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Dear Sirs

ICSA response to the Independent Review of the Financial Reporting Council - call for evidence

We welcome the opportunity to contribute to the Independent Review of the Financial Reporting Council (FRC), call for evidence.

ICSA: The Governance Institute is the professional body for governance. We have members in all sectors and our Royal Charter purpose is to lead 'effective governance and efficient administration of commerce, industry and public affairs'. With more than 125 years' experience, we work with regulators and policy makers to champion high standards of governance and provide qualifications, training and guidance. ICSA is the professional body that qualifies Chartered Secretaries, which includes company secretaries. Company secretaries have a key role in companies' governance arrangements, including the development of governance policies, the application of and compliance with the UK Corporate Governance Code, supporting the board on all governance matters, and in companies' relationship with investors. Our members are therefore well placed to comment on the FRC's role in relation to the UK Corporate Governance Code and the UK Stewardship code.

In preparing our response we have consulted, amongst others, with a number of groups of our members, including the ICSA Company Secretaries Forum, a group of company secretaries from more than 30 large UK listed companies from the FTSE 100 and FTSE 250. However, the views expressed in this response are not necessarily those of any individual members of any of these groups, nor of the companies they represent.

We set out below some general comments, followed by our responses to specific questions set out in the call for evidence. As The Governance Institute, our focus is on the FRC's role in corporate governance, rather than accounting, so our response concentrates on the questions covering the FRC's governance role.

PART 1 – GENERAL OBSERVATIONS

We very much support the work of the FRC, particularly in relation to the UK Corporate Governance Code (the Code) and the UK Stewardship Code.

In a paper that we published in January 2017 on the future of governance, we observed that:

"It is now 25 years since the first corporate governance code for listed companies was established in the UK, and the regulatory framework on which we still rely for improving standards of governance in that sector was introduced. During that time our definition of corporate governance has changed, and what we see as its scope and purpose has broadened significantly ... [from] 'the system by which companies are directed and controlled' ... focused on the control and reporting functions of boards' ... [but] ... That relative modesty of ambition has long since been discarded. An informal definition of how we now think of corporate governance might be 'everything that companies do'".

In the same way, the role of and expectations placed on the FRC have changed radically since its establishment following the Dearing Report in 1988 and even, we would suggest, since the last review of its purpose and function in 2012.

It is therefore right that the purpose and function of the FRC be reviewed.

We would, however, caution that you will receive a number of responses to this call for evidence. Many will be sensible and well-considered, but there is a risk that some will be self-serving, advancing private interests or grinding axes over existing disputes with the FRC. We are pleased to see that the scope of the review specifically excludes some of these, but we would counsel caution over adopting some of the more radical options that will be put before you. It is inevitable that a regulator will attract more criticism for its actions than praise. This is especially the case where that regulator is responsible for the oversight of accounting, auditing and financial reporting at a time when there have been some significant market failures and not all the criticism will be grounded in fact. We will leave those with greater technical accounting expertise to comment on the culpability of regulation and accounting standards for those market failures, but there is a real risk that change for change sake may make things worse, rather than better. Whilst we agree that some change at the FRC is necessary, this should not be allowed to adversely affect those areas of the FRC which work most effectively.

As we discuss in more detail below, two of these areas are the FRC's oversight of the UK Corporate Governance Code and the work of the Financial Reporting Lab.

We believe that since it was first established in 1992 the FRC has developed the Code to reflect the changing needs of the corporate governance environment. The Code makes a huge contribution to the UK's high standards of corporate governance, which are highly regarded globally.

The one concern that we have with the implementation of both the UK Corporate Governance Code and the Stewardship Code are the lack of sanctioning powers open to the FRC to enforce them. In our response to question 33 below, we have suggested how the existing powers of the Financial Conduct Authority (FCA) might be better used to achieve this enforcement, but would emphasise our view that responsibility for making judgements about compliance with either of these codes should rest with the FRC as it, and not the FCA, has the competence to make such judgements. The suggestion that we have heard that responsibility for corporate governance should pass from the FRC to another regulator makes no sense to us given the expertise that has been developed by the FRC.

PART 2 – RESPONSES TO SPECIFIC QUESTIONS ABOUT THE FRC’S ROLE IN UK CORPORATE GOVERNANCE

Q1: What should the FRC’s objective(s) be? Is its present mission statement the right one?

We have no issue with the current mission statement as set out in paragraph 8 of the Call for Evidence.

Q2: Does the FRC’s name remain right?

This is difficult. The FRC does so much more than regulate ‘financial reporting’, but equally most of what it oversees relates to reporting – financial or non-financial – in some way. It may be that a different name might be more reflective of what the FRC does, but we have no better suggestions to offer on which basis we would keep the existing name.

Q3: Are the functions and structure of the FRC still relevant and appropriate, or is there a case for any structural change? Should any of the FRC’s functions move to other regulators?

The functions of the FRC as set out in paragraph 10 of the Call for Evidence remain deeply relevant and we do not see that a case has been made for moving any of them to another regulator. We would argue that the regulation of corporate governance should be given a higher profile within the FRC, which often seems to be an accountancy focused organisation, and as noted in our response to question seven below would like to see the enforcement powers of the FRC enhanced.

Q7: What are the FRC’s strengths and weaknesses?

We will leave others to comment on the strengths and weaknesses of the FRC as a regulator of financial functions (accountancy, actuarial and audit) and will focus on corporate reporting and corporate governance.

As noted in our general comments above, we believe that, since the Cadbury Committee first established the Code in 1992, the FRC has curated and developed it to reflect the changing needs of the corporate governance environment. This is particularly laudable given the changing demands on and expectations of the Code noted above and the tendency of governments of both complexions to deal with more complex issues through asking the FRC to change the Code rather than to legislate. To give just one recent example, the government’s desire to see increased recognition of stakeholder, especially employee, interests at board level has been translated into a Code requirement rather than imposed by legislation. Such political pressures can disrupt the balance of the FRC’s work.

The Code makes a huge contribution to the UK’s high standards of corporate governance, which are highly regarded globally. The comply or explain approach to company reporting on Code Provisions, together with reporting on the application of its Principles, has contributed to the generally high standards of corporate governance in UK companies. We believe the rules based approach adopted in some other jurisdictions tends to lead to poor governance outcomes. We therefore very much support the FRC continuing in its current role in monitoring and maintaining the UK Corporate Governance Code.

We also support the FRC’s development of a UK Stewardship Code. Although a relatively new and ambitious initiative, it has already made a substantial contribution to good corporate governance in the UK and has inspired a number of other jurisdictions globally to introduce similar codes. The FRC is already looking to develop the UK Stewardship Code and we believe it is the most appropriate organisation to continue to do this.

Although not directly part of the FRC, we would also like to commend the excellent work undertaken by the Financial Reporting Lab (the Lab). The Lab’s close connection with the FRC enables it to identify key

areas where companies need and would welcome assistance on reporting. The Lab's engagement with practitioners to assist in developing its reports provides excellent practical assistance to companies in developing and improving their reporting and promotes a collaborative approach from which some other regulators could learn.

In terms of weaknesses, we believe that the main one is the absence of effective enforcement powers. It came as a surprise to many market participants when the FRC revealed that they are only able to take action against a defaulting director if they happen to be a member of an accounting body. We have been told by one of our members that one new director was advised to resign his professional membership for that reason. Similarly, although the FRC has some powers to seek the revision of flawed accounts, that seems a significantly more complicated route than the fining regime open to other regulators.

Q8: The recent joint report on Carillion from the Business, Energy and Industrial Strategy and the Work and Pensions Select Committees considered the FRC to be characterised by “feebleness and timidity” and recommended that a change of culture and outlook is needed. Do you agree? If so, please cite relevant evidence which informs your view.

We strongly disagree. Our direct engagement with the FRC is largely in relation of the UK Corporate Governance Code and the UK Stewardship Code. We do not recognise the characterisation of the FRC as one of “feebleness and timidity” and we do not see any evidence of poor culture and outlook. It is our experience that the Corporate Governance team at the FRC listens to the views of all other interested parties but also challenges the views expressed. They have been particularly sensitive to the potential for unintended consequences of proposed changes to either Code and always seek input on the risk of unexpected outcomes ahead of implementing changes to either Code.

We have direct experience of the way in which the Corporate Governance Team frequently seeks feedback from our Policy team and our members, as well as from other market participants, when considering amendments to the Code or associated guidance and, although they do not always act on our feedback we recognise that our views have been given serious consideration whether or not they were agreed. We were particularly impressed by the work that the Corporate Governance Team put into the recent Code review to ensure that all had the opportunity to put their views forward.

Q10: Are arrangements for financial reporting, audit and corporate governance the critical elements for effective delivery of FRC's mission, or are elements missing?

We believe that these are the critical elements on which the FRC should be focused.

Q13: What force is there in the concern of some that the FRC may be too close to the “big 4”? Or that the FRC is too concerned with the risk of failure of one of the “big 4”?

We have followed this debate with interest but this question lies outside our expertise and we will leave other to provide you with a more detailed response. We have two observations on the issue. Firstly, that it seems reasonable, if one is the Competent Authority for audit and has oversight of the accountancy profession, to employ people who have expertise in these professions. In our experience, and given the preponderance of the “big 4” firms in training the better accountants and auditors, it would be more surprising were FRC staff not to have links, at least in terms of past employment, with them. Given the focus already on the dominance of the “big 4” it seems to us that any further contraction of the market would be detrimental and so the FRC is right to be concerned about “big 4” failure. We wonder whether there is a little ‘conspiracy theory’ in this debate.

Our second observation is that one of the exacerbating features of this concern must be the funding model of the FRC. The fact that the FRC is obliged to go ‘cap in hand’ to the accountancy profession – of

which, of course, the ‘big four’ form a significant proportion - for a voluntary levy is not a model calculated to develop confidence in the FRC’s independence. We believe that a mandatory levy would be a more appropriate model.

Q17: Can questions regarding the effectiveness of the FRC be separated from the wider question on whether change is needed to audit arrangements to take account of shifting expectations?

There is an important education issue here – the political, press and public expectation of the role of audit is very different from what an auditor would perceive it to be. Whether this education should be undertaken by the FRC or the accountancy profession is a matter for them. Equally, whether the law or regulation should be changed to bring those two views into line is a matter for the government and/or the FRC.

Q22: In relation to the UK Corporate Governance Code, are there issues relevant to the Review’s terms of reference that respondents believe the Review should consider?

As set out in our general comments above, we very much support the FRC’s work in relation to the Code. We believe the FRC’s Corporate Governance Team make a substantial contribution to the UK’s excellent standards of corporate governance and to its continuing evolution through continuous monitoring of the corporate governance environment and making changes to the Code when necessary to maintain standards.

We also believe a major strength of the Code lies in the FRC’s ‘comply or explain’ approach, which allows companies to set the best governance arrangements for their particular circumstances and respond quickly to the changing corporate governance environment. We believe a ‘rules based’ approach to the Code would be detrimental to UK corporate governance and would therefore be concerned were the FRC’s role in monitoring and maintaining the Code undertaken by another regulatory body.

Q23: How effective has the Stewardship Code been in driving more and higher quality engagement by institutional investors? If not, why? How might quality of engagement be further strengthened?

We also support the FRC’s continuing involvement in the UK Stewardship Code. This ambitious initiative was developed by the FRC and, although it is relatively new, it has already made a substantial contribution to good corporate governance in the UK and has improved engagement between companies and their institutional shareholders. We think the development of this Code and practice in this area will improve engagement over time and we believe the FRC is the most appropriate organisation to take this forward. We look forward to the review of the Stewardship Code that the FRC has announced for later this year and will be making a number of recommendations, but we do not believe that regulating engagement practices would be appropriate or helpful in improving engagement between companies and their institutional investors.

Q27: Is there more the FRC could or should do to help reduce the risk of major corporate failure?

No. In our view the introduction of the viability statement has focused attention on the longer term, but it is only as useful as the foresight of the directors and auditors responsible can make it.

Q31: Are there gaps in the FRC’s powers? Would its effectiveness be improved with further (or different) powers?

As noted above, we believe that the FRC should be given more effective powers and the points made by the FRC and reported in paragraph 30 of the Call for Evidence should be given active consideration by the government.

Q32: Are the FRC’s powers coherent in relation to those of other regulators?

No. The FRC seems to be significantly underpowered when compared with the Competition and Markets Authority, the FCA or the Prudential Regulation Authority.

Q33: Taking account of Sir Christopher Clarke’s review of sanctions, and subsequent changes, does the sanctions regime now have the right deterrent effect? Does the FRC make best use of the sanctions at its disposal?

Our one suggestion here would be that the FRC takes a more robust approach where a company does not provide an adequate explanation for either its application of a Principle of the Code or non-compliance with a Code Provision. The fact is often overlooked that Listing Rule 9.8.6 requires that a UK listed company must include both a statement of how it has applied the Main Principles of the Code “in a manner that would enable shareholders to evaluate how the principles have been applied” and a statement of whether it has complied with all the provisions of the Code and, if not, with which provisions it did not comply and why.

In our view, the FRC should have a specific additional remit to review the reports and accounts of public and large private companies for compliance with the UK Corporate Governance Code, to come to a judgement as to whether any explanation for non-compliance is of an adequate quality and, where it is not, refer the company to the FCA for them to impose a fine or other regulatory action for breach of the Listing Rules. Any such fine could then provide additional income to support the work of the FRC. This is an existing power of the FCA, which is rarely used and, in our view, it should be, albeit only where the FCA is instructed to do so by the experts on reporting at the FRC.

Q34: Should the Government legislate to put the FRC on a more conventional consolidated statutory footing?

This would make sense in the context of the review being undertaken.

Q36: In terms of the FRC’s broader accountability, is there a case for further transparency in its actions or functions?

In our view no such case has been made.

Q37 - 41: The governance and leadership of the FRC

We have no strong views on these questions, other than to say that we are not aware of any significant issues.

We hope you find our comments helpful and would be happy to expand on any of these points should you wish to discuss them further.

Yours faithfully



Peter Swabey
Policy & Research Director