

**BIS** | Department for Business  
Innovation & Skills

**PROPOSALS TO REFORM THE  
FINANCIAL REPORTING COUNCIL**

A joint BIS and FRC consultation

OCTOBER 2011



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# Foreword

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment.

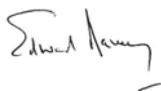
An effective, world class regulatory framework for corporate governance and reporting is essential to support continued investment in the UK. Through its work, the FRC makes a significant contribution to the UK's overall regulatory framework which promotes corporate accountability and transparency, encourages responsible business behaviour, and so provides the markets with confidence.

The FRC is already well-regarded in the UK, the EU and internationally, but we believe by tightening the focus of its activities and reforming its structural framework that it could be even more effective, increasing still further the contribution it makes to supporting the UK's business interests. This consultation document seeks views on a set of reforms designed to build on the FRC's strengths as well as tackle the underlying issues that currently inhibit its effectiveness. Reform is needed to:

- reinforce the FRC's independence from those it regulates;
- improve its efficiency and effectiveness; and
- rationalise and minimise the regulatory burdens on market participants.

It is not intended that reform should introduce further regulatory processes which impact significantly on business. However, to achieve our aims some proposed reforms will require changes to the legislative framework. An impact assessment has been prepared and is available at <http://www.bis.gov.uk/Consultations>. We are committed to reducing the cost to business associated with FRC regulation and will consider carefully any opportunities for cost reduction identified through responses to this consultation.

We intend that, guided by the responses to the consultation, the proposed reforms should be implemented by April 2012. Responses to the consultation paper are invited by 10<sup>th</sup> January 2012.



Department for Business, Innovation  
and Skills (BIS) Minister



FRC Chairman

## Executive Summary

The FRC has a strong reputation – within the UK, EU and internationally – for its work on corporate governance and reporting and for the oversight of the accounting and actuarial professions. However, regulatory authorities, the FRC included, must be self-aware and should always strive to improve.

Currently, the FRC has a range of regulatory activities which extend beyond its core mission of supporting the effective functioning of the capital markets and UK business; it is structured in a way that is over-complex and insufficiently understood, with a risk that, in aggregate, regulation by its seven different bodies will be over-burdensome; is insufficiently independent from the accountancy professional bodies in its supervisory and disciplinary role in relation to audit; and is equipped with a range of sanctions and procedures which might be disproportionate in some cases.

The aim of the reforms, therefore, is to:

- consider how better to focus the FRC's activities where it can make the biggest difference, taking into account its core mission
- create a simplified structure which is easily understood by the FRC's stakeholders
- reinforce its independence from those it regulates
- ensure it has the powers to respond proportionately and effectively where problems are identified.

It is our intention that building on its current strengths the FRC should emerge as a body that is more effective, more joined up and capable of addressing the big issues, has proportionate sanctions available to it and is able to target its resources to greatest effect.

### ***An investment focus for the FRC's regulatory activities***

The scope of the FRC's regulatory activities should be reviewed with the aim of enabling it to concentrate on those areas that are most important for the operation of the capital markets. Comments are invited on the scope for such narrowing and, in particular, on the following proposals:

- the FRC should set or promulgate standards for governance, accounting, audit and actuarial work in the interests of investors in the corporate sector with its primary focus, in relation to monitoring and enforcement, being on publicly-traded and the largest private companies;
- the scope of the FRC's accountancy disciplinary arrangements should 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. It should leave other cases of potential misconduct to be dealt with by the relevant professional body.

### ***Streamlined governance and structure***

The FRC should remain well connected to and informed by market participants - but it needs to be more streamlined and efficient. It is therefore 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 will replace the existing seven operating bodies.

### ***Reinforced independence***

The FRC's supervisory and disciplinary responsibilities should be operated independently of the accountancy professional bodies. In particular, it is proposed that the FRC should have:

- the power to determine and require a Recognised Supervisory Body to impose proportionate sanctions on an audit firm and/or individual auditor in respect of poor quality work;
- the ability to make its own rules for the independent disciplinary arrangements which it operates in relation to accountants without being required to obtain the agreement of the accountancy professional bodies.

***Proportionate regulation***

The FRC should have a range of proportionate sanctions and procedures. In particular, it is proposed that:

- 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;
- the FRC should undertake supervisory inquiries at its own initiative into significant matters of concern.

## 1 The case for FRC reform

“During the coming year we will be keeping in particularly close touch with our stakeholders, on whom we will rely heavily for advice, in our efforts to create an FRC that is:

- easier to understand, focused and clear in its purpose;
- disciplined, proportionate and restrained in the execution of that purpose;
- flexible, acute and sensitive to the impact of its work on companies, markets, professions and the people who work in all three.”

Baroness Hogg, FRC Chairman, Annual Report 2010/11<sup>1</sup>

- 1.1 Good corporate governance, and trust in the disclosures made by public companies are essential to the effective operation of the capital markets. 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. However, it is challenging regulators to do more to reduce the costs of regulation and to focus on risks and outcomes rather than processes. This paper sets out the case for reform and makes proposals designed to enable the FRC to deliver against those goals.

### **FRC’s regulatory approach**

- 1.2 The FRC has many successes to be proud of, achieved with the support of participants in the capital markets and the professions. The UK Corporate Governance Code and the quality of UK governance are world-leading. So too is the quality of auditing and actuarial work in the UK. The FRC aims to operate on the basis that it should:

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<sup>1</sup> See the FRC Annual Report 2010/11; <http://www.frc.org.uk/about/annual.cfm>

- be capable of addressing major issues of corporate governance and professional oversight in a timely and effective way, with a clear focus on the issues of greatest concern to investors and users of the capital markets;
- be independent from those it regulates and effectively challenge failure to meet the standards of behaviour expected by investors and in the capital markets;
- meet the principles of good regulation – accountability, proportionality, transparency, targeting and consistency;
- be alert to developments in the markets and provide thought leadership on matters within its remit;
- support the leadership of the professional bodies it oversees in their work to raise standards, ensuring that its own work does not detract from their responsibilities and their influence for good over their membership;
- draw on the services of highly-qualified and experienced individuals with real-time experience of how the capital markets and professions are changing; consulting and engaging with those responsible for decisions on governance and reporting and with the investors and others who depend on the quality of those decisions.

1.3 These are the distinguishing characteristics of the FRC's approach to regulation which the proposed reforms are designed to strengthen. Independence from the professions and others, whose activities it regulates, is crucial for public confidence in its regulatory effectiveness. At the same time, however, the FRC's access to market and professional expertise and their involvement in its decisions has been invaluable and must be maintained.

#### *Corporate governance*

As an example of its regulatory approach: the FRC has in the past year brought into effect a revised UK Corporate Governance Code and – the first of its kind – a Stewardship Code for investors. The FRC has undertaken an extensive consultation on Effective Company Stewardship and a series of discussions on best practice for boards in fulfilling their responsibilities in relation to risk. The Government has supported these initiatives, which have in turn secured a significant degree of support from boards and investors. The new Stewardship Code has given the FRC an important voice globally with the institutional investor community. The FRC has had discussions with policymakers in

Brussels, Washington, Singapore and Australia to communicate views and learn from good corporate governance practice in other jurisdictions.

#### *Actuarial standards*

The FRC's Board for Actuarial Standards has also in the past year completed its set of technical actuarial standards (TASs) – again the first of their kind – in response to the recommendations of the Morris Review in 2005. The TASs are principles-based and have been developed following an extensive consultation exercise with practitioners, but with a clear focus on the needs of users for reliable actuarial information. The Government's decision to ask the FRC to provide independent standard-setting and oversight of the actuarial profession reflected the perceived strengths of the organisation and the regulatory approach set out above. Typical of the FRC's approach has been the development of an Actuarial Quality Framework which has encouraged the profession itself to recognise the need for greater clarity about the technical and communication skills, ethics and professionalism that users can expect of practising actuaries, as well as the quality controls at actuarial firms.

## **Contributing to the Plan for Growth**

1.4 The Government's Plan for Growth set a challenge for the FRC in fulfilling its mission:

#### *The Plan for Growth: Professional and Business Services Review – Action 11*

Action 11 – The Financial Reporting Council will work closely with the professions, businesses and market participants to reinforce the principle that independent regulation and enforcement should focus on risks and outcomes rather than process.

1.5 The Government and the FRC believe that the FRC's regulatory approach remains appropriate, but that its effectiveness in responding to this challenge will be enhanced if it addresses four issues. These are that:

- the scope of the FRC's regulatory activities is not sufficiently clearly defined;
- its structure is overly-complex;
- it is insufficiently independent from the accountancy professional bodies; and

- it does not have a proportionate range of sanctions and procedures available to it.

Taking each of these in turn:

### **The scope of the FRC's regulatory activities is not sufficiently clearly defined**

- 1.6 The Government and the FRC seek views on whether some elements of the FRC's current activities can be dispensed with altogether, while still ensuring that its powers to discharge the core responsibilities vested properly in the FRC are adequate, proportionate and fit for purpose. The FRC's present structure means that thresholds for regulatory action are set at different levels for some areas of activity and we believe there is a case for recalibration in a deregulatory direction.

### **The FRC's structure is over-complex**

- 1.7 The FRC is an amalgamation of several organisations: the result of bringing together, over time, a series of responsibilities for which successive Governments have sought to find a suitable home. Some of these organisations still have elements of self-regulation and are vulnerable to challenge. The FRC today consists of seven different bodies<sup>2</sup> to do one job: promote high quality corporate governance and reporting to foster investment.
- 1.8 The perpetuation of the current complex structure does not, the Government and the FRC believe, serve anyone well. Evidence from its stakeholders is clear: the FRC's structure is hard to understand, even by those who know it best. The complexity of its structure increases the risk that the FRC will interfere too much in some areas and neglect others. This concern is no criticism of the highly-respected people working in each of the FRC's operating bodies, who have earned the FRC its reputation, but rather a frustration that – sometimes because of statutory restrictions – their information and expertise cannot be used to their full potential across the whole spectrum of the organisation's operations.
- 1.9 Questions about the handling of risk, the future role of audit in respect of narrative reporting and even the future of corporate financial reporting are examples of issues which were not, and could not have been, dealt with during the financial crisis within

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<sup>2</sup> Accounting Standards Board (ASB), Auditing Practices Board (APB), Board for Actuarial Standards (BAS), Professional Oversight Board (POB) which includes the Audit Inspection Unit (AIU), Financial Reporting Review Panel (FRRP), and Accountancy and Actuarial Discipline Board (AADB).

any of these operational bodies alone, despite the high quality of their membership and professional input. Furthermore, the main FRC Board, which has been responsible for addressing them, is not itself directly equipped with the powers to achieve change.

- 1.10 There is also the risk that the federation of seven regulators adds up to a considerable self-generated pressure to regulate. The FRC's work has commanded confidence in the market; nevertheless the volume of standards and guidance adds up to a formidable mountain of words to guide a relatively narrow set of activities.

### **The FRC is insufficiently independent from the accountancy professional bodies**

- 1.11 It is in the public interest that the audit profession should be subject to independent oversight as is illustrated by the requirements of Parliament and the EU. The FRC is the oversight regulator by virtue of the powers delegated to the POB and the monitoring and discipline arrangements with the AADB and AIU. However, the independence of the FRC in this role is still governed by complex agreements with the profession that sometimes inappropriately limit its independence and therefore its ability to pursue the public interest.
- 1.12 For example, if the AIU, following an audit inspection, is of the view that further action should be considered against the relevant firm, it must refer its concerns to a committee of the relevant professional body which is currently chaired by an audit partner, has no lay majority and includes partners who have significant responsibility at their respective firms for dealing with AIU inspections.
- 1.13 The FRC's independence is less fettered if it wishes to undertake a disciplinary investigation but its independence is still not clear cut. It cannot launch an investigation until it has consulted the accountancy profession, and the whole process is governed by a scheme the provisions of which must be agreed by the profession.
- 1.14 The Government and FRC consider that the independence of the FRC's oversight role would be enhanced if the FRC were given powers to impose sanctions on auditors/audit firms in respect of poor quality work, and if its disciplinary schemes could be amended by consultation rather than by agreement with the accountancy professional bodies. The European Commission is currently developing proposals on audit regulation that may have implications for the FRC. The Government and the FRC consider that the broad principles on which the reform proposals set out in this document are based will remain appropriate and will guide their response to any specific Commission proposals.

## **The FRC does not have a proportionate range of sanctions and procedures**

- 1.15 As stated above, the effective oversight of the audit profession is in the public interest. However, 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 serious cases.
- 1.16 The Government and the FRC consider that a more graduated range of powers would sharpen the speed and quality of the responses of the recognised bodies to recommendations. Furthermore, the lack of proportionate powers gives a perception that the oversight body is too dependent on the goodwill of the regulated bodies to bring about change and reformed powers would establish more firmly the independence of the FRC from those being regulated.
- 1.17 At the same time 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. The Government and the FRC consider that, in appropriate circumstances, the FRC should be able to agree sanctions with firms and individuals without referral to a public hearing before a tribunal. An individual or firm subject to disciplinary proceedings will still have the right to a public hearing before an independent tribunal.
- 1.18 The Government and the FRC also consider that inquiries targeted at issues of corporate governance and reporting following the collapse or near collapse of a public interest entity - using the FRC's reformed powers as proposed in this document - would have the advantage not only of informing its stakeholders but also of ensuring that any referral to enforcement or disciplinary procedures is appropriate.

## **Impact assessment**

- 1.19 No regulatory change should be contemplated without assessing the cost and considering whether, as new powers are secured, existing regulation can be eased or repealed. A consultation impact assessment has been prepared and is available at <http://www.bis.gov.uk/Consultations>.
- 1.20 It is important to recognise that the Government and FRC are not proposing significant additional regulatory processes. In fact, the proposals are deregulatory. The accountancy profession has and uses some of the proposed powers already. The proposals in this document are designed to extend those powers to the FRC to ensure they can be exercised independently rather than to extend supervision into

new areas. The proposals on sanctions are designed to enable the FRC to apply lesser remedies more cost-effectively, through a more straightforward process.

**Consultation questions**

1. Do you have any comments on the case for FRC reform as set out in this document?
2. Do you agree that the proposals for reform will bring benefits and increase the effectiveness of the FRC?
3. Do you have any comments on the consultation stage impact assessment?

## 2 An investment focus for the FRC's activities

- 2.1 The FRC's mission requires it to view the world from a number of different perspectives: boards, audit committees, preparers of financial statements, auditors, accountants and actuaries – and, in particular, investors and all those who rely on the quality of the information that is provided. Its current activities span a very wide range. Through codes and standards, monitoring and enforcement it influences governance and reporting by capital markets participants and private companies - and the audit requirements that apply to them; oversees the regulatory activities of the accountancy and actuarial professional bodies; influences international standards for financial reporting and auditing; sets a range of accounting and auditing standards that apply to other entities (including public benefit entities); and sets technical actuarial standards.
- 2.2 We are proposing that the scope and targeting of the FRC's activities should in future be more closely aligned with its mission.
- 2.3 The Government and the FRC believe 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.
- 2.4 However, we would welcome 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 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. The FRC is proposing that it will continue to maintain an appropriate framework of UK accounting and audit standards that address the needs of smaller companies. 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: working closely with those who rely on actuarial information and with the actuarial profession.
- 2.5 The Government and the FRC are considering in particular whether:

- The public interest should be defined by publicly traded companies, including AIM and PLUS Markets, together with large private companies (defined as those with an annual turnover of £500m or more – the definition currently used, following public consultation, for the purposes of the FRC’s levy arrangements), or whether this definition should be narrowed;
- The scope of the FRC’s accountancy disciplinary arrangements should 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. It should leave other cases of potential misconduct to be dealt with by the relevant professional body.

2.6 It would follow from this approach that the FRC may be able to narrow the scope of its activities and limit or withdraw from some of the functions it carries out in respect of lower risk areas of the economy. This will, of course, require careful choices about the most effective use of the FRC’s resources to maximise impact. The Government and the FRC will continue to have regard to the requirements under the EU Statutory Audit Directive to maintain an appropriate framework of public oversight; this will include the ability of the FRC to conduct investigations and take disciplinary action.

2.7 As a focus for comments on the future scope of the FRC’s activities in each area within the proposed new structure, its current major activities and projects are summarised below:

## Codes and Standards

### ***Maintaining an effective framework of UK codes and standards, including accounting and reporting standards***

- Monitoring the effectiveness of the UK Corporate Governance Code and the Stewardship Code for institutional investors.
- Supporting BIS in its initiative to drive up the quality of narrative reporting: promoting narrative reports that provide good quality and relevant information on the issues which matter to companies’ long term success, including social and environmental issues.
- Implementing an agreed approach for the future of UK GAAP.
- Maintaining the suite of UK auditing standards based on the International Standards for Auditing (ISAs)

- Reviewing, together with the International Auditing and Assurance Standards Board (IAASB), the impact of the introduction of the Clarity ISAs.
- Completing the review of standards and APB guidance in relation to reports provided to the Financial Services Authority (FSA) on client assets in the financial services sector which commenced in 2010/11; and updating and issuing appropriate professional standards for work in this area.
- Keeping under review, with the POB/AIU, issues arising from audit inspection and other issues and conditions that may impact on the work of auditors, that are relevant to the UK framework of auditing standards.
- Maintaining a suite of Technical Actuarial Standards (TASs) and start to assess the effects of TASs in meeting the needs of users of actuarial information, including the governing bodies of insurers and pension schemes.
- Working with Government and other regulators to ensure consistency between TASs and other regulatory requirements.

### ***Influencing the wider regulatory framework***

- Working with the EU and the BIS to influence the development and implementation of legislative provisions relating to corporate governance and reporting.
- Stimulating improvements to corporate reporting, including narrative reporting, focusing on business model and risk disclosures.
- Taking forward audit-related issues emerging from the consultation on improvements to the annual reporting, accounting and audit infrastructure; and issues arising from the APB/POB consultation on auditor scepticism.
- Taking a lead role in influencing the development of the International Financial Reporting Standards (IFRS) and the International Accounting Standards Board (IASB) strategy when the convergence with US Generally Accepted Accounting Principles (GAAP) project ends in 2011.
- Playing an active role in European Financial Reporting Advisory Group (EFRAG) and European proactive projects, including the development of a disclosure framework. Seeking to ensure continued support in the EU for implementing IFRS

as issued by the IASB. Playing a leading role in the global group of National Standard Setters.

- Playing a leading role in the International Auditing and Assurance Standards Board (IAASB) and work effectively with the International Ethical Standards Board for Accountants (IESBA).
- Influencing the development of international actuarial standards, including those for Solvency II.

## Conduct

### ***Promoting high quality corporate reporting including narrative reporting***

- Reviewing a selection of annual and interim accounts and directors' reports for compliance with the Companies Acts, including applicable accounting standards; and aim to review around 300 sets of accounts in total in 2011/12. A key area of interest addressed in reviews and taken up with companies is the extent to which there are clear linkages between narrative reports and the accounts, principal risks and uncertainties, and the descriptions of business models.
- Stimulating improvements to corporate reporting, including a continuing focus on the importance of narrative reporting.
- Liaising with the UK Listing Authority; and responding to matters drawn to the FRC's attention as a result of complaints or public comment, and encourage referrals from the investment community, professional advisers and others.
- Influencing the development of international enforcement practices.
- Monitoring and reporting on the quality of audits, based on the reviews of some 100 audits, of which the majority will relate to the largest audit firms, focusing on areas of high subjectivity and professional judgement and the application in practice of the new Clarity ISAs.
- Keeping under review the risks associated with concentration in the UK audit market and, if appropriate, making proposals on further action. Responding to the

outcomes of the House of Lords inquiry into the audit market and the European Commission's green paper on auditing.

- Influencing the work of the International Forum of Independent Audit Regulators (IFIAR) and European Group of Auditors Oversight Bodies (EGAOB) to promote effective regulatory oversight of audit firms, including those managed on a regional basis, and taking a leading role in such regulation in Europe.
- Overseeing the regulatory processes of the Recognised Supervisory Bodies and Recognised Qualifying Bodies in respect of auditing.
- Continuing to work with the Department for Communities and Local Government to develop and implement appropriate proposals on the oversight of audits for local authorities and other local public bodies, with a view to taking on a proportionate role as part of the remit of the FRC.
- Ensuring that the legislative framework and practical measures for audit regulation in Europe under the Statutory Audit Directive appropriately address the issues relating to third country auditors. Participating in the arrangements for the co-ordination of the regulation of audit and the oversight of the auditing profession in the EU.
- Overseeing the regulatory activities of the accountancy and actuarial professional bodies.
- Making significant progress on, and where possible finalising, the disciplinary cases with which the AADB is currently dealing. Identifying and investigating other matters which meet the criteria for AADB investigations.

### **Consultation questions**

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

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

### **Local public audit**

- 2.8 The FRC is working with the Department for Communities and Local Government (DCLG) to agree an appropriate framework for regulation of local public audit. Details are available at:  
<http://www.communities.gov.uk/documents/localgovernment/pdf/1876169.pdf>.

### **Republic of Ireland**

- 2.9 This paper is written in a UK context. Certain FRC standards, for example those relating to accounting and audit, are also applied by the relevant authorities in the Republic of Ireland. The FRC will liaise as appropriate with these authorities on the proposals and any potential impact on the Republic of Ireland.

### 3 Streamlined governance and structure

3.1 Our proposals envisage that the FRC Board will set the strategic direction and priorities of the organisation. The Executive will lead the necessary work to enable the Board and two Board Committees to make key decisions. In preparing its advice to these decision-makers, the Executive will consult expert advisory councils and will ensure their views are fully reported. Through this governance structure of the Board, Board Committees and advisory councils, the FRC will retain its commitment to secure input from its network of external experts and market participants at all levels of the organisation.

3.2 The two Board Committees will cover the FRC's work on:

- **Codes and standards**, including the work currently undertaken by the Board's Corporate Governance Committee, the ASB, the APB and the BAS.
- **Conduct**, covering supervisory and disciplinary matters, including the work currently undertaken by the FRRP, the POB and the AIU, and the AADB.

The current and proposed structure of the FRC are summarised in the organisation charts at Annex A.

#### The role of the Board

3.3 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.

The FRC Board will:

- determine FRC strategy, annual plan and budget;
- appoint the members of the FRC Board (save for Chair and Deputy Chair, who will be appointed by the Secretary of State for Business, Innovation and Skills as now) and Board Committees;
- approve standards and make other decisions reserved to it under statutory powers and delegated authority, subject to giving full account to expert

advice and departing from that advice only in accordance with set criteria;

- determine the terms of reference of Board Committees and delegate authority to those Committees as appropriate;
- approve membership of advisory councils and other groups/panels supporting the Board Committees;
- review significant issues of public interest;
- report annually to Secretary of State and Parliament on the exercise of the FRC's powers;
- where appropriate, provide final approval of the FRC's codes, standards and guidance and its international thought leadership and policy papers.

3.4 There will be a published Scheme of Delegated Authority which will define the authority of the FRC Board, its Committees and sub-committees and advisory councils and the Executive. Key decisions will be made by the Board or Board Committee and other decisions made by the Executive.

### **The Board Committees and Advisory Councils**

3.5 The two Board Committees will each be led by a member of the main Board and one senior executive, supported by other Board members and other market participants. They will each have a lay majority. They will in turn be supported by advisory councils and panels as necessary. In this way the FRC will remain well connected to, and informed by, market participants but will be able to operate on a more streamlined and efficient basis.

3.6 The Board Committees will operate on the basis of two core principles:

- They will always seek to advance the overall mission of the FRC;
- They will be transparent, accountable and efficient in their work.

### **Codes and Standards**

The Codes and Standards Committee will:

- prepare a detailed operating plan governing the FRC's codes and standards activity for approval by the Board, and oversee the quality of work and the delivery of the plan;
- work on the basis that well informed users are powerful regulators;
- target the use of its powers, taking a proactive, risk-based and proportionate approach, including making effective use of impact assessments;
- emphasise principles and clarity in its standard-setting; be clear on the extent to which it sets prescriptive standards;
- be consultative – involving investors, boards, preparers of financial statements, other users of financial statements and actuarial reports, and other regulatory organisations in its decision-making and, where appropriate, wider groups, allowing adequate time for consultation, without compromising its independence or confidentiality;
- seek to influence and contribute to any emerging EU and international standard-setting developments.

3.7 The Executive will ensure that the Board/Board Committee are well-appraised of the views, expertise and experience of market participants. To support the Executive in achieving this, advisory councils will be established to cover accounting, audit and actuarial matters. These may have further specialist groups, subject to the approval of, and annual renewal by, the Board Committee. The Executive will take account of the advice it receives and report it fully to the Board/Board Committee.

3.8 The advisory councils will be chaired by a Board or Board Committee member who is well respected for their experience and knowledge on the subject matter addressed by that council. The chair will also have a leading role in promoting the UK position on the matters considered by the council to international standard-setters and other national regulators. Whilst the Executive may put forward to the Board or a Board Committee a different recommendation to that of the advisory council, the council chair will ensure that its advice is properly reported.

3.9 In relation to standard-setting, the Board would expect to follow the relevant advisory council's expert advice. The Board or Codes and Standards Committee may reject a proposal to adopt a code, standard or guidance which the advisory council has supported in one of four circumstances:

- where it is apparent that a significant group of stakeholders has not been adequately consulted;
- where the necessary assessment of the impact of the proposal has not been completed, including an analysis of costs and benefits;
- where insufficient consideration has been given to the timing or cost of implementation; or
- where the cumulative impact of a number of proposals would make the adoption of an otherwise satisfactory proposal inappropriate.

## Conduct

The Conduct Committee will:

- prepare a detailed operating plan governing the FRC's conduct activity for approval by the Board; and oversee the quality of work and the delivery of the plan;
- determine the areas of risk that need to be explored, set guidelines for applying different types of sanction (or other forms of regulatory intervention);
- where appropriate, make decisions on major issues;
- determine whether disciplinary investigations are to be launched;
- be responsive – obtaining feedback on its regulatory effectiveness through regular interaction with investors, boards, preparers of financial statements, other users of financial statements and actuarial reports, other regulatory organisations in its decision-making and where appropriate wider groups – proposing change as appropriate;
- engage with other regulators, domestic and international to inform its

programme of work;

- provide timely feedback into standard-setting and thought leadership.

The Board will not make decisions on individual cases. It will determine the strategic focus, plan and level of resources for the FRC's conduct work and approve the publication of major public reports.

3.10 There will be published Guidelines on the criteria which the FRC will use in making decisions on conduct issues. The Guidelines will include the role of the sub-committees which will deal with specific matters, including the outcome of reviews of financial reports and audit inspections.

3.11 The Conduct Committee will, in view of the resource implications and significance for the reputation of firms and individuals, determine whether disciplinary investigations are to be launched. It may invite observers from other regulatory bodies to its meetings to promote good co-ordination of supervisory and enforcement activity.

3.12 The Executive will advise the Conduct Committee and run the supervisory and disciplinary functions.

### **The benefits of the new arrangements**

3.13 The Government and FRC Board believe that the new structure will enable the FRC to operate more effectively in a number of areas. In particular it will help ensure that:

#### ***FRC regulation as a whole is proportionate and properly targeted***

3.14 The FRC Board, supported by the two Board Committees, will be in a stronger position to manage the overall impact of FRC regulation on the regulated communities and ensure that alternatives to regulatory requirements are explored where appropriate.

#### ***The FRC works effectively with other UK regulatory authorities***

3.15 The FRC has worked closely with the FSA and will build strong links with the FSA successor bodies: the Financial Policy Committee, the Prudential Regulatory Authority and the Financial Conduct Authority. The proposed reforms are intended to ensure the FRC Board will be in a stronger position to ensure that the FRC maximises the value of its strategic and technical input to the wider UK regulatory framework.

***The FRC has the necessary strong voice at EU and international level***

- 3.16 The proposed reforms are intended to enhance the FRC's ability to influence EU and international developments. The FRC's influence on behalf of the UK as a whole is at its greatest, with organisations such as the European Commission and the US Securities and Exchange Commission, when it can speak about reporting as a whole rather than, for example, separate accounting, auditing or actuarial issues.
- 3.17 The need for such influence will become greater with the increasing trends we are seeing towards international discussion focusing on wider reporting and assurance issues. Building on its technical strengths, the FRC needs to ensure that it is well-placed to meet the challenges of those wider perspectives. As the financial crisis demonstrated, the UK's leadership in accounting should be directed by a strategic, not just a technical appreciation of the issues – focusing on the value of corporate reports for investors.
- 3.18 The FRC and its individual operating bodies have built up excellent international reputations over the years. Maintaining and maximising its ability to continue to play a leading role both globally and within the EU will be an important aspect of the reformed FRC. Leading and authoritative figures will be chosen to chair the advisory councils and make sure, through the work of the advisory councils and the executive, that they have the support needed to exert influence internationally.

**Consultation questions**

8. Do you agree that streamlining the FRC's governance and structure will bring the benefits described?
9. Do you have any comments on the proposed reformed FRC governance and structure?

## **FRC funding**

- 3.19 The FRC currently operates on the basis that its funding arrangements should provide a fair, cost-effective and stable basis for it to raise the funds it requires to fulfil its statutory responsibilities and to promote high quality corporate governance and reporting in the UK to foster investment. The FRC obtains the funds it requires on the basis of voluntary arrangements and widespread support for its activities from the major groups which have regard, directly or indirectly, to its regulatory requirements. It has not sought additional funding in the last year - despite the additional pressures arising from the financial crisis. Indeed this year levy payers have seen, on average, a 7% fall in what they pay. The efficiencies from the proposed streamlining will help ensure that costs continue to be tightly managed.
- 3.20 Section 17 of the Companies (Audit, Investigations and Community Enterprise) Act 2004 provides that the Secretary of State may by regulation provide for a levy to be paid to the FRC for the purposes of carrying out the functions listed in section 16 of the Act.
- 3.21 The Government and the FRC believe that the proposed streamlined structure will enhance its ability to manage and demonstrate the necessary accountability for its expenditure. However, if it becomes evident that the current arrangements are no longer operating in a way that is fair and cost-effective, the Government may bring forward proposals to establish new arrangements backed by Section 17 or by another appropriate statutory power.

## 4 Independent supervisory and disciplinary arrangements

- 4.1 Regulatory independence of the FRC is vital to underpin confidence in the accountancy profession. Some suggest that the criticisms levelled by an independent regulator undermine such confidence. The FRC rejects this notion. Confidence must be based on honest appraisal, openly reported. That does not mean the regulator should be remote from the professions. Their advice should be sought and respected. There should be a commitment to work together to drive up standards for the benefit of all. But ultimately the regulator needs to be able to determine what needs to be looked into and, if necessary and subject to safeguards, what requirements for change should be applied.
- 4.2 There are two areas in which the present arrangements do not provide the FRC with the necessary independence from the accountancy profession:
- monitoring the quality of audit for public interest entities;
  - providing independent disciplinary arrangements for public interest cases involving members of the accountancy professional bodies.
- 4.3 The Government and the FRC believe that the public interest, and the wider interests of the profession, would be best served if these arrangements were reformed.

### Monitoring the quality of audit

- 4.4 The audit profession is regulated by the RSBs. The monitoring units of the RSBs are responsible for the monitoring of 'non-public interest entity' audits within the scope of audit regulation in the UK. The AIU monitors the audits of publicly traded companies and other economically significant entities. Audit firms and individual auditors are subject to discipline by the professional bodies of which they are members. The RSBs must also participate in independent disciplinary arrangements in relation to statutory audit public interest cases in order to retain their RSB status: in practice these arrangements are provided by the FRC's AADB.
- 4.5 Accordingly, a number of bodies may be involved in the monitoring and discipline of auditors whose undertakings include the audits of public interest entities. This gives rise to the risk of failure on the part of those bodies to coordinate adequately with the possibility of failure to detect problems and then to deal consistently with any shortcomings.

- 4.6 However, neither the POB nor the AIU has any express power of referral or power of enforcement following findings of poor quality. Any enforcement or disciplinary action is taken by other bodies (including the AADB) and neither the POB nor the AIU has the power to require action to be taken. The AIU reports publicly and has the power to report particular issues to the audit registration committees of the relevant RSB but its ability to act is limited to making recommendations.
- 4.7 It is proposed that there should be a new arrangement, backed by secondary legislation, under which the relevant RSBs continue to license auditors but where, subject to the consideration of evidence, the FRC has the power to determine and require an RSB to impose sanctions on an audit firm and/or individual auditor for poor quality work.

### **Consultation questions**

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

### **Enhanced independence for the FRC's disciplinary arrangements**

- 4.8 Schedule 10 of the Companies Act 2006 (the Act) requires RSBs to participate in appropriate arrangements for independent investigation for disciplinary purposes of public interest cases arising in connection with the performance of statutory audit functions. The appropriate arrangements set up to meet the requirements of the Act are met by the Accountancy Scheme operated by the AADB.
- 4.9 The Scheme cannot be amended without the agreement of the accountancy professional bodies (including the RSBs). The Government and the FRC are concerned that this requirement is unduly cumbersome and may create the impression that the FRC does not operate independently of the professional bodies or in the public interest. This is in the interest of neither the FRC nor those it regulates.
- 4.10 It is proposed that the arrangements should be changed so that the FRC, subject to appropriate consultation with the professional bodies on the provisions of the

Accountancy Scheme, has the ability to amend the Scheme without the agreement of the professional bodies.

**Consultation questions**

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 accountancy professional bodies?
13. If not, how would you propose the FRC demonstrates its independence in this regard?

## 5 Proportionate regulation

### *Oversight of the audit supervisory and qualifying bodies*

- 5.1 The Secretary of State for Business, Innovation and Skills delegates to the POB oversight of the direct regulation of statutory auditors by professional accountancy bodies recognised for this purpose. Part of the oversight function is to detect and correct non-compliance by a Recognised Supervisory or Qualifying Body with its statutory obligations.
- 5.2 The FRC currently has two statutory enforcement powers. It can remove a body's recognition to offer an audit qualification and/or to supervise auditors; and it can apply for a court order which, if granted, would set out what a body must do to meet its statutory obligations.
- 5.3 The difficulty with both powers is that they are essentially "nuclear" options, which are not proportionate to the issues most commonly faced by the FRC in exercising oversight over the bodies. The powers have not been used in the past and it is unlikely that they would be used, or their use seriously threatened, other than in the most serious of situations.
- 5.4 Whilst the recognised bodies generally take the FRC's findings and recommendations seriously, a more graduated range of powers should sharpen their responses, in particular, the timeliness of actions, and would establish more firmly the independence of the regulator from the regulated. Moreover, the lack of proportionate FRC powers gives a perception that the oversight body is too dependent on the goodwill of the regulated bodies to bring about change.
- 5.5 The FRC considers that the independence of its oversight role would be enhanced if a wider range of proportionate powers were available to it and it needed, therefore, to rely less on influence to bring about timely change. The result should be a more credible deterrent to non-compliance that enhances the FRC's ability to insist on improvements in audit regulation, and thus indirectly in the quality of audit.

#### **Consultation questions**

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?

### Independent disciplinary arrangements

- 5.6 The AADB Accountancy Scheme is based on the provisions of the Act and currently provide that, where a decision to prosecute is made, the matter must proceed to a full public hearing before disciplinary action can be taken. The Scheme does not include a procedure for the early resolution or settlement of cases. This limitation gives rise to a risk of disproportionality, particularly in cases where there is no dispute on the factual issues and/or the appropriate outcome.
- 5.7 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.
- 5.8 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. Where the proposed sanction is not accepted or where a public hearing is otherwise desirable, a full public hearing would be held and the outcomes of all cases whether concluded at a public hearing or by agreement without a hearing would be published. It is proposed that the Act be amended to allow for disciplinary action to be taken whether or not following a public hearing and that the Scheme be amended to allow for procedures concluding matters without public hearings.

#### Consultation question

15. Should the Companies Act and the AADB Accountancy Scheme be amended to allow for the conclusion of cases without public hearings where

appropriate and where agreed by the parties?

## Supervisory inquiries

- 5.9 At present there is no clear mechanism within the UK regulatory structure for an independent and speedy inquiry into an issue affecting confidence in corporate governance and reporting. The Government and the FRC believe that the proposals in this paper, including the delegation of powers to the FRC Board rather than the individual operating bodies and the streamlined governance and structure, will enable the FRC to take the first steps in creating a mechanism that will fulfil this role. The intention would be to 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 and reporting. Such inquiries would enable the FRC to consider whether any further regulatory and/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.
- 5.10 A supervisory inquiry could be conducted, using the FRC's powers - reformed as proposed in this document - as follows:

- An early review by the FRC (consisting of a multi-disciplinary team) which might include, amongst other things, a review of the entity's recent accounts and other information, a review of its audit and possibly interviews with key management and others.
- The findings from a supervisory inquiry might, if appropriate, result in one of the following actions:
  - Issuing general guidance to the market on aspects of governance and reporting.
  - Referral to another regulator, a professional body or another part of the FRC for enforcement action.
  - Amending FRC codes, standards or guidance.

- 5.11 The current regulatory framework does not allow access by the FRC to information for speedy inquiry in the circumstances described above. Whilst the FRRP and the AIU have powers to require information in relation to their respective activities, those powers are only exercisable in relation to their monitoring and reviewing functions.
- 5.12 Consideration will be given in the light of the operation of the FRC following the implementation of the reform proposals to new powers to enable it to require co-operation and the production of information and documentation in relation to its supervisory inquiries and disciplinary arrangements.
- 5.13 If experience suggests that such powers are necessary, the Government will consult on proposals to provide such powers but subject to carefully defined limits on their use, a clear relationship with powers to require information exercised by other authorities, and appropriate safeguards.

**Consultation 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?

## 6 List of consultation questions

The questions asked in this consultation document are as follows:

### **The case for FRC reform**

1. Do you have any comments on the case for FRC reform as set out in this document?
2. Do you agree that the proposals for reform will bring benefits and increase the effectiveness of the FRC?
3. Do you have any comments on the consultation stage impact assessment?

### **An investment focus for the FRC's activities**

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?
5. Is the definition of large private company for this purpose – an annual turnover of £500m or more – appropriate?
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?
7. Are there other areas of activity from which the FRC could appropriately withdraw?

### **A streamlined structure**

8. Do you agree that streamlining the FRC's governance and structure will bring the benefits described?
9. Do you have any comments on the proposed reformed FRC governance and structure?

## Independent supervisory and disciplinary arrangements

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?
11. If not, what are your concerns and how do you believe this issue should be addressed?
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?
13. If not, how would you propose the FRC demonstrates its independence in this regard?

## Proportionate regulation

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?
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?
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?

## 7 How to respond

Responses to the consultation questions should be sent to:

David Andrews  
Financial Reporting Council  
5<sup>th</sup> Floor  
71-91 Aldwych  
London  
WC2B 4HN

Email: [d.andrews@frc.org.uk](mailto:d.andrews@frc.org.uk)

When responding please state whether you are responding as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation represents and, where applicable, how the views of members were assembled.

The deadline for responses is: 10<sup>th</sup> January 2012

### Additional copies

This consultation can be found at: <http://www.bis.gov.uk/consultations> and is also available from the BIS Publications Orderline, ADMAIL 528, London SW1W 8YT, Tel: 0845 015 0020, Minicom: 0845 015 0030. You may make additional copies without seeking permission.

### Confidentiality and data protection

Information provided in response to this consultation, including personal information may be subject to publication or release to other parties or to disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004. If you want information, including personal data that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory code of practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

## 8 Help with queries

Questions about the policy issues raised in the document can be addressed to David Andrews (contact details as above).

If you have any comments or complaints about the way this consultation has been conducted, these should be sent to:

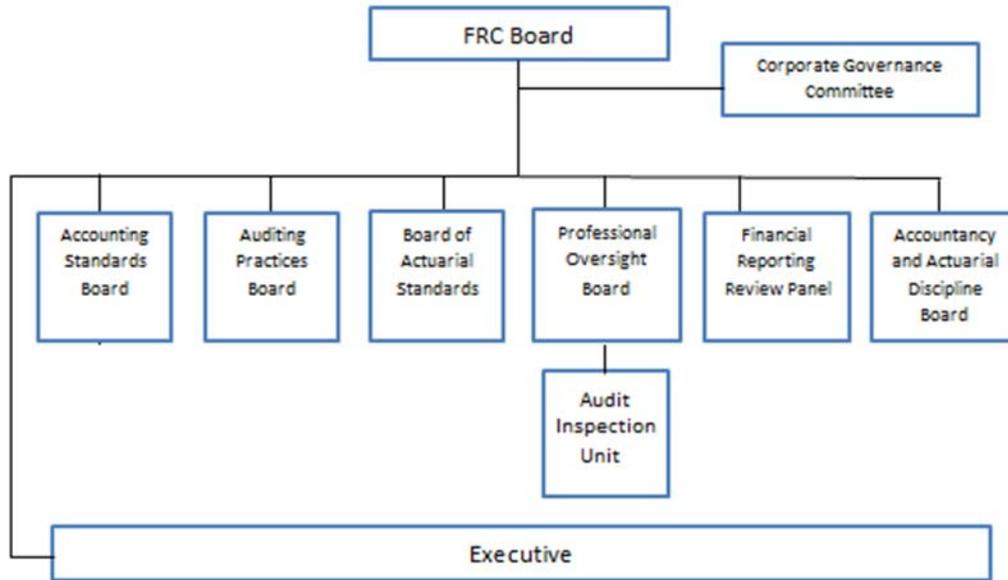
Sameera De Silva  
BIS Better Regulation Team,  
1 Victoria Street,  
London  
SW1H 0ET  
Telephone: 020 7215 2888

or e-mail to: [Sameera.De.Silva@bis.gsi.gov.uk](mailto:Sameera.De.Silva@bis.gsi.gov.uk)

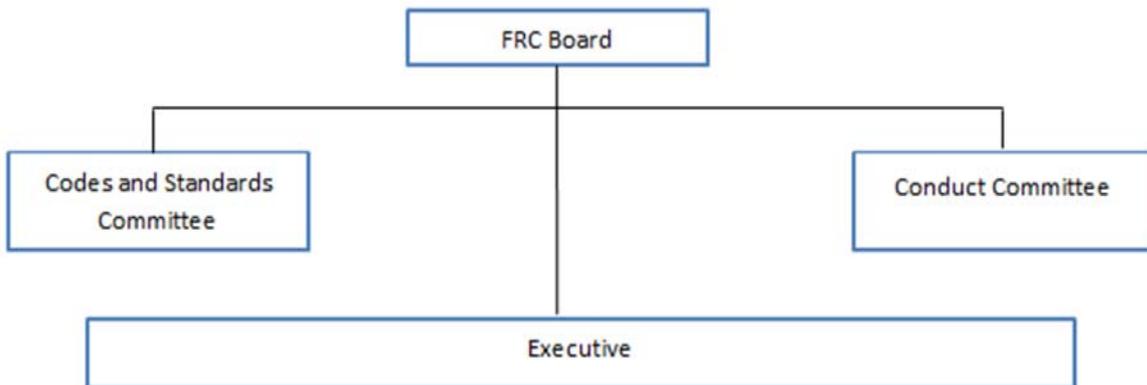
A copy of the Government's Code of Practice on Consultation is attached at Annex D.

## Annex A: Current and proposed structure of the FRC

### Current structure



### Proposed structure



## Annex B: Abbreviations

The following abbreviations have been used in the consultation document:

AADB	Accountancy and Actuarial Discipline Board
AIU	Audit Inspection Unit
APB	Auditing Practices Board
ASB	Accounting Standards Board
BAS	Board for Actuarial Standards
BIS	Department for Business, Innovation and Skills
EU	European Union
EFRAG	European Financial Reporting Advisory Group
EGAOB	European Group of Auditors Oversight Bodies
FRC	Financial Reporting Council
FRRP	Financial Reporting Review Panel
FRS	Financial Reporting Standard
FSA	Financial Services Authority
GAAP	Generally Accepted Accounting Practice
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IESBA	International Ethical Standards Board for Accountants
IFRS	International Financial Reporting Standard
ISA	International Standard on Auditing
POB	Professional Oversight Board
RSB	Recognised Supervisory Body
RQB	Recognised Qualifying Body
TAS	Technical Actuarial Standard
UK GAAP	UK Generally Accepted Accounting Practice

## **Annex C: Consultation Impact Assessment**

The Impact Assessment accompanying this consultation document can be obtained at the following url: <http://www.bis.gov.uk/Consultations>

## Annex D: The Consultation Code of Practice

1. Formal consultation should take place at a stage when there is scope to influence policy outcome.
2. Consultation should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
3. Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
4. Consultation exercise should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
5. Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
6. Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
7. Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

The complete code is available on the Better Regulation Executive's web site, address <http://bre.berr.gov.uk/regulation/consultation/code/>

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