experts and for those with less training. This brings its own problems for clear presentation.

"The man on the Clapham omnibus doesn't stand a chance, does he!"

The introduction of International Financial Reporting Standards brought with it added uncertainties in preparing useful financial information, as companies began to adapt to the new standards. The Panel had anticipated that the IFRS would lead to its workload increasing, as companies disputed its interpretation of treatments under the new standards. In fact, the opposite took place: because the treatments were all new, companies had no entrenched views as to what should be done, and the advice offered was generally appreciated.

"Getting it right first time is a big thing. Most companies get it there or thereabouts first time, and improve it the next year." (Ernst & Young)

The FRRP representatives noted the challenges caused by IFRS, but pointed out that they do not set financial reporting standards. Although they have contact with the standard-setting bodies, the Panel's work by its nature tends to be backward-facing, looking at financial statements prepared under the last set of standards rather than considering forthcoming ones.

One initiative referred to at the meeting was the recent publication by the FRC, Louder than Words, which is the output from their project on reducing complexity in corporate reporting. Box 3 gives details.

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2 Quotes that are not attributed were made by audit committee chairs.

Box 3 – FRC Project on Complexity in Corporate Reporting

LOUDER THAN WORDS: PRINCIPLES AND ACTIONS FOR MAKING CORPORATE REPORTS LESS COMPLEX AND MORE RELEVANT.

[The paper] is intended to remind all of those involved in corporate reporting that it is what we all do in practice that affects the quality and readability of corporate reports.

The paper seeks to address growing concerns about the complexity of corporate reporting. Many people point to the increasing length and detail of annual reports – and the regulations that govern them – as evidence that we have a problem.

The paper recommends a commonsense approach to reducing complexity based on eight guiding principles – four for better communication in reports and four for improving the quality and effectiveness of regulations. It also recognises that there is no easy solution and that change will only happen if all of those involved in corporate reporting make a concerted effort.

http://www.frc.org.uk/press/pub1994.html

It was pointed out by several of the audit committee chairs that the analyst community is generally against any initiative to reduce or simplify disclosures, as this might remove information that was of use to them. However, the view was expressed that many of the disclosures currently required are unlikely to be used in company analysis.

International comparisons

> *"The SEC publishes its correspondence, and as a result corporate lawyers get busy." (FRRP)*

As stated earlier, the Panel is a small body compared to some of its international peers, and has fewer investigatory powers than they do. It relies on a principles-based approach to reviews and regulation, rather than putting an emphasis on rules and enforcement.

There was some discussion concerning the relative merits of the different approaches internationally, and all agreed that the UK approach seemed more useful than the bureaucratic and somewhat adversarial systems elsewhere. The equivalent bodies in the USA and parts of Europe are much bigger than the FRRP and have the manpower and authority to go on fishing expeditions to see what is underlying the accounts. Furthermore, the legal system in the USA is such that companies will almost always restate their financials if the SEC makes an objection about them, in order to avoid any future litigation.

Value for money?

"Just your existence is a regulatory burden."

"We used to live in an environment of comply-or-explain. Now, it's comply-and-explain, which has doubled the size of the accounts."

The need for having a Panel at all was challenged by some of those present, who took the view that it added a regulatory burden to companies, which was greater than any benefit provided to shareholders and markets. Whilst it was accepted that the Panel is run at a lower cost and with less intrusion than other regulators internationally, the argument put forward by some audit committee chairs was that the accounts are prepared by experienced staff and audited by independent professionals, which should suffice.

"Everything you read has been signed off by the great and the good; all highly paid and very competent, with massive technical departments... Aren't we entitled to rely on them?"

There was a lot of discussion abut the extent to which the Panel added value. The FRRP representatives, and some audit committee chairs argued that it did serve a useful purpose, and that its activities were proportionate and targeted. [3]

Examining the right documents?

"Analysts rely on the CFO's unaudited and unreviewed presentation."

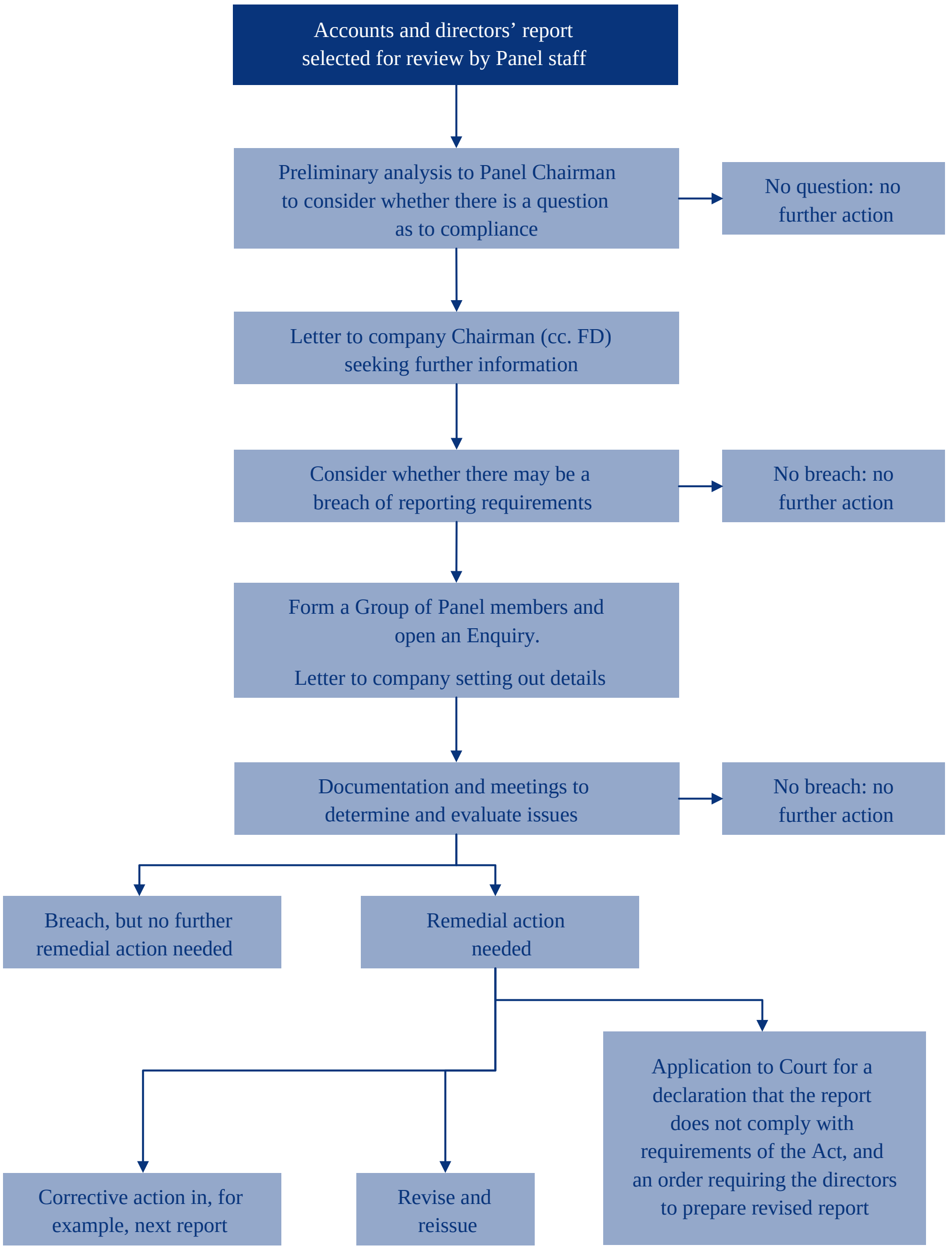
In discussing the nature and value of the Panel's work, the meeting commented upon the fact that by the time the financial statements are published, most of the analysis of the company's performance has already been undertaken. The analyst and shareholder communities pay considerable attention to the preliminary statement and investor presentations, after which the final publication of the accounts is somewhat of an anti-climax. This being the case, the argument was made that the Panel's work is perhaps less important than it first appears.

3 *There is no independent research which assesses the full impact of the Panel. However, a useful review which suggests that the Panel is a well-respected regulator improving accounting compliance is included in an ECGI working paper "Non-Enforcement Led Public Oversight of Financial and Corporate Governance Disclosures and of Auditors" by Kathryn Cearns and Eilis Ferran. This can be downloaded from http://ssrn.com/abstract=1111779.*

Questions to ask yourself?

1. Did our last set of published financial statements ‘tell the story’ in a clear and intelligible way?
2. What could we do to improve the clarity and presentation of our financial information?
3. Does the discussion of risks in the business review reflect our concerns as a board?

Appendix 1
Outline of FRRP Operating Procedures for Reports Issued under the Companies Act 2006[4]



4 *Summarised by the author from*
http://www.frc.org.uk/images/uploaded/documents/FRRP%20Operating%20procedures%20-%20August%202008.pdf

Appendix 2
Extract from FRRP activity report covering the year from 1 April 2006 to 31 March 2007

Analysis of Company Reviews

	FTSE 100	FTSE 250	Other listed	AiM	Third Country	Unlisted public and private	TOTAL
Accounts reviewed							
Annual	52	41	81	49	15	36	274
Interim	6	25	3	3	-	n/a	37
Selected by the FRRP							
Annual	46	33	74	42	14	21	230
Interim	5	25	2	4	-	n/a	36
Complaints/referrals							
Annual	6	8	7	6	1	15	43
Interim	1	-	1	-	-	n/a	2
Approaches to companies							
Annual	18	24	46	24	4	12	128
Interim	1	4	1	1	-	n/a	7
Groups established							
Annual	1	-	1	1	-	1	4
Interim	-	-	-	-	-	-	-
Improvements							
Annual	14	21	34	13	2	5	89
Interim	-	4	1	-	-	n/a	5
Continuing							
Annual	1	1	5	10	2	5	24
Interim	-	-	-	-	-	-	

311 reports were reviewed in 2006/7, compared to 284 in the previous year.

The Panel selected 266 reports for review in accordance with its risk-based approach. The remaining 45 came to the Panel's attention through complaints, referrals from other regulators or in connection with matters raised in the financial press.

Of the reports reviewed, 135 (43%) resulted in approaches to companies. This compares to 82 (29%) in the previous year.

At the time of publication of the Activity Report, all but 24 of the 2006/7 cases had been concluded. Of the 135 companies approached, 94 voluntarily undertook to provide corrected or improved treatments or disclosures in their next accounts.

The Panel's Activity Report for 2008 has not yet been published.