



REVIEW OF THE FINANCIAL REPORTING COUNCIL BY SIR JOHN KINGMAN: ICAEW SUBMISSION

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The Review of the FRC by Sir John Kingman comes at a pivotal point for the UK accounting and auditing profession and the UK's corporate sector. The immediate rationale for the Review, as implied in the first objective set out in the Call for Evidence, is a concern over the quality of corporate governance and audit in the wake of recent high profile corporate collapses and subsequent questions over the FRC's role, powers and effectiveness in these areas.

Hence many of the questions posed in the consultation document point to an analysis of past performance by the FRC, in its engagement with recognised supervisory bodies, corporate boards, audit committees, audit firms and investors. These questions are legitimate and the suggested answers and solutions will no doubt assist to strengthen corporate governance and audit in public interest entities and improve investor confidence.

However, alongside that, we would argue for the greater importance of the Review's second objective: 'to see the FRC standing as a beacon for the best in governance, transparency and independence.' In our opinion it is vital that the Review considers the wider context created by the UK's impending exit from the European Union in March 2019 and to ask 'what kind of FRC do we need, to assist the UK economy to prosper in future?'. The FRC in its current form is partially a product of the UK's membership of the EU, in particular the way in which it derives its role as the UK's ultimate competent authority for audit regulation from the EU's audit regulation and directive, enacted in UK law through the Statutory Auditors and Third Country Auditors Regulations (SATCAR) 2016.

Taking this perspective, it is quite appropriate that the Review should ask whether the FRC is the right body to represent the UK's interests and to promote international regulatory and investor confidence in accounting, auditing and corporate governance in a post-Brexit world where the framework within which the UK operates will have fundamentally changed.

We believe the FRC is the right body, but that significant changes in its governance, powers, culture and ways of working are required if it is to fulfil this vital forward-looking role. We submit our representation in this spirit and trust that it will assist the Review in reaching conclusions that are in the best interests of UK businesses and the wider economy.

The content of this representation dealing with the FRC's responsibility for statutory audit and associated regulatory activity has been supplied by the ICAEW Regulatory Board, as distinct from ICAEW Council and Board.

In the interests of transparency, ICAEW is the largest UK Recognised Supervisory Body (RSB) under the FRC's scheme of delegation for audit regulation. We licence the majority of public interest entity (PIE) audit firms, including the 'Big Four'. ICAEW, together with the firms it licences for audit, comprise the largest single funding source of the FRC's activities.

MAJOR POINTS

1. The primary responsibility of the FRC should be to create and sustain domestic and international investor confidence in the UK business sector by setting, promoting and maintaining high standards of corporate governance, financial reporting and public interest entity (PIE) audit. ICAEW believes that this role must be seen in the context of the need for the UK after its exit from the European Union to be perceived as a place where the business and investment environment is both attractive and well regulated. Central to that perception will be a regulator of global standing: with a clearly-understood remit, excellent political, market and professional insight and a reputation for acting proportionately and with integrity and agility. (Questions 1, 3 and 10 mainly refer).
2. The FRC should operate with enhanced integrity, and its relationships with government, business and the professions should support its institutional autonomy and its ability to act at all times in accordance with its statutory responsibilities. It cannot be responsible for preventing all corporate failures, but should operate within a 'risk envelope' agreed with government. It should intervene reasonably and proportionately, conscious of the impact of regulatory activity and the manner in which it is conducted, not least on market concentration and competition and the UK's wider reputation as a place in which to invest and do business with confidence. (Questions 15, 27 and 35 mainly refer).
3. The future standing, status and pronouncements of the FRC should be commensurate with its global responsibility. It will be a key contributor to how the UK is seen around the world as a market for investment and a place to do business. It must therefore have both the capacity and the capability to play a leading role in influencing the development of international accounting, auditing and ethical standards. Although the updating of the FRC's remit to cover corporate governance, financial reporting and public interest entity audit would suggest that a change to its title would be appropriate, this should be balanced against the substantial equity which exists internationally in its current name and brand. (Questions 2, 18 and 43 mainly refer).
4. To better equip it to undertake its primary responsibility, the FRC should include a new 'Corporate Governance Office' or similar, with a specific mandate to monitor and improve technical, ethical and other standards in corporate governance, and powers to hold to account all directors of unitary boards - not just members of professional accountancy bodies - in public and large private companies and public interest entities. (Questions 3, 27 and 31 mainly refer).
5. We do not believe that the remit of the FRC should include public sector audit, actuarial standards and the monitoring and oversight of non-audit activities of the professional accountancy bodies. In our view these functions do not align with the FRC's future role of promoting confidence in the UK corporate sector, and would distract it from its core objectives. (Questions 3, 11 and 26 mainly refer).
6. The responsibilities and powers of the FRC should have full statutory footing including a clear statement of its regulatory objectives, similar to how the responsibilities of the Legal Services Board are enshrined in the Legal Services Act 2007. To avoid regulatory confusion it should have clearly-defined boundaries with other regulators such as the Financial Conduct Authority (FCA), the Pensions Regulator, the Insolvency Service and the Competition and Markets Authority (CMA). (Questions 3, 32 and 34 mainly refer).
7. The FRC should have powers to challenge, investigate and sanction businesses, firms and individuals, sufficient to deter unethical or other non-compliant conduct - including full access to all documents and records necessary for such actions. The current slow speed of investigations is not in our view symptomatic of FRC timidity but in part a reflection on the

- nature of the legal processes involved and complexity of the cases. (Questions 25, 31 and 33 mainly refer).
8. The FRC needs to recognise the importance of the UK's small and medium enterprises (SMEs) and small and medium practices (SMPs) to the UK economy, both in the approach it takes to setting accounting and auditing standards for this sector and the representation of persons with the requisite experience within the FRC's governance structure. The emphasis on PIEs which has characterised the FRC in the past should now be balanced with an ability to understand and address the interests of the SME and SMP sector. (Questions 7, 20 and 43 mainly refer).
 9. The governance and culture of the FRC should support its operation as a 'learning organisation' and an 'improvement regulator'. To that end, the FRC's corporate vision should be at the strategic rather than just the technical level - that is, focused on the systemic effect it aims to deliver in business and the wider UK economy. Creation of an 'Audit Improvement Office' within the FRC would give focus to the desired outcomes from this aspect of FRC work. (Questions 3, 11 and 19 mainly refer).
 10. The FRC's regulatory objectives should include a duty to have regard to how its policies, decisions and actions impact or promote competition in the UK audit market. In particular, the range of sanctions which the FRC currently deploys in disciplinary cases should be expanded from the current two (fines and expulsions from membership) to the full range of nine set out in the SATCAR (Questions 16, 31 and 33 mainly refer).
 11. Regular and meaningful engagement and consultation with stakeholders in business (including employees and pension-holders), the investment community, government, the professional bodies, professional firms and other regulators should be at the core of its business model. It should be prepared to anticipate issues as well as addressing them, demonstrating a commitment to proactive innovation and improvement - as well as retrospective enforcement. With enhanced powers, the FRC must be ready to act quickly, both in terms of identifying an actual or potential risk, and in developing and delivering a response. (Questions 3, 7 and 28 mainly refer).
 12. The FRC should be adequately funded and resourced to undertake its primary responsibility, including the international aspects. Arrangements for financing the FRC need to balance the requirements of equipping it to perform its enforcement, research and influencing activities effectively (and if necessary, proactively), while maximising transparency and avoiding the perception of conflicts of interest. If the FRC remains as an arm's length body of a government department, the application of public sector recruitment and remuneration policies and practices must not constrain its ability to attract very high quality talent with the necessary technical expertise and professional credibility. (Questions 35, 36 and 43 mainly refer).

Question 1: What should the FRC's objective(s) be? Is its present mission statement the right one?

13. The FRC's revised regulatory objectives should anticipate a post-Brexit landscape which will require the FRC to promote the quality, competence and reliability of UK corporate governance, accountancy, auditing and ethical standards to international investors and regulatory institutions. The FRC's future objectives should also include the promotion and enforcement of high standards of corporate behaviour and conduct, and continuous improvement in accounting and auditing practice.
14. While the objectives might not include promotion of competition in the audit market (this arguably being the preserve of the CMA), it may be advisable for the FRC to 'have regard to

how its actions may promote or detract from measures taken by the CMA to improve competition’.

15. The FRC’s future mission should focus on fulfilling its regulatory objectives, which should include an over-arching public interest principle. We draw attention to the Regulatory Objectives in Part 1 of the Legal Services Act 2007, which state what is expected of the Legal Services Board by legislators, as an example of clarity in this respect. A duty on the FRC to consider the impact of its work on the UK’s SME and SMP sectors should also be included in its future objectives.
16. We do not believe that in a post-Brexit world the FRC should continue with its responsibilities for public sector audit. In particular, monitoring the quality of public audit in the local government and health sectors in England would now appear non-core to the FRC’s future role promoting confidence in the UK corporate sector. In our view, passing this function to the public sector Recognised Supervisory Bodies (currently ICAEW and ICAS) would be a suitable alternative and offer a better strategic fit.
17. With respect to the FRC’s role in actuarial standards, while actuarial work can contribute to material items in corporate balance sheets, we see no reason why this work needs to remain with the FRC. Discussion with the Institute and Faculty of Actuaries about a solution with a public interest oversight mechanism would seem appropriate.

Question 2: Does the FRC’s name remain right?

18. The FRC’s focus is clearly not just on financial reporting, but its current name does not encompass the other functions it performs. The FRC’s name should reflect its future remit in full, support the perception of it as a respected regulator and carry authority in an international context.
19. Some options which might better reflect the FRC’s future mission include:
 - Office of Corporate Standards
 - Office of Standards in Corporate Governance
 - Office of Supervision of Corporate Governance and Audit
 - Financial Reporting and Corporate Governance Council
20. Additionally, we note that the term ‘reporting’ connotes reactivity, whereas we believe that proactivity needs to be a more fundamental function of this regulatory body. We want the FRC to be respected as a proactive improvement regulator and to maintain its global reputation and stature.

Question 3: Are the functions and structure of the FRC still relevant and appropriate, or is there a case for any structural change? Should any of the FRC’s functions move to other regulators?

21. As mentioned in our answer to Question 1, we do not believe that the FRC should in future be responsible for public sector audit or setting actuarial standards. Post-Brexit, the FRC will have additional responsibilities with respect to the adoption of audit and accounting standards for the UK market and the assessment of third country auditors of non-UK companies listing on the UK market. Clarity and focus of functions will be essential.
22. We believe that the current function of the FRC to act as a wider accountancy regulator will no longer be necessary or advisable post-Brexit because:

- a) It dilutes the FRC's focus from its responsibilities as the UK's ultimate competent authority for audit under the Statutory Audit and Third Country Auditor Regulations 2016.
- b) Professional accountancy bodies have restructured their regulatory governance functions: for example, ICAEW has created the ICAEW Regulatory Board with a lay chair and equal membership of ICAEW and lay members. Supervision of accountancy outside of audit has only ever been under a voluntary arrangement.
- c) The Government's position in 2016 was that professional bodies should take the lead on wider accountancy issues and we are not aware that has changed.
- d) The inspection and regulatory work carried out by ICAEW and the other accountancy regulators in recent years has not revealed any systemic shortfall in the standards applied in these areas. There have been no questions or criticisms raised about the ability of the professional bodies to supervise accountancy work outside of audit.
- e) We are aware that the FRC Board is, in principle, in favour of changing the Accountancy Scheme to permit the professional bodies to deal with all disciplinary cases outside of statutory audit. The only sticking point is a requirement for changes to be made to the threshold for liability for business members, which is in part influenced by the limited powers of the FRC over corporate board members.
- f) The FRC has little or no in-house expertise in the investigation and enforcement of accountancy matters outside of audit.
- g) The professional bodies are overseen by, or answerable to, other independent regulators such as the Insolvency Service, the Legal Services Board, the Financial Conduct Authority, HMRC and OPBAS, for a range of non-audit services. The tendency of the FRC to also become involved leads to confusion for other bodies such as the Pensions Regulator and the Charities Commission as well as investors, consumers and the public.

Question 4: What lessons can be learned from other countries' regulatory systems? Which ones?

- 23. Oversight bodies in the United States (USA) and the Republic of Ireland have stronger enforcement mechanisms available to them. In the USA, the Securities and Exchange Commission (SEC) is able to exercise investigation and enforcement steps against directors as well as auditors¹. The Public Company Accounting Oversight Board (PCAOB) reviews the responsibilities of preparers of financial statements with respect to the internal control requirements of the Sarbanes-Oxley Act, as well as the work of auditors. In the Republic of Ireland the measures against directors and the auditors are side by side in Statutory Instrument No. 312 and the Companies Act 2014². There are no such similar measures in the UK Companies Act legislation except through narrowly defined elements in the Insolvency Act 1986³; this gap in the law requires further examination.
- 24. Lessons can also be learnt from other regulatory systems within the UK. There are elements of the regulatory framework under the Legal Services Act 2007 (LSA07) that work very well for the Legal Services Board (LSB) and could read across to the regulation of audit. For example:

¹US Securities Exchange Act 1934 Section 21

² Irish Companies Act 2014 Section 949

³ Eg, Section 76 of the Insolvency Act 1986

- Under the Government's Public Bodies Reform Programme, the Ministry of Justice is required to carry out a tailored review of the LSB every three years.⁴ As part of this review, a call for evidence is made to all stakeholders. This allows a quality feedback mechanism to give assurance to government, the stakeholders and indeed the LSB itself that the body is functioning effectively and meeting the statutory objectives;
- The use of series of objectives⁵ that allow for a wider view of the market to be taken so key policy decisions on certain objectives are not at the expense of other economic and social factors;
- An approach that seeks continuous improvement and innovation in regulation, rather than simply penalising shortfalls in performance, particularly where they arise as a result of new and innovative practices.

Question 5: How effective has the FRC been in influencing wider debates that affect its ability to deliver its objectives – for example, around audit competition or its legal powers?

25. Only very recently has the FRC encouraged any form of public debate in relation to its lack of powers to investigate company directors who are not members of professional accountancy bodies. This issue was raised by the HBOS report and the FRC Chief Executive's appearance before the Business, Energy and Industrial Strategy Select Committee, however we had previously on several occasions highlighted this disparity and its lack of recognition of the unitary board principle.
26. In addition, it is clear that some of the criticism arising from recent corporate failures comes from an expectation gap - between what an audit as defined under the Companies Act can deliver, and assurances the public believe are given as a result of an audit opinion, particularly in the areas of directors' responsibilities and fraud. This is a weakness in the law rather than in the efficacy of the FRC itself, but it is an area where the FRC could have been more proactive.
27. The FRC needs to have more regard in future to the impact its actions have on competition in the audit market. Proper discussion about the impact on competition for PIE audit work does not appear to have played a significant role in the recent sanctions review by the independent panel or in the FRC board's endorsement and implementation of the greater financial sanctions policy.
28. In particular, more regard is required to the possibility that increasing financial penalties may reduce further the number of firms in the PIE audit market and the number of partners prepared to sign PIE audit opinions. Lack of such consideration will cut across any initiative by the firms themselves and the CMA to encourage firms outside of the Big Four to re-enter this market. When this concern has been raised with the FRC, they have expressed disappointment about this criticism rather than balanced it with their enforcement obligations.

Question 6: Is the current balance between cross-cutting reviews and firm-specific investigations most effective?

29. Unlike other audit regulators, rather than just issuing inspection reports for individual firms, the FRC's Audit Quality Review (AQR) team issues thematic review reports, drawing on evidence from across the firms and covering audit areas that are of the greatest public interest. These reports have highlighted challenges faced by auditors and made practical suggestions for improvements. Examples of good practice are a key feature of these reports and these have been well received by auditors and by stakeholders.

⁴ Tailored Reviews – Guidance on Review of Public Bodies issued by the Cabinet Office in 2015

⁵ Legal Services Act 2007 Section 1

30. We encourage the FRC to continue this programme of thematic reviews. We are not aware of any indications that the programme has led to any lack of focus on firm-specific investigations, which are, of course, of paramount importance.

Question 7: What are the FRC's strengths and weaknesses?

Strengths

31. At the national level, the FRC has proven to be an effective standard setter, and it is also a significant contributor to international standards. It is a world class organisation in this respect and its work has aided the success of UK business and the reputation of the UK for high quality and proportionate reporting.
32. The FRC maintains a strong commitment to audit quality and has individual employees and governance members who are highly knowledgeable in the area of audit quality review.
33. There is a good sharing of intelligence and information by the FRC regarding potential risk issues uncovered at firms and there is also a close working together by the monitoring teams on thematic reviews.
34. In our role as a Recognised Qualifying Body (RQB), we have found the FRC to be proportionate, fair-minded and respectful in its work with us. We have built a constructive and transparent relationship, which is now codified under the Delegation Agreement. There is a consistency to the FRC's interactions with us, which helps us to plan and better comply with its requirements.
35. From an RQB perspective, where the FRC challenges our work, it gives us the opportunity to state our case, and may change its opinion as a result of what we say. Over the years there has been a marked and welcome drive by the FRC to only raise a formal recommendation against us in an RQB report if the matter is significant and cannot be closed off beforehand.
36. The FRC is also able to appreciate how a rule may affect a student, a member or an Authorised Training Employer (ATE). The director we work with most closely has always made herself available to meet with our Learning and Professional Development staff where there are major items we wish to discuss, and she is welcoming and incisive in her thinking.

Weaknesses

37. We believe that a heavy focus on compliance has weakened the FRC's role as a proactive and forward-looking regulator. This may in part be due to perceived constraints within the Companies Act that the FRC regards as limiting its opportunity to take such steps, but we have not found similar inhibitions in other oversight bodies. Objectives that permit a wider interpretation of the Act should aid innovative solutions and enable greater proactivity. We would have liked it to lead on development and change, and reach out proactively to the professional bodies to assist them.
38. The FRC can sometimes fail to listen or make adjustments when its approach is queried. When such concerns are raised, there is a tendency to be over-defensive rather than engaging in constructive dialogue. One example is its continued involvement in matters where it does not have the requisite in-house expertise or where its involvement confuses another statutory oversight regime, such as insolvency regulation.
39. The FRC's approach to its compliance duties, whilst diligent, is not always set in the context of wider objectives for business and the economy as a whole. An example of this is the setting of impractical KPIs for itself and its delegates that are outside the control of both parties. The FRC needs to improve its commercial understanding of issues, propose

- pragmatic solutions to problems and focus its resources on more important matters that pose greater risk.
40. Oversight inspections work well when, as in the past, the Oversight teams have identified systemic problems or made suggestions how the professional bodies could improve their processes to reduce risk. However, more recent inspections have had an over-concentration of listing all one-off errors identified which have had no significant consequence and which do not reveal systemic issues.
 41. The FRC's attention is widely spread and this weakens its impact in the areas of highest sensitivity and risk. The 2011 Barnier proposals (translated into the EU Regulation and Directive) were aimed at audits linked to systemic economic risk. The regulation sets out the active work of the ultimate competent authority (the FRC) for these risk areas, and the directive facilitates a less demanding regime for non-PIE auditors. The approach of the FRC in our view has lingered on the earlier regime that did not make such a distinction.
 42. It can take a long time for FRC staff to answer queries, even where there is no referral needed to FRC committees. The delays appear to be getting longer and there is now some evidence of a reluctance to respond at all. We appreciate that the reluctance may come from a realisation that the queries relate to complex policy and operational matters and there is no easy fix. But even if an instant answer cannot be given, we feel the FRC needs to build confidence both within itself and with the professional bodies by abiding by reasonable norms for responding.
 43. We would like the FRC to convene more discussions on challenges facing the profession. For example, it has often been up to ICAEW to bring a major education development in the profession to the FRC's attention, and to stress the need for action. The FRC rarely provides roundtable opportunities to discuss challenges, and projects can be discontinued without explanation.
 44. We would like the FRC to be quicker to recognise the practical issues with applying some of the more cumbersome parts of their own regulation, for example the imported EU Audit Regulation independence wording.
 45. We think the FRC should do more to ensure there is a level playing field across RQBs, particularly with respect to differing approaches to compliance with Schedule 11 of the Companies Act 2006. This has significant implications for competition issues between RQBs and also for clarity for organisations training students for the profession.
 46. The FRC needs to allow sufficient time for RQBs to respond to matters on which the FRC has had much longer to consider its needs or position. We are frequently asked to approve or supply something within a couple of weeks, where the FRC has had months. This fails to take into account the workload at RQBs.

Question 8: The recent joint report on Carillion from the Business, Energy and Industrial Strategy and the Work and Pensions Select Committees considered the FRC to be characterised by “feebleness and timidity” and recommended that a change of culture and outlook is needed. Do you agree? If so, please cite relevant evidence which informs your view.

47. We do not agree with the ‘feebleness and timidity’ characterisation. On the contrary, we have encountered examples of FRC firmness over the years, and there have been moments of marked disagreement between us. The FRC's enforcement team has, in our view, on occasion demanded excessive sanctions. The protracted legal process involved in investigating and prosecuting complaints should not necessarily be interpreted as ‘timidity’ – rather it underestimates how strongly firms will defend their work and reputations. The longer

process is also a necessary by-product of Article 6 of the Human Rights Act 1998, which gives individuals the right to a fair trial and adequate time to respond to evidence against them.

48. The role and powers of the FRC are also relevant. If the lack of punishment and taking to task of company directors for shortfalls in competence are seen as the main issues, then that is feebleness and timidity that is a characteristic of the law, not of the regulatory oversight body that cannot operate outside its terms of reference and the law. The FRC cannot do what it is not empowered to do.
49. We do think a change of FRC culture is needed, but to one that seeks to work more energetically and imaginatively with the profession on meeting the challenges brought by change. The FRC might do more to promote public understanding of the audit profession, by seeking to explain the scope of statutory audit and the outcomes it can be expected to deliver.

Question 9: Are there changes respondents would like to see to achieve the vision set out in the Review's terms of reference?

50. The terms of reference do not mention education; the FRC needs to be more attuned to the changing demands upon the profession and the RQBs, and this requires much greater engagement in solving the educational challenges facing the profession.
51. The terms of reference also fail to mention how the FRC's initiatives and strategy should have regard to the potential adverse effects on competition in the PIE market

Question 10: Are arrangements for financial reporting, audit and corporate governance the critical elements for effective delivery of FRC's mission, or are elements missing?

52. We believe these to be the three most important elements. However it is also important that the FRC's powers and focus allow it to investigate effectively the actions of all directors and senior managers at companies, rather than just those who are members of professional accountancy bodies, so that it takes proportionate action in relation to the individuals who have made the greatest errors or who have caused the greatest loss. This exclusive focus on members of professional accountancy bodies needs to be changed to reflect the enshrined principle of English company law that directors are collectively responsible.
53. At the moment, it is far easier for the FRC to investigate and sanction auditors (where possibly a poor audit was not the cause of the company becoming insolvent but rather that it was due to actions of the directors) as the FRC has far wider jurisdiction over auditors than directors. The FRC can only investigate based on expected standards. Auditing standards are far more detailed than the principles-based governance code for directors.
54. Consideration should also be given to include responsibility for the exercise of criminal prosecution powers within the FRC or any successor body which relate to this area, including the prosecution of persons who lie or provide misleading information to an auditor. It is notable that, despite this offence having been in company law for many years, there has not been any recent prosecution of a director. Furthermore, Section 501 of the Companies Act 2006 has also been held by the Court of Appeal not to apply to companies under its present drafting. Consideration should be given to changing the legislation to allow prosecution of companies and conferring this power on the FRC or a successor body.

Question 11: How effective is the FRC at driving quality improvements in audit? What further improvements would respondents like to see?

Setting standards

55. The FRC has played a positive role in the adoption of auditing standards.
56. The FRC's adoption of International Standards on Auditing (ISAs), with limited additions to reflect particular UK circumstances, has been an important development in this respect. These are high quality standards, recognised and widely adopted internationally, and provide the opportunity for transnational audits to be carried out effectively and efficiently. In particular, the principles-based nature of UK ISAs is a key factor in supporting high quality audits.
57. By providing a member to the International Auditing and Assurance Standards Board (IAASB), the FRC has both contributed to the quality of output of the Board, and been actively involved in the evolution of ISAs.
58. Similarly, the FRC's Ethical Standard is aligned with the best international practice on auditor independence and plays a key role in ensuring the independence of the auditor. The FRC is helpfully involved in the work of the International Ethics Standards Board for Accountants (IESBA), shaping its Code of Ethics, which is widely adopted internationally.
59. We recognise, however, that there are significant concerns in the UK and around the world about the impact of the increasing number and complexity of requirements in both auditing and ethical standards, in particular the impact on SMPs and others conducting smaller entity and less complex audits. ICAEW supports the plans of the IAASB to examine whether changes to standards are necessary to address the needs of these engagements.
60. The FRC's focus is PIE audits, in line with its inspection and oversight responsibilities. However, the auditing standards adopted by the FRC are at present applicable to all audits, covering the full range of size and type of entity. It is important to ensure that the FRC plays its part in ensuring that adequate support is available to those seeking to carry out smaller audits effectively and appropriately.

Audit inspections

61. The FRC's AQR team plays a vital role in carrying out audit inspections of firms that audit PIEs, enabling improvements by providing feedback on actions that can be taken by firms themselves and by audit committees.
62. However, it is important to recognise the risks involved here. If inspections are regarded as overly burdensome, the significant costs of dealing with the AQR regime might mean that firms skew their audit work to what they believe will score well with the AQR, rather than what might actually be needed for the most effective and efficient audit. We also note that the costs involved may deter some firms from taking on PIE audits, so as to be outside the AQR scope. This is detrimental to competition in the market. It is clearly important to ensure that inspection work is seen by firms as supporting better audit quality rather than being a barrier to its achievement.
63. With regard to the post-Brexit environment, there is a need for the FRC to more carefully consider and balance its role as a critical regulator with the need to promote confidence in UK audit firms. For example, reporting that 'over 30% of PIE audits examined required significant improvements', as the FRC did in early summer 2018, left the door open to an interpretation that 30% of audits resulted in wrong audit opinions that misled investors. This was not the case and the FRC needs to consider in future how it might report in a more balanced way on what it finds during its inspections. Otherwise there is a risk of damaging

investor confidence in the UK compared with audit regulatory reports issued in competing capital markets.

Innovation

64. In a number of respects, the FRC has been highly innovative in relation to audit. We discuss under Question 6 above, the contribution to audit quality of the FRC's thematic reviews. Similarly, the requirements on extended audit reporting, first introduced in the UK and now incorporated in the ISAs, have also been well received by stakeholders. They enable better information about the audit to be communicated to users. The FRC is to be applauded for showing leadership with this initiative, designed to improve the quality of audit reports and enhance the information provided to the markets.
65. The FRC has been able to take a broad perspective on audit issues, drawing on lessons arising from its wide range of responsibilities on corporate governance and financial reporting. This has enabled the FRC to play a leading part nationally and internationally in initiatives designed to improve the quality of audits. For example, the FRC has been a key contributor to the success of the Audit Quality Forum and is showing leadership in supporting better use of technology to improve the quality of audits. This is a vital role given the need for agility in audit in a fast-changing world.
66. However, we understand that the extent to which the FRC is committed to innovation and improvement as a core regulatory objective was highlighted in a 2015 private report by McKinsey and Company, which recommended that the FRC deliberately styles itself as an improvement regulator. We are not sure whether this was accepted and implemented by the FRC. If it was, then we have not seen much evidence of this in our interaction with the FRC. We therefore recommend that the FRC create an 'Audit Improvement Office' or equivalent deliberately to focus its audit activities on a proactive improvement agenda.
67. In this regard, there is a strong perception that the FRC still regards enforcement as a mechanism for achieving improved audit quality. Whilst we would agree with this up to a point, there are a number of side effects which (if pushed to extremes) create a reverse dynamic. The use of punitive sanctions for example has the merit of sending a message to the public that 'something is being done' but at the same time does not make any visible effort to improve education or understand the causes behind poor performance in firms. While sanctions can improve quality as a deterrent, they can also drive out market participants and discourage individual partners from working on PIE audits. This ultimately drives down audit quality. They also convey to the public the impression in the event of corporate collapse that the underlying problems lie with the auditors rather than the directors of the relevant entity being audited.
68. Linked to this, the FRC in recent years has combined minor inadvertent errors with high visibility negligent errors under one standard under its Audit Enforcement Procedure. This is not proportionate and places higher levels of risk on smaller firms which contributes to firms and partners with the skills exiting the market and reducing competition and potentially quality.

Question 12: Where quality does fall short, do the FRC's interventions have sufficient impact and deterrent effect?

69. While the FRC's Audit Quality Review report for 2018 showed a decrease in quality across all of the Big Four, there has been a long-term improvement in the quality of audits and FRC actions have contributed to this. We comment above on the way that the FRC reports its

findings on audit inspections and the need to be clearer in stating that it has not found any examples of audit opinions that misled investors.

70. The information provided in AQR reports enables firms and audit committees to take appropriate action to improve audit performance, both at firm level and in the processes followed on individual audits. The thematic review reports are particularly helpful in areas where audit is developing, enabling firms to meet expectations and evolve their audit practices.
71. Root cause analysis is now a vital part of the largest firms' approach to understanding why audits go wrong and determining measures to minimise the risk of poor performance. The AQR's role is important here, albeit the most important part is played by firms themselves by way of their internal reviews. The FRC should monitor the way firms carry out these reviews and flag any concerns.
72. Our biggest concern is that an over-reliance on sanctions as a deterrent and a focus on increasing the level of penalties is likely to have a negative impact, as it does not address the real root causes of poor audit quality. Higher penalties may also discourage firms from taking on the largest, more risky audits, which could be detrimental to competition in the market and shareholders' interests.
73. More proactive work should be undertaken to educate and to probe factors within firms that might lead to poor performance. For example, the performance criteria for audit partners when setting remuneration and whether this takes into account sufficiently the quality of the work assessed by internal and external reviews. We understand this is the intention of the FRC's recently introduced audit firm monitoring approach.

Question 13: What force is there in the concern of some that the FRC may be too close to the "big 4"? Or that the FRC is too concerned with the risk of failure of one of the "big 4"?

74. We are not aware of any evidence that this is the case and indeed the FRC has clear rules to prevent this. We do not recognise this image of 'closeness' between the FRC and the Big Four which has been painted by some politicians and the media.
75. A balance needs to be struck here as the FRC needs to have the appropriate level of specialist expertise, given its responsibility for areas that are very technical and require an understanding that is greatly enhanced by relevant experience.
76. We believe that the role of a regulator and oversight body is as much to work with, as well as challenge, those they regulate to meet the quality objectives required for audit under the Companies Act. In working collaboratively, it can be perceived that the relationship is too close, but the requirements for independence need to be weighed with other objectives such as audit quality, competition and public interest.
77. We have seen no evidence that the FRC is cowed from undertaking investigations against any major firm, nor have we seen any evidence that the FRC pulls back from action for fear of undermining one of the Big Four.

Question 14: Are investigations of audit work effective, transparent, satisfactorily concluded and unfettered?

78. Answering this question would require reviewing a cross-section of the FRC's investigation files. The professional bodies have no insight after the complaint is called in for investigation (under the Accountancy Scheme) or kept by the FRC under the Audit Enforcement Procedure. In certain cases, increasing transparency may in fact compromise an investigation.

79. In our response to Question 4, we noted the tailored review by the Ministry of Justice of the activities of the LSB. We would support a similar review by BEIS of the FRC's activities. At the moment there is no independent mechanism for challenge.

Question 15: Could a different regulatory strategy or tactics result in greater avoidance of harm?

80. See our answer to Question 11. There are many positive aspects to the current regulatory regime, for example the AQR's thematic review reports. However, an appropriate balance is needed in regulation to minimise the risk that it results in fewer firms being involved in the PIE audit market, to the detriment of competition.
81. The FRC should also be proactive alongside audit firms in ensuring that realistic levels of audit fees are being paid. It is concerning that audit fees have seen no real-terms increase in recent years, despite the increasing complexity of audits and the added cost burden of tendering on rotation. There is an increasing danger that such a market squeeze could drive down performance and relegate immediate supervision of the work to more junior and less skilled staff, in order to recover costs and preserve profit margins. The ultimate result would be an inevitable erosion in underlying audit quality. A market with limited fee growth potential but an increasing cost base is also a barrier to new entrants.
82. The FRC must also be more proactive in ensuring that appropriate education is embedded in university courses and is being rolled out in the right way in firms.
83. In 2015, McKinsey carried out a review of the effectiveness of the FRC's Audit Quality Review and Corporate Reporting Review work. The detailed outcome of this review was not shared with ICAEW, but we are aware that the recommendations included an 'improvement' stance⁶. We have not seen any significant changes that would suggest such a strategy change has been deployed.

Question 16: Could or should the FRC's work promote competition and a well-functioning audit market? Does the FRC's work undermine competition or a well-functioning audit market in any way?

84. We note that 'competition' has merited just one small paragraph in the FRC's 2018 Strategy Plan, stating a concern about the dominance of the Big Four at the top end of the audit market⁷.
85. The creation and upholding of high standards to ensure audit quality may of itself restrict competition but is an inevitable part of a market in which the product is complex and not easily assessable by the consumer. However, there are different ways of creating, applying and monitoring such standards and it is wholly appropriate that the FRC should consider the competition consequences of its actions. The FRC's objectives should include having regard to the impact its decisions may have on competition in the audit market and the extent to which its actions may encourage or discourage current and future firms and partners from wanting to lead on public interest entity audits.
86. The absence of such an objective may have contributed to a fall in the number of UK firms prepared to undertake audit by 40% between 2011 and 2018, although increases in the audit threshold will also have contributed. Under the Small Business Enterprise and Employment Act 2015, there is a requirement⁸ for the Secretary of State 'to have due regard to the effect

⁶ Minutes of FRC Board meeting 14 October 2015 paragraph 2.2

⁷ FRC Strategy Plan 2018, page 7: March 2018

⁸ Ibid Section 21(6)

of regulation on economic growth and competitiveness and proportionality'. The FRC as a relevant regulator⁹ under the Act should ensure this clause is being exercised.

Question 17: Can questions regarding the effectiveness of the FRC be separated from the wider question on whether change is needed to audit arrangements to take account of shifting expectations?

87. No, these points are interlinked. The current effectiveness of the FRC can be judged on the basis of its current responsibilities, but its future role post-Brexit will need to take account of plans for a more fundamental review of audit and whether it needs to change in line with new expectations.
88. Change may mean, for example, that concerns about the liability regime should also be addressed, alongside the role of the FRC.
89. The Audit Quality Forum is advocating an independent review of the future of audit, including the current expectations gap and the FRC should be a key contributor to this review alongside other stakeholders.

Question 18: Has the FRC been effective in influencing the development of accounting standards internationally as well as accountable and effective in setting UK GAAP?

Influencing the development of standards internationally

90. The UK GAAP standards developed by the FRC are of considerable interest to other jurisdictions looking to develop high quality, proportionate standards in line with current international practice.
91. In terms of influencing the development of IFRS by the IASB, we acknowledge the important input over the years of the FRC, including as a member of the IASB's Accounting Standards Advisory Forum (ASAF). We think however that there is potential for the views of an appropriately independent and well-resourced UK standard setter to carry very substantial weight with the international standard setters, and are not convinced that potential has yet been fully realised.

Accountable and effective in setting UK GAAP

92. The FRC should be applauded for its innovative and inclusive work as the standard setter for UK reporting entities that do not use IFRS.
93. The FRC has brought about significant change to UK GAAP over the past decade, and at every stage has consulted widely and proved responsive to the views and concerns of constituents. The end result, while not perfect, is a more concise set of standards that are broadly aligned with international norms, overall of high quality and generally well regarded, both in the UK and internationally.
94. The benefits to business of this effective discharge of standard setting responsibilities should not be underestimated. For example, FRS 102 is a more coherent and concise standard than the suite of standards it replaced in 2015, and the new IFRS-based standard FRS 101 represents an innovation that has improved the efficiency of group accounting processes where the parent company is an IFRS reporter.
95. As we leave the EU, there will be opportunities to look again at the requirements applicable to small companies (the great majority of UK companies), which currently reflect EU requirements to a substantial degree. It will be important to ensure that the post-Brexit FRC

⁹ Under the Schedule to The Business Impact Target (Relevant Regulators) Regulations 2017 SI344

plays its part in this process and, more generally, is willing and able to provide appropriate support to preparers of non-PIE financial reports.

Question 19: How else could the FRC improve the quality of financial reporting with a view to ensuring investor confidence?

96. The FRC Financial Reporting Lab is an innovation that contributes significantly to the quality of UK corporate reporting, especially through its engagement with investors and preparers in a 'safe environment', to discuss ways of promoting good practice in reporting and improving the understanding by boards of the information needs of investors. The work of the Lab should continue. We also welcome other recent efforts of the FRC to encourage more effective dialogue with investors.
97. We would also refer in this context to our answers to questions regarding financial reporting enforcement activity.

Question 20: Are there wider issues of financial and other reporting on which a stronger regulatory role would be desirable to better meet the information needs of investors and other stakeholders?

98. It may be beneficial post-Brexit to reconsider the scope of the regulatory oversight of the FRC in relation to the narrative and non-financial components of the annual report and accounts, information which is increasingly important to investors and other users.
99. Although not a crucial aspect of regulation, one dynamic that informs the process is one of diversity. It has been a quirk of legislation that all the major oversight bodies in the UK are required under the Equalities Act 2010 to comply with the equality duty of the Act¹⁰ and for some of them to report diversity. In April 2011, Schedule 19 of the Act, listing bodies performing public functions, was modified to include the audit RSBs but not the FRC¹¹. As a consequence, diversity considerations have not featured significantly in the approach of the FRC, save perhaps for gender equality.
100. Even in the area of reporting, where the EU Directive¹² required companies to address diversity issues in their reports, the FRC has not provided significant leadership. In the regulation of legal services, diversity is one of the key objectives addressing both the ten protected characteristics of the Act but also the variety and types of firms that provide the service to promote competition. The absence of the equality duty in our view has contributed to a less rounded approach in the FRC's understanding of their public interest responsibilities and failing to encourage access to audit by SMEs and employment in the industry by members of the UK's minorities.

Question 21: Is the current combination of statutory and voluntary methods of oversight for professional bodies effective, and do they remain fit for the future?

Accountancy

101. During the 14 years since the Scheme was introduced, the internal functions of the accountancy bodies as they relate to regulation have significantly improved and fallen under the inspection and challenge of not just the FRC, but the FCA, Insolvency Service and the

¹⁰ Ibid Section 149

¹¹ Equality Act 2010 (Public Authorities and Consequential and Supplementary Amendments) Order 2011 SI 1060

¹² EU Directive 2014/95/EU Disclosure of non-financial and diversity information by certain large undertakings and groups article 2(a) incorporated as Section 414CA(9)(a) of the Companies Act 2006 by SI 1245 2016

LSB. Their ability to function as independent regulators across the voluntary areas not covered by statute is now highly effective.

102. In such circumstances, the need for the FRC to be involved in the regulation of accountancy outside audit is questionable. The lack of expertise in other areas of accountancy work currently supervised by the FRC leads the FRC to move into areas which are governed by separate statutory regimes or where the professional bodies have far greater expertise in-house and have far greater experience in dealing with the issues. The lack of expertise can also lead to the outsourcing of this work to expensive external contractors.
103. There is a gap in the regulatory process that the FRC is currently using the Accountancy Scheme to plug; that is the holding to account of accountants in industry who contribute to corporate failure. This scheme only provides the FRC with jurisdiction over directors who are members of the professional bodies. It does not provide it with jurisdiction to investigate any other members of a board of directors. It is inequitable that the only members of an errant board to be punished under UK law are the qualified accountants. It is not a difficult step for accountants to resign membership before taking up a board-level appointment and thus be outside scope. That would move them outside the professional ethical and technical training that makes them such an important part of the integrity of accounting within industry.
104. Whilst we do not believe that such individuals should go unpunished for poor behaviours within a corporate failure, this needs to be effected through a statutory and not a voluntary process that creates loopholes and inequality. We have indicated above that the laws of other countries cover board failure and believe those of the UK should too.

Audit

105. The current structure as regards the supervision of audit is one prescribed by European law and also applied in many jurisdictions outside the EU. The monitoring and enforcement of audit regulation as relates to the auditors of PIEs lies with the FRC as the ultimate competent authority. These processes and that of licensing for all auditors lie with the RSBs. The FRC as competent authority supervises the work undertaken by the RSBs.
106. In our view there is no need to alter the current process of supervision (subject to the comments below) because there is no evidence that this is not working. None of the issues in the media and in front of the Select Committee resulted from any specific or systemic failure in this work or in any of the work carried out by the professional bodies to supervise firms' and members' work in this area..
107. However, within the framework, as it stands, there are tensions in how regulation should be enforced between the RSBs and the FRC. The biggest problem lies in the oversight of the work of the RSBs. This has not been helped with a change of attitude at the FRC since becoming the competent authority, where there is an increased tendency to take strategic decisions affecting the operations of the recognised supervisory bodies with limited consultation or a subsequent refusal to engage in constructive dialogue on practical consequences. This approach does not respect the longer involvement and greater experience of the professional bodies' work in this area or reflect the independence of the RSBs' functions. Neither does it reflect the preferred approaches of other oversight bodies in areas of overlap or consistent process. An example of this was the issuing of KPIs to the recognised supervisory bodies for the improvement in audit quality through their monitoring work where the issued KPIs were based on matters beyond the bodies' control.
108. A second issue that we believe needs to be addressed by the FRC is to improve the quality and experience of the people employed in this area, so that recommendations and judgements made by the FRC are better grounded in the day-to-day realities of delivering on RSB responsibilities.

109. It is also important to note the change in the scope of audits directly reviewed by the FRC. Prior to 2016, the FRC had focused its resources almost exclusively on the audits of listed companies within the 'major audit' definition. The changes have therefore been positive in ensuring that large private companies and charities are put under same degree of scrutiny as PIE audits by the RSBs, with the FRC monitoring the quality of that work in its reviews.
110. We therefore find it incongruous that the FRC should seek that the RSBs performing work on audits previously classified as 'major audits', should apply the more rigorous standards they previously applied themselves on PIE audits. This is inconsistent with the way the European legislation is structured and with the 'red tape' provisions of the Small Business Enterprise and Employment Act 2015.

Question 22: In relation to the UK Corporate Governance Code, are there issues relevant to the Review's terms of reference that respondents believe the Review should consider?

111. The terms of reference refer to putting the FRC in a position to stand as a beacon for the best in governance. We support this objective, but in order to achieve and maintain this status, the FRC must not become complacent. Historically, the UK has led corporate governance standards, but rising expectations, new and disruptive business models, changes to the way in which companies operate, and a series of corporate governance scandals, is threatening this reputation. It is vital that the UK regulator for corporate governance leads efforts to restore trust and integrity in corporate behaviour. This must include innovations in company reporting so that reports are relevant to and reassure all stakeholders, including the public. Corporate governance should therefore be a clear focus of the regulator.
112. The FRC needs to strike the right balance between understanding the needs of listed companies and company directors, and public and political expectations. The Review should bear in mind that the FRC did not instigate either the changes being made to the Corporate Governance (CG) Code or the development of principles for very large private companies. To be effective, a regulator must take the lead when problems and gaps become apparent rather than waiting to be tasked. Again, however, we note that the FRC is reactive and follows events rather than being proactive and attempting to resolve matters before they escalate into serious and potentially systemic problems.
113. Recent corporate collapses have at their heart an inability or lack of will of non-executive directors to challenge and scrutinise decisions made by executives. We believe that the FRC should set standards as to what is expected of directors of listed and very large private companies, and monitor behaviour with reference to these expectations. The effective operation and integrity of the entire corporate system depends on a new focus on the responsibilities of individual directors.
114. There needs to be appropriate and visible tension between the regulator and the regulated community. Applying the Freedom of Information Act to the extent that it is applied to other regulators, requiring compliance with the Equalities Act (see our answer to Question 20), building a website which is user-friendly for non-specialists, dropping the use of individuals' names in respect of projects, and advertising all vacancies, would help send the right message that the regulator is a public body with public interest at its heart. The Review should consider whether a statutory footing would support this process of modernisation. The FCA has done a lot of work on explaining the relevance of its role to consumers, and the FRC could do the same in relation to its role for current and future stakeholders.
115. As part of this work, the regulator should not only be mindful of, but proactively seek to improve, diversity in the boardroom as a means of ensuring that UK businesses reflect the

society in which they operate, as well as encouraging greater challenge and scrutiny to promote improved strategic business decisions.

116. In our response to Question 32, we refer to the FRC's expansion into oversight and investigation of non-audit accountancy services. The FRC's remit for governance has diversified because of the relatively recent evolution of the Stewardship Code. This code is being reviewed later this year, and its voluntary status should be one of the issues considered.
117. Implementation of the EU Shareholder Rights Directive (the Directive) has implications for proxy advisers. BEIS will need to allocate responsibility for proxy advisers' compliance with the Directive to a Competent Authority. This function could be allocated to the FCA, but it could also be allocated to the FRC.
118. However, the Review (paragraph 35) exaggerates the expansion in the FRC's responsibilities in respect of the Wates Principles. Our understanding is that the FRC is only providing the initial secretariat for the Principles, including managing the open consultation (although we do not underestimate the difficulties of that task, or the resources it will take). It is unclear whether the finalised Wates Principles will carry FRC brand, but what is clear is that the FRC will not have any ongoing responsibilities in relation to the Principles, and there will not be any ongoing monitoring of the Principles performed by the FRC or by any other agency or group.
119. It is critical that the Review pays particularly close attention to what the FRC cannot or does not do. We have already mentioned the monitoring lacuna with the Wates Principles, but ironically this gap is consistent with the lack of oversight for the CG Code. Although the FRC is responsible for maintaining the CG Code, the FRC does not monitor compliance with the Code. The Listing Authority (the FCA) is also benign in this area despite the listing requirements to report on compliance with the main principles and provisions in the CG Code¹³. In Question 23 we explain why stewardship is no longer fit for purpose as a monitoring tool for the CG Code.
120. For these reasons, we recommend the creation of a specifically-tasked and properly resourced office overseeing standards of corporate governance. A dedicated sub-agency would send a strong message about the importance of this subject area, and underline that a new era of monitoring has begun. Our recommendation for a Corporate Governance Office (CGO), or similar, includes certification and monitoring of the directors of listed and very large private companies. Companies House or companies themselves could confirm the fitness and propriety of directors, with reference to criminal convictions and employment history. The corollary will be a solid framework which will allow the CGO to monitor the behaviour of directors on an ongoing basis, and to hold individual directors to account when appropriate.
121. As with entry to any professional sector, including achieving the status of chartered accountant, there should be an objective assessment of individuals' skills if they wish to take on the significant responsibility of running one of our most important companies. The CGO must ensure that individual directors fully understand their role, particularly non-executive directors' responsibility to use their independence to challenge management regardless of their personal interests. A requirement for continuous professional development, and the threat of the removal of certification, will help guard against complacency setting in as a director's tenure matures.

¹³ Despite their inaction, in June 2018 the FCA announced a new category of premium listing to cater for sovereign controlled companies.

122. This new personal certification regime for company directors will also remove inconsistency of treatment between ICAEW members compared with other company directors once and for all. As we state elsewhere in our response, this inconsistency is an illogical quirk of history which should be removed by expecting the same high standards of all directors, rather than singling out members of a professional body, which can have perverse consequences.
123. The creation of the CGO is pertinent to the objective to strengthen the FRC's position and reputation, and we suggest that the Review thinks globally in this respect. Historically the CG Code has had broad international reach but this may wane. Recent changes to the CG Code do not necessarily resonate elsewhere; other countries do not share our challenges around executive remuneration and employee engagement. Many countries have already chosen to replace 'comply or explain' with 'apply and explain' for their codes. A step forward in regulation and the personal accountability of company directors is required in the UK, and a side benefit would be refreshed reasoning for why the UK is the global leader for corporate governance. The performance of the CGO will help inform other countries about what can be achieved.

Question 23: How effective has the Stewardship Code been in driving more and higher quality engagement by institutional investors? If not, why? How might quality of engagement be further strengthened?

124. The Review should first acknowledge the dysfunction in the current structures, and the barriers which are in place. The privatisation of this important public interest function is no longer fit for purpose. Complete reliance on the principal-agent relationship, reporting, and board evaluations, has been overtaken by changes in the market: outsourcing of stewardship to advisers; the rise in tracker funds which do not perform stewardship functions; and shares with no voting rights, often referred to as the ownerless corporation¹⁴. Scrutiny and challenge by non-executive directors is critical, but this has been lacking in several high profile cases.
125. The expectations being placed on stewards have grown because corporate responsibilities have grown. Investors' core function is to provide capital and monitor its deployment, but they have become unwilling and often under-resourced watchdogs of the corporate landscape.
126. The bilateral relationship between investors and investee companies is being disrupted by investors' reliance on advisers. This over-reliance is a symptom of institutional investors being placed in an invidious position. Investee companies complain about their lack of engagement and the unwillingness of advisers to accept any explanations for non-compliance with the provisions in the CG Code. The reference to higher quality engagement raises questions about the concentration of AGMs into short timeframes and whether this should be changed.
127. At the moment institutional investors adopt the Stewardship Code voluntarily, but they are regulated by the FCA so any encouragement to improve engagement would need to come from that direction. However, in our answer to Question 22 we mention the FCA's benign approach to the CG Code, which does not bode well for taking the lead in improving the quality of engagements.
128. Stewardship should not be discarded – when it works, it works very well. However, stewardship should form just one of many elements of the regulatory architecture. Backup is needed in the shape of the CGO which we have described in Question 22. One of the

¹⁴ Andy Haldane, Chief Economist at the Bank of England, articulated these issues in a speech delivered on 22/5/15 which is available from: <https://www.bankofengland.co.uk/-/media/boe/files/speech/2015/who-owns-a-company.pdf>

functions for the CGO could be to act as a bridge and arbiter between investors and investee companies.

Question 24: Do respondents view the FRC as reluctant to undertake investigations or enforcement, or able to do so at speed?

129. We do not view the FRC as being reluctant to undertake investigations. It is thorough in its approach and in our experience does not hesitate to act if it believes there are grounds for doing so. Indeed, we believe it has at times been overzealous in undertaking them on occasion when its competence and remit is questionable, or it does not fully understand the relevant practice.
130. Speed is often dictated by the circumstances, which in many cases are outside the control of the FRC. These circumstances include the time that is required;
- to gather and review all relevant documents;
 - to enable the instruction of experts and Counsel;
 - to secure the availability of key interviewees;
 - to respond to the regulators' complaints evidence by lawyers (often substantial) who threaten 'unfairness of process' if sufficient time is not provided, given the potential for the charges to harm or end an individual's professional career;
 - for the UK courts to address specific issues relating to these matters if they come before them.
131. Speed is also dictated by the resources available at any one time to deal with the sporadic nature of corporate and audit failures.
132. Proceedings can also be slowed down if individuals part from their firms during the course of an investigation and are then separately represented; new lawyers will need to familiarise themselves with the case and the regulator has to weigh separate and possibly differing accounts of events.
133. We believe the FRC could investigate cases quicker if they had more investigation case managers or outsourced more of its investigation work, but this increases operational costs. Such costs would be passed on to the audit firms, increasing their regulatory charges as a price for remaining in the market. There is however, currently limited opportunity for firms to pass these additional charges on to the audit clients, and thus would affect the commerciality for firms of remaining a supplier of audit services. A consequential reduction in the number of firms reduces competition and can impact on quality, so it is a vicious circle. Often, a series of significant cases may emerge within a short timeframe, particularly after a wave of insolvencies in an economic downturn, and it is difficult to match resources with demand.
134. It is recognised, however, that the time taken in some of the cases does not inspire public confidence. Periods of up to ten years elapsing before a case is finally resolved results in delayed penalties on those found liable, as they will have retired or moved on to other employment. There is also the issue of the health and wellbeing of those under scrutiny, as has been recently identified in HMRC investigations. The issue here is not so much with the FRC and the RSBs, but rather UK procedural law in the elements identified above, which may be outside the remit of this review.

Question 25: How could the FRC better ensure it is able to take swift, effective and appropriate enforcement action? What practical or legal changes would be needed to achieve this?

135. The FRC should be provided with powers to investigate all directors and senior managers of PIEs and to bring misconduct, or even criminal, actions against them - for example the

offence of lying to an auditor under Section 507 of the Companies Act 2006. In addition, the effectiveness of the FRC's investigation of directors should be assisted by far-reaching powers to demand the disclosure of company documentation. Criminalisation is however a step that would complicate and extend the process of investigation and this delay could be contrary to the public interest aim of swift and effective action.

136. The FRC's powers at the moment stem only from the Audit Enforcement Procedure, are questionable in legal basis and enforcement, and require the FRC to be involved in investigating the audit. Its powers to investigate a company's board and senior management are therefore constrained.
137. We also refer to our answer to Question 10, that responsibility for the exercise of criminal powers could also be given to the FRC to ensure the prosecution of people who mislead auditors.

Question 26: Have the arrangements put in place following the 2005 Morris Review stood the test of time, or is there a need for change? Should actuarial regulation be a focus for the Review's work?

138. We have no first hand evidence of actuarial regulation, but we would prefer this to be outside of the FRC's future remit, in order to assist the focus on its key objectives.

Question 27: Is there more the FRC could or should do to help reduce the risk of major corporate failure?

139. Areas the FRC is responsible for help equip market participants to assess the risk of corporate failure. There are actions that could be taken to optimise this.
140. The FRC cannot eliminate the risk of corporate failure; it is an inherent risk of capitalist endeavour. Failure can be postponed or averted by government support, but this is a matter of public policy quite unrelated to the FRC's remit.
141. There is even an expectation now that government would not step in to rescue a failing bank – at least not until bail-in creditors, and presumably equity shareholders, have been wiped out first. Risk appetite varies between investors and within portfolios, and investors will accept higher risk for higher return. The problems arise where risk is obscured and consequently mispriced.
142. Market participants rely on corporate disclosures in financial statements, prospectuses and other sources to assess risk and for the baseline metrics on which they build valuations and make investment decisions. Financial regulators have specific financial data reported to them, but this is not wholly detached from the same underlying recognition and measurement decisions applied in the financial statements. The FRC does not set the IFRS accounting standards that most major corporates apply, although it does have some influence over them and could have more following Brexit. However, its corporate reporting review activities are the primary regulatory mechanism for financial reporting quality, transparency and comparability. Moreover, audit quality is significant for financial reporting quality as well as for the assessment and reporting of going concern, which is an alerting signal where the risk of failure is exceptionally high.
143. As regards the reviewing of corporate reporting, we have found the FRC's activities to have been of a generally high quality. We understand that transparency and financial reporting quality in UK markets is often held to be a gold standard internationally and a differentiator in the competition for capital. Nevertheless, despite and indeed because of this, there are no grounds for complacency. We commend the FRC's work through the Financial Reporting Lab to open up and examine areas of particular difficulty and importance in corporate reporting.

The initiative has been very helpful to the community of professionals supporting and developing reporting quality within UK listed companies, as well as to consumers of that information and to auditors. It should be supported and bolstered.

144. A key part of the Corporate Reporting Review's work is in communicating examples of poor practice as well as areas needing particular care and attention. This is done through both enforcement decisions and consolidated reporting – most significantly the FRC's annual review of corporate reporting and technical findings. These activities are very important, they are one of the few windows into real examples of risky areas in corporate reporting. They are a key resource for the ecosystem of individuals and institutions central to the development of better financial reporting standards and guidance. They are also drawn on by specialist analysts who investigate and highlight financial reporting risks both within individual companies and more widely.
145. The Review should recognise the importance of this work. The FRC should be encouraged to be as specific as is appropriate in the explanation of the issues encountered so that lessons can be drawn from them. More could be done to group issues together and investigate them to highlight to standard setters areas for their attention. The thematic reviews are a good example of work that can be done to target areas of particular importance.

Question 28: Is the FRC quick and effective enough to act on warning signs arising from its work on accounts and financial reporting, or on evidence of concerns over poor corporate governance?

146. There is room for improvement. Speed and effectiveness should be a general aspiration that a regulator is always seeking to improve on, but there are specific improvements here that could be made. Ineffectiveness and delay penalises all stakeholders but is particularly regrettable where an opportunity is missed or deferred to communicate decision-useful information. Delay is particularly cruel for those subject to investigation and possible sanction.
147. We encourage this review to consider some of the FRC's past cases, with a natural focus on the small number of high profile corporate failures or scandals during and since the financial crisis. For these cases the Review should ask, reasonably, how long action should have been expected to take and what were the impediments to speedier action. It should evaluate the published material to ask whether and how it might be enhanced for those using it to apply lessons learnt.
148. We also understand that the ability of the FRC to act in such circumstances is dependent on the tools made available to them. They have limited intervention powers, and there is a question as to where responsibility lies when potential insolvency arises; that is arguably in the purview of the Insolvency Service rather than the FRC.
149. The FRC has no ability to go into companies and demand access to papers. Their only insight comes through inspecting audit files. This happens a number of months after the audit, and the audit in turn happens a number of months after the end of a financial year. So the process is not real time and the FRC's ability to spot the warning signs, let alone react to them, is a long way down the line. In the case of Carillion, the audit may not have been reviewed in the year's inspections, and even then if the review picked up something unsettling, there would be limited powers to exercise as follow-up.
150. There is no enforcement process to underpin the FRC's work on corporate governance. If weaknesses in governance become apparent, there needs to be a statutory framework to make those interventions.

Question 29: Is there a case for a more “prudential approach”? If so, how could this operate in practice, and to which category of company might such an approach apply?

151. The consultation paper suggests that ‘some stakeholders would like to see the FRC play a more interventionist and forward-looking role in reducing the risk of major corporate failure’. We are curious as to what it is envisaged this might entail. Financial institutions are already subject to a prudential regulatory regime from the PRA and we do not consider this to be within the scope of this review.
152. It is essential that banks are subject to prudential regulation because they hold deposits and are crucial to the functioning of the economy. Prudential regulation imposes a significant cost on banks, their shareholders and customers. But a proportionate system is worth it to protect depositors, government and financial stability. It is difficult to imagine the shareholders or customers of other sectors being keen to meet the costs of such a regime. It is also unclear who such prudential regulation would seek to benefit. In the absence of depositors it would benefit other creditors, but they are unlikely to want to pay for it. They may be able to buy credit insurance or credit default swaps in the market anyway should they want such protection. Or they can simply choose to provide credit to a different company – the key is transparent, high quality financial reporting so they, or more specifically the credit rating agencies, can assess risk. Perhaps a prudential regime would be intended to benefit employees; but it would not prevent layoffs or eventual failure and the social security system already exists to protect employees – although the Government could do more to ensure that all workers are covered by national insurance contributions.
153. There are exceptions. It is essential that a robust regulatory regime exists to protect pensioners, but this is the remit of the pensions regulator and outside the scope of this review. However, it might also be considered whether the growth of government outsourcing leads to specific questions of business continuity for entities performing significant government contracts. A great many contracts with the state will not give rise to material continuity issues. But where there is reliance on a particular firm, there may be merit in considering continuity more carefully – while avoiding moral hazard. We do not believe this is within the remit of the FRC and therefore would be outside the scope of this review.
154. There have been some suggestions in the media about whether there should be a prudential regime for auditors. It has been highlighted that some accountancy firms have relatively small capital reserves in comparison to the legal claims they may conceivably face in the event of a major audit failure. Concerns are raised about the implications for clients with incomplete audits and potential litigation creditors in the event of audit firm failure. Such a failure by one of the Big Four would of course also further concentrate the market for audit. We believe such concerns should be carefully considered. Trust in the stability and continuity of audit firms is an important element of the value conveyed by audit and it is in the interests of all parties to secure this. Indeed, this outcome is a central objective of the supervisory regime. We welcome the current review of that regime and anticipate it will make recommendations where it feels improvements could be made.
155. However, we do not believe that the supervisory regime should be supplemented by a prudential regime. For the reasons explained above, a prudential regime is a welcome safeguard for financial institutions, but is not appropriate for other industries. There are many industries where failure has grave public interest implications, the oil and gas industries, airlines and pharmaceuticals being just three examples. Failure in these industries can result in significant loss of life. It is right that they operate within strict legal and oversight regimes. But a prudential regime is not appropriate for these industries and should not be considered for accountancy firms either. Failure of an auditor may result in some loss to its clients and

delays in approval of accounts – but these risks do not have systemic implications on a scale comparable to failure of a major bank.

Question 30: Introduction of the viability statement was an important development, but could it be made more effective?

156. Yes, but it will be difficult and might distract from more important matters. There is real value in requiring companies to think very carefully about the nature and parameters of going concern. It is right that directors ask not only why they are confident they are a going concern, but also what things might happen, in order of likelihood/impact, that would challenge this. It is helpful to disclose this thought process and the conclusions from it. It is to be expected that these material going concern risks would be found in a company's risk statement or elsewhere in the accounts (for example the maturity profile of debt).
157. However, in practice viability statements are often not particularly helpful. They should not necessarily be expected to be. Businesses fail because they are too highly leveraged (or geared), their margins are squeezed, they have to make exceptional cash payments they don't have the capacity to meet, their assets are impaired or their franchise is compromised. All of these factors can be expected to show up in financial statements, given appropriate measurement, recognition and disclosure. Often where companies fail the risks are already apparent in these metrics. Where this is not the case, an accounting scandal may have obscured the reality or there might be a deficiency in accounting standards. All of this is well documented in the reports that follow major corporate failures, which are in the public domain and which the Review might refer to.
158. Nevertheless, viability statements can be useful. Some companies carefully articulate material factors that do have uncertainty connected to them, for example refinancing dates. It can be helpful to have a succinct statement articulating these factors in one place, so long as it is reasonably complete. The viability statement could contain additional information, otherwise undisclosed, on what causes companies to worry and how they assured themselves on the risks. If this good practice could be encouraged it would make these statements more effective.
159. However, too many viability statements are bland and generic. Adding a few reassuring words in the annual report will not help if the company is precariously highly geared. It might provide a false sense of security to unsophisticated users of accounts. Indeed, it might be asked who the viability statement is aimed at. It should not be much comfort to the analyst, who should be expected to do the heavy lifting of crunching the metrics and other information to properly understand the risks aforementioned.
160. Much of the statement is often occupied with a justification of why the time horizon has been selected. It might be asked who cares whether three or five years is used. Few people can forecast accurately over either period. However, there may be some merit in exploring the suggestion that the viability statement should be underpinned by working capital projections for the selected viability period. These could then be appropriately assured to give investors confidence that the directors have undertaken a rigorous process.
161. However, it is also right to ask whether it is an unrealistic, and dangerous, expectation that directors can be really candid or searching in such statements. The future is not set in stone; it depends on human actions and other factors. Crucially it depends on confidence. It would be reckless for directors to undermine confidence in their company and they should studiously avoid doing so, while also scrupulously observing their legal duties. We should expect true and fair accounts to square this circle – for the diligent analyst and the public consumers of their conclusions. The accounts should tell us truthfully and fairly about the

assets and liabilities, profitability and cash flow of the company. We should not unrealistically expect this insight to be served up in a brief summary statement.

Question 31: Are there gaps in the FRC's powers? Would its effectiveness be improved with further (or different) powers?

162. We have identified in our response to Question 4 above, the gap in the powers for dealing with errant directors of companies which other jurisdictions afford to their competent authorities. In addition, there may be merit in formalising a regulatory framework around corporate governance, and direct inspection or investigative powers to go into PIE companies where their operations are of systemic risk and there is evidence of mismanagement. Such powers would need to be exercised proportionally, perhaps along the lines of Section 2 interviews under the Criminal Justice Act 1987, but would place more proactive tools at the FRC's disposal. We have also mentioned criminal sanctions for lying to auditors, and the need for the FRC to have powers to access PIE company papers and not just audit firm documents.

Question 32: Are the FRC's powers coherent in relation to those of other regulators?

163. As we have identified above, the extension of the FRC into non-audit accountancy matters has resulted in overlap and conflict in the jurisdiction of other oversight regulators and the obligations of the RSB's in performing their work under statutes other than the Companies Acts.

164. We have identified above in response to Question 4, the powers and responsibilities of other UK professional service regulators and areas where we believe the FRC's effectiveness could be enhanced as a result of utilising some of those bodies' principles and methodologies.

Question 33: Taking account of Sir Christopher Clarke's review of sanctions, and subsequent changes, does the sanctions regime now have the right deterrent effect? Does the FRC make best use of the sanctions at its disposal?

165. The EU Audit legislation as enacted in UK law in 2016, provides the FRC with nine different forms of sanction¹⁵. One of these is the imposition of financial penalties and another is expulsion from membership of a professional body. The FRC's Enforcement team and the Tribunals appear to focus on these two sanctions, with rare deployment of the seven other non-financial sanctions listed in the SATCAR Section 5.1. These include, for example, publishing reprimands, prohibiting signing of audit reports for a specified period and prohibiting acting as a director of a PIE for up to three years.

166. Increasing financial sanctions can produce an alternative 'deterrent effect' – a deterrent to firms whom the CMA and others might want to encourage to be involved in PIE audit work, and a deterrent to astute audit partners at firms still involved in PIE audits from wanting to get involved in signing a PIE audit.

167. Including the whole revenue of a firm as a factor in determining a financial sanction ignores the fact that, in most major firms, audit now accounts for less than 30% of revenue – thus the sanctions are impacting other non-audit partners. We recognise that they are business partners and collectively represent the 'culture of the firm'. So in theory it is not wrong to penalise non-audit partners as the risk should encourage them to ensure the firm's culture is correct. But as business partners they are also required under governance rules to assess and mitigate business risk. This could, with the additional negative of reputational damage,

¹⁵ Statutory Auditors and Third Country Auditors Regulations 2016 Regulation 5

and the greater attraction of providing non-audit services, lead to non-audit partners questioning whether audit should remain within their firms. Neither the FRC nor the independent review panel share this concern.

168. Whilst the imposition of large sanctions make for good headlines, they do also convey the impression that there are wide scale deficiencies in the management of UK companies and the audit firms, which is misleading and damaging for international investment. We believe that the FRC can and should make wider use of the sanctions tools available to them to forge an improvement rather than fear culture, and thus contribute more effectively to a better quality audit delivery.
169. The sanction of expulsion from membership of the respective professional body is regarded by the FRC as being the highest possible punishment. We believe it should be limited to dishonesty or lack of integrity. In our view, its application by the FRC for poor professional work is disproportionate and sits uncomfortably with employment law.
170. We do not understand why the FRC and its tribunals consider it in the interests of the accountancy profession or the general public, for a member to be expelled from their professional body other than for dishonesty or lack of integrity. Because neither 'accountant' nor 'tax adviser' are proprietary titles, that person can provide advice the following day to the public without being a member of a professional body, with there being no disciplinary process available to investigate their future actions, and without that person having any requirements to carry out CPD and demonstrate competence. This does not improve anything and increases the risk to the public.
171. Expulsion also potentially inhibits that person from practising in other areas of accountancy that are unrelated to audit, and if integrity or honesty are not in question, could be construed as a breach of that individual's employment and human rights. In our view, the most appropriate sanction for an auditor, where there has been no dishonesty or lack of integrity, would be removal of Responsible Individual status.
172. It may well be that in a disciplinary context such individuals may still be expelled from their membership body for reputational and public interest reasons, but this should be at the discretion of the membership body and not an external body.

Question 34: Should the Government legislate to put the FRC on a more conventional consolidated statutory footing?

173. We believe that this is needed. The Ministry of Justice's difficult experience with the governance and conduct of the Legal Ombudsman in 2013 has all too clearly illustrated the difficulties that can arise where the statutory footing of a regulatory body is unclear. The powers of the National Audit Office and other mechanisms of accountability are essential for the supervision of the delegated functions of state, and the unusual development of the FRC has put it in an isolated position.
174. We have referred to the Cabinet Office tailored reviews and believe this is a process that could usefully be mirrored by BEIS in the accountability of the functions of the FRC. We would also contrast the accountability of the FRC for its budgets, activities and consultations thereon which in the UK are managed by the FRC, but in the Republic of Ireland in respect of the Irish Auditing and Accounting Supervisory Authority (IAASA), are managed by the Department of Business, Enterprise and Innovation (DBEI).
175. We have also referred in Question 20, to the omission of the FRC from Schedule 19 of the Equalities Act 2010 because of its nebulous status. Such omissions may have occurred on other legislation and it seems inappropriate for this body to be exempt from the standard obligations checks and balances required of other statutory oversight bodies in the UK.

176. However, a caveat is necessary. Audit is a highly technical and complex area, and supervision and review requires highly skilled competent people to understand what is going on and to make robust challenges to the firms and, where appropriate, management. These resources can be expensive and may not fit comfortably into Whitehall pay guidelines. The position is analogous to the skills required in HMRC and there may need to be some alignment with the pay policy in that department.

Question 35: What is the optimal structure for the relationship between the FRC and the Government, best balancing proper accountability with enabling the FRC's effectiveness?

177. Although other regulatory models exist (for example, companies limited by public guarantee – as with the FCA), we believe that the FRC's current status as a non-departmental public body, responsible to the Secretary of State for BEIS, should provide the opportunity for balancing proper accountability with enabling the organisation's effectiveness.

178. A sustainable funding model to allow the FRC to properly resource and plan is a key factor in this, as is the FRC's ability to recruit and retain high quality talent when operating within public sector remuneration and employment rules.

Question 36: In terms of the FRC's broader accountability, is there a case for further transparency in its actions or functions?

179. We have referred above to the approach in Ireland where we have been able to express concerns to the DBEI about IAASA's activities under their consultation process, and they have responded to such observations. In the UK, such criticism has to be directly made to the FRC via consultation, and it is rarely acted upon or responded to.

180. In its reporting, the FRC have concentrated on the errors and omissions of the RSBs and the firms in their compliance with audit regulation. It has not given equal comment on the good quality and improvements that it has found. Whilst one would not expect it to be necessarily gushing in praise, the continued messaging of failure gives the impression to the general public that the profession and the delivery of audit services is constantly in bad shape. This not only undermines public confidence in the quality of audit, it suggests the FRC is unable to carry out its role effectively.

181. We believe the work of the firms, the RSBs and the FRC itself are better than that. Something as simple as awards for best reporting, governance and auditing could help redress the balance of the image of an industry seemingly projected by the oversight body as one of consistent failure.

Question 37: How effective is the current leadership and Board of the FRC? Please cite relevant evidence which informs your view.

182. We respect the current leadership and board of the FRC, being individually and collectively committed to delivering on the FRC's mandate. They have improved many aspects of UK financial reporting, but as already mentioned, have done so in the context of the FRC being given responsibilities not in accordance with its core mission (public audit being an example).

183. However we believe that there are unresolved stakeholder management issues which the FRC Board needs to resolve.

Question 38: Is the Board's composition appropriate? Is it the right size? Does it have appropriate membership?

184. The FRC must be an exemplar of good internal governance, which will require appropriate layers of accountability, an optimum mix of industry expertise and independent scrutiny, and sufficient transparency of decision-making, diversity and executive remuneration. It may be possible and preferable to apply the Corporate Governance Code and related legislation to the FRC, with the FRC Board being regularly evaluated.
185. Extensive research was undertaken on behalf of the Council for Healthcare Regulatory Excellence (CHRE) in 2011 on the appropriate composition for oversight bodies.¹⁶ This concluded that the best number for a decision-making body was twelve. The FRC Board comprises 15 individuals.
186. The terms of reference, even for non-executives, require individuals 'knowledgeable in the areas relevant to statutory audit'. This funnelling of skill means that there is a lack of challenge that lay members typically bring to areas that are internally perceived as 'the norm' for the industry.
187. We note that few of the Board members appear to have recent experience of the SME sector, and that none appear to be investors or users of accounts. These are constituencies that should in our view have some form of representation on the Board.
188. The Board has four white female members and eleven white male members. There appears to be no minority interest represented. This in part reflects an apparent lack of diversity impetus in the appointments, even though there is a reference to diversity in the appointments policy.
189. We would also point out that the lack of practising representation from the accountancy profession on the Board, on the grounds of conflict of interest/lack of independence, does not appear to apply to some FRC Board members who are subject to the 'comply or explain' principle in their capacities as members of other corporate boards. Consideration may therefore need to be given to whether a sufficiently robust governance structure can be implemented so that it can be accepted that individuals may well have recent audit or corporate governance roles.

Question 39: Is the balance of decision-making between the Board, its Committees and the Executive described in paragraphs 34-36 above right, given relevant legal constraints?

190. There appears to be an increasing pattern of the Executive having to take matters through committees in order to have something authorised. As noted above, we would prefer the FRC to be more agile, as referral to committees can add significant further delays.

Question 40: Is the Board's structure appropriate, including given the FRC's roles on standard setting, assessment and enforcement? Does the Board's accountability appropriately reflect its role and functions? Are its decisions appropriately transparent, bearing in mind the need to balance public interest and confidentiality?

191. In 2012, when the governance changes were put out for consultation, we expressed concern about the judge and jury combination of the enforcement activities. Since then, the FRC have addressed some of the process issues through their Audit Enforcement Procedure. However, we still believe the balance and independence of process is not sufficiently robust.
- 192.

¹⁶ Board size and effectiveness: advice to the Department of Health regarding health professional regulators, September 2011.

Question 41: How should the Executive's effectiveness be assessed and ensured?

193. We have referred to the Cabinet Office's tailored review procedure above, as a mechanism of securing third party and stakeholder views on the effectiveness of the FRC, which can be assessed independently of the organisation.
194. The process for the review and feedback from stakeholders on the FRC's proposed annual budget and operational plan activity should equally be managed by BEIS, rather than by the FRC itself.
195. There has to be a greater focus on responsiveness to change in the market and solving problems rather than following process. However, we are not aware of how the senior executives are appraised as to their performance, as this is presumably a matter for the FRC's remuneration committee.

Question 42: Who should fund the FRC, and how? What are the impacts of current funding arrangements, including of having a partially voluntary funded regime?

Who should fund the FRC, and how?

196. This depends in part on the proposed purpose and remit of the FRC and the stakeholders it seeks to serve.
197. The FRC performs a range of functions, some of which are focussed on corporate organisations and these organisations are levied directly. Other activities relate to, for example, the FRC's role as a competent authority and the majority of the funding requirement for these activities is established and defined in law (such as the Companies Act).
198. As context, it is helpful to remember that a decade ago the FRC was funded one third from the accountancy profession, one third from government and one third from the corporate sector. Today, there is no government funding and the accountancy profession funds 50% of the FRC's costs. While unrealistic to propose that the Government resumes some level of funding from general taxation, we suggest below that fine monies from disciplinary cases handled by the FRC should be retained by the FRC rather than passed to the Consolidated Fund.
199. Regarding the profession's contribution, the FRC relies on the RSBs to allocate and collect the FRC's levies. The FRC does not have direct interaction with firms on this matter.
200. Under the current remit, the FRC should be overseeing effective regimes for, amongst others, financial reporting, corporate governance and audit in public interest entities. It is therefore reasonable to expect that those who are engaged in these processes pay the 'admission price' for access to this function.
201. Those contributing should include the audit profession, preparers of financial statements (i.e. listed companies, large private companies) and the investor community.
202. We have argued elsewhere in our response, that the regulatory and enforcement regime could encompass all directors and not leave those directors who are members of professional bodies to bear a disproportionate risk. To that end we would seek a funding regime which would require a greater contribution from the corporate sector in recognition of the responsibilities of their directors. This would also reinforce the corporate governance framework promoted by the FRC.
203. Making levies proportionate to activity in these markets by the various actors is a method of placing this on a 'user pays' basis. 'User pays' is a useful and powerful principle. This is a particularly apt approach where the regulated activity directly benefits only a selected group in society as, arguably, is the case with the FRC's suite of activities.

204. So fees on the regulated providers provide a mechanism whereby the costs of the regulation are incorporated into the costs of delivering the service. However, we consider it important that this sits alongside a commitment to quality (local and global) and also to appropriate competition.
205. The ‘user pays’ principle can be further refined by reference to size of market participant: – how that is measured needs to be defined fairly ie, by income/profit/volume. At the margins of the charging bands this can begin to feel unfair to market participants. It could of course also be weighed by other metrics, for example relative risk and types of operation.
206. Fine monies are also a potential source but there are issues around perceptions with regards to moral hazard for example regulators could be accused of being overzealous in their disciplining to ensure a flow of funds. If these perceptions and concerns could be allayed there is some scope to utilise fines in this way.
207. For enforcement matters, we note that fines imposed under the Audit Enforcement Procedure will be remitted to HM Treasury. We propose that the FRC is instead permitted to retain these fines in order to fund an efficient and cost-effective enforcement process in the public interest. This would reduce reliance on the current paradox of obtaining funding from those under investigation (albeit indirectly). It would also ensure the FRC can exercise the enforcement function unfettered by needing to engage with RSBs. In turn this would free up RSBs from the need to pay extensive financial contributions with no control over how the FRC uses them. Where costs are contributed by RSBs then cost recovery orders should return these costs to the RSB.
208. It would be useful to look at how regulatory bodies are funded in other (comparable) sectors - particularly in financial services regulation – and not just in the UK but in the USA and further afield to garner examples of what seems to work well and fairly. This would be a separate exercise and probably outside of the scope of this review, but there is much merit in considering best practice when considering a suitable approach.
209. The FRC has recently become a non-departmental public body. As a public body (and there are various types, which in turn can affect the reserves requirement) it is likely that there will no longer be a need for the c£12m of reserves the organisation currently holds, as we assume that the FRC and its activities will be underwritten by government (which, as stated above, makes no general contribution to the FRC’s running costs). These reserves could therefore be returned to past contributors or used to offset future FRC levies.

What are the impacts of current funding arrangements, including of having a partially voluntary funded regime?

210. While characterised as a ‘partially voluntary funded’ regime, we understand that the Secretary of State has statutory powers to levy any party which has an interest in, or benefits from the work of, the FRC should the funding available to the FRC prove insufficient. While a power to be used in extremis, the implication that ‘voluntary’ implies ‘discretionary’ should therefore be avoided.
211. Around half of the FRC’s budget is funded from the audit and accountancy profession. The inevitable consequence of sharing this across the firms and RSBs is that the largest firms pay the largest share. This does little to dispel the perception of ‘closeness’ to the Big Four.
212. However, a shift of the balance to other firms would place a heavy burden on smaller firms and would likely create a barrier to market entry and reduce competition.
213. It should of course be noted that FRC funding is only a part of the regulatory burden on firms. Significant sums are invested in attracting and training high quality staff into the profession and the ongoing development and oversight of these key players.

214. Conduct cost funding, fines and cost recovery is under review by BEIS and HM Treasury as we write. The FRC is building reserves (the level of which ICAEW has queried on a number of occasions as part of the FRC's annual consultation on its plan and budget) and fines are destined to go to HM Treasury. We are assuming that reserves will be reduced, as they were are not necessary with the NDPB government guarantee, but there is as yet no clarity from BEIS. However it is not clear as to whether, where a case is successful, conduct cost funding will be returned. Professional bodies would welcome more clarity on the direction of travel.
215. In terms of funding more generally, there is a balance to be struck between having sufficient funding to achieve the desired regulatory outcomes versus imposing unnecessary or inefficient administrative burdens or compliance costs on regulated entities. These burdens are counter-competitive and can force all but the very largest participants out of a market.
216. As part of the process of looking at funding methods, it would perhaps be helpful to consider how funds are used.
217. As the FRC has grown in size and expenditure, ICAEW has been supportive of the organisation devising new ways to demonstrate value for money to interested parties, as well as it designing ways to seek feedback from those under its wider regulatory remit. KPIs and value for money metrics are particularly necessary in the areas of audit quality and public interest disciplinary cases
218. A fair and transparent method of funding is vital to ensure a healthy number of market participants and competitive choice. Alongside this the efficient and effective use of resource by the regulator is key – rather than simply adding more costs to the model – which ultimately gets passed onto the consumer.

Question 43: What skills are needed for the FRC to be most effective? Does the FRC have the people, skills and resources it needs, of the quality it needs?

What skills are needed for the FRC to be most effective?

219. As with many organisations, the FRC needs to find a balance between technical expertise and experience, and more generally, lay governance and non-executive challenge. Bringing in such expertise comes at a market price but also risks criticism, as this knowledge is likely to come from those previously regulated or overseen.
220. The FRC should show independence and rigour but not be isolated in a position of intellectual purity. It is hard to undertake many aspects of its work without high levels of knowledge of the sector and associated professional experience. At the same time, this opens the FRC to accusations of being too close to the firms being regulated, from where individuals may have been recruited. This should be rebuffed positively by demonstrating these desired skills.
221. The FRC's staff and governance should reflect the knowledge and diversity of those it oversees.
222. The FRC may not be best placed to carry out all actions in its remit. Consideration should be given to determining the best provider for a service and acquiring it on preferential terms. This could involve partial delegation of work back to RSBs where economies of scale may be obtained, rather than buying in services from major legal and accountancy firms.
223. The concept of regulators employing individuals (either as executives or as non-executives on boards and committees) who are either current or previous employees of regulated entities has long been debated.
224. There is obvious value to be gained from the industry and technical expertise and the insight practitioners bring in helping to frame and understand issues and to understand matters of

practical, 'on the ground' conduct. Other regulators in other sectors do this such as, but not exclusively, the FCA.

225. However, this practice is open to significant scrutiny, especially from the media and in turn the public, who perceive this as ripe for conflict of interest, moral hazard and for the undue influencing and shaping of policy. ICAEW is not aware of any incidents to illustrate this actually happening and in practice/one would hope there are many checks and balances built into boards and committees to ensure that no one or two voices can bring undue influence.
226. Conversely, other regulators suffer from issues around loss of staff back into the private sector, attracted by higher salaries in corporate compliance departments. This is quite possibly an issue the FRC has encountered in keeping its own staff. It is a real concern and has often resulted in calls for staff at regulatory bodies (in general) to be paid more – perhaps also being paid a performance related bonus.
227. On balance, the practice of employing staff from the regulated population is probably necessary – and is a counter to avoiding further accusations of operating in a vacuum or at a distance from the practicalities. The key requirement must be that it can source technically-competent staff with the necessary practical hands-on experience, to ensure a robust regulatory outcome in the public interest.
228. Whilst external scrutiny is vital and ICAEW endorses that, the FRC could benefit from illustrating clearly and communicating promptly and robustly on the checks, balances and safeguards it builds in to avoid real or perceived risks and accusations of conflict of interest. There is both a communication and education exercise needed to bridge what can sometimes be an unhelpful gap in understanding and insight which leads to (sometimes unfair) media scrutiny and market disquiet.

Does the FRC have the people, skills and resources it needs, of the quality it needs?

229. The FRC does not publish details on its staffing levels or other aspects of its people resourcing and skills. In ICAEW's response to the FRC consultation on its 2017 plan and budget we stated: "...More information on staffing levels, key cost drivers and relevant metrics-based KPIs would assist transparency..."
230. We note that the FRC has many skilled and dedicated individuals but they require specific and clear focus on core activities. The FRC has been involved in scope creep into areas outside of the core remit, such as insolvency and taxation. If it could focus on the core remit then there is a good base within the team to build upon.
231. The FRC's staffing costs were set to increase by £1.5m in 2018, an increase of 7.5% on the previous year. There were staff increases planned in relation to the FRC's Competent Authority status and development of the UK's corporate governance framework. There was also an increase in staff in the enforcement area: this team had expanded since 2013 with plans to expand further in 2017. It is unclear to which areas or aspects of enforcement these resources were deployed.
232. Notwithstanding whether the FRC has the people and skills it needs, we feel the inclusion of statistics on number of cases concluded in a year, and length of time to conclude cases, would assist as an effectiveness metric or indeed a KPI. This in itself is a good measurement of staff quality and competence
233. One point ICAEW makes regularly during the FRC's annual consultation on its plan and budget, is in reference to the relatively large number of non-executive directors the FRC utilises and their pay, which appears to be above comparable market levels.

**Question 44: Are there conflicts of interest in the FRC's structure, processes, or culture?
Are there deficiencies in the FRC's approach to managing conflicts of interests?**

Are there conflicts of interest in the FRC's structure, processes, or culture?

234. Much depends on the perspective of the viewer. The FRC employs individuals, either in its staff or on its boards, who have extensive knowledge of the regulated sector it oversees, then some stakeholders may perceive the possibility of a conflict of interest. The FRC must be clear and transparent in how it deals with these apparent conflicts of interest and demonstrate that results are unaffected by the personnel involved or the firms monitored. As described in our answer to Question 43, the majority of the FRC's personnel will have worked for firms regulated by or subject to enforcement procedures of the FRC. This is inevitable given the professional skill set required for the activities.
235. Generally speaking, issues around conflict of interest actually materialising (for example, sully regulatory outcomes and resulting in adverse outcomes) can often be more apparent than real. With regards to the FRC, there is a lack of actual examples of real demonstrable issues, including regulatory capture, but conversely these can be difficult to definitively identify and trace. The FRC's Register of Interests (published in November 2017) did attract some external scrutiny.

Are there deficiencies in the FRC's approach to managing conflicts of interests?

236. We are not in a position to be definitive or evidence-based on this point.

Question 45: Are there any other issues relevant to the terms of reference that respondents would like to raise?

237. The scope of this Review excludes reference to accountancy standards and company law, and yet some of the issues facing the FRC and the challenges contained within this review, emanate from those two sources.
238. The law does not permit the FRC to carry out certain activities, and there is an expectation gap between what the public think an audit does and what the FRC and the firms are required by law to deliver.
239. There are also accounting standards issues around revenue recognition and going concern, which characterise views on recent corporate collapses and have arguably contributed to the clean audit opinions provided in previous years.
240. A separate review commissioned by the Audit Quality Forum will be looking at the expectation gap and how to address it, but these other factors need to be understood if not immediately responded to in the short term.

Paragraph number	Recommendation for action
13	<p>The FRC's revised regulatory objectives should anticipate a post-Brexit landscape which will require the FRC to promote the quality, competence and reliability of UK corporate governance, accountancy, auditing and ethical standards to international investors and regulatory institutions.</p> <p>The FRC's future objectives should also include the promotion and enforcement of high standards of corporate behaviours and conduct, and continuous improvement in accounting and auditing practice.</p>
14	<p>While the objectives might not include promotion of competition in the audit market (this arguably being the preserve of the Competition and Markets Authority (CMA)), it may be advisable for the FRC to 'have regard to how its actions may promote or detract from measures taken by the CMA to improve competition'.</p>
15	<p>The FRC's future mission should focus on fulfilling its regulatory objectives, which should include an over-arching public interest principle.</p> <p>A duty on the FRC to consider the impact of its work on the UK's SME and SMP sectors also should be included in its future objectives.</p>
16	<p>We do not believe that in a post-Brexit world the FRC should continue with its responsibilities for monitoring local public sector audit work in England. This work could be passed to the local public audit RSBs.</p>
17	<p>With respect to the FRC's role in actuarial standards, while actuarial work can contribute to material items in corporate balance sheets, we see no reason why this work needs to remain with the FRC going forward.</p> <p>Discussion with the Institute and Faculty of Actuaries about a solution with a public interest oversight mechanism would seem appropriate.</p>
18	<p>The FRC's name should reflect its future remit in full, support the perception of it as a respected regulator and carry authority in an international context.</p> <p>The FRC's international 'brand' is respected by other regulators, therefore careful consideration is needed in any name change.</p>
27	<p>The FRC needs to have more regard in future to how its actions impact on competition in the audit market.</p>
43	<p>We recommend the FRC convene more discussions on challenges facing the profession.</p>
49	<p>A change of FRC culture is needed to one that seeks to work more energetically and imaginatively with the profession on meeting the challenges brought by change.</p> <p>The FRC should do more to promote public understanding of the scope of audit.</p>
52	<p>The FRC's powers should allow it to investigate effectively the actions of all directors and senior managers at companies, rather than just those who are members of professional accountancy bodies. This change is needed to reflect the enshrined principle of English company law that directors are collectively responsible.</p>

APPENDIX A: SUMMARY OF RECOMMENDATIONS

Paragraph number	Recommendation for action
60	<p>The FRC's focus is PIE audits. Auditing standards adopted by the FRC are at present applicable to all audits, covering the full range of size and type of entity.</p> <p>It is important to ensure that the FRC plays its part in ensuring that adequate support is available to those seeking to carry out smaller audits effectively and appropriately.</p>
63	<p>With regard to the post-Brexit environment, there is a need for the FRC to more carefully consider and balance its role as a critical regulator with the need to promote confidence in UK audit firms.</p>
66	<p>We recommend that the FRC create an 'Audit Improvement Office' or equivalent deliberately to focus its audit activities on a pro-active improvement agenda.</p>
73	<p>More proactive work should be done to educate and to probe factors within firms that might lead to poor performance. For example, the performance criteria for audit partners when setting remuneration and whether this takes into account sufficiently the quality of the work identified in internal and external reviews.</p>
81	<p>The FRC and audit firms should be proactive in ensuring realistic levels of audit fees are being paid. It is concerning that audit fees have seen no real-terms increase in recent years, despite the increasing complexity of audits and the added cost burden of tendering on rotation.</p>
85	<p>The FRC's objectives should include having regard to the impact its decisions may have on competition in the audit market and the extent to which its actions may encourage or discourage current and future firms and partners from wanting to lead on public interest entity audits.</p>
95	<p>As the UK leaves the EU, there will be opportunities to look again at the requirements currently applicable to small companies (the great majority of UK companies), which currently reflect EU requirements to a substantial degree. It will be important to ensure that the post-Brexit FRC plays its part in this process and, more generally, is willing and able to provide appropriate support to preparers of non-PIE financial reports.</p>
96	<p>The work of the (FRC Financial Reporting) Lab should continue. We also welcome other recent efforts of the FRC to encourage more effective dialogue with investors.</p>
98	<p>It may be beneficial post-Brexit to reconsider the scope of the regulatory oversight of the FRC in relation to the narrative and non-financial components of the annual report and accounts, information which is increasingly important to investors and other users.</p>
103	<p>The Accountancy Scheme should be amended so that the FRC has regulatory jurisdiction over all PIE board members, not just those who are members of a professional accountancy body.</p>
113	<p>We believe that the FRC should set standards as to what is expected of directors of listed and very large private companies, and monitor behaviour with reference to these expectations. The effective operation and integrity of the entire corporate system depends on a new focus on the responsibilities of individual directors.</p>
115	<p>As part of this work, the regulator should not only be mindful of, but proactively seek to improve, diversity in the boardroom as a means of ensuring that UK businesses reflect the society in which they operate, as well as encouraging greater challenge and scrutiny to promote improved strategic business decisions.</p>

APPENDIX A: SUMMARY OF RECOMMENDATIONS

Paragraph number	Recommendation for action
120	We recommend the creation of a specifically-tasks and properly resourced office overseeing standards of corporate governance. Our vision for a Corporate Governance Office (CGO), or similar, includes certification and monitoring of the directors of listed and very large private companies.
121	The CGO should ensure that individual directors fully understand their role, particularly Non-Executive Directors' responsibility to use their independence to challenge management regardless of their personal interests. A requirement for continuous professional development, and the threat of the removal of certification, will help guard against complacency setting in as a director's tenure matures.
123	The creation of the CGO is pertinent to the objective to strengthen the FRC's position and reputation, and we suggest that the Review thinks globally in this respect.
135	The FRC should be provided with powers to investigate all directors and senior managers of PIEs and to bring misconduct, or even criminal, actions against them (for example the offence of lying to an auditor under Section 507 of the Companies Act 2006). In addition, the effectiveness of the FRC's investigation of directors should be assisted by far-reaching powers to demand the disclosure of company documentation.
138	We have no first-hand evidence of actuarial regulation, but we would prefer this to be outside of the FRC's future remit, in order to assist the focus on its key objectives.
155	We do not believe that the FRC's supervisory regime should be supplemented by a prudential regime.
162	There may be merit in formalising a regulatory framework around corporate governance, and direct inspection or investigative powers to go into PIE companies where their operations are of systemic risk and there is evidence of mismanagement. Such powers would need to be exercised proportionally, perhaps along the lines of the SPO Section 2 interviews, but would place more proactive tools at the FRC's disposal.
165	The FRC should consider using the full range of sanctions permitted under the SATCAR – not just fines and exclusions.
169	The sanction of expulsion from membership of the respective professional body is regarded by the FRC as being the highest possible punishment. We believe it should be limited to dishonesty or lack of integrity. In our view, its application by the FRC for poor professional work is disproportionate and sits uncomfortably with employment law.
173	We believe that legislation to put the FRC on a more conventional consolidated statutory footing is needed.
178	A sustainable funding model to allow the FRC to properly resource and plan is a key factor required, as is the FRC's ability to recruit and retain high quality talent unfettered by public sector remuneration and employment rules.
184	The FRC must be an exemplar of good governance and should consider applying the Corporate Governance Code to itself.

APPENDIX A: SUMMARY OF RECOMMENDATIONS

Paragraph number	Recommendation for action
189	The FRC governance should be robust enough to accept individuals with recent audit or corporate governance roles.
193	The process for the review and feedback on proposed FRC annual budgets and operational plan activity should be managed by BEIS, rather than challenged back to respondents by the FRC itself.
201	The FRC's regulatory and enforcement regime could encompass all directors and not leave those directors who are members of professional accountancy bodies to bear a disproportionate risk. To that end we would seek a funding regime which would require a greater contribution from the corporate sector in recognition of the responsibilities of their directors. This would also reinforce the corporate governance framework promoted by the FRC.
206	For enforcement matters, we note that fines imposed under the Audit Enforcement Procedure will be remitted to HM Treasury. We propose that the FRC are instead permitted to retain these fines in order to fund an efficient and cost-effective enforcement process in the public interest. Costs contributed by the RSBs should be refunded to the RSBs.
220	The FRC's staff and governance should reflect the knowledge and diversity of those it oversees.
233	The FRC must be clear and transparent in how it deals with apparent conflicts of interest and demonstrate that results are unaffected by the personnel involved or the firms monitored.

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