Revised transcript of evidence taken before

The Select Committee on Economic Affairs

Inquiry into

GOING CONCERN

Evidence Session No. 1  Heard in Public  Questions 1 - 14

TUESDAY 22 JULY 2014

3.30 pm

Witnesses: Sir Winfried Bischoff and Stephen Haddrill

Members present

Lord Hollick (Chairman)
Lord Carrington of Fulham
Lord Griffiths of Fforestfach
Lord Lawson of Blaby
Lord McFall of Alcluith
Lord Monks
Baroness Noakes
Lord Rowe-Beddoe
Lord Smith of Clifton

Examination of Witnesses

Sir Winfried Bischoff, Chairman, Financial Reporting Council, and Stephen Haddrill, Chief Executive, Financial Reporting Council
Q1 The Chairman: Sir Win and Mr Haddrill, welcome back to the Economic Affairs Committee and thank you very much for coming to talk to us today. As you know, we published a report in 2011 as the result of a review of auditors, where we made some fairly forcible remarks about the importance of scepticism and the importance of principles-based accounting as opposed to simply rules-based accounting. We were pleased to see that that was taken up by Lord Sharman’s committee and, of course, this matter has now arrived very much in your bailiwick. It would be helpful, Sir Win, as this is your first occasion appearing before us as chairman of the council, if you could just give us a sense of your overall views on these matters and on the importance of principles-based accounting and the approach that we were advocating, which I think was strongly supported by Lord Sharman’s report, particularly for banking information institutions.

Sir Winfried Bischoff: Thank you very much, Lord Chairman. On the 2011 report, particularly in relation to Lord Sharman’s report and the going concern aspects of it, obviously the FRC is very keen on the matters of “true and fair” and prudence. This is one of the areas, particularly in relation to banking, which I think is important. There are likely to be some changes coming on that in relation to expected loss, rather than just incurred loss. As you know, the standard is in fact very much on the incurred loss rather than on the expected loss. Some changes are going to be proposed, which Stephen can talk about.

In relation to Sharman and going concern, there have been consultations. In particular, what does “going concern” actually mean to people? Is it just at a point in time or one year hence, or is it a little bit further? We think that it is important that companies give consideration to the longer-term viability rather than just the going concern, which I suppose many of us are familiar with and which is a year out. We are not specifying a particular timeframe. The proposal is that we would leave that to boards, because different companies have different
business models and structures and they should make the determination of what a reasonable period is to look forward to. We have discussed this with various stakeholders—investing institutions on the one hand, companies on the other—and we believe that we will be able to come forward with something that, while there are elements of disagreement either on the investor side or on the company side, will make sense to the broad body of stakeholders.

The Chairman: Would it be fair to say that this approach has your broad support? Having been chairman of Lloyds, you are very familiar with how accounting works in financial institutions. Do you feel that, in the light of that experience, principles-based accounting has an important role to play?

Sir Winfried Bischoff: I do.

The Chairman: We want to explore a number of the points that you have raised, so I will now hand over to Lord Lawson.

Q2 Lord Lawson of Blaby: As the Lord Chairman pointed out, in our 2011 report we were extremely critical of how IFRS worked in the case of banks. I think that it is probably defective as a standard generally, but it is particularly serious in the case of banks. There is the provisioning rule on incurred or expected loss, where we are expecting some kind of change very soon. There has been a lot of talk about it but we will see what we will see in due course. But there are other things that are defective. The absence of “true and fair” and so on makes a significant difference, and there are various other matters. On the Banking Standards Commission, as you will know, we proposed that, since we cannot get IFRS to change in the way that we would like it to and because there has to be European Union agreement, which means that it is difficult to get any change, the way of cutting the Gordian knot was to say that banks should have two sets of accounts: one according to the IFRS rules and another according to rules set down by the regulator to fit regulatory needs—that
is the PRA/Bank of England. We felt, too, that the presumption should be that this second set should also be published. Although this means that there is more work to be done, the gain is so much greater that we think that this should happen. Do you agree?

**Sir Winfried Bischoff:** First, I would prefer there to be one set, which would in fact meet the standards that you would have liked to see at the Banking Standards Commission. If there are going to be two, it would be up to the PRA to go along with that. If they wished to do it and were in favour of it, we would be perfectly happy to go along with that.

**Stephen Haddrill:** I would agree with that.

**Lord Lawson of Blaby:** That takes us half way, but you are extremely experienced and influential as an individual. You also have a very responsible job. Should you not be not merely going along with the PRA if they do it but urging the PRA to get on with it?

**Stephen Haddrill:** We have urged the Bank of England and the PRA to consider this in line with what the committee recommended and we made it clear that we would support a change in that direction. As Sir Win said, we want the core of that information to be information that the financial services regulator thinks is appropriate, so we feel that the design work needs to come from them. We also think it important that we end up with as much comparability for investors as possible and we do not end up creating an entirely new set of regulatory accounts, as that would clutter up the picture that investors see. If the PRA can find a way forward here, we would be very supportive of this.

**Lord Lawson of Blaby:** And you would like them to do that.

**Stephen Haddrill:** Yes, we think that there is great merit in it. We are a bit nervous about creating two sets of accounts for lots of sectors, because that undermines the principle that there should be comparability between companies of different kinds and investors should be able to make a decision about where to put their money based on that comparability. So we do not want to end up with an energy sector—
Lord Lawson of Blaby: No, I am just talking about banks. Banks are different for a number of reasons, not least because they have to be regulated by the PRA, whereas the energy sector is partly and the motor car industry is not at all. That shows that we accept that, because of the particular place that the banks have in the economy, they are different. I am not suggesting for a moment and we did not suggest that there should be a different set of accounts for any other form of company, but for banks which are regulated there should be a set of accounts that best meets the needs of the regulator.

Sir Winfried Bischoff: Yes, I can understand that. I think that what would be very important, if that were to come about, would be that the assumptions that the regulator makes in relation to presenting the accounts, which have effectively been stress-tested and forward-looking and all this kind of thing, are that this is intelligible to investors—that is, that this is a fair, proportionate and understandable way of presenting accounts. That is our remit and it actually applies to those accounts, too, rather than that this is a document that only the most sophisticated people would be able to understand.

Q3 Lord Griffiths of Fforestfach: My understanding is that the way that the PRA works at present is that de facto it does a regulatory audit continuously of all systemically important financial institutions. If the PRA felt that, for example, a systemically important bank did not have enough capital, liquidity or funding, on what would be a reasonable assumption to make and had been stress-tested, it would require that institution to change.

Sir Winfried Bischoff: Yes.

Stephen Haddrill: Yes.

Lord Griffiths of Fforestfach: So effectively we actually have a regulatory audit that goes on month after month, as I see it, by the PRA.
Sir Winfried Bischoff: Yes, but I think that Lord Lawson was thinking that these would be accounts that would be made available more broadly. What the PRA does is transparent to the management of the bank but it is not transparent to investors.

Lord Lawson of Blaby: That is right. It is a very important point, which is buttressed by the fact that the regulatory authority had this power before but that did not prevent the crisis that the banks went through. I have a separate question before we move on. The Banking Standards Commission was also concerned about remuneration. I am talking not about the level but about the structure of remuneration. Is that something that you would attach importance to as well? Do you have any views on that subject?

Sir Winfried Bischoff: We have in relation to remuneration—Stephen can talk about this more broadly—come forward with a suggestion that is more nuanced than in the past. In the past, the admonition has been that remuneration be set in order to attract and retain the most appropriate talent for the company. We have now proposed that we should pay the kind of remuneration that is in the best interests of the company—that is, the priority is perhaps the company rather than the individual. It is a nuance but I think that it is quite a meaningful nuance. Stephen, would you like to say something about that?

Stephen Haddrill: Yes, it is quite an important shift from our perspective, because it gets away from this idea that the company should constantly be trying to catch up with the salaries market, if you like, and instead should be thinking about what its interests are and explain its remuneration policies on that basis. The responsibilities of the FRC are principally to do with the clear reporting of remuneration, which is another concern, rather than how you actually set it, which is the responsibility of the PRA, if any regulator is going to get involved. We have been concerned recently that, despite the changes that have gone through, the structure of remuneration is becoming more complicated, not less complicated, which raises a question about whether it is incentivising the right sort of behaviour. To do
that, it needs to be understood. There is also a question about whether investors can understand what the package means. Increasingly they have said to us that they cannot understand that. From a purely reporting point of view, that is a concern.

Q4 Baroness Noakes: I declare my interest as a director of RBS. Those of us who are involved in the preparing of bank accounts sometimes pause over the “fair, balanced and understandable” bit that we now sign off. The reporting accounts are now routinely around 600 pages. How will an additional several hundred pages add to the clarity of information reaching the intended community? I can understand how the PRA might want additional information, but I struggle with whether or not an additional set of accounts will actually serve the public interest in an area of such complex accounting altogether. Do you believe that changes in the pipeline to deal with expected credit losses, for example, would deal substantially with a large number of the problems of people identified during the banking crisis?

Sir Winfried Bischoff: I am on record as saying that expected losses should be taken into account by bank managements, and if bank managements take it into account it should be something that you should be able to reflect in the accounts, which has not been the case, and therefore the transparency that I think is important in bank accounts has not been there. I am personally concerned, as I think is the FRC, about particular bank accounts being 400, 500 or even 600 pages long this year. That goes for Lloyds Banking Group alone, and that is supposedly a simple, rather boring bank. Who actually reads all this stuff? If some of the regulatory information contained in the accounts can be more narratively described so that it is actually understandable, I suspect that that will be useful. Our mantra is “clear and concise”, but clarity is one thing while being concise is another. I hope that we will not get to a stage where accounts are becoming even more voluminous than they are at the moment.
**Q5 Lord Carrington of Fulham:** Coming back to the UK corporate governance code, particularly as it affects risk management and going concern, I know that we touched on this earlier before we got into banks, but could you run through what it is you are actually proposing?

**Stephen Haddrill:** As Lord Hollick said, this actually comes from Lord Sharman’s proposals. Lord Sharman wanted three things, two of which we can securely deliver but the third one of which we are struggling with. The first was that there should be much greater clarity about what the going concern statement of the company actually means. The principal statement actually means that the company is a going concern on the day when the accounts come out. I think that a lot of people think that that statement applies some way into the future; it does not, and we are asking for it to be made explicit by the directors exactly how forward-looking it is. The accounting standards also require that the material uncertainties and risks to a going concern are reported. Typically now companies report on what their circumstances and risks are, but they do not link that through to whether or not they are a going concern, so we want that to be made more explicit as well so that we get a better picture of what the going concern statement actually means. Secondly that Lord Sharman was looking for was for a more prospective view given by the directors of the way the business is going and so on. We very much agree with that. We understand that it is difficult, and this area has been somewhat controversial through the consultation. We are proposing an additional statement in which the company, taking account of its risks and uncertainties, says that it has a reasonable expectation of meeting its solvency and liquidity requirements over a period that it defines. As Sir Win said just now, the reason why that has to be defined by the company rather than the regulator is that it should be different for each company. The crucial thing is that they should then explain why they have chosen that period. Take the banking sector: if one bank chooses a period of two years and another one chooses five
years, the investors have a basis for asking questions of those two banks. We believe that
that this judgment is a responsibility on the directors. It is subject to a safe harbour, which I
think is quite important. It will lead to a boardroom discussion about what the appropriate
period is to take for considering the security of the business looking forward, and, crucially,
it will lead to its being explained to investors why that view has been taken. That will enable
comparisons to be made and further questions to be asked. We think that it will have a
behavioural impact in the boardroom, which is what Lord Sharman was looking for. The
third thing that Lord Sharman asked was for us to take the lead in trying to establish the
framework that we have come up with in the UK at an international level. Frankly, that has
been something of a struggle. We have taken that up with the International Accountancy
Standards Board but we have not really made any progress there; the board has decided not
to go down the sort of route that we are going down. We therefore face a decision about
whether the UK does something quite ground-breaking in international terms—no one else
has done this. Nevertheless our board is minded to do so. We operate on a comply-or-
explain basis, which gives people an opportunity to consider how they pursue it, and then,
hopefully, in future we can point to the UK as best practice and persuade people to take
matters further forward internationally.

**Sir Winfried Bischoff:** From a practical point of view, of course, boards meet with the
management and take a view that the company is going to survive. It is very unusual that a
board will be sitting there in the normal course of business and think that it will survive for
only a year. You will have your planning cycle of three years, five years et cetera. What Lord
Sharman is proposing, and we think it is reasonable, is that boards inform their shareholders
what their view is of the longer-term viability. This is not for the ensuing 20 years,
obviously—although some may think that it will exist for 20 years and some perhaps for 50
years; that is very difficult to say—but certainly longer than the common 12-month period,
which is not very informative for shareholders. Shareholders will be able to make the
differentiation if they wish to.

**Lord Griffiths of Fforestfach:** It introduces a greater subjective element—obviously there
is already a subjective element in these sorts of statements—but it introduces a greater
element of uncertainty for an investor. You are not going to get a board publishing accounts
that say, “We think we’re going to be out of business in five years”, to take it to one
extreme. They are always going to say, “The probability is that we are going to be here in
five years’ time”, so I am not sure what digital information is going to provide that is not
already implicit in the current accounts.

**Sir Winfried Bischoff:** They are going to provide the assumptions on which they have made
that statement, so I think that that will be quite useful—for example, their borrowings are
relatively longer-term, they do not have break clauses or whatever assumption they have
made. “We have long-term contracts”, “We are a utility and we have a regime that we have
agreed with the Government for seven years”—it will be that kind of information.

**Stephen Haddrill:** No doubt the company has plans, looking further ahead, and it has
probably made statements when it raised capital, but if it has not raised equity capital, the
investors may not know much about its forward view. There is great value in it opening the
curtain a bit on the planning that it is done and the discussions that have been had in the
boardroom. Clearly there is a widening funnel of doubt the further out you go. That is why
we want the directors to judge how far they feel able to go and, crucially, to explain that.

**Sir Winfried Bischoff:** But they do have a safe harbour. The other thing to consider is that
boards discuss that forward look with rating agencies and so on, and they say to the agencies
that they can be rated A-plus or whatever because there is certainty as to their ability to
repay their borrowings, which ultimately is viability.
Lord Carrington of Fulham: You do not see this as being validated by the company’s external auditors?

Stephen Haddrill: The company’s external auditors will need to say whether they are aware of anything that would call into question what the company has said.

Lord Carrington of Fulham: So it is a negative valuation rather than a positive one.

Stephen Haddrill: Yes.

Sir Winfried Bischoff: Interestingly enough, although one would have thought that companies would have found this most difficult, one can actually say that the group of 100, the CFOs of the FTSE 100, are broadly in line with our thinking on this.

Stephen Haddrill: We have had responses from the 100 group and a number of other specific companies. There is a range of responses. I do not think that anyone is really saying, “Don’t do it”. Some people are saying, “This is the right thing to do”. Others are saying, “You’ll generate a lot of verbiage”, which is perhaps the risk that Baroness Noakes was talking about. That is why the quality of these explanations is so important, as is shareholders actually testing what the companies are saying, because that will create a move towards best practice. I think that companies are also saying, “Could you please get on with it after three consultations? It would be nice if you put this to bed”.

Q6 Lord Griffiths of Fforestfach: I was remiss in not declaring my particular interest as chairman of the audit committee of Goldman Sachs International and Goldman Sachs International Bank when I asked my first question. I would like to continue on this theme by referring to a letter that a group of investors sent to the FT, which was published, arguing that the broader statement that you are asking boards to make in a way waters down the foreseeable risks to the business. To me, the key question is: do you think that the proposals that you are making make directors sufficiently accountable?
**Sir Winfried Bischoff:** We disagreed with that interpretation by the investors that wrote to the *FT*. We think that directors are more accountable and that it is a positive aspect. Quite a number of investors also disagreed with them and agreed with us. It is not a question of whether or not one agrees; it is a question of whether directors are going to be able to make intelligible assertions about future viability, and that is important.

**Stephen Haddrill:** I agree with that. I think there has been a long-standing misunderstanding about the value of the going concern statement that we have. Companies use the word “foreseeable”. When investors said they did not want to lose that, I think they were thinking that it applied for some distance in the future. That is not how companies use it, so we are not losing anything. In fact, we are asking companies to make explicit what they mean by the language they use in the existing statement. The going concern statements will not be watered down; it will be made more apparent what they mean. In addition to that, we will have this longer-term piece.

**Lord Griffiths of Fforestfach:** As I looked at these questions, I asked myself: if your proposed changes had been in operation in 2008, would they have made any difference?

**Stephen Haddrill:** One certainly hopes so.

**Lord Griffiths of Fforestfach:** Well, I would hope so as well, but I just think that it is very difficult to get any director to sign off on accounts if they think that something is not going to be viable for the foreseeable future.

**Stephen Haddrill:** When Baroness Hogg and I gave evidence to the committee a couple of years ago now, one of the things that we were discussing then was what happened in the phony war during 2008, when there was quite a long period between Northern Rock’s failure and those of the other major banks; in that period, people were reporting and auditors were signing off on accounts. Similar things happened in 2007 and indeed earlier. We recognise that there was a failure of gatekeepers of all sorts, including boards, and
auditors and regulation. The challenge that we talked about was how to take some of the discussion further back, ahead of the crisis point being reached. Lord Sharman came up with his proposals, in a sense, to ensure that everyone—the boards, the auditors and regulators—was being sufficiently forward-looking. Part of that was ensuring that those real risk discussions were happening in the boardroom and that the auditors themselves were thinking hard about that because, even if they were not giving a positive assurance, they would have to think about the quality of their negative assurance. It was a dreadful period and we hope that we do not have to have these proposals tested in anger, again—at least, not for a very long time. I think that the proposals go with the analysis that was in this Room to some extent, and with Lord Sharman’s view that we needed to get the conversation going earlier.

**Lord Griffiths of Fforestfach:** So they would have made a difference?

**Stephen Haddrill:** I believe they would.

**Sir Winfried Bischoff:** Well, together with some other aspects. I do not think that it would necessarily have made a difference by itself, but the capital regime, liquidity, buffers—all of these kinds of things that have been put around it, particularly when one is talking about banks—together with the viability forward look and the stress-testing, to which the noble Lord, Lord Lawson, referred, would have made a difference.

**Lord Griffiths of Fforestfach:** The only thing that I would add is the intensive supervision.

**Stephen Haddrill:** Yes, it is a part of a picture. Another part of the picture that we have discussed before is that some of the banks and indeed other companies were saying that before the crisis they were coming under considerable pressure from their investors to go further and take more risks. Fronting investors up to the consequences of that is also important.
**Lord Lawson of Blaby:** The banks may have been pressed by their investors but that does not lessen the responsibility on the auditors. There seems to be a particular problem. The way that auditors certified that the bank was a going concern months before it went belly-up was appalling; clearly there was something seriously wrong and it is right that you should be addressing that. But there is another problem: in other companies, if auditors have slight reservations about something or other, they can qualify the accounts, and that happens from time to time. That is a useful indication. You cannot do that with a bank; if a bank’s accounts were qualified, that would be the end of the bank. Have you instead considered the possibility for banks of adopting—although I hesitate to say anything good about the ratings agencies—a similar sort of system that is not either/or, where it is not a question of accounts being qualified or not being qualified but where instead auditors could rate bank accounts between, say, AAA and CCC? This would give a better indication to investors of the relative standing of different banks.

**Sir Winfried Bischoff:** I have not personally considered that.

**Stephen Haddrill:** I think if you give them a CCC, you are going to end up with some of the same risks.

**Lord Lawson of Blaby:** Quite, but there could still be a difference between AAA and AA.

**Stephen Haddrill:** Yes, there is that. We have not looked at such a proposal but there are one or two other things that we do that are relevant. First, we inspect the quality of the accounts of something like 300 companies, a number of which are banks. If we feel there is something wrong with them, we get them to change them, so there is something of a supervisory regime there.

**Sir Winfried Bischoff:** Post.

**Stephen Haddrill:** Post—after the event. We also inspect the audits of about 100 listed companies a year, and we are focusing particularly on banks; we have done since the crisis.
We are doing 12 or 13 major bank audits this year. The report of this Committee also looked at competition as an issue, and we were very pleased that the Competition Commission looked at the quality of competition in the audit market. One of the things that it said should happen is that our audit inspection reports, whether of banks or other companies, should be published by the company. I not sure that the commission was right to think that that would assist competition, but it would certainly generate a pressure for audit quality because the client would not want to have to publish a bad report. That is something that we are considering and will be consulting on in the next couple of months. It is not a rating but it would provide quite a lot of information going out there to enable investors to see what we thought about the quality of the audit.

**Q7 Baroness Noakes:** You talked about the 100 group supporting and a conversation with the ratings agencies, but the proposals for going concern do not affect only the FTSE; they affect all listed companies, at least, which goes down quite a long way. We have heard expressions of concern by those who deal at that end—for example, from the Institute of Directors, which says that forecasting beyond 12 months is impossible, while John Moulton says that it is madness. As I understand it, there is a genuine sense of concern at the smaller end in particular because many of those companies are heavily dependent on bank financing. At the moment their financing is 12 months or 15 months beyond the balance-sheet date and that gets them through the going concern, but they may start to look difficult to explain as banking facilities typically are not structured in the much longer term. Have you looked at the repercussions of the implementation of this for the smaller end of the corporate sector?

**Sir Winfried Bischoff:** We have certainly looked at it. We think that it is information that is useful for shareholders to have. We think that if companies can rely only on short-term finance from their banks, that is a risk factor that investors should be aware of. So this is a concern but it may actually lead to a different kind of behaviour: bank finance for smaller
companies may in fact have a committed nature of slightly longer than a year or whatever it is. Banks may or may not fall in line—I suspect they will. The smaller companies will of course be more impacted by that than, say, BP; that is the nature of things, and it is why small companies sometimes sell at a discount.

We saw John Moulton’s quote about this being madness. I have much admiration for John Moulton, who used to be a colleague of mine; he is very outspoken on these things. He represents one view. There is another view from investors who say, “You’re not doing enough in relation to this”. In the third consultation, as Stephen has said, we have tried to come up with something that does not necessarily please all investors or companies but which gives trustworthy information to the shareholders, which we happen to think is very important and is part of our remit.

**Lord McFall of Alcluith:** I was speaking to John Moulton last week and he asked me to pass on his regards, critical as ever, to you.

**Sir Winfried Bischoff:** Critical as ever? Tell him he is wrong.

**Q8 Lord McFall of Alcluith:** Our 2011 inquiry was into auditors and consulted on their role, identifying weaknesses and international financial reporting standards. What have been the main developments in accounting standards since then? Have our recommendations on a prudent approach by auditors and a true and fair view been taken into consideration and perhaps implemented?

**Sir Winfried Bischoff:** We think that the true and fair view is still there. Prudence has perhaps not been as much a centrepiece of all that but it should be. However, we believe that true and fair is part of the IFRS standards; we have had legal advice in relation to that.

**Stephen Haddrill:** We published guidance to companies on the importance of respecting the true and fair view, saying that it continued to exist and that both they and auditors should recognise that.
Lord Lawson of Blaby: But prudence has gone, has it not? It is now neutrality. That is a big difference.

Stephen Haddrill: Prudence went, and has been out of the picture in international standards for a few years now. We have lobbied very hard since the 2011 report to get it reinstated as a concept, and the IFRS has now agreed to put it back into the conceptual framework.

Lord McFall of Alcluith: Tim Bush gave us evidence in 2011 when he referred to the relevant IFR standard, IAS39, which he stated was “in conflict with clause 19 of UK accounting rules under the Companies Act 2006 which requires accounts to be prepared prudently, and without crediting any unrealised profits, while recognising any contingent liabilities”. Has that issue been attended to or even resolved?

Sir Winfried Bischoff: We took legal advice on Tim Bush’s view. Both the legal advice that we took and that which Ministers took concluded that he was wrong, and that the true and fair view prevailed. We published that legal advice and the department itself published its own view of the same time. I will forward that to you.

Lord McFall of Alcluith: Okay, fine. Was the “prudent” aspect, which Lord Lawson mentioned, reinstated?

Stephen Haddrill: This is early days. The conceptual framework of the International Accounting Standards Board is the criteria that it uses when it is writing the standards. It has agreed to put “prudent” back into the criteria but then it has to flow through into the rewriting of standards and so on over time.

Lord McFall of Alcluith: This is an uphill struggle. I have been taking evidence on this for seven or eight years, and the evidence that I get says, “Look, we are in a sense loners. It is like pushing water uphill trying to change IFRS”. Is that really the situation?

Stephen Haddrill: Any international discussion is a long—
Lord McFall of Alcluith: So the answer is yes?

Stephen Haddrill: The answer is yes.

Lord McFall of Alcluith: Right, fine. You mentioned annual reports of 700 pages. Why do we need 700 pages? We have increasing complexity and opaqueness in the financial system, which means that only the experts understand it. In fact the financial crash shows that even the experts did not understand it; at the end of the day, we were all ignorant on that. Why can we not have annual reports of, say, a 60-page to 70-page executive summary with all the relevant issues in it so that people can understand it? Otherwise we are all playing in the dark here.

Stephen Haddrill: I think that that is what the Government are trying to do here with the introduction of the strategic report. The regulations came in on that some months ago now. Companies will produce a strategic report, which is trying to deliver what you are quite rightly calling for. Other information will then go on to their website or whatever. That is very new. We have issued guidance to support companies in doing that; they are just starting to do it, and we will see. So you will still get a significant volume of information but there will be a condensed key-issues document as well.

Sir Winfried Bischoff: I quite like the idea, as long as it is legal and sufficient, of having an executive summary. You can then turn to the 600 pages or whatever it is if you want to. The problem is, will the executive summary contain all the relevant information that is necessary? However, I totally agree with Lord McFall: who is going to read 700 pages? Still, regulation, standards and so on make it imperative for companies to produce this kind of length of report—400 or 700 pages, in the case of Lloyds.

Q9  Lord McFall of Alcluith: I have a quick question on Lord Lawson’s earlier point. Lord Lawson and I have examined auditors on the Banking Standards Commission. It was obvious that auditors got under the radar in terms of their obligations and duties. As Lord
Griffiths has said, the bank accounts were approved and going concern statements were published only weeks before the institutions went under. To add more clarity to Lord Griffiths’s point to you, are you confident that such a situation will not happen again as a result of what you have proposed and the other measures, such as capital liquidity or whatever, that have been put in, and that auditors will really do their jobs?

Stephen Haddrill: I am confident that we will not see a repeat of the mistakes of that period.

Lord McFall of Alcluith: Why?

Stephen Haddrill: First, partly at Lord Lawson’s prodding, if that is the right word, there is now much better dialogue between the banks, the auditors and the regulator. That happens on a regular basis now, so if the regulator has anxieties then the auditor has to take those into account.

Lord McFall of Alcluith: Lord Lawson insisted on that in his legislation in the 1980s but it fell by the wayside.

Lord Lawson of Blaby: I put it in the Banking Act 1987 but it did not have statutory backing at that time. It was recommended, as it were. The Act removed the confidentiality bar on these discussions. Previously, there could not legally be discussions between the Bank of England, which was the regulator at that time, and the auditors. The Act removed that barrier but did not insist on it, because the Bank of England did not want it. We have gone on about it, though, and it is now statutorily required.

Sir Winfried Bischoff: In fact there is symmetry: auditors are supposed to inform the PRA if they have particular concerns.

Lord Lawson of Blaby: Absolutely, it is a two-way street. That is very important.
Lord McFall of Alcluith: We actually suggested that auditors should embrace investors, shareholders and others. That is very important. So there is a wider remit for auditors rather than the narrow one that they had.

Stephen Haddrill: The second point is that we have just begun to produce better competition for quality in the audit market rather than competition for price. We have laid the groundwork for competition with the introduction of the retendering of the audit on a regular basis. At the same time we introduced requirements for an enhanced audit report, so auditors will have to say more about the work that they have done, how they have addressed the issues that have come up and the materiality threshold judgments that they have reached. We have started to see investors really paying attention to that and applauding the reports that are coming through. If you combine that with competition, and most of the banks are putting their audits out for tender now, you actually have the auditors thinking quite hard about how to win an audit by doing a good job rather than by doing the cheapest possible job. I think that that has changed. The other thing is that we have really focused our own inspection activities on the banking sector, and if we find things wrong we are doing much more now to require work to be put right, and so on. It is a more intensive effort on our part as well.

Q10 The Chairman: Can I come back to the possible conflict between the IFRS and company law? As I understand it, the local authority got an opinion from George Bompas who said that there was a clear conflict and, further, that the FRC’s view that the true and fair view did not encompass distributable profits was incorrect. We are not here to try to judge one or the other, but what steps are you taking to resolve what could be quite a serious problem?

Stephen Haddrill: We did two things. First, we took our own legal advice from Martin Moore QC, who concluded almost exactly the opposite of what Mr Bompas had concluded.
Secondly, we asked the Government also to review this, because after all a matter of company law is a matter for the Government rather than for the regulator. Government’s lawyers also looked at it and concluded that they agreed with Martin Moore’s opinion. The Minister issued a statement, as did we, a year or so ago to that effect in order to clarify the matter for the market. So we feel that the matter is resolved. I do not think that the local authority pension funds feel that it is resolved, but we feel that we have done what we needed to do.

Q11 Lord Monks: You have been rather pessimistic about any prospects for a successful international convergence, if I may put it delicately; in fact, you have been thinking of it almost as a dead duck. In a world where global businesses are responsible to different regulators, I am interested why this is proving so difficult. Where do you think the main problems might lie? Is it possible to account for the difference, perhaps the key difference, between the Americans and the IFRS over the forward loan-loss provisions that banks are required to develop? This is obviously a big difference. Can I press you to say a little more than you have so far, and check your pessimism?

Sir Winfried Bischoff: I am not quite as pessimistic as Mr Cox was in his comments that convergence is a dead duck. I think that it will continue to be difficult. The problem lies with the fact that there is a very large economy that does not work on IFRS but on the US GAAP. My own view is that as the proportion of the world economy in the United States diminishes, although the US is still going to be an immensely powerful place to do business, there may in fact be some greater convergence. Will there be uniformity? My own view is that that is still a long way away, but there is already convergence—for example, Paul Volcker and others have been very outspoken on looking forward in relation to provisioning, although I think that their provisioning is somewhat different; it is more
formulaic than an actual judgment call. So there are areas of convergence but uniformity is still a long way away. That is my view, but Stephen will have his own view.

Stephen Haddrill: Well, it is important that we do not give up on the project but, as you say, it is not going to come about any time soon. The best hope now is that the US considers whether it will allow US companies to adopt IFRS on a voluntary basis. That is a pretty difficult thing to do because it reduces comparability within the US, but there are already two systems there because the dual-listed companies in New York are allowed to use IFRS, and generally do. Elsewhere in the world, about 13% of the market in Japan has moved to using IFRS, even though there is still Japanese accounting. The principle here is that basically the market will decide; if the market likes IFRS then more companies will sign up and we will go down that route.

Sir Winfried Bischoff: Asian companies are increasingly using it and that is a growing part of the world economy, so, to that extent, geographic diversity in the strength of GDP is going to continue to happen. I think that IFRS will become more important, but at the moment the US is still the stand-out.

Q12 Lord Smith of Clifton: Gentlemen, the Law Commission recently expressed concern that the concentration of stewardship in the EU equity market may lead to a “lowest common denominator” approach. Do you think that the concentration of stewardship is a concern?

Sir Winfried Bischoff: Why do you not start this time, Stephen? I have a slightly different view.

Stephen Haddrill: I am not sure that concentration is the core issue here. One of the real issues is that we are seeing the globalisation of asset management, reflecting the globalisation of the market. All that we want to see is good-quality engagement between asset owners, asset managers and companies. With the best will in the world, that happens less the higher
the proportion of the market owned outside the UK, in relation to UK companies. Equally, some of the asset owners who have traditionally engaged heavily, the insurance companies, are owning smaller volumes of equities than they did in the past. That is one of the reasons why the quality of engagement is potentially threatened. Some of the proposals that Professor John Kay came up with and which the Government have been promoting, including the setting up of a new investor forum, are needed so that we get continuing pressure for engagement coming for investors.

**Sir Winfried Bischoff:** Stephen and I are ad idem on that. At the same time, I believe that it is incumbent particularly on some of the larger investors, whether they are direct investors or agents for investors, to engage more with companies. I know from personal experience that if there are two bodies that you listen to as the chairman or chief executive of a company, it is the regulator and your large shareholders. The large shareholders are underestimating their power to make companies get things done. Even though it is correct, as Stephen has mentioned, that UK institutions own far less of the UK market, and we can influence only UK institutions, I hope that those institutions that take an interest in this will be able to make their influence heard.

**Lord Smith of Clifton:** We are all aware of the change in the nature. Recently there have been a number of highlighted shareholder revolts, particularly over executive remuneration. What improvements would you like to see in fund manager and shareholder engagements with companies? Many of these shareholders, welcome though they are in some senses, peter out. Even when they have a majority of the shares, it is not legally binding. We are in a kind of no-man’s-land here between the shareholders and the equity owners. How can we make this better and bring them closer together?

**Stephen Haddrill:** Part of the consultation on the corporate governance code is on the question of remuneration. It is important that that engagement takes place at a relatively
early stage and that companies talk to investors at an early stage. Equally, if investors are going to have major concerns, it is important that they do not raise them at the last minute; it is too late then for the company to do anything about them. To a large extent it is about timing. There has been some anxiety this year because companies have felt that investors have voted for a policy but then have not voted for the results that came through from it, while investors have felt that companies have not done enough to interpret the policy sensibly.

**Lord Smith of Clifton:** That redefines the problem. It does not solve it.

**Stephen Haddrill:** It does not solve it. Engagement is the answer—engagement at an early stage—along with genuine listening and, as Win was saying, more of it from people who have the power to make a real difference. That is the other trick. Some companies probably have not seen the investor for some considerable time, on any issue.

**Lord Smith of Clifton:** That must also be the investor’s fault.

**Stephen Haddrill:** It is a mix of the asset owner and their fund manager. One of the things that we would certainly like to see is more attention paid to engagement in the mandates that the asset owner is giving to the fund manager.

**Sir Winfried Bischoff:** From a purely practical point of view, even though it is not legally binding, it is quite interesting to observe companies if they have a 30% vote against versus a 70% vote for. There is already quite a reaction among companies and chairman of remuneration committees. This is a warning shot and they are not just taking it lying down; they are actually going to do something about it. In fact, with a few exceptions, they are doing something. There is an element of it that the companies have heard, when 30% vote against the remuneration report.

**Lord Smith of Clifton:** But this change in attitudes has taken a hell of a long time.

**Sir Winfried Bischoff:** It has.
Q13 The Chairman: In your annual report last week you said that you had concerns about whether companies, markets and policy-makers take a sufficiently long-term view. This of course was one of the issues that John Kay raised in his report. It is always striking that shareholders get themselves into quite a lather about executive pay, and there is nothing wrong with that, but sometimes whether an executive is paid more or less than he or she is worth is surely less important than whether or not the company is going to survive beyond the end of the year. When we did our 2011 report, it was striking that the shareholders had been quiescent in the period leading up to the crisis, and in fact in many cases had been egging on management to pursue business models that turned out to be completely hopeless and led to the collapse of those businesses. We can wring our hands about this state of affairs, but what can we actually do? What can you do, given that you are in charge of the stewardship code, to encourage and possibly insist upon a much greater degree of engagement between owners of companies and those who manage them about the long-term future viability of the company?

Sir Winfried Bischoff: One of the areas is for asset managers to be more descriptive about what they are doing and the way in which they are engaging with companies. Another is for companies to be more transparent about their longer-term viability. We have talked about going concern. There have been examples, such as IBM in the US under Ms Rometty and Sam Palmisano giving out a five-year plan; the share price of IBM responded positively to that. Many managements would find it difficult to do that but it is another way of doing it. There is a very difficult one: debt is advantaged tax-wise from equity, and perhaps consideration ought to be given to narrowing that advantage in some way so that longer-term equity capital would be the longest-term capital, so that institutions would then go for that. So there are a number of areas, none of which as far as I can see would be the recipe or the silver bullet. To some extent, there is the question of remuneration; we are now
talking about three-year or five-year vesting being more appropriate so that there is a more considered long-term view by management also. Transparency, the stewardship code, putting investors or their agents on notice that they should in fact be describing what they are doing and how they are investing—it is these kinds of things.

Q14 Lord Lawson of Blaby: On the tax front, it is indeed absurd that the regulator is urging the banks to have more equity and less loan capital while the tax system says—

Sir Winfried Bischoff: Do the exact opposite.

Lord Lawson of Blaby: The exact opposite. The change was recommended by the report, whose commission the IFS hosted. It was also recommended by the parliamentary commission. Are you urging the Chancellor of the Exchequer to make a change?

Sir Winfried Bischoff: We have not yet urged him. We have spoken about it—I spoke about it at the London Stock Exchange last Thursday—but we have not made a formal recommendation.

Stephen Haddrill: Perhaps after today.

Lord Lawson of Blaby: I think it would be a good time to do so.

The Chairman: On that very positive note, thank you very much indeed for your evidence. Just one question: when do you expect the consultation period to be finally concluded and your recommendations to be published?

Stephen Haddrill: On going concern? It closed at the end of June. We will be considering responses over the next couple of months, and we hope to make an announcement in the middle of September. If you wish to give as a view before then, we will take that into account.

The Chairman: My predecessor set out the view of the Committee very clearly in the correspondence that he had with you. We will look forward to your publication in the
middle of September, and we hope to see that it reflects our concerns. Thank you very much.