

BIS | Department for Business
Innovation & Skills

**PROPOSALS TO REFORM THE
FINANCIAL REPORTING COUNCIL**

A joint Government and FRC
response

MARCH 2012



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Proposals to reform the Financial Reporting Council: A joint Government and FRC response

Foreword

This document sets out the Government and FRC's plans to reform the Financial Reporting Council (FRC).

The FRC's mission – to promote high quality corporate governance and reporting to foster investment – contributes to the efficiency of the capital markets in the UK and the ability of companies to raise finance, and hence to the achievement of the Government's Plan for Growth. The Government endorses this mission. In pursuing this, it wants the FRC to be as strategic as possible, focusing on key risks, and to maximise its international influence.

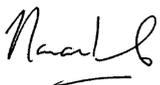
In October 2011, the Department for Business, Innovation and Skills and the FRC consulted on proposals to align the scope of the FRC's activities with the investment focus of its mission, streamline its governance and structure, and enhance its independence from those it regulates.

The response to the consultation, which closed in January 2012, has helped the Government and the FRC refine and modify the proposals.

This document summarises the response to the consultation and sets out the finalised proposals for each area covered by the reforms. It notes those areas where the Government and the FRC have modified the proposals as a result of the consultation.

The Government now proposes to make legislative changes to underpin key aspects of the reforms. Subject to Parliamentary passage of the necessary secondary legislation these changes will come into force on 2 July 2012. The FRC will make the proposed changes to its governance and structure, consulting as necessary those with an interest in its work on the detailed implementation of the reform proposals.

We are grateful to all those who have contributed to the consultation for their thoughtful and detailed responses. The reforms are not an end in themselves. We believe that the consultation marks the beginning of a deeper and wider relationship between the FRC and its stakeholders. The FRC will continue to work with investors, business, the professions and other regulators and other interests to identify and help address the challenges facing those responsible for corporate governance and reporting in the UK.



Norman Lamb

Department for Business, Innovation
and Skills (BIS) Minister



Sarah Hogg

FRC Chairman

Executive Summary

The consultation

The consultation on the proposals was launched on 18 October 2011 and closed on 10 January 2012. Two documents were published: a consultation paper “Proposals to reform the Financial Reporting Council” and a consultation stage impact assessment.

Who responded to the consultation?

In total, 75 responses were received. Of the total, 6 were from investor organisations, 5 from those responsible for preparing accounts, 12 from accountancy professional bodies, 11 from individual audit firms, 7 from organisations and firms focusing on the FRC’s responsibilities for actuarial standards and regulation, and 34 from other organisations and individuals, including a Member of Parliament, an EU regulatory group and overseas regulators.

The responses are available on the FRC website at www.frc.org.uk/about.

What did the consultation tell us?

The majority of respondents expressed their support for the role of the FRC in promoting high standards of corporate reporting and governance in the UK.

There was substantial support for the objectives of the reforms. Investor and business respondents broadly supported the objectives. The accountancy professional bodies and audit firms took a range of views: some supportive, some challenging the case for change.

The two proposals that commanded the greatest support were those to provide for early conclusion of disciplinary cases and to undertake supervisory inquiries.

Some respondents were concerned about changing aspects of the FRC’s activities that they considered were working well; others suggested that there should be a more significant extension of the FRC’s role.

A number of respondents sought a fuller explanation of specific aspects of the proposed changes; and some argued for a longer period of debate and reflection before the reforms were finalised and implemented. Some respondents questioned the need for progress on FRC reform at this stage given impending changes in EU legislation on audit regulation.

What were the major issues raised and how will the Government and FRC respond?

- *Maintaining the quality of FRC standard-setting and its international influence, particularly in relation to accounting standards.*

This is a central objective. The Government and the FRC recognise the contribution that the standard-setting bodies that have operated as part of the FRC have made, while remaining convinced that the changes proposed are needed to strengthen the UK voice. In the new structure the FRC should be better equipped to tackle the most strategic issues and to provide high quality thought leadership as well as continuing to develop excellent technical solutions. Standard setting is increasingly debated in the UK, EU and internationally in fora that cover a

wide range of issues. The FRC needs to exert influence accordingly. The FRC Board has the experience, seniority and, through the new structure, the authority to do this.

The Councils on accounting, audit and assurance, and actuarial matters will be an important part of the new decision making structure. Their advice will be put fully to the FRC Board. The Board member chairing each Council will act as a guarantor of this and will be responsible for submitting the Council's advice to the Board. The minutes of meetings of the FRC Board will record the discussion and the views expressed. If, exceptionally, the Board rejects the advice, it will explain its reasons and consult further with the relevant Council before taking a decision. In the event any such differences of view remain unresolved, the nature and reasons for such differences of view will be made public.

The FRC Board member chairing the relevant Council will in general lead the response to formal consultations by other authorities – including, for example, the European Financial Reporting Advisory Group and the international standard-setting bodies.

In establishing the Councils the FRC will appoint individuals who, like the members of the existing operating bodies, command respect for the quality, range and objectivity of their input. The FRC will ensure that they can make a strong contribution to EU and international policy-making.

- *Maintaining appropriate governance arrangements, including for standard-setting*

Some respondents questioned the proposed governance arrangements given the enhanced role of the FRC Board. The FRC Board's governance will be conducted overall in as close conformity with the Corporate Governance Code as is appropriate for a regulator, including regular Board performance reviews. As a regulator serving the public interest it will practice a high level of transparency and publish papers on key matters of public interest in advance of meetings. In making senior appointments the FRC will involve an outside assessor to ensure it follows due process in accordance with best practice for bodies operating in the public interest.

In response to the views expressed during the consultation, the FRC will enhance the role of the Councils for accounting, audit and assurance, and actuarial matters in relation to standard-setting. Their advice will be put directly and fully to the FRC Board by the Board member who chairs the relevant Council.

In establishing this new framework for decisions on standards the FRC will emphasise the importance of the user as well as the preparer perspective. There is a determination to build on high quality input from investors and businesses as well as the professions.

- *Defining the respective roles of the FRC and the professional bodies*

Certain of the accountancy professional bodies expressed concerns over a perceived dilution in their role and emphasised the importance of clearly defining the relationship between the FRC's responsibilities and their regulatory functions in relation to their members. The Government and the FRC consider that an important aspect of the reform proposals is to enhance the FRC's independence from the professional bodies; but do not agree that this calls the importance of their role into question. Indeed a key feature of the UK reform proposals is to enhance the role of the professional bodies – in contrast the current European proposals would greatly reduce the role of professional bodies.

In asserting the case for reform, and in finalising the proposals set out in this document, the Government and the FRC acknowledge the quality and integrity with which the UK

accountancy and actuarial professional bodies discharge their responsibilities. This includes the Recognised Supervisory Bodies (RSBs) and Recognised Qualifying Bodies (RQBs).

The members of the accounting and actuarial professions are in the front line of ensuring good quality work; and it is the FRC's job not just to oversee but also to support their professional bodies in their vital work of encouraging high standards and tackling any shortfalls in conduct. However, an important element of the case for reform is that, in relation to audit regulation in particular, the FRC and the professional bodies need to clarify their respective responsibilities and the boundaries between them. The Government and the FRC continue to believe that there is scope for the professional bodies to undertake some of the oversight work that at present fall to the FRC. Equally the Government and the FRC believe it is vital that the FRC is, and is seen to be, sufficiently independent from the professions it regulates, in particular where the FRC undertakes that regulation directly.

- *Procedures and sanctions in relation to conduct*

Mindful of the concerns expressed during the consultation about the detailed operation of the sanctioning regime in relation to poor quality auditing and independent disciplinary arrangements, the FRC is publishing additional detail about the procedures that will be provided to ensure that they are operated in a fair and transparent way.

In relation to the monitoring of the quality of audit, the FRC will issue detailed Sanctioning Procedures. The Procedures will include the right to a hearing by an independent tribunal in the event that a sanction or condition in relation to the quality of audit is not accepted; and the publication of the conclusion of all disciplinary cases irrespective of whether a sanction has been imposed following a public hearing.

- *FRC scope*

There was some concern that the proposed reforms did not adequately address the interests of providers and users of actuarial information; or of those bodies primarily concerned with governance and reporting in the public sector and wider not-for-profit sector. The FRC will continue to have regard to the interests of both groups and maintain an appropriate framework of codes and standards.

As a general policy, the FRC will ensure that the scope of its regulatory activities in relation to both codes and standards and conduct reflects the wide public interest in the quality of corporate governance and reporting in the UK.

What will happen now?

The reforms will enhance the FRC's effectiveness as part of the wider UK regulatory framework. They will give the UK more credibility and a stronger platform from which to help shape EU developments. The Government and the FRC are not persuaded of the case for delaying the implementation of the reforms to take account of possible changes in EU legislation, the timing and content of which are uncertain and which might be damaging in certain key respects, such as the removal of regulatory responsibilities from the professional bodies.

The Government and the FRC therefore believe that the proposed reforms should now be put in place. Failure to address the specific shortcomings that have been identified in relation to

aspects of the current arrangements could potentially compromise their overall credibility and effectiveness, including the FRC's ability to identify and respond promptly to emerging issues.

Some of the reforms can be initiated on the basis of the FRC's existing powers; others require secondary legislation.

The Government will bring forward proposals for secondary legislation that will:

- delegate most statutory powers to the FRC Board not the Operating Bodies;
- provide the FRC Board with powers to determine and require Recognised Supervisory Bodies (RSBs) to impose sanctions for poor quality audit
- provide the FRC Board with powers to impose directions and financial penalties on the RSBs and Recognised Qualifying Bodies (RQBs) for shortcomings in discharging their regulatory responsibilities in relation to the quality of auditing in the UK; and
- enable the FRC to conclude disciplinary cases without a public hearing where all involved agree.

Subject to Parliamentary approval, these legislative changes will enter into force on 2 July 2012 and enable the FRC to complete the proposed reforms.

The FRC is publishing further details of the new structure and regulatory procedures. In particular, it will explain how and where responsibility will lie for decisions made at all stages of the regulatory process and, as appropriate, the extent to which such decisions will be subject to oversight (recognising the need for certain parts of the FRC's regulatory activities, such as disciplinary proceedings, to be undertaken independently).

In line with the final stage impact assessment, the FRC will undertake a review of the effectiveness of the reforms in consultation with its stakeholders within three years of the implementation of new structure and powers.

Details

1. The case for FRC reform

The proposals

The Government and FRC identified a number of constraints on its effectiveness:

- the FRC's existing structure means that its scope in terms of the thresholds for regulatory action are set at different levels for some areas of activity;
- the FRC family currently consists of seven different bodies¹ to do one job: promote high quality corporate governance and reporting to foster investment;
- the independence of the FRC as oversight regulator for the audit profession is still governed by agreements with the profession that sometimes inappropriately limit its independence;
- the FRC's powers (currently exercised by the POB) in relation to its oversight of the Recognised Supervisory and Qualifying Bodies (RSBs and RQBs) is limited to bringing about any change by influence or through statutory enforcement powers which, if they are to be considered proportionate, should only be exercised in the most serious cases; and
- the current disciplinary procedures can take too long to conclude, even when all parties agree there has been misconduct and on the appropriate disciplinary action.

To address these constraints, the Government and FRC published for consultation in October 2011 a set of proposals designed to:

- clearly align the scope of FRC's activities with its mission to maximise the benefits of its activities to capital markets;
- simplify its organisational structure to make it more joined up and relevant to current and future challenges;
- ensure sufficient independence of the FRC from the accountancy professional bodies; and
- provide the FRC with a more proportionate range of sanctions and procedures for it to carry out its monitoring and enforcement activities.

¹ The Accounting Standards Board (ASB), the Auditing Practices Board (APB), the Board for Actuarial Standards (BAS), the Professional Oversight Board (POB) which includes the Audit Inspection Unit (AIU), the Financial Reporting Review Panel (FRRP), and the Accountancy and Actuarial Discipline Board (AADB).

Question 1

Do you have any comments on the case for FRC reform as set out in the consultation document?

Question 2

Do you agree that the proposals for reform will bring benefits and increase the effectiveness of the FRC?

Views

In general, respondents expressed their support for the role of the FRC in promoting high standards of corporate reporting and governance in the UK.

Investor and business respondents broadly supported the case for FRC reform. The accountancy professional bodies and audit firms took a range of views: some supportive, some challenging the case for change.

A number of respondents sought a fuller explanation of specific aspects of the proposed changes; and some argued for a longer period of debate and reflection before the reforms were finalised and implemented. Some respondents questioned the need for progress on FRC reform at this stage given impending changes in EU legislation on audit regulation.

Response

The Government and the FRC maintain their view that an effective and proportionate regulatory framework for corporate governance and reporting is strongly in the interests of investors, business and the professions – and continue to believe that aspects of the regulatory framework should be reformed

The Government and the FRC are not persuaded of the case for delaying the implementation of the reforms to take account of possible changes in EU legislation, the timing and content of which are uncertain and which might be damaging in certain key respects, such as the removal of regulatory responsibilities from the professional bodies.

Question 3

Do you have any comments on the consultation stage impact assessment?

Views

Some respondents supported the analysis; others noted the challenge of quantifying the costs and benefits of the reforms. A number of respondents highlighted the importance of the FRC's role in promoting high quality corporate governance and reporting and that the overall benefits of the reforms in enhancing the FRC's effectiveness would be significant.

Response

In preparing the final stage impact assessment accompanying these finalised proposals, the Government and FRC have taken careful account of the respondents who commented on the likely costs and benefits of the proposals.

The response to the consultation has enabled the Government and the FRC to refine the estimated quantifiable and direct benefits to business from the detailed proposals. They are estimated to be of the order of £8m rather than £10m as originally estimated.

However, we agree with the argument that the benefits of the proposed reforms in enhancing the FRC's ability to promote high quality corporate governance and reporting are likely to be more significant than the immediately quantifiable benefits: though more difficult to quantify.

The FRC will, in consultation with its stakeholders, keep the direct costs and benefits of reform under review and seek evidence of their wider impact based on further research.

2 - An investment focus for the FRC's regulatory activities

The proposals

The FRC is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC currently discharges its responsibilities by setting codes and standards and monitoring the conduct of market participants in meeting the required standards, enforcing them where appropriate.

The Government and the FRC proposed that the FRC should retain its current broad range of regulatory activities in relation to key aspects of corporate governance and reporting - from standard setting to monitoring and discipline. There are strong connections between these areas and oversight of them allows the FRC to be more strategic in its judgements about, for example, how audit can develop and the governance of reporting which directly impinge on the quality of information available to investors. As companies focus more on risk management as an issue for governance, the FRC's work with the actuarial profession also has a growing place in its priorities.

However, it sought views on whether the primary focus of the FRC's monitoring and enforcement effort should be restricted to the governance and information provided by publicly traded companies and the largest private companies. This was on the basis that it is the area where good governance and the flow of high quality information to investors and the capital markets is most important and involves the area of greatest risk to the economy.

Question 4

Should the primary focus for regular FRC activity in relation to codes and standards for corporate governance, accounting and auditing, and for monitoring the quality of corporate reporting and auditing, be publicly traded companies and large private companies?

Question 5

Is the definition of large private company for this purpose – an annual turnover of £500m or more – appropriate?

Question 6

Should the scope of the FRC's accountancy disciplinary arrangements be narrowed to cover the quality of work and conduct of accountants in relation to the preparation and audit of annual reports and other reports for the capital markets, leaving other cases of potential misconduct to the professional bodies?

Question 7

Are there areas of activity from which the FRC could appropriately withdraw?

Views

There was general support for maintaining the FRC's current role in establishing codes and standards for corporate governance, accounting, auditing and actuarial practice for a wide community of interests, including the public sector and wider not-for-profit sector.

Views were more mixed on whether the focus of the FRC's monitoring and enforcement effort should be narrowed. In general, investor groups, the accountancy professional bodies, and the audit firms supported a focus on publicly traded and large private companies, with some respondents arguing that it should be further narrowed to exclude AIM and PLUS Markets and large private companies.

There were a number of comments on the FRC's mission. Some respondents argued that the focus on the capital markets was too narrow and did not take account of a wider public interest.

Response

The Government and FRC do not propose to change the current scope of the FRC's work in setting codes and standards. Passing responsibilities to other regulatory bodies, or creating new bodies, would add cost without clear benefit.

The FRC will continue to set accounting and auditing standards for SMEs and public interest entities.

The FRC will continue to deliver its responsibilities for setting technical actuarial standards, overseeing the regulatory activities of the actuarial profession and providing independent disciplinary arrangements for public interest cases involving members of the actuarial profession. It will continue to work closely with those who rely on actuarial information and with the actuarial profession.

The FRC will ensure that there is a close dialogue with the accountancy and actuarial professional bodies on the relationship between its independent disciplinary arrangements and the arrangements operated by the professions. The Government and the FRC remain open to the professional bodies undertaking some of the oversight work that currently falls to the FRC, so consistent with the European legal framework.

Local public audit

The FRC is working with the Department for Communities and Local Government (DCLG) to agree an appropriate framework for the regulation of local public audit. Details are available at: <http://www.communities.gov.uk/publications/localgovernment/localauditgovresponse>

3 - Streamlined governance and structure

The proposals

In order for the FRC to be more streamlined and efficient, while remaining well connected to and informed by market participants it was proposed that:

- statutory powers should be delegated direct to the FRC Board, and not to its individual operating bodies as at present, to enable the FRC to take decisions at the right level within a streamlined structure;
- the FRC should report annually to the Secretary of State and Parliament on the exercise of its powers and those delegated to it;
- in future the FRC Board should be supported by two Board Committees – one to focus on Codes and Standards, the other on Conduct. This arrangement would replace the existing seven operating bodies.

Question 8

Do you agree that streamlining the FRC's governance and structure will bring the benefits described?

Question 9

Do you have any comments on the proposed reformed FRC governance and structure?

Views

There was a diversity of views on the details of these proposals. There was a significant degree of support from investors and business and some of the accountancy professional bodies and audit firms for simplifying the FRC's structure.

Others, including some of the accountancy professional bodies and a number of the individual respondents expressed serious reservations about the proposal to change the present arrangements for setting standards through the FRC's operating bodies. It was felt that the current bodies had strong international reputations and secured detailed technical input, from the accountancy profession in particular, that it might be difficult to replicate under the governance arrangements as proposed. Allied to this was a concern that the FRC Board would need to ensure that it was appropriately accountable for decisions on standards.

Response

The Government and FRC agree that the governance arrangements around standard-setting must demonstrate the necessary accountability and transparency.

The FRC will make an annual written report to the Secretary of State, which will be laid before Parliament.

In response to the specific concerns expressed by a number of respondents, the FRC will ensure that its future governance and structure demonstrate that:

- the process for appointing members of the FRC Board and the other key elements of the new governance structure incorporates an independent element;
- there will be an appropriate degree of transparency in setting and influencing codes and standards;
- the three Councils on accountancy, audit and assurance, and actuarial matters will be an essential part of the FRC's overall work to set standards that are technically sound and reflect the needs of the users as well as providers of information.

Future governance and structure

The finalised proposals involve a new structure which makes the FRC Board accountable for all the FRC's statutory activities other than the powers to apply to Court in respect of defective reports or accounts, which will be delegated to the Conduct Committee.

The proposals seek to ensure that the responsibility for regulatory decisions is at a level where there is an appropriate balance of experience, expertise and understanding of the impact on stakeholders and on the overall quality of governance and reporting.

The FRC Board

The FRC Board will ensure that the organisation as a whole fulfils its core mission and operates in the public interest in accordance with the principles of good regulation and its regulatory philosophy. Subject to the passage of the proposed statutory instruments, it will exercise the statutory powers delegated by the Government. Specifically, it will set and amend UK corporate governance, accounting, audit and actuarial standards. It will also maintain the effectiveness of the UK Corporate Governance and Stewardship codes. It will also set the annual Plan and Budget for the FRC and oversee the effectiveness of the executive.

The Board's governance will be conducted overall in as close conformity with the Corporate Governance Code as is appropriate for a regulator, including regular Board performance reviews. As a regulator serving the public interest it will practice a high level of transparency and generally publish papers on key matters, especially on changes to codes and standards, in advance of meetings.

As much standard-setting is conducted at international level, the Board will oversee the FRC's international work with appropriate members playing a significant role in representing it as the UK standard-setter at major national standard-setting and similar senior meetings. As European developments in corporate reporting and governance are likely to be of particular importance, the FRC will ensure that, where possible, it is appropriately represented on key decision making and influencing bodies.

The FRC Board will be supported by two Committees, the Codes and Standards Committee and the Conduct Committee.

The FRC Board will comprise the Chair, Deputy Chair, Chief Executive, two Executive Directors, the Chairs of the Codes and Standards and Conduct Committees and Chairs of the Councils with around eight non-executives with a balance of skills and experience in investment, audit, accounting and actuarial matters.

The FRC Chairman and Deputy Chairman will be continue to be appointed by the Government.

Other appointments to the Board will be made by a Nominations Committee, comprising the Chair, the Deputy Chair, other non-executive directors and at least one outside assessor in keeping with the best practice as set out by the Commissioner for Public Appointments. The Nominations Committee will lead the selection process for membership of the Board and oversee the selection process for members of the Board Committees, the Councils and the conduct sub-committees.

The FRC's Articles of Association will enshrine the need for balance and independence (for example, by including limitations on the positions that may be held by currently practising auditors and officers of professional bodies).

Codes and Standards

The FRC Board will retain the authority to issue codes and standards, but may delegate other decisions, for example, guidance related to the application of codes and standards, as it sees fit.

The Board's Codes and Standards Committee will be responsible for advising the Board on maintaining an effective framework of UK codes and standards and influencing the wider regulatory framework, and for its research programme. It will advise the Board on the annual plan for codes and standards work and for making appointments to and overseeing the work of the Councils. It will pay special attention to identifying cross-cutting issues that the FRC needs to tackle, looking across the coverage of individual codes and standards, identifying emerging risks and ensuring work is in hand to manage them. It will advise the Board on corporate governance questions. It will take decisions on matters delegated by the Board, for example, on some international issues.

The FRC Board and the Codes and Standards Committees will be advised by the Councils on accounting, audit and assurance, and actuarial matters. The Councils will be an important part of the new decision-making structure. Their advice will be put fully to the FRC Board. The Board member chairing each Council will act as a guarantor of this and will be responsible for submitting the Council's advice to the Board. The minutes of meetings of the FRC Board will record the discussion and the views expressed. If, exceptionally, the Board rejects the advice, it will explain its reasons and consult further with the relevant Council before taking a decision. In the event any such differences of view remain unresolved, the nature and reasons for such differences of view will be made public.

Where the FRC contributes to or seeks to influence EU or international developments, the FRC Board member chairing the relevant Council will in general lead the response to formal consultations by other authorities – including, for example, the European Financial Reporting Advisory Group and the international standard-setting bodies.

Conduct

The Board's Conduct Committee will be responsible for overseeing the FRC's conduct work aimed at promoting high quality corporate reporting. The powers to apply to Court in respect of defective reports or accounts will be delegated to the Conduct Committee.

It will set strategic goals for the FRC's supervisory, monitoring and disciplinary work, including by identifying the main areas of risk that need to be addressed. It will also set standards for the quality of supervisory work and the criteria to be applied in regulatory decisions. It will, in particular, determine how a major new issue should be looked into and what kind of regulatory intervention is most appropriate. It will also monitor the progress of disciplinary activities.

The Conduct Committee will comprise a mix of main Board and other members with a range of skills and experience, including individuals with relevant technical expertise. It will have a lay majority of members and exclude current practising auditors or officers of the professional bodies it regulates. It will be supported by two sub-committees, one to ensure the consistency and quality of the FRC's monitoring work and one to advise on the handling of disciplinary cases.

Resources and funding

The costs associated with the FRC activities post-reform will continue to be met on the basis established, following public consultation, in 2008. The FRC employs approximately 100 staff, and its total budget for 2011/12 was £22m.

Core operating costs in relation to corporate governance, accounting, auditing and the oversight of the accountancy profession (£12.2m budget in 2011/12) were met through a preparer's levy (contributing £7.0m), a levy on the accountancy profession (£4.7m) and a Government contribution (£0.5m). Audit inspection costs (£2.8m budget 2011/12) are funded by the individual Recognised Supervisory Bodies with which the firms that are subject to inspection are registered. Accountancy disciplinary case costs (£4.4m estimate 2011/12) are funded by the relevant professional body of the member or member firm subject to the investigation.

All costs, including disciplinary case costs, in relation to actuarial standards and regulation (£2.6m budgeted costs in 2011/12, plus a contribution to reserves of £0.3m) are met through levies on insurance companies (£1.3m) and pension funds (£1.3m) and a contribution from the actuarial profession (£0.3m).

It is anticipated that the reform proposals will have no material impact on the overall staff numbers although there are expected to be some anticipated reductions in overall costs as a result of the more streamlined governance arrangements: from the proposed narrowing of the scope of some aspects of the FRC's conduct activities and from the proposed arrangements for the early conclusion of disciplinary cases where appropriate.

4 - Independent supervisory and disciplinary arrangements

The proposals

It was proposed that the FRC's supervisory and disciplinary responsibilities should be operated independently of the accountancy professional bodies. The proposals related to the FRC ability to determine and require sanctions by the professional bodies in respect of poor quality audit work, and to the operation of its independent disciplinary arrangements.

Proposals - Sanctions in respect of poor quality audit work

The Companies Act 2006 requires the Recognised Supervisory Bodies (RSBs) to participate in arrangements independent of the RSB in relation to the monitoring of audits of listed companies and other major bodies. The arrangements are provided by the FRC through its audit inspection work.

At present, the FRC can request but not require an RSB to impose sanctions on an audit firm /and or individual auditor in response to shortcomings identified as a result of its inspection work. While no such request has ever been rejected, the current arrangements risk the FRC not being seen to be independent from the RSBs – thus potentially damaging the FRC and the RSBs.

Question 10

Do you agree the FRC should be given powers to determine and require a recognised supervisory body to impose proportionate sanctions, subject to appropriate safeguards, on an audit firm and/or individual auditor in respect of poor quality work?

Question 11

If not, what are your concerns and how do you believe this issue should be addressed?

Views

In general, investors and businesses supported these proposals while the accountancy professional bodies and individual audit firms questioned the case for changing the present arrangements and sought more detail about how the new arrangements might be applied. Other respondents expressed a diversity of view: with some strong support and some strong opposition.

Response

The Government and the FRC agree that the RSBs have an important regulatory role and that the RSBs are committed to working with the FRC to promote high standards in UK auditing. The RSBs will retain a crucial role in ensuring that high standards are maintained and any shortcomings are addressed. However, the FRC should be, and be seen to be, independent from the professional bodies in its role as the UK's lead audit regulator. The Government and FRC consider, therefore, that the FRC should be able to:

- determine an appropriate condition or sanction to be observed by an auditor or audit firm where the FRC's audit inspection arrangements identify shortcomings;
- where such a condition or sanction is not accepted by the auditor or audit firm; refer the matter for hearing by an independent tribunal;

- require the RSB to implement any condition or sanction accepted or determined by the independent tribunal.

The FRC Board will issue detailed Sanctioning Procedures. The Procedures will include the right to a hearing by an independent tribunal in the event that a sanction or condition in relation to the quality of audit is not accepted.

Proposals - Disciplinary arrangements

The FRC's disciplinary powers are established through two schemes - the Accountancy and Actuarial Schemes in which the professional bodies participate.

Currently, any changes to the schemes must be agreed with the professional bodies. It was proposed that in future the FRC should be required to consult the professional bodies and other interested parties; but the professional bodies would not retain what is in effect a veto over any changes.

Question 12

Do you agree the FRC should have the ability to make its own rules for the independent disciplinary arrangements without being required to obtain the agreement of the professional bodies?

Question 13

If not, how would you propose the FRC demonstrates its independence in this regard?

Views

The investor and business groups broadly supported this proposal; some professional bodies and audit firms challenged the case for enhanced independence, arguing that the present arrangements already provide an appropriate degree of operational independence from the professions.

Response

The Government and the FRC believe that the accountancy and actuarial professional bodies have a key role in promoting high standards of behaviour by their members and maintaining appropriate disciplinary arrangements.

The Government and the FRC maintain the view that the disciplinary arrangements operated by the FRC should be, and should be seen to be, independent from the professions.

It is intended that this proposal is implemented by the FRC through changes to the Schemes that are made with the support of the professional bodies. It is currently envisaged this should not require legislative changes, although the Government would be prepared to consider legislation if this was found to be the simplest way of achieving the necessary changes.

Additional detail

Mindful of the concerns about the operation of the sanctioning regime and independent disciplinary arrangements expressed by consultation respondents, the FRC is publishing

additional detail about the procedures that will be provided to ensure that they are operated in a fair and transparent way

5 - Proportionate sanctions and procedures

The proposals

It was proposed that the FRC should have a range of proportionate sanctions and procedures. In particular:

- the FRC should be able to take more proportionate, nuanced action against a Recognised Supervisory or Qualifying Body and should therefore be given a wider range of enforcement powers against the recognised bodies;
- the FRC should be able to take disciplinary action against individuals or firms without the need for a full tribunal hearing provided that this would not be contrary to the public interest and the parties agree.

Proposals - Action in relation to a Recognised Supervisory or Qualifying Body

Question 14

Should the FRC be able to take more proportionate, nuanced action against a Recognised Supervisory or Qualifying Body and therefore be given a wider range of enforcement powers against the recognised bodies? In particular, should the FRC be able to:

- Issue an enforcement order, requiring the body to take specified actions by a specified date, without the need for a court order?
- Impose conditions on continued recognition as an RSB or RQB?
- Impose fines on an RSB or RQB and if so, at what level?

Views

Investor and business respondents largely supported these proposals. Some of the accountancy professional bodies and audit firms expressed concern that changing the present arrangements was not justified on the grounds that the RSBs and RQBs were generally compliant: and sought more detail on how the proposed arrangements would be operated.

Response

The Government and the FRC remain of the view that a more graduated range of powers is necessary and would achieve two purposes:

- it would help sharpen the RSB and RQB responses, in particular, the timeliness of actions; and
- it would establish more firmly the independence of the regulator from the regulated.

As the consultation document emphasised, the lack of proportionate FRC powers gives a perception that it is too dependent on the goodwill of the regulated bodies to bring about change.

Under the proposed arrangements, the FRC Board will be responsible for decisions to recognise, refuse recognition or revoke recognition of an RSB or RQB or apply to Court for an

Order to require a Body to meet its statutory obligations. The Conduct Committee will be responsible for monitoring RSBs' and RQB's compliance with the requirements of the Act.

Proposal – Early conclusion of disciplinary cases

Question 15

Should the Companies Act and the AADB Schemes be amended to allow for the conclusion of cases without public hearings where appropriate and where agreed by the parties?

Views

Investor and business respondents largely supported this proposal. The accountancy professional bodies and audit firms expressed a range of views, and pressed for reassurances about the safeguards that would be built into the proposed procedures and the transparency of decisions on the early settlement of disciplinary cases.

Response

In the light of the response to the consultation, the Government and the FRC continue to believe that the power to resolve disciplinary cases quickly is in the public interest. There will always be cases which, by their nature, demand a public airing of the issues to best serve the public interest. But where cases do not fall into this category and where agreement could be reached and the outcome published, the resources of regulated individuals and/or firms and of the FRC could be saved; the procedure would be concluded more quickly; and disciplinary messages would be relayed in a more timely fashion. This would be more effective, proportionate and efficient regulation.

The Government and the FRC consider that, in appropriate circumstances, the FRC should be able to propose sanctions which could be accepted by firms or individuals bringing the matter to a conclusion without a public hearing as required at present. In defining these circumstances and introducing the necessary arrangements, the FRC Board will be responsible, on the advice of the Conduct Committee, for approving amendments to the Schemes including on scope and for issuing any guidance on the application of the public interest test. In all circumstances it will be also be possible for a party to require a public hearing.

It will be an essential principle of the new arrangements that the conclusion of all disciplinary cases will be published, irrespective of whether a disciplinary sanction has been imposed following a public hearing.

The proposal – Supervisory inquiries

It was proposed that the FRC should undertake supervisory inquiries at its own initiative into significant matters of concern.

Question 16

Do you agree that the FRC should develop a mechanism to enable it to undertake supervisory inquiries into matters of concern, either of individual market events or wider market interest, initially building on its current powers to secure information?

Views

There was general support for the proposed supervisory inquiries, subject to the need to avoid overlaps with other regulatory authorities.

Response

Initially it is not anticipated that the FRC will have any additional powers to conduct such inquiries. Should it become apparent that the FRC is unable to conduct such work effectively within its existing powers, the Government will consider providing the FRC with further powers.

The FRC will undertake supervisory inquiries to provide an understanding of the reasons for the collapse or near collapse of a public interest entity or other issue affecting confidence in corporate governance or reporting. Such inquiries would enable the FRC to consider whether any further regulatory or other action should be taken, including whether any improvements should be made to the corporate reporting and governance regime, or whether more formal disciplinary proceedings should be set in hand.

In particular supervisory inquiries will provide:

- a bridge between the various elements of the FRC's conduct work;
- input to the standard setting function of the FRC;
- information sufficient to decide whether to investigate a matter with a view to disciplinary action (together with appropriate protections for those involved);
- investigative resources focused on the most appropriate issues;
- the proportionate use of other regulatory tools available to the FRC for less serious issues and ensure the appropriate lessons are articulated in a more timely fashion; and
- a basis for more thematic studies of issues affecting confidence in Corporate Reporting and Governance.

A supervisory inquiry will not be initiated unless there are clear indications that there might have been either significant individual or systemic shortcomings or risks to the quality of corporate governance of public interest entities, for example a major corporate collapse or near collapse shortly after the release of their annual report, or widespread concerns over the quality of reporting or governance on a particular issue.

The outcomes from a supervisory inquiry could include:

- the referral for a formal investigation with a view to potential disciplinary action either by the FRC or by the relevant professional body;
- the publication of a report;

- a recommendation for an issue to be considered in relation to possible changes to the framework of codes and standards;
- referral to another regulatory body; or
- no further action.

The timescale for a supervisory inquiry will depend on the complexity of the relevant issues, the availability of information and clarity of the appropriate next steps. However, it is envisaged that on average a supervisory inquiry should be completed within two months. The time needed should be significantly less, where it is clear that the appropriate outcome is referral for a formal investigation with a view to disciplinary action.

Republic of Ireland

The consultation on FRC Reform was conducted in a UK context. Certain FRC activities, for example those relating to standards for accounting and audit, are also applied by the relevant authorities in the Republic of Ireland. The FRC will continue to liaise as appropriate with these authorities on the proposals and any potential impact on the Republic of Ireland.

Annex A – List of respondents

Association of British Insurers
Association of Chartered Certified Accountants
Actuarial Profession
Association of Financial Markets in Europe
Association of International Accountants
Association of Practising Accountants
Audit Commission
Audit Scotland
Baker Tilly
Barclays
BDO
C. G. Lewin
Confederation of Business Industry
Consultative Committee of Accountancy Bodies-Ireland
Certified Practising Accountant Australia
Chartered Financial Analyst Institute
Chartered Accountants Ireland
Chartered Accountants Regulatory Body
Chartered Institute of Management Accountants
Chartered Institute of Public Finance and Accountancy
Chris Try
Conference of Professors of Accountancy and Finance
Consultative Committee of Accountancy Bodies
Crowe Clark Whitehill
Deloitte
Department for Jobs, Enterprise and Innovation
Ernst & Young
European Financial Reporting Advisory Group
Fair Pensions
Graham Milne
Grant Thornton
Hermes
Ian Foxley
Institute & Faculty of Actuaries
Institute of Chartered Accountants in England and Wales
Institute of Chartered Accountants in Ireland

Institute of Chartered Accountants in Scotland
Institute of Chartered Secretaries and Administrators
Investment Management Association
Jim Shannon MP
K. M. Stevenson
Kingston Smith LLP
KPMG
Legal & General Investment
Local Authority Pension Fund
Martin Groak
Mazars
Mercer
Mike Jones
Mira Makar
Mohammad Faiz Azmi
National Audit Office
Neil Harris
Paul Moore
Paul Turner
Peter Walton
PKF
Professor Geoffrey Meeks
Professor Geoffrey Whittington
Professor Martin Walker
Professor Stella Fearnley
Professor Stephen Zeff
Pricewaterhouse Coopers
Quoted Companies Alliance
Regulation and Ethics Review Panel
Richard Macve
ShareSoc
SORP
Society of Pension Consultants
Standard Chartered
Suk-Sig (Steve) Lim
The Pensions Regulator
Towers Watson
UK Sustainable Investment Fund

Wales Audit Office

Annex B: Impact Assessment of Proposals to reform the Financial Reporting Council

The Final Stage Impact Assessment is available at <http://www.bis.gov.uk/Consultations> .

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