INVESTMENT ASSOCIATION RESPONSE

INDEPENDENT REVIEW OF THE FINANCIAL REPORTING COUNCIL: INITIAL CONSULTATION ON RECOMMENDATIONS

JUNE 2019

ABOUT THE INVESTMENT ASSOCIATION

The Investment Association (IA) is the trade body that represents UK investment managers, whose 250 members collectively manage over £7.7 trillion on behalf of clients.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

The UK is the second largest investment management centre in the world and manages 37% of European assets. IA members hold in aggregate one third of the value of UK publicly listed companies. More information can be viewed on our website.

EXECUTIVE SUMMARY

The Investment Association welcomes the opportunity to respond to the Independent Review of the FRC: Initial consultation on recommendations.

The UK's capital markets are reliant on high corporate governance standards and trustworthy financial reporting. For investors to make informed investment decisions and carry out their stewardship activities, this reporting needs to be subject to a high quality audit process. An effective regulator is required to set and enforce high reporting standards.

In June 2018 we welcomed the launch of Sir John Kingman's Independent Review of the FRC (the 'Independent Review'). In our response to the Independent Review, we set out our vision for a new regulator. We called for:

"A strong, independent regulatory body with a remit of upholding audit standards, financial reporting and corporate governance.

The new regulator should set and maintain best practice in audit, financial reporting and corporate governance to facilitate and promote investment in the UK. It 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. It is also essential that investors and other market participants trust the regulator to carry out its duties and functions effectively."

We welcomed Sir John's final report and his 83 recommendations for a new regulator – the Audit, Reporting and Governance Authority ('ARGA').

We support the majority of Sir John's recommendations being taken forward according to the Government's timetable. These include placing the new regulator on a statutory footing, the replacement of the voluntary levy with a mandatory levy, a review of the regulator's panel and committee structure, and the publication of the outcomes of individual AQR and CRR reports. These recommendations are in line with our vision for the new regulator and should be implemented as quickly as possible. Installing the new board and senior leadership for the regulator will help take these changes forward.

However, there are a small number of recommendations from Sir John Kingman which we do not support or believe should be modified or clarified before being implemented.

We do not support Recommendation 50 being taken forward. Investors and other stakeholders want to see a strong new regulator that is willing to use its powers to set and enforce standards. Where ARGA considers that a change to a company's dividend policy or board composition is required, it should have confidence to take action itself, rather than issuing recommendations to shareholders. This will help position the new regulator as a dynamic organisation that is willing to act to enforce standards. Furthermore, if the regulator makes such a recommendation to shareholders, shareholders may feel they had no option but to follow this. This would impinge on the rights and responsibilities of shareholders.

Other recommendations require further consideration in being taken forward and should be consulted on in more detail. These include:

- **Pre-clearance of company accounts:** Effectively operating such a mechanism, especially considering its likely popularity amongst issuers, would require considerable resources and expertise. Any resourcing issues would result in operational delays, which would in turn cause delays in issuer reporting. This would have consequences for companies, shareholders and other stakeholders. Operating a pre-clearing mechanism would also have significant liability implications for the

regulator, particularly in situations where accounts were pre-cleared and then subsequently found to contain material issues. It would cause a conflict of interest if the regulator later had to investigate the accounts. Such outcomes would result in significant reputational damage to the regulator and a lack of trust amongst stakeholders. At the same time it is not obvious that pre-clearance would provide a significantly higher level of assurance in most cases, compared to the statutory audit. Operating a pre-clearance process could also create confusion over the responsibilities for preparing and assuring a company's accounts; this responsibility currently lies with the directors and auditors respectively. Many of our members feel that due to these issues this proposal should not be taken forward.
If the Government decides to take this proposal forward it should consult on a clearly defined set of circumstances in which it would be used – these should be exceptional. It should clarify that the mechanism would review rather than 'clear' company accounts. ARGA should also publicly disclose the names of companies who have their accounts reviewed.

- **Duties and functions:** To avoid a loss of focus, ARGA's duties and functions should centre on the organisation's primary purpose of setting high standards of statutory audit, corporate reporting and corporate governance. They should not be widened to include promoting reporting brevity, where the focus should be improving the quality of reporting in the first instance. If promoting competition is included as a duty, it should be clarified that this work can only be undertaken when compatible with advancing ARGA's other objectives, namely setting high standards of corporate governance, corporate reporting and statutory audit.
- **Director enforcement regime:** The proposed director enforcement regime on corporate reporting should cover all directors, not just the CEO, CFO, Chair and Audit Committee Chair, as it is the responsibility of all directors to prepare a company's accounts.
- **Power to remove an auditor:** Use of this power outside a strictly defined set of circumstances may cause a loss of market confidence. In bringing more detailed proposals for consultation, the Government should strictly define the circumstances in which this power would be used.

Many of Sir John's recommendations relate to new powers and/or responsibilities for the regulator. In each case the regulator should engage with shareholders and other stakeholders and ensure it has the resources and experience to take on these additional responsibilities. A shift in culture is also needed: while the FRC was seen as reticent to use its powers, the new regulator must demonstrate that it is willing to do so. This will position ARGA as a dynamic and effective organisation that can meet the needs of market participants.

In implementing Sir John's recommendations the Government should also take into account the other components of the wider audit reform programme. This will help develop a coherent and effective regulatory framework, set high corporate reporting standards, and position the UK as a competitive place to do business.

We have set out our views on the issues raised in full in the answers to the consultation questions below.

RESPONSES TO QUESTIONS

CHAPTER 1 – FRC STRUCTURE AND PURPOSE

Q1. WHAT COMMENTS DO YOU HAVE ON THE PROPOSED OBJECTIVE SET OUT IN RECOMMENDATION 4?

We welcome the new objective. It effectively sets out ARGA's remit of setting and maintaining high standards in audit, corporate reporting and corporate governance.

As we set out in our response to the Independent Review, the FRC's current objective and mission statement are too wide-ranging to provide any real strategic guidance for the body and have contributed to a lack of focus in the organisation. We therefore support ARGA being given a new objective clearly setting out the body's central purpose – maintaining a strong audit regime, reporting framework and corporate governance regime to boost investor confidence in market mechanisms and encourage investment in UK companies.

Q2. WHAT COMMENTS DO YOU HAVE ON THE DUTIES AND FUNCTIONS SET OUT IN RECOMMENDATIONS 5 & 6?

Clearly defined duties and functions will also help promote ARGA's remit and guide its activities. In his Independent Review, Sir John noted that the FRC's remit grew organically over time, without any general underlying logic. In order to prevent this occurring at the new regulator, the new duties and functions should be clearly defined. They should avoid committing the regulator to work which others may be better equipped to carry out, and should have a clear focus on ensuring high quality corporate reporting.

Most of the proposed duties and functions will help the regulator deliver this aim and we support these being implemented. While the FRC was seen as reactive in its approach, ARGA's duty to be forward-looking and act on emerging risks sets a proactive approach for the new regulator. We also support the duty to collaborate more closely with other regulators in the UK and especially internationally. Where international standards impact the UK it is proper that the FRC seeks to influence their design and evolution.

We have reservations about three of the proposed duties and functions regarding promoting brevity, competition and compliance with the UK Corporate Governance and Stewardship Code. We set out these reservations in more detail below.

<u>Promoting brevity</u>

Investors welcome succinct reporting. However, their main priority is ensuring that corporate reporting is of high quality and contains the right information for investors to carry out their stewardship activities and make informed investment decisions. This should be ARGA's primary focus.

It is important to recognise that overly lengthy corporate reporting is often a behavioural response by companies to a complex regulatory environment, where companies are expected to report on various different factors to meet a number of different regulatory requirements. This environment can result in compliance-driven behaviour by companies and overly lengthy reporting that doesn't always suit the needs of investors.

We therefore consider that the regulator can play a role in coordinating with other government departments that are responsible for setting requirements on corporate reporting, to consider where reporting expectations could be streamlined. It should also consider streamlining the requirements it is responsible for producing. However, its primary focus should be on ensuring high quality corporate reporting. This will also help promote brevity of reporting by proxy, as higher quality reports are often more succinct.

Competition

In our response to the CMA's Market Study, we raised concerns over the lack of competition in the UK statutory audit market. Our members consider that the high degree of market concentration in the top four audit firms are limiting the choice of Audit Committees when carrying out audit tenders. Some also feel that the lack of competition is directly impacting on audit quality.

It is clear that action is needed to address these issues. This work should be taken forward by the CMA. We support the work of the CMA in assessing the UK audit market, and welcome ARGA working more closely with the CMA on competition issues. With expanded capacity to carry out monitoring and enforcement work, ARGA will be better equipped to inform the CMA of any concerns identified throughout the normal course of its regulatory activities.

We also support the proposed competition duty for ARGA, and the regulator being given the appropriate powers to support this, such as requiring firms to provide audit pricing, cross-subsidy and market share data (Recommendations 71 and 73). The proposed competition duty from Sir John Kingman's report is clear that the regulator must, so far as is compatible with advancing its other objectives, discharge its general functions in a way which promotes effective competition in the market for statutory audit services. Clarifying that this work must be compatible with advancing its other objectives is important, as without it the regulator could become conflicted when deregistering firms for audit quality issues: this would be in line with its regulatory function but would simultaneously decrease competition.

It is also important that ARGA's official duties and functions (Recommendation 5) reflect this focus on competition "so far as is compatible with advancing its other objectives, discharge its general functions in a way that promotes effective competition". As highlighted by Sir John, the FRC's remit expanded over time which caused a loss of focus in the organisation. As such, we do not support "promoting competition" being an official function for the regulator, without clarity that it has to sit alongside being compatible with advancing other objectives namely setting high standards of corporate governance, corporate reporting and statutory audit.

Compliance with the Corporate Governance and Stewardship Codes

One proposed function of the new regulator is to maintain and promote the UK Corporate Governance Code and the UK Stewardship Code and to report annually on compliance with the Codes.

Investors support the maintenance of these Codes and greater transparency over how companies and firms report against them. Corporate governance disclosures made by issuers are helpful to investors in carrying out investment decisions and stewardship activities, while the Stewardship Code disclosures made by investors help firms demonstrate their stewardship activities to clients.

An important principle employed by both Codes is 'comply or explain'. This sets best practice standards, but also gives signatories the flexibility to explain why they have chosen not to comply with specific Code provisions, ensuring that stakeholders can scrutinise any deviations from best practice. The principle is a core function of the UK's globally respected corporate governance regime. However, reporting on compliance with the Corporate Governance and Stewardship Codes could drive signatories to being fully compliant with the Code rather than taking the approach which is most appropriate for their company or business and explaining their deviations from the Code.

To protect the principle of 'comply or explain', and allow signatories to continue 'explaining' any deviations from best practice, any reporting should ensure that equal weight is given to both compliance and explanations for non-compliance. The focus should be on ensuring greater transparency for both types of disclosure.

Q3. HOW DO OTHER REGULATORS MITIGATE THE POTENTIAL FOR CONFLICT BETWEEN THEIR STANDARD SETTING ROLES AND ENFORCEMENT ROLES AS SET OUT IN RECOMMENDATION 14?

ARGA's board should have a stronger role in overseeing the regulator's investigative and enforcement functions. Enabling the board to launch audit investigations in cases of public interest; require regular reports from the Conduct Committee and from the director of enforcement on investigations and question the director of enforcement as needed (Recommendation 14) would provide impetus and help address the FRC's slowness in taking regulatory action.

We do not consider it a problem that the board should have a role in setting standards and enforcement. The FCA's board functions in a similar way. However, in order to determine that any conflicts are addressed (and to assess the quality of the board more generally) the board should regularly undergo an independent board evaluation and should make the results of this evaluation public. This process will help stakeholders trust that the board is carrying out its work effectively.

Q4. ARE THERE SPECIFIC CONSIDERATIONS YOU THINK WE SHOULD BEAR IN MIND IN TAKING FORWARD THE RECOMMENDATIONS IN THIS CHAPTER? ARE THERE OTHER IDEAS WE SHOULD CONSIDER?

To effectively challenge the regulator's Executive, and lead the strategic direction of the regulator, ARGA's board should be composed of skilled and knowledgeable individuals with a diversity of different experiences, expertise and perspectives. We support the proposal that the board be made up of individuals with the "skills, experience and knowledge needed to ensure strategic direction and effective, constructive challenge to the executive" (Recommendation 9).

To further probe the Executive's decision-making the board needs to have effective channels of communication to stakeholders such as investors. The board should act to open such channels. A greater cultural shift is also required throughout the organisation to ensure that stakeholder voices are better heard. Investors felt that their views were not always appropriately considered or actioned by the FRC. ARGA should address this issue by beginning a wider and deeper programme of stakeholder engagement.

CHAPTER 2 – FRC: EFFECTIVENESS OF CORE FUNCTIONS

Q5. HOW WILL THE CHANGE IN FOCUS OF CRR [CORPORATE REPORTING REVIEW] WORK TO PIES [PUBLIC INTEREST ENTITIES] AFFECT CORPORATE REPORTING FOR NON-PIE ENTITIES?

We welcome ARGA expanding its Corporate Reporting Reviews ('CRR') work (Recommendation 24) and publishing CRR findings and correspondence (Recommendation 26). CRR reports, which are undertaken on a risk-based basis, assess whether a company's directors' report, strategic report and annual accounts comply with reporting requirements. Publicising CRR findings provides investors with additional assurance that these reports can be trusted and allows shareholders to engage with companies on the findings. Market integrity will be improved as a result.

A defined remit for the CRR work is needed so that the team can allocate resources efficiently. This remit should include PIEs and should also be extended to cover large private companies. CRRs help investors to trust in the reports produced by issuers, which helps boost investment in these companies; the same principle holds true for large private companies. Extending the remit to large private companies will also align with recent initiatives aimed at raising corporate governance standards at these companies, such as the Wates Principles.

Q6. WHAT ARE YOUR VIEWS ON HOW THE PRE-CLEARANCE OF ACCOUNTS PROPOSED IN RECOMMENDATION 28 COULD WORK?

Our members have raised significant concerns over the proposed pre-clearance mechanism. Many do not support this proposal being taken forward.

Effectively operating such a mechanism, especially considering its likely popularity amongst issuers, would require considerable resources and expertise. Any resourcing issues would result in operational delays, which would in turn cause delays in issuer reporting. This would have consequences for companies, shareholders and other stakeholders. Operating a pre-clearing mechanism would also have significant liability implications for the regulator, particularly in situations where accounts were pre-cleared and then subsequently found to contain material issues. It would cause a conflict of interest if the regulator later had to investigate the accounts. Such outcomes would result in significant reputational damage to the regulator and a lack of trust amongst stakeholders. At the same time it is not obvious that pre-clearance would provide a significantly higher level of assurance in most cases, compared to the statutory audit. The proposal in its current form could also cause confusion over the responsibilities for preparing and assuring the accounts. The IA supports the current system where it is the responsibility of the company directors to prepare the accounts and the responsibility of the auditor to provide assurance.

If the Government decides to take forward this proposal, any pre-publication review process should only operate in truly exceptional circumstances, such as highly complex accounting judgements or where there is a history of financial irregularities. These circumstances should be consulted on and would have to be strictly defined and aligned with stakeholder expectations before work could begin. To manage expectations it should also be made clear that the mechanism would review rather than ‘clear’ company accounts. ARGA should also publicly disclose the names of companies who have their accounts reviewed. In these exceptional circumstances the value added by the additional check could outweigh the concerns highlighted above.

Q7. ARE THERE SPECIFIC CONSIDERATIONS YOU THINK WE SHOULD BEAR IN MIND IN TAKING FORWARD THE RECOMMENDATIONS IN THIS CHAPTER? ARE THERE OTHER IDEAS WE SHOULD CONSIDER?

Our members have raised the following considerations on the other recommendations covered by Chapter 2:

<u>New powers and responsibilities</u>

We agree that the new regulator should have access to, and be willing to use, a diverse range of sanctions (Recommendation 16). In our response to the Independent Review we noted that the FRC previously had a large range of available sanctions, including temporary and permanent bans and variable fines, but has not historically used them. Therefore, as well as access to new sanctions, a change in culture is needed at ARGA to ensure that the body is willing to use its powers.

As those ultimately responsible for preparing company reports, it is appropriate that ARGA has powers to set and enforce standards for company directors on corporate reporting. We therefore welcome the regulator drawing up proposals for an enforcement regime for company directors (Recommendation 36). As it is the responsibility of all the directors to prepare the company’s financial statements and to determine that these give a true and fair view of the company, the new regime should apply to all directors, rather than just the company’s CEO, CFO, Chair and Audit Committee Chair (Recommendation 36).

The new powers will provide a useful deterrent. However, to be used effectively, a shift of culture is also needed: ARGA must be willing to use the new powers when it needs to. The regulator will also need to convince investors, directors and other stakeholders it has the resources and experience to carry out this work.

A number of new responsibilities have also been proposed for ARGA. Investors welcome the Government considering whether to strengthen qualitative regulation over a wider range of investor information than currently covered by the FRC's corporate reporting work (Recommendation 30). Sir John also recommends that the regulator put in place a stronger reporting review process, and that this be extended to also cover corporate governance reporting (Recommendation 29). Investors welcome initiatives to increase visibility of corporate governance reporting and how companies 'comply or explain' against the Corporate Governance Code. This information is used by investors to identify material issues on which to engage with companies.

It is ultimately the responsibility of investors to make a judgement on the corporate governance disclosures made by companies, and to assess the quality of the explanations, not the regulator. However, the regulator can help investors make these judgements by considering the consistency, quality and reliability of these statements. In implementing any stronger review process for these disclosures, the regulator must ensure that the principle of 'comply or explain' is protected, and that companies retain the flexibility to explain why certain governance arrangements might not be appropriate for their individual circumstances. These explanations are important to investors in carrying out their stewardship responsibilities – they identify potential material issues on which to engage with companies.

<u>Brevity in corporate reporting</u>

As we set out in Q2, while investors welcome succinct corporate reporting (Recommendation 23) their primary focus is on ensuring corporate reporting is of high quality and contains the necessary information to make investment decisions and carry out stewardship activities. We also note that overly lengthy corporate reporting is a behavioural response by companies to a complex regulatory environment.

<u>Reporting to Parliament</u>

Sir John recommends that ARGA report to BEIS on how the statutory reporting framework is serving the interests of the users of company reports, at least once in every Parliament (Recommendation 23). As the main users of company reports, investors welcome this, but would support more regular disclosure. In order to avoid irregular reporting due to variance in the length of Parliaments, the regulator should report according to a fixed schedule, such as once every three or five years.

<u>Stewardship Code</u>

In his Independent Review, Sir John was clear that the Stewardship Code should undergo a fundamental shift or be abolished. The Review recommended that any new Code have a far greater focus on outcomes and effectiveness rather than policy statements. We also called for this shift in our response to the FRC's consultation on a new UK Corporate Governance Code.

We welcomed the FRC's recent consultation on a revised Stewardship Code and support several aspects of the revised Code, including:

- A greater emphasis on stewardship across asset classes
- Introducing an 'Activities and Outcomes' report to act as an accountability mechanism for asset owners
- Explicit references to ESG factors

- Requiring signatories to coordinate their approach to stewardship with their firms' overarching objectives and governance, and integrate stewardship into the investment process.

However, we also have a number of concerns with how these important developments have been drafted. If not addressed, these will result in a Code that hinders the development of an effective market for stewardship. In particular:

1. **Definition of Stewardship**: The new proposed definition of stewardship conflicts with asset managers' and asset owners' fiduciary duty to clients and beneficiaries.
2. **Activities and Outcomes**: The proposed Code is too prescriptive about certain policies and processes, and doesn't have sufficient emphasis on improving outcomes for clients and beneficiaries.
3. **Stewardship for active and index strategies**: The proposed Code doesn't have sufficient flexibility to be adopted across different investment strategies. It assumes that good stewardship can only be achieved by active management, when in fact stewardship forms an essential component of both index and active management strategies.
4. **Differentiation of the roles and responsibilities of asset owners and asset managers**: The proposed Code conflates the roles and responsibilities of asset managers and asset owners; this may dis-incentivise asset owners from becoming signatories.

The FRC should act to ensure that the new Code better "differentiates excellence in stewardship", in line with Sir John's recommendations.

CHAPTER 3 – CORPORATE FAILURE

Q8. ARE THERE SPECIFIC CONSIDERATIONS YOU THINK WE SHOULD BEAR IN MIND IN TAKING FORWARD THE RECOMMENDATIONS IN THIS CHAPTER? ARE THERE OTHER IDEAS WE SHOULD CONSIDER?

We propose the following for the recommendations covered by Chapter 3:

<u>Report to shareholders</u>

Sir John recommends that, "in the most serious cases", ARGA be able to issue a report to shareholders suggesting that the company's dividend policy should be reviewed, or that they consider the case for a change of CEO, CFO, Chair or Audit Committee Chair (Recommendation 50).

We do not support this recommendation.

Investors want to see a strong new regulator with the powers to set and enforce standards. In our response to the Independent Review we noted that the FRC was often viewed by stakeholders as toothless and unwilling to act. ARGA should have the necessary powers to enforce high standards of corporate reporting and behaviour and should be willing to use these powers.

Where it considers that a change in dividend policy or board composition is required, ARGA should have the confidence and powers to take action itself. The regulator should set out the specific circumstances to shareholders in which this power would be used, and should then use the power as needed. This will provide an effective deterrent and will help position the regulator as dynamic and willing to act. If the regulator makes such a recommendation to shareholders, shareholders may feel they have no option but to follow this recommendation. This would impinge on the rights and responsibilities of shareholders. The regulator should have the confidence and powers to direct companies to make changes to dividend policy or board composition itself rather than seeking to direct shareholders to take action.

Removal of auditor or immediate retendering

Sir John recommends that ARGA be given the power to order the removal of a company's auditor or an immediate retendering (Recommendation 49) in some circumstances. While we are supportive of ARGA being able to use this power in clearly defined circumstances, we have a number of reservations which the Government should consider in taking it forward.

The responsibility to appoint or remove an auditor currently lies with the Audit Committee, with investors ratifying any decision made at the AGM. Investors use audited company information to make investment decisions and inform their stewardship activities. As such, it is appropriate that investors ratify appointments to the Audit Committee and any appointment or re-appointment of the statutory auditor at the AGM. The power to order the removal of an auditor or immediate re-tendering therefore represents a substantial shift away from the status quo and an erosion of shareholder rights regarding an issue that directly effects investors. Use of the powers outside a strictly defined set of circumstances could also cause a loss of market confidence.

However, giving the regulator the power to order the removal of an auditor or an immediate retendering would drive up rigour in the auditing of company accounts, benefitting shareholders and other stakeholders. We are supportive of ARGA having the necessary powers to enforce high standards of corporate reporting. The circumstances in which any new powers would be used should be strictly defined.

In bringing more detailed proposals on this recommendation for consultation, the Government should therefore:

- Set out the proposed circumstances in which the power would be used, and consult with stakeholders on these
- Be clear that these circumstances are exceptional and that this power would not be used routinely
- Convince stakeholders that the new regulator would have the experience, market sensitivity and confidence to handle cases that could result in large share price movements

Market intelligence function and Skilled Person Review

We agree that ARGA should develop a market intelligence function to identify emerging risks in corporate reporting (Recommendation 44). This will help support a more proactive, forward-looking attitude towards setting corporate reporting standards. We also support the regulator being be able to commission a skilled person review, paid for by the company, where they have identified reporting quality issues (Recommendation 47). With both of these new powers, stakeholders will need to trust that ARGA has the necessary skills and experience to carry out this work effectively.

Viability statements

The IA welcomed the FRC setting the requirement for companies to produce a viability statement. These disclosures were seen as a useful new way for companies to report on their long-term prospects.

Investors welcome companies taking a longer-term approach to their reporting. This helps investors better identify, support, and finance companies that deliver sustainable returns to shareholders. We have set out investor expectations on long-term reporting in our Long Term Reporting Guidance, and specifically on viability statements in our Guidelines on Viability Statements.

Our members are concerned how companies have implemented the viability statements and feel not enough has been done to ensure that they provide meaningful information for shareholders. The majority of companies produce statements covering just the next three years, rather than the recommended longer timeframe. While anecdotally our members have noticed a recent rise in quality, most statements are made up of boilerplate language and are regarded by companies as just another legal and compliance hurdle to overcome.

To address this problem, Sir John recommended that viability statements should be reviewed and reformed with a view to making them substantially more effective (Recommendation 52). He also recommended that ARGA have the power to require a company to procure additional assurance on the viability statement or other aspects of corporate reporting, as needed (Recommendation 49). We support these recommendations being taken forward. We also support the proposal that ARGA should notify a company of its view of the risks to financial viability, requiring a formal response from the board with a recovery plan if appropriate (Recommendation 49). Flagging emerging risks in this way would be helpful to both companies and investors.

The new regulator should reform viability statements, and in the interim should be able to procure additional information from companies as needed. The IA would be willing to work closely with the regulator on these reforms, with a view to updating our Guidelines on Viability Statements.

These actions will be helpful to investors seeking to understand the long-term viability of a business. The regulator should then review, at the end of a set time period such as five years, whether the reforms have been successful in improving the quality of statements.

Board evaluations

We support ARGA being given powers to require a company to procure an independent boardroom evaluation focused on particular areas of concern such as a specific examination of the effectiveness of the audit committee (Recommendation 49). This will help investors carry out stewardship and engage with companies on material issues identified in these evaluations. In consulting on this proposal the Government should set out in more detail how this power would be used and in which circumstances.

Graduated audit

Investors welcomed the introduction of the enhanced audit report for year ends ending after 30 September 2013 for premium listed companies that have to report under the UK's Corporate Governance Code. For the first time the audit report moved from the binary choice of accounts being either 'true and fair' or not, and became more discursive in explaining the audit risks identified and the company's response – what the auditor did, the materiality used and the overall scope of audit work undertaken.

Investors particularly welcomed the increased clarity around the risks of material misstatement. This allowed firms to express a range of opinions on the estimates and judgements used by management: 'graduated' findings. However, while investors were clear that they welcomed the provision of graduated findings, companies were not in favour of auditor's producing these findings. As such only one firm produced graduated findings, for around nine audits. None of the Big Four audit firms have since produced graduated findings.

Our members support the provision of graduated findings and as such welcome the regulator considering whether 'graduated' findings should be required as part of the Independent Auditor's Report (Recommendation 53). However, the audit firms should not wait for the provision of graduated findings to become a requirement – they should start producing graduated findings immediately, in line with the expectations of investors.

CHAPTER 4 – THE NEW REGULATOR: OVERSIGHT AND ACCOUNTABILITY

Q9. ARE THERE SPECIFIC CONSIDERATIONS YOU THINK WE SHOULD BEAR IN MIND IN TAKING FORWARD THE RECOMMENDATIONS IN THIS CHAPTER? ARE THERE OTHER IDEAS WE SHOULD CONSIDER?

As noted in our response to the Independent Review, a key concern regarding the effectiveness of the FRC has been the issue of conflicts of interest – real and perceived – within the body. This issue has been caused by the large number of ex-audit staff at the regulator. Shareholders and other stakeholders are concerned that when staff work on projects involving their previous employers, they may be influenced in their judgements.

As noted by Sir John, the new regulator needs to have the right expertise to carry out its activities effectively. The Independent Review recommended that the regulator carry out a recruitment drive, especially amongst experienced, senior individuals – the so-called "grey panthers", to address the skills deficit. Many of these individuals will have built up industry experience over the course of a long career, including working at one or more of the audit firms. Some may have worked exclusively on audit matters; others may have trained as an auditor at the beginning of their career and gone on to specialise in another field, such as investment.

It is vital that the regulator is able to recruit the talent it needs. However, it is equally important that any conflicts of interest are appropriately managed. Defining an approach to managing conflicts is essential good governance practice for any regulator.

To address both issues, instead of the proposed lifetime ban on ex-audit staff working on projects involving a previous employer, we would support the regulator implementing a ten-year 'cooling off' period for staff. This would address any conflicts of interests, but also give the regulator the flexibility to recruit effectively, given that an increasing number of audit professionals will work for more than one audit firm during the course of their working life.

CHAPTER 5 – STAFFING AND RESOURCES

Q10. ARE THERE SPECIFIC CONSIDERATIONS YOU THINK WE SHOULD BEAR IN MIND IN TAKING FORWARD THE RECOMMENDATIONS IN THIS CHAPTER? ARE THERE OTHER IDEAS WE SHOULD CONSIDER?

We support these recommendations and their proposed implementation.

CHAPTER 6 – OTHER MATTERS

Q11. ARE THERE SPECIFIC CONSIDERATIONS YOU THINK SHOULD BE BORNE IN MIND IN TAKING FORWARD THE RECOMMENDATIONS IN THIS CHAPTER? ARE THERE OTHER IDEAS WE SHOULD CONSIDER?

As set out in Q2, we support the regulator being given a new competition duty and having the powers to support this duty (Recommendations 71 and 73).

CHAPTER 7 – INTERIM STEPS

Q12. ARE THERE SPECIFIC CONSIDERATIONS YOU THINK WE SHOULD BEAR IN MIND IN TAKING FORWARD THE RECOMMENDATIONS IN THIS CHAPTER? ARE THERE OTHER IDEAS WE SHOULD CONSIDER?

We welcome the recommendation set out in this chapter and note the Government's proposed implementation timetable. In the answers above we have set out our views on the Category 1 recommendations that the Government intends to take forward immediately. We have also provided our views on the Category 2 and 3 recommendations and welcome further consultation on these recommendations in due course.

Q13. WHAT EVIDENCE OR INFORMATION DO YOU HAVE ON THE COSTS AND BENEFITS OF THESE REFORMS?

No comment.

Q14. WHAT FURTHER COMMENTS DO YOU WISH TO MAKE?

No further comments.