INDEPENDENT REVIEW OF THE FINANCIAL REPORTING COUNCIL

BEIS CONSULTATION

Initial Consultation on Recommendations
Introduction

The Institute of Chartered Accountants of Scotland (ICAS) is the oldest professional accountancy body in the world, established by Royal Charter of 1854. We were the first body to adopt the designation ‘Chartered Accountant’. The designatory letters ‘CA’ are the exclusive privilege of our members in the UK.

We are a professional body for over 22,000 members who work in the UK and more than 100 countries around the world. We are proud that our CA qualification is internationally recognised and respected.

ICAS is an experienced and respected regulator, with a wide and varied regulatory portfolio, including statutory delegated authority as:

1. A Recognised Supervisory Body (RSB) for UK statutory company audit and local audit (supervised by the FRC).
2. A Designated Professional Body for incidental investment business (supervised by the FCA).
3. A Recognised Professional Body for insolvency licensing and regulation (supervised by the Insolvency Service).
4. A Supervisory Body for anti-money laundering (supervised by OPBAS).

ICAS is generally supportive of most of the recommendations made by Sir John Kingman, as set out in his report following his independent review of the Financial Reporting Council (FRC) (“the Review”). Many of his conclusions are reflected in our submission to the Review. We have not responded to every question (particularly as we are supportive of the majority of the recommendations), instead, we have looked to assist the Department for Business Energy and Industrial Strategy (BEIS), in its assessment of the key recommendations, and to provide some further insight into practical applications, and where appropriate any unintended consequences. We understand that BEIS will co-ordinate the reforms with the Competition and Markets Authority (CMA) and Brydon outcomes. That approach is warmly welcomed, as the most successful reforms will be complementary to each other.

We recognise that there are a number of recommendations that will form the substance of future consultations. Of particular interest to ICAS is the future funding arrangements of the new regulator and enforcement. In our response to the Review, ICAS set out detailed submissions in relation to funding and we would encourage BEIS to give consideration to a wider funding model. For 2019/20, the professional accountancy bodies’ contribution to the running costs of the FRC has increased by 32% (excluding case costs). That level of funding increase is not sustainable in the long term and we would encourage BEIS to reflect on the funding model during the course of 2019.
KEY PRIORITIES

- The proposed name of the new regulatory body should reflect the role that each component part plays in the corporate reporting eco-system. Audit is not the primary component of this system. It is an important, and independent, check and balance. We would suggest that the name of the new Regulator needs to more accurately reflect the actual sequencing of corporate governance, corporate reporting and audit. As currently proposed the order provides the wrong emphasis.

  We believe that the new Regulator should be named the Governance, Reporting and Audit Authority (GRAA).

- The main Board of a regulator should be independent of the enforcement arrangements. Under the current proposal, it is being suggested that the new board would exercise significantly stronger ownership and oversight of the investigation and enforcement functions, and indeed be involved with decisions on cases. Such an approach would blur the lines of governance, and undermine the independence of the enforcement decisions.

- The proposal to consult separately on the future of PIE regulation, enforcement and funding is welcomed. We consider that these issues will require more careful consideration.

- It will be important for BEIS to consider some of the recommendations alongside the outcomes of the CMA and Brydon Reviews, to ensure that they are complementary, and to minimise unintended consequences.
FRC STRUCTURE AND PURPOSE

New Name (Recommendation 3)

We strongly believe that the proposed name of the new regulatory body needs further consideration. We do, however, welcome that the body will be referred to as an “Authority” rather than a “Council” which we believe adds to its perceived strength and independence.

The proposed name should reflect the role that each component part plays in the corporate reporting ecosystem. Audit is not the primary component of this system, nor is it the most important. It is an independent check and balance. We would suggest that the name of the new Regulator needs to more accurately reflect the importance of strong corporate governance and reporting, and may also fuel the public’s expectation gap (of audit) at a time when a greater focus is required on all aspects of the entire corporate reporting framework.

As currently proposed, the order provides the wrong emphasis. We believe that the new Regulator should be named the Governance, Reporting and Audit Authority (GRAA).

We recognise that the acronym “ARGA” has already been widely adopted in publications and by politicians. However, we do feel that there is still time to bring about a name change, and as an alternative might offer the Authority for Governance, Reporting and Audit (AGRA).

Objectives (Recommendation 4)

We are not convinced that the objectives for the new regulator should be so narrowly focused on protecting the interests of users of “financial information” but rather should be wider in scope, i.e. “corporate information”. As ICAS outlined in our submission, it is important that the new regulator is clearly focused on Public Interest Entity (PIEs) companies. This should be reflected in its objectives. Furthermore, “non-financial information” needs to be within the scope of the new regulator, as we believe this will be of growing importance in the future.

A suggested alternative might be:

“To protect the interests of users of corporate information, and the wider public interest, by setting high standards of corporate governance, corporate reporting and statutory audit of public interest entities, and by holding to account the companies, directors, professional advisers and others responsible for meeting those standards.”

Furthermore, it is not clear whether the reference to “professional advisers” is intended to encompass persons other than the auditors. We believe it could have a wider scope, so as to enable professionals other than auditors (or indeed accountants) to be held to account by the new regulator for the advice provided to PIEs. Such a framework might better serve the public interest, but it not clear that this is what the Review proposed. If that is not the intention, then we believe the words “professional advisers” will require further review.

Note.
We would again highlight that the ordering of statutory audit, corporate reporting and corporate governance needs to be revised in the strategic objective wording (if retained):

Regulatory Approach (Recommendation 5)

The Review has given due consideration not just to the name and purpose of the new regulator, but also its regulatory approach going forward. We are generally supportive of the proposed ways of working set out in Recommendation 5.

If we were to make one small point, it would be to question whether the risks should instead be referred to as “emerging environmental risks of whatever nature that may impact on corporate governance, reporting or audit”.
Duties (Recommendation 6)

We welcome the recommendation that the new regulator should set and apply high corporate governance, reporting and audit standards. We believe that this is the correct sequence, and is reflective of the current framework. Naturally, we would encourage “corporate governance” to be added to the core functions of the new regulator. Otherwise, we consider that the proposed duties of the new regulator appear fair and reasonable.

The Board (Recommendations 7, 8 and 9)

In our submission, ICAS set out clear proposals to revise the governance arrangements of the FRC. We welcome many of the proposed recommendations to achieve this. We are supportive of these changes but the transition arrangements, from the FRC to its new entity, will be crucial, not only to ensure the institutional knowledge of the board and the staff is not lost, but also to transform the culture.

In terms of the skills composition of the new Board, in our submission to the Review, ICAS proposed that the members of the board should be executive and non-executive, with the latter being sourced from a diverse range of candidates, who may or may not have direct experience of the three key stakeholder groups (PIEs, investors and auditors). We also suggested that experience would be preferred, but not essential, if supported by appropriate Advisory Boards.

Whilst we recognise that the Board is comprised of a mix of skills, experience and relevant knowledge, we would encourage BEIS to reflect further on the ICAS proposal to establish an Advisory Board. Such an advisory board could provide an effective way of advising key board members on complex or technical matters without compromising their independence (although our evidence suggests the independence threat is more perceived rather than actual). We would encourage BEIS to consider and reflect on our submission to the Review, which set out detailed proposals for the Advisory Boards. We have attached a copy for your reference.

Governance and Enforcement (Recommendation 14)

We are deeply concerned by this recommendation. It does not reflect good regulatory practice.

The main board of a regulator should be independent of the enforcement arrangements. Under the current proposal, the new board would exercise significantly stronger ownership and oversight of the investigation and enforcement functions, and indeed be involved with decisions on cases. Such an approach would blur the lines of governance and could undermine the independence of any enforcement decisions (such as the decision to take proceedings). It may also potentially expose the new regulator to legal challenge. ICAS cannot support this recommendation and would strongly encourage BEIS to reflect on the approach of other regulators, which separate the governance and oversight of enforcement from the main governance arrangements.

That is not to say that the enforcement function should operate in a governance vacuum. While there needs to be a degree of accountability to the Board, particularly around performance and expenditure, the board should not be involved with the day to day decisions on cases. That could be delegated to a sub-board, reporting to the main board. This is the approach adopted by many financial regulators (including ICAS), and ensures that the independence of the enforcement proceedings cannot be compromised (whether actual or perceived).

We would be delighted to provide further information to BEIS about the ICAS governance arrangements.

We have also included further comments on the enforcement function below.
FRC: EFFECTIVENESS AND CORE FUNCTIONS

Scheme of Delegation to RSBs (Recommendations 15 and 16)

The Review recommends that the approval and registration of audit firms conducting PIE audits should be reclaimed from the RSBs, and that the Government should work with the regulator to develop and consult on the detail of how this regime should operate.

In our response to Kingman, we argued that the new regulator ought to be concerned with the whole regulatory process insofar as it relates to PIE audit. We recognised that this was a significant change but considered that it was correct, as a point of principle. We welcome the proposal that BEIS will consult separately on this recommendation.

In the meantime, we wish to clarify that whilst the new regulator could have registration, inspection and enforcement rights for PIE audit, it does not necessarily follow that it ought to be responsible for the approval and registration of a firm’s audit registration in general, just because it happens to undertake PIE audit. Clear and careful consideration needs to be given to a future model, not least because for most firms the majority of their audit work does not relate to public interest entities (PIEs). It would be disproportionate to bring such firms within the full scope of the new regulator for all of their audit work. Any change would need to relate to PIE audit only, and would need to be proportionate for the wide spectrum of firms that undertake this work.

We do not understand Recommendation 16, as there is already a range of sanctions available for firms conducting PIE audit, including restrictions and conditions.

Consideration needs to be given to the unintended impact for so called “challenger firms”, and the way in which this particular recommendation could interface with some of the competition proposals. For example, an expanded definition of a “public interest entity” could have a significant impact on the business model of some firms, and the prospect of increased sanctions may offer a threat to increased competition and the level of choice in the market.

ICAS will contribute fully to the future BEIS consultation process.

Audit Quality Reviews (Recommendations 20 to 22)

In our submission to the Review, ICAS highlighted the need for change to the inspection regime. While we support the desire for a fundamental review, and the direction of the proposed reform, it is not just about transparency of the reporting.

Ensuring delivery of Recommendation 22 (staff resource) will be key to achieving meaningful reform. The ability to deliver change could also depend on (a) the speed of the transition to the new regulator, (b) the ability of the leadership to demonstrate a revised culture and approach, and (c) to both recruit and retain key resources.

We would be supportive of publishing AQR reports on an anonymised basis in the first instance.

Corporate Reporting Review (Recommendation 24 to 27 and 29)

ICAS is supportive of the proposed reforms. In our submission to the Review, ICAS highlighted the significant strength that a CRR team could deliver. Coupled with the oversight supervision by a markets’ intelligence unit (see Recommendation 44), and the prospect of better PIE whistleblowing arrangements, this should help the new regulator to proactively challenge companies and flag issues of concern earlier, to possibly avert avoidable business failures.

The public interest is best served by focusing the scope of CRR activities on those entities that are PIEs.

Pre-clearance Procedure (Recommendation 28)

Careful consideration should be given to the practicalities of such a system.
There is a danger that this could intrude on the current system where management make a judgement on the accounting treatment of a material matter to be reported in the financial statements, and the auditor would then need to assess the particular judgement. If a pre-clearance procedure is introduced, would this involve an approach by the company to the new authority before any consideration by the auditor? Consideration would need to be given to the legal implications for both the company and the regulator, and also the prospective impact on future enforcement proceedings where the regulator had approved a matter which the AQR team subsequently sought to challenge.

Additionally, we question whether the new regulator would have sufficient resources to be able to effectively operate such a system.

**Investor Information (Recommendation 30)**

We hope this would be welcomed by the investment community, which would have a greater vested interest in the success of the new regulator. We would hope that it would also be supported by both PIE companies and auditors.

**Guidance (Recommendation 31)**

The Review recommends that the new regulator should be more sparing and disciplined than the FRC in promulgating guidance and discussion documents. The FRC has issued a number of high quality pieces of guidance and thematic review type publications. This is part of the reason as to why the FRC is well respected internationally.

While we would not be supportive of a proposal which diluted the role of the new regulator in areas where it could otherwise demonstrate influence, we appreciate that this will be a matter for the new Authority to decide.

**Enforcement (Recommendations 32 to 38)**

Investigations under the Audit Enforcement Procedure and the Accountancy Scheme take too long. The public interest and the rights of individuals are not served by such delays. It is right that the board should have access to relevant management information to ensure that reputational and operational risks are managed appropriately, and that such data should be reported publicly. However, the board ought not to be directly involved in any decision or operational aspects. Increased accountability to government is right and appropriate. We welcome the proposals for the new regulator to appear before the BEIS Select Committee. In terms of publicity of cases which do not progress to a formal enforcement phase, it is widely accepted that only adverse decisions carry mandatory publicity. As a developmental regulator we recognise that the points of learning could be communicated in other ways.

As for the enforcement proceedings for PIE entities, we agree that the current arrangements are in need of reform. However, we are disappointed that the Review has sought to retain the Accountancy Scheme in any form. ICAS had argued for a new regime to be created, providing a level playing field for all directors (and not just the qualified accountants or restricted to certain other directors). We remain of the view that this would be the best approach going forward.

ICAS supports, and would strongly encourage, a regime in the future which would recognise the UK’s unitary board structure and present a level playing field which holds all PIE board members to the same standards.

Chartered Accountants with knowledge, skills and ethical values should be encouraged to sit on the boards of PIES, and we would not wish to continue to encourage an environment which could have the perverse effect of dissuading some members of the chartered bodies from joining PIE boards.

ICAS note that BEIS will consult separately on the enforcement arrangements and we simply wished to note our outline position.

**Oversight of the Accountancy Profession (Recommendations 39 to 41)**

The FRC is the Competent Authority in the UK and enjoys certain statutory powers to delegate to the four RSB bodies. Beyond that, the Review seeks to retain some oversight of the “accountancy profession”. It is presumed that this recommendation refers to public interest concerns that are not related to audit, and
therefore brings the role of the new regulator into an environment whereby it can influence the professional bodies but cannot influence the “accountancy sector” in the widest sense. “Accountant” and “accountancy” are not protected terms. BEIS is being asked to retain a model which places increased regulatory and financial burdens on the members of certain professional bodies, to the exclusion of all others. If there are emerging concerns of public interest outwith the scope of audit, then they are likely to impact on the accountancy sector in its widest sense.

It may be that government will consider enhanced regulation of accountants who are not members of one of the current professional accountancy bodies, so that all accountants would fall within the scope of the new regulator.

**Stewardship and Investor Relations**

ICAS fully support the proposals to enhance stewardship and investor relations, which would be consistent with the new regulator’s role in promoting stronger corporate governance.
CORPORATE FAILURE

Market Intelligence Unit (Recommendation 44)

In our response to the Review, ICAS set out a vision of a Capital Markets Intelligence Unit. We welcome the proposals set out in Recommendation 44.

Duty of Alert (Recommendation 45)
Duty to Report (Recommendation 46)

We are supportive of these recommendations in principle, but we agree with the BEIS conclusion that careful consideration will be needed to ensure that: (1) they are a meaningful tool, and (2) any unintended consequences are explored, and minimised. Many PIEs are also subject to regulation by other entities (including the PRA and FCA), and the reporting arrangements will need to be clear and concise.

The duties for companies to co-operate with the new regulator may require primary legislation, but they are consistent with the future role of the new regulator and we expect would support the work of the Corporate Reporting and Markets Intelligence teams.

Skilled Persons and Reports (Recommendations 47 to 49)

We are supportive of these recommendations as they will enable the new regulator to have access to skills and expertise as it requires. That said, we would encourage careful consideration in relation to any publication of the report, and the timing of such publication, as investors would "be able to reach their conclusions on the company’s conduct and management". There may be unintended consequences. Furthermore, regulatory intervention in the governance of a PIE should be considered carefully to ensure that it is provided for in appropriate circumstances.

UK SOX (Recommendation 51)

ICAS is very supportive of this recommendation. We have made further submissions to Sir Donald Brydon’s Call for Views. The key will be to ensure that any strengthened framework around internal controls is proportionate.

Viability Statement (Recommendation 52)

We are supportive of making them more effective but not of abolishing them.
OVERSIGHT AND ACCOUNTABILITY

Complaints (Recommendation 61)

The recommendation appears to be largely process orientated, but we would draw attention to our submission to the Review, where we noted that "consideration should be given to the current whistleblowing arrangements for PIE officers and employees, with changes being made where appropriate to ensure that adequate protections are in place to encourage concerns to be voiced at the appropriate time. People could make a strong contribution to the future management of systemic risks."

Complaints can also be a way of individuals expressing concern. We would encourage BEIS to reflect on how these recommendations could be addressed.

OTHER MATTERS

Competition Objective (Recommendations 71 to 73)

We note the FCA has a general competition objective, and we recognise that the new regulator may have a role to play in this respect. We are broadly supportive of this role being incorporated into the regulator’s objectives. However, we agree with the BEIS conclusion that any such role should be considered more holistically, not just following the publication of the CMA Report (now issued), but also having regard to any outcomes of the review by Sir Donald Brydon.

Local Audit (Recommendations 76 to 82)

We are supportive of the recommendations relating to local audit. ICAS is a RSB for local audit in England and Wales. We do have some concerns that a competitive market may not have been achieved yet, but we also recognise that Government will wish to review the arrangements in due course. We would add that achieving consistency of audit standards across the public and private sector needs to be considered, and we would encourage this work to be factored into the review.