

# Investors require a robustly independent audit regulator

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## Summary

The Financial Reporting Council (FRC) is a quasi-regulatory body that has been delegated a statutory mandate to oversee accounting standards and audit. The investor signatories to this paper believe that the FRC's ability to scrutinise auditors has been impaired by its heavy dependence on the very profession that it is tasked with overseeing. This has resulted from an opaque and piecemeal statutory basis; weak governance structures; funding that depends on the audit profession's discretion; and poor public transparency. The consequence has been a body with inadequate accountability to Parliament, the public, investors or companies; and excessive influence by the audit profession. This situation is harmful to corporate governance, long-term investment and the public interest.

The investor signatories to this paper are calling on the Government to address these failings through structural reform that establishes an independent public body (and potentially two bodies – one responsible for standard setting and the other responsible for enforcement); a clearer and more complete statutory basis ensuring full accountability to Parliament; robust governance structures to minimise conflicts of interest; strengthened and independent funding and full public transparency.

## Context

Efficient markets and robust long-term stewardship are built on reliable accounts that provide a true and fair view of companies' economic health. For investors to trust company accounts, they must have faith in the independence, objectivity and professionalism of the external audit.

Notwithstanding important reforms to the audit market currently underway, we believe investor and public confidence in audit has reached new lows. A steady flow of audit failures in large listed companies raises important questions over who is policing the auditors to ensure high standards are achieved, and whether the system is working effectively.

## Investor view

The signatories to this paper believe that the audit system is not functioning properly, and needs to be improved. In particular, audit oversight implemented by the Financial Reporting Council (FRC) is excessively permissive, and this weakness is undermining confidence in the audit system. While the reasons for this weakness are complex, a central concern is the conflicts of interest that are present within the regulatory system.

While the conflicts between auditors and shareholders are well known (auditors too often view executives they are auditing as their clients, rather than the shareholder for whom the audit is done), less attention has been given to the conflicts that exist within the regulator. These conflicts need to be significantly reduced and robustly managed if we are to build trust in audit.

## Weak governance and conflicts of interest that hamper the FRC

We believe the FRC is vulnerable to excessive influence of the audit profession that it oversees due to a range of structural problems with its governance arrangements, funding sources, legal constitution and public accountability:

- **Legal constitution is piecemeal and opaque:** Unlike many other regulators which are established by an Act of Parliament, the FRC is an independent company limited by guarantee<sup>1</sup>, that derives its regulatory functions and powers partly from legislative powers that have been delegated to it by the Department for Business, Energy and Industrial Strategy (BEIS)<sup>2</sup>; partly from private arrangements with government and other regulators<sup>3</sup>; partly through conventions or voluntary arrangements with other stakeholders, including the audit profession; and partly through its own constitutive documents<sup>4</sup>. Many areas of the FRC's work are not subject to oversight by Government, Parliament or the public. Critically, however, one area in which it is accountable to Parliament is in its oversight of the audit profession<sup>5</sup>. The problem comes with how it has fulfilled its obligations given the other limitations we identify below.
- **Governance is not sufficiently independent:** The FRC's Board and key operational committees determine where it focuses its resources and how effectively these are deployed. The representation of the audit profession in these bodies is excessive – including currently serving audit firm employees – and this risks materially limiting the ability of the FRC to act robustly. Moreover, the FRC board is bound by the FRC Articles of Association and the Code of Conduct, which appear to demand that directors are responsible for holding themselves to account.
- **Funding depends on the audit profession:** The FRC depends on the audit profession for c50% of its funding (2016/17)<sup>6</sup>. This funding, moreover, is voluntary. Any specific enforcement action requires additional funding sanctioned by the auditors, and funds collected from any sanctions are returned to the auditors. It is not hard to see how the FRC's hands are potentially tied in determining what it decides to pursue, and how well resourced its enforcement actions are<sup>7</sup>.
- **Combination of standard setting and enforcement has proven damaging:** Conflicts can emerge where standard setting is combined with enforcement, especially if the standards themselves are viewed as overly onerous and difficult to enforce. There is evidence that this has been the case at the FRC, where accounting standards appear to have diverged from requirements under the capital maintenance regime, thereby causing confusion. The heavy representation of the audit profession in accounting standard setting in the UK has also been a concern (as has the auditors influence over the International Accounting Standards Board, which in turn impacts UK standards). Ultimately, the conflicts have increased the risk that the FRC fails to deliver guidance consistent with Company Law<sup>8</sup>.
- **Public accountability is limited:** Linked to the lack of clarity over its status as a public body, the FRC has argued that it is not subject to Freedom of Information requirements like other

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1 Company Number 2486368.

2 For example, The Secretary of State for BEIS has delegated to the FRC powers under Part 42 of the 2006 Act, in relation to oversight of the regulation of the auditing profession.

3 For example, the FRC has entered into a number of publically available MoUs with government departments, (including BEIS' predecessor) and other regulators which set out arrangements, of varying degrees of formality, for their interactions.

4 For example, the FRC Articles of Association (art 5.3) provide the primary source for the right of the Secretary of State for BEIS to appoint the Chair and Deputy Chair of the FRC.

5 See Companies Act 2006, sections 1231(3) and 1252(10); paragraph 10(3) of Schedule 13.

6 The amount varies every year, but is always significant.

7 See for instance the Consultative Committee of Accountancy Bodies formal comment on the FRC's draft plan & budget and levy proposals for 2017/18.

8 This concern has been upheld by George Bompas QC in two opinions delivered in 2013 and 2015, where he has outlined the disconnect between International Financial Reporting Standards approved by the FRC for use in the UK and Company Law. Bompas goes as far as to describe the FRC's logic as "defective".

regulators. While the FRC Code of Conduct for Board Members requires the FRC to keep a conflict of interest register and a gifts register and states that there is an expectation that directors register their interests and receipts of gifts and hospitality, this conflicts register is not publicly available.

### **What needs to change**

To address the areas of concern above, the FRC needs to be reconstituted and restructured. Specifically, we would like to see the following core principles reflected in a reformed FRC:

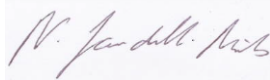
- **Legal constitution:** Parliament should legislate to set out a clear and all-encompassing legal framework for the FRC, which should be designated as a public body. We would favour a structure that permitted operational independence – assuming the other safeguards are in place – but with ultimate accountability to Parliament, similar to other non-ministerial departments like the Serious Fraud Office or the Office of National Statistics.
- **Governance:** The FRC Board must be explicitly required to have independent directors, and ideally a minimum number of investor representatives given that investors are the key users of accounts and audit. Audit firm-linked directors should be strictly limited up to a maximum threshold of no more than 40%, in these cases a gap of no less than 3 years between leaving the audit firm and taking up the FRC position should be imposed; and the Chair of the relevant committee should not be a former audit partner. Other directors should be scrutinised for all commercial or other relationships with the audit industry, and where these exist, a similar 5 year rule should apply. Similar safeguards should be applied to the main operating committees as they are responsible for substantive matters, including conduct and enforcement.
- **Funding:** The FRC should not depend on the audit profession's largesse to fund its activities. One option would be to impose a mandatory charge on preparers and broker-dealers, a model adopted by the US audit regulator, the Public Company Accounting Oversight Board. Even a mandatory charge on audit firms would be acceptable, as long as discretion is eliminated.
- **Consider separation of standard setting function from enforcement:** There are strong arguments to split these functions to protect against conflicts creeping in where the regulator may decide to weaken its own standards to protect it from criticism over weak enforcement. As we proceed with Brexit, there is already a need for standard setting to be strengthened as the UK steps outside of the EU accounting standard endorsement process. This is an opportune time to establish a newly constituted standard setter with a clear mandate to promote high quality reporting and to ensure compliance with the UK's capital maintenance regime.
- **Public accountability:** In line with the preceding proposals, the newly constituted FRC would be subject to public transparency rules such as the Freedom of Information Act for all its activities, much like other regulators.

### **Conclusion**

While shareholders have a key role to play in holding auditors to account through their votes at annual general meetings, limited visibility and diffuse company ownership mean the regulator plays a critical role in underpinning market confidence, and enforcing company law requirements as they pertain to audit and accounting. As it is currently structured and governed, the FRC is unable to fulfil this role. Conflicts of interest are pervasive in the audit sector, and the damage done to the public

interest and shareholders insidious. As we proceed with Brexit, the Government has an opportunity to strengthen the UK's accounting and audit regime by restructuring and reconstituting the FRC. It should take it.

## Signatories



Natasha Landell-Mills, Head of Stewardship  
**Sarasin & Partners LLP**



Kieran Quinn, Chair  
**Local Authority Pension Fund Forum**



M.G. White, Director  
**UK Shareholders' Association**



Robert Talbut  
**Independent Director & pension fund trustee**



Frank Curtiss  
**Pension Fund Trustee**