

INVESTMENT ASSOCIATION RESPONSE TO SIR JOHN KINGMAN'S INDEPENDENT REVIEW OF THE FINANCIAL REPORTING COUNCIL

EXECUTIVE SUMMARY

The Investment Association ('IA') welcomes the opportunity to respond to the Independent Review into the Financial Reporting Council's (FRC) call for evidence. The IA is the trade body that represents UK investment managers. Our 250 members collectively manage over £6.9 trillion on behalf of clients in the UK and around the world.

Effective corporate governance, financial reporting and audit practices helps boost investor confidence, ensuring that the UK attracts global capital flows and remains a desirable place to list companies. A well respected and fully functioning capital market relies on companies upholding high corporate governance standards and trustworthy financial reporting. In order to be trusted by investors this reporting needs to be subject to a high quality audit process. These minimum standards allow investors to make well-informed investment decisions, and guide the stewardship activities that asset managers carry out on behalf of their clients.

To maintain this important market structure, there is a need for a strong, independent regulatory body with a remit of upholding audit standards, financial reporting and corporate governance - a similar remit and range of functions to the FRC. This regulator should continue to set and maintain best practice in audit, financial reporting and corporate governance in order to facilitate and promote investment in the UK. This body should be well-governed, transparent in its ideology and processes, and respected. It should have a diversity of perspective throughout its employee base and governance structures, be receptive to outside views, and have a strong and coherent culture.

The IA's members hold mixed views as to whether the FRC is effectively performing this role at the current time. While some investors believe the body performs well, the majority believe that there are significant areas where the FRC could improve, with some calling for the FRC's abolition and the formation of a new body. **The discussion about the role of the FRC should include serious consideration of what are the most important aspects of the FRC's work, which aspects should be retained and which could be passed to other bodies. Ensuring that the FRC can focus on high quality outcomes from its core activities.**

The most immediate concerns for improvement of the FRC relate to the organisation's purpose, mission and culture. The FRC's current mission statement ("to promote transparency and integrity in business") is vague. **The FRC should refocus its objectives and mission statement. We recommend more strongly linking the FRC's work to promoting investment in the UK, as was the case with previous FRC mission statements.**

The FRC's objectives also need to be clarified, potentially in law. This clarification will help the organisation to better determine its responsibilities and ensure that it has the right remit and responsibilities. Members have suggested that **the FRC's objectives could be set in law with accountability to BEIS, and Parliament potentially through the BEIS Select Committee.**

Investors are supportive of the work of the Corporate Reporting Review and Audit Quality Review. The FRC has also been effective in starting a wider debate on a number of issues, such as viability statements, auditor reporting, the Culture Coalition project, board effectiveness reviews and auditor rotation. Investors would like to see greater transparency. For example, **the FRC should make public the outcomes of the Corporate Reporting Reviews (CRR) and Audit Quality Reviews (AQR) into individual companies, so that investors can understand the FRC's findings and concerns.** Investors will be able to use this information in their engagement with companies and when making investment decisions.

The FRC's role as a regulator of accountants, and not all Directors, should also be reconsidered. The FRC should have powers to investigate all Directors, not just those Directors who are qualified accountants or members of an accountancy body where there are concerns over the preparation and approval of the financial statements. Additionally, the voluntary levy should be replaced with a mandatory levy on individual audit firms and other contributors.

Culturally, the organisation is seen as being reactive, too slow when undertaking investigative or enforcement action, fails to take investor feedback into account, and narrowly focused on processes rather than outcomes with staff who have a homogenous skill set. **The FRC should focus on a cultural change to address these issues and increase diversity across the organisation including its board and committees to provide more diversity of perspective.**

SECTION 1: FRC PURPOSE AND FUNCTION



Q1: WHAT SHOULD THE FRC'S OBJECTIVE(S) BE? IS ITS PRESENT MISSION STATEMENT THE RIGHT ONE?

There is a need for a strong, independent regulatory body with a similar remit to the FRC. The IA is supportive of the FRC remaining in this role rather than giving way to the formation of a new entity. However, the FRC needs to have a clearer central purpose and mission and to articulate this better to stakeholders such as investors, and to the wider public. A central part of this articulation should be a clear outline of who the FRC's key stakeholders are and how they are served by the FRC.

Over time the FRC's remit has expanded. The organisation now covers a broad range of activities, from setting audit standards, regulating and enforcing audit quality, to maintaining the corporate governance and stewardship codes and setting UK accounting standards. In addition, the body also regulates, sets standards and provides oversight for the UK's actuarial sector.

The FRC's current mission statement ("to promote transparency and integrity in business") has developed as this remit has expanded but the IA is concerned that this statement is now too wide-ranging to provide any real strategic guidance for the organisation.

The IA believes that the FRC needs to reaffirm that the reason behind maintaining a strong audit regime, reporting framework and corporate governance regime is to boost investor confidence in market mechanisms and encourage investment in UK companies. The FRC's previous Mission Statement had a clear link to investment - "Our mission is to promote high quality corporate governance and reporting to foster investment". We believe it would be very helpful to reset the mission statement to make the connection to investment much clearer.

Q2: DOES THE FRC'S NAME REMAIN RIGHT?

The FRC's activities now cover a much broader range of activities and remit than the name would suggest. For instance, there is no mention of corporate governance or stewardship in the FRC's current name. To better inform a discussion about the regulators name, the ultimate role and responsibilities of the organisation should be determined along with the culture it is seeking to promote within the organisation. The regulator would then be in a position to choose a more encompassing name which embeds the culture and objectives of the organisation.

Q3: 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?

The FRC's scope has developed organically over time, with different responsibilities being added in a piecemeal fashion. As such, it may be necessary to take stock and assess whether all of the FRC's objectives and responsibilities fit well together.

There are concerns that the FRC current structure feels like it has been reached reactively, rather than according to a clear vision. This form of development may have led to the body being spread too thin, and may also be affecting the organisation's culture – the FRC has repeatedly been criticised for only responding to events when it is under scrutiny. The Review should consider the mission and objectives of the FRC and, following that, whether all the powers and responsibilities are still appropriate to be held by the FRC, or whether it is more appropriate for some of the responsibilities to reside with a different body.



That said, a number of investors support the FRC's wide scope. They believe, that if managed effectively, this depth can be a strength, allowing the FRC to have oversight of the important aspects of maintaining a strong reporting and governance regime. These investors would not be supportive of redistributing the FRC's powers amongst a number of different organisations – they feel it is better to have all of these in the same place, as long as they are well managed, and enable the organisation to provide joined-up policy and its implementation. One aspect of the FRC's current remit that members have questioned is whether the FRC's work on actuarial standards is an appropriate fit for the FRC's mission and objectives or whether this should be addressed elsewhere.

While the IA does not support abolishing the FRC, some members recommend reviewing the body's responsibilities to ensure they appropriately meet the new organisation's mission and objectives. An effective structure is crucial to ensuring the FRC can meet its mission and objectives. This should therefore be revisited once these have been set. It should be noted that some members are calling for the FRC's abolition and the formation of a new body.

Q4: WHAT LESSONS CAN BE LEARNED FROM OTHER COUNTRIES' REGULATORY SYSTEMS? WHICH ONES?

IA members have noted that regulators in other countries are more disparate than in the UK, with powers spread over a much wider array of bodies. For example, in the US there are at least four different regulators carrying out similar work to the FRC (FASB, PCAOB, SEC, ASB), as well as separate accounting regulators operating at federal and state or local government level (FASAB, GASB). However, a number of IA members consider the FRC's wide remit, if well managed, to be a strength.

Q5: 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?

The FRC has been an influential commentator on certain issues around corporate governance, reporting and audit. The recent consultation on and redrafting of the UK Corporate Governance Code has helped to stimulate a wider debate on corporate governance, and the FRC will have a similar opportunity when it begins to consult on the revised Stewardship Code. The FRC's work on corporate governance and stewardship is carried out on limited resources compared to other areas of the regulators work.

The FRC also has been effective in initiating a wider debate on a number of issues, such as viability statements, auditor and audit committee reporting, the culture coalition project, board effectiveness reviews and auditor rotation. While the FRC may be effective at starting these discussions, it is less effective at bringing about real change in these areas.

Q6: IS THE CURRENT BALANCE BETWEEN CROSS-CUTTING REVIEWS AND FIRM-SPECIFIC INVESTIGATIONS MOST EFFECTIVE?

Cross-cutting reviews have an important role in helping to identify market trends and emerging issues. Therefore, we believe that they are important and should be retained. However, the IA would like to see greater transparency from the FRC on company-specific issues, such as those revealed by Audit Quality Results ('AQR') and the Corporate Reporting Review ('CRR') results.

In handling CRR results, the FRC publishes unannotated lists of companies' reports with no explanatory guidance, leaving responsibility for the disclosure of issues identified by the review to

companies. However, many of the companies reviewed have simply not disclosed the results of the inspections nor the issues uncovered by the CRR, meaning that these issues have not been disclosed to investors. It would be beneficial for this information to be made available to the market in a structured way.



The FRC should be required to publish the findings of the reviews undertaken, including of the AQR and CRR. Investors would like a better understanding of the issues uncovered by the FRC in these reviews. Publishing the findings would enable investors to make more informed investment decisions and to guide their stewardship activities, which include engaging with companies and voting at shareholder meetings.

SECTION 2: IMPACT AND EFFECTIVENESS

Q7: WHAT ARE THE FRC'S STRENGTHS AND WEAKNESSES?

The FRC has a number of strengths and is performing well in a number of areas.

- **Scope** – The IA believes that the FRC's wide remit, if managed effectively, can be a strength. Having complete oversight of audit regulation, financial reporting and corporate governance in one place is a benefit.
- **Instigating new initiatives to improve market practice** – The FRC has been effective in starting a wider debate on a number of issues, such as viability statements, culture coalition, board effectiveness reviews and auditor rotation. However, members feel that while the FRC may be effective at starting these discussions, it is less effective at following through with their conclusions/findings, bringing about real change and developing best practice.
- **Leading in Corporate Governance and stewardship** – The review of the Corporate Governance Code demonstrates that the FRC can lead the way on corporate governance and stewardship. This approach is internationally renowned.
- **Work of the AQR and CRR** – Members have commented that they believe that the work of the AQR and CRR to be important, and that the Reviews help to improve the quality of audit and reporting in the UK. This work could be improved if the individual results of the CRR and AQR were published.
- **Work of the FRC Lab** – The FRC Lab has helped to facilitate investor-company engagement in a non-confrontational, constructive environment. The Lab has been useful in considering different ways in which reporting can be improved.

There are also a number of areas in which the FRC needs to improve.

- **Purpose and Mission** – As outlined in our response to questions 1 and 3, members feel that the current Purpose and Mission of the FRC could be improved. The FRC's previous Mission strongly linked improving governance and market standards to **promoting investment**. The FRC's remit has expanded significantly in recent years. It is important for the objectives of the FRC to be clarified, potentially in law. Once these objectives have been clarified the right responsibilities can be determined to ensure that the FRC is following the right approach.
- **Culture** – A strong and coherent culture, best implemented by an organisation's leadership, helps to drive positive performance. However, there are concerns over the FRC's current culture. This is seen as a key concern and an issue which is fundamental to addressing other concerns. The FRC is viewed by our members as having a 'closed' culture: the



organisation is characterised as being unreceptive to outside views. Members feel that when they have raised issues or concerns, they have not been appropriately considered or addressed, even when presented to senior FRC staff, with one member noting that “they listen but do not respond.” Other members have commented that the FRC is too focused on processes rather than outcomes.

- **Diversity of perspective** - There is a perception that the FRC is staffed by too many ex-auditors. It is clearly important to have people in the organisation with the technical skills to deal with audit matters. However, a greater role for independent voices and diversity of thought is needed. This will be particularly important when addressing some of the more subjective aspects of the FRC’s work, such as perceived conflicts in audit work. .
- **Communication and accountability** – The FRC needs to communicate better on wide range of issues, starting with what it does and does not do. More transparency is needed over its use of enforcement and how it holds companies and individuals to account, to demonstrate that the body is appropriately fulfilling its regulatory duties. For instance, the FRC needs to move faster when taking enforcement action, but it also needs to explain when there are barriers to quick enforcement so they can be addressed. The FRC should also be able to make public statements on their judgements and investigations, including AQR and CRR results. This would inform the market or investors about issues with a particular audit or accounting practice. Such statements would draw attention towards the issues which need addressing, and would also show the regulator to be active and involved. The FRC should also publish any judgements it makes on issues such as potential conflict of interest, so that the whole market is aware of these issues and its decisions.

Powers – Members have raised concerns over the quality of FRC’s enforcement and investigation work in the audit market, and question whether the FRC is doing enough to hold auditors to account. There are concerns that both auditors and the FRC are too focused on complying with a set process rather than achieving the right outcomes. In its response to the Government’s inquiry into Carillion the FRC asked for greater and more wide-ranging powers. The IA believes that the FRC should address the issues highlighted through this Review before asking for further responsibilities. Addressing these problems will help the organisation use its existing powers more effectively.

However, some additional powers may be appropriate to enhance the regulator’s work specifically in the areas where there are anomalies in the existing powers. For example, the IA would support the FRC being given powers to investigate all Directors for the preparation and approval of the accounts, not just those Directors who are qualified accountants or members of an accountancy body. However, before supporting this expansion of the FRC’s powers, we would need to be confident that the FRC is addressing the issues identified through this Review. These problems will not be resolved by simply expanding the body’s remit.

- **Leadership and proactivity** – The IA would encourage the FRC to be more proactive in its regulatory approach. A reactive regulator that only responds to issues when absolutely necessary will not be well-respected by those it regulates and thereby limits the effectiveness of its enforcement activity. The perception that the FRC is only moved to action when it is under the spotlight is concerning. The flurry of activity carried out by the FRC following the collapse of Carillion, which included the formation of the Investor Advisory Group and holding information sessions for investors, amplifies this perception. In recent years the FRC has only sought changes to its remit or greater powers when the body is under scrutiny or its role is being challenged. These arguments would be more persuasive and better received by stakeholders if they were presented proactively as part of the FRC’s ongoing research and statements, rather than only when the performance of the organisation is under question.



- **Resources and funding** – There are concerns that the FRC’s funding structures may be limiting its effectiveness at setting and maintaining high standards in financial reporting. The Review should consider whether the FRC’s status as a Public Body has led to difficulties in recruiting senior employees, given the constraints on salaries. It has been suggested that an increase in resources may lead to a more powerful, engaged regulator. The FRC’s funding model and use of fines levied should be evaluated by the Review.
- **The investor voice** – Investors have had varied experiences in dealing with the FRC. Members have noted that the FRC is willing to listen to investors in certain settings, such as in the FRC Lab, but not in others. At times members have been asked by the FRC to identify particular issues or concerns, however once issues have been raised they have not been actioned or addressed. Some investors feel that shareholders, who are the end user of the products that the FRC regulates, are not considered to be key stakeholders by the FRC. The IA welcomes the formation of the Investor Advisory Group, but feel that the FRC could do more to take the investor voice into account. For instance, the FRC should consider appointing more than two investors to its Board.

Q8: 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.

An effective regulator needs to employ effective deterrents. Some members have suggested that the FRC’s use of audit fines is an ineffective deterrent as they are insignificant when compared to the revenue of these firms. The Review should consider whether the size of fines levied is appropriate, and whether the FRC should focus more on the sanctioning of the Audit Firms. Members feel that the non-financial sanctioning of individual auditors has had a significant impact. Furthermore, the FRC needs to provide more information on the use of its enforcement mechanisms. Providing more disclosures on the FRC’s enforcement approach and outcomes in a timelier manner is likely to create more confidence in the organisation.

Lastly, it is important to note that even the most effective regulator will not be able to prevent all corporate failures. The UK’s economy relies on participants taking risks, and providers of capital look for higher returns to offset that risk with the understanding that sometimes that risk may lead to corporate failure. However, it is right that the FRC or a similar body has the correct powers to look into the failures and if necessary take action.

Q9: ARE THERE CHANGES RESPONDENTS WOULD LIKE TO SEE TO ACHIEVE THE VISION SET OUT IN THE REVIEW’S TERMS OF REFERENCE?

As set out in Q7 the FRC has a number of weaknesses. These include issues relating to the FRC’s objectives and mission, culture and communication. In order to address these areas of weakness the IA makes the following recommendations:

- The FRC should refocus its objectives and mission statement. In doing so, the FRC should re-establish a strong link between its mission and promoting investment. During this process the review should be clear which activities are core to the FRC’s work and meeting these objectives and which should be given to other bodies. The Review should consider the legal accountability of the FRC. Our members have suggested that the FRC’s objectives

could be set in law with accountability to BEIS, and Parliament potentially through the BEIS Select Committee, similar to the FCA's relationship with HM Treasury.

- The FRC should make public the outcomes of the Corporate Reporting Reviews (CRR) and Audit Quality Reviews (AQR) into individual companies, so that investors can understand the FRC's concerns. Investors will be able to use this information in their engagement with companies and when making investment decisions.
- The FRC should have powers to investigate all Directors, not just those Directors who are qualified accountants or members of an accountancy body where there are concerns over the preparation and approval of the financial statements. It is the responsibility of all directors to sign off the Report and Account therefore, all directors should be held accountable under the FRC's Accountancy Scheme for the preparation of the accounts.
- The FRC should focus more on the implementation of initiatives to ensure they achieve real change. These initiatives include the FRC's work on viability statements, the 'culture coalition' and Board effectiveness reporting.
- The FRC should increase diversity across the organisation including its board and committees to provide more diversity of perspective.
- The voluntary levy should be replaced with a mandatory levy on individual audit firms and other contributors – see question 42

Q10: ARE ARRANGEMENTS FOR FINANCIAL REPORTING, AUDIT AND CORPORATE GOVERNANCE THE CRITICAL ELEMENTS FOR EFFECTIVE DELIVERY OF FRC'S MISSION, OR ARE ELEMENTS MISSING?

The IA is supportive of the FRC's current remit of setting and enforcing best practice in financial reporting, audit and accounting and corporate governance in order to promote investment in the UK. Investors believe that the responsibility and oversight of stewardship activities needs to be considered carefully. The review of the Stewardship Code and implementation of the Shareholder Rights Directive will create an opportunity to consider the best way to focus and create change in stewardship. We note that the FCA has stated that it intends to consider stewardship activities in its oversight of regulated firms. We await further details of the FCA's intended approach, and seek assurance that the oversight of stewardship is appropriately joined up. It is important to note, that good stewardship relies on investors choosing the right approach and issues to engage on. These will change dependent on the individual circumstances of their investments. Stewardship cannot and should not be boiled down to a checklist or compliance exercise, which should be considered when reviewing where the responsibility for stewardship lies.

SECTION 3: AUDIT REGULATION

Q11: HOW EFFECTIVE IS THE FRC AT DRIVING QUALITY IMPROVEMENTS IN AUDIT? WHAT FURTHER IMPROVEMENTS WOULD RESPONDENTS LIKE TO SEE?

Investor views on the FRC's audit work are mixed. Some investors feel that the FRC is doing a good job, with no clear evidence that there are underlying issues over the quality of audits. However, others believe that the FRC needs to make adjustments, such as looking at more audits through the AQR and publishing the outcomes of individual companies' AQRs. Investors support increasing the number of AQRs and increasing the sample size for these reviews, in order to increase the reliability of the results. Please see Q6 and Q7 for a discussion of weaknesses and suggested improvements.

Q12: WHERE QUALITY DOES FALL SHORT, DO THE FRC'S INTERVENTIONS HAVE SUFFICIENT IMPACT AND DETERRENT EFFECT?



The FRC's interventions often lack sufficient impact, and that the FRC's current use of its powers may not constitute an effective deterrent. The Review could consider whether the size of fines levied are appropriate and whether the FRC could use more non-financial sanctions, such as time-limited bans on auditors, and other non-financial sanctions on audit firms. Members have welcomed the limited use of non-financial sanctions of individual auditors and audit firms as a positive approach.

Q13: 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"?

There is a clear perception that the FRC is staffed by too many ex-auditors, especially from the 'big 4'. There is also concern that the FRC's Board does not comprise enough individuals from non-audit backgrounds.

It is important to have people within the FRC with the technical skills to deal with audit matters, and it is understandable that the FRC has traditionally viewed the 'big 4' as a source of talent to draw from. However, the FRC should ensure that there is an appropriate diversity of perspective and other perspectives, including at board level, are brought in. In the listed sector, for the last 18 months, there has been considerable debate about how Boards hear from their material stakeholders to take their views into account when making decisions. The FRC should be no different, and should seek to establish a diversity of perspective and bolster relationships with material stakeholders. Furthermore, the FRC should seek to recruit audit professionals from outside of the largest auditors.

One way of improving the diversity of the FRC is to increase the amount of non-audit voices within the organisation, such as investors and other stakeholders. The FRC should consider the best way to make these voices heard, whether by employing individuals with different areas of expertise or setting up new initiatives or committees. In doing so the body should not seek to fill a particular quota, which may lead to box-ticking, but should focus on quality of input. These independent and diverse voices are particularly important when the FRC makes subjective judgements, such as on perceived conflicts in audit work.

It is not just the issue of too many being recruited from the big 4 that needs to be addressed, but also how individuals are managed and developed ensuring that the FRC is setting an appropriate culture to allow individuals from a non-big 4 background to effectively contribute and flourish in the FRC.

Regarding competition in the audit market, there is a perception that the FRC feels it has to balance appropriately sanctioning the big 4 with concerns that this could impact on competition and result in the big 4 becoming the 'big 3'. There are concerns that this perception may lead to bad practices in the biggest auditors going unpunished.

Q14: ARE INVESTIGATIONS OF AUDIT WORK EFFECTIVE, TRANSPARENT, SATISFACTORILY CONCLUDED AND UNFETTERED?

It is difficult for investors to judge how effectively the FRC conducts investigations into audit work because of the time it takes to complete investigations, and in some instances the lack of

transparency, as noted in Q7. The FRC needs to better communicate the investigation process as well as the end result. Increased speed and transparency will act as a catalyst for further improvements in the organisation's efficacy and will allow investors to assess the effectiveness of enforcement action.



Q15: COULD A DIFFERENT REGULATORY STRATEGY OR TACTICS RESULT IN GREATER AVOIDANCE OF HARM?

The IA believes greater disclosure of investigatory outcomes, for example AQR results, will help investors focus on the issues raised. This will help to improve the performance of individual companies, facilitated by informed engagement pressure from shareholders on the companies and individual auditors.

The FRC has not made it sufficiently clear how its different stakeholders should best transmit their concerns to the FRC and how they will be acted upon. The FRC could consider implementing a mechanism whereby stakeholders can privately raise concerns over different areas of the FRC's remit. The organisation could then take a better-informed decision on whether to investigate the issues raised.

Q16: 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?

It is important to note that the FRC is not a competition regulator. The IA believes that the FRC should primarily focus on the quality of audit work produced, and consider the best ways to achieve this. The responsibility for competition in the audit market should be an issue for the CMA.

Q17: 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?

As noted above, issues around the competition in the audit market should be a matter for the CMA and the FRC should be focussed on improving audit quality and scope.

SECTION 4: ACCOUNTING AND FINANCIAL REPORTING

Q18: HAS THE FRC BEEN EFFECTIVE IN INFLUENCING THE DEVELOPMENT OF ACCOUNTING STANDARDS INTERNATIONALLY AS WELL AS ACCOUNTABLE AND EFFECTIVE IN SETTING UK GAAP?

Members consider it important for the FRC to have an international focus, and that the FRC has helped to improve accounting standards and audit practices internationally. Where these standards affect the UK it is proper that the FRC seeks to influence their design and evolution. The IA believes it is important that the UK's financial reporting regulator participates in the development of international standards. This should not come at the expense of effectiveness in domestic regulation.

However, concerns have been expressed that the FRC may be devoting a disproportionate amount of its resources to international work, potentially at the expense of its domestic programme and regulatory work. Please also see Q42 for a further discussion on the FRC's resourcing.



Q19: HOW ELSE COULD THE FRC IMPROVE THE QUALITY OF FINANCIAL REPORTING WITH A VIEW TO ENSURING INVESTOR CONFIDENCE?

High quality financial reporting is important to investors, who use this information to get the best possible understanding of the companies they invest in. The FRC has tried to develop confidence in financial reporting and improve the quality of reporting through initiatives such as the FRC's Strategic Report Guidance and the FRC Reporting Lab. These are welcome developments, but investors would also appreciate having more information on individual CRR analyses and the issues identified under the process. As we have outlined above, the FRC leaves the individual companies to publish information of the CRR review. We believe this approach to be ineffective, and ask that the FRC publishes information on each individual company that undergoes a CRR. This will help investors make better-informed investment and engagement decisions.

Q20: 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?

Yes. As noted in Q7, the IA would support the FRC having the powers to investigate all Directors in relation to the preparation and approval of financial reports, rather than just those who are qualified accountants or members of an accountancy body.

Before considering whether a stronger regulatory role is needed in other areas, the IA will wait to assess the impact of the new reporting requirements approved by Parliament on reporting on Directors Duties and Executive Remuneration.

Q21: IS THE CURRENT COMBINATION OF STATUTORY AND VOLUNTARY METHODS OF OVERSIGHT FOR PROFESSIONAL BODIES EFFECTIVE, AND DO THEY REMAIN FIT FOR THE FUTURE?

Investors are concerned that the current combination of statutory and voluntary oversight may be resulting in sub-optimal outcomes. However, any change to this system would likely require a significant increase in the FRC's workforce. This would not be feasible given the body's current budgetary constraints.

A change in the legal accountability of the FRC, or as some members have suggested the formation of a new body, would be an opportunity to review and if necessary move away from the current model.

SECTION 5: CORPORATE GOVERNANCE AND STEWARDSHIP CODES

Q22: 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?

The UK Corporate Governance Code has been the cornerstone of corporate governance in the UK for over 25 years and is internationally well-regarded. One of the Code's strengths has been that it has evolved to respond to emerging governance issues and best practice. A prime example is the recent review of the Code, which has refocused on the Principles of the Code and the Board's key responsibilities.



There have been a number of instances where the FRC has instigated initiatives through the Corporate Governance Code, such as the drive for viability statements or the focus on culture. Concerns remain about their long-term effectiveness. For example, on viability statements IA members were keen to see companies report effectively on their long-term viability, beyond the three year horizon. However, in this area there has been a failure to develop real change and instigate an assessment of viability appropriate to the individual business.

Q23: 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?

The UK is recognised internationally as being a leader on stewardship. For many decades, UK institutional investors have believed that working with investee companies to ensure the long-term success of those businesses for the benefit of their end clients is essential.

The original Stewardship Code was developed by institutional investors under the Institutional Shareholder Committee (ISC) following the Walker Review and building on the ISC's Statement of Principles. The FRC took over responsibility for the Code in 2010. The original Stewardship Code and the recent tiering exercise have had the impact of clarifying individual signatories' approach to stewardship and determining the approach these institutions take. The Code has been effective in doing this.

The IA believes that the Stewardship Code's role is to provide broad, high-level principles of good stewardship. In its current form, the Stewardship Code has generally met its objective, however, it should evolve to reflect how stewardship practice has developed, and could, in some areas, be improved. For example, the current Code predominantly focuses on governance issues, investments in equities, the role of asset managers and proxy voting. Stewardship encompasses a much greater range of activities, actors in the investment chain, and topics.

Going forward, it is essential that the Code maintains its high-level principles approach, and does not prescribe specific activities or topics that investors must comply with. Good stewardship relies on investors choosing the right approach and issues to engage on. These will change dependent on the individual circumstances of their investments. Stewardship cannot and should not be boiled down to a checklist.

There are elements of the Stewardship Code that could be improved to help to grow stewardship activities in the UK, and we welcome the opportunity to contribute to the 2018 review of the Stewardship Code to develop the Code further. We also note that the Shareholder Rights Directive (which will be implemented in the UK by June 2019) will necessitate some amendments to the Stewardship Code and the way that Asset Managers and Asset Owners report on their stewardship policies and activities.

The focus of the current Stewardship Code is very much on the policies which individual institutions have for fulfilling their stewardship responsibilities. However, the IA believes that there should be a greater focus on exactly how individual signatories have carried out their stewardship responsibilities and met their policies.

The IA does not consider expanded powers over investor stewardship to be warranted. However, some members have suggested that other regulators could do more to encourage investors to disclose stewardship activity. The review of the Stewardship Code and implementation of the Shareholder Rights Directive will create an opportunity to consider the best way to focus and create

change in stewardship. We note that the FCA has stated that it intends to consider stewardship activities in its oversight of regulated firms. We await further details of the FCA's intended approach, and seek assurance that the oversight of stewardship is appropriately joined up. We also note the DWP's recent consultation on recommendations for pension funds to incorporate ESG and stewardship factors into their Statement of Investment Principles and believe that this will help to create a better market for stewardship from pension funds and greater demand for stewardship reporting from asset managers. The IA welcomes the opportunity to respond to Stewardship Code consultation and will lay out these ideas more fully as part of this response.



SECTION 6: SPEED AND EFFECTIVENESS OF INVESTIGATIONS; ENFORCEMENT AND COMPLIANCE

Q24: DO RESPONDENTS VIEW THE FRC AS RELUCTANT TO UNDERTAKE INVESTIGATIONS OR ENFORCEMENT, OR ABLE TO DO SO AT SPEED?

To follow due process effective investigations will take time and should not be rushed. However, as the FRC has admitted, it has previously been too slow in its enforcement and investigation work. The FRC needs to balance due process with a need and desire for the investigations to be taken forward with appropriate speed to ensure that the conclusion of investigations is timely and enables the outcome to be delivered in a way that allows the FRC's input to have maximum relevance. It is important for the FRC to be transparent on progress and outline any of the key barriers to timely enforcement action so that they can be addressed.

Q25: 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?

It is important for the relationship between the various regulators to be clear, in order that there are no impediments to each fulfilling their individual responsibilities. We welcome the MOU between the FCA and FRC signed last year. It is important that similar issues with other regulators are identified and addressed through similar MOUs. The FCA and FRC should also consider if there are additional issues or concerns which should be addressed following the signing and implementation of the MOU.

SECTION 7: ACTUARIAL OVERSIGHT

Q26: 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?

Members have questioned whether the FRC's actuarial work is key to its objectives and mission and whether these responsibilities would better lie with another body.

SECTION 8: FRC AND CORPORATE FAILURE

Q27: IS THERE MORE THE FRC COULD OR SHOULD DO TO HELP REDUCE THE RISK OF MAJOR CORPORATE FAILURE?

There will always be corporate failures in a market-based economy; risk-free capital does not exist. However, poor accounting, and reporting can be indicators of poor governance that might,

combined with market factors, contribute to corporate failure or otherwise result in misleading signals to investors about the strength of a company. In regulating to make sure that accounts are fair, balanced and understandable, the FRC should ensure that there is sound information for investors and other stakeholders to assess and based on which to challenge boards and management more effectively. Without clear reporting the owners of businesses cannot successfully hold management and boards to account. This is why the IA has argued for public disclosures of the AQR and CRR reports.



The main way in which the FRC could lower the prevalence of corporate failures is by driving up the quality of reporting and auditing. The FRC needs to be seen as the appropriate regulator to act as a deterrent, and must make clear and public judgements. The FRC also needs to appropriately disclose the CRR and AQR results so that investors can better hold companies to account.

Q28: 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?

As we set out above we believe the FRC's concerns and findings through the CRR should be published. The reporting events of Carillion highlight potential issues over the FRC's approach. As noted in the BEIS Select Committee report into Carillion, the FRC identified 12 areas of concern in the Carillion accounts in 2015 but failed to follow through on these concerns. The concerns identified included a lack of clarity in goodwill assumptions to inadequate explanation of a significant decline in the book to bill ratio. As noted in the report, the FRC "did not follow up by reviewing Carillion's account the following year, nor by investigating further."

We believe that the FRC should be more public and proactive in following up on issues identified. The FRC should ensure the concerns have been addressed and made public so investors can also help them be addressed.

Q29: 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?

The IA does not support the idea of a prudential regulator for normal trading companies outside the financial services sector. It is the role of investors to take a view of the company, but as we have stated previously investors require appropriate information to make informed investment, engagement and stewardship decisions. This could be supported by more information from the FRC on the issues it has identified through the AQR or CRR.

Q30: INTRODUCTION OF THE VIABILITY STATEMENT WAS AN IMPORTANT DEVELOPMENT, BUT COULD IT BE MADE MORE EFFECTIVE?

As noted in our response to Q5, the FRC has been effective in starting a wider debate on a number of issues such as viability statements, board effectiveness reviews, auditor reporting and auditor rotation. However, on certain of these issues such as viability statements, our members feel that while the FRC was effective in starting these discussions, it has been less effective in bringing about lasting change.

For example, the FRC initially set the requirement for companies to produce a viability statement. However, the implementation and promotion of best practice has been weak, and we now see the majority of companies providing viability statements for just the next 3 years, rather than the

(recommended) longer term. Many companies now regard viability statements as just another legal and compliance hurdle to overcome. The FRC has not done enough to encourage long-lasting best practice and innovation in this area. Going forward, more needs to do more to drive better disclosure from Boards on how they assess their viability and over what time period. Investors want to see meaningful long-term statements.



SECTION 9: POWERS AND SANCTIONS

Q31: ARE THERE GAPS IN THE FRC'S POWERS? WOULD ITS EFFECTIVENESS BE IMPROVED WITH FURTHER (OR DIFFERENT) POWERS?

Please see Q7. We support the FRC having powers to sanction all Directors with regard to the preparation and approval of the financial statements.

Q32: ARE THE FRC'S POWERS COHERENT IN RELATION TO THOSE OF OTHER REGULATORS?

Please see Q15. We believe that the relationships with other regulators should be considered and outlined in MOUs as with the FCA. In the longer term, the MOUs should be replaced with clearer regulatory powers and objectives, so the differing roles and responsibilities of the different regulators are clear in statute.

Q33: 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?

In terms of efficacy the IA welcomes the recent use of non-financial sanctions on individual auditors. For example, our members feel that exercising a ban on an auditor for 15 years would be more effective than a fine in terms of achieving the desired outcome. Similar sanctions should be more commonly extended to audit firms as well.

As noted in Q8, the IA would like to see better judgement over the application of financial penalties. Fines are an important component of the FRC's enforcement strategy. The IA would also like the Review to consider whether the FRC could retain the fines it imposes on companies, whilst noting the potential conflict which could arise by incentivising the organisation to deliver more fines.

SECTION 10: THE FRC'S LEGAL STATUS AND ITS RELATIONSHIP WITH GOVERNMENT

Q34: SHOULD THE GOVERNMENT LEGISLATE TO PUT THE FRC ON A MORE CONVENTIONAL CONSOLIDATED STATUTORY FOOTING?

The IA would support the Government legislating to put the FRC on a more conventional statutory footing. This would help to clarify the FRC's objectives in law and would lead to a stronger accountability chain for the organisation. We would support a similar approach to that which applies to the FCA, with the Statutory Objectives set in law, the FCA being accountable to both HM Treasury and Parliament through the Treasury Select Committee. For the FRC, their objectives could be set out in law, with the body being answerable to BEIS and therefore held accountable by Parliament through the BEIS Select Committee.

Q35: WHAT IS THE OPTIMAL STRUCTURE FOR THE RELATIONSHIP BETWEEN THE FRC AND THE GOVERNMENT, BEST BALANCING PROPER ACCOUNTABILITY WITH ENABLING THE FRC'S EFFECTIVENESS?

Please see Q34.

Q36: IN TERMS OF THE FRC'S BROADER ACCOUNTABILITY, IS THERE A CASE FOR FURTHER TRANSPARENCY IN ITS ACTIONS OR FUNCTIONS?

The IA has highlighted a number of areas where greater transparency is required from the FRC. At the most basic level the FRC needs to better communicate what it is doing and why, and how it fulfils its obligations. The body could look to other regulators for ways in which to improve. For example, the FCA is well-regarded by asset managers in terms of market communications, with well-received initiatives such as sector briefings, risk reviews and an annual business plan.

Greater transparency is also needed over governance matters; investors would welcome greater disclosure on Board matters and also the activity carried out by the major committees including the Conduct and Code and Standards Committees. The FRC should also have greater freedom to make pronouncements on judgements, such as statements on individual CRRs and AQRs.

SECTION 11: GOVERNANCE AND LEADERSHIP

Q37: HOW EFFECTIVE IS THE CURRENT LEADERSHIP AND BOARD OF THE FRC? PLEASE CITE RELEVANT EVIDENCE WHICH INFORMS YOUR VIEW.

The IA welcomes the recent change of pace from the FRC's leadership and Board, as demonstrated by the increased activity in investigatory work and regulatory announcements. However, it is possible that this recent change in stance has been provoked by public scrutiny and investors are concerned that these positive developments may not last if this level of scrutiny of the FRC dies down.

Effective leadership means taking decisions and helping to set and monitor an organisation's culture. Ultimately, culture is underpinned by how people are treated, respected, evaluated and rewarded. This means effectiveness oversight, accountability and assessment of the senior team (and greater workforce), as well as clarity on long-term staff development. There should be increased focus on the management, training and assessment of all individuals within the FRC to ensure they have fulfilling the objectives of the organisation within the right culture. Going forward, the FRC's culture should re-emphasise the importance of transparency and accountability.

Q38: IS THE BOARD'S COMPOSITION APPROPRIATE? IS IT THE RIGHT SIZE? DOES IT HAVE APPROPRIATE MEMBERSHIP?

The FRC should approach the composition of its Board in the same way as any large organisation – the Board should be well-balanced and diverse.

There is a clear need for independent voices on the FRC's Board, especially given the large proportion of ex-auditors working throughout the rest of the organisation. While we welcome the recent appointment of two directors with public interest experience, it is worrying that there are only two investor voices on the FRC's Board. It was only recently that stakeholder voices were brought onto the Board.



Q39: 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?

Well-run committees can be an effective addition to an organisation. The FRC has a large number of committees. However, to outsiders it can be difficult to assess which of these are the most impactful. Committees should be set up so that their remit is clear and they help the FRC board become more effective overall.

Once the mission and objectives of the organisation have been set, it is important that the FRC or the Review consider what might be the best governance and committee structure to fulfil the body's mission and objectives.

Q40: 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?

The FRC's Board should approach the question of Board structure as any complex organisation does. The Board should approve the organisation's mission and strategy, and ensure that the executive is being effective in implementing it. The Board does not need to be filled with accounting experts, but should draw on a range of directors who can provide challenge and assessment, and who have an understanding of the expectations of different stakeholders, in particular those in the investment chain. The Board should not be tempted into side projects, which may provide profile but ultimately detract from the FRC's real purpose.

The Board's decision-making could be more transparent. This increased transparency could also extend to the Conduct and Code and Standards Committees.

Q41: HOW SHOULD THE EXECUTIVE'S EFFECTIVENESS BE ASSESSED AND ENSURED?

The Executives' effectiveness should be assessed against the objectives and outcomes that the organisation delivers.

SECTION 12: FUNDING, RESOURCES AND STAFFING

Q42: WHO SHOULD FUND THE FRC, AND HOW? WHAT ARE THE IMPACTS OF CURRENT FUNDING ARRANGEMENTS, INCLUDING OF HAVING A PARTIALLY VOLUNTARY FUNDED REGIME?

The IA proposes a number of considerations with regards to the FRC's funding model. The Review could consider whether:

- the FRC should move to a formal levy system. There are concerns that there may be unacceptable conflicts of interest in the voluntary levy system;
- the FRC could retain the fines they collect. Some members feel that this may better incentivise enforcement work; however, others have highlighted that this may create a conflict which would incentivise the FRC to levy more fines.

Q43: 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?



The funding and resource needs of the FRC should be informed by the mission and objectives of the organisation.

There is a view that the FRC is not attracting the talent it needs to deliver on its mission. As an immediate step, the FRC should consider the Takeover Panel's model of the use of secondments in order to maximise the talent available to it. This would help with recruiting and would also broaden the scope and experience of employees. This should be from a broad range of skills to ensure undue conflicts are avoided.

There is also a view that the FRC's limited resources has constrained their ability to recruit appropriate talent. It is important that the FRC is able to recruit individuals with the appropriate skills and experience to fulfil the role of the organisation and it should dedicate resource to ensuring this.

Q44: 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?

The most important conflict of interest that needs addressing is the large prevalence of ex-auditors, especially those drawn from the 'big 4', within the FRC's workforce. Please see Q7 for a more detailed discussion on this point and suggested remedies.

SECTION 13: OTHER MATTERS

Q45: ARE THERE ANY OTHER ISSUES RELEVANT TO THE TERMS OF REFERENCE THAT RESPONDENTS WOULD LIKE TO RAISE?

N/A