

Independent Review of the Financial Reporting Council



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Independent Review of the Financial Reporting Council

The Rt Hon Greg Clark MP
Secretary of State for Business, Energy and Industrial Strategy
Department for Business, Energy and Industrial Strategy
1 Victoria Street
London, SW1H 0ET

Dear Secretary of State,

In April, you asked me to undertake an independent review of the Financial Reporting Council, to report by the end of 2018. You asked for a root and branch review that would put forward proposals to make the regulator a beacon for the best in governance, transparency, and independence.

This report sets out my conclusions. It makes detailed proposals for a new organisation with a new mandate, a new clarity of mission and purpose, new leadership and new powers.

It will be possible to achieve part, but only part, of what needs to be done without legislation, as I set out in Chapter 7. But I emphasise that to achieve anything like the vision you set out in commissioning the Review, primary legislation will be essential. Only this can give the new organisation the tools it needs to do its job.

I should like to thank:

- First, all those stakeholders who have engaged with the Review and responded to the Review's call for evidence;
- Second, the excellent team which has supported the Review's work: Charlotte Daly; Sanu de Lima; Amy Ellison; Paula Lovitt; Robin Mueller; Samantha Oakley; Ben Robertson; Hitesh Shivam Tank; Peter Stevenson; Chris Thresh; Peter Wade – and in particular Claire Hardgrave who was with the Review from the beginning and bore the brunt of writing this report; and
- Third, all the members of the Review's advisory group – Lucinda Bell; Mark Burgess; John Cridland; Amelia Fletcher; Simon Fraser; Sir Peter Gershon; Nikhil Rathi; and Anne Richards – and especially Dame Mary Keegan and Teresa Graham, who were exceptionally generous with their time, especially in assisting on technical accounting and audit issues. This formidable group provided much wise guidance and counsel, as well as lively challenge and debate. I am hugely grateful. Responsibility for the Review's conclusions and recommendations, however, is mine alone.

Yours sincerely,

John Kingman

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Summary

- 1.** The quality, accuracy and reliability of corporate reporting, governance and audit are fundamental to the trust shareholders, investors and the wider public place in companies. They are the lifeblood of financial markets, contributing to the UK's standing as a pre-eminent international financial centre, financing business investment, and contributing to wider growth.
- 2.** The importance of the Financial Reporting Council's (FRC) role in this context is clear. The FRC sets the governance standards the UK's biggest companies are expected to live up to. It inspects the figures companies produce, and it oversees the quality of the audit work that is supposed to keep those figures honest. It therefore makes, or should make, a critical contribution to trust in business.
- 3.** Yet, having spent most of its institutional life largely in obscurity, the FRC now finds itself subject to tough and persistent criticism. Two major Select Committees have accused it, in the strongest terms, of timidity, a lack of pace and excessive closeness to those it regulates. These criticisms have put the FRC under an unprecedented spotlight.
- 4.** What this spotlight has revealed is an institution constructed in a different era – a rather ramshackle house, cobbled together with all sorts of extensions over time. The house is – just – serviceable, up to a point, but it leaks and creaks, sometimes badly. The inhabitants of the house have sought to patch and mend. But in the end, the house is built on weak foundations.
- 5.** It is time to build a new house.
- 6.** The Review believes that the FRC should be replaced with a new body which:

 - Has a clear and precise sense of purpose and mission;
 - Is firmly focused on the interests of consumers of financial information, not producers;
 - Is respected by those who depend on its work, and where necessary feared by those whom it regulates;
 - Has the right powers and resources it needs to do its job; and
 - Is able to attract the highest-quality people.
- 7.** These are not unrealistic aspirations for a regulator. Broadly speaking, all these things are now, after a decade of post-crisis reconstruction, true for both of the UK's two main financial regulators. At the FRC, by contrast, none of these things is consistently true.

8. In fact, the financial crisis as much reflected failings in accounting and financial reporting as anything else. Yet at the time of the crisis, the FRC went through nothing like the same radical soul-searching and reform as its fellow financial regulators.

The FRC: strengths

9. Before addressing the FRC's weaknesses and the need for change, it is important to acknowledge some clear strengths:

- The UK is reasonably respected amongst the international regulatory and standard-setting community.
- The FRC has been an effective custodian of the UK Corporate Governance Code, which is still rightly regarded as world-leading.
- The FRC has been willing to act even beyond its limited statutory powers, for instance putting in place arrangements to enhance monitoring of the Big 6 audit firms on a voluntary basis, including on the suitability of significant senior appointments, notwithstanding the absence of any formal power to do so.
- Some of the FRC's innovations, for instance the creation of the Financial Reporting Lab, have been notably successful.

10. The Review has also been struck by the thoughtful and constructive way in which FRC staff at all levels have engaged with this Review, and embraced the opportunity to make positive suggestions for change. The FRC has some excellent people.

The FRC: current constraints on its effectiveness

11. An objective account of the FRC's strengths and weaknesses must also acknowledge – as this Review acknowledges – that many of the FRC's deficiencies are to some extent the product of its history and the limited hand it has been dealt by successive governments. For instance:

On the FRC's status:

- It is only slowly that the FRC has become to be seen as a regulator at all. It did not start life as one, and expectations have shifted substantially over time.
- Uniquely amongst major UK regulators, it has no meaningful statutory base.
- For much of its history, the FRC was not a public institution at all, but – oddly – a private one.
- Its board is largely self-perpetuating, with government involvement only in relation to the appointments of the Chair and Deputy Chair (and that based only on an informal agreement).
- It is still titled a 'Council', not an 'Authority' or 'Regulator'. At one level this is a minor presentational point. But it does reflect the FRC's origins in a different, more corporatist and self-regulatory era, and traces of this mindset remain.
- It has acquiesced in numerous extensions of its role over the years, not all of which have helped enhance its organisational coherence.

On its powers:

- The FRC¹ still operates under a clear Direction from government, dating from 2016, requiring it to rely on delegation to industry bodies “to the maximum extent possible”.
- This means, for instance, that the FRC has no direct regulatory purchase on the major audit firms. It means that some of the biggest and most important economic actors in the UK are still regulated not by an independent body but, in effect, by their trade association.
- In a number of important areas, notably oversight of regulation of the actuarial profession and local authority audit, the FRC’s powers are limited or even non-existent, leaving it in the unfortunate situation of having been given responsibility without power.

And in relation to its resources:

- The FRC is still partly funded through a voluntary levy. This voluntary aspect of a regulator’s funding, depending each year on the willingness of companies and others to contribute, is seriously inappropriate. It creates a clear danger of blunting the FRC’s incentive to bite the hand that feeds.
- Following the FRC’s reclassification as a public body, the Government is currently in the process of imposing a series of new operational controls on the FRC. The Department for Business, Energy and Industrial Strategy (BEIS) and HM Treasury are asking the FRC to apply Public Sector Pay Guidance structures even to highly specialist roles; and any appointment over £100,000 currently requires approval by a BEIS committee. The Review is clear that this approach will, if continued, be very damaging and will make the FRC significantly less effective than it is today. It is inappropriate for a body that receives no taxpayer funding. Other market-facing regulators, such as the Prudential Regulation Authority (PRA), Financial Conduct Authority (FCA), and Office of Communications (Ofcom), do not operate on this basis.

The FRC: other weaknesses**12.** The Review has also identified a number of further significant concerns:

- Whilst the FRC’s powers are clearly deficient, the FRC has failed to make the case for change, or has failed to make its case persuasively.
- More generally, the Review does not believe that the FRC has been as effective as it might have been in shaping the debate on major issues related to its work, such as the so-called audit “expectations gap”, or on competition in audit, or auditor rotation, or on the relationship between audit and non-audit work.
- The FRC’s work on audit quality does not command the same credibility as that of, for instance, the Public Companies Accounting Oversight Board (PCAOB) in the United States.
- The FRC’s Corporate Reporting Review (CRR) work is limited in its scale and scope. It excludes key areas of reporting, including companies’ reporting against the principles and provisions set out in the UK Corporate Governance Code, and their remuneration reports.

¹ As the Competent Authority in respect of statutory audit.

- The FRC has not, to date, been a particularly effective champion of the need for annual reports and accounts to be comprehensible and of genuine value for their readers, rather than simply to provide ever greater volumes of information.
- The Review is not convinced that the FRC's relationships with the investment community are as deep as they should be. To be fair, it is equally true that investors are not as engaged, particularly in audit and accounting issues, as they could or should be. Nevertheless, it is only very recently that the FRC created a forum to engage with investors, and that committee is heavily focused on Environmental, Social and Governance (ESG) specialists as opposed to investment decision-makers.
- The Stewardship Code, whilst a major and well-intentioned intervention, is not effective in practice.
- Co-ordination with other regulators – especially the Insolvency Service which operates powers to act against directors of companies – appears limited and deficient.
- The FRC's approach to the recruitment of board and council members appears surprisingly, and inappropriately, informal, often not employing open advertising or using headhunters, and sometimes even relying on the alumni networks of the largest audit firms. Of the 21 vacancies in relevant positions between 2016 and 2018 only one role was advertised in the national press, and just 6 involved external search consultancies.
- The organisation's staffing and culture is not as open and attractive to the best talent as it could be. The FRC needs to become, in the words of a distinguished international stakeholder, *“a place where you go to enhance your career, not a place where you end your career”*.
- The FRC has previously applied an inconsistent and incomplete approach to managing conflicts of interest, only very recently publishing its hospitality register and adopting a standardised approach to recording declarations of interests for staff. It has chosen not to adopt an open and competitive approach to procurement, and there is no uniform approach to record the deployment of staff to work on matters relating to former employers nor the steps taken to mitigate any risks that could bring.
- Freedom of Information (FOI) provisions do not apply to all of the FRC's statutory functions, and there is limited transparency around significant areas of the FRC's work.
- There has also been a persistent tendency for important FRC decisions to leak in advance (a full list is set out in Chapter 4). These leaks are very damaging to the FRC's standing and credibility. This occurs only rarely with other major regulators. It needs to stop.

13. All in all, the Review considers that some of the FRC's critics overstate their case. Nevertheless, the Review does have sympathy with the view that the FRC has tended, overall, to take an excessively consensual approach to its work. The FRC's approach to its own governance has also not been consistent with either its public importance, or its role in championing governance in the corporate world.

Summary of main recommendations

The FRC should be replaced as soon as possible with a new independent regulator with clear statutory powers and objectives. It should be named the Audit, Reporting and Governance Authority.

The new body should be accountable to Parliament, with the Chair and Chief Executive subject to a pre-approval hearing with the BEIS Select Committee, and appearing annually in front of the Select Committee. The Government should issue a remit letter to the regulator, at least once each Parliament, as it does for the FCA and PRA.

The regulator should have an overarching duty to promote the interests of consumers of financial information, not producers. It should also have a duty to promote competition; a duty to promote innovation; and a duty to apply proportionality to all its work.

A new board should be appointed. This should have some, but limited, continuity with the existing board. It should be significantly smaller than the FRC's. It should not seek to be "representative" of stakeholder interests.

The board should cease to be self-perpetuating. All appointments to the new board should be public appointments. All appointments to both the board and committees of the new regulator should be advertised, and headhunters should be used. The regulator's sub-board structure should be simplified.

The board of the new regulator should exercise significantly stronger ownership and oversight of the regulator's investigation and enforcement functions.

The regulator should be better equipped to ensure that its work and decision-making is informed by market analysis, particularly the dynamics of the audit market. It should have a view on the economics of audit and whether audit work is being properly resourced and priced.

The current self-regulatory model for the largest audit firms should end.

The Government should review the UK's definition of a Public Interest Entity (PIE).

The new regulator should work towards a position where individual audit quality inspection reports, including gradings, are published in full upon completion of Audit Quality Reviews (AQRs). This will, however, be a major step, requiring a high level of confidence in the AQR process. For the present, as a first and interim step, the Review recommends publication of AQR reports on an anonymised basis.

The regulator's corporate reporting work should be extended from its current limited scope to cover the entire annual report. It should be given stronger powers to require documents and other relevant information in order to conduct that review work. The regulator should be given the power to require restatements promptly (rather than requiring a Court Order).

The Government, working with the FCA and the new regulator, should consider whether there is a case for strengthening qualitative regulation around a wider range of investor information than is covered by the FRC's existing corporate reporting work, to ensure that disciplines to drive up the quality of companies' disclosures in the UK are at least as demanding as best practice internationally.

The Government, working with the new regulator, should develop detailed proposals for an effective enforcement regime in relation to PIEs that holds all relevant directors, not just members of professional bodies, to account for their duties to prepare and approve true and fair corporate reports and to deal openly and honestly with auditors.

The regulator should ensure that a consistent approach is taken in enforcement action against auditors, accountants, and responsible non-member directors by putting in place schemes that are equivalent to the Audit Enforcement Procedure (AEP).

The Review recommends that CRR findings are reported publicly by the regulator. The regulator should publish full correspondence following all CRR reviews, and the findings should be published in a set timeframe following closure of a review. The new regulator should develop a new capability to offer pre-clearance on interpretation of relevant standards.

BEIS should monitor closely the speed and effectiveness of the regulator's performance on enforcement to ensure that previous long delays do not recur. The regulator should report annually to Parliament on its enforcement performance.

In relation to the regulator's oversight of professional accountancy bodies, the Government should put a backstop statutory power in place, that would require action to be taken by a professional body if there was a need in the public interest.

The regulator should be required to promote brevity and comprehensibility in accounts and annual reports, to engage meaningfully with investors and asset owners about their information needs, and to ensure the proportionality and value of reports. At least once in every Parliament, the regulator should report on its assessment of the extent to which the statutory reporting framework is serving the interests of users of company reports.

The new regulator should be more sparing and disciplined than the FRC in promulgating guidance and discussion documents. These documents should only be issued if they are genuinely useful, and their utility clearly exceeds the considerable costs they impose through users having to read and check them.

A fundamental shift in approach is needed to ensure that the revised Stewardship Code more clearly differentiates excellence in stewardship. It should focus on outcomes and effectiveness, not on policy statements. If this cannot be achieved, and the Code remains simply a driver of boilerplate reporting, serious consideration should be given to its abolition.

The regulator needs to engage at more senior level in a much wider and deeper dialogue with UK investors, both fund managers and representatives of end-investors.

The regulator should not be funded on a voluntary basis. BEIS should put in place a statutory levy.

The regulator must be able to recruit staff of the calibre, expertise and seniority necessary to hold those regulated to account. It should recruit more partner-equivalent staff, adding weight and commanding more substantial respect in conversations with firms. The regulator should also develop a pool of 'grey panthers' whose expertise could be drawn on when needed.

The regulator is a market-facing body which, like other financial regulators, is funded by those it regulates, not the taxpayer. Accordingly, the control arrangements on pay for the new regulator should mirror those of other financial regulators such as the FCA, PRA and Ofcom which are not funded by the taxpayer. The regulator's budget should be set by Ministers, as should the CEO's pay, but other pay decisions should be made by the regulator subject, of course, to proper transparency, and within the overall financial budget set by Ministers.

For the foreseeable future, the new regulator should not allow staff, or board or committee members ever to work on any regulatory functions relating to a past employer, removing themselves and/or delegating to others as necessary.

The regulator should engage closely with the proposed work on the future of audit and help ensure that its conclusions are put into effect. This work should be firmly driven by the interests of consumers and users of audited figures, not producers or the audit profession.

A new regulator

The Audit, Reporting and Governance Authority should be an independent regulator, accountable to Parliament and to the Department for Business, Energy and Industrial Strategy (BEIS). It should have the following strategic objective and operational duties:

Strategic objective

To protect the interests of investors and the wider public interest by setting high standards of corporate governance, corporate reporting and statutory audit, and by holding to account the companies and professional advisers responsible for meeting those standards.

Operational duties

In pursuing its strategic objective, it must act in a way that:

- is forward looking, seeking to anticipate and where possible act on emerging corporate governance, reporting or audit risks, both in the short and the longer term;
- promotes competition in the market for statutory audit services;
- advances innovation and continuous quality improvements;
- promotes brevity, comprehensibility and usefulness in corporate reporting;
- is proportionate, having regard to the size and resources of those being regulated and balancing the costs and benefits of regulatory action;
- is collaborative, working closely with other regulators both in the UK and internationally; and
- prioritises regulatory activity on the basis of risk, having regard to the Regulators' Code.

Corporate failure

14. Part of the genesis of this Review was a concern in some quarters that a more effective FRC could do more to avert major corporate collapses, such as that of Carillion plc.

15. The Review was not asked to conduct, and has not conducted, any post-mortem into the Carillion collapse. Nevertheless, it has very carefully considered the wider question.

16. The Review believes, first, that a degree of realism is necessary. Companies will sometimes fail. To some degree, despite the very painful dislocation this can cause, this is inevitable in a vibrant and competitive economy.

17. Nor does the Review believe it would be feasible or desirable to charge a new regulator with a general responsibility to oversee the workings of all companies, their management, strategy and operations. No country in the world has attempted such a regulatory regime.

18. The Review does, however, consider that there is more that could and should be done by the regulator, where feasible, to act on intelligence and to identify problems earlier. The FRC's current practice, which is focused on the promotion of good corporate governance, and on work which is important but inherently backward-looking on corporate reporting and audit quality, could and should be supplemented by new forward-looking powers.

Recommendations

The Review believes that a number of measures could be put in place, which could be workable and make a meaningful difference:

- First, the regulator should develop a robust market intelligence function to identify emerging risks by better informing itself about sectoral, thematic and individual company trends, drawing together market and internal intelligence, and conducting economic and risk analysis.
- Second, the Review proposes that the new regulator should be given a new power to look into concerns relevant to the regulator's strategic objective. Such concerns might stem from the regulator's work on corporate reporting and governance; they might result from whistleblowing from members of staff or an auditor; or they might stem from evidence of investor disquiet. The regulator should be empowered to issue a public report if appropriate.
- Third, the regulator should be able to deploy a range of responses, appropriate to the circumstances. The Review suggests that those could include modest steps such as notifying the company of its views of the risks and requiring the company to make a rapid formal response; requiring additional assurance on the viability statement or any other aspect of the company's reports or accounts; requiring an independent board evaluation, or examination of the audit committee; repeating AQR or CRR inspections more quickly than usual; or ensuring that problematic issues are raised with other regulators or standard setters. But stronger measures should also be available where serious concerns about governance or financial viability come to light. The regulator should be given new powers to order the removal of the auditor or an immediate retendering. It should be able to require the production of a recovery plan; and the prompt restatement of accounts, or other disclosure to the market. In the most serious cases, the regulator should also be able to recommend to shareholders that they consider a change of CEO, CFO, chair or audit committee chair, or that they reconsider the payment of dividends.

- Fourth, the Government should introduce a duty of alert for auditors to report viability or other concerns relating to audit.
- Fifth, viability statements should be reviewed and reformed with a view to making them more effective. If they cannot be made more effective, serious consideration should be given to abolishing them.
- Sixth, a number of stakeholders have suggested to the Review that there is a case for considering introducing in the UK something more closely similar to, though not the same as, the Sarbanes-Oxley (SOX) regime in the US specifically relating to internal controls, and assurance by directors around internal controls. The Review is particularly struck by the support for this amongst senior audit committee chairs with experience of operating this regime in US-listed companies. This would however clearly be a very major step. It could impose significant costs, particularly on medium-sized companies. BEIS should give serious consideration to the case for a strengthened framework around internal controls in the UK, learning any relevant lessons from operation of the Sarbanes-Oxley regime in the US. The pros and cons of such a change should be analysed and consulted upon, giving special consideration to the importance of proportionality in relation to the size of company.
- The Review also recommends that the regulator considers requiring further enhancement to the Independent Auditor's Report to include "graduated" audit findings.

19. These measures cannot eliminate the risk of corporate collapse. But they will better and more explicitly equip the regulator with the tools and the responsibility to take early action when it is feasible and practical to do so.

Structural questions

20. Whilst the Review believes the FRC should be put onto a very different basis in a new organisation with new roles, functions, and powers, it has not recommended major structural change, for instance merger with another regulator or splitting standard-setting from enforcement.

21. A case can be made for such changes, and has been made by some respondents, but the Review is not persuaded that they would be the best way to achieve more effective regulation. The Review's thinking on these questions is set out in detail in Chapter 1.

Other issues: actuarial oversight

22. Following Sir Derek Morris' review of the actuarial profession in 2005, a memorandum of understanding (MoU) was put in place between the FRC and the Institute and Faculty of Actuaries (IFoA), which sought to give the former an oversight (and standard-setting) role in relation to the actuarial profession. However, this is not in practice proving an altogether effective arrangement. The FRC's oversight role is based on a voluntary understanding, and it has no powers with which to enforce any meaningful oversight of the IFoA. More than 13 years after Sir Derek reported, only now is the IFoA embarking on a first attempt at quality regulation of the profession. Moreover, the FRC has limited actuarial expertise and resource.

23. HM Treasury has told the Review that it wishes to see effective regulatory oversight of the actuarial profession. The Government Actuary has said the same.

24. The Review:

- Sees a very real risk that stakeholders may be assuming that the FRC's current oversight of the actuarial profession is a great deal more thoroughgoing and effective than, in the absence of credible powers, it actually is or can be;
- Suggests that, if stakeholders wish to see effective independent oversight of regulation of the actuarial profession, suitable legal powers must be put in place to make this possible;
- Questions whether the FRC is the best body to do this; and
- Suggests in any event that regulation of actuarial work, as opposed to the profession, is likely to have considerably more impact than regulation of the profession ever can. This is done very thoroughly by the PRA for insurance companies, through scrutiny of actuarial models. This is however much less the case for pension schemes.

Recommendations

- The Government, working with the PRA and The Pensions Regulator (TPR), should review what powers are required effectively to oversee regulation of the actuarial profession.
- The Review recommends that neither the FRC, nor its successor body, is best-placed to be the oversight body. The PRA (which employs around 80 actuaries) is a much larger repository of regulatory actuarial expertise than the FRC and would be best-placed to take on all the actuarial responsibilities currently vested in the FRC.

Other issues: local audit

25. Following the abolition of the Audit Commission (AC) in 2015, the framework for the local audit regime was split. It is now complex and fragmented. For England, the FRC is responsible for inspecting the quality of audits of the largest local public bodies; overseeing the regulation of relevant audit firms and auditors by relevant Recognised Supervisory Bodies (RSBs); and setting specific statutory requirements on auditors.

26. There are important differences between local authority audit and private sector audit:

- Auditors of local public bodies report not only on the financial statements, but also on arrangements for securing value for money, and financial sustainability;
- Auditors of those bodies carry out their work on behalf of the public, yet in comparison to the lines of accountability in companies between the directors, audit committee and shareholders, there is substantially lower awareness and challenge of the auditors' work in the public sector;
- The FRC's enforcement powers in relation to local audit are meaningfully different in comparison to its powers in relation to private sector statutory audit. The former are not within scope of the Audit Enforcement Procedure. Instead of the question as to whether an auditor has 'breached a relevant requirement', a far narrower test applies in relation to local audit – that there are reasonable grounds to suspect misconduct, and that the matter appears to raise 'important issues affecting the public interest'; and

- Unless the local body is also a PIE, there are no requirements regarding the rotation of auditors.

27. Historically, the AC also appointed auditors to a range of local bodies in England and Wales, as well as setting and overseeing relevant standards, and conducting UK-wide anti-fraud work. Since the AC's abolition in 2015, the new local audit framework enables bodies to procure and appoint their own auditors from an open and competitive market of qualified providers. However, 98% of relevant authorities have opted into a central procurement body. The Review has serious concern that those arrangements, in practice, are prioritising a reduction in cost of audit at the expense of audit quality.

28. These arrangements, if allowed to persist, run a very clear risk of allowing weak and limited audit disciplines to prevail in local government. This is particularly concerning given the vital role played historically by district auditors for instance, in detecting and seeking out corruption.

29. Particularly at a time when local authorities are under acute financial pressure, and some local authorities are engaging in risky speculative ventures, high-quality and robust scrutiny of local authorities' finances and financial management in the public interest is a critical part of local democracy. The Review is very concerned that the quality of this scrutiny is being pared back at the worst possible time.

Recommendations

- The Review recommends that the arrangements for local audit need to be fundamentally rethought. This should include robust assessment and scrutiny of the quality of local audit work, with individual reports shared with audit committees and published; a more appropriate threshold for enforcement action; and, bringing together in one place all the relevant responsibilities, so a single regulatory body can take an overview.
- Such a role (regarding local audit) could be taken on by the FRC or its successor body, but the Review recommends that it would be much better undertaken by a separate body that has (or could develop) a deeper expertise in the local audit world. That body should have a different and much more focused remit than the former Audit Commission. It should have a clear objective to secure quality, and should set the relevant standards, inspect the quality of relevant audit work and oversee the relevant professional bodies. It should also take on responsibility for appointing auditors for local bodies and agreeing fees.

Other issues: oversight of the NAO

30. Audits carried out by the National Audit Office (NAO) in relation to companies (such as Network Rail, and parts of the BBC) are subject to oversight and monitoring by the FRC. Accordingly, the FRC carries out a number of AQRs for relevant audit work, which are shared with the NAO. The results of those AQR reports are not, however, shared with the audit committee of the company itself, nor are they reported to Parliament or made public.

31. The Review also questions whether there is any good justification for the present restriction of the FRC's work to Companies Act audits, and whether there is not also a public interest in the rest of the NAO's audit work also being subject to quality oversight. At present, there is no statutory requirement to examine the quality of financial audit work undertaken

for Departments, Agencies, Arm's Length Bodies, or Charities. Given the size, systemic importance, and Parliamentary and public interest in their financial reporting, the Review considers it would be just as important and valuable to inspect the quality of audit work conducted for such bodies.

Recommendations

These are clearly matters for Parliament to decide. Nevertheless:

- The Review sees no credible justification for limiting the role of the regulator to reviewing Companies Act audits, or to limiting any work beyond that to the discretion of the Comptroller and Auditor General (C&AG). The Review recommends that the regulator should quality-assess all the NAO's financial audit work, in a similar way to its existing work on Companies Act audits.
- Just as the Review recommends public disclosure of AQR findings and gradings in relation to the private sector, the Review recommends that the new regulator's individual AQR reviews in relation to the NAO should be shared with the relevant audit committee and Parliament, and should be published.

Interim steps

32. Many of the Review's recommendations would require primary legislation. Naturally, this will take time. But in the meantime, there is much that can be implemented more quickly.

33. Given the broad consensus and support for improvements in key areas, it is the Review's expectation that the actions below should be taken forward voluntarily by the FRC or with relevant changes to secondary legislation in the first instance.

34. The Review recommends that the FRC and the Government should work together to:

- Shift the FRC's mission and purpose to those set out in this Review – as a public body and independent regulator, and in line with the proposed strategic objective of the new body. This should include adoption of the Managing Public Money requirements, the Regulators' Code, and appropriate FOI and conflicts of interest arrangements. As part of that work, the FRC should introduce a new consistent and centrally managed complaints procedure, and publish information on how that will operate.
- Introduce a remit letter from government.
- Change the FRC's framework agreement with BEIS, and its internal governance documentation, in line with the Review's recommendations, making clear that the Chief Executive and all board members are public appointments that will be advertised through open and transparent means. BEIS should remove the requirement to clear pay and HR matters, in line with the Review's recommendations.
- Reshape the Board in line with the Review's recommendations.
- Develop a new resourcing and capability plan and pay strategy, to include the new areas of work proposed by the Review, addressing the calls for greater resource, a broader range of skills, and increased seniority and experience for key areas.

- Begin work on market and economic analysis; and undertake cost-benefit analyses of its programmes and proposed changes.
- Significantly step-up co-ordination with the Insolvency Service, including agreeing an MoU with that body.
- Reshape engagement with investors and asset owners.
- Take forward the Review's recommendations on the Stewardship Code, and the viability statement.
- Take interim measures to increase the regulatory reach of the FRC in terms of the direct registration and regulation of PIE audit firms. This would include revising the current delegation letter from the Secretary of State, the eligibility criteria and guidance set by the FRC in relation to its RSBs, and the delegation agreements with the RSBs.
- In relation to funding, activate the existing Companies (Audit, Investigations and Community Enterprise) Act 2004 provisions for the voluntary levy to be made compulsory.
- Play an active role in relation to work on the audit expectation gap and solutions for that.

Chapter 1 – FRC: structure and purpose

Background

1.1 The Financial Reporting Council (FRC) was established in 1990, in response to recommendations in Sir Ron Dearing's 1988 report, 'The Making of Accounting Standards'. Before then, the oversight of standards for accounting and financial reporting had been carried out – and funded – by the UK's (then) six professional accountancy bodies through the Consultative Committee of Accountancy Bodies. Sir Ron's report recognised the need for improved accounting standards delivered by an independent body to increase confidence in financial reporting.

1.2 This remit was extended in 1992 to cover corporate governance at quoted companies, in response to Sir Adrian Cadbury's report on 'Financial Aspects of Corporate Governance' which set new baseline standards to improve independence, integrity and challenge in company boardrooms. The Cadbury recommendations were implemented through changes to the UK Listing Rules in 1992 and were subsequently incorporated, along with Sir Richard Greenbury's 1995 recommendations on executive remuneration, into a Combined Code on Corporate Governance published in 1998. The Code has been through several revisions since then and has since 2009 been known as the UK Corporate Governance Code. Its provisions must be followed on a 'comply or explain' basis by all UK premium listed companies under the Listing Rules.

1.3 Over time, the regulator has taken on a number of other responsibilities. Since 2005 it has been responsible for audit, overseeing regulation of actuaries and the independent setting of actuarial standards (in response to the Morris Review of the actuarial profession). And since 2010, it has been responsible for maintaining the UK Stewardship Code, which sets out principles of good stewardship for UK asset managers and asset owners (in response to a recommendation in the 2009 Walker Review of corporate governance in the financial sector). Additionally, the FRC's core accounting and audit responsibilities have broadened over time to include, for example, various functions related to local public sector audit and independent supervision of Auditors General.

1.4 The FRC was created as a company limited by guarantee, which it remains today. It is now classified by the Government and the Office for National Statistics as a public (central government) body in view of the various statutory functions it fulfils and powers delegated to it by the Secretary of State².

² In particular, following changes introduced by the Companies (Audit, Investigations and Community Enterprise) Act 2004, the Companies Act 2006 and by European law.

1.5 Additionally, since 2016 the FRC has been the UK Competent Authority for Audit, following implementation of the 2014 Audit Directive in the UK.

1.6 The FRC's funding has evolved over time and it is now funded through a mix of statutory and voluntary funding arrangements, provided mainly by accountancy professional bodies (mostly statutory contributions) and by quoted and large private companies, pension schemes and insurance companies (voluntary contributions).

1.7 The FRC's governance structures have also developed. In particular, in 2012, following a joint government-FRC consultation³, seven discrete operating subsidiaries were rationalised into two committees – the Codes and Standards Committee and the Conduct Committee – both of which report to the FRC Board.

Statutory base

1.8 The FRC's lack of a clear statutory base provided by Parliament is very unusual for a regulator. The FRC currently relies on a blend of statutory functions and limited delegated powers (mainly in relation to audit) and voluntary agreements (in particular regarding its oversight of the accounting and actuarial professions). Whilst the FRC undertakes some statutory functions in their execution, the FRC is not bound by any statutory duties.

1.9 This ad hoc series of arrangements and understandings is not appropriate and significantly limits the FRC's effectiveness. The absence of clear statutory duties is also a weakness in that there is no real clarity around what the FRC is to achieve, or how it can properly be held to account by Parliament and others.

A new regulator

Recommendation 1: The Review recommends that the FRC should be replaced as soon as possible with a new independent regulator with clear statutory powers and objectives.

Recommendation 2: The Review recommends that the new regulator's statutory powers, purpose and objectives should be complemented – like the FCA's – by a remit letter from the Government at least once during the lifetime of each Parliament setting out those aspects of economic policy that the regulator should have regard to when advancing its objectives and discharging its duties. The regulator should respond publicly to this letter.

³ <https://www.gov.uk/government/consultations/financial-reporting-council-reform>

Alternative structures

The Review has considered carefully a range of suggestions that responsibility for audit, reporting and governance standards be broken up and assigned separately to different regulators, or that the FRC be merged with another existing regulator, such as the FCA.

A case can certainly be made for such changes, and was made by some respondents. However, the Review has concluded that this would not be the best way to secure the Government's objectives in relation to the FRC. The Review:

- Believes that there are genuine synergies between most of the FRC's current functions, especially its work on audit quality, corporate reporting and corporate governance. If anything, the Review would like to see significantly more made of these synergies, not less;
- Considers that whilst a case can certainly be made for merger with the FCA in particular, and other countries do have combined structures of this kind, in practice the Review is concerned that the FCA's responsibilities already cover an extraordinarily broad span, and it already has many pressures and challenges to juggle. The Review considers that this kind of merger would, in practice, impede the speed with which the FRC can be strengthened and reshaped; and
- Is not convinced that a split between the FRC's standard-setting and enforcement roles, advocated by some respondents, is in practice necessary or likely to lead to enhanced outcomes for the reasons set out below.

Recommendation 3: The Review recommends that the new regulator should be named the Audit, Reporting and Governance Authority.

Recommendation 4: The Review proposes that the new regulator should have the following strategic objective:

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

1.10 The pursuit of the strategic objective will require a clear set of underpinning duties to guide the new regulator in how it acts, how it priorities its resources and how it measures success.

1.11 In particular, it is important that the new regulator takes a proportionate and risk-based approach, which focuses effort and challenge on the areas of greatest potential harm.

1.12 The new regulator will also need to work more closely, systematically and effectively with other regulators in the UK, including the FCA, the Insolvency Service, the PRA and the TPR. This should be formally embedded into the new regulator's policies and procedures.

Recommendation 5: The full set of duties that the Review proposes be placed on the new regulator are below, requiring that it should act in a way which:

- **Is forward-looking, seeking to anticipate and where possible act on emerging corporate governance, reporting or audit risks, both in the short and the longer term;**
- **Promotes competition in the market for statutory audit services;**

- Advances innovation and quality improvements;
- Promotes brevity, comprehensibility and usefulness in corporate reporting;
- Is proportionate, having regard to the size and resources of those being regulated and balancing the costs and benefits of regulatory action;
- Is collaborative, working closely with other regulators both in the UK and internationally; and
- Prioritises regulatory activity on the basis of risk, having regard to the Regulators' Code.

Recommendation 6: The Review recommends that the new regulator's duties will guide the new regulator in carrying out its core functions on audit and corporate reporting. The Review proposes that its functions should also include:

- To set and apply high corporate governance, reporting and audit standards;
- To regulate and be responsible for the registration of the audit profession;
- To maintain and promote the UK Corporate Governance Code and the UK Stewardship Code, reporting annually on compliance with the Codes;
- To maintain wide and deep relationships with investors and other users of financial information;
- To monitor and report on developments in the audit market, including trends in audit pricing, the extent of any cross-subsidy from non-audit work and the implications for the quality of audit; and
- To appoint inspectors to investigate a company's affairs where there are public interest concerns about any matter that falls within the Authority's statutory competence.

1.13 The successful delivery of the new strategic objective, and the supporting duties and functions, will demand strong leadership. It will require a regulator that is able to anticipate and shape emerging issues and ideas, as well as being a tough and respected enforcer of standards. The new regulator will need to be at the leading edge in the development of audit, corporate reporting and corporate governance in the UK and globally.

Role of the board

Recommendation 7: The new regulator will require a new board with significant new powers and responsibilities in a challenging environment. It will need to demonstrate strong leadership to effect the major shift in tone and culture to rebuild the respect of those it regulates and other stakeholders. There should be some, but only limited, continuity from the existing FRC board.

An improvement regulator

Many respondents, particularly audit firms, have argued that the new regulator should act as more of an “improvement regulator”. Specifically, it has been repeatedly argued that the new regulator can usefully learn from the safety regulation work of the Civil Aviation Authority (CAA), and the way in which the CAA works with airlines.

The Review agrees that the new regulator should be, and should think of itself as, an improvement regulator. However, the Review also believes it is important to be precise about what should be meant by this term.

It may well be possible to learn from the CAA’s respected work and approach. However, it is essential to be clear about the radically different industry context. An airline already has extraordinarily strong commercial incentives not to allow aeroplanes to fall out of the sky, devastating its business and brand. The commercial pressures on auditors to pursue stringent, challenging and high-quality audits are much weaker than this. The direct read-across in terms of regulatory approach is therefore limited, or at any rate should be interpreted with care.

To be clear, an improvement regulator should not be a soft regulator. What it should do is use all the available levers it has – including robust enforcement and the powerful deterrent effect this can create – to maximise self-reinforcing incentives to pursue quality and best practice.

The Review has been struck in this context by the apparent respect of the major audit firms for the tougher approach of the PCAOB in the US, and the benefits this has brought.

The Review strongly agrees with respondents that the regulator should be very concerned with the effective diffusion of innovation and best practice, particularly in relation to audit quality. Some of the FRC’s innovations, such as its thematic reports and the work of the Financial Reporting Lab, are already good examples of this.

In addition, the regulator should take responsibility for improvement over and above checking the work of others, and reporting on trends. The regulator’s action needs meaningfully to contribute to improvement and it will therefore need to improve and innovate itself in order to achieve that.

Board size and composition

1.14 The current FRC board is comparatively large. There are 14 board members – 13 of whom are non-executives.

Figure 1: Regulators’ boards

| Regulator | Total board size | Executives | Non-executives |
|---------------------------------------|------------------|------------|----------------|
| FRC | 14 | 1 | 13 |
| Financial Conduct Authority | 10 | 2 | 8 |
| Prudential Regulation Authority | 12 | 6 | 6 |
| Competition and Markets Authority | 11 | 4 | 7 |
| The Office for Communications | 9 | 2 | 7 |
| Gas and Electricity Markets Authority | 7 | 1 | 6 |

Source: regulator’s websites

1.15 Many respondents to the call for evidence believed that the FRC’s board was too large. The FRC has told the Review that the breadth of its responsibilities and the number of stakeholder groups that needed to be regulated or served had led it to having a large board, but that it had plans for reducing its size.

Recommendation 8: The Review recommends that the new regulator’s board should be significantly smaller than the current one.

1.16 The Review is concerned by what appears to be a widespread assumption that the FRC’s board should in some sense be “representative” of the many stakeholders affected by its work. Many respondents, in fact, asked for additional representatives to be added to the board. At a practical level, even if this “representative” approach were right in principle, this approach clearly cannot work. If all stakeholder groups who might legitimately hope to be represented on the board were accommodated, it would need to be even larger than the current board, potentially encompassing:

| | |
|--------------------------------------|-------------------------------------|
| Asset managers | Large listed companies |
| Pension funds and other asset owners | Smaller listed companies |
| Retail investors | AIM (Alternative Investment Market) |
| Accountancy and audit professions | companies |
| Actuarial professionals | Private companies |
| Company secretaries | Small and Medium-sized Enterprises |
| Business ethics groups | Local authorities |
| Academic experts | Unions, and other employee groups |
| Civil society groups | Wider society groups |

1.17 A board directly accommodating all of these interests would be incapable of providing the necessary degree of accountability and strategic direction.

1.18 This approach would also, however, be wrong in principle. Other regulators have not adopted a representative approach. The FCA, for example, has if anything a much wider group of stakeholders, but a smaller board. This reflects the purpose of a regulator’s board, which is not to represent all the multiplicity of views of relevant vested interests and somehow reconcile them in discussion, but rather to ensure that the regulator is doing a highly effective job in protecting and promoting the public interest.

Recommendation 9: The regulator’s board should comprise a mix of the skills, experience and knowledge needed to ensure strategic direction and effective, constructive challenge to the executive. It should not seek to be “representative” of stakeholder interests. In line with provisions in the UK Corporate Governance Code, appointments should be diverse, based on merit and objective criteria.

Board appointments

1.19 Currently, only the FRC Chair and the Deputy Chair are appointed by the Secretary of State for BEIS, and this following an informal agreement rather than by right. Other board members, including the CEO, are appointed by the FRC’s nominations committee.

1.20 The FRC uses a number of channels to advertise these posts, using an approach which is not always consistent. There is only limited use of open advertising or headhunters. On occasion, board and committee posts have been filled using only alumni networks of the “big four”, LinkedIn and the FRC’s own website. This is clearly inappropriate.

Figure 2: Advertising methods used to recruit non-executives (2016–18)

| Type of non-executive appointment | Total no. of positions advertised | National press or journals used? | Headhunters used? | Specialist recruitment website used? | Stakeholder networks used? | LinkedIn used? | FRC website used? |
|--|-----------------------------------|----------------------------------|-------------------|--------------------------------------|----------------------------|-----------------|-------------------|
| Board members | 4 | Yes – 1 role | Yes – 2 roles | Yes – 3 roles | Yes – 1 role | Yes – all roles | Yes – all roles |
| Council or committee appointments ⁴ | 17 | No | Yes – 4 roles | No | Yes – 10 roles | Yes – 12 roles | Yes – all roles |

Source: FRC

Recommendation 10: The Review recommends that all appointments to the regulator’s board, including the CEO, should be public appointments approved by the Secretary of State for Business, Energy and Industrial Strategy.

Recommendation 11: There should be a consistent approach to the appointments process and all board, committee and senior posts should be openly advertised with headhunters used.

Recommendation 12: The Review recommends that the posts of chair and CEO should be subject to confirmation hearings with the BEIS Select Committee, if the committee wishes.

1.21 The FRC is responsible for the UK Corporate Governance Code, which sets out key principles for effective board leadership. It also publishes comprehensive guidance on board effectiveness. The FRC, and the new regulator, must therefore lead by example.

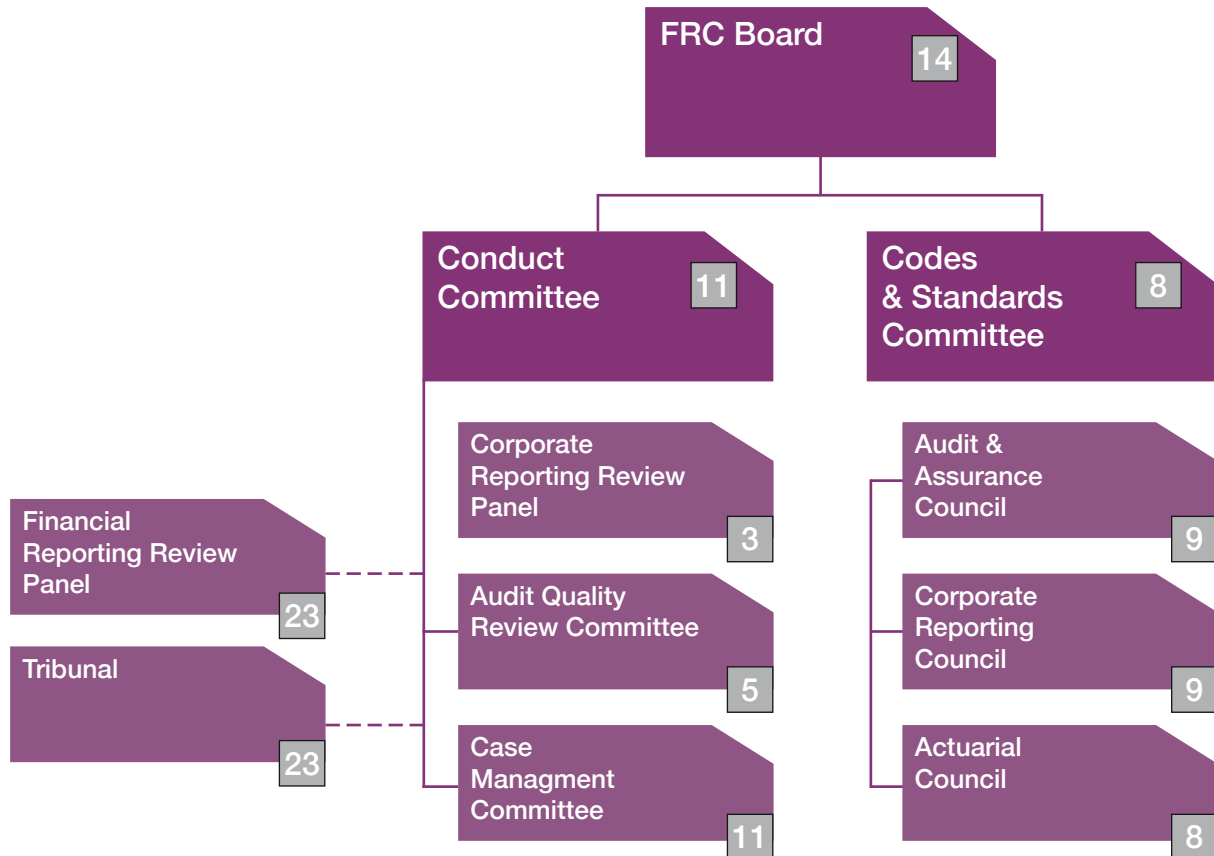
1.22 In line with the Code and guidance, the new regulator’s board should provide effective leadership and direction, ensure that the necessary resources are in place for the organisation to meet its objectives, and that it is systematically assessing its performance. The board needs to promote the right culture and should constantly test the effectiveness of its regulatory activities. The Review considers that the new board will need to show particular strengths in setting a strategic direction for the new regulator and in regularly reviewing and taking stock of its purpose and objectives, and whether it is achieving them.

1.23 It will also need to be equipped and ready to exercise strong intellectual leadership. As a regulatory authority with a public profile, the board should ensure that the new regulator is outward-looking, demonstrating leadership and influencing and shaping the public debate on issues affecting the audit and accountancy sector, and on other corporate matters for which it is responsible.

Sub-board structures

1.24 The FRC board is currently supported by three governance committees – the audit committee, nominations committee and the remuneration committee. It is also supported by two key business committees – the Codes & Standards Committee and the Conduct Committee. In addition to these two committees, there are separate advisory councils for Corporate Reporting, Audit & Assurance and Actuaries and a number of other committees, panels and tribunals. The FRC currently engages more than 60 non-executive directors in more than 100 roles.

⁴ Examples of these councils and committees include the Actuarial Council, the Conduct Committee and the Audit Quality Review Committee.

Figure 3: FRC board and key committee structure⁵

Source: FRC

1.25 This is an elaborate architecture. It needs to be further simplified and streamlined. The Review has not attempted to design a new committee structure for the new organisation but recommends a number of principles and other factors that should be taken into account when this is done.

Proposed principles for new committee structure

- Simplicity, transparency and effectiveness should guide the design of the new structure.
- The committee structure should be aligned with the key duties and functions of the new regulator.
- There should be a clear line of sight from the board to each committee and vice versa.
- The regulator should publish 'plain English' terms of reference for each committee, its membership and its current priorities.
- Appointments should be made in line with the regulator's policies for diversity and inclusion.
- Each committee should review its purpose and effectiveness annually and make recommendations to the board.

⁵ Chart excludes the board's three governance committees (for audit, nominations and remuneration); its Enforcement Committee Panel (4); its stakeholder or investors' panels.

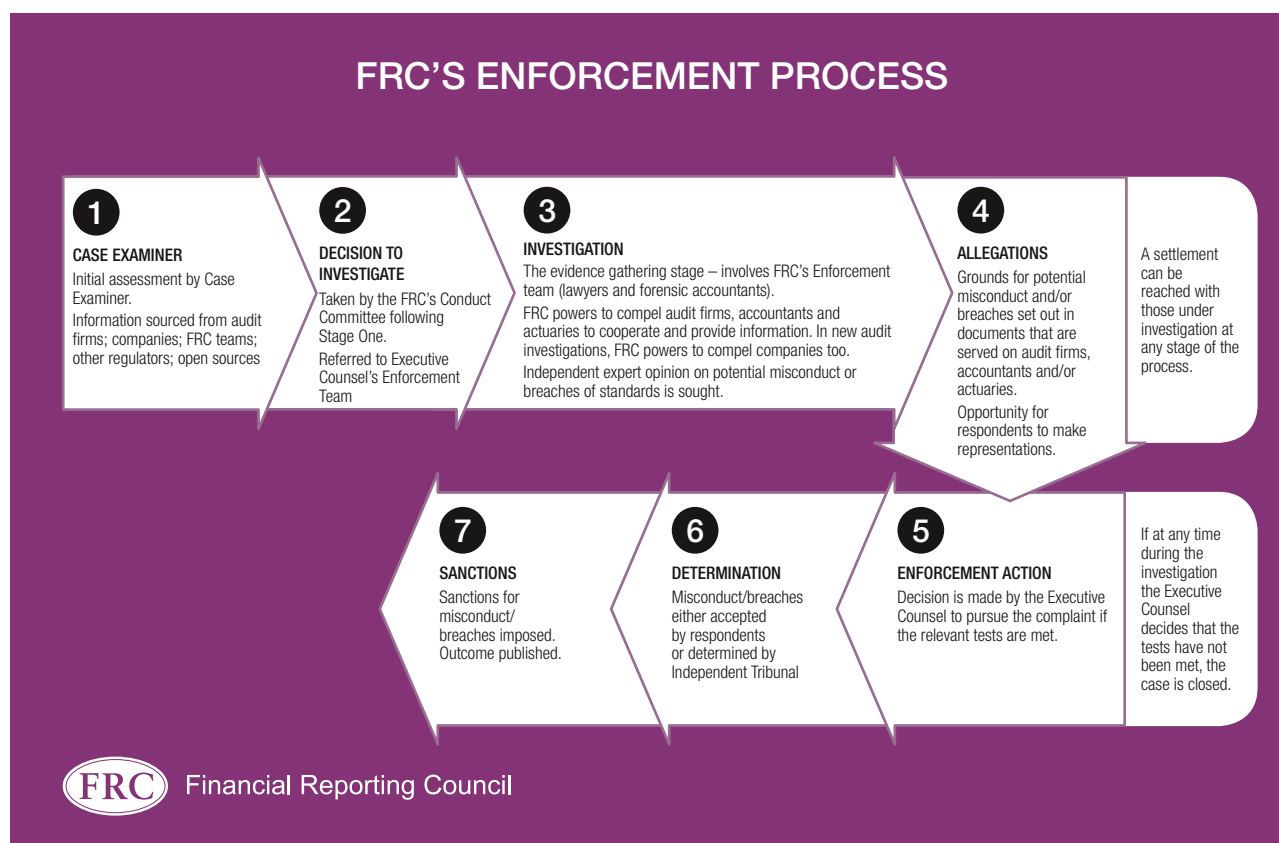
Recommendation 13: The Review recommends that the Government, working with the chair of the new board, should review the existing FRC committee and panel structure with a view to achieving a significant simplification of the architecture in line with the principles set out in the Review. Thereafter, there should be a rigorous annual evaluation of the performance of the board, its committees, the chair and individual directors.

Board involvement in enforcement decisions

1.26 Following implementation of the 2014 European Union (EU) Audit Regulation and Directive, the Government designated the FRC as the UK Competent Authority for audit with responsibility for the regulation of statutory audit, including setting auditing and ethical standards and monitoring and enforcement.

1.27 Whilst the law gives the FRC, as an organisation, clear responsibility for enforcement, it has chosen through its internal rules, to delegate decisions on audit investigations to the Conduct Committee. Where an investigation is authorised, it is handled by an Executive Counsel (the FRC's Director of Enforcement). In the event of a dispute about the findings, an Independent Tribunal is involved. The process is set out below.

Figure 4: FRC Enforcement process



1.28 The FRC board is not formally involved in enforcement decisions. As the FRC's report on its investigation of KPMG's audits of HBOS confirms, enforcement decisions are "taken by the Conduct Committee, the Executive Counsel and independent tribunals. No decisions are taken by the FRC Board"⁶.

⁶ The FRC's enquiries and investigation of KPMG's 2007 and 2008 audits of HBOS, November 2017 (paragraph 4.12).

1.29 The Conduct Committee comprises members with the legal and accountancy expertise and experience suited to making these judgements about whether to initiate investigations. Enforcement work is detailed, which, if undertaken regularly by the board, would distract it from its main purpose of providing strategic leadership, direction and oversight.

1.30 However, this strict formal demarcation of responsibilities carries with it very significant reputational risks for the leadership of the FRC. In controversial cases which are in the public eye, the CEO and board can appear powerless and detached from some of the most important decisions being taken by the organisation they lead.

Recommendation 14: The Review recommends that the board of the new regulator should exercise significantly stronger ownership and oversight of the investigation and enforcement functions. The regulator should ensure that its internal rules and procedures enable the board to:

- **Take decisions itself on whether to launch audit investigations in cases it regards as of particular significance or public interest. The Review does not anticipate the board taking decisions in many such cases, but it should maintain an ability to do so;**
- **Require regular reports from the Conduct Committee and from the director of enforcement on progress being made with investigations and any subsequent enforcement decisions; and**
- **Question the director of enforcement at any point where it considers that a particular decision or investigation is taking too long.**

1.31 Some respondents to the Review have raised concerns that the regulator should not both set standards and regulate their execution, considering it to risk the regulator ‘marking its own homework’. Some have suggested that the organisation should be split apart for this reason.

1.32 The Review does not agree. There are valuable synergies in the same regulator developing and enforcing standards. The Review sees particular benefits in the standard-setter being able to bring practical, operational experience to bear in discussing and developing new standards, adjusting existing standards or other international action. That will include the identification of emerging trends and novel developments, that arguably may be acted on in quicker time; and also the identification of systemic deficiencies in quality that could point to the need to adjust the standards themselves. Most if not all other UK regulators undertake enforcement as well as standard-setting roles, and the Review does not believe different considerations apply in this case.

Chapter 2 – FRC: effectiveness of core functions

2.1 This chapter makes recommendations concerning the effectiveness of each of the FRC's core functions in turn:

- Audit regulation;
- Audit quality;
- Corporate reporting;
- Enforcement;
- Accountancy oversight; and
- Stewardship.

Audit regulation

2.2 If the FRC becomes concerned that an audit firm has systemic quality issues, as opposed to an isolated failure of an individual audit, it is currently almost powerless to take regulatory action, other than to issue a report voicing its concerns. Whilst the FRC can act against individual auditors and partners, it has no purchase on the firm. The FRC has been directed by the Government to delegate the relevant regulatory functions – the approval and registration of those audit firms – to the firms' professional bodies, in effect their trade association. Although self-regulatory models are appropriate and can work well in some circumstances, the Review's clear conclusion is that, given the strong public interest in further improving the quality of PIE audit, in this case it is not.

2.3 Through its AQR programme, thematic reports and audit firm monitoring approach,⁷ the FRC develops a view of audit firms' quality, systems and performance. But should the FRC become concerned that problems of quality or compliance exist throughout an audit firm or its associated local offices, it cannot formally intervene, require improvement, or mandate changes at the firm.⁸

⁷ Described further at paragraph 2.19.

⁸ Unless enforcement procedures (on an individual case) are initiated.

2.4 In the UK, the Government has directed⁹ that the regulatory tasks to approve and register statutory auditors be delegated to the professional accountancy bodies (as the Recognised Supervisory Bodies (RSBs)¹⁰).

2.5 The Review considers this to be a serious deficiency in the regulator’s functions and power. By contrast, the audit regulators of the USA, Canada, Australia and the Netherlands¹¹ are all able directly to affect the registration of audit firms.

Recommendation 15: The Review recommends that the approval and registration of audit firms conducting PIE audits should be reclaimed from the RSBs. The Government should work with the regulator to develop and consult on the detail of how this regime should operate.

2.6 For instance, the Government may want to consider an equivalent to the Senior Managers Regime currently operating in the financial services sector to be adopted at those audit firms conducting PIE audit.

Recommendation 16: The Review recommends the new regime for the approval and registration of audit firms conducting PIE audits should incorporate a range of sanctions including some that are less severe than the ‘nuclear option’ of audit firm deregistration.

2.7 For example, the Canadian Public Accountability Board applies a range of restrictions to underperforming audit firms, including but not limited to:

- Requiring firms to implement actions;
- Temporary bans on tendering for new audit clients; and
- Requiring firms to perform enhanced quality control reviews.

Audit Expectations Gap

The audit “expectations gap” has been defined and described in a number of ways. In the broadest terms, the expectations gap is the difference between what users expect from the auditor and the financial statement audit, and the reality of what an audit is and what auditors believe their responsibilities entail.

In particular, there continues to be a difference between public perceptions about the auditor’s ability to detect financial statement fraud and the auditor’s responsibilities relating to fraud under the existing professional standards.

Users of corporate financial information also point to the existence of a gap between the information they believe is needed to make informed investment and fiduciary decisions, and what is available to them through the entity’s audited financial statements or other publicly available information.

⁹ <https://www.gov.uk/government/publications/audit-regulatory-tasks-direction-on-delegation>

¹⁰ ICAEW, ICAS, ACCA (Association of Chartered Certified Accountants), and Chartered Accountants Ireland (CAI), which operate the approval and registration of all statutory auditors in the UK, including PIE auditors, as well as the monitoring and enforcement for non-PIE statutory audit following the Government’s Direction to the FRC to delegate those tasks.

¹¹ The PCAOB, CPAB (Canadian Public Accountability Board), ASIC (Australian Securities and Investments Commission), and AFM respectively.

This information gap has implications for the efficiency of capital markets and the cost of capital. The information gap is also seen as increasing the challenges of understanding how corporate financial information, including the audited financial statements and related disclosures, reflects the overall picture of the entity's financial condition, performance, and the sustainability of its business.

These gaps could in principle be closed either through persuading users of accounts that their expectations are unreasonable or unrealistic, or through requiring auditors to do more than they currently do.

Recommendation 17: The Review strongly welcomes the proposal that a piece of independent work should be done to explore the issues arising from the audit expectation gap, which have not been addressed in this Review. It is essential that this should be driven, and be seen to be driven, by the interests of users of accounts.

Definition of a Public Interest Entity

2.8 The definition of a PIE is set by EU audit legislation and requires those entities and their auditors to adhere to requirements for auditor rotation, capping the provision of non-audit work, and the prohibition of some forms of non-audit work (which do not apply to non-PIE entities). The UK classification of such entities has been defined as:

- UK entities with transferable securities (equity/debt) admitted to trading on a regulated market in the European Economic Area (EEA);
- Credit Institutions, irrespective of whether they are listed or not; and
- Insurance Undertakings.

2.9 However other countries (see table below) have incorporated a much wider range of entities into their definition of a PIE, such as: all quoted companies, major private companies, pension funds, or asset management companies. The Review is concerned that the UK's current PIE definition may be somewhat too narrowly drawn and may exclude entities whose audit arrangements are a matter of public interest.

Figure 5: Overview of the definition of PIE across EEA States

| Country | Extent of the EU definition | | | | Other designation entities at national level | | | | | |
|-------------|-----------------------------|---------------------|------------------------|---------------------------|--|-----------------------------|----------------|----------------------------|-------------------------------|-------|
| | Listed Entities | Credit Institutions | Insurance Undertakings | Other designated entities | Pension funds | UCITS/ Investment Companies | Size Criterion | Asset Management Companies | Electronic Money Institutions | Other |
| UK | X | X | X | | | | | | | |
| France | X | X | X | X | | | | | X | X |
| Germany | X | X | X | | | | | | | |
| Italy | X | X | X | | X | X | X | X | X | X |
| Netherlands | X | X | X | X | | | | | | |
| Spain | X | X | X | X | X | X | X | | X | X |

Source: Accountancy Europe, *Definition of Public Interest Entities in Europe: State of play after the 2014 Audit Reform, Survey, November 2017*

Recommendation 18: The Government should review the UK’s definition of a PIE.

Audit quality

2.10 The FRC does useful and valuable work through its audit quality monitoring programme. However, this work continues to identify persistent and continuing shortfalls in the quality of audit work in the UK. Recent high-profile enforcement action against auditors and audit firms, and an increase in the number of individual audit file inspections receiving poorer gradings, are all contributing to reduced confidence in audit quality.

2.11 As UK Competent Authority for statutory audit, the FRC is responsible for monitoring the quality of audit for PIEs. The FRC’s Audit Quality Review Team (AQRT) performs this role, and also monitors certain other entities within the retained scope of the FRC.¹² Monitoring all other statutory audit work (including for large private companies) is delegated by the FRC to RSBs.

2.12 The AQRT uses three monitoring approaches to form an assessment of audit quality within an audit firm:

- Reviews of firm-wide quality processes;
- Reviews of individual audit engagements, focusing on areas of high risk, referred to as Audit Quality Reviews (AQRs); and
- Thematic reviews.

2.13 Results of this monitoring programme are communicated annually in a number of audit firm and thematic inspection reports. Individual audit engagement inspection findings and gradings are not reported publicly, except to the extent that audit committees make some disclosure of their own about significant findings arising from a review within a company’s annual report and accounts.¹³

2.14 AQR inspections of individual audit engagements focus on selected aspects of the audit to ensure compliance with auditing and professional standards. In the most severe cases, the AQRT may find that the auditor failed to gather sufficient audit evidence to support an audit opinion. If significant concerns are identified as to whether or not an accounting treatment complies with the applicable accounting framework, the AQRT may draw the matter to the attention of the FRC’s corporate reporting team to consider.

2.15 For 2017/18, results of the individual audit engagement inspection work indicated a decline in audit quality year on year, following a five-year period of improvement. However, the annual sample size is not statistically significant and caution is therefore needed in extrapolating this trend to unreviewed audit work of the firm, or to the audit market more generally.

2.16 The data also shows that for 2017/18, no firms subject to AQR reviews met the FRC’s stated quality target.¹⁴ This included all of the “big 4”.

¹² These are currently large AIM/ Lloyd’s Syndicates/Listed Non-EEA entities

¹³ As recommended by paragraph 81 of the FRC’s 2016 audit committee guidance

¹⁴ For 90% of their FTSE 350 audits to require no more than ‘limited improvements’

2.17 Currently 2,350 audits fall within the AQR remit of which 2,136 are conducted by the largest eight audit firms.¹⁵ In 2017/18, 126¹⁶ AQR inspections were conducted covering 6% of this total population. The AQR team will increase its inspections in 2018/19, carrying out 170 inspections.

2.18 AQR files are selected for review on the basis of risk, and the FRC has a commitment to examine the audits of FTSE 350 companies over a broadly five-year cycle. In determining which files to examine, the FRC will take account of risk factors such as profit warnings, short selling of shares, or if the company is in a priority sector, together with the need to examine audits where there has been a change in auditor. Under the EU Audit Regulations, PIE audit firms must be looked at every 3 years and non-PIE audit firms every 6 years. The AQR currently undertakes inspections of the larger audit firms annually.

2.19 In addition to carrying out an increased number of inspections, in early 2018 the FRC announced plans to enhance its monitoring of the six largest audit firms. This approach is referred to as the Audit Firm Monitoring Approach (AFMA). The responsibilities in this area come from the EU Audit Regulation, although monitoring will operate under a voluntary arrangement as the FRC does not have specific powers with which to fulfil this responsibility. Recruitment of the team to perform this work is still underway and to date, therefore, limited work has been undertaken.

2.20 The Review supports this new monitoring approach. It will allow the FRC more insight regarding possible structural problems within firms which in turn may be leading to poor quality statutory audits.

Recommendation 19: The Review recommends that AFMA should not be carried out on a voluntary basis, but instead the regulator should have statutory power to carry out this monitoring work. It is critical that this monitoring work is performed by individuals with the appropriate skills and seniority.

2.21 Currently only a summary of the AQR gradings for a firm is published along with a high-level summary of findings. However, the Review notes that investors and representatives of the 100 Group of Finance Directors have unanimously told the Review that greater transparency with regards to audit quality findings is needed.

Recommendation 20: The Review recommends that the new regulator should work towards a position where individual audit quality inspection reports, including gradings, are published in full upon completion of AQRs. This will, however, be a major step, requiring a high level of confidence in the AQR process. For the present, as a first and interim step, the Review recommends publication of AQR reports on an anonymised basis (similar to the approach taken in the US and the Netherlands, for example).

2.22 In terms of the FRC's examination of audit work carried out overseas, where a UK-registered entity has components overseas that form part of its group-level financial statements, it is the responsibility of the UK signing-partner to ensure they have been sufficiently involved in the work of the component audit in order to be in a position to sign an opinion on the Group accounts. This includes having obtained sufficient, appropriate evidence regarding the quality of any audit work.

¹⁵ Deloitte, Ernst & Young (E&Y), KPMG, PwC, BDO, Grant Thornton, Mazars and Moore Stephens

¹⁶ Excluding inspections of audits conducted by UK and Crown Dependency audit firms, Third Country Auditors, Local Public Audit and the National Audit Office, 20 further inspections.

2.23 In the case of the Public Company Accounting Oversight Board (PCAOB) in the US, inspection staff will travel to the relevant country and inspect the locally-held audit files and interview staff should they consider it necessary. The FRC does not deploy this approach, instead interpreting its role as being to examine a UK auditor’s compliance with the relevant auditing standard.¹⁷

2.24 The Review believes that the new regulator should be willing for staff to examine non-UK files on a risk-based basis. This is of clear potential importance in relation to multinational groups.

Recommendation 21: The Review recommends that the regulator should change its approach to examining the quality of component audit work conducted overseas, on a risk-based basis.

2.25 The AQRT is made up of around 40 people, generally with long-standing experience in the regulator. The Review is struck by the contrast to audit firms’ views of the PCAOB in the US, where the seniority and experience of the PCAOB’s staff means that they are better able to challenge and engage firms on complex matters of judgement with sophistication and certainty. Respondents to the Review also noted the observable difference between the FRC’s resourcing, areas of focus, and ability to deal with complex sector issues in comparison to inspections carried out by, for example, the PCAOB.

Recommendation 22: The regulator should revisit and strengthen AQR resourcing, and should seek to:

- **Recruit more senior staff (including at partner-equivalent level) who would attend AQR inspection visits, adding weight and commanding more substantial respect in conversations with firms; able to make a call on complex matters on-site; and bringing to bear a comparative overview of sector-practice;**
- **Ensure its approach to staffing addresses the need for its teams to include recent experience of external audit and understanding of current practice, in order to test and scrutinise firms as effectively as possible; and**
- **Widen and appropriately deploy the team’s sector expertise, in particular in those most complex and high-risk sectors where public interest and risk of corporate failure is highest.**

Corporate reporting

2.26 The FRC undertakes a range of activities to support robust and reliable corporate reporting in the UK and to promote improvements in quality. In particular, it monitors and reviews companies’ compliance with reporting requirements in the Companies Act 2006 (‘the 2006 Act’) and applicable accounting standards. The FRC also performs thematic reviews which aim to supplement monitoring work by sharing examples of good practice reporting and highlighting areas where improvements can be made.

2.27 This review work is respected and has real value, though is hindered somewhat by a lack of visibility, low levels of review activity (by international standards) and cumbersome enforcement mechanisms. It also covers only a part of the annual report – important sections such as the corporate governance statement and the directors’ remuneration report are out of scope.

¹⁷ ISA 600 – audits of group financial statements (including the work of component auditors)

2.28 Within the FRC, a corporate reporting review (CRR) team currently undertakes review work looking to test whether the directors' report, strategic report and annual accounts comply with the relevant reporting requirements. A risk-based approach is taken to select reports and accounts for review, supplemented by an element of random sampling to ensure that all entities within scope stand a chance of being reviewed. In addition to its own monitoring programmes, the CRR team investigates complaints received, including from other regulators, in relation to corporate reporting.¹⁸

2.29 The FRC's authority to review accounts extends to all companies and limited liability partnerships required to prepare reports by virtue of the 2006 Act. In practice, reports are normally only selected for review if they concern publicly listed or large private companies. It is estimated that there are in excess of 15,000 entities falling within this remit, including more than 2,300 issuers.¹⁹

2.30 The FRC also reviews annual and interim accounts of listed entities to ensure that they have been prepared in accordance with the relevant reporting framework, as required by the EU Transparency Directive. This work is additional to the FRC's functions under the 2006 Act, and includes companies incorporated elsewhere in the EU but with a listing on a UK stock exchange.

2.31 The FRC has enforcement powers to support its corporate reporting function. Its ultimate power is to go to court for a declaration that the annual accounts, or the strategic or directors' report of a company do not comply with the legal requirements, and to obtain a court order requiring the directors to prepare revised accounts or a revised report. This power has never been used, although the FRC has begun legal proceedings on several occasions and settled before the case reached trial. The FRC also has powers under the 2006 Act to require a company (or its auditors) to produce any document or to provide any information or explanations that it needs in order to determine whether to seek revision of the accounts.

2.32 The Review has heard that the FRC's monitoring work has a positive impact on overall standards of financial reporting in the UK. Although the scale of monitoring is relatively small and formal action rare (see Figure 6), the threat of an investigation – and the effect of this on a company's reputation, even though the process is confidential in its early stages – is a serious deterrent to poor reporting. Financial reporting standards in the UK are generally regarded as relatively high by international standards. If the FRC did not undertake this function, reporting standards would certainly be lower.

2.33 The Review therefore considers that the regulator should continue to undertake corporate reporting review work. However, the Review believes that some steps can and should be taken to increase the impact of this work.

2.34 First, the Review notes that the length and volume of required elements in annual reports have grown substantially with no overall examination of their usefulness, or evidence that they have become more comprehensible to users.

Recommendation 23: The regulator should be required to promote brevity and comprehensibility in accounts and annual reports, engage meaningfully with users and asset owners about their information needs, and ensure the proportionality and value of reports. At least once in every Parliament, the FRC should report to BEIS a public assessment of the extent to which the statutory reporting framework is serving the interests of the users of company reports together with any recommendations for how it can be improved.

¹⁸ There are a small number of such cases each year (11 in 2017/18, 20 in 2016/17).

¹⁹ https://www.esma.europa.eu/sites/default/files/library/esma42-111-4138_peer_review_report.pdf

2.35 The scale of monitoring by the FRC is relatively low by international standards. A review²⁰ conducted by the European Securities and Markets Authority in 2017 showed that the FRC selected a significantly lower proportion of issuers for review each year than the majority of other member states. In the US, the Securities and Exchange Commission (SEC) undertakes some level of review of each reporting company at least once every three years. This compares to the FRC’s more modest aim of reviewing the full reports and accounts of FTSE 350 companies at least once in every five years with at least one thematic review in between. Thematic reviews look at one aspect of reporting across a sample of company reports and accounts. Recent thematic reviews include judgements and estimates and pension disclosures.

Recommendation 24: The Review recommends that the regulator should consider expanding the volume of CRR activity on a risk-based basis.

Figure 6: Action taken by the FRC from 2013/14 – 2017/18 in relation to corporate reporting

Corporate reporting reviews – action taken

Over a five-year period of corporate reporting reviews (2013/14 – 2017/18):

- One review group has been convened.
- 7 FRC public press notices have been issued outlining concerns.
- 35 of 1,138 companies subject to review (3%) have been requested by the FRC to publish details of the FRC’s intervention in their next set of annual financial statements*.
- No accounts have been required to be withdrawn and replaced with revised accounts.

**In instances where the outcome is less significant, but a degree of publicity is still deemed appropriate, the FRC asks companies to refer to the FRC’s intervention in their next published accounts. Some interventions require restatements of primary statements.*

Source: FRC website and publications

2.36 The existing mechanism requiring companies to amend their accounts where there are deficiencies is cumbersome. Most equivalent regulators abroad have a power to direct a company to amend its accounts.

Recommendation 25: The Review recommends that the new regulator should be given a power to direct changes to accounts rather than having to go to court.

2.37 This process would shift the balance of authority between the regulator and the preparers of accounts, enhancing the regulator’s credibility and status and giving it “teeth”, particularly in the case of larger private companies which may be less concerned about reputational impact than listed companies. It would also help to ensure that material misstatements and corrections can be communicated to the market on a timely basis. Current enforcement processes give preparers too much scope to defer and delay so that by the time any eventual correction is made, it has lost its value to shareholders. In the majority of cases, the change is made to the following year’s accounts as these are almost ready by the time the issues have been resolved.

²⁰ https://www.esma.europa.eu/sites/default/files/library/esma42-111-4138_peer_review_report.pdf

2.38 The Review also considers that the regulator’s review work should be more transparent to ensure there is greater visibility for users of accounts about any deficiencies and shortcomings identified, and to provide a further incentive for the preparers of accounts to get them right in the first place.

Recommendation 26: The Review recommends that CRR findings are reported publicly by the regulator. The regulator should publish full correspondence following all CRR reviews, and the findings should be published in a set timeframe.

2.39 This improvement in transparency would mirror the SEC’s practice in the US. It will require primary legislation to amend the current confidentiality restrictions in the Companies Act 2006, which currently prevent disclosure.

2.40 Too much reliance is currently placed on allowing companies to make changes to future year accounts. Greater urgency is required for material misstatements. These need to be communicated to investors on a timely basis with the regulator taking ownership of this communication. The combination of stronger powers for the regulator to direct companies to correct misstatements, combined with the power to publish correspondence, should give the regulator the tools to make this happen.

2.41 The scope of the FRC’s corporate reporting review work and its separate audit quality review regime is not aligned. The former applies, in practice, to all publicly listed and large private companies (although, as mentioned above, the legal scope extends even wider than this); the latter applies to PIEs and certain non-PIE entities, NAO Companies Act audits and major local audits. The Review does not believe this difference makes sense: either there is a public interest in an entity’s accounts and its audit, or there is not.

Recommendation 27: The Review recommends that the new regulator’s CRR work should be limited to PIEs, except to the extent unavoidable under EU law.

2.42 The responsibility for preparing accurate accounts, compliant with accounting standards, rests with companies. However, some accounting treatments, such as profit recognition and measurement, and presentation and disclosure can be very complex. Rather than solely picking these issues up retrospectively, the Review considers that the new regulator could do more to help those companies who want assistance to get it right the first time.

Recommendation 28: In addition to stronger retrospective monitoring of company reporting, the Review recommends that the new regulator should introduce a pre-clearance procedure in advance of the publication of accounts.

2.43 The regulator would need to take on additional expert resource to provide such a service, which could operate on a charged-for basis.

2.44 The FRC’s current reporting review work applies only to the strategic report, the directors’ report and annual accounts, meaning that other important, mainly non-audited, non-financial, parts of annual reports are not subject to any regulatory oversight. These areas include the directors’ remuneration report, reporting against the principles and provisions set out in the UK Corporate Governance Code (which includes viability statement provisions), and the audit committee report.

2.45 In relation to corporate governance, the Review considers that the FRC has been an effective custodian of the UK Corporate Governance Code and that it should remain a part of the new regulator’s core functions. Standards of reporting against the Code, however, are mixed, yet the FRC does not currently have any powers to enforce the accuracy, adequacy or completeness of reporting.

Recommendation 29: The Review recommends that the stronger corporate reporting review process described earlier should be extended to cover the entire annual report, including corporate governance reporting. This should be done on the basis of risk.

2.46 As for other aspects of the annual report and accounts, this will mean that where the regulator has concerns on any reporting matter it will be able to require explanations and more information from a company. If necessary, it will be able to direct a company to correct a statement or provide a fuller explanation or include information required by law that has been omitted.

2.47 Extending the corporate reporting review process to the rest of the annual report is not a substitute for the work performed by the auditor. It must also be recognised that there will be some limitations on the regulator's scope to intervene, because non-financial reporting is often more subjective and open to interpretation than pure numbers. Nevertheless, an extension of scope should provide stronger reassurances for shareholders and other users that:

- Annual reports are meeting all the legal requirements;
- The reporting is sufficient to ensure that shareholders can understand the matter being reported upon; and
- The non-financial reporting is not clearly inaccurate or inconsistent with the financial figures or other aspects of a company's performance and prospects set out elsewhere in the report.

2.48 The new regulator will be concerned primarily with the accuracy and completeness of the reporting, so that shareholders and other stakeholders have accurate information and are not misled.

Extension of reporting oversight to investor information

2.49 In addition to the annual report and accounts, listed companies share a significant amount of information with investors. As well as required regulatory announcements, firms often issue non-required communications, including earnings releases and investor presentations. This information, including forward-looking information, is of significant interest to investors. It is often not subject to the same quality control measures as information contained within annual financial statements; nor is it audited or subject to any assurance procedures. There is therefore significantly more scope for companies to pick and choose measures, and interpretations of measures, which put a positive gloss on the facts.

2.50 In the US, investor information submitted as a filing with the regulator falls within the scope of the SEC's monitoring regime. Inappropriate or questionable approaches to non-GAAP measures, and questionable use of or interpretation of key performance indicators, are both a focus of the monitoring work on these filings. Enforcement action is taken when appropriate. Generally, investor presentations or conference calls, for example, which are not formally filed with the SEC, are required to comply with the federal securities laws' anti-fraud requirements and regulations with respect to all statements made in such communications, including non-GAAP measures. The SEC may selectively read this information as part of a wider filings review. If inconsistencies are observed between this information and a filing, they can raise it with the issuer.

2.51 In the Netherlands, press releases submitted to the AFM (the Dutch 'Authority for the Financial Markets') are monitored before the market opens using a joint approach between the market abuse monitoring team and the financial reporting quality supervision team. Urgent corrective action is taken if required. The AFM also listens in to investor presentations/capital

markets investor days, taking action as it deems necessary should information provided raise concerns. The AFM usually receives the information presented during these events beforehand.

2.52 At present, the FRC does nothing similar to either of these monitoring actions, although monitoring of investor communications is of course done by the FCA on a risk-of-harm basis, under its existing market supervision responsibilities.

Recommendation 30: The Government, working with the FCA and the new regulator, should consider whether there is a case for strengthening qualitative regulation around a wider range of investor information than is covered by the FRC's existing corporate reporting work, to ensure that disciplines to drive up the quality of companies' disclosures in the UK are at least as demanding as best practice internationally. One possibility would be for the new regulator to trial some additional work in this area, on a risk-based and/or sampled pilot basis; if so, this should be done in close collaboration with (or possibly even in support of) the FCA.

Guidance

2.53 The FRC publishes guidance from time to time. The FRC's Guidance on Audit Committees, its Best Practice Guide to Audit Tendering, and the guidance on Risk Management, Internal Control and Related Financial and Business Reporting are all useful and draw on the FRC's considerable technical knowledge in these areas. However, some other guidance, such as the Guidance on Board Effectiveness, which includes guidance on such matters as succession planning for boards, range more widely into areas where the FRC is not expert and where it could be said to apply a rather bureaucratic mindset to business. Such documents create material costs to business, as companies will inevitably feel an obligation to give them careful consideration.

Recommendation 31: The Review recommends that the new regulator should be more sparing and disciplined than the FRC in promulgating guidance and discussion documents. These documents should only be issued if they are genuinely useful, and their utility clearly exceeds the considerable costs they impose through users having to read and check them.

International standards-setting

International accounting standards are set by the International Accounting Standards Board (IASB), becoming a mandatory requirement in the UK after their endorsement.²¹ Once adopted, latitude for the FRC to adjust the standards to the UK context only applies to smaller companies through its role in setting UK Generally Accepted Accounting Principles.

There are two UK nationals sitting on the IASB's advisory boards; and one UK national sitting on the IASB's Board of Trustees.

For international auditing standards, there is greater latitude for the UK to adapt standards if that is necessary for the UK context. Standards are set by the International Auditing and Assurance Standards Board (IAASB). Those standards are not binding nor mandatory. For example, the UK was the first country internationally to adopt a requirement for preparation of an extended auditor report. A member of the FRC's staff sits on the IAASB board, and the UK participates actively in the board's working groups.

The Review has not identified major concerns in relation to these aspects of the FRC's work and does not make recommendations in this area. As a general matter, however, the Review's proposed overarching duty that the new regulator should seek to promote the interests of users of accounts should apply here, as elsewhere.

Enforcement

2.54 Public confidence in business depends not just on regulators setting and monitoring standards but on auditors, accountants and directors being held to account when necessary.

2.55 There has been substantial criticism of the FRC's historic enforcement performance. The FRC has been widely viewed as reluctant to act, slow to achieve results and therefore failing to create an adequate deterrent to wrongdoing.

2.56 Poor past decisions, such as not to investigate KPMG's audit of HBOS, have unquestionably damaged confidence in the regulator as well as the integrity and reliability of the regulatory process.

2.57 The FRC has itself recognised that it needed to improve the speed of its investigations, especially following its decisions on HBOS. Many respondents to the Review have also noted a significant and positive shift in the FRC's approach since the introduction of the Audit Enforcement Procedure (AEP) in 2016.

2.58 The FRC has now set itself a key performance indicator to conclude investigations within two years. The FRC has told the Review that it is, 30 months on from the introduction of its new AEP process, "in general, meeting the target". There are examples where significant delays appear to remain; it is inevitably very hard to judge, case-by-case, the extent to which such remaining delays are genuinely unavoidable.

Recommendation 32: Although the Review is heartened by the FRC's evident recent change in approach, and by the strengthening of the enforcement team's resourcing and new leadership of the enforcement function, the Review recommends that both the board and the Government should continue to monitor enforcement performance

²¹ Currently undertaken at EU level.

closely. The new regulator should report on this in its Annual Report, and the regulator should regularly be held accountable by Parliament through appearances at the BEIS Select Committee.

2.59 The Review notes the review of FRC sanctions undertaken by Sir Christopher Clarke which took effect in June 2018. A wide range of financial and non-financial sanctions is available, including exclusions of up to 10 years for dishonesty, and unlimited fines for seriously poor audit work. In the light of these changes, as well as the outcomes of recent enforcement cases, the Review does not believe there is any shortfall in the severity of sanctions²² available to the FRC or Tribunal.

2.60 In the US, fines for audit failure are subject to statutory limits, with the PCAOB able to levy fines of up to \$15m,²³ in the case of firms that have engaged in international misconduct. Since January 2017, the largest fine levied by the PCAOB following enforcement has been \$1.5m, compared with £6.5m²⁴ by the FRC. Fines levied against individuals have also been considerably lower. Overall, therefore, fines in the US are more modest than have been levied in recent years in the UK (Figure 7). The PCAOB also applies a wider range of sanctions for audit misconduct, including censures, limitations on firms' practice, revocations of firm registrations, or bars and suspensions of individuals.

Figure 7: Fines for audit failures imposed by the FRC and the PCAOB (January 2017 to September 2018)²⁵

| | FRC (£) | | PCAOB (\$) | |
|-----------------------------|-------------|------------|-------------|------------|
| | Firm | Individual | Firm | Individual |
| Maximum fine | £6,500,000 | £325,000 | \$1,500,000 | \$50,000 |
| Upper quartile | £5,000,000 | £135,000 | \$20,000 | \$25,000 |
| Median | £3,000,000 | £79,500 | \$10,000 | \$12,500 |
| Lower quartile | £2,100,000 | £55,125 | \$10,000 | \$9,375 |
| Minimum | £700,000 | £45,000 | \$5,000 | \$2,500 |
| Total value of fines | £29,625,000 | £1,288,050 | \$5,322,500 | \$352,500 |
| Number of fines | 9 | 12 | 43 | 20 |

Source: FRC and PCAOB

2.61 In its 2018 Developments In Audit publication, the FRC reported that it considered “around a third of cases to be less serious and consequently have been resolved by the FRC’s Case Examiner through constructive engagement”. The FRC has not published its findings or any information on the outcomes of any of these cases or the number of cases. The Review considers this an insufficient degree of transparency and scrutiny.

²² Following introduction of the AEP, fines now flow to HM Treasury, rather than to the professional bodies.

²³ Adjusted for inflation.

²⁴ Reduced from £10m for early settlement.

²⁵ FRC fines are those imposed under the Accountancy Scheme for misconduct relating to statutory audit (no AEP cases have yet been concluded) and include any discounts for early settlement. In addition, costs totalling £1.288m were awarded against firms.

The PCAOB may impose sanctions for violations of PCAOB rules and standards, SEC Rules applicable to the preparation and issuance of audit reports, and the Sarbanes-Oxley Act. The penalties noted above relate to cases in which audit firms or individuals were sanctioned for conduct including violations of PCAOB standards in relation to the performance of audits, PCAOB quality control standards, failure to co-operate with Board inspections and/or investigations of failure to comply with the Board’s reporting rules. Published disciplinary orders represent settlements that the PCAOB has reached with registered firms or their associated persons and public adjudicated orders imposing sanctions against registered firms or their associated persons.

2.62 The Review notes the sensitivity in reporting specific details of cases, but considers that the transparency of the regulator’s actions is nevertheless of key importance. Reporting more information regarding undertakings will serve as a deterrent whilst having a beneficial effect on audit quality.

Recommendation 33: The regulator should revisit application of its publication policy in relation to concluded cases that result in undertakings.

2.63 The FRC currently limits statutory audit enforcement investigation to UK firms and individuals, consistent with its approach taken to Audit Quality Reviews. By comparison, the PCAOB conducts enforcement action against overseas auditors, and the Review is struck by the significant action it has taken as a result, including the case of Deloitte Turkey where the PCAOB has imposed sanctions on the firm and has barred the CEO and others from US public company audit work.

Recommendation 34: The international reach of the regulator’s statutory audit enforcement action should be extended, on a risk-based basis.

Different approaches to enforcement – auditors and accountants

2.64 The FRC operates two enforcement procedures, the Audit Enforcement Procedure (AEP) for matters relating to the statutory audits of PIE and other retained audits, and the Accountancy Scheme. The Accountancy Scheme is the disciplinary scheme for the accountancy profession i.e. members of the various professional bodies covered by the Scheme. The AEP came into effect in June 2016, and prior to this all statutory audit related matters were dealt with under the Accountancy Scheme. There are key differences between the AEP and the Scheme. These include:

- The threshold for conduct capable of attracting sanction is lower under the AEP, being a breach of a relevant requirement. The threshold under the Accountancy Scheme is the higher one of misconduct (i.e. an act or omission which falls significantly short of the standards reasonable to be expected);
- Under the AEP, the FRC has the power to compel information and documentation from PIE audited entities, whereas under the Accountancy Scheme they are only able to obtain such material on a voluntary basis; and
- Under the current arrangements it is possible that investigations into the same company can be conducted under two separate enforcement procedures. For example, investigations into the audit of Patisserie Holdings plc will be conducted under the AEP, whereas the CFO’s behaviour will be investigated under the Accountancy Scheme. The same situation arises in relation to the Carillion plc investigation.

2.65 Whilst there are historic reasons for these differences, the Review feels there is no good justification for them and that they need to be addressed. Auditors and accountants should be held to account on an equal footing; the bar should be aligned. The Review also believes that the regulator should take the lead in investigating apparent wrongdoing by accountants in relation to financial reporting or corporate governance of Public Interest Entities.

Recommendation 35: The Review recommends that enforcement action against accountants in relation to apparent wrongdoing in Public Interest Entities should be undertaken by the regulator on a statutory basis. The current voluntary scheme should be discontinued and replaced with a new statutory regime with tests and

powers aligned and similar to those in the Audit Enforcement Procedure. Those in scope would be judged against the requirements that already apply to them (legislative requirements, financial reporting standards and professional ethical standards).

2.66 Key characteristics of the two schemes as currently operating are set out in the table below.

Figure 8: Audit enforcement procedure and accountancy scheme characteristics

| | AEP | Accountancy Scheme |
|---|--|--|
| Applies to | Auditors and their firms when conducting statutory audit for PIE and retained audits as below | Members/Member Firms of of accountancy professional bodies participating in the Scheme other than in relation to statutory audit work. |
| Statutory or voluntary | Statutory | Voluntary/contractual arrangements |
| Companies in scope | Listed companies, credit institutions, insurance undertakings; some AIM-listed companies; Lloyds syndicates | All |
| Test to be met to impose a sanction | Breach of a relevant requirement (including audit standards and ethical standards) | Misconduct |
| Test to commence investigation | Allegation i.e. information which raises a question as to whether they have breached a Relevant Requirement; and there is "good reason" to investigate | Matter raises important issues affecting the public interest in the UK; and there are reasonable grounds to suspect misconduct |
| How are investigations of cases not meeting the threshold dealt with | n/a | Where the public interest test is not met, the RSB under its disciplinary rules |
| What powers to obtain information | Power to obtain information from the audited entity and the audit firm | Powers limited to obtaining information from Members and Member Firms |
| Fines paid to | The Government | The relevant participating accountancy body |

Source: FRC

Retrospective action

2.67 The Chairs of the BEIS and Department for Work and Pensions Select Committees have asked the Review to consider whether the FRC should open new investigations into the work completed by an individual or a firm for a previous year's audit, if successful action has already been taken in relation to that firm. Particular attention is drawn to the case of BHS.

2.68 In response to this question, the FRC has stated that:

"This situation arises in a significant number of our investigations. In such circumstances, as a risk-based regulator with finite resources, we do not, as a matter of course, open new investigations into previous audit years where steps have already been taken to safeguard the public interest and sanctions have been imposed to those who fall within scope of our regulatory remit."

2.69 The Review does consider the FRC's approach reasonable in this case. Very substantial sanctions have been imposed on the audit firm and the responsible audit partner, which included a 15-year ban. The Review does not consider that there has been a failure to protect the public interest as a result of the FRC's decision not to examine previous years' audits.

Enforcement: directors

2.70 The FRC currently has no authority to act against company directors unless they are a member of a professional accountancy body (“member directors”). Perhaps more than any other single issue, respondents to the Review’s call for evidence commented on this point, with the great majority concerned that the current position is inadequate in holding ‘non-member’ directors to account for any part they have played in a serious reporting or audit-related failure.

2.71 It is clear from a helpful mapping exercise carried out by the FRC, FCA, and Insolvency Service that there is a wide range of arrangements to hold directors to account for the suite of duties and requirements applying to them:

- Shareholders can act through the courts;
- The Insolvency Service has wide-ranging powers to disqualify directors (including where insolvency has not occurred) usually as a result of serious corporate abuse and fraud; and to prosecute directors for criminal offences in the Companies Act. This is however a high hurdle;
- The FCA may act in cases of breaches of the rules applying to listed companies, which include disclosure failings and market abuse, etc; and
- The FCA and PRA may act to enforce requirements specific to companies in the financial services sector.

2.72 Whilst the Review welcomes that mapping process and the memoranda of understanding put in place to achieve better co-ordination between regulators, inconsistency remains between the treatment of member directors and non-member directors particularly in relation to corporate reporting. The Review considers that this is undesirable and has the unintended consequence of creating an artificial incentive for individual directors to resign their professional body membership. It is the directors of a company who are responsible for the accurate preparation of a company’s report and accounts, and it is important that they should face appropriate consequences if this is not properly done. This is also important in creating an effective deterrent.

2.73 While all directors face disqualification if they are found unfit to be a company director, this sanction is usually reserved for serious corporate abuse such as fraud and wrongful trading. The Review considers that a more effective system is needed to deal specifically with accounting and corporate reporting failures.

Recommendation 36: The Review recommends that the Government, working with the new regulator, should task the regulator to develop detailed proposals for an effective enforcement regime in relation to Public Interest Entities that holds relevant directors to account for their duties to prepare and approve true and fair accounts and compliant corporate reports, and to deal openly and honestly with auditors. The Review recommends that this should apply to a company’s CEO, CFO, chair, and audit committee chair.

Recommendation 37: The Review recommends that the regime for non-member directors should follow the principles of the Audit Enforcement Procedure, with the same threshold for action to be taken, and a graduated range of sanctions. To achieve this, the regulator should set out relevant requirements or statements of responsibilities in relation to auditing and corporate reporting in order that directors are individually accountable for their roles.

Recommendation 38: Although the regulator should be able to impose a range of sanctions, the Review recommends that action relating to director disqualification should continue to rest with the Insolvency Service. The Review does, however, recommend that the FRC should have the necessary powers to investigate directors and refer cases to the Insolvency Service, working closely with them to ensure effective action is taken where necessary.

Accountancy oversight

2.74 As set out from paragraph 2.2 above, the Review recommends that the current self-regulatory regime for PIE audit firms should end. There remain, however, important regulatory tasks that sit with professional accountancy bodies, largely following a voluntary self-regulatory model. This section deals with the FRC's role in regard to those functions, and the oversight of those bodies it undertakes on a voluntary basis.

2.75 To step back, the voluntary oversight of accountancy regulation was established following reforms in 2003. That saw the FRC expand its operations in response to the WorldCom and Enron collapses to provide additional assurance to the self-regulatory model and improve confidence in it.²⁶

2.76 In terms of the oversight carried out by the FRC, it states that it “may review other regulation by the professional accountancy bodies²⁷ of their members in: education, training, Continuing Professional Development, standards, ethical matters, professional conduct, and discipline, registration and monitoring and may make recommendations on how these activities might be improved. The professional accountancy bodies have agreed that they will consider the FRC recommendations carefully, and either implement them within a reasonable period, or give reasons in writing for not doing so”.

2.77 Until 2010, the FRC conducted oversight thematic reviews of the accountancy profession. The FRC has told the Review that securing action to meet its recommendations was not always easy to achieve, not least when the recommendations were unwelcome. As a result, the FRC has told the Review that it “prioritised its resources after 2010 with a greater focus on achieving outcomes through its consideration of complaints ..., combined with its statutory oversight monitoring which involves monitoring of the Recognised Qualifying Bodies' (RQBs) and RSBs' processes and procedures”.

2.78 Although the Review has seen some complaints about the FRC's handling of matters dealt with by the professional bodies, it has not received evidence of substantial failure which would merit a significant shift in the regulatory model for the accountancy profession at this point, particularly since the Review is recommending the replacement of the FRC with a new regulator with a different culture and less consensual approach.

Recommendation 39: The regulator should continue to operate its oversight role of the accountancy profession, but with a work programme sufficiently wide and expert to identify any emerging concerns of public interest.

²⁶ The FRC's remit in this area was set out in an exchange of letters between the FRC and the Consultative Committee of Accountancy Bodies (CCAB), which now comprises Institute of Chartered Accountants in England and Wales (ICAEW), ACCA, CIPFA, ICAS, CIPFA and CAI. CIMA (Chartered Institute of Management Accountants) is no longer a member of the CCAB. A separate draft MoU exists between CIMA and the FRC

²⁷ ICAEW, ACCA, CIPFA, ICAS, CIPFA, CAI and CIMA only

2.79 The FRC historically in dealing with the profession has adopted a “consensus-building” approach in its oversight role. However, there is a clear risk that if the new regulator should identify issues of significant public interest in the future, its recommendations and actions would not be enforceable or mandatory under the current oversight arrangements.

Recommendation 40: The Review recommends that the Government should put in place a backstop statutory power, requiring action to be taken by a professional body if there was a need in the public interest. The Review recommends that such a power would be activated only if needed and at the regulator’s request.

Recommendation 41: The regulator should replace exchanges of letters with formal memoranda of understanding with each of the UK’s professional accountancy bodies.

Stewardship

2.80 The FRC is responsible for maintaining and monitoring compliance with the UK Stewardship Code.²⁸ The Code sets out high-level principles, supported by guidance, for Code signatories to follow on a comply or explain basis in the course of their stewardship activities. It was introduced in 2010, in response to a recommendation in Sir David Walker’s 2009 report on corporate governance at banks and other financial institutions.

2.81 The Code currently has 278 signatories, comprising 172 asset managers, 94 asset owners (such as pension funds) and 12 proxy advisers or investment consultants. Asset managers are required under the FCA’s Conduct of Business Rules to disclose whether, and if so how, they comply with Code. If they do not comply with the Code, they must disclose what their alternative investment strategy is.²⁹ Other than this rule for asset managers, the Stewardship Code has no basis in law or formal regulation.

2.82 Since 2016, the FRC has adopted a tiering approach to Code signatories, to help differentiate publicly the extent of signatories’ commitment to the Code’s principles. The aim has been to raise standards by providing an incentive on signatories to join the top tier. Tiering is based primarily on an annual FRC assessment of each signatory’s public statement of its commitment to the following principles:

- Publicly disclose their policy on how they will discharge their stewardship responsibilities;
- Have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed;
- Monitor their investee companies;
- Establish clear guidelines on when and how they will escalate their stewardship activities;
- Be willing to act collectively with other investors where appropriate;
- Have a clear policy on voting and disclosure of voting activity; and,
- Report periodically on their stewardship and voting activities.

²⁸ <https://www.frc.org.uk/investors/uk-stewardship-code>

²⁹ <https://www.handbook.fca.org.uk/handbook/COBS/2/2.html>

2.83 Initially, the FRC adopted three tiers, with only 40 signatories awarded top Tier 1 status to begin with. The bottom Tier 3 was subsequently dropped, and over the past two years Tier 1 has expanded very significantly to the point that 200 of the current 278 signatories to the Code are now in Tier 1. This has happened as more signatories have expanded their policy statements stating their commitment to the Code's principles.

2.84 Apart from some minor amendments in 2012, and the introduction of tiering in 2016, the Stewardship Code has not been significantly updated since first published in 2010. The FRC will be launching a consultation on a revised Code early in 2019. At the same time, the UK Government is due to implement a number of new statutory reporting requirements for stewardship as part of implementation of a revised Shareholder Rights Directive³⁰ by June 2019.

2.85 Informed and engaged stewardship of companies by UK investors helps the FRC to meet its wider responsibilities in relation to corporate governance, corporate reporting and audit.

2.86 However, the existing tiering approach focuses predominantly on checking the content of stewardship statements, not on actual effectiveness or outcomes.

Recommendation 42: The Review recommends that a fundamental shift in approach is needed to ensure that the revised Stewardship Code more clearly differentiates excellence in stewardship. It should focus on outcomes and effectiveness, not on policy statements. The Government should also consider whether any further powers are needed to assess and promote compliance with the Code. If the Code remains simply a driver of boilerplate reporting, serious consideration should be given to its abolition.

2.87 The FRC also seeks more broadly to engage with the UK investment community, both to help promote compliance with the Stewardship Code and to seek investor views on governance, reporting and audit matters. However, it was only in June 2018 that the FRC established an Investor Advisory Group³¹ and this very largely consists of ESG specialists, not investment decision-makers. Overall, the Review is not convinced that the FRC has anything like the depth and breadth of relationships with senior decision-makers in the investor community that it needs to exercise its functions well. To be fair, it is also true that the investor community is also not as engaged, particularly in complex technical audit or accounting topics, as it should be.

Recommendation 43: The FRC needs to engage at more senior level in a much wider and deeper dialogue with UK investors, including both fund managers and representatives of end-investors.

³⁰ Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement
<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017L0828>

³¹ [https://www.frc.org.uk/about-the-frc/structure-of-the-frc/investor-advisory-group-\(iag\)/members-of-the-investor-advisory-group-\(iag\)](https://www.frc.org.uk/about-the-frc/structure-of-the-frc/investor-advisory-group-(iag)/members-of-the-investor-advisory-group-(iag))

Chapter 3 – Corporate failure

The role of the regulator

3.1 The failure of major companies naturally raises public concern over whether more could have been done by public authorities to prevent failure from occurring.

3.2 Responsibility for corporate failure must always rest, first and foremost, with a company's directors, as well as to some degree with shareholders.

3.3 The Review does not believe it would be practical or desirable to task a regulator with a general responsibility to ensure that even major companies are well-run and that failure could not occur. Such a regulatory regime would require very intensive oversight of a company's operations, strategy, finances and management. It would be a huge inhibitor to risk-taking, investment and innovation in the economy, and the costs would almost certainly exceed the benefits. The Review is not aware that any country in the world has attempted such a regulatory regime, and strongly doubts that it could ever be effective.

3.4 All that said, it is clear that the FRC's work already can, and should, contribute at least to some degree to avoiding unnecessary and avoidable causes of major corporate failure.

3.5 The FRC sets accounting and auditing standards, issues guidance and regulates the quality of corporate reports and statutory audits for the UK's largest companies. It shapes the system that provides the essential information that allows capital markets to work. It also seeks to promote high standards of corporate governance. Company accounts should provide an accurate picture of the company's performance and financial position, independently assured by external audit; and other reports should describe fairly the company's strategy and principal risks. Investors, creditors and customers should be able to use this information to make an informed assessment of a company's prospects.

3.6 However, the FRC's current work is generally backward-looking: its remit is to check whether a company's published accounts are defective; and whether its statutory audit was of acceptable quality. Further, the FRC's enquiries on company accounts are essentially technical in nature and intended to lead to incremental improvements in future years.

3.7 The Review has considered whether there is scope for the new regulator to play a more forward-looking role, particularly in acting in response to intelligence it has, or to potential "warning signs". The Review considers that there is potential to do this.

3.8 First of all, the new regulator should put in place more effective and pro-active arrangements to identify emerging risks, at market and company levels. Through its work on AQR, CRR and corporate governance, the regulator gains potential insights and information

relating to companies. This intelligence should be put to better use. It also needs to be supplemented with a more comprehensive and effective picture, using analysis of publicly available market data of sectors and companies at risk, as well as information gathered through its own work.

Recommendation 44: The Review recommends that the regulator should develop a robust market intelligence function to identify emerging risks at an early stage, helping to shift its perspective to current and future risks, as well as its existing retrospective focus.

3.9 In addition, the Review considers that the effectiveness of the regulator will be improved by greater engagement with auditors about risks at a sector and company level, using the PRA's regulator-auditor meetings as a useful reference point. At present in the UK, auditors of banks and insurance firms are obliged to report to the PRA if they believe that the company is not, or may cease to be a going concern; but this duty does not apply to auditors of other PIE entities.

Recommendation 45: The Review recommends that the Government introduces a duty of alert for auditors to report viability or other serious concerns. The regulator should also take a close interest, and engage with the auditor, in situations where a PIE auditor has parted company with its client outside the normal rotation cycle.

3.10 The Review suggests that in developing the detail of that duty, the Government should look at the system applied in France, which requires statutory auditors to report viability concerns to the company board, thereafter to escalate them to the shareholders and ultimately to a regulatory body if their concerns are not addressed.

3.11 Bringing together the range of intelligence and analysis set out above would be of benefit to the regulator in relation to the FRC's existing regulatory functions. It would enable the regulator:

- Better to inform its risk-based approach for AQR and CRR work;
- Proactively to convene stakeholders to clarify the application of standards in higher risk areas;
- To issue 'practice guidance' to auditors to inform forthcoming audits;
- To work with companies and auditors to develop guidance on the interpretation of accounting standards for a particular issue, or to recommend – and possibly mandate – additional disclosures; and
- Better to share intelligence with other regulators such as the FCA and the Insolvency Service where it is relevant to their work.

New powers

3.12 The Review considers that it would also be possible to go further and task the new regulator with new powers to take more pro-active steps.

Recommendation 46: The regulator needs to be able to act quickly where potentially serious problems are indicated. The Review recommends that the regulator should be able to require rapid explanations from companies about reasonable concerns raised by the regulator.

3.13 Where those concerns are serious enough, it should also be able to assess the underlying issues in more depth. The FCA and PRA have the power to commission experts ('skilled persons') to visit companies and examine any matter relating to the regulators' strategic objectives. For example, the FCA commissions skilled person reviews of authorised firms in the financial services sector to assess their systems of control, business conduct, risk management or information security, using powers in section 166 of the Financial Services and Markets Act 2000. The skilled person reports confidentially to the FCA with their findings and recommendations, and the FCA can decide what further action is necessary, which may include mandating improvements to the firm's operations. The company may appoint its own contractor to undertake the skilled person review from a panel pre-selected by the FCA, but the FCA must approve the company's selection and decides the remit of the review. The company is required to pay for the review.

3.14 In comparison, the FRC's current powers to investigate concerns (other than for statutory audit) are limited. The FRC has a statutory power to obtain information from a company to discharge its delegated statutory responsibilities on corporate reporting. That is, to obtain explanations where it appears that a company's financial statements, directors' report or strategic report may not comply with the Companies Act 2006. However, the FRC has no authority to make more in-depth enquiries into a company's risks, systems or other affairs unless these are relevant to its delegated statutory responsibilities for corporate reporting.

Recommendation 47: The Review recommends that the new regulator should be able to commission a skilled person review, paid for by the company, in circumstances where there is any significant interest arising from its strategic objective:

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

3.15 The regulator would need to use this power in a proportionate manner, bearing in mind its potential cost and administrative burden.

3.16 This power would be novel and would differ in a number of significant respects from the regulators' powers in the financial services sector where the nature of the supervisory regime is very different. The Review considers that the circumstances justifying an inspection could include:

- Where there are concerns about the accounting treatment of key areas of audit judgement;
- Where there is evidence of significant investor concern;
- Where there are concerns about the credibility of a company's viability or going concern statement or the methodologies used to underpin the statements;
- Where there are concerns that corporate governance explanations are seriously misleading or inaccurate and that shareholders may be receiving a misleading impression of what is really happening;
- Where there are grounds to believe that important aspects of corporate governance are seriously deficient;
- Where there is intelligence that an audit committee is not doing its job effectively or is being unduly influenced by executive directors;

- Where internal controls or risk management appear to be seriously inadequate;
- Where a dividend has been announced that appears rash or unaffordable and incompatible with the UK's capital maintenance rules; or
- Where there are indications that a company might not be financially viable, and the company is not acting responsibly in dealing with these risks.

3.17 In many cases, the Review would expect the skilled person to recommend certain improvements to the company's accounting or governance and for the company to accept those recommendations voluntarily, with the regulator monitoring subsequent progress. In such cases, it may well be appropriate for the report and the outcome of it to remain confidential.

Recommendation 48: The Review recommends that the regulator should also have the power to publish the skilled person's report if it judges that to be in the public interest. Investors would then be able to reach their own conclusions about the company's conduct and management.

Recommendation 49: In terms of further action that may flow as a result of an inspection, depending on its findings the Review recommends that the regulator should be given powers to:

- Require a company to procure additional assurance on the viability statement or any other aspect of company reports and accounts;
- Require a company to procure an independent boardroom evaluation focused on particular areas of concern such as a specific examination of the effectiveness of the audit committee;
- Notify the company of its view of the risks to financial viability and require a formal response from the board, with a recovery plan if appropriate; or
- Order the removal of the auditor or an immediate retendering.

Recommendation 50: In the most serious cases, the Review suggests it may be appropriate for the regulator to issue a report to shareholders suggesting that the company's dividend policy should be reviewed, or that they consider the case for a change of CEO, CFO, chair or audit committee chair, or for other strengthening of the board of directors. The Review believes that, where the severity of the facts merit it, the regulator should have the confidence to do this. Decision-making should rest, as now, with boards and shareholders.

Other relevant issues

Internal controls

3.18 A number of respondents to the Review suggested that there is a serious case for considering the introduction of stronger regulation in respect of companies' internal controls, similar to that applying in the US under the Sarbanes-Oxley Act (SOX). The relevant provisions in SOX are requirements for the CEO and CFO of public companies to report annually on the effectiveness of the company's internal controls over its financial reporting and for the company's auditor to attest to, and report on, management's assessment of its internal controls.

3.19 The Review is particularly struck by the extent of support for these provisions amongst senior audit committee chairs with experience of operating this regime in US-listed companies. A number of members of the Review's own advisory group also support the provisions. The arrangements are seen as having led to better financial reporting, fewer significant accounting restatements and stronger reassurances for audit committee members about the robustness of internal controls. The provisions also underline clearly that the primary responsibility for internal financial controls and the accuracy of financial reporting rests with the board and management of a company.

3.20 Introducing SOX-style provisions would clearly be a very major step. It could impose significant costs, at least initially, particularly on smaller listed companies. The US experience shows that smaller companies are affected disproportionately and listing could become less attractive. Ongoing, recurring costs, however, are said to be lower. So too are the costs of auditing automated and centralised systems which, in itself, provides an incentive to improve controls.

Recommendation 51: BEIS should give serious consideration to the case for a strengthened framework around internal controls in the UK, learning any relevant lessons from operation of the Sarbanes-Oxley regime in the US. The pros and cons of options for change should be analysed and consulted upon, giving special consideration to the importance of proportionality in relation to the size of the company.

Viability statements

3.21 The viability statement was introduced in 2014 as part of the revised UK Corporate Governance Code. The statement is published in a company's annual report and explains the directors' assessment of the company's prospects over a specified period, taking account of its current position and principal risks. It should set out how the directors have assessed the company's prospects, whether the company is viable over the period selected and why that period is appropriate, and any assumptions or qualifications. For the most part, companies have used a three-year period to assess viability, although there is no upper limit on the period that may be selected.

3.22 It is widely acknowledged that whilst a well-meant innovation, viability statements are not performing an effective role. In general they consist of boilerplate statements that provide little meaningful insight for investors and users of accounts.

Recommendation 52: The Review recommends that viability statements should be reviewed and reformed with a view to making them substantially more effective; and if they cannot be made more effective, serious consideration should be given to abolishing them.

3.23 For instance, one possibility for consideration could be to require the inclusion in viability statements of detail on what specific stress testing has been undertaken by the company to underpin the viability statement. There may also be a case for bringing the viability statement within the scope of audit, or some other form of assurance.

Reporting graduated audit findings

3.24 The Review also believes that there is scope for the audit information provided to investors and other stakeholders to improve, so as better to inform their scrutiny of the company. The UK was the first country globally to introduce extended audit reports, which auditors of listed (and more recently PIE) companies are required to produce. Those reports

are intended to provide greater transparency about the audit to the users of accounts including communicating key audit matters. The enhanced audit report was welcomed by investors, and reporting is now embedded.

3.25 Extending this further, the Review has considered the audit reports of a small number of FTSE 100 companies which have included additional information in relation to key audit matters over and above that required by the auditing standards. Included in the opinions are the conclusions reached by the auditor in relation to the key audit matters. Findings are not presented just as yes/no, or pass/fail, but instead the audit report presents judgemental views as “graduated” findings: for example describing an estimate as being cautious, balanced or optimistic.

3.26 The Review understands that, in essence, these are the findings that the auditor already presents to audit committees indicating their views on the judgements taken. The Review considers that including this information within the audit report could provide shareholders with more detail about the findings of the audit, and a year on year comparison of how balanced accounting estimates and judgements are.

3.27 Reporting “graduated” findings in this way has been well received by investors. However, the Review understands that there is currently only very limited appetite amongst preparers for auditors to report in this way.

3.28 The Review supports further enhancements to the audit report of this kind. Reporting “graduated” findings could ensure greater transparency with regard to the conclusions reached, ultimately providing more information with which shareholders can challenge management.

3.29 The regulator should be the driver of such a change. It should consult appropriately and influence internationally. Consistency in approach across UK audit firms is critical as too is ensuring international buy-in. This is a further opportunity for the UK regulator to drive best practice and improvement globally.

Recommendation 53: The Review recommends that the regulator considers requiring further enhancement to the Independent Auditor’s Report to include “graduated” audit findings.

Chapter 4 – The new regulator: oversight and accountability

Oversight by Government and Parliament

4.1 Chapter 1 set out recommendations for a statutory base for the new regulator. New arrangements for accountability to Parliament, and an appropriate relationship with the Government, are also required.

4.2 The oversight and accountability arrangements for regulators vary. In relation to Parliamentary oversight, the FRC is currently called to account for its actions by relevant Select Committees at their invitation, but in practice this only occurs sporadically. Parliament does not have a formal role in scrutinising the FRC’s work, or its performance. At present, the FRC Chair and Deputy Chair are appointed by the Secretary of State for BEIS (though they are not public appointments) and there is no scrutiny of these appointments by Parliament.

4.3 Given the significant role it plays, the Review concludes that a higher degree of Parliamentary scrutiny and accountability is warranted.

Recommendation 54: The regulator should submit an Annual Report to Parliament.

4.4 The Review has also recommended in Chapter 1 that all board appointments should be public appointments, that the appointment of the Chair and CEO should be subject to a pre-appointment hearing with the BEIS Select Committee, and that the Government should issue a remit letter to the regulator at least once each Parliament.

Recommendation 55: In terms of its internal systems and controls, the Review recommends that the new regulator must apply:

- The provisions of **Managing Public Money**³²;
- The **Regulators’ Code**³³, which sets out a clear principles-based framework for how regulators should engage with those they regulate; and
- The **Public Contracts Regulations**³⁴ regarding procurement.

4.5 The Review also expects the regulator to ensure that its work fully considers and assesses equalities impacts, particularly given that it will be taking on the FRC’s existing role in relation to the Corporate Governance Code and its requirements on equality and diversity.

³² <https://www.gov.uk/government/publications/managing-public-money>

³³ <https://www.gov.uk/government/publications/regulators-code>

³⁴ <https://www.gov.uk/guidance/public-sector-procurement-policy>

Recommendation 56: The regulator should actively promote diversity, especially in its work on corporate governance.

Conflicts of interest

4.6 The FRC has been the subject of strong criticism from some stakeholders over a perceived closeness to those it regulates, its reliance on recruiting from the major audit firms, and an associated concern that the FRC has an ingrained cultural sympathy towards the accounting profession.

4.7 It is inevitable that the regulator will need to, and should, recruit former partners and employees of major audit firms – it needs to employ qualified, experienced auditors and accountants in order to have the expertise, knowledge, and skill needed to test complex issues of corporate reporting and audit quality. Many of them will have worked in the “big 4”. There is nothing inappropriate in this, any more than it is inappropriate for the financial regulators to employ former staff of major financial firms. All the FRC’s international peers employ former “big 4” staff.

4.8 This, however, makes it all the more critical that the regulator has procedures and arrangements in place that provide a robust and defensible basis for the legitimacy of its decision-making, in particular to avoid any potential for actual or perceived conflicts of interest.

4.9 The FRC publishes the code of conduct applying to its board, committees and councils; and it has a principles-based code of conduct that applies to all staff. Both set out the requirements and expectations in relation to conflicts of interest.

4.10 In the case of the executives and non-executives on the FRC’s board, committees and sub-groups, a register of interests is published; a confidential register of financial interests is maintained (applying a £25,000 minimum threshold); and individuals withdraw from discussion when any conflicts arise. In addition, the majority of board members may not have been practising accountants or actuaries in the five years prior to their taking up the role;³⁵ and no member of the board may have been a practising auditor³⁶ in the three years prior to their taking up that role.³⁷

4.11 For staff at the FRC, AQR inspectors are legally required to observe a 3-year cooling-off period³⁸, while staff in other roles “as a general principle, ... should not be involved with monitoring or enforcement work in relation to a former employer”. Managers are therefore able to exercise some discretion in considering how best to manage potential conflicts of interest.

³⁵ The majority of directors on the Board may not be individuals who in the five years prior to appointment have: (i) been practising accountants or actuaries; or (ii) held voting rights in an accountancy or actuarial firm; or (iii) been employees of an accountancy or actuarial firm, members of the administrative or management body of an accountancy or actuarial firm.

³⁶ No director/member appointed may be an individual who in the three years prior to appointment has: (iv) been a practising auditor; or (v) held voting rights in an audit firm; or (vi) been an employee of, partner of or otherwise contracted by an audit firm, a member of the administrative, management or supervisory body of an audit firm or an officer holder of an audit body.

³⁷ This rule also applies to members of the FRC’s Conduct Committee, Codes and Standards Committee, Case Management Committee, and Enforcement Committee Panel.

³⁸ As required by Article 26 of the EU Audit Regulation, which states that “a person shall not be allowed to act as an inspector in an inspection of a statutory auditor or an audit firm until at least three years have elapsed since that person ceased to be a partner or employee of that statutory auditor or of that audit firm or to be otherwise associated with that statutory auditor or audit firm”.

4.12 The FRC’s hospitality register has only been published in recent weeks; and it is only recently that the FRC has applied a consistent approach to the documentation of conflicts of interest for its staff. Whilst this is welcomed, the Review understands that the FRC does not have a uniform approach to documenting deployment of staff to work concerning former employers, nor the mitigations or other safeguards put in place as a result.

4.13 The Review considers that all these arrangements need to be strengthened. For the foreseeable future, the priority needs to be to rebuild the regulator’s credibility.

Recommendation 57: The Review recommends that:

- **For the foreseeable future, it would be wise for the regulator not to allow staff, board or committee members ever to work on any regulatory functions relating to a past employer, removing themselves and/or delegating to others as necessary; and**
- **Written declarations for all staff members’ conflicts of interest and financial interests should include proposed mitigations, and record any exercise of management discretion in relation to work undertaken relating to a former employer.**

4.14 The Review recognises that the extent of the first of these recommendations is unusually stringent, and some reasonable flexibility should be permitted if for instance an individual only undertook very early-career training in a relevant firm. But the Review does consider that a very rigorous regime is justified at least until such time as the new regulator’s credibility and reputation for tough independent-minded judgement is fully and unequivocally established. These arrangements should not however be enshrined in legislation.

4.15 There has also been some criticism from stakeholders of the FRC’s approach to procurement. The Review believes there is force to this, in particular around the FRC’s failure to adopt an open competitive approach. The FRC told the Review that it does not consider that public contracting regulations apply to it; nor does the FRC apply them in spirit. During the last 3 years, it has not tendered openly for the majority of its legal and professional services, the value of which has been over £2m. The Review does not believe this approach is appropriate.

Recommendation 58: The Review recommends that the regulator should establish a procurement policy that adheres to public contracting regulations, and that follows an open tendering process. Its policy should be published, along with a summary of those contracts awarded that are above the Public Contracts Regulation threshold.

Complaints

4.16 The FRC handles complaints about accountants, auditors, professional bodies, financial reporting and other areas. There is currently no uniform approach across the FRC when dealing with complaints, and most are dealt with under voluntary arrangements. Complaints about the FRC itself may be escalated to an Independent Complaints Reviewer (ICR)³⁹.

4.17 Last year, the FRC received over 300 complaints. Twelve complainants raised issues about the FRC itself, 2 of which were referred to the ICR. The majority of complaints received by the FRC were about the conduct or performance of an accountant or auditor.

³⁹ <https://www.icrev.org.uk/about-the-icr/>

4.18 In responding to the Review's Call for Evidence, concerns were raised around the length of time the FRC takes to resolve complaints, there was frustration at the lack of clarity about outcomes, and some considered the FRC's handling to be defensive.

4.19 The Review has also heard that complaints can be of value to the FRC and may provide useful information regarding its CRR functions, for example.

4.20 The FRC has a limited role in handling complaints about the bodies it oversees on a voluntary basis (on accountancy and actuarial regulation, for example). In those circumstances, the FRC is only mandated to test if the relevant professional body has followed its own complaints procedure, rather than to examine the merit of the complaint itself. The Review has not examined the detail of each professional body's complaint handling process, but notes the other avenues of appeal and independent review available to individual complainants, as well as civil mechanisms for redress. The Review remains concerned, however, that current systems do not appear to look for emerging sector-wide issues of concern that need to be addressed. Here there is strong cross-over to the wider oversight of professional bodies as set out in Chapter 2, which examines whether the regulator should have stronger powers to act should it have concerns about the adequacy of professional bodies' performance.

4.21 The Review's concern in this matter is exacerbated by an apparent absence of transparency. Very little information about complaints is published by the FRC, with its annual report referring only to the outcomes of complaints relating to the FRC itself, rather than reporting on those raised about others.

Recommendation 59: The Review considers the lack of transparency regarding complaints to be unhelpful and recommends that aggregated data on the trend, nature, and outcome of complaints referred to the FRC be published, as well as information on the speed at which they were dealt with.

Recommendation 60: The Review recommends that the new regulator should more proactively monitor trends in complaints received by, and regarding, professional bodies, since this provides useful intelligence on the way in which professional bodies are operating. The new regulator should be actively interested in the substance of complaint-handling, especially where it is clear that complaints have merit, and not simply be monitoring process-compliance.

4.22 The Review is concerned that the absence of a central or consistent approach to complaints management may result in missed opportunities to drive improvements in auditing or corporate reporting, and to ensuring that all relevant parts of the regulator are aware of a concern.

Recommendation 61: Given the complex nature of the issues dealt with by the FRC, the Review recommends that a central team receive, triage, respond, and ensure appropriate action is taken in relation to complaints or complaint-like contact from stakeholders. That team should also develop clear guidance on how complaints will be dealt with, including timelines. Although basic, the review considers these changes necessary to improve the regulator's credibility.

4.23 The FRC has a whistleblowing policy that is in line with those of other regulators.

Freedom of Information

4.24 The Review's terms of reference specifically question the FRC's application of Freedom of Information (FOI) provisions.

4.25 At present, only some of the FRC's functions are subject to FOI⁴⁰, with its application⁴¹ including information about:

- The recognition of recognised supervisory and qualifying bodies;
- The independent supervision of the Auditors General; and
- The registration of third country auditors.

4.26 The Review is surprised that the FRC's other statutory functions are not covered by FOI provisions, including its activities as the Competent Authority for audit. By comparison, the Freedom of Information Act 2000 (FOIA) applies in full to the FCA⁴².

4.27 The Review has heard that that the FRC lacks transparency and is not always forthcoming with information when requested. In its published disclosure log⁴³, the FRC received 16 Freedom of Information (FOI) requests in the year ending 31 March 2018, and it provided the requested information to 4 of these. The FRC did not provide the requested information to the majority of its respondents because their requests did not fall within the statutory functions covered by the FOIA.

Recommendation 62: The Review sees no reason why FOI provisions should not apply in full to the regulator's functions and internal running and recommends that it is designated as a Public Authority for this purpose.

Leaks

4.28 The Review is dismayed at the scale and sensitivity of information about the FRC's activities that appears routinely to leak to the media. Such leaks are extremely rare in the case of other regulators.

4.29 The Review notes that recent leaks of FRC activities have included:

- Pre-emptive stories, including detailed facts around the outcomes of individual cases, including highly sensitive settlement negotiations or embargoed Tribunal judgments in the cases of Connaught, BHS (British Home Stores) and Redcentric;
- The content of anticipated publications, including on the revised Corporate Governance Code and the FRC's review of audit quality;
- Internal staffing information – including the resignation of Stephen Haddrill; and
- Information known to the FRC relating to this Independent Review.

4.30 The FRC is a public interest regulator which handles highly market sensitive information. Its enforcement activities have substantial impacts on companies, professional firms and individuals. As the organisation responsible for good corporate governance, the Review expects the FRC to take stronger and more comprehensive action to ensure the protection of sensitive information, whether through operating tighter internal procedures or by being more restrictive and disciplined in sharing information in advance with external stakeholders.

⁴⁰ <https://www.frc.org.uk/frc-for-you/freedom-of-information>

⁴¹ The FRC has been delegated to exercise functions of the Secretary of State under Part 42 of the Companies Act (which relates to Statutory Audit). As a result of that delegation order, the FRC has been designated under section 5 of the FOIA.

⁴² <https://www.fca.org.uk/freedom-information/fca-freedom-information-act>

⁴³ <https://www.frc.org.uk/frc-for-you/freedom-of-information/disclosure-log>

Figure 9: Leaks during the period of the Review

| Date | Issue |
|--------------|--|
| October 2018 | Resignation of Stephen Haddrill |
| October 2018 | Settlement details of enforcement case against PwC's audit of Redcentric |
| July 2018 | Revised Corporate Governance Code |
| June 2018 | Series of stories relating to PwC's audit of BHS |
| June 2018 | FRC reporting on 'big four' audit quality review results |
| May 2018 | Names of members of the Advisory Group for Independent Review |
| April 2018 | Appointment of Sir John Kingman to lead Independent Review |

Recommendation 63: The Review recommends that FRC and the new regulator must ensure that their internal procedures and approach to sharing information with external stakeholders, and its procedures to investigate and act on any leaks, are much more robust and effective.

Chapter 5 – Staffing and resources

Funding

5.1 The FRC's budget of £36.3 million is funded by market participants: those it regulates, those who directly benefit from its regulatory activities, and those who have regard to the standards it sets. The funding groups pay the FRC levies through a mixture of statutory, contractual and voluntary arrangements.

Figure 10: FRC budget

| Table 1: Budget | 2017/18 | | 2018/19 |
|---|-------------|-------------------|-------------|
| | Budget | Estimated outturn | Budget |
| | £m | £m | £m |
| Corporate Governance & Reporting | | | |
| Corporate governance | 1.1 | 0.9 | 0.8 |
| Accounting and reporting | 2.9 | 3.1 | 3.2 |
| Corporate reporting review | 4.0 | 3.9 | 4.2 |
| Financial Reporting Lab | 1.0 | 0.8 | 0.9 |
| XBRL | 0.2 | 0.2 | 0.2 |
| Central costs | 1.8 | 1.7 | 1.6 |
| Sub total | 11.0 | 10.6 | 10.9 |
| Audit and Assurance Regulation | | | |
| Audit quality review | 7.7 | 7.6 | 7.9 |
| Audit & Assurance standards | 1.9 | 2.0 | 1.9 |
| Audit firm monitoring | | | 0.6 |
| Professional oversight | 1.9 | 2.1 | 2.2 |
| Central costs | 1.8 | 1.8 | 1.9 |
| Sub total | 13.3 | 13.5 | 14.5 |

| Table 1: Budget | 2017/18 | 2017/18 | 2018/19 |
|---|-------------|-------------------|-------------|
| | Budget | Estimated outturn | Budget |
| | £m | £m | £m |
| Actuarial Standards & Regulation | | | |
| Technical actuarial standards | 0.9 | 0.7 | 0.8 |
| Professional oversight | 0.2 | 0.2 | 0.2 |
| IFoA actuarial monitoring | | | 0.1 |
| Central costs | 1.0 | 1.0 | 1.0 |
| Sub total | 2.1 | 1.9 | 2.1 |
| Enforcement | | | |
| Enforcement core costs | 3.4 | 3.4 | 3.3 |
| Sub total | 29.8 | 29.4 | 30.8 |
| Audit and accountancy case costs | 5.0 | 5.0 | 5.0 |
| Actuarial case costs | 0.5 | 0.1 | 0.5 |
| Total | 35.3 | 34.5 | 36.3 |
| Increase/(Decrease) in reserves | 0.7 | 1.7 | – |
| Funding requirement | 36.0 | 36.2 | 36.3 |

Source: FRC Strategy 2018/21 Budget and Levies 2018/19

5.2 At present, the bulk of FRC funding is provided by preparers of accounts and the audit profession. The contributions from preparers of accounts are provided to the FRC on a voluntary basis. These payments contribute to the FRC’s work on audit quality, corporate governance and reporting, alongside funding provided by accountancy bodies, RSBs and others via a combination of contractual arrangements and statutory requirements. Preparers contribute 50% of FRC funding; the RSBs and accountancy bodies also contribute around 50%.

5.3 The voluntary nature of part of the FRC’s funding is very unusual and is clearly inappropriate.

Recommendation 64: The Review recommends that the regulator should not be funded on a voluntary basis. BEIS should put in place a statutory levy.

5.4 Some of the Review’s recommendations – to strengthen staffing in the AQR and CRR teams to increase the volume and quality of that work undertaken; to develop new functions on intelligence and to execute its competition duty; and to undertake its forward-looking work on corporate failure – will require further funding.

Recommendation 65: The Review recommends that BEIS should agree a new budget, consistent with the Review’s recommendations, working with the new regulator and consulting stakeholders.

Recommendation 66: The Review recommends that BEIS should set the regulator’s budget each year, and having consulted, determine the proportions of the levy that will apply to different parties.

Staffing

5.5 This Review was set clear objectives, to:

“Put the FRC in a position to stand as a beacon for the best in governance, transparency and independence; strengthening its position and reputation.”

And to:

“Ensure that its structures, culture and processes; oversight, accountability, and powers; and its impact, resources, and capacity are fit for the future.”

5.6 For these objectives to be achieved, the regulator must be able to recruit high-calibre candidates from a wide variety of professional backgrounds. Its staff must be technically expert and must inspire respect. There must be openness and diversity of thought in the organisation.

5.7 There is a clear public interest in enabling this: the regulator’s staff must hold to account some of the biggest companies and firms in the economy, and it must provide national and international leadership at a time of significant change.

5.8 Having examined the detail of FRC’s current staffing position, the Review makes recommendations focusing on three key areas: diversity and openness; seniority and expertise; and on pay, as set out below.

5.9 On diversity and openness, the review is concerned that the FRC needs to do more to ensure that its staff have greater recent experience outside the regulator to ensure that understanding of current practice, new developments, and emerging trends is as up to date as possible. High levels of staff loyalty are of course good. But a narrow organisational culture is not. The regulator needs a more open staffing model than in the past.

Recommendation 67: As set out in Chapter 3, the regulator needs to develop new teams, and should look to recruit analysts, investment experts, economists, and those skilled in corporate law.

5.10 As recommended in Chapter 2, the Review considers that the regulator should increase the seniority of its staff carrying out regulatory functions, particularly AQR. It should mirror the PCAOB’s approach to employ former partner-equivalent experts, which would better enable teams to deploy the degree of challenge, breadth of knowledge and sophistication of judgement necessary to hold such significant actors to account.

Recommendation 68: The Review recommends that the new regulator should develop a staffing and resourcing strategy to achieve the vision set out in this Review. That should include a more diverse approach to hiring. The regulator should also build on the experience of the Financial Reporting Review Panel and, like the other financial regulators, develop a pool of former or retired senior executives and experts – so-called ‘grey panthers’ – to boost its capacity to deploy expertise at short notice.

5.11 On pay, the Review is satisfied that the FRC has generally been able to advertise vacancies at a rate that attract candidates of suitable quality and qualification. Its pay strategy is based on a methodology similar to that of other market-funded regulators; and rates of pay are comparable to those for similar grades working at the FCA and PRA. If anything, there is evidence that some junior and generalist staff are paid over the market reference point, and the FRC is taking action to address this.

5.12 However, the right arrangements must also be put in place for the future.

5.13 The FRC was recently required for the first time to submit for government approval each individual role with a salary over a £100,000 threshold. This is a very time-consuming and bureaucratic process that risks the regulator being unable to recruit when needed, or unable to engage the best candidate for a role. It is of particular concern to the Review that, owing to the seniority and qualifications of staff needed by the regulator, 50% of its staff currently fall above this threshold, including those in key regulatory and enforcement roles. The Review also understands that BEIS and HM Treasury are asking the FRC to agree a Long-Term Pay Strategy and apply Public Sector Pay Guidance structures even to highly specialist roles.

5.14 These new arrangements are anomalous. Neither the FCA nor the PRA is subject to requirements of this kind. Both are public bodies; have similar rates of pay to the FRC; and use a similar methodology to set their pay strategy. Like the FRC, they are not funded by the taxpayer, but by those they regulate. The Review is clear that if the recently-introduced arrangements persist, the new regulator inevitably will become steadily a *less* effective body over time than the FRC is now, at a time when the Government is very clear that it wishes to see a *more* effective body.

Recommendation 69: The Review recommends that the control arrangements on pay for the regulator should mirror those of other financial regulators such as the FCA, PRA and Ofcom which are not funded by the taxpayer. This approach should apply immediately. The new regulator's budget should be set by Ministers, as should the CEO's pay, but other pay decisions should be made by the regulator subject, of course, to proper transparency, and within the overall financial budget set by Ministers.

Recommendation 70: The Review recommends that the new regulator's pay arrangements should be set out in the new regulator's legal base, and mirror that of Ofcom. That sets out with clarity that the arrangements for the terms, conditions, and remuneration of staff are a matter of Ofcom's responsibility. The Office of Communications Act 2002 states that:

Schedule (7)(1): "The employees of Ofcom who are not executive members shall be appointed to and hold their employments on such terms and conditions, including terms and conditions as to remuneration, as Ofcom may determine."

The Review recommends that the same wording be used for the founding legislation for the new regulator.

Chapter 6 – Other matters

Competition issues

6.1 The market for audit services is highly concentrated – currently 97% of audits of FTSE 350 firms are undertaken by the Big Four auditors. One of the mid-tier auditors, Grant Thornton, which could, in principle, provide competition to the Big Four, announced earlier this year that it would no longer tender for FTSE 350 audit work because of the difficulties and costs of making inroads into this market.

6.2 The FRC has a major role in regulating the audit market but does not currently have a competition duty or remit, and has resisted taking one on. In 2013 the Competition Commission recommended that the FRC should amend its articles of association so that “without prejudice to its other objects, in performing its functions it will have due regard to the need for competition in the statutory audit market for FTSE 350 companies”. The FRC did not adopt this recommendation, seeing its role as being focused on quality rather than competition, and having concerns about situations where there could be tension between the two.

6.3 Under the EU Audit Directive the FRC, designated as the “Competent Authority” for audit in the UK, has the task of monitoring developments in the market for providing statutory audit services to Public Interest Entities, including market concentration levels. The Competent Authority must report every three years on developments in the market for statutory audit services to PIEs. This role is still developing, but the FRC already has a stronger formal interest in competition in the audit market alongside audit quality issues⁴⁴.

How the FRC’s work can affect competition

6.4 Whilst the Review entirely agrees that quality must be the regulator’s principal focus, the Review is also clear that there are numerous areas where the FRC’s work can have a direct effect on competition and the dynamics of the audit market and where regulation and competition can work hand in hand to deliver higher quality. These were also noted by many responses to the Review. For instance:

- The FRC’s approach to using and publicising findings from its Audit Quality Review (AQR) work. In a market where the quality of the product is largely invisible unless things go wrong, AQR findings are one of the key ways in which audit customers

⁴⁴ Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities – Article 27 (Monitoring market quality and competition).

can differentiate between providers. More transparency on findings – including ratings – would help audit committees and shareholders make better informed choices and drive competition in quality.

- The number of audit firms covered by the FRC's AQR programme. If AQR findings are a key means of assessing audit providers, then not being part of the assessment programme represents a barrier to entry. Only six providers are currently subject to annual FRC reviews. The lack of regular external reports on other auditors can have the effect of limiting choice for audit committees who will want to play safe and only include auditors on shortlists where they have satisfactory current reports. The FRC's recent decision to enhance reviews for the six largest audit firms may have a similar effect in entrenching the incumbents because audit committees may only want to pick firms where the FRC has validated their processes. In both cases, there may be ways in which the FRC could try to counteract this potential barrier to entry.
- The FRC's approach to setting or negotiating audit and accounting standards – Wherever possible, standards need to be set in ways that are proportionate and take account of the different scale and size of providers. Where standards and other rules are set internationally, the FRC's negotiating approach and objectives could similarly take account of competition issues.
- The FRC's approach to determining fines, liabilities and other sanctions – The approach taken, including the respective weights given to financial and non-financial sanctions, can have a strong bearing on smaller firms' willingness to enter the audit market.
- The FRC's approach to the development of the UK Corporate Governance Code. This has a strong potential bearing on competition, particularly the Code provisions and supporting guidance on how audit committees should procure auditors and assess pricing and quality.
- The future development of the FRC's new responsibility under Article 27 of the EU Audit Directive, as the Competent Authority, to monitor and report every three years on developments in the market for providing statutory audit services to PIEs. This role could be expanded voluntarily, beyond the minimum EU requirement.
- The extent to which the FRC encourages or discourages permitted alternative approaches, such as joint audits – These are allowed under audit standards applying in the UK and could be used to involve a wider range of firms at the top end of the listed audit market and increase the capacity and capabilities of mid-tier audit firms.
- The FRC's approach to approving the transfer of audit technologies to challenger-firms – In the future this could help address entry barriers by ensuring that these capabilities can be made available on viable terms, more broadly among audit firms.

A new competition duty

6.5 When the FRC rejected the Competition Commission's recommendation of a new competition duty, its main concern was a potential clash between audit quality and competition; for instance, in the pursuit of audit quality, it might need to restrict competition by preventing a poorly-performing firm from continuing to offer audit services.

6.6 The Review agrees that safeguarding audit quality must remain central to the regulator’s mission and purpose. However, it is perfectly possible to draft duties which allow regulators to promote competition to the extent that this is compatible with other objectives or as a way of furthering other objectives. Indeed, the Competition Commission’s proposed formulation at the time was of this type, and arguably a fairly weak formulation.

6.7 There are a number of potential models for a competition duty set out in the legislation establishing the FCA, the PRA and economic regulators such as Ofcom, Office of Gas and Electricity Markets (Ofgem) and the Office of Rail and Road (ORR), as set out in the table below.

Figure 11: Examples of other regulators’ competition duties and objectives

| Regulator | Competition duty |
|-----------|---|
| FCA | Has a strategic objective and three operational objectives, including a competition objective. It must, “so far as is compatible with acting in a way which advances the consumer protection objective or the integrity objective, discharge its general functions in a way which promotes effective competition in the interest of consumers.” |
| PRA | Must “so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons. . .” |
| Ofcom | Has a principal duty to further the interests of citizens in relation to communication matters and “to further the interests of consumers in relevant markets, where appropriate by promoting competition.” |
| Ofgem | Must carry out its functions in the manner it considers is best calculated to further its principal objective, wherever appropriate by promoting effective competition. |
| ORR | Has five equally weighted objectives, including to “promote competition in the provision of railway services for the benefit of users of railway services.” |

Source: Regulators’ websites

Recommendation 71: The Review recommends that the new regulator should be given a competition duty in a stronger form than the “have regard to” formulation recommended by the Competition Commission in 2013 and should follow the model set out in Chapter 6, which is broadly based on the FCA’s competition duty.

Figure 12: Proposed competition duty for the new regulator

Proposed competition duty

The new regulator must, so far as is compatible with advancing its other objectives, discharge its general functions in a way which promotes effective competition in the market for statutory audit services.

The matters to which the new regulator may have regard in considering the effectiveness of competition include:

- The availability of information about the quality of service provided by auditors and the extent to which audit customers are able to make informed choices;
- The impact of competition on the price and quality of audit;
- The ease with which the procurers of audit services can change provider;
- The ease with which new auditors can enter the market; and
- How far competition between auditors is encouraging innovation.

New function to keep the audit market under review

Recommendation 72: In addition to a competition duty, the Review also recommends that the regulator should be given a specific statutory function to keep the statutory audit market under review and to report regularly on market and competition developments. This will need to include reporting on trends in audit pricing, the extent of any cross-subsidy from non-audit work and any implications for the quality of audit.

6.8 This function will build on the role that the FRC has recently been given under the EU Audit Directive to report on developments in the UK market for statutory audit services to PIEs. It will ensure that the regulator has the knowledge and expertise needed in terms of market intelligence, analysis and competition expertise to be able to act on a new competition duty effectively. These capabilities will also be needed if the regulator is to take on a role in implementing any competition remedies identified following the Competition and Markets Authority's (CMA) current market study and monitoring their impact.

New powers and resources

Recommendation 73: The Review recommends giving the regulator the powers it needs to support a competition duty and an ongoing market review function. In particular, it will need powers to require firms to provide audit pricing, cross-subsidy and market share data and powers to act to address competition issues where necessary. The position should be reviewed again following completion of the CMA's market study to ensure that the regulator has the powers needed to implement or monitor the CMA's competition remedies and to act on evolving or new competition issues in the future.

6.9 The new duty and market review functions will have resourcing and organisational implications. These will need to draw on the experience of the FCA and other regulators who have been successful in adopting and implementing competition duties.

Actuarial oversight

6.10 Following Sir Derek Morris' review of the actuarial profession in 2005, a memorandum of understanding was put in place between the FRC and the IFoA, which sought to give the former an oversight (and standard-setting) role in relation to the actuarial profession. However, this is not in practice proving an altogether effective arrangement. The FRC's oversight role is based on a voluntary understanding, and it has no powers with which to enforce any meaningful oversight of the IFoA. More than 13 years after Sir Derek reported, only now is the IFoA embarking on a first attempt at quality regulation of the profession. Moreover, the FRC has limited actuarial expertise and resource (4 actuaries are employed within the Actuarial Policy team).

6.11 The FRC assumed non-statutory oversight of the UK actuarial profession's self-regulation of actuaries in 2006. Responsibilities for the professional regulation of actuaries is summarised in the following diagram.

Figure 13: Responsibilities of the FRC and IFoA in relation to actuarial oversight

| FRC | IFoA |
|--|---|
| Setting Actuarial Standards: <i>Generic Technical Actuarial Standards</i> <i>Specific Technical Actuarial Standards</i> | Actuaries' Code Ethical Standards (APSS) |
| Professional/Independent oversight | Educations and examinations CPD Practising certificates Member support |
| Enforcement – Actuarial Scheme Public interest disciplinary cases | Discipline (excluding public interest) |

Source: FRC

6.12 Although the FRC carries out oversight of the IFoA by reviewing relevant IFoA activities and monitoring visits, it performs no monitoring or supervisory role over the quality of actuarial work; and at present nor does the IFoA.

6.13 Technical Actuarial Standards are enforced in the context of an Actuarial Scheme investigation into misconduct by an actuary. The FRC's enforcement remit is limited to investigating, in the public interest, potential misconduct by individual actuaries (not firms).

6.14 Actuarial work is key in a number of matters relating to pensions and therefore of interest to TPR. HM Treasury has told the Review that it wishes to see effective regulatory oversight of the actuarial profession. The Government Actuary has said the same.

6.15 The Review:

- Sees a significant risk that stakeholders may be assuming that the FRC's current oversight of the actuarial profession is a great deal more thoroughgoing and effective than, in the absence of credible powers, it actually is or can be;
- Suggests that, if stakeholders wish to see effective independent oversight of regulation of the actuarial profession, suitable legal powers must be put in place to make this possible;
- Questions whether the FRC is the best body to do this; and
- Suggests in any event that regulation of actuarial *work*, as opposed to the profession, is likely to have considerably more impact than regulation of the profession ever can. This is already done thoroughly by the PRA for insurance companies, through scrutiny of their actuarial models. This is, however, much less the case for pension schemes.

Recommendation 74: The Government, working with the PRA and TPR, should review what powers are required effectively to oversee regulation of the actuarial profession.

Recommendation 75: The Review recommends that neither the FRC, nor its successor body, is best-placed to be the oversight body. The PRA (which employs around 80 actuaries) is a much larger repository of regulatory actuarial expertise than the FRC and would be best-placed to take on all the actuarial responsibilities currently vested in the FRC.

6.16 Actuarial work performed within a statutory audit context will continue to be subject to audit oversight monitoring and enforcement and therefore will remain the responsibility of the FRC.

Local audit

6.17 In 2010 the Secretary of State for Communities and Local Government announced plans to disband the Audit Commission, transfer the work of its in-house practice to the private sector and put in place a new audit framework. This was enacted in The Local Audit and Accountability Act 2014 (LAAA) which in turn introduced a new Local Audit regime in England. Transitional arrangements were put in place and on the 1 April 2018 the new Local Audit regime became fully operational.

6.18 As a result of the new regime, the responsibilities of the Audit Commission in relation to statutory audit transferred to other bodies, namely the FRC, the NAO and RSBs. The framework is now complex and fragmented. Key players on statutory audit under the LAAA are:

Figure 14: Summary responsibilities of organisations for local body statutory audit

| Organisation | Summary Responsibilities |
|--|--|
| Ministry of Housing, Communities and Local Government | Responsible for delivering implementation of the Act. |
| FRC | Monitoring and enforcement. Professional oversight of local auditors has been delegated to the FRC. In turn, the FRC has specified three professional bodies to undertake specific regulatory activities. |
| NAO | Responsible for setting relevant standards, which incorporate the FRC's auditing and ethical standards. Local auditors must also have regard to guidance to auditors published by the C&AG. The Act also allows the C&AG to examine the economy, efficiency and effectiveness with which local authorities and other local public bodies use their resources, providing evaluation, commentary and advice of a general nature rather than examining specific authorities. |
| Professional Bodies | Responsible for registration and qualification of firms and individuals subject to FRC oversight. |
| RSBs = ICAEW, Institute of Chartered Accountants of Scotland (ICAS) | Monitoring and enforcement. |
| RQBs = Chartered Institute of Public Finance and Accountancy (CIPFA) | |
| Public Sector Audit Appointments Ltd (PSAA) | Now the central procurement body |

6.19 For England, the FRC is responsible for inspecting the quality of major local audits⁴⁵ and operating enforcement procedures under the Accountancy Scheme. The FRC has oversight of the regulation by RSBs (ICAEW and ICAS) of auditors of local public bodies and is responsible for recognising bodies as RSBs and Recognised Qualifying Bodies (CIPFA) for Local Audit purposes.

⁴⁵ Major local audits – Local Authority and Health Bodies where total income or expenditure exceeds £500 million and pension funds with assets of £1 billion or more than 20,000 members. The Local Audit (Professional Qualifications and Major Local Audit Regulations) 2014, part 3, schedule 12.

6.20 There are important differences between local authority audit and private sector audit:

- Auditors of local public bodies report not only on the financial statements, but also arrangements for securing value for money, and financial sustainability;
- Auditors of those bodies carry out their work on behalf of the public, yet in comparison to the lines of accountability in companies between the directors, audit committee and shareholders, there is substantially lower awareness and challenge of auditors' work in the public sector;
- The FRC's enforcement powers in relation to local audit are meaningfully different in comparison to its powers in relation to private sector statutory audit. The former are not within scope of the Audit Enforcement Procedure. Instead of the question as to whether an auditor has 'breached a relevant requirement', a far narrower test applies in relation to local audit – that there are reasonable grounds to suspect misconduct and that the matter appears to raise important issues affecting the public interest; and
- Unless the local body is also a PIE, there are no requirements regarding the rotation of auditors.

6.21 These new arrangements, overall, appear to be insufficient to work adequately to promote and deliver audit quality:

- The structure is fragmented and piecemeal. Public sector specialist expertise is now dispersed around different bodies. The structure means also that no one body is looking for systemic problems, and there is no apparent co-ordination between parties to determine and act on emerging risks. The NAO has an overall oversight role, but it is very unclear from what evidence base it is supposed to operate;
- These arrangements only apply to the examination of the quality of financial audit and value for money, not issues of public interest which an auditor is also obliged to report. Where issues are raised about corruption, impropriety, or a failure to comply with relevant rules for example; the role of the FRC, and their ability to intervene or act is unclear;
- There is also no one body tasked to understand and examine any tensions arising from current trends: for example, between reducing audit fees and the increasing complexity of local audit given the challenging financial situation of local authorities;
- The FRC's execution of its functions regarding local audit appear based on an assumption that financial audit is a uniform product based on a uniform process, regardless of the body subject to the audit and the landscape within which it sits. The FRC is an expert in private sector corporate audit; and its expertise on, and detailed understanding of issues relevant to local audit are currently limited;
- The results of the FRC's individual reports on audit quality are not yet shared with audit committees in the same way that they are for company audits inspected. Nor are there yet appropriate gateways in place to share results with the PSAA. Nor are they published. Even when results are shared in the future, as is planned, it is very unclear who is supposed to take action to understand and address issues raised about the quality of local auditors' work;
- The PSAA has said that it intends to manage contracts for auditing on a 5-yearly cycle, but there is no stated intention on auditor rotation, nor a requirement for rotation to take place; and

- The threshold for enforcement against an auditor – misconduct – is extremely narrow, far narrower than in private sector audit.

6.22 The review also has concerns in relation to the new arrangements for appointing local authority auditors. Historically these appointments were made by the Audit Commission. From 2015, this responsibility was transferred to local authorities – with transitional oversight by PSAA for contracts running to 31 March 2018.

6.23 Under the Appointing Person provisions of the LAAA, PSAA has since been selected to take on the ongoing Appointing Person role, in effect appointing local auditors and setting associated scale fees. Under the new framework, relevant authorities can in theory procure and appoint their own auditors. However, in practice the vast majority choose not to. 98% of relevant authorities (484 of 494⁴⁶) have opted in to the central procurement body, in effect delegating this decision.

6.24 The PSAA is very focused on reducing the costs of local audit. Its consultation on 2018/19 fee scale highlighted the following fee savings:

“We propose that scale fees for 2018/19 for all opted-in bodies should be reduced by 23 per cent, compared to the fees applicable for 2017/18. This proposal continues the practice of averaging firms’ costs, so that all bodies benefit from the same proportionate savings irrespective of the firm appointed to a particular opted-in body.

This reduction is possible as a result of the favourable prices secured from firms in the recent audit services procurement. It follows a period from 2012/13 to 2017/18 in which scale fees reduced in two stages by an aggregate of 55 per cent, in part reflecting reductions in the size and scope of the Audit Commission, for example with the closure of its inspection services.”

6.25 The Review has serious concern that these arrangements, in practice, may well be prioritising a reduction in cost of audit, at the expense of audit quality. The Review understands that CIPFA has raised publicly its concerns that local public audit fees have been driven too low.

6.26 Particularly at a time when the entire local authority system is under acute financial pressure, and some local authorities are engaging in risky speculative ventures, high-quality and robust scrutiny of local authorities’ finances and financial management in the public interest is a critical part of local democracy. All in all, the Review is very concerned that the quality of this scrutiny is being pared back at the worst possible time.

Recommendation 76: The Review recommends that the arrangements for local audit need to be fundamentally rethought to ensure they:

- **Deliver robust assessment and scrutiny of the quality of local audit work, with individual reports shared with audit committees and published;**
- **Establish a more appropriate threshold for enforcement action; and,**
- **Bring together in one place all the relevant responsibilities, so a single regulatory body can take an overview.**

⁴⁶ In October 2016, PSAA formally invited all eligible principal local government and police bodies to become opted-in authorities for a five-year period commencing on 1 April 2018. Out of 494 bodies eligible to join the scheme at that time, 484 took the decision to opt in. The number of bodies can change when new bodies are created or bodies cease to exist.

Recommendation 77: Such a role (regarding local audit) could be taken on by the FRC or its successor body, but the Review recommends that it would be much better undertaken by a separate body that has (or could develop) a deeper expertise in the local audit world. That body should have a different and much more focused remit than the former Audit Commission. It should have a clear objective to secure quality; and should set the relevant standards, inspect the quality of relevant audit work and oversee the relevant professional bodies. It should also take on responsibility for appointing auditors for local bodies and agreeing fees.

6.27 As shown in Figure 15, there is inconsistency in the arrangements for local bodies. For example, Health Bodies appoint auditors directly and cannot participate in the PSAA's Appointing Person regime, and the PSAA has no responsibility for health in the new framework. The LAAA does not capture Foundation Trusts, with the responsibility for audit quality resting with NHS Improvement.

Figure 15: Volume of local bodies categorised as major local audits or PIE⁴⁷

| Category | Total Population | Major local audits | Major local audits also meeting PIE definition |
|--|------------------|---------------------------------------|--|
| Health Bodies (NHS Trusts and Clinical Commissioning Groups) (auditors appointed directly - not part of the PSAA) | 276 | 66 (AQR monitoring from 01/04/18) | 0 |
| Local Public Bodies (majority of auditors appointed by PSAA from 01/04/18 onwards) | 505 | 141 (AQR monitoring from 01/04/19) | 21 |
| Local Authority Pension Funds (majority of auditors appointed by PSAA from 01/04/18 onwards) | 79 | 66 (AQR monitoring from 01/04/19) | 0 |
| Total – in scope of the LAAA | 860 | 273 | |
| Small bodies (Annual audits not required) | 9,752 | N/A | N/A |
| Foundation Trusts (not within the scope of the LAAA – responsibility for oversight of audit quality rests with NHS Improvement) | 151 | N/A | N/A |
| Total | 10,763 | 273 | 21 (subject to AQR monitoring) |

Source: FRC

Recommendation 78: In the same spirit, the Government should review whether the arrangements now in place for other public sector audits, such as Foundation Trusts, are genuinely robust and effective. It is very unlikely that they are.

National Audit Office

6.28 In England, the NAO audits the financial statements of all central government departments, agencies and other public bodies, and reports the results to Parliament. Parliament appoints the NAO for this purpose. The NAO is independent of government.

⁴⁷ This table has been produced using publicly available data (PSSA and NHS improvement websites) along with FRC data on major local audits and PIEs.

6.29 The Companies Act 2006 requires that Auditors General who audit relevant companies (i.e. those subject to statutory audit requirements) are subject to oversight and monitoring of that audit work by an “Independent Supervisor”. The FRC has been appointed as the Independent Supervisor for the NAO.

6.30 In the year ending March 2018 the C&AG certified 370 sets of accounts, of which 62 were statutory accounts pursuant to the 2006 Companies Act. It is these 62 sets of statutory accounts which fall within the remit of the FRC’s supervision. Audits are carried out in relation to companies such as Network Rail, UK Asset Resolution and parts of the BBC.

6.31 The FRC’s Audit Quality Review (AQR) team monitors the quality of this statutory audit work performed by the NAO. On a voluntary basis, that is only when requested by the C&AG, the FRC also reviews selected non-Companies Act (government department and public body) audits, reporting privately to the C&AG the results of this work. (Similar monitoring is performed by the ICAEW for the Auditor General for Wales and ICAS for Audit Scotland).

6.32 Results of the AQR are only reported privately to the NAO. The FRC does not interact with the audit committee chair of the company whose audit is subject to review. Nor are its reports published, or shared with Parliament.

6.33 The FRC does have a statutory obligation to report annually to the Government on its supervision of the C&AG, a responsibility it discharges in a high-level summary report within the FRC’s annual report.

6.34 One further C&AG responsibility of relevance to the Review relates to local audit. Following the abolition of the Audit Commission, responsibility for preparation, publication and maintenance of the Code of Audit Practice (which public sector auditors must follow) was passed to the C&AG under the LAAA. Effectively the C&AG determines the standards and other requirements that local auditors must meet to fulfil their statutory responsibilities under the LAAA.

6.35 All matters relating to the NAO, and its accountability, are matters for Parliament to consider. Nevertheless, the NAO is a near monopoly provider of audit services within the public sector, operating within (currently) a framework of limited scrutiny and accountability. The Review believes there is a case for strengthening those arrangements in the case of the NAO, just as in the case of private sector audits. The Review suggests that this should include greater transparency and accountability to Parliament.

Recommendation 79: Just as the Review recommends public disclosure of AQR findings and gradings in relation to the private sector, the Review recommends that the new regulator’s individual AQR reviews in relation to the NAO should be shared with the relevant audit committee and Parliament, and should be published.

6.36 The Review also questions whether there is any good justification for the present restriction of the FRC’s work to the NAO’s Companies Act audits, and whether there is not also a public interest in the rest of the NAO’s audit work also being subject to more thorough quality oversight. At present, examination is sometimes made of the quality of financial audit work undertaken for Departments, Agencies, arm’s length bodies, or charities but this is solely at the request and discretion of the C&AG. Given the size, systemic importance and public interest inherent in many of the accounts audited by the NAO there would appear to be a strong case for scrutiny of a fuller population of NAO audits.

Recommendation 80: The Review recommends that all financial audits in scope of the NAO should be brought within the audit quality monitoring scope of the new regulator, and not only at the discretion of the C&AG.

6.37 Were the Government to create a new body to undertake more effective scrutiny and oversight of local audit (as set out above) one additional possibility would be to transfer quality oversight of the NAO's audit work from the FRC to that body. This would reduce the risk that the FRC successor body may take a "cookie cutter" approach applying the same private sector standards and approaches without regard to the different context of public sector audit work. The Review would support such an approach.

Recommendation 81: In light of the Review's recommendations on local audit, and those above, the Review recommends that the Secretary of State for Business, Energy and Industrial Strategy should reassess if the FRC remains the most appropriate body to perform the role of Independent Supervisor of Auditors General in respect of statutory audits.

Recommendation 82: The Review also recommends that responsibility for the local audit "Code of Audit Practice" should be moved to the same body that monitors the quality of local audit work.

Chapter 7 – Interim steps

7.1 Some of the Review’s recommendations, such as putting the new regulator on a full statutory footing, and giving it stronger powers, will require primary legislation to bring them fully into effect. This will take time.

7.2 In the meantime, however, there are important interim steps that can be taken to move the FRC significantly in the direction envisaged by the Review. Many of the recommendations can be implemented in whole or in part without legislation. The Review believes that all opportunities for early implementation should be taken in order to maintain momentum for delivery of the changes for which there is a broad consensus. Implementation will involve different methods, including secondary legislation, amendments to the FRC’s articles of association, revisions to the FRC’s existing internal processes and procedures and new or revised voluntary MoUs with the professional bodies and other regulators.

7.3 The table below sets out some of the key areas and recommendations where the Review considers that early implementation is possible and should be actioned as a priority.

Figure 16: Interim implementation plan

| Recommendation | Interim action |
|---|---|
| Structure and purpose | |
| Align the FRC’s strategic objective, duties and functions to those recommended by the Review | Pending legislation, amend the FRC’s articles of association to align them as closely as possible with Review’s recommendations |
| Reshape the size and composition of the Board in line with the Review’s recommendations | Implement immediately |
| Make all board appointments public appointments subject to approval by the Secretary of State | Implement immediately |
| Ensure that all board, committee and senior posts are openly advertised | Implement immediately |
| Introduce a remit letter from government once each Parliament. | Implement immediately |
| Ensure that Board is able to exercise stronger ownership of the FRC’s enforcement functions. | Implement immediately |

| Recommendation | Interim action |
|--|--|
| Effectiveness of core functions | |
| Increase the regulatory reach of the FRC in terms of the direct registration and regulation of PIE audit firms. | <p>Revise the current delegation letter from Secretary of State along with the eligibility criteria and guidance set by the FRC in relation to its RSBs</p> <p>Finalise new delegation agreements with the RSBs to clarify that their role no longer includes registration and approval of PIE audit firms</p> |
| The regulator should play an active role in relation to work on the audit expectation gap and solutions for that. | Implement immediately |
| Extend the regulator's oversight to cover the entire annual report, including corporate governance reporting | Powers to request information and order corrections require primary legislation. As an interim step, the FRC should be ready to write to companies pointing out reporting that is clearly deficient |
| The Government should review the UK's definition of a PIE | Take forward immediately |
| As an interim step towards more transparency about audit quality, the FRC should publish AQR reports on an anonymised basis | <p>Implement immediately</p> <p>The FRC should also revisit and strengthen its AQR resourcing</p> |
| Reshape engagement with investors and asset owners and take forward the Review's recommendations on the Stewardship Code, and the viability statement | Implement immediately |
| Step-up co-ordination with the Insolvency Service to create an effective and seamless regime in which responsible directors are held to account. | Prioritise the finalisation of an MoU between the FRC and the INSS |
| Corporate failure | |
| Regulator should develop a robust market intelligence function to identify emerging risks | The FRC should develop a plan for how this intelligence function should be structured and resourced ahead of new powers to allow the regulator to shift its perspective to current and future risks |
| BEIS should examine the case for a strengthened framework around internal controls learning from the operation of the Sarbanes-Oxley regime in the US | Early public consultation on pros and cons of options for change is needed so that potential new legislation can be identified in good time |
| New regulator: oversight and accountability | |
| BEIS should remove the requirement to clear individual pay approvals, in line with the Review's recommendations. | Implement immediately |
| Significant improvements should be made to the FRC's internal systems and controls including adoption of: | <p>Implement immediately</p> <p>The FRC should also urgently ensure that its procedures for investigating and acting on any leaks are robust and effective</p> |
| <ul style="list-style-type: none"> – A consistent and centrally managed complaints procedure – The provisions of Managing Public Money – The Regulators' Code – The FOI Act, and – The Public Contracts Regulations | |
| The FRC should tighten its rules and procedures to manage and mitigate conflicts of interest including: | Implement immediately |
| <ul style="list-style-type: none"> – The new regulator should not allow staff, board or committee members ever to work on any regulatory function relating to a past employer, removing themselves and/or delegating to others as necessary, and – Written declarations for all staff members' conflicts of interest and financial interests should include proposed mitigations, and record any exercise of management discretion in relation to work undertaken relating to a former employer. | |

| Recommendation | Interim action |
|--|--|
| Staffing and resources | |
| The regulator should no longer be funded on a voluntary basis | BEIS should prepare secondary legislation to activate the existing Companies Act provisions to put in place a statutory levy |
| A new resourcing and capability plan and pay strategy should be developed to include the new areas of work proposed by the Review, addressing the calls for greater resource, a broader range of skills, and increased seniority and experience for key areas. | Implement immediately |
| Control arrangements on pay should mirror those of other financial regulators such as the FCA, PRA and Ofcom which are not funded by the taxpayer. | Implement immediately |
| Other matters | |
| The Government, working with the PRA and TPR should review what powers are required effectively to oversee regulation of the actuarial profession. | Take forward immediately |
| Arrangements for local audit need to be fundamentally rethought including bringing together in one place all the relevant responsibilities so that a single body can take an overview | MHCLG should bring forward as soon as possible plans for strong oversight of local audit and how they will be introduced |

Recommendation 83: An immediate priority task for the FRC and the Government should be to work together to identify all the recommendations that can be implemented in whole or in part without primary legislation and to develop an interim implementation plan. This plan should be published along with a clear timetable for action.

Annex 1: List of all recommendations

Chapter 1

Recommendation 1: The Review recommends that the FRC should be replaced as soon as possible with a new independent regulator with clear statutory powers and objectives.

Recommendation 2: The Review recommends that the new regulator's statutory powers, purpose and objectives should be complemented – like the FCA's – by a remit letter from the Government at least once during the lifetime of each Parliament setting out those aspects of economic policy that the regulator should have regard to when advancing its objectives and discharging its duties. The regulator should respond publicly to this letter.

Recommendation 3: The Review recommends that the new regulator should be named the Audit, Reporting and Governance Authority.

Recommendation 4: The Review proposes that the new regulator should have the following strategic objective:

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

Recommendation 5: The full set of duties that the Review proposes be placed on the new regulator are below, requiring that it should act in a way which:

- Is forward-looking, seeking to anticipate and where possible act on emerging corporate governance, reporting or audit risks, both in the short and the longer term;
- Promotes competition in the market for statutory audit services;
- Advances innovation and quality improvements;
- Promotes brevity, comprehensibility and usefulness in corporate reporting;
- Is proportionate, having regard to the size and resources of those being regulated and balancing the costs and benefits of regulatory action;
- Is collaborative, working closely with other regulators both in the UK and internationally; and
- Prioritises regulatory activity on the basis of risk, having regard to the Regulators' Code.

Recommendation 6: The Review recommends that the new regulator's duties will guide the new regulator in carrying out its core functions on audit and corporate reporting. The Review proposes that its functions should also include:

- To set and apply high corporate governance, reporting and audit standards;
- To regulate and be responsible for the registration of the audit profession;
- To maintain and promote the UK Corporate Governance Code and the UK Stewardship Code, reporting annually on compliance with the Codes;
- To maintain wide and deep relationships with investors and other users of financial information;
- To monitor and report on developments in the audit market, including trends in audit pricing, the extent of any cross-subsidy from non-audit work and the implications for the quality of audit; and
- To appoint inspectors to investigate a company's affairs where there are public interest concerns about any matter that falls within the Authority's statutory competence.

Recommendation 7: The new regulator will require a new board with significant new powers and responsibilities in a challenging environment. It will need to demonstrate strong leadership to effect the major shift in tone and culture to rebuild the respect of those it regulates and other stakeholders. There should be some, but only limited, continuity from the existing FRC board.

Recommendation 8: The Review recommends that the new regulator's board should be significantly smaller than the current one.

Recommendation 9: The regulator's board should comprise a mix of the skills, experience and knowledge needed to ensure strategic direction and effective, constructive challenge to the executive. It should not seek to be "representative" of stakeholder interests. In line with provisions in the UK Corporate Governance Code, appointments should be diverse, based on merit and objective criteria.

Recommendation 10: The Review recommends that all appointments to the regulator's board, including the CEO, should be public appointments approved by the Secretary of State for Business, Energy and Industrial Strategy.

Recommendation 11: There should be a consistent approach to the appointments process and all board, committee and senior posts should be openly advertised with headhunters used.

Recommendation 12: The Review recommends that the posts of chair and CEO should be subject to confirmation hearings with the BEIS Select Committee, if the committee wishes.

Recommendation 13: The Review recommends that the Government, working with the chair of the new board, should review the existing FRC committee and panel structure with a view to achieving a significant simplification of the architecture in line with the principles set out in the Review. Thereafter, there should be a rigorous annual evaluation of the performance of the board, its committees, the chair and individual directors.

Recommendation 14: The Review recommends that the board of the new regulator should exercise significantly stronger ownership and oversight of the investigation and enforcement

functions. The regulator should ensure that its internal rules and procedures enable the board to:

- Take decisions itself on whether to launch audit investigations in cases it regards as of particular significance or public interest. The Review does not anticipate the board taking decisions in many such cases, but it should maintain an ability to do so;
- Require regular reports from the Conduct Committee and from the director of enforcement on progress being made with investigations and any subsequent enforcement decisions; and
- Question the director of enforcement at any point where it considers that a particular decision or investigation is taking too long.

Chapter 2

Recommendation 15: The Review recommends that the approval and registration of audit firms conducting PIE audits should be reclaimed from the RSBs. The Government should work with the regulator to develop and consult on the detail of how this regime should operate.

Recommendation 16: The Review recommends the new regime for the approval and registration of audit firms conducting PIE audits should incorporate a range of sanctions including some that are less severe than the ‘nuclear option’ of audit firm deregistration.

Recommendation 17: The Review strongly welcomes the proposal that a piece of independent work should be done to explore the issues arising from the audit expectation gap, which have not been addressed in this Review. It is essential that this should be driven, and be seen to be driven, by the interests of users of accounts.

Recommendation 18: The Government should review the UK’s definition of a PIE.

Recommendation 19: The Review recommends that AFMA should not be carried out on a voluntary basis, but instead the regulator should have statutory power to carry out this monitoring work. It is critical that this monitoring work is performed by individuals with the appropriate skills and seniority.

Recommendation 20: The Review recommends that the new regulator should work towards a position where individual audit quality inspection reports, including gradings, are published in full upon completion of AQRs. This will, however, be a major step, requiring a high level of confidence in the AQR process. For the present, as a first and interim step, the Review recommends publication of AQR reports on an anonymised basis (similar to the approach taken in the US and the Netherlands, for example).

Recommendation 21: The Review recommends that the regulator should change its approach to examining the quality of component audit work conducted overseas, on a risk-based basis.

Recommendation 22: The regulator should revisit and strengthen AQR resourcing, and should seek to:

- Recruit more senior staff (including at partner-equivalent level) who would attend AQR inspection visits, adding weight and commanding more substantial respect in conversations with firms; able to make a call on complex matters on-site; and bringing to bear a comparative overview of sector-practice;

- Ensure its approach to staffing addresses the need for its teams to include recent experience of external audit and understanding of current practice, in order to test and scrutinise firms as effectively as possible; and
- Widen and appropriately deploy the team's sector expertise, in particular in those most complex and high-risk sectors where public interest and risk of corporate failure is highest.

Recommendation 23: The regulator should be required to promote brevity and comprehensibility in accounts and annual reports, engage meaningfully with users and asset owners about their information needs, and ensure the proportionality and value of reports. At least once in every Parliament, the FRC should report to BEIS a public assessment of the extent to which the statutory reporting framework is serving the interests of the users of company reports together with any recommendations for how it can be improved.

Recommendation 24: The Review recommends that the regulator should consider expanding the volume of CRR activity on a risk-based basis.

Recommendation 25: The Review recommends that the new regulator should be given a power to direct changes to accounts rather than having to go to court.

Recommendation 26: The Review recommends that CRR findings are reported publicly by the regulator. The regulator should publish full correspondence following all CRR reviews, and the findings should be published in a set timeframe.

Recommendation 27: The Review recommends that the new regulator's CRR work should be limited to PIEs, except to the extent unavoidable under EU law.

Recommendation 28: In addition to stronger retrospective monitoring of company reporting, the Review recommends that the new regulator should introduce a pre-clearance procedure in advance of the publication of accounts.

Recommendation 29: The Review recommends that the stronger corporate reporting review process described earlier should be extended to cover the entire annual report, including corporate governance reporting. This should be done on the basis of risk.

Recommendation 30: The Government, working with the FCA and the new regulator, should consider whether there is a case for strengthening qualitative regulation around a wider range of investor information than is covered by the FRC's existing corporate reporting work, to ensure that disciplines to drive up the quality of companies' disclosures in the UK are at least as demanding as best practice internationally. One possibility would be for the new regulator to trial some additional work in this area, on a risk-based and/or sampled pilot basis; if so, this should be done in close collaboration with (or possibly even in support of) the FCA.

Recommendation 31: The Review recommends that the new regulator should be more sparing and disciplined than the FRC in promulgating guidance and discussion documents. These documents should only be issued if they are genuinely useful, and their utility clearly exceeds the considerable costs they impose through users having to read and check them.

Recommendation 32: Although the Review is heartened by the FRC's evident recent change in approach, and by the strengthening of the enforcement team's resourcing and new leadership of the enforcement function, the Review recommends that both the board and the Government should continue to monitor enforcement performance closely. The new regulator should report on this in its Annual Report, and the regulator should regularly be held accountable by Parliament through appearances at the BEIS Select Committee.

Recommendation 33: The regulator should revisit its publication policy in relation to concluded cases that result in undertakings.

Recommendation 34: The international reach of the regulator's statutory audit enforcement action should be extended, on a risk-based basis.

Recommendation 35: The Review recommends that enforcement action against accountants in relation to apparent wrongdoing in Public Interest Entities should be undertaken by the regulator on a statutory basis. The current voluntary scheme should be discontinued and replaced with a new statutory regime with tests and powers aligned and similar to those in the AEP. Those in scope would be judged against the requirements that already apply to them (legislative requirements, financial reporting standards and professional ethical standards).

Recommendation 36: The Review recommends that the Government, working with the new regulator, should task the regulator to develop detailed proposals for an effective enforcement regime in relation to Public Interest Entities that holds relevant directors to account for their duties to prepare and approve true and fair accounts and compliant corporate reports, and to deal openly and honestly with auditors. The Review recommends that this should apply to: a company's CEO, CFO, chair, and audit committee chair.

Recommendation 37: The Review recommends that the regime for non-member directors should follow the principles of the Audit Enforcement Procedure, with the same threshold for action to be taken, and a graduated range of sanctions. To achieve this, the regulator should set out relevant requirements or statements of responsibilities in relation to auditing and corporate reporting in order that directors are individually accountable for their roles.

Recommendation 38: Although the regulator should be able to impose a range of sanctions, the Review recommends that action relating to director disqualification should continue to rest with the Insolvency Service. The Review does, however, recommend that the FRC should have the necessary powers to investigate directors and refer cases to the Insolvency Service, working closely with them to ensure effective action is taken where necessary.

Recommendation 39: The regulator should continue to operate its oversight role of the accountancy profession, but with a work programme sufficiently wide and expert to identify any emerging concerns of public interest.

Recommendation 40: The Review recommends that the Government should put in place a backstop statutory power, requiring action to be taken by a professional body if there was a need in the public interest. The Review recommends that such a power would be activated only if needed and at the regulator's request.

Recommendation 41: The regulator should replace exchanges of letters with formal memoranda of understanding with each of the UK's professional accountancy bodies.

Recommendation 42: The Review recommends that a fundamental shift in approach is needed to ensure that the revised Stewardship Code more clearly differentiates excellence in stewardship. It should focus on outcomes and effectiveness, not on policy statements. The Government should also consider whether any further powers are needed to assess and promote compliance with the Code. If the Code remains simply a driver of boilerplate reporting, serious consideration should be given to its abolition.

Recommendation 43: The FRC needs to engage at more senior level in a much wider and deeper dialogue with UK investors, including both fund managers and representatives of end-investors.

Chapter 3

Recommendation 44: The Review recommends that the regulator should develop a robust market intelligence function to identify emerging risks at an early stage, helping to shift its perspective to current and future risks, as well as its existing retrospective focus.

Recommendation 45: The Review recommends that the Government introduces a duty of alert for auditors to report viability or other serious concerns. The regulator should also take a close interest, and engage with the auditor, in situations where a PIE auditor has parted company with its client outside the normal rotation cycle.

Recommendation 46: The regulator needs to be able to act quickly where potentially serious problems are indicated. The Review recommends that the regulator should be able to require rapid explanations from companies about reasonable concerns raised by the regulator.

Recommendation 47: The Review recommends that the new regulator should be able to commission a skilled person review, paid for by the company, in circumstances where there is any significant interest arising from its strategic objective:

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

Recommendation 48: The Review recommends that the regulator should have the power to publish the skilled person’s report if it judges that to be in the public interest. Investors would then be able to reach their own conclusions about the company’s conduct and management.

Recommendation 49: In terms of further action that may flow as a result of an inspection, depending on its findings the Review recommends that the regulator should be given powers to:

- Require a company to procure additional assurance on the viability statement or any other aspect of company reports and accounts;
- Require a company to procure an independent boardroom evaluation focused on particular areas of concern such as a specific examination of the effectiveness of the audit committee;
- Notify the company of its view of the risks to financial viability and require a formal response from the board, with a recovery plan if appropriate; or
- Order the removal of the auditor or an immediate retendering.

Recommendation 50: In the most serious cases, the Review suggests it may be appropriate for the regulator to issue a report to shareholders suggesting that the company’s dividend policy should be reviewed, or that they consider the case for a change of CEO, CFO, chair or audit committee chair, or for other strengthening of the board of directors. The Review believes that, where the severity of the facts merit it, the regulator should have the confidence to do this. Decision-making should rest, as now, with boards and shareholders.

Recommendation 51: BEIS should give serious consideration to the case for a strengthened framework around internal controls in the UK, learning any relevant lessons from operation of the Sarbanes-Oxley regime in the US. The pros and cons of options for change should be analysed and consulted upon, giving special consideration to the importance of proportionality in relation to the size of the company.

Recommendation 52: The Review recommends that viability statements should be reviewed and reformed with a view to making them substantially more effective; and if they cannot be made more effective, serious consideration should be given to abolishing them.

Recommendation 53: The Review recommends that the regulator considers requiring further enhancement to the Independent Auditor's Report to include "graduated" audit findings.

Chapter 4

Recommendation 54: The regulator should submit an Annual Report to Parliament.

Recommendation 55: In terms of its internal systems and controls, the Review recommends that the new regulator must apply:

- The provisions of Managing Public Money;⁴⁸
- The Regulators' Code,⁴⁹ which sets out a clear principles-based framework for how regulators should engage with those they regulate; and
- The Public Contracts Regulations⁵⁰ regarding procurement.

Recommendation 56: The regulator should actively promote diversity, especially in its work on corporate governance.

Recommendation 57: The Review recommends that:

- For the foreseeable future, it would be wise for the regulator not to allow staff, board or committee members ever to work on any regulatory functions relating to a past employer, removing themselves and/or delegating to others as necessary; and
- Written declarations for all staff members' conflicts of interest and financial interests should include proposed mitigations, and record any exercise of management discretion in relation to work undertaken relating to a former employer.

Recommendation 58: The Review recommends that the regulator should establish a procurement policy that adheres to public contracting regulations, and that follows an open tendering process. Its policy should be published, along with a summary of those contracts awarded that are above the Public Contracts Regulation threshold.

Recommendation 59: The Review considers the lack of transparency regarding complaints to be unhelpful and recommends that aggregated data on the trend, nature, and outcome of complaints referred to the FRC be published, as well as information on the speed at which they were dealt with.

Recommendation 60: The Review recommends that the new regulator should more proactively monitor trends in complaints received by, and regarding, professional bodies, since this provides useful intelligence on the way in which professional bodies are operating. The new regulator should be actively interested in the substance of complaint-handling, especially where it is clear that complaints have merit, and not simply be monitoring process-compliance.

Recommendation 61: Given the complex nature of the issues dealt with by the FRC, the Review recommends that a central team receive, triage, respond, and ensure appropriate action is taken in relation to complaints or complaint-like contact from stakeholders. That team

⁴⁸ <https://www.gov.uk/government/publications/managing-public-money>

⁴⁹ <https://www.gov.uk/government/publications/regulators-code>

⁵⁰ <https://www.gov.uk/guidance/public-sector-procurement-policy>

should also develop clear guidance on how complaints will be dealt with, including timelines. Although basic, the review considers these changes necessary to improve the regulator's credibility.

Recommendation 62: The Review sees no reason why FOI provisions should not apply in full to the regulator's functions and internal running, and recommends that it is designated as a Public Authority for this purpose.

Recommendation 63: The Review recommends that FRC and the new regulator must ensure that their internal procedures and approach to sharing information with external stakeholders, and its procedures to investigate and act on any leaks, are much more robust and effective.

Chapter 5

Recommendation 64: The Review recommends that the regulator should not be funded on a voluntary basis. BEIS should put in place a statutory levy.

Recommendation 65: The Review recommends that BEIS should agree a new budget, consistent with the Review's recommendations, working with the new regulator and consulting stakeholders.

Recommendation 66: The Review recommends that BEIS should set the regulator's budget each year, and having consulted, determine the proportions of the levy that will apply to different parties.

Recommendation 67: As set out in Chapter 3, the regulator needs to develop new teams, and should look to recruit analysts, investment experts, economists, and those skilled in corporate law.

Recommendation 68: The Review recommends that the new regulator should develop a staffing and resourcing strategy to achieve the vision set out in this Review. That should include a more diverse approach to hiring. The regulator should also build on the experience of the Financial Reporting Review Panel and, like the other financial regulators, develop a pool of former or retired senior executives and experts – so-called 'grey panthers' – to boost its capacity to deploy expertise at short notice.

Recommendation 69: The Review recommends that the control arrangements on pay for the regulator should mirror those of other financial regulators such as the FCA, PRA and Ofcom which are not funded by the taxpayer. This approach should apply immediately. The new regulator's budget should be set by Ministers, as should the CEO's pay, but other pay decisions should be made by the regulator subject, of course, to proper transparency, and within the overall financial budget set by Ministers.

Recommendation 70: The Review recommends that the new regulator's pay arrangements should be set out in the regulator's legal base, and mirror that of Ofcom. That sets out with clarity that the arrangements for the terms, conditions, and remuneration of staff are a matter of Ofcom's responsibility. The Office of Communications Act 2002 states that:

Schedule (7)(1): "The employees of Ofcom who are not executive members shall be appointed to and hold their employments on such terms and conditions, including terms and conditions as to remuneration, as Ofcom may determine."

The Review recommends that the same wording be used for the founding legislation for the new regulator.

Chapter 6

Recommendation 71: The Review recommends that the new regulator should be given a competition duty in a stronger form than the “have regard to” formulation recommended by the Competition Commission in 2013 and should follow the model set out in Chapter 6, which is broadly based on the FCA’s competition duty.

Recommendation 72: In addition to a competition duty, the Review also recommends that the regulator should be given a specific statutory function to keep the statutory audit market under review and to report regularly on market and competition developments. This will need to include reporting on trends in audit pricing, the extent of any cross-subsidy from non-audit work and any implications for the quality of audit.

Recommendation 73: The Review recommends giving the regulator the powers it needs to support a competition duty and an ongoing market review function. In particular, it will need powers to require firms to provide audit pricing, cross-subsidy and market share data. The position should be reviewed again following completion of the CMA’s market study to ensure that the regulator has the powers needed to implement or monitor the CMA’s competition remedies and to act on evolving or new competition issues in the future.

Recommendation 74: The Government, working with the PRA and TPR, should review what powers are required effectively to oversee regulation of the actuarial profession.

Recommendation 75: The Review recommends that neither the FRC, nor its successor body, is best-placed to be the oversight body. The PRA (which employs around 80 actuaries) is a much larger repository of regulatory actuarial expertise than the FRC and would be best-placed to take on all the actuarial responsibilities currently vested in the FRC.

Recommendation 76: The Review recommends that the arrangements for local audit need to be fundamentally rethought to ensure that they:

- Deliver robust assessment and scrutiny of the quality of all local audit work, with individual reports shared with audit committees and published;
- Establish a more appropriate threshold for enforcement action; and,
- Bring together in one place all the relevant responsibilities, so a single regulatory body can take an overview.

Recommendation 77: Such a role (regarding local audit) could be taken on by the FRC or its successor body, but the Review recommends that it would be much better undertaken by a separate body that has (or could develop) a deeper expertise in the local audit world. That body should have a different and much more focused remit than the former Audit Commission. It should have a clear objective to secure quality, and should set the relevant standards, inspect the quality of relevant audit work and oversee the relevant professional bodies. It should also take on responsibility for appointing auditors for local bodies and agreeing fees.

Recommendation 78: In the same spirit, the Government should review whether the arrangements now in place for other public sector audits, such as Foundation Trusts, are genuinely robust and effective. It is very unlikely that they are.

Recommendation 79: Just as the Review recommends public disclosure of AQR findings and gradings in relation to the private sector, the Review recommends that the new regulator’s individual AQR reviews in relation to the NAO should be shared with the relevant audit committee and Parliament, and should be published.

Recommendation 80: The Review recommends that all financial audits in scope of the NAO should be brought within the audit quality monitoring scope of the new regulator, and not only at the discretion of the C&AG.

Recommendation 81: In light of the Review's recommendations on local audit, and those above, the Review recommends that the Secretary of State for Business, Energy and Industrial Strategy should reassess if the FRC remains the most appropriate body to perform the role of Independent Supervisor of Auditors General in respect of statutory audits.

Recommendation 82: The Review also recommends that responsibility for the local audit "Code of Audit Practice" should be moved to the same body that monitors the quality of local audit work.

Chapter 7

Recommendation 83: An immediate priority task for the FRC and the Government should be to work together to identify and agree a set of measures that should be implemented in the short term ahead of legislative time being available for primary legislation. This interim implementation plan should be published along with a timetable.

Annex 2: Glossary of acronyms

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| ACCA | Association of Chartered Certified Accountants |
| AEP | Audit Enforcement Procedure |
| AFM | Authority for the Financial Markets (Netherlands) |
| AFMA | Audit Firm Monitoring Approach |
| AIM | Alternative Investment Market |
| AQR | Audit Quality Review |
| AQRT | Audit Quality Review Team |
| ASIC | Australian Securities and Investments Commission |
| BEIS | Department for Business Energy and Industrial Strategy |
| C&AG | Comptroller and Auditor General |
| CAI | Chartered Accountants Ireland |
| CCAB | Consultative Committee of Accountancy Bodies |
| CFO | Chief Financial Officer |
| CIMA | Chartered Institute of Management Accountants |
| CIPFA | Chartered Institute of Public Finance and Accountancy |
| CMA | Competition and Markets Authority |
| CPAB | Canadian Public Accountability Board |
| CRR | Corporate Reporting Review |
| E&Y | Ernst & Young |
| EEA | European Economic Area |
| ESG | Environmental, Social and Governance |
| EU | European Union |
| FCA | Financial Conduct Authority |

Annex 3: List of respondents to the Call for Evidence

A total of 69 organisations, and a further 33 individuals, responded to the Review's call for evidence. Responding organisations are listed below.

Aberdeen Standard Investments
AIA Group
Association of Accounting Technicians
Association of Business Recovery Professionals (R3)
Association of Chartered Certified Accountants
Association of Consulting Actuaries
Association of International Accountants
BDO Global
BlackRock
Brunel Pension Partnership
CFA Society
Chartered Accountants Ireland
Chartered Institute of Internal Auditors
Chartered Institute of Management Accountants
Chartered Institute of Personnel and Development
City of London Law Society
ClientEarth
Climate Disclosure Standards Board
Competition and Markets Authority
Crowe UK
Deloitte
Duncan & Toplis
Ernst & Young
Financial Reporting Council
Freshfields Bruckhaus Deringer
GC100
GES International
GlaxoSmithKline

Government Actuary's Department
Grant Thornton UK LLP
Group A and APA
Halex
Hermes Investment Management
Institute and Faculty of Actuaries
Institute of Business Ethics
Institute of Chartered Accountants in England and Wales
Institute of Chartered Secretaries and Administrators
Institute of Directors
Invesco Perpetual
Investment Association
Investor Relations Society
K&L Gates
KPMG
Kreston Reeves
Legal & General Investment Management Limited
Local Authority Pension Fund Forum
M&G Investments
Mazars
Old Mutual Global Investors
Pensions and Lifetime Savings Association
Pensions Research Accountants Group
Percitus
Principles for Responsible Investment
Public Sector Audit Appointments
PricewaterhouseCoopers
Sarasin & Partners
Schroders
ShareAction
State Street Global Advisors Ltd
The Association of Investment Companies
The Charity Commission
The Institute of Chartered Accountants of Scotland
The Quoted Companies Alliance
The Society of Professional Accountants
Trades Union Congress
UK Shareholders' Association and ShareSoc
UK Sustainable Investment and Finance Association
WMT Chartered Accountants

Annex 4: Review terms of reference

Independent Review of the Financial Reporting Council (2018)

A: Purpose and Timing

The Secretary of State for the Department for Business, Energy, and Industrial Strategy (BEIS) invites Sir John Kingman to conduct a review of the FRC.

The review will aim to submit its findings to the Secretary of State for Business, Energy and Industrial Strategy and the FRC Board by the end of 2018. The review process will include a public consultation. The final report will be published, and the government will consult on its response to the review's recommendations.

B: Review Objectives

Mindful of the FRC's role in helping to ensure the effective functioning of UK capital markets, and in safeguarding the reputation of the UK as a world-leading financial and commercial hub, the review objectives will be to:

- Put the FRC in a position to stand as a beacon for the best in governance, transparency and independence; strengthening its position and reputation.
- Ensure that its structures, culture and processes; oversight, accountability, and powers; and its impact, resources, and capacity are fit for the future.

C: Scope

The review's scope is taken to include the objectives and context included in these terms of reference, and will include the FRC's governance and transparency; the avoidance of conflicts of interest, as well as its independence, oversight and accountability; and finally its impact, resources and capacity. The detail of the review's scope is set out in annex A.

D: Context

The FRC and its remit have developed considerably since it was initially established; and it was last the subject of a review in 2011/12. Since then, there have been changes both in regulation, and in expectations of regulators and how they operate. The FRC is a public body. Some stakeholder groups have called for the FRC to demonstrate greater independence from those they regulate.

The government's expectation is to see the UK at the forefront of corporate governance internationally, including in terms of regulation. In the context of the UK's exit from the EU, it is even more important that our regulatory structures are fit for the future. With reforms to the UK's Corporate Governance Code in hand, it is also appropriate to make sure that the governance of the FRC as the body with responsibility for the Code, is best in class.

E: Governance

The review will be led by Sir John Kingman.

The Independent Reviewer will be supported by an Advisory Group that will advise on the direction of the review and sources of evidence and will help to scrutinise and challenge emerging findings and recommendations.

Advisory Group discussions will be held under Chatham House principles to enable free and frank scrutiny of the issues. A summary meeting note will be produced and made available if requested.

F: The Review Secretariat

There will be a small dedicated Review Secretariat acting in support of the Independent Reviewer.

G: Stakeholder Engagement

The Review will undertake engagement with significant stakeholder groups, including those involved in preparing financial accounts, the users of accounts and those affected by other aspects of the FRC's work, including governance and stewardship, in order fully to understand the range of issues, and provide constructive challenge.

Annex A: Detailed scope

The Review will consider and make recommendations on the issues set out below.

1. Governance

The review will consider whether current governance arrangements and their transparency are suitable given the FRC's status as a public body; the increasing span of its functions (including in relation to large private companies); and in comparison to the increasing expectations on companies, including those that will flow from anticipated changes to the Corporate Governance Code, and especially so as to promote confidence and emulation.

2. Independence

The review will consider whether the FRC is sufficiently independent:

Within government;

From those whom it regulates; and

Including as a result of its funding arrangements, or to the extent that independence is insufficient, the review will propose how this might be addressed.

The review will also consider, in particular, whether there are sufficient safeguards in place to ensure and assure that independence. Such measures may include FRC's processes, transparency, culture, or other factors.

3. Avoidance of Conflicts of Interest

In addition to the question of independence, it is important that the FRC is able to carry out its broad range of functions and responsibilities without conflicting, or being seen to conflict with other functions. The review will therefore consider:

Whether the practices, structure, culture and functioning of the FRCs activities and operations are safeguarded against conflicts of interest, or a perception that there may be conflicts of interest.

Whether existing mechanisms and practices for the prevention, detection, and resolution of conflicts of interest are adequate, or if additional measures are needed.

Whether the procurement of legal and consulting services are suitable.

4. Oversight & accountability

Whilst respecting the FRCs operational independence, the review will consider appropriate mechanisms to realise its accountability to Parliament and government. The review will also consider whether current arrangements for the FRC's accountability to stakeholders and the public are appropriate, including on the specific matter of Freedom of Information.

5. Powers

The review will consider whether the current legal bases for FRC activities are adequate; or whether there is a case for an underpinning statutory architecture. In addition, the review will look ahead to consider whether any extension of powers is necessary, advisable, or otherwise recommended.

6. Impact

As a critical part of the UK's oversight of the economy, it is important that the FRC is seen as a world class regulator able to take effective action to detect and act on breaches, as well as to deter inadequacy and wrong-doing, and incentivise compliance. The review will consider what changes would best enable the FRC to achieve this; and how best the FRC can lead globally on issues of governance.

7. Resources & capacity

It is important that the FRC has sufficient resource, skills, experience, and capacity to deliver its responsibilities. The review will consider this, as well as whether current funding arrangements are adequate and desirable. In so doing, the review will take account of whether there are lessons that could be taken from international comparator bodies.

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