

Alan MacDougall
Managing Director
Pensions & Investment Research Consultants Ltd
Exchange Tower
8th Floor, Suite 8.02
2 Harbour Exchange Square
London, E14 9GE

21 December 2016

Dear Alan

I would like to correct points made by PIRC in its supplementary evidence to the BEIS Select Committee dated 5 December, and published on the Select Committee's website.

Your evidence suggests a misunderstanding of the meaning of the relevant parts of company law related to directors' duties and the strategic report, and the purpose of the FRC's Guidance on the Strategic Report. I also cover the issues of true and fair and distributions.

Section 172 and 414C of the Strategic Report Regulations

On the issue of s172 and s414C, the legislation says that "The purpose of the strategic report is to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company)" (s414C(1), my underlined emphasis). The focus of section 172 is on directors' duties in respect of the conduct of business. Section 414C(7) sets out detailed disclosure requirements for the Strategic Report that may enable members to make their assessment:

"(7) In the case of a quoted company the strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include—

(a) the main trends and factors likely to affect the future development, performance and position of the company's business, and

(b) information about—

(i) environmental matters (including the impact of the company's business on the environment),

(ii) the company's employees, and

(iii) social, community and human rights issues,

including information about any policies of the company in relation to those matters and the effectiveness of those policies.

If the report does not contain information of each kind mentioned in paragraphs (b)(i), (ii) and (iii), it must state which of those kinds of information it does not contain.”

There are no specific legal requirements to report separately on the issues to which directors must have regard under s172 and how they have done so, which has led the FRC to recommend that a change in the law is required. We made this point clear to the BEIS Select Committee in our follow up letter which we attach for completeness.

The government’s recent green paper on Corporate Governance Reform provides an opportunity to consider improvements to the way in which s172 operates. During 2017, we will be considering possible improvements to the Corporate Governance Code and the FRC’s Guidance on the Strategic Report but there may be some areas where legislative changes are required.

True and fair requirement

Under section 393 of the Companies Act, directors are responsible for ensuring that the accounts provide a true and fair view. The FRC has confirmed that the true and fair requirement remains of fundamental importance in IFRS and UK GAAP. The FRC’s statement on the application of the true and fair requirement, published in June 2014, is consistent with the legal framework. We therefore disagree with the view that the FRC is transcribing legislation wrongly and taking a different approach in its standards and guidance.

The FRC has obtained an opinion from Martin Moore QC to confirm the centrality of the true and fair requirement to the preparation of financial statements in the UK. Directors must ensure that the financial statements that they approve provide a true and fair view. Usually a true and fair view will be achieved by compliance with accounting standards and by additional disclosure to fully explain the issue. In October 2013, the Department for Business considered the matter and confirmed it was satisfied the concerns were misconceived and that the existing legal framework, including international financial reporting standards, is binding under European law.

Similarly, auditors are required to exercise professional judgment before expressing an audit opinion. As a result, the opinion confirms that it will not be sufficient for either directors or auditors to reach such conclusions solely because the financial statements were prepared in accordance with applicable accounting standards.

It is my understanding that your subsequent legal advice has in effect agreed this point. Crucially, this is also the common understanding of practitioners which Mr Bompas accedes in his Further Opinion, noting that,

“there is a widely held conviction [in the UK], supported by the Government and by the FRC...that [achieving a true and fair view is an overriding objective of IAS accounts] is the true position, so that no directors or auditors will be open to criticism were they [to] act in accordance with that principle; and, indeed, to disregard that principle in the preparation of accounts, even IAS accounts, in the UK would be brave.”

Given there is a widely held conviction that the necessary true and fair override already exists in IFRS we do not believe this point merits further examination.

Distributions

As you know we have considered very carefully the issue of distributions, including the opinion of Mr Bompas on each occasion you have raised it, but have not found reason to change our views that the Companies Act does not require the publication of information on realised profits or distributable reserves in the Annual Report. We have taken our own legal opinion from Martin Moore QC, who disagreed with Mr Bompas' interpretation.

We share the views of many investors that the disclosure of more information on dividend policy and practice and the binding constraints on the policy, such as the levels of distributable reserves, regulatory reserves or cash and other liquid assets, is desirable. We have encouraged this, including through our recent Financial Reporting Lab report on dividends. However, such information is not required by the Companies Act. Consequently we are not in a position to require companies to report as Mr Bompas suggests they should.

The Government supports the view we take as does the audit profession and other stakeholders including many investors. In these circumstances we do not believe a further opinion would help. The matter can only be resolved by either an investor securing an interpretation of the law by the courts or by the Government changing the Act. The FRC is not in a position to change the law nor could it sensibly take a Company to court on such a matter, although if the Government were willing to legislate we would suggest some improvement to the current wording.

We strongly refute any suggestion that decisions made by the FRC are affected by conflicts of interest. The FRC maintains and adheres to strict principles to ensure its independence.

It is disappointing that you continue to pursue an agenda which in our view undermines confidence in corporate reporting. I am sure we share a common desire to see continued improvements in the quality of reporting and I hope that you will contribute more constructively to our work in the future.

I am copying this letter to Chris Shaw, clerk to the BEIS Select Committee.

Yours sincerely



Paul George
Executive Director
Corporate Governance & Reporting Division
DDI: 020 7492 2340
Email: p.george@frc.org.uk