

6 August 2018

FRC Review Secretariat
Victoria 1, 1st Floor
1 Victoria Street
London
SW1H 0ET

Submitted via email: FRCReview@beis.gov.uk

Dear Sir John,

The Chartered Institute of Internal Auditors (Chartered IIA) welcomes the chance to respond to the call for evidence on the Independent Review of the Financial Reporting Council (FRC).

The Chartered IIA represents internal audit professionals in organisations spanning all sectors in the UK and Ireland. It champions the contribution internal audit makes to good governance, strong risk management and a rigorous control environment leading to the long-term success of organisations.

We are happy to engage with the review panel on any of the comments in our response and if you have any questions, please do not hesitate to get in touch.

We are happy for our response to be published.

Yours sincerely,



Dr Ian Peters MBE
Chief Executive

Response to the Financial Reporting Council Independent Review: call for evidence

The Chartered IIA represents 10,000 internal audit professionals in organisations spanning all sectors of the economy, including most FTSE companies, across the UK and in Ireland.

Internal audit is a function that sits within the governance structure but it must be independent of the areas it evaluates, and internal auditors must be free from undue influence from management, so that their judgments can be as objective as possible.

The internal audit profession plays a key role in helping to ensure good corporate governance in public interest entities and therefore has an interest in an effective and well-functioning FRC.

Below are our overall comments on the remit, structure and effectiveness of the FRC. Following on are our answers to the specific questions that are of particular relevance to the Institute.

Overall comment

The current scope of the FRC is too broad, too high level and its mission and objectives need to be clearer. The FRC would benefit from a sharper focus; achieving clarity on the purpose of the FRC should result in increased effectiveness.

Below are our recommendations on substantial changes to be made to the FRC:

Core work of the FRC – increasing the focus

The FRC is not sufficiently focused and requires more clarity. It is important to identify the mission, focus and core functions of the FRC.

The Chartered IIA suggests that the mission statement and objective of the FRC should be to:

Promote high standards of corporate governance, transparency and accountability in public interest entities.

The Chartered IIA suggests that there are two types of work that the FRC currently undertakes, core and non-core. If a role does not fit into the above objective, it is not a core activity of the FRC. Any work that is non-core is a distraction and may take away vital resources from the core work of the FRC.

We set out in the table below the Chartered IIA's views as to what are the current core and non-core functions of the FRC.

Area	Function	Core or non-core
Corporate Reporting	The FRC sets UK accounting standards and works to influence international accounting standards (IFRS).	Core
	Through the Conduct Committee, it reviews the financial statements of public and large private companies for compliance with the Companies Act.	Core

Corporate Governance	The FRC monitors and maintains the UK Corporate Governance Code and the Stewardship Code, together with their associated guidance. Compliance with both codes is voluntary although the Listing Rules require companies to report on their compliance with the former.	Core
Audit	As the Competent Authority for audit the FRC has a number of statutory functions including: <ul style="list-style-type: none"> • Public oversight of the regulation of statutory auditors by the relevant professional bodies • The determination and manner of application of technical, ethical and other standards • Setting criteria for determining the eligibility of persons for appointment as statutory auditors • Monitoring of statutory auditors and audit work by means of inspections • Investigations of statutory auditors and audit work; and imposing and enforcing sanctions 	Core
	In addition, the FRC has responsibility for: <ul style="list-style-type: none"> • Recognition (in the capacity of Delegate of the Secretary of State) of the Recognised Supervisory and Qualifying Bodies for audit 	Core
	<ul style="list-style-type: none"> • Registration of persons approved to audit non-EU registered companies that have issued securities admitted to trading on EU regulated markets (Third Country Entities and Third Country Auditor) and keeping of the Third Country Audit Register • Various functions related to local public sector audit • Independent supervision of Auditors General • Monitoring of audits of entities listed on an EEA exchange and incorporated in Jersey, Guernsey or the Isle of Man 	Non-core
Accountancy	The FRC provides independent oversight of the regulation of the accountancy profession by the chartered accountancy bodies. This is conducted on a voluntary basis by agreement with the relevant accountancy bodies.	Non-core
	By private arrangement with the relevant accountancy bodies, the FRC provides independent investigation and/or disciplinary hearings in respect of misconduct by chartered accountants in public interest cases.	Non-core
Actuarial	By agreement with the Institute & Faculty of Actuaries (IFoA), the FRC sets actuarial standards and provides independent oversight of the regulation of the actuarial profession by the IFoA.	Non-core
	By private arrangement with the Institute and Faculty of Actuaries (IFoA), the FRC provides independent investigation and / or disciplinary hearings in respect of misconduct by actuaries in public interest cases.	Non-core

Removing the non-core functions would strengthen the FRC by allowing it to focus on its core areas of work. Any work that is non-core should be, ideally, transferred to a different regulator. If this is not possible the FRC could continue to undertake this work, but in a separate ring-fenced division, as to not dilute the FRC's core work.

Additional functions for the FRC

The Chartered IIA believes that the FRC would be more effective at regulating good corporate governance with additional responsibilities.

For these reasons, the Chartered IIA recommends that the responsibility of the UK Listing Authority (UKLA) should be moved from the remit of the Financial Conduct Authority (FCA) and combined with the responsibilities of the FRC.

The role of the UKLA is to monitor market disclosures, review and approve prospectuses and operating the UK listing regime. The Chartered IIA believes that there are substantial synergies between the core work of the FRC and the role of the UKLA. For example, the choice and appropriate implementation of accounting policies is of relevance to prospectuses and preliminary announcements (UKLA oversight) and to audited financial statements (FRC function).

Currently, the FCA regulates these organisations including non-financial services companies listed in the London Stock Exchange even if they are not financial services providers, for example, Unilever.

The Chartered IIA believes that moving this work from the FCA to the FRC would also lighten the load of the FCA and allow them to focus on the providers of financial services rather than issuers of securities.

Proactivity

The Chartered IIA suggests a more proactive approach to the regulatory strategy and tactics of the FRC to increase the avoidance of harm.

We suggest that if the UKLA and FRC functions are combined then the effectiveness of both functions will be enhanced as they will be able proactively to approach companies when they notice a number of risk indicators being flagged.

Another suggestion is to allocate a specific supervisor, as the FCA do currently, to companies that are systemically important. This would provide the resources and knowledge to undertake real time monitoring of higher risk companies, as well as allowing a requirement to be created for an external auditor to approach their FRC supervisor if they believed that an organisation is potentially in trouble. This would allow for a more effective early warning system to be developed.

Statutory footing and relationship with government

The Chartered IIA advocates for government to legislate and put the FRC on a statutory footing with its renewed mission, objective, powers and sanctions included in the legislation.

We suggest that the legislation establish the FRC not as an arm of government, rather an independent regulator of corporate governance, accountability and transparency, for public interest entities to protect the interests of corporate stakeholders. We believe that this would provide a stronger basis on which to operate as well as providing a clearer message to stakeholders and the public on the role and legal status of the FRC.

The Chartered IIA suggests replicating the relationship between the FCA and government, which involves:

- a. Being independent of government but accountable to the relevant government department (in the FRC's case, BEIS);
- b. Report to BEIS on progress through an annual report;
- c. BEIS to submit a report to Parliament that examines performance against statutory objectives and how major cases have been dealt with; and
- d. Appear before government committees, answer MPs questions and respond to information requests.

The FRC is designed as a non-departmental public body – this means that the FRC is subject to public sector pay caps. We note that this restriction currently does not apply to the FCA or PRA. We believe this restriction will over time substantially reduce the ability of the FRC to recruit key specialist talent required to undertake their core duties and we suggest this should be reviewed.

Sanctions

The FRC also requires the ability to effectively sanction directors for misconduct.

Currently, the FRC only has the power to sanction chartered accountants. However, it is not appropriate that chartered accountants should have a different set of sanctions to directors who are not chartered accountants given the joint and several responsibilities of directors.

For this reason, the Chartered IIA advocates that the FRC should have a range of sanctions available, including disqualification, which may be applied to directors in respect of accountancy and transparency failings. These should be a statutory power.

Call for evidence questions

FRC purpose and function

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

The Chartered IIA suggests that the mission statement and objective of the FRC should be to:

Promote high standards of corporate governance, transparency and accountability in public interest entities.

The Chartered IIA believes that the FRC will be more effective if it is limited to, and focused on, the above mission.

Q2. Does the FRC's name remain right?

The FRC's name should reflect the above mission statement and objective. A possible name could be the Regulator of Standards in Corporate Governance.

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?

As mentioned above in the overall comments, the current scope of the FRC is too broad, too high level and their mission and objectives need to be clearer. The FRC would benefit from a sharper focus; achieving clarity on the purpose of the FRC should result in increased effectiveness.

As suggested in question 1, there are three broad areas for which the FRC should be responsible in promoting high standards for public entities:

- Corporate governance;
- Transparency; and
- Accountability.

All the work the FRC undertakes should fall under one of these three areas of scope.

The Chartered IIA suggests that there are two types of work that the FRC currently undertakes, core and non-core. If a role does not fit into one of the above objectives, it is not a core activity of the FRC. Any work that is non-core is a distraction and may take away vital resources from the core work of the FRC.

Any work that is non-core should be, ideally, transferred to a different regulator. If this is not possible the FRC could continue to undertake this work, but in a separate ring-fenced division, as to not dilute the FRC's core work.

Below the Chartered IIA's views as to what are the current core and non-core functions of the FRC:

Area	Function	Core or non-core
Corporate Reporting	The FRC sets UK accounting standards and works to influence international accounting standards (IFRS).	Core
	Through the Conduct Committee, it reviews the financial statements of public and large private companies for compliance with the Companies Act.	Core
Corporate Governance	The FRC monitors and maintains the UK Corporate Governance Code and the Stewardship Code, together with their associated guidance. Compliance with both codes is voluntary although the Listing Rules require companies to report on their compliance with the former.	Core
Audit	As the Competent Authority for audit the FRC has a number of statutory functions including: <ul style="list-style-type: none"> • Public oversight of the regulation of statutory auditors by the relevant professional bodies • The determination and manner of application of technical, ethical and other standards • Setting criteria for determining the eligibility of persons for appointment as statutory auditors • Monitoring of statutory auditors and audit work by means of inspections • Investigations of statutory auditors and audit work; and imposing and enforcing sanctions 	Core
	In addition, the FRC has responsibility for: <ul style="list-style-type: none"> • Recognition (in the capacity of Delegate of the Secretary of State) of the Recognised Supervisory and Qualifying Bodies for audit 	Core
	<ul style="list-style-type: none"> • Registration of persons approved to audit non-EU registered companies that have issued securities admitted to trading on EU regulated markets (Third Country Entities and Third Country Auditor) and keeping of the Third Country Audit Register • Various functions related to local public sector audit • Independent supervision of Auditors General • Monitoring of audits of entities listed on an EEA exchange and incorporated in Jersey, Guernsey or the Isle of Man 	Non-core
Accountancy	The FRC provides independent oversight of the regulation of the accountancy profession by the chartered accountancy bodies. This is conducted on a voluntary basis by agreement with the relevant accountancy bodies.	Non-core
	By private arrangement with the relevant accountancy bodies, the FRC provides independent investigation and/or disciplinary hearings in respect of misconduct by chartered accountants in public interest cases.	Non-core
Actuarial	By agreement with the Institute & Faculty of Actuaries (IFoA), the FRC sets actuarial standards and provides independent oversight of the regulation of the actuarial profession by the IFoA.	Non-core

	By private arrangement with the Institute and Faculty of Actuaries (IFoA), the FRC provides independent investigation and / or disciplinary hearings in respect of misconduct by actuaries in public interest cases.	Non-core
--	--	----------

Furthermore, the Chartered IIA suggests that the function of the FRC should change to include the function of the UKLA.

Impact and effectiveness

Q7. What are the FRC's strengths and weaknesses?

Strengths

- The UK's corporate governance regime and in particular, the FRC's UK Corporate Governance Code and the 'comply or explain' principle, are well respected globally.
- The FRC is effective at engaging with a range of different stakeholders.

Weaknesses

- The FRC's current remit is too widely spread – it needs to be more focused and also comprehensive.
- The FRC is too reactive – the FRC only investigates a company once a failure has occurred.
- The FRC is only able to sanction individuals or organisations for inaccurate reporting or inappropriate behaviour if they are a chartered accountant.
- The FRC is designed as a non-departmental public body – this means that the FRC is subject to public sector pay caps. We note that this restriction currently does not apply to the FCA or PRA. We believe this restriction will over time substantially reduce the ability of the FRC to recruit key specialist talent required to undertake their core duties and we suggest this should be reviewed.

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 "febleness 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.

The Chartered IIA suggests that the culture and outlook of the FRC should be revisited following the implementation of any changes stemming from the outcome of this review.

Q9. Are there changes respondents would like to see to achieve the vision set out in the Review's terms of reference?

The Chartered IIA does not wish to suggest any changes to the vision set out in the terms of reference.

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

The Chartered IIA agrees that financial reporting, audit and corporate governance are critical elements to the delivery of the FRC's mission. But we also suggest that non-financial reporting and transparency should also be included.

Audit regulation

Q11. How effective is the FRC at driving quality improvements in audit? What further improvements would respondents like to see?

The FRC is slow at driving quality improvements in external audit and has not really done so to date.

As an observer, the Chartered IIA suggests that when looking at the quality of audits, the FRC review the bigger picture rather than picking up on relatively small, potentially irrelevant issues. The FRC should be focussing on significant risks, rather than apparently promoting a tick-box culture and approach; i.e. a principle based approach as is taken by other regulators.

The FRC should aim to be tough on basic and fundamental requirements and focus on these issues.

Q12. Where quality does fall short, do the FRC's interventions have sufficient impact and deterrent effect?

When there is a shortfall in quality, the Chartered IIA does not believe the FRC's interventions have sufficient impact or a deterrent effect.

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"?

There is a perception that the FRC is too close to the "big 4" but the Chartered IIA does not believe this to be the case.

It is important that there is some degree of separation, between the FRC and those who were recently a partner at one of the "big 4"; however, it is also vital to hire people with adequate experience and knowledge and inevitably some of these experts will come from the "big 4". The Chartered IIA believes that this position should be defended more avidly in the media.

Nonetheless, it is important to have some safeguards to ensure the separation between recent partners and the FRC. For example, there should be a minimum time between retiring your partnership and joining the FRC; any

conflicts of interest should be disclosed; and there should be a limit or maximum proportion of those in the FRC who are from the “big 4”.

The Chartered IIA has no evidence that the FRC is too concerned with the risk of failure of one of the “big 4”.

Q15. Could a different regulatory strategy or tactics result in greater avoidance of harm?

The Chartered IIA suggests a more proactive approach to the regulatory strategy and tactics of the FRC to increase the avoidance of harm.

We suggest that if the UKLA moves to the FRC they will be able proactively to approach companies where they notice a number of risk indicators are being flagged.

Another suggestion is to allocate a specific supervisor, as the FCA do currently, to companies that are systemically important. This would provide the resources and knowledge to undertake real time monitoring of higher risk companies, as well as allowing a requirement to be created for an external auditor to approach their FRC supervisor if they believed that an organisation is potentially in trouble. This would allow for a more effective early warning system to be developed.

Q16. Could or should the FRC’s work promote competition and a well-functioning audit market? Does the FRC’s work undermine competition or a well-functioning audit market in any way?

Whilst the FRC’s ability to ensure external audit provision depends on there being an adequate level of competition, we feel that ensuring competition is the role of the Competition & Markets Authority, rather than the FRC.

Nonetheless, regulatory requirements have the potential to stifle competition by creating a barrier to entry or growth of smaller audit organisations.

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?

The Chartered IIA questions whether current inclusions in the audit opinion provide all the required information. The FRC has a role to play in guiding what should be included in the audit opinion and ensuring that this is accurate.

Accounting and financial reporting

Q20. Are there wider issues of financial and other reporting on which a stronger regulatory role would be desirable to better meet the information needs of investors and other stakeholders?

As mentioned in question 17, we suggest that what is included currently in the audit opinion may not be sufficient to meet the information needs of investors and other stakeholders. For example, the audit opinion could be extended to include the audit risk assessment (ARA) and how this relates to other requirements.

Q21. Is the current combination of statutory and voluntary methods of oversight for professional bodies effective, and do they remain fit for the future?

The current combination of statutory and voluntary methods of oversight for professional bodies is sub-optimal. It is not the role of the FRC to oversee the work of professional bodies.

Corporate Governance and Stewardship Codes

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?

The Chartered IIA welcomes the revised UK Corporate Governance Code published on 16 July 2018 and believes it is important not to review the Code too soon.

However, one measure that could help strengthen corporate governance is some additional clarification about what is an adequate explanation when an organisation chooses to explain under the 'comply or explain' principle.

Speed and effectiveness of investigations; enforcement and compliance

Q24. Do respondents view the FRC as reluctant to undertake investigations or enforcement, or able to do so at speed?

The perception of the FRC is that they only investigate when a major failure has occurred. As mentioned in question 15, the Chartered IIA would like to see the FRC intervene sooner, based on a number of risk indicators, and then, where justified, undertake enforcement.

We believe this would result in more often a course correction before a business failed and resulting in wider ramifications.

Q25. How could the FRC better ensure it is able to take swift, effective and appropriate enforcement action? What practical or legal changes would be needed to achieve this?

In addition to moving the UKLA work to the FRC, the FRC could establish a monitoring team to use market, media, financial and other data to monitor those significant businesses under the FRC's remit and to launch investigations and inquiries as warranted.

If additional legal powers are required to make such investigations and enquiries and to support requests for information, then they should be sought through a statutory footing.

Actuarial oversight

Q26. Have the arrangements put in place following the 2005 Morris Review stood the test of time, or is there a need for change? Should actuarial regulation be a focus for the Review's work?

The Chartered IIA advocates that the actuarial work of the FRC is non-core work, therefore, should be removed from its remit.

FRC and corporate failure

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

The responsibility of reducing the risk of major corporate failures lies with the directors of each company. However, focussing the FRC's responsibilities and a more proactive stance would go a long way toward identifying and preventing major corporate failures.

Q28. Is the FRC quick and effective enough to act on warning signs arising from its work on accounts and financial reporting or on evidence of concerns over poor corporate governance?

No, the FRC is not quick and effective enough to act on warning signs arising from accounts and financial reports in relation to corporate governance.

As mentioned in question 24, there is a perception that the FRC only investigate when a major failure has occurred.

Q29. Is there a case for a more "prudential approach"? If so, how could this operate in practice, and to which category of company might such an approach apply?

The Chartered IIA suggests that the FRC undertake a more "prudential approach" to regulation.

This should be a risk driven approach, in which the FRC actively engages with systemically important companies. This could involve reviewing how these companies are approaching corporate governance, questioning how they apply the Code and following up explanations when they indicate they are not applying Code provisions. In addition, creating a strong relationship with the

auditors on disclosure, transparency, key accounting judgements and the viability statement for these systemically important companies would add value.

As mentioned in question 15, another suggestion is to allocate a specific supervisor, as the FCA do currently, to companies that are systemically important.

Powers and sanctions

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

As mentioned above in the overall comments, the current scope of the FRC is too broad, too high level and their mission and objectives need to be clearer. The FRC would benefit from a sharper focus; achieving clarity on the purpose of the FRC should result in increased effectiveness.

The Chartered IIA suggests that there are two types of work that the FRC currently undertakes, core and non-core. If a role does not fit into one of the above objectives, it is not a core activity of the FRC. Any work that is non-core is a distraction and may take away vital resources from the core work of the FRC. These should be moved to another regulator.

There is also a gap in the FRC's current powers because the UKLA currently sits with the FCA, not FRC. The Chartered IIA believes that moving the UKLA to the FRC would improve both the FRC and the FCA's effectiveness.

Furthermore, as mentioned throughout the response, the proactivity of the FRC should increase. This may require further powers and should be allocated as appropriate.

Finally, the FRC also requires the ability to effectively sanction directors for misconduct.

Currently, the FRC only has the power to sanction chartered accountants. However, it is not appropriate that chartered accountants should have a different set of sanctions to directors who are not chartered accountants given the joint and several responsibilities of directors.

For this reason, the Chartered IIA advocates that the FRC should have a range of sanctions available, including disqualification, which may be applied to directors in respect of accountancy and transparency failings. These should be a statutory power.

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?

As mentioned in the overall comments, the FRC also requires the ability to effectively sanction directors for misconduct.

Currently, the FRC only has the power to sanction chartered accountants. However, it is not appropriate that chartered accountants should have a different set of sanctions to directors who are not chartered accountants given the joint and several responsibilities of directors.

For this reason, the Chartered IIA advocates that the FRC should have a range of sanctions available, including disqualification, which may be applied to directors in respect of accountancy and transparency failings. These should be a statutory power.

The FRC's legal status and its relationship with Government

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

The Chartered IIA would advocate for government to legislate and put the FRC on a statutory footing with its renewed mission, objective, powers and sanctions included in the legislation.

Q35. What is the optimal structure for the relationship between the FRC and the Government, best balancing proper accountability with enabling the FRC's effectiveness?

The FRC should not be seen as an arm of government, rather an independent regulator of corporate governance, accountability and transparency, protecting the interests of corporate stakeholders (including employees).

The Chartered IIA suggests replicating the relationship between the FCA and government, which involves:

- a. Being independent of government but accountable to the relevant government department (in the FRC's case, BEIS);
- b. Report to BEIS on progress through an annual report;
- c. BEIS to submit a report to Parliament that examines performance against statutory objectives and how major cases have been dealt with; and
- d. Appear before government committees, answer MPs questions and respond to information requests.

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

If powers are to be increased, it is important that they report back transparently on the use of those powers, the activities performed and regularly seek feedback on how their role and activities could be improved.

Governance and leadership

Q37. How effective is the current leadership and Board of the FRC? Please cite relevant evidence which informs your view.

The Chartered IIA believes the board of the FRC is effective given the organisations current remit and focus. We believe that renewing the mission and objectives will allow the board to be even more focused and in turn, effective.

Q38. Is the Board's composition appropriate? Is it the right size? Does it have appropriate membership?

The Chartered IIA notes that the size of the current FRC is larger than many commercial companies and it is vital that each member of the board plays his or her role and adds sufficient value.

Q41. How should the Executive's effectiveness be assessed and ensured?

The renewed mission and objective of the FRC should result in clear objective developed, and the executive assessed in the context of achieving those objectives.

Funding, resources and staffing

Q43. What skills are needed for the FRC to be most effective? Does the FRC have the people, skills and resources it needs, of the quality it needs?

The Chartered IIA suggests that the people, skills and resources of the FRC should be reviewed following the completion of any changes from this review having been implemented.

ENDS

About the Chartered Institute of Internal Auditors

Established in the UK and Ireland in 1948, the Chartered Institute of Internal Auditors (Chartered IIA) has 10,000 members. It is the only professional body dedicated exclusively to training, supporting and representing internal auditors in the UK and Ireland. We are part of a global network of 180,000 members in more than 170 countries. Members of the Chartered IIA work in all sectors of the economy: private businesses (including most FTSE 100 organisations), government departments, utilities, voluntary sector organisations, local authorities, and public service organisations such as the National Health Service. All members work to the same global International Standards and Code of Ethics, which are part of a globally agreed International Professional Practices Framework and have been recognised in the Financial Reporting Council's Guidance for Audit Committees and adopted as the basis of the Public Sector Internal Audit Standards in UK central government, local government and the NHS.