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cc Richard Carter, BIS

9 January 2012

Dear Mr Andrews

BIS / FRC consultation – Proposals to Reform the Financial Reporting Council

We appreciate the opportunity to respond to this important consultation being undertaken jointly by the Department for Business Innovation & Skills (BIS) and the Financial Reporting Council (FRC). Our specific responses to the questions in the consultation document are set out in the accompanying Annex. In this letter we highlight our views on what we consider to be some of the more important issues raised by these proposals.

We support the objectives underpinning these proposals – the focus on maintaining confidence in the capital markets; support for the growth strategy and avoiding additional regulation; and simplifying the FRC structure.

As the detail of these FRC reforms is developed, we consider that there is a need for further consultation and stakeholder engagement on the governance mechanisms and on the proposed committee structure (particularly for standards). Given the increased focus in society on governance and accountability, particularly for those organisations that have a wide range of stakeholders and that operate in the public interest, we believe support for these reforms will be enhanced if some further refinements are made to the proposed governance arrangements.

The UK's influence in standard setting

The corporate reporting environment for UK listed companies has changed since the FRC was first set up. It is now one where the standards for accounting (IFRS) and auditing (ISAs) are set at international level. Increasingly, this is also the case for private companies. This represents a significant change in the backdrop against which the FRC and its operating bodies conduct their activities - and the implications of this changed environment are not in our view fully explored in these proposals.

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In relation to listed companies, the priority of BIS and the FRC should be how to ensure the UK's voice is heard and that the UK is able to influence the development of international accounting and audit standards. This includes how the UK works with European institutions and how it identifies individuals who could serve on international and European bodies involved in standards setting.

With regard to other areas – standards for private entities, corporate governance codes and actuarial standards - there is a greater UK focus and more of the development work will be conducted within the FRC's structures. Hence we believe there is no 'one size fits all' approach that is appropriate for all aspects of standard setting activity. It should not be presumed that the FRC Board and the proposed Standards and Codes Committee will be able to handle every aspect in the same way, or that the same mix of skills will be appropriate in each case. These considerations should be elaborated further as the detailed proposals are developed.

In particular, the future structure should reflect the fact that the UK will only be able to continue influencing the international scene effectively if high calibre individuals are persuaded to join the reconstituted bodies under the FRC.

Attracting high calibre individuals to the FRC's Standards activities

Standard setting activity requires a range of capabilities. For example, influencing the agenda of the International Accounting Standards Board (IASB) requires political skills in understanding the various channels through which to work, the perspectives of other stakeholders and how to deploy the relevant arguments. But it also requires technical knowledge and skills so that individuals representing the UK can debate issues on an equal footing with IASB board members.

Those representing the UK on the international stage need to have the authority and skills to be seen as credible by their international peers. We note that past chairmen of the UK ASB have gone on to become chair or vice-chair of the IASB in recent years. A key objective for BIS and FRC should be to ensure that the type of talented individuals from the business, investor and professional communities who have been attracted to join the ASB and APB in the past, partly as a result of those bodies' reputation and standing domestically and internationally, will continue to want to serve the UK's interest in these international debates. The full range of skills and experience cannot be expected to be provided solely through the Executive staff of the FRC.

The following further enhancements to the proposals should be considered as they would, in our view, contribute to ensuring that individuals with the requisite skills, experience and credibility are attracted to join the advisory councils supporting the FRC's work:

- ***Holding meetings in public.*** Consideration should be given to making appropriate parts of meetings of the Standards and Codes Committee, the related advisory councils, and indeed the FRC Board itself, accessible to the public. This would help to reinforce the FRC's independence, transparency and accountability, as



well as being good practice (we note that similar standard setting organisations such as the IASB and IAASB hold most of their meetings in public). It would also enhance the profile of members of these bodies.

- **Communicating advisory council views.** Advisory council views should always be presented directly to the FRC Board by the chair (or another member) of the advisory council, rather than via the staff. Where the Executive has a different view, this should be characterised as an alternative view to that of the council. In addition, where individual advisory council members have dissenting views on proposals, these should be given appropriate visibility.
- **Enhanced public reporting on the FRC's activities.** The FRC should itself adopt best practice reporting in the corporate sector – by providing commentary on its strategy, key performance indicators and operating and financial performance. Giving appropriate prominence in such reports to the Standards and Codes activities, including the work of the advisory councils, will also raise the visibility of the council members and help attract quality candidates.
- **Identification of international liaison roles.** As a result of the reforms process, there should be a clearer identification of each of the various international liaison roles that the FRC needs to maintain (for example with the IASB, IAASB, EFRAG and ESMA) and the relevant individual (for example an advisory council chair or a member of the Executive) that is primarily responsible for that liaison.
- **Identifying the leaders of the future.** BIS and FRC should have as a continuing objective to identify individuals from different backgrounds (for example from the corporate, investor and professional communities) that can come through and assume key roles in the various bodies under the FRC in the future, including the important international liaison roles, and who could serve as 'UK members' on international bodies such as the IASB and EFRAG.

We consider BIS should evaluate whether these aspects have been sufficiently debated and whether the proposed reforms will enable the UK to secure the degree of influence over financial reporting and auditing developments that the size of its capital markets deserves.

Enhancements to the governance arrangements

As a body acting in the public interest, the FRC should be seen to be setting an example of good governance in its own arrangements. As we discuss in our response to Question 9, we believe support for these proposals will be enhanced if some further refinements are made to the FRC's governance and accountability. Our suggestions for this include:

- **Enhancements to the appointments process for the Board and Executive** - including a nominations committee independent of the Board and an open recruitment process for all senior positions, both executive and non-executive. There



should also be consideration of the Board composition, so that it is reflective of the FRC's key stakeholders.

- **Clearer processes for the flow of accountability and communication between the different structures** – particularly between the expert advisory councils and the Board (as noted above).
- **Periodic reviews of performance** - of members of the Board and its committees, and of the effectiveness of the bodies themselves.

Regulatory and disciplinary aspects

We agree that the FRC should be a credible regulator for accounting and audit and have a range of sanctions available to it that are exercised in a proportionate manner.

The consultation document sets out a number of proposals for change. We very much concur that the AADB scheme should include a procedure for early settlement of cases by mutual consent as we believe this will be of demonstrable benefit to all parties, in particular with regard to costs. In other respects, we would be supportive of changes that would enhance the efficiency of the conduct and disciplinary processes and would be keen to understand better the detail around the FRC's proposals in this area.

We understand that it is intended to implement the changes arising from the proposed Reforms from April 2012. We consider this timetable to be ambitious, particularly since the European Commission has published legislative proposals which may impact on the way auditors are regulated throughout the European Union (EU). It would be unfortunate if the FRC were to press ahead with changes in the UK, only to have to make further changes in a relatively short timeframe in order to accommodate requirements issued by the EU.

We would be pleased to discuss our views further with you. If you have any questions in the meantime regarding this letter, please contact Richard Sexton (0207 804 5058), Pauline Wallace (0207 804 1293) or Graham Gilmour (0207 804 2297).

Yours sincerely

PricewaterhouseCoopers LLP

Detailed responses to the Questions in the Preliminary Report

The case for FRC reform

Q1. Do you have any comments on the case for FRC reform as set out in the document?

Now is a good time for a fresh look at the FRC. In view of the financial crisis, it is to be expected that government and regulators want to review all aspects of the financial architecture, to see if lessons can be learned. We agree that it is opportune to consider if changes can be made that will enhance market confidence in the quality of audited financial information. It is also appropriate that the FRC's arrangements be re-evaluated in light of other recent reviews of the financial regulatory infrastructure in the UK as a result of the crisis (in particular, the replacement of the Financial Services Authority by its successor agencies the PRA and FCA) and of the new regulatory architecture in Europe. We would like to see more detail on how the FRC will in practice relate to other regulatory structures in the UK and in Europe such as the European Securities Markets Authority (ESMA).

Moreover, as noted in our covering letter, the changing landscape of standard setting, with an increasing shift in focus from national to international solutions, provides good grounds to conduct a review. The FRC increasingly has to balance the different roles of being on the one hand an 'influencer' of IFRS and ISAs, while on the other hand being a setter of 'GAAP' for smaller companies and a setter of ethical and actuarial standards. We consider that the responsiveness of the proposals to this changing landscape should be addressed and embedded as the proposals are further developed. For example, a further strategic objective of this review should be a vision of how the UK will continue to have a prominent role in international standard setting debates.

As the detail of these reforms is developed, there should be further consultation and stakeholder engagement on the proposed committee structure (particularly in relation to the Standards and Codes activities) and on the governance mechanisms.

We agree with the focus on the capital markets and the aims of supporting the Government's growth strategy and avoiding additional regulatory burdens on business. We also agree that, while aspects of the current FRC structure and activities are working well, there is a need for change - a structure with seven different operating bodies is relatively complex and may make it more difficult to work on some cross-cutting issues.

Q2. Do you agree that the proposals for reform will bring benefits and increase the effectiveness of the FRC?

Stakeholders would be better able to come to a rounded judgment of the potential impact and benefits of the proposals if some aspects were set out and analysed in greater detail. As noted above, the different considerations around standards setting and the mix of capabilities needed are not sufficiently well explored.



We set out in our covering letter some suggestions for how the proposals could be further enhanced so that high quality individuals will be willing to continue to contribute to standard setting activities and the effectiveness with which the FRC can influence the international environment. These include:

- Holding meetings of boards and councils in public
- Clear communication of advisory council views to the FRC Board
- Enhanced public reporting on the FRC's activities
- Identification of international liaison roles
- Identifying potential future leaders that can come through and assume key roles in the various bodies under the FRC and on international standards setting bodies.

In our response to Question 9, we also set out some suggestions for enhancements to the governance arrangements that we consider will strengthen the accountability and hence the effectiveness of the FRC.

Q3. Do you have any comments on the consultation stage impact assessment?

Although the current seven operating bodies will be superseded, the FRC will still have a relatively large number of entities within its structure – two Board Committees plus a number of advisory councils (supporting the Standards and Codes Committee) and other committees (supporting the Conduct Committee). These bodies will all require appropriate technical support and meeting administration by the staff, as well as executive and staff time in communicating and coordinating different bodies. We therefore question whether the anticipated £260k annual operational cost savings included in the impact assessment will be realised.

An investment focus for the FRC's activities

Q4. Should the primary focus for regular FRC activity in relation to codes and standards for corporate governance, accounting and auditing, and for monitoring the quality of corporate reporting and auditing, be publicly traded companies and large private companies?

In general, we agree with the focus.

The consultation document refers to both the capital markets and the public interest. We note that these are not necessarily equivalent terms. In the consultation document the 'public interest' is defined as publicly traded companies, including AIM and PLUS markets, together with large private companies (which self-evidently are not traded on public capital markets). No mention is made of other, non-listed, financial institutions that deal with the public. These will be subject to various other forms of regulation, including by the FSA and its successor bodies. Our preference would be that all matters of audit regulation of 'public interest' bodies be coordinated through the FRC.



Q5. Is the definition of large private company for this purpose – an annual turnover of £500m or more – appropriate?

We have no particular view on the threshold of £500m for private companies.

Q6. Should the scope of the FRC's accountancy disciplinary arrangements be narrowed to cover the quality of work and conduct of accountants in relation to the preparation and audit of annual reports and other reports for the capital markets, leaving other cases of potential misconduct to the professional bodies?

Yes, we agree.

Q7. Are there other areas of activity from which the FRC could appropriately withdraw?

We believe the FRC's range of activities, as amended by these proposals, is appropriate.

A streamlined structure

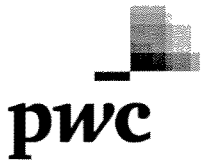
Q8. Do you agree that streamlining the FRC's governance and structure will bring the benefits described?

We believe that the potential benefits of the proposed structure will be increased if some further refinements are made to enhance governance and accountability, as we outline under Question 9. Indeed, we believe such further refinements are necessary to avoid the potential adverse consequences of the FRC being seen to lack the appropriate accountability in today's environment and hence the confidence of stakeholders in its activities being undermined.

At the same time, we believe the review of the FRC should include looking at those aspects of the current activities that are working well and seeking to preserve those elements in the new structure. For example, our experience is that the current operating model for the FRRP is working well and we suggest this be maintained to the maximum extent possible under the new structure.

Q9. Do you have any comments on the proposed reformed FRC governance and structure?

As a body acting in the public interest, the FRC should exhibit good governance. The FRC is not identical to a public company but it is responsible for maintaining the UK Corporate Governance Code, and stakeholders might reasonably expect the FRC Board to apply a similar level of transparency and accountability to its own operations. Moreover, the FRC has a range of stakeholders who need to understand and trust the processes of a body that is charged with quasi-governmental powers of policy making, standard setting, monitoring and discipline of an important component of the capital markets. It therefore needs to operate, and be seen to operate, in a manner that is transparent and accountable to those different groups of stakeholders.



We note from the proposals that members of the FRC Board, with the exception of the chair and deputy chair whose appointments are approved by the Secretary of State, are appointed by the Board. The perception of having a self-perpetuating Board could expose the FRC to criticism, and to unfavourable comparisons being drawn with other similar organisations. (A relevant example is the IASB/IFRS Foundation structure, where the Foundation's Trustees are no longer self-appointing – candidates proposed by the Trustees are approved by the Monitoring Board of regulatory authorities. Similarly, in the case of the US PCAOB, the Board members are appointed by the SEC in consultation with the chairman of the Federal Reserve and the Secretary of the Treasury.)

We suggest that all members of the FRC Board instead have their selection confirmed by an independent nominations committee. Such a committee could include, in addition to representatives of government - and consistent with the FRC's mission - other representatives of the key stakeholders in the capital markets including the corporate and investor communities. The nominations committee would oversee an open recruitment process for all FRC Board member positions and those of the most senior members of the Executive (the chief executive plus the two executive directors). In confirming or renewing appointments of Board members, the committee should also have regard to any perceived conflicts of interest of candidates.

The composition of the FRC Board itself should also be reflective of the range of stakeholders to whom the organisation should be responsive. (It is important to note that stakeholders can be regulated by the FRC while also being users of other aspects of its activities. For example, the audit profession is regulated by the FRC, while at the same time being a significant 'user' of, and therefore relevant stakeholder in, the corporate governance codes that the FRC promulgates for companies.)

The proposals suggest that the Board and its committees will be supported by expert advisory councils and panels as necessary. There is not a great deal of detail in the proposals about how the advisory councils will operate, but our understanding is that they will be chaired by Board members, and it is for the Executive to keep the Board and Committees informed about the advice given by the experts. The Executive has the right to put forward to the Board or Committee a different recommendation from that of the expert advisory council. Although the chair of the advisory council has the responsibility to ensure that the advice of that council is properly reported, there are no details on how this would be done. Hence there is a risk that the Executive may unintentionally present information in a way that does not accord with the precise messages that the advisory council felt it was necessary to deliver to the Board.

We therefore believe that more consideration needs to be given to good governance practice in the information flows between the Board, its Committees, the expert advisory councils and the Executive. It should be clear for example how, in the absence of the chair of the advisory council at a particular meeting, the Board or Committee has a clear channel of communication directly to the advisory council.



The Board Committees will be dealing with a range of matters (broader than each of the previous individual operating bodies) and hence care will be needed in ensuring a sufficient mix of skills and experience in each case. For example, both the Codes and Standards Committee (which embraces accounting, audit and actuarial standards) and the Conduct Committee (which embraces the FRRP and audit and actuarial disciplinary matters) would need appropriate accounting, audit and actuarial expertise and experience.

Corporate governance best practice recommends that boards, their committees and individual members undergo a formal and rigorous annual evaluation of performance. In addition, for FTSE 350 companies, board effectiveness reviews are typically carried out at least every three years by an external facilitator. Boards are required to report on how this evaluation was conducted. We suggest that the FRC Board and its committees undertake appropriate periodic reviews of performance.

We note also from the Impact Assessment that as part of the planned Post-Implementation Review (PIR) there will be a full evaluation of the effectiveness of the proposals three years after implementation. We strongly encourage an evaluation of the governance arrangements to be performed as part of the PIR, to assess whether the new structure is delivering its anticipated benefits and is sufficiently accountable.

Independent supervisory and disciplinary arrangements

Q10. Do you agree the FRC should be given powers to determine and require a recognised supervisory body (RSB) to impose proportionate sanctions, subject to appropriate safeguards, on an audit firm and/or individual auditor in respect of poor quality work?

We believe that the UK should have credible and independent external monitoring of the quality of audits on public interest entities. We agree that regulators should have a range of proportionate sanctions available to them which can be exercised subject to appropriate safeguards.

We would be supportive of changes that would enhance the efficiency of the conduct and disciplinary processes. As explained further below in our response to Question 11, we believe that the current arrangements are working satisfactorily and that a range of proportionate sanctions is available. We are, however, willing to listen and understand better the FRC's proposals in this area and would be keen to evaluate further evidence on how the processes can be made more efficient and effective for all stakeholders.

Q11. If not, what are your concerns and how do you believe this issue should be addressed?

Our understanding is that the AADB and the RSBs currently communicate with each other and have some flexibility in deciding who will look at matters. The AADB already has the power to ask the relevant RSB to launch an initial investigation of a matter and form an initial view. In more serious cases, the AADB can launch a formal investigation of its own.



In relation to lesser matters, the AIU can report failings (for example in relation to ISQC 1 where a policy or process in a firm is not considered satisfactory) to the relevant RSB. The AIU can also review and challenge individual firms and can include any matters of concern in its report on that firm which is made public. The Macrory final report of 2006 '*Regulatory Justice: Making Sanctions Effective*' noted that the publication of enforcement action such as improvement notices was an appropriate means of demonstrating to industry that the regulator will take action and of publicly holding industry to account for its behaviour.

We also consider that, while external monitoring and enforcement of the accounting profession needs to be independent, there is a tension between 'independence' on the one hand (which pushed to its logical conclusion might require that all investigations be conducted by non-accountants such as lawyers) and the need for an appropriate level of knowledge and expertise in audit on the other. We believe that it is in the public interest that professional work be reviewed, investigated and judged by those that understand it.

Hence, while we are not aware of evidence that the current arrangements are not operating satisfactorily, we would be keen to understand better the FRC's proposals in this area and how the processes can be made more efficient and effective.

Q12. Do you agree the FRC should have the ability to make its own rules for the independent disciplinary arrangements without being required to obtain the agreement of the professional bodies?

We believe that it is important to have appropriate checks and balances in the disciplinary system, and obtaining the agreement of the RSBs is part of those checks and balances.

The Companies Act 2006 (Schedule 10, paragraphs 13, 16, 23 and 24) provides the legal basis for independent monitoring of audits of listed companies and other major bodies and for independent investigation for disciplinary purposes of public interest cases. The Act specifically ascribes a participative role to the RSBs in the disciplinary arrangements. We therefore believe the legislation supports a view that the professional bodies have an important role to play in the system and that this role should remain.

Further, significant changes were made to the powers of the AADB post the Mayflower case (for example in relation to the threshold for misconduct) and these only came into effect in 2008. Only a few of the 18 investigations launched since that date have so far been concluded. Our view is that more time should be allowed to assess the impact of these changes, and how they are operating in practice, before the introduction of further amendments to the disciplinary arrangements is considered.

Q13. If not, how would you propose the FRC demonstrates its independence in this regard?

Please see our response to Question 12 above.



Proportionate regulation

Q14. Should the FRC be able to take more proportionate, nuanced action against a Recognised Supervisory or Qualifying Body and therefore be given a wider range of enforcement powers against the recognised bodies? In particular, should the FRC be able to:

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

We should like to understand better the FRC's arguments as to how the proposals will enhance the arrangements but do not consider there is sufficient information in the consultation document to enable us to assess whether a change to the current powers is justified.

Q15. Should the Companies Act and the AADB Schemes be amended to allow for the conclusion of cases without public hearings where appropriate and where agreed by the parties?

Yes. We strongly support a move that allows the AADB Scheme to include a procedure for early settlement of cases by negotiation and mutual consent. We agree that it would be desirable in appropriate circumstances to resolve cases more quickly and avoid for all parties the additional cost and dedication of resources involved in preparing for public hearings.

Q16. Do you agree that the FRC should develop a mechanism to enable it to undertake supervisory inquiries into matters of concern, either of individual market events or wider market interest, initially building on its current powers to secure information?

We note that similar proposals were included in the report and recommendations of the Sharman Panel of Inquiry on Going Concern, to which we responded on 22 December 2011.

We agree with the principle that it is important to collect information on, assess and learn the lessons of, failures of significant companies. We presume that the FRC's interest in this is to determine whether lessons can be learned from the perspective of financial reporting and auditing, rather than on any wider basis. We believe this would be best achieved in cooperation with the other agencies that already have powers and responsibilities to enquire into company failures, rather than through the FRC launching its own inquiries.

More important is what the FRC would seek to do with the information it obtained – it is not explained in the document how it would use the lessons learned from inquiries into company collapses. If the intention is to try to change company behaviour, then the lead for this must come from the corporate community itself – it is not something the FRC can simply change through issuing more regulation and guidance.



In summary, we believe any proposals should be further elaborated and carefully assessed, including an impact analysis, taking into account how any review conducted by the FRC of a company's governance, accounting and audit in those circumstances would fit with the existing investigative processes of other agencies. Any proposals to improve the method of analysing corporate failures should be based on a full understanding of the current system and evidence of why changes are needed.

Other matters

The consultation document makes no reference to the Financial Reporting Laboratory launched under the FRC in October 2011. It will be important to retain under the new structure a focus on encouraging innovation and experimentation with new forms of corporate reporting in the UK as this will help maintain the FRC's relevance and international reputation. We therefore believe that the status of the 'lab' under the new structures should be clarified.