Chartered Institute of Internal Auditors

10 June 2019

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

Submitted via email to: FRCConsultation@beis.gov.uk

Dear Mr Clark

The Chartered Institute of Internal Auditors (Chartered IIA) welcomes the opportunity to contribute to the Independent Review of the Financial Reporting Council – initial consultation on the recommendations.

The Chartered IIA represents internal audit professionals in organisations spanning all sectors in the UK and Ireland, and 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.

The Chartered IIA is happy to discuss any of the comments included in the response.

We are happy for our response to be published.

Yours sincerely,

Dr Ian Peters MBE
Chief Executive

Chartered Institute of Internal Auditors

Independent Review of the Financial Reporting Council – Initial consultation on the recommendations: written response from the Chartered Institute of Internal Auditors

Introduction

The Chartered Institute of Internal Auditors (Chartered IIA) welcomes the opportunity to contribute to the Independent Review of the Financial Reporting Council – Initial consultation on the recommendations.

The Chartered IIA represents over 10,000 internal audit professionals in organisations spanning all sectors of the economy, including most FTSE companies, across the UK and Ireland. We champion the contribution internal audit makes to good corporate governance, strong risk management and a rigorous control environment leading to the long-term success of organisations.

We previously submitted a detailed response to the Independent Review of the Financial Reporting Council and we were pleased to see that many of the ideas we advocated were reflected in the recommendations made in Sir John Kingman's final report. This included advocating for the Government to legislate and put the Financial Reporting Council (FRC) on a statutory footing with a renewed mission, objectives, powers and sanctions.

Given our established policy position on FRC reform, we therefore welcomed the central recommendation of the independent review that the FRC should be abolished and replaced by an entirely new body, putting it on a statutory footing, with enhanced powers and the authority to do its job properly. We also welcomed the Government announcement in March that it supported, and would be acting swiftly on, Sir John Kingman's recommendations.

In our response below we have offered views consistent with those we advocated previously to both the Independent Review of the Financial Reporting Council, as well as to the subsequent BEIS Committee Future of Audit Inquiry.

Q1. What comments do you have on the proposed objective set out in Recommendation 4?

We previously suggested in our consultation response to the review that the FRC/new body's strategic objective should be to *"Promote high standards of corporate governance, transparency and accountability in public interest entities".* We were pleased to see that the sentiment of our proposal was reflected in the strategic objective suggested by Sir John Kingman in recommendation 4, so we support and are happy with what has now been proposed.

Q2. What comments do you have on the duties and functions set out in Recommendations 5 & 6

Broadly speaking we support the duties and functions set out in recommendations 5 & 6. In our response to the review we made clear that we felt that the current scope of the FRC was too broad, was too high level and their mission and objectives needed to be clearer and that the FRC would benefit from a sharper focus. We are pleased to see that this has now been addressed in the duties and functions recommended by the review which are far clearer and more focused.

We would further add that we suggested the FRC/new body should take a more proactive approach and intervene sooner, based on a number of risk indicators, and then, where justified, undertake enforcement. Furthermore, we suggested that promoting high standards of corporate governance, transparency and accountability should be one of the core areas of the new regulator. We also suggested that the FRC is too reactive and tends to investigate a company only once a failure had occurred.

We believe that the duties and functions recommended should help to address these issues and should result in a more effective audit regulator.

Q3. How do other regulators mitigate the potential conflict between their standard setting roles and enforcement roles as set out in recommendation 14?

The Chartered IIA does not wish to offer views on this question.

Q.4 Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

Whilst we support recommendation 7, we would like to add that in our consultation response to the review we suggested that the culture and outlook of the FRC/new body should be revisited after any changes stemming from the review have been implemented. So once the new body has been established, a new board has been appointed and a new culture has had time to be embedded, we would recommend the Government continues to monitor and assess the new body's effectiveness at regular intervals as appropriate. This will help to ensure that the major shift in tone and culture required to rebuild stakeholder trust and confidence is delivered as envisaged.

In relation to recommendation 8, we agree that there could be value in having a smaller board. Indeed, in our consultation response to the review we noted that the current FRC board is larger than that of many commercial companies. However, with a smaller board it is all the more important that each board member plays their role and adds sufficient value.

On recommendation 12, please note we support the proposal that the posts of Chair and CEO should be subject to confirmation hearings with the BEIS Select Committee. We believe that this would be an appropriate mechanism for ensuring Parliamentary scrutiny of the new regulator's Chair and CEO, and whilst we appreciate that the BEIS Select Committee already has the power to call whomever they wish to appear before them, there could be value in formalising such an arrangement.

Q5. How will the change in focus of CRR work to PIEs affect corporate reporting for non-public interest entities?

The Chartered IIA does not wish to offer views on this question.

Q6. What are your views on how the pre-clearance of accounts proposed in Recommendation 28 could work?

The Chartered IIA does not wish to offer views on this question.

Q.7 Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

In accordance with the views we expressed to the review, we support recommendation 18 which calls on the Government to review the UK's definition of a PIE (Public Interest Entity). In principle we would support widening the current definition beyond just publicly listed companies. We think it would be beneficial to include some, or possibly even all, large private companies within the definition, being mindful that when BHS collapsed it was itself a large private company. We therefore look forward to the forthcoming proposals and consultation on this in due course.

On recommendation 20, which proposes that AQRs (Audit Quality Reviews) should be published in full, we would like to highlight that the publication of the full results of individual company audit inspections could have the unintended effect of revealing potentially sensitive information about the client's financial position or internal control weaknesses. We therefore welcome that these reports will be published on an anonymised basis, and we agree that careful consideration will be needed to ensure that information published appropriately respects confidentiality, personal data and market sensitivity restrictions.

We would like to add that we support recommendation 36 which chimes with our view that the FRC/new body requires the ability to sanction directors for misconduct, based on an effective enforcement regime for public interest entities that holds relevant directors to account for their duties.

In this regard we would like the Government to note that currently the FRC only has the power to sanction chartered accountants. However, we believe 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 all directors. We would therefore advocate that the new body should have a range of sanctions available, including disqualification, which may be applied to all relevant directors. We believe that in terms of any new regime this should be a statutory power. We hope these views are reflected in the forthcoming proposals for consultation.

Q.8. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

We support recommendation 44 that the regulator should develop a robust market intelligence function and we are pleased that the FRC will be introducing this immediately. We would further add that in our consultation response to the review, we suggested that 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 to launch investigations and inquiries as warranted. We therefore suggest that the Government should work with the FRC to ensure that any new market intelligence function's defined roles and duties include this.

We support recommendation 46 that the regulator needs to be able to act quickly where potentially serious problems are indicated and that the regulator should be able to require rapid explanations from companies. However, whilst we acknowledge this will require primary legislation to ensure that the FRC/new body has the necessary powers to do this effectively (indeed this is something we advocated in our response to the review), we believe delivering a more proactive approach to the regulatory strategy and tactics at the regulator will be equally as important in achieving this. Along with new powers this will require a change in culture.

In our consultation response to the review, we argued that the FRC is not quick and effective enough to act on warning signs regarding corporate governance, and there is a perception that the FRC will only investigate once a major failure has occurred. So along with giving the regulator the powers to act quickly, it is vital that a more proactive culture is embedded throughout the organisation that encourages a greater willingness to act swiftly and fully deploy the new powers it is given when and where appropriate.

In principle we support recommendation 51 which says that BEIS should give serious consideration to a strengthened framework around internal controls in the UK learning the lessons of the Sarbanes-Oxley regime in the US.

However, as we have previously articulated to the BEIS Committee Future of Audit Inquiry, there could be unintended policy consequences were any new regulation to be too prescriptive and careful consideration should be given to its introduction. It should be noted that the Sarbanes-Oxley Act was passed in the US in 2002, and internal controls have modernised and developed considerably since then due to technological developments such as data analytics.

We are therefore pleased to see that the Government acknowledges that this is a detailed and complicated issue and we welcome the consultation in due course, which we will engage with and offer more detailed views on.

Q.9. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

We would like to add that we too support recommendation 57 and we are pleased to see that the FRC will be implementing this immediately. In our consultation response, we noted that it is important to have some safeguards to ensure the separation between recent partners of professional services firms and the FRC, and suggested for example a minimum time between retiring one's partnership and joining the FRC, disclosing conflicts of interest, and limiting the maximum proportion of those working at the FRC that are from the "big four".

Q.10. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

On recommendations 64, 65 and 66 regarding the funding and budget of the new regulator. We welcome the proposal that the new regulator should be paid for by a statutory levy. However, we do have some concerns that the budget for the new regulator will be set in future by BEIS. This could potentially create a situation whereby the Board and CEO of the new regulator are held accountable for delivering some very challenging objectives, but do not have complete control over the budget and resources required to deliver those objectives. We therefore advocate that the proposal is brought in line with the arrangements for the FCA and PRA, where the relevant boards are responsible for setting the budgets, subject to the need to consult with relevant stakeholders.

We are pleased to see that the Government has welcomed recommendation 69 regarding the regulator's pay arrangements. This supports our view that the FRC/new body should not be subject to public sector pay caps, that instead the arrangements for remuneration should mirror those of other financial regulators including the FCA and PRA. We are concerned that if left in place, the current restrictions on pay could over time substantially reduce the ability of the FRC/new body to recruit key specialist talent.

Q.11. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

We support recommendation 75 that neither the FRC, nor its successor body, is best placed to be the oversight body for the actuarial profession. In our consultation response to the review, we argued that this function is 'non-core' work and should be removed from its remit, to enable the FRC/new body to focus on its 'core' work. We agree that the PRA (which already employs around 80 actuaries) is far better placed than the FRC to take on all the actuarial responsibilities currently vested in the FRC. We hope this view is reflected in the Government's forthcoming proposals.

Q.12. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

Given recent corporate collapses – most notably at Carillion, but also BHS before it and more recently Patisserie Valerie – establishing the new regulator as soon as possible is vital to ensure we strengthen the UK's corporate governance framework, help to identify and prevent future corporate collapses, as well as restore trust and confidence in business.

We therefore believe that it is crucial that the main recommendation of the review, which is to replace the Financial Reporting Council with the new Audit, Reporting and Governance Authority, is implemented as swiftly as possible.

Where primary legislation is required to do this, especially in terms of putting the new body on a statutory footing with the enhanced powers to do its job properly, we believe this should happen under the swiftest possible parliamentary timetable.

We believe it would therefore be optimal for the Government to start introducing the necessary legislation to establish the new body before the end of 2019. If this is not done, then we have serious concerns for the future of these much-needed reforms.

Furthermore, we would urge that when the Government publishes a more complete implementation plan as envisaged, this includes a clear roadmap and proposed timetable for the required legislation to be passed through Parliament, and a clear indication of when the new regulator will be up and running and fully functional.

Q13. What evidence or information do you have on the costs and benefits of these reforms?

The Chartered IIA does not wish to offer views on this question.

Q.14. What further comments do you wish to make?

We have no further comments that we wish to make.