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Dear Stephen

EFFECTIVE COMPANY STEWARDSHIP

Thank you for the opportunity to respond to the FRC's thoughtful Paper that considers how the effectiveness of the stewardship role of Boards and Audit Committees can be enhanced through corporate reporting and audit. As you know, Standard Life Investments is a strong supporter of stewardship and is keen to improve its effectiveness in a cost efficient manner, recognising that the principles and practices of good stewardship evolve continually.

Let me convey our comments in chapter order, recognising that many of them pertain to the Paper as a whole.

Chapter One: Introduction

When answering the question 'What is Stewardship?' we agree that the system of stewardship 'is dependent on the provision of robust and reliable information by companies to investors', noting that such information is just one ingredient in the recipe for good stewardship. However, we believe that more effective stewardship will be achieved by putting more emphasis on 'the communication' of information as opposed to its mere 'provision'. As we continue to reflect on the shortcomings of stewardship in the past, we have come to recognise that effective communication was supplanted by the provision of information in accordance with relevant standards. Such provision was deemed acceptable at the time by regulators, investors and others but in retrospect it is clear that the provision of information did not of itself always communicate effectively the inherent risks of an enterprise. It follows that 'increasing transparency' in respect of the FRC's aim is welcome but must be seen as a means to an end rather than an end in itself. Therefore, we encourage the FRC to reflect on our comments with a view to giving more emphasis in future to the importance of effective communication.

Effective communication may, of itself, merit further consultation. To our mind, the aspects it encompasses includes the use of clear language, the quality of explanations, the presentation and positioning of key messages and the communication of trend information, which may extend beyond just the prior year information generally included in annual reports so that the user of the information appreciates its long-term context. We commend to you 'Making Corporate Reports Readable', which was published last year by The Institute of Chartered Accountants of Scotland; it is a thought leadership paper that may provide inspiration.

Regarding the scope of the proposals which are being developed, we note that the FRC will consult on whether they should apply to all listed companies or some other grouping. Notwithstanding, from our perspective, we should like the proposals to be mandatory for all listed companies in the FTSE 350 as a minimum. Although we are mindful of cost considerations, especially for smaller listed companies, we would encourage all listed companies to comply with the FRC's ultimate proposals. We believe the benefits of effective company stewardship will outweigh the costs of the FRC's proposals, and help to bolster investor confidence in smaller listed companies, thereby enabling such companies to realise their full potential.

We support the FRC's approach to take forward proposals that are not 'over prescriptive' and we should like to emphasise our agreement to the FRC's view that the proposals should 'take account of the undesirability, in the context of promoting economic prosperity, of building a regulatory framework that eliminates the risk of failure'. Rather, we see them as building a framework that enables the effective stewardship of risk and related matters.

Chapter Two: Key Recommendations

In respect of recommendation #2, we believe it is very desirable that directors should give due emphasis to the important contribution of internal audit when describing the reliability of the information on which the management of the company is based. In our view, the contribution of internal audit in this regard is often understated.

In relation to recommendation #3, we should emphasise the importance that we attach to the identification of any matters in the Annual Report by the external auditors that they believe are incorrect or inconsistent with the information not only contained in the financial statements <u>but also</u> obtained in the course of their audit.

With reference to recommendation #5, we agree there should be greater investor involvement in the process by which auditors are appointed. That said, we believe the FRC should go further with a view to increasing the effectiveness of engagement by institutional investors on the quality of corporate reporting and the assurance provided thereon. Accordingly, we commend to the FRC the recommendation of the Institute of Chartered Accountants of Scotland in its Paper entitled 'The Future of Assurance' that a principle should be added to the UK Stewardship Code whereby 'Institutional shareholders should be willing to engage with their investee companies on the quality of their reporting and assurance provided on that reporting'. We believe that this principle is consistent with good stewardship and that without making provision for it in the Stewardship Code there is a risk of inertia in relation to achieving improved investor engagement on corporate reporting issues.

Chapter Three: Narrative Reporting

In respect of the Key Points, we suggest that specific reference be made to make clear that significant joint ventures are included within the scope of narrative reporting. In our experience, such joint ventures contain significant risks to the company and there may often be a tendency to not pay sufficient attention to them because they are embedded in an entity that is not fully controlled by the company concerned.

The FRC notes that investor presentations are underpinned by information provided in Annual Reports. This is true but we observe that investor presentations often contain much additional information to that in the Annual Report and/or present the information in a different way in order to communicate the desired (rather than balanced and reasonable) message. It is common practice for companies to put their investor presentations on their website. Institutional investors place due reliance on the information contained in such presentations. Therefore, we suggest that the FRC should, in due course, consider how companies should exercise appropriate stewardship in respect of information contained in investor presentations. In view of the fact that the presentations generally pertain to a wide range of financial and non-financial information, including strategy, perhaps they should be subject to scrutiny and review by the board prior to release.

We support the FRC's view that the narrative report 'should not be promotional in nature'. Mindful of the incentives to 'gild the lily', we believe it is appropriate for the FRC to consider enforceable arrangements whereby auditors take responsibility for satisfying themselves that the language used by companies in the narrative report is balanced and reasonable.

On page 10 of the Paper the FRC refers to 'a narrative reporting standard' and then goes on to refer to 'a Code' that sets out principles governing the preparation of Annual Reports. We should like to lend our support to a Code on the basis proposed but we question whether requirements should be enshrined in a 'standard', which implies an approach that is more definitive and less flexible than a Code might be.

We endorse the FRC's view that access to the information in Annual Reports would be improved if companies were to provide access through the web in a form that enables the information to be obtained quickly and easily. We believe that the FRC should encourage progress towards this but do so in an orderly manner. In this regard, we are particularly concerned to ensure that there are appropriate and adequate safeguards in place to ensure that the information provided on a company's website is subject to effective controls to ensure its integrity over time.

We support the FRC in its resolve to avoid replicating the costs that have arisen from the US Sarbanes-Oxley Act. Also, we are keen to avoid the 'box ticking' approach to compliance which is associated with it.

<u>Chapter Four: Assuring Integrity</u>

We support the FRC in seeking to improve the quality of reporting by audit committees and auditors to shareholders. Over recent years we have witnessed some improvements in the reports of audit committees. We commend to you as an example of best practice, the audit committee report of BP plc in its recently published 2010 Annual Report, which communicates effectively the work the committee has done and thereby serves to reinforce investors' confidence. We believe that it is important that audit committee reporting should not be unduly prescriptive. Therefore, whilst we would be minded to support the provision of guidance notes, we are not supportive of the use of reporting standards in this regard. Also, we encourage you to consider the Enhanced Disclosure Guidelines[1], which were published by a Working Group of representatives from Standard Life Investments and other major long-term global investors, and have been endorsed by a number of important organisations including the ABI, the NAPF and the ICGN. The Working Group intends to review and refresh the Guidelines during 2011.

With reference to the quality of financial statements, we should like the FRC to revisit the role and effectiveness of the 'true and fair override'. In our opinion, it is not functioning effectively. It has the potential to improve the quality of financial reporting but it is never used. We regard this view as consistent with the view expressed by the FRC that 'the effective exercise of professional judgement is fundamental to the quality of every audit'.

We welcome the FRC's recognition that professional scepticism should be enhanced. The Paper suggests that the assessments made by auditors should be open to effective challenge by the audit committee and investors. In our opinion, it is the role of the audit committee to challenge the assessments made by the auditors; however, investors are not in a position to do so at the time when the financial statements are signed off - and nor should they be.

We support the FRC's proposal that the standards governing the provision of reports by auditors to audit committees should be enhanced. We suggest that the minimum scope of this should also include the

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1 http://www.enhanceddisclosure.org/view_the_guidelines.html

auditors' views on post-balance sheet events. Such events can have significant implications for a company's financial position and going concern status. However, in our opinion, the focus on compliance with IFRS as at the balance sheet date has tended to detract from the audit significance of post balance sheet events. We suggest that this can sometimes be detrimental to prudence and the provision of a true and fair view. Therefore, we should like the standards to address this with a view to positioning post balance sheet events more prominently in the menu of matters that are considered by auditors and audit committees in fulfilling their respective responsibilities.

We are concerned that many audit committees struggle to cope with the increased complexity of accounting and auditing standards and, consequently, may not always be able to exercise independent judgement with the degree of conviction that is commensurate with their responsibilities. Therefore, we should like the FRC to give serious consideration to giving explicit encouragement to audit committees to retain independent advisors in the normal course to assist them in fulfilling their responsibilities. Such advisors should not, for the avoidance of doubt, be the auditors. Rather, they might be another accounting firm or an individual adviser. We believe that this approach will not only improve the effectiveness of audit committees - both behaviourally and technically - but also strengthen the confidence which shareholders and others place in the audit process, taken as a whole.

We believe that an expanded audit report would provide an important contribution to enhancing users' confidence in corporate reports. We agree the comments set out in the Paper but would observe that, in our opinion, the content of the audit report should evolve over time and on a company by company basis. The ossification of the audit report has been an unwelcome feature of corporate reporting and therefore, we urge the FRC to commit to keep the audit report content under review in a manner that is designed to prevent such ossification in the future and ensure that it remains fit for purpose over time.

We support in principle the view that the independence of the decision to appoint a new auditor would be reinforced through greater shareholder involvement. The paper suggests that the audit committee should be required to either report on the process by which they had reached their recommendation or discuss the approach with a number of principal investors. We suggest that these two requirements are not mutually exclusive and, consequently, we believe both should apply. We should emphasise that the report on the process by which the audit committee reaches its recommendation should provide sufficient granularity - and not boilerplate language - so as to enable the reader to have a genuine appreciation of the factors that influence its recommendation.

We give a cautious welcome to the safe harbour proposals. On balance, we believe that safe harbours are appropriate to enable meaningful forward looking statements and other relevant representations to be made in a manner that is consistent with providing investors with a balanced and reasonable report overall. However, we are mindful that the Davies Report that addressed directors' liability several years ago, following the publication of the Companies Act, set such high levels of proof that, in effect, it has proved impossible for shareholders and others to demonstrate that the directors did not exercise due care etc in making their representations. Therefore, before proceeding to implement the safe harbours, we believe it is essential the FRC engage with BIS and others, as appropriate, with a view to ensuring that safe harbours are only created once the burden of proof is set at a level that, on the one hand, is fair to the directors, officers and auditors of companies but, on the other hand, is realistically within the grasp of investors and others should they have reasonable grounds for calling into question whether the statements or judgements subject to the safe harbour were made recklessly, dishonestly or fraudulently.

Chapter Five: Fostering Quality improvements

We support strongly the FRC's belief that consideration should be given to how, in the event of a corporate failure, a review might be carried out of that company's governance, accounts, and audit to ensure lessons, where appropriate, are learned and to ascertain whether further investigations or regulatory actions are necessary. We have written previously to your predecessor to express our frustration regarding the lack of a focal point to which concerns can be referred and to enable relevant action to be taken in the event of a corporate failure. In our opinion, this is a significant weakness in the current stewardship landscape and the FRC's implied resolve to address this is appreciated. We should emphasise that it is important that the process be both timely and transparent - whilst we would not wish to promote an approach that involves undue haste, we believe that it is important that the review be undertaken within a timeframe that permits reliable and complete reference to the factors that contributed to the corporate failure. Possibly, there is a need for an early and transparent interim review to be undertaken with a view to determining whether or not the circumstances warrant further action. Also, we should emphasise that it is important that such reviews are transacted in a manner that is perceived as being independent. We suggest that the FRC should give consideration to setting up an independent review board to oversee the reviews that might be undertaken in the event of a corporate failure.

We agree the proposal to create a forum comprised of market practitioners supported by the FRC and the UK Listing Authority to exchange views about current market developments on a regular basis. We emphasise that 'market practitioners' should be defined to refer to those who are involved in stewardship matters on a day to day basis. We suggest that there might be a role for the Institutional Investors' Council in supporting the forum, in addition to the bodies otherwise cited.

The possibility of two groups being formed to provide the forum seems a reasonable starting point. It is important that the two groups be 'joined up' in order that their respective views can help to inform the discussions and deliberations that ensue in both groups. We note the proposal that the groups should meet 'at least twice per year'. We are inclined to suggest that they should meet 'at least three times per year' in order to ensure an appropriate degree of momentum in the discussions and to engender appropriate group dynamics - we are concerned that if the groups default to meeting twice a year then the dynamics and momentum would be sub-optimal.

With reference to the proposal to create a 'financial reporting lab', we are cautiously supportive. We believe it is an interesting suggestion that has the potential to facilitate experimentation in financial reporting in a controlled and practical way. However, we are concerned to ensure that such a lab is not only subject to strong governance in order to avoid the risk of capture by those promoting the experimentation but also seen to uphold the integrity of the findings, which should be objective and free from bias. Accordingly, we urge the FRC to put in place the necessary checks and balances before launching the lab and to undertake to review its effectiveness and status after, say, five years, as a matter of good practice.

Chapter Six: The Legislative and Cost Implications of the Proposals in the Consultation Paper

We note that the proposals set out in the Paper would 'require the development of Narrative Reporting Standards by the ASB'. Whilst we agree that there is a need to develop appropriate guidance in respect of narrative reporting, we would urge the FRC (and the ASB) to steer clear of 'Standards' and adopt an approach of authoritative guidance along the lines envisaged by the IASB in respect of Management Commentary. We are concerned that a standard based approach will serve to encourage, albeit unintentionally, box ticking, which is counter intuitive in the context of narrative reporting. Rather, narrative reporting, by definition, amends itself to non-prescriptive guidance in order that it can yield the intended benefits. (See also our comments on Chapter 3.)

Additional Comment

The 'elephant in the room' in respect of enhancing corporate reporting and audit is the complexity of accounting standards and the density of annual reports, which makes it difficult for users to 'see the wood from the trees'. In respect of IFRS, we believe that the time is right - and arguably overdue - to pause for thought in order that the standards setting process can be subject to a thorough evaluation. In particular, we are concerned that it has become progressively detached from the views of users - especially shareholders and investors - and we are not convinced that it has embraced stewardship effectively. We understand the IASB is planning to stem the flow of new proposals. Notwithstanding, we urge the FRC to use its influence to ensure that a sufficiently in-depth and rigorous review is undertaken of standard setting. There should be no 'sacred cows'.

Conclusion

We hope our views will assist the FRC as it continues to strengthen the stewardship environment in the UK and, thereby, enhance the corporate governance environment in a way that is consistent with fostering long-term wealth creation.

We are sending a copy of our comment letter to the European Commission in view of its interest in corporate reporting and audit matters, to keep it abreast of our views.

Yours sincerely

Guy R Jubb
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Standard Life Investments

cc. Ms Nathalie de Basaldúa - European Commission
Mr Arvind Wadhera - European Commission