The Hundred Group
of Finance Directors

Investor Relations and Markets Committee

By email: codereview@frc.org.uk

Mr Christopher Hodge
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Dear Mr Hodge

Revisions to the UK Corporate Governance Code, Guidance on Audit Committees and the UK Stewardship Code

We welcome the opportunity to contribute to the debate on the future of UK Corporate Governance. The amendments you propose to the Corporate Governance Code represent, in our view, the biggest changes for many years and as such have the potential to significantly impact the current governance procedures in place for many of our members.

Who we are

The Hundred Group represents the views of the finance directors of FTSE 100 and several large UK private companies. Our member companies represent almost 90% of the market capitalisation of the FTSE 100, collectively employing over 7% of the UK workforce and in 2011, paid, or generated, taxes equivalent to 13% of total UK Government receipts. Our overall aim is to promote the competitiveness of the UK for UK businesses, particularly in the areas of tax, reporting, pensions, regulation, capital markets and corporate governance.

Our views

We have set out below our detailed comments on the proposed changes to the Corporate Governance Code and the Guidance for Audit Committees. We agree with the sentiment behind the proposed changes to provisions C.1.3 (which appears to be aimed at countering the perception that the narrative section of the report has become too much of a "marketing" document) and to provision 3.6, which is intended to address the perception that the auditor's independence becomes increasingly impaired over the duration of the audit contract. We should add, that whilst there may be a concern over perception, in our experience the safeguards in place ensure that there is no issue in practice.

We would welcome further clarification on three specific aspects of these proposed changes:

- In implementing provision C.1.3, whether the Board is expected to provide a commentary on the *process* it has undertaken to ensure that the report is 'fair, balanced and understandable' or rather provide a more qualitative discussion. If we

understand the provision correctly, in either case we struggle to see how this will result in more meaningful information being provided;

- A clarification on how to benchmark ‘understandable;’ recognising, hopefully, that users of accounts are by definition a fairly astute audience; and

- In assessing compliance with provision C.3.6, precisely what constitutes an audit “tender.”

These queries are explained in more detail in the attached response.

In addition, we are concerned that the enhanced role for the Audit Committee set out in provision C.3.2, which requires the Audit Committee to specifically advise the Board on whether the report is ‘fair, balanced and understandable,’ has the potential to undermine the unitary board structure, whilst also resulting in increased circular reporting.

Already the auditor relies on representations from the Board and the Audit Committee relies to a certain extent on the Auditor: Now the Board will be specifically relying on the Audit Committee. We urge that this provision is reconsidered in the light of the Board’s overall responsibilities and its critical role in achieving and sustaining strong corporate governance. We agree that there is a role for the Audit Committee, but in our view its more appropriate function is in reviewing the process for the preparation of the Annual Report, leaving the overall judgement on whether the report meets the defined criteria to the Board as a whole.

In relation to provision C.3.7, we recognise the desire for a more informative Audit Committee report. However the key estimates and judgements that the Directors make in overseeing and assessing reporting of their financial information are already required to be disclosed in the financial statements by International Accounting Standards. To require the Audit Committee to also report on the significant issues it considered in relation to the Annual Report is likely to result in a duplication of the existing disclosure.

We support the changes being proposed to the UK Stewardship Code, although in our view the revisions as currently drafted represent a missed opportunity to codify aspects of effective company stewardship, particularly in relation to the use of proxy advisors. Again, we set out our detailed recommendations below.

Finally, we strongly support the FRC’s objective in improving the already high standard of UK Corporate Governance in anticipation of possible EU legislation being issued later in 2012 and we would welcome the opportunity to engage further with the FRC to discuss our views and recommendations. It is in all our interests to continue to develop and demonstrate the success of the UK’s current comply or explain approach to corporate governance, as opposed to the more legislative framework often proposed by EU bodies.

Yours sincerely

Robin Freestone
Chairman
Hundred Group: Investor Relations and Markets Committee

Revisions to the Corporate Governance Code and Guidance on Audit Committees

C.1.3 The directors should set out in the annual report the basis on which they consider that:
- **the report is fair, balanced and understandable; and**
- **provides the information necessary for users to assess the company's performance, business model and strategy.**

We agree with the overall objective underlying this provision, which is to counter the perception that the narrative section of the Annual Report has become influenced by a desire to paint the company in the most favourable possible light.

The integrity of the information provided in the narrative section is key to supporting the effective operation of the capital markets and we fully support a management commentary that is consistent with the financial statements. To achieve this, the Directors should go beyond ensuring that where the same financial metrics are quoted in the narrative report they are aligned with the financial statements and apply the same rigour to the presentation of key messages, use of terminology and coherence of information.

In assessing how the Board should comply with this provision, it is not altogether clear to us whether the revised Code is seeking a commentary on the process the Board has undertaken, or a more qualitative discussion.

If the intention is for a more qualitative discussion, we would expect this provision to be fulfilled by the narrative report itself being presented in a manner consistent with a 'fair, balanced and understandable' assessment, whilst also containing the information necessary for users to assess the company's performance. We would therefore welcome clarification as to what additional reporting this provision is seeking for narrative reports. It is, after all, already a requirement that directors 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. Is it simply required that Directors now confirm their belief that this requirement is being fulfilled?

Any additional narrative that is focussed on disclosing the process the Board has undertaken to asses that the narrative section is fair, balanced and understandable is likely, in our view, to result in the addition of further meaningless information into a report that is already cluttered with process descriptions. Users of the financial statements consistently tell us that extensive commentary on process adds little to their understanding of the performance or prospects of the company whilst in fact serves to obscure the key messages that management is seeking to make. As preparers, we are also conscious that adding additional processes to the work of the Board Committees during a results season can have significant implications for the efficient functioning of the wider organisation and can ultimately deflect from a dynamic and involved engagement with the actual materials which are the subject of the review.

We recommend that further guidance is issued to supplement this proposed change to the Code to clarify the requirement, whilst also taking the opportunity to explain the benchmark against which the Board assesses whether the report is 'understandable.' Key to making this assessment is determining who are the primary users of the financial statements and what level of knowledge they possess – in our view, the primary users are consistent with the definition of the International Accounting Standards Board (IASB) as comprising *existing and potential investors, lenders and other creditors who are unable to require information to be reported directly to them (IASB's Conceptual Framework for Financial Reporting, paragraph OB2)*. In making this assessment we consider that the users are familiar with the regulatory

environment which governs the company's reporting and so benchmarking 'understandable' should be seen in this context.

C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- **to advise the board on whether the annual report is fair, balanced and understandable and provides the information necessary for users to assess the company's performance, business model and strategy.**
- **to report to the board on how it has discharged its responsibilities**

We agree 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 financial year under review.

Under the UK's unitary board structure, the responsibility for the Annual Report lies with the Board as a whole. We are concerned over the suggestion that the Board should rely on the advice of the Audit Committee in judging whether the Annual Report is 'fair, balanced and understandable' as this has the potential to undermine the unitary board structure and neglects the importance of the entire Board in the operation of effective corporate governance. We strongly believe that the Annual Report should be owned by the entire Board and clearly identified as such – the Audit Committee's role serves to strengthen corporate governance and should be understood in the context of the role of a single, unitary board.

We agree that the Audit Committee has a specific role in reviewing and advising the Board on the more specialised areas of the financial statements and related matters. However we do not consider it necessary or appropriate for the Audit Committee to take on the more general responsibility that is implied by this provision. To ask it to do so may lead to the unintended consequence of creating an implied reliance by other Board members on the Audit Committee's review and hence reduce the scrutiny of the Annual Report by other Board members with relevant knowledge and expertise.

We also point out the potential for this recommendation to reinforce the circular reporting that already exists to a certain extent. Already the auditor relies on representations from the Board in forming its opinion and the Audit Committee relies on the auditor's report. Under this recommendation, the Board will be specifically relying on the Audit Committee for aspects of its representations to the auditor.

We urge that this recommendation is reconsidered in the light of the Board's overall responsibilities and its importance in achieving strong corporate governance outcomes. In particular we recommend that it is clarified that the Audit Committee's more appropriate role, given its non-executive nature, is to provide review and challenge as to the whether the Annual Report is fair, balanced and understandable, taking into account the process the Board has undertaken in its preparation, leaving the overall judgement on whether it meets the defined criteria for the Board as a whole to make.

C.3.7 A separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include:

- **the significant issues that it considered in relation to the financial statements, and how these issues were addressed;**
- **an assessment of the effectiveness of the external auditor and the approach taken to the appointment or reappointment of the external auditor, including the length of tenure of the current audit firm and when a tender was last conducted; and**
- **if the auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded.**

The Annual Reports of our members already include a section on the work of the Audit Committee, which typically covers reporting on the auditor appointment process, the tenure of the auditor and the independence safeguards that are in place to ensure the auditor's objectivity. We do not object to a further disclosure of the time period since a tender was last conducted (subject to the comments we make in relation to recommendation C.3.6 below).

We also recognise the desire for a more informative Audit Committee report although struggle to envisage in practice what the report on the 'significant issues considered as part of the audit' would add to a users' understanding of the financial information when International Accounting Standards already include a requirement to disclose the key judgements and estimates that have been made in the preparation of the financial information.

This accounting standards' requirement already recognises that the preparation of the financial information requires the Directors to make significant judgements and estimates (a fact that is often overlooked by those who assume the financial statements are merely an aggregation of the information already contained within the company's IT accounting system). To require this information to be replicated in the Audit Committee's report would result in duplication of information and a report that becomes excessive in length, serving to obscure the other key messages being presented.

We should add that under the current framework, if a particular judgement or estimate falls outside of an acceptable range defined by accounting standards, the result would be a qualified auditor's report. To the extent that the judgement or estimate is within the acceptable range we do not understand how a discussion of the alternatives that could have been considered could do anything other than undermine the Directors judgement, which has after all been made in the full knowledge of the company's particular circumstances. It may also result in the disclosure of information that would be prejudicial to the Company's business.

C.3.6 FTSE 350 companies should put the external audit contract out to tender at least every ten years.

We strongly believe that the right to appoint, evaluate and determine the tenure of auditors should be retained by shareholders and consequently we would object to any proposals which introduce mandatory audit firm rotation. In our view, such a move would risk a reduction in audit quality in the initial and final years of the appointment. The inevitable reduction in audit quality that would result from mandatory rotation could only be alleviated

by increased audit fees during the transition years – a cost which very few investors have expressed a desire to incur.

As such, we do not object to the principle of a provision that recommends audits should be tendered (rather than rotated) after a set engagement period, recognising that those companies who did not tender their audit after this period have the option of providing their shareholders a robust explanation as to why they did not.

It remains our strong view that the issue this provision (common with the regulators in other jurisdictions) is attempting to solve is one of perception, which in our experience bears no resemblance to the reality of the challenging relationship our members have with their auditors. To suggest that there is a real issue with auditor independence is to fundamentally misunderstand the reality of the working relationship between the company and the auditor, where there is no incentive on either side for the auditor to conduct anything other than a robust, high quality, independent audit. We do not recognise, and have seen absolutely no recent evidence of (so called) 'institutional familiarity' and in our view, the regular rotation of audit partners (every 5 years) is sufficient to maintain an independent and robust audit. In our experience, this is complemented by the regular rotation of senior audit staff, which although not mandated, is a common feature of audit engagements in practice.

In taking this provision forward, we recommend the FRC considers:

1. issuing guidance to clarify what constitutes an audit tender. Many of our members, rather than going to full tender, will "market test" their audit fees using independent benchmarks and use these as a basis for fee discussions with their current auditors to obtain a competitive audit fee. Assuming that companies are satisfied with the qualitative aspects of auditor performance and efficiency, this approach is seen by many to deliver a similar outcome to tendering the audit, while avoiding the significant cost and non-financial administrative burden of an audit tender.

2. Removing the reference to a specific time period between tenders, as its inclusion undermines the independence of the Audit Committee. Whilst we acknowledge that the Code is applied on a 'comply or explain' basis, in reality the interpretation of this provision is likely to introduce automatic tendering every ten years.

   Provided that the Audit Committee report properly addresses the second bullet of provision C.3.7, the frequency of tendering should remain a decision for the Audit Committee, recognising that there may be circumstances when to tender on the 10th anniversary may not be the most appropriate course of action for the company (for example if the company undertaking a significant transaction) and to avoid lengthy compliance statements having to be given. We prefer that the time period is either removed altogether, or, at a minimum, replaced with a time band (for example within 10 – 15 years).

3. Providing more initial flexibility in the transitional rules (for example a period of three-five years for compliance), so that an implicit mandatory tender is not automatically required in the year following adoption of the Code for any company that has not tendered its audit since 2000. We consider that this would avoid the potential for significant non-compliance in year following transition, where companies and their Audit Committees do not consider it necessary or appropriate to immediately put their audit out to tender, following the revised Code becoming effective.

Finally, we are cautious over proposals to require companies to report a year in advance of their plans to tender. We believe that more flexibility is required in this regard, particularly as it is not uncommon for a company's circumstances to change such that a planned tender may need to be postponed.

Revisions to the Stewardship Code

Stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, remuneration and corporate governance, as well as voting. Engagement is purposeful dialogue with companies on those matters as well as on issues that are the immediate subject of votes at general meetings.

Institutional investors' policy on stewardship should disclose how the institutional investor applies stewardship towards the aim of enhancing and protecting the value for the ultimate beneficiary or client.

This disclosure should be posted on the institutional investor's website, or if it does not have a website in another accessible form.

The statement should reflect the institutional investor's activities within the investment chain as well as the responsibilities that arise from those activities. In particular, the stewardship responsibilities of those whose primary activities are related to asset ownership may be different from those whose primary activities are related to asset management or other investment-related services.

We support the changes being proposed to the Code as described above, and note that good stewardship will become increasingly important as the role of shareholders is expanded to include binding votes on remuneration reports. In our view, the Code could be improved by specifically covering the following key aspects of effective stewardship:

- Investors should be open and unambiguous about their total financial interest in a Company, including holdings through derivatives, nominee holdings and short positions.
- Investors should be open and clear with management on their attitudes to the Company, including differences of view between asset managers and their compliance functions.
- Investors abstaining or voting against AGM motions should make the Company formally aware of their reasons in good time ahead of the AGM and be prepared to discuss their views with the Company.

Institutional investors should disclose the use made, if any, of proxy voting or other voting advisory services. The statement should disclose the extent to which they follow, rely upon or use recommendations made by such services.

As Directors of large public companies, we recognise the growing role of proxy advisors in advising institutional investors. We fully understand why these investors might seek support at a time when they face ever growing demands for greater engagement whilst also contending with significant resource constraints, particularly in the AGM high season for December year end reporting Companies. From our discussions with the investor community, it is clear that reliance on proxy advisors represents a significant saving in both time and cost and consequently their use is likely to grow in the future, particularly by smaller investment houses.

In our view, the revisions to the Stewardship Code outlined above are a missed opportunity to incorporate key provisions which will help to address the failings that arise from the use of proxies. The provisions we envisage would include features such as:

- A requirement that investors should not rely on the services of proxies where they own a significant holding in a company – we suggest a threshold of 1% of the voting capital.

- A requirement that investor representatives engage in dialogue with their proxies and challenge the advice of the proxy well in advance of votes being cast.

- A requirement that any votes against AGM resolutions be notified well in advance to the company so that the company can put its case.

- An acceptance that engaging with the company is necessary to fully appreciate the company's particular circumstances, in particular a requirement that the proxy advisor engages with the issuer in advance to discuss any adverse recommendations

- Increasing the transparency by which the proxy determines their advice

- A requirement that proxy advisors should explicitly have to reference their advice to the governance framework in place in the jurisdiction of the issuer (i.e. in the UK, to properly recognise our "comply or explain" framework) .