



FRC PLAN AND BUDGET 2022-25

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ICAEW welcomes the invitation to comment on the **Draft Strategy, Plan and Budget for 2022-25** that the FRC published on 18 January 2022.

The transition from the FRC to ARGA will be a period of considerable change. We encourage the FRC to use the next year to undertake the following measures:

- The FRC should clarify how it aims to build capabilities that meet expectations for ARGA and how it will approach the task of shifting public perceptions.
- We would welcome further information about how the FRC is changing as it starts to apply the Regulators' Code, and how it intends to report on performance against it.

This letter makes a series of suggestions grouped in these areas. It is intended to provide constructive ideas and suggestions to help the FRC as it transitions to ARGA.

This ICAEW representation is made by the Reputation & Influence Department and reflects consultation with the Business Law Committee. The Business Law Committee includes representatives from public practice and the business community.

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- We appreciate the invitation to comment on the FRC's **Draft Strategy, Plan and Budget for 2022-25** ('the Strategy'). The transition from the FRC to ARG A will be a period of considerable change. With high expectations of the new regulator, the transparency of this exercise sets the tone for how the regulator can meet expectations to drive up quality. In doing this it will be essential to work with the whole corporate reporting ecosystem, including ICAEW, and we welcome further dialogue as the FRC transitions into ARG A.
- We welcome the recent announcements of appointments to the FRC Board and of Sir Jan du Plessis as Chair. We believe these appointments put the FRC in a strong position to advance work on its transition to ARG A. A key determinant of the new board's effectiveness will be its inclusivity and reflectiveness in understanding the needs and expectations of constituents across the corporate reporting eco-system, including SMEs. In this regard, we hope the comments in this letter will be helpful to the Board as they guide the journey ahead.
- The Strategy visibly reflects engagement with stakeholders. We warmly welcome the FRC's efforts in considering carefully how best to encourage high standards. Among other references to this collaborative approach, the Strategy recognises 'with our regulatory powers comes a responsibility not only to apply those powers fairly and proportionately but also to provide clear and effective guidance to all those we regulate and support them to improve and meet our expectations over time'. This is a clear and thoughtful statement of intent. It provides a strong frame of reference for the FRC's transformation to ARG A. We encourage the FRC to further develop this thinking.
- As a funding body of the FRC we appreciate the macro context is that the FRC's budget is going up considerably. The £9.1m increase (18%) comes after major rises in previous years. We support these increases. The FRC needs sufficient resources to be able to address the recommendations of the Kingman review and the expectations that sets. It needs to be equipped to carry out all the functions expected of it, and to attract and retain skilled staff. The statutory funding review needs, in due course, to consider how the cost of regulation is shared fairly across the eco-system.
- Regardless of funding, the principle should be transparency and value for money. There are some areas where further elaboration would help stakeholders to better understand the FRC's plan and strategy during this critical period – including some aspects that need to be developed with some urgency. We welcome the invitation to share our thoughts with the FRC – in this letter we suggest how the Strategy could be developed and where further disclosure would be helpful.

1) Key points

- Preparing for transition in 2022/23: Sir John Kingman envisaged a new regulator quite different in resource, power and approach to the FRC and it is good to see the Strategy thoughtfully consider the transformation in maturity and mandate required. Getting to ARG A will require not only that the regulator builds a lot of new capabilities, but also that it succeeds in changing perceptions among consumers of corporate financial information.

There are high expectations on ARG A, for whom BEIS has set the intangible and ambitious objective of restoring trust in corporate reporting and audit. It has not yet been articulated what success for ARG A would look like, or how it will be measured, and the first task for the new regulator will be to set clear expectations for what it can reasonably achieve. To do that ARG A will need to make a balanced assessment of the public interest, and what the public are seeking it to achieve.

The challenge ARG A faces is to reverse perceptions that corporate reporting and audit is failing. The FRC has successfully brought cases of serious misconduct into the public consciousness, including by highlighting increasingly severe sanctions. We expect all stakeholders will welcome a regulator that, with appropriate balance, upholds

Kingman's vision of being 'respected by those who depend on its work, and where necessary feared by those whom it regulates'.

To inspire that respect, ARGA will need to rapidly establish confidence that under its guidance reporting, audit and governance is of high quality and can be trusted. To do that evidence is vital – what has worked and what has not? Four years after the Carillion failure, and with the experience of a period of rapid action by the FRC and regulated firms, that evidence should be clearer. Evidence should help with a comprehensive response to the criticisms of the corporate reporting eco-system which continue to be repeated in public debate.

It is these perceptions that ARGA will need to address. We believe that doing so will require a paradigm shift, and that the Strategy should reflect the scale of this task. The delays currently being encountered in the release of the Feedback statement may have repercussions on the Strategy that need to be considered.

The FRC should clarify how it aims to build capabilities that meet expectations for ARGA and how it will approach the task of shifting public perceptions.

- **Implementing the Regulators' Code:** We warmly welcome the indication that the FRC will apply the Regulators' Code, has spent time considering what it means for them, and will be providing regular reporting on how it has applied its principles. The Regulators' Code is a balanced and thoughtful document that can provide a strong underpinning to ARGA. The 'four faces' appear to be an interpretation of the Code's principles and have potential as a model to guide ARGA's approach; nevertheless, accountability should, of course, be to the Code itself.

We would welcome further information about how the FRC is applying the Code and how it intends to report on performance against it.

2) Transitioning from the FRC to ARGA

- Sir John Kingman said AGRA needs 'a clear and precise sense of purpose and mission' and Chapter 2 of the Strategy anticipates new statutory objectives 'underpinned with a clear set of regulatory principles'. We hope these statutory objectives define the clear and precise mission that Kingman desired –there is a risk that where they leave room for interpretation they may set expectations that are difficult to meet. Chapter 2 sets out the FRC's current objective of 'setting high standards of corporate governance, reporting and audit and holding to account those responsible for delivering them'. It would be helpful to articulate how the FRC sees success against this objective being measured.

The FRC could articulate how it will progress to a clear and precise definition of ARGA's mission.

ARGA's mission will be more achievable if it is focused squarely on Directors' responsibilities in Part 15 and 16 of the Companies Act 2006 for reports, accounts and audit. We await to see ARGA's statutory objectives, principles, and powers, but at this stage a proportionate response could be for the FRC to start planning for how it sees the perimeter and focus of its role. That would imply a narrower focus than suggested in Chapter 2. Specifically:

- What options will it have to increase PIE director accountability for effective internal controls over financial reporting? This is the nub of the question of how better governance can be achieved. How will it work with other regulators that have powers in this regard?
- How will the 'early warning system' of corporate stress, as envisaged by Kingman, provide actionable intelligence?
- How can investors be mobilised as more effective stewards of reporting quality? They have a key role to help prepare for a new statutory requirement for an Audit

& Assurance Policy. With growing focus on ESG reporting, what levers can ARGAs expect to have to drive a culture of improvement?

- We welcome the statement by the FRC's Board and executive that they 'believe strongly in the important contribution our activities make towards improved outcomes for all stakeholders in our ecosystem'. This could be extended by recognising the importance of 'improved outcomes **by** all stakeholders'. We believe that improved corporate reporting has to be at the heart of all ARGAs' work. The ARGAs envisaged by Kingman recognised the role of an effective ecosystem where company directors, auditors, audit committees and investors all played their part.

The FRC could clarify the role of all ecosystem partners in achieving its mission.

3) What kind of regulator will ARGAs be?

- We're pleased to see the Strategy recognises that 'stakeholders would value a clearer understanding of what kind of regulator ARGAs will be, and how we will use the various regulatory and other tools available to us'. It's encouraging to see the FRC will aim to be fair & proportionate, provide clear & effective guidance, and offer support to help those it regulates to improve. This is the approach we believe the Regulators' Code envisages.

We encourage the FRC to develop this approach and disclose more about it.

- It would be good to see further elaboration of how ARGAs will be transparent in carrying on its activities and how it will be accountable. In developing its regulatory approach, we would like to see this dimension expanded.

Transparency is important in consulting on new and improved rules and regulations, and the FRC already operates a good due process. Transparency could be improved in reporting on outcomes and decisions reached – both to ensure processes are fair and enable better opportunities for learning and to help in demonstrating value for money.

- The 'four faces' reflects the spirit of the Regulators' Code. We are pleased to see the FRC identify an explicit focus on being a system partner and facilitator alongside its established approaches of supervision and enforcement. We assume that for teams and individual staff members the four faces would combine in different ways, as supervision and enforcement are carried out by distinct teams – but it would be a shame if at least to some extent the role of system partner and facilitator was not embodied in all ARGAs' activities.

We hope that each of the four faces will be given equal weight as ARGAs develop its working practices, procedures, policies and culture.

- We also hope that the four faces can have equal weighting as ARGAs develop its reporting, so that more reactive KPIs for supervision and enforcement activities are presented alongside proactive KPIs for partnering and facilitating activities.
- The education aspect of Partnering deserves particular attention in the transition to ARGAs – both educating the regulated about regulatory expectations, and educating the market in a fair and balanced way about audit, reporting and governance quality. It should explain the meaning of reported results and encourage better user engagement with those results. We recognise the importance of ARGAs communicating poor outcomes candidly and quickly – but market confidence equally depends on timely information about positive developments.

ARGAs should celebrate what is done well in creating an affirming regulatory environment.

- Education also implies consistency – that equivalent expectations will apply, for example from the point audit planning commences to the point an inspection concludes – possibly an extended time period. Achieving this requires discipline and fairness, especially where hindsight suggests different conclusions. But quality is likely to be

undermined where the regulated suspect moving goalposts. Guidance must first be issued, then consumed and acted upon, before performance against it can be assessed.

- An ARGA with a culture of improvement is also important. We believe that means taking a bespoke, risk-based approach to supervision and enforcement. Where failures occur, they are invariably attributable to major and acute areas of risk. These vary between businesses, sectors and economies, but what they share is their relative size and significance. Those factors need to be addressed with a risk-based approach.

4) The operational impact of change

- The document is helpful in setting out both anticipated new responsibilities and areas of increased focus and the FRC's specific priorities and deliverables for 2022/23. We did note that there is only a little alignment between the two. We agree that some activities will have to wait for legislation, that uncertainties remain and that new staff need to be brought on board. Nevertheless, we would have expected the 2022/23 plan to lay more groundwork for ARGA than it appears to. That is particularly important when it comes to creating the forward-looking, risk focused regulator Kingman envisaged. While partly this depends on new powers not yet received, it also requires a change in culture and approach more pervasive than suggested by the 2022/23 priorities.
- In reality, ARGA will be defined both by the expectations placed on it – which are already set out in the three reviews and the White Paper – and by the extent and limits of its powers, both 'soft' and 'hard'. It may face gaps in powers awarded or undefined overlap in its remit with other regulators. Even where there are statutory provisions, effective impact may depend on actions across the eco-system and require attention to hearts and minds. For example, the Audit & Assurance Policy has great potential, but will require commitment and goodwill to build critical mass. Combined, these challenges risk an expectation gap and this could be exacerbated by delay as ARGA gets up to speed.

To address this, there is an opportunity in 2022/23 to define ARGA's mission, perimeter and mandate and to build mechanisms to support the relationships and partnerships vital to success.

Partly, this is about developing fair, achievable and stretching expectations – taking the frame of reference beyond the three reviews and the White Paper into practical implementation. Partly it's about 'pushing the envelope' to see where and how collaboration, capabilities and political support can enable ARGA to do things differently.

- Specifically, we see five challenges that could start to be addressed in 2022/23, but are not explicit in the priorities listed:
 - i. delivering high-quality corporate reporting: Kingman and Brydon had a clear vision of reforms they felt were necessary to avoid surprise failure. We agreed with steps to enhance regulation around internal control effectiveness, resilience and fraud which we saw as vital to ARGA's success. The White Paper envisaged an ARGA that could both receive early warning of stress and enforce greater accountability for internal control. Achieving this will require a lot of work and the groundwork for that could be laid now. Were ARGA not to receive the full range of powers anticipated, even more work is likely to be necessary to construct compensating measures. That needs to start early.

There is a particular challenge, and high expectations, around Environmental, Social and Governance reporting. In the short-term the FRC will need to increase its focus on TCFD reporting and to lay the foundations for increasing requirements in this area as the standards of the International Sustainability

Standards Board are developed and the UK government increases its ambitions. This is not visible in the plan for this year.

We support the new audit sandbox and are pleased to see this included. More disclosure could be given of how this will be structured and funded and how it will operate. The FR Lab has a strong role to play and deserves greater visibility in the Strategy.

The increase in budget for Corporate Reporting Review and the FR Lab is lower than the average overall increase. Given how important this is, we question whether this is the right allocation. Investment in corporate services appears high in comparison and is surprising given that economies of scale might be expected as the FRC grows.

- ii. addressing fraud and resilience: where corporate failures occur and reporting plays a part, history tells us that this is often due to reporting being undermined by fraud or failing to properly reflect resilience. These factors are unlikely to change and should be an area of specific focus in the transition to ARGA.
- iii. building stakeholder confidence: restoring trust will require strong engagement and visible performance across the ecosystem - for example, by better enabling investor and audit committee decisions on the basis of audit quality – this is a major deliverable and there is a risk the bigger picture is lost in micro-activities. For example, in developing the Audit Firm Governance Code the bigger objective of increasing decision useful information for those commissioning audits should be prioritised over shorter-term operational changes.

Communicating improvement is also important. Despite significant focus by auditors and audit firms on quality in recent years, improvements achieved are sometimes difficult to discern in the FRC's communications.

- iv. supporting smaller audits: the priorities do not refer to SMEs or smaller audits, yet by the end of the 2022/23 many more small firms will have withdrawn from the audit market. This crisis in the small audit market is a matter of public interest that risks key community entities such as charities struggling to find local support to ensure their accountability. The FRC needs to be clear what it will do here.
- v. local audit systems leader: local audit is in crisis and failings in local authority reporting are increasingly apparent. The market for local authority audits is becoming more and more unattractive and some local authorities risk being unable to find an auditor. Expectations are high that ARGA can remedy this situation when it assumes the role of systems leader, but it will be challenging to make an early impact. Preparing for this role is listed a priority and this will need concerted attention and wide support.

5) Risks and challenges

- The FRC's Annual Report and Accounts for 2020/21 provides a good reflection of the strategic risks facing the FRC as it transitions to ARAG. It recognises these risks:
 - a) regulatory reforms are delayed or ineffective;
 - b) failure to drive the necessary behaviours and outcomes;
 - c) inconsistent corporate reporting and audit quality;
 - d) disruption in audit market.
- The Strategy recognises that many risk factors are outside the FRC's direct control. This highlights the value of early preparation and planning for different scenarios. We believe the four actions below could help mitigate the principal risks and assist in planning for how ARGA can use its new powers and resources most effectively:
 - a) Educate and collaborate with stakeholders to develop reasonable expectations: Kingman set high expectations for the new regulator and even with the full range

of statutory powers envisaged, achieving the outcomes suggested will be very challenging. The BEIS White Paper, in places, appeared to imply the regulator could delay or prevent failure. To be successful ARGA should be careful in avoiding the misconception that it can play some kind of prudential role. ARGA can reduce the risk of surprise failure by encouraging transparency around resilience and stronger controls against financial reporting fraud – and should be clear in articulating this precise focus. As the new regulator works through the detail of its mandate, collaboration with and education of stakeholders will be needed to move on from the three reviews and establish clear and deliverable expectations. That work can start early.

A major challenge the FRC faces is in clarifying expectations so that they correspond with its powers and responsibilities. There are particularly likely to be expectation gaps where action is expected of the regulator, but it lacks the power, to act – or doesn't even have a formal nexus for action in that area. A key example is Environmental, Social and Governance reporting; stakeholders are calling on auditors to do more, but while this information is presented outside of the financial statements there are limits on the extent to which they, and the regulator, can intervene.

- b) Bring the ecosystem together with a culture of improvement: We were disappointed that the BEIS White Paper said little about the importance and role of the ecosystem working together to drive improvement. We hope that the System Partner approach will be elaborated as ARGA is set up – and Chapter 5 could say more about collaboration and engagement. In our view this needs much greater emphasis if the regulator is to be successful in inspiring behavioural change.
- c) Structure engagement to encourage higher quality: Consistent quality can best be achieved by collaboration and engagement with those ARGA regulates. The way in which these mechanisms are constructed, invested in and relied up will be just as important as the regulator's statutory enforcement powers. This could also be given more emphasis in Chapter 5. This work can start ahead of statutory powers – especially where it involves strengthening trust between the regulator and regulated.
- d) Monitor behaviours and outcomes to support the audit market: There is a risk that regulatory action or market forces have the opposite effect on the PIE audit market than that sought – namely that competition and choice is reduced rather than increased. Careful observation is needed of the effect regulation has on firms considering entering the PIE audit market or remaining in it. We outlined concerns in this regard in our response to the Audit Firm Governance Code. Chapter 5 could recognise the importance of researching and monitoring developments in the PIE audit market, to inform regulatory responses.

The chapter does not cover SMEs or the smaller audit market. We believe that audit availability for SMEs plays an important part in Levelling-Up and that this should be an immediate priority for the FRC.

6) Key outputs

- It is good to see that the Strategy includes quantitative KPIs. It is important that the FRC's performance is monitored over time and that improvements across the corporate reporting ecosystem are recognised consistent with growing budgets and expectations for ARGA. Presented alone or with undue focus, these KPIs may not give a compelling impression of the regulator's effectiveness. Ultimately what needs to be accomplished is a sense of confidence in consumers of corporate reporting. That is quite different to the numbers of inspections concluded and may not even be correlated with these levels of activities.

The strategy says that enforcement activity is expected to increase due to 'economic stresses on companies'. We disagree with this expectation; enforcement should follow reporting and/or audit failures. Although corporate failures are evidently more likely in times of stress, we do not agree that should be expected to correlate to increased failures of reporting or audit. Quality reporting and audit should be expected throughout the economic cycle.

ARGA needs to set clear expectations for how specifically it will seek to restore trust in audit and corporate governance – and how that will be measured.

7) Growing to meet existing and new obligations

- The information on page 15 about the FRC's new approach to its people is helpful and it is welcome to see the efforts being made to instil a positive culture. The four objectives of being Influential, Effective, Fair and Independent will undoubtedly enhance the capacity to deliver on the mission anticipated for ARGA.
- The headcount plans indicate that capacity will be built rapidly to support transition to ARGA. The Strategy could give more explanation about how these investments will enable the FRC to deliver capabilities in areas not yet fully served. We see these as;
 - i. delivering the 'early warning' system envisaged by Kingman;
 - ii. being an international leader in rapidly developing sustainability reporting and assurance;
 - iii. getting investors engaged to take a more active role in stewardship;
 - iv. developing capabilities to be effective in encouraging boards to take greater accountability for the effectiveness of internal control;
 - v. greater analytical capabilities to support significant new powers for Corporate Reporting Review;
 - vi. gearing up to be effective in influencing internationally at the highest levels, making best use of provisions in the UK-EU TCA and other trade agreements for regulatory cooperation and deepening UK representation and effectiveness in international fora.
- Greater detail would be useful about what the FRC anticipates the additional staff to be working on and what they are expected to deliver. It is also likely to be the case that recruitment at the pace envisaged will be difficult in the current market, the Strategy could further consider contingencies and implications if vacancies prove hard to fill during the period of the plan. That could include whether changes will be needed to pay strategy.
- We are disappointed that the budget only covers the next 12 month period. The budget has already increased considerably since 2018 and it would help for the Strategy to set clear expectations for how it will evolve following this year.

8) Statutory funding plans

- We agree it is best to consult on the new statutory funding model once draft legislation is announced. As we say above, significant questions remain about the right expectations and mission for ARGA and these will require refinement and engagement to hone them down. That exercise needs to be done properly to avoid another expectation gap and it is difficult to see how a financial footprint can reasonably be arrived out without greater clarity around the mission. We agree that the funding model should be fairer, more transparent and more proportionate. Action is needed to spread the load more equitably across the eco-system.
- Beyond this we note that the document does not contain any metrics to enable assessment of value for money. We support sustained and adequate investment in quality audit, reporting and governance. But there needs to be a clear understanding of what the regulator is delivering to help achieve this.