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Dear David

ICAEW response to the joint BIS and FRC Consultation on Proposals to reform the Financial Reporting Council (FRC), published in October 2011

I attach ICAEW's detailed response to the Consultation on Proposals to reform the Financial Reporting Council (FRC).

As you are aware, ICAEW is the largest Recognised Supervisory Body (RSB) and Recognised Qualifying Body (RQB) for statutory audit in the UK, registering in excess of 3,800 firms and 10,000 Responsible Individuals (RIs). As a world leading professional accountancy body, we provide leadership and practical support to over 136,000 members who work across business and practice.

We have considered the arguments for simplifying the FRC's structure and operations. However, we are unable to support substantive elements of these proposals. In our view, many are in conflict with the stated objectives as set out in the consultation document. The consequences and implications of many have not been fully thought through. In particular:

- The consultation document fails to present specific examples of wrongs or poor practice which the restructure purports to remedy; in short there is a lack of an evidence base throughout
- The proposals do not demonstrate how the existing high standards of quality, independence and transparency (for which the FRC is currently known) will be maintained and enhanced. There is a risk that these attributes will be compromised by the new structure with consequent damage to the FRC's reputation and influence both at home and abroad
- The Impact Assessment is inadequately evidenced and we question some of the financial assumptions on which it is based
- The implicit emasculating of the ASB and APB will in our view erode the UK's reputation and positioning as a key contributor to European and international standard setting bodies
- The speed at which the proposals are intended to be implemented opens BIS and FRC to the risk of failure in executing reforms
- There is a distinct possibility that some of the proposed reforms will need to be revised in the light of changes to the EU Statutory Audit Directive proposed by Commissioner Barnier

The proposals must also be seen within the context of the Government's wider desire for effective regulation. In this context the proposals run the risk of compromising better regulation principles, in particular the principle of co-regulation. Business Minister Mark Prisk has argued for greater accountability and transparency between the regulator and regulated community, with economic growth and competitiveness as drivers of this collaborative relationship. By separating business knowledge from regulation we believe these proposals run the risk of diluting the effectiveness of what good regulation should look like.

It is in both the public and the accountancy profession's interests to have a strong oversight body such as the FRC that can both maintain and enhance business, investor and consumer confidence, especially given the economic challenges faced by the UK. We sincerely hope that both BIS and the FRC will take on board the comments contained within our detailed response to rethink the approach proposed for reform of the FRC.

We would be very happy to meet you or your colleagues to discuss our response in more detail.

Yours sincerely

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ICAEW REPRESENTATION

CONSULTATION ON REFORM OF THE FINANCIAL REPORTING COUNCIL

Response submitted in January 2012 by ICAEW, to a Department for Business Innovation & Skills and Financial Reporting Council consultation paper Proposals to Reform the Financial Reporting Council published in October 2011

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INTRODUCTION

1. ICAEW's comments on the consultation paper *Proposals to Reform the Financial Reporting Council* (the paper) published by the Department for Business Innovation & Skills (BIS) and the Financial Reporting Council (FRC) are set out in this document.

WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the FRC. As a world leading professional accountancy body, we provide leadership and practical support to over 136,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide. ICAEW is the largest Recognised Supervisory Body (RSB) and Recognised Qualifying Body (RQB) for statutory audit in the UK, registering in excess of 3,800 firms and 10,000 Responsible Individuals (RIs).
3. Half of our members work in business, industry, the public and not-for profit sectors and half in professional practice; 84% of UK FTSE100 companies have an ICAEW Chartered Accountant as a board member and 75% of the UK FTSE250 boards have an ICAEW Chartered Accountant as Chairman, CEO or CFO. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.

THE EC AUDIT REFORM PROPOSALS

4. On 30 November 2011, the European Commission (EC) published a wide-ranging draft amendment to the Statutory Audit Directive (the amendment) which impacts a number of areas which the FRC consultation paper is seeking to address. It is not best regulatory practice to introduce UK based changes before such a comprehensive reform of audit regulation in a final European Union (EU) enactment which will impose new change requirements on the UK. As the amendment is some way from finalisation and enactment we have not addressed its impact in this response. We have, however, made brief reference to the amendment where it may significantly influence the approach to the proposals.

MAJOR POINTS

5. ICAEW is unable to support substantive elements of the proposals. In our view, many are in conflict with the stated objectives as set out in this consultation. The consequences and implications of many of the proposals have not been fully thought through. Key observations on the proposals are:
 - In a paper headlined as addressing the corporate governance of the FRC, the FRC's own accountability to government and the public is not addressed. We have concerns around the whole of the structure but particularly with this lack of accountability.
 - The paper in its preface quite reasonably refers to the good reputation the FRC and its constituent bodies such as the Accounting Standards Board (ASB) and the Auditing Practices Board (APB) have built over the past few years. We do, however, have concerns that some of the proposals risk endangering that reputation, in the UK and internationally, and ultimately could be self-defeating.
 - Independence is defined as a key driver for seeking changes, but too much focus on this driver risks compromising other strengths such as technical expertise and engagement of the regulated.

- The changes have a number of ramifications for BIS itself and place added cost and resource demands on the Department at a time when it is seeking to save costs. The inconsistencies of some of the proposals with government pronouncements only serve to cast doubt on the objectives and timeliness of the paper.
- In conflict with the aim of rationalising and minimising regulatory burden and reducing costs to business expressed in the introduction to the paper, we find the financial case unproven. There are risks of greater costs and intervention, such that business is disadvantaged rather than strengthened through the proposals.
- The short timescales for consultation and enactment, combined with a lack of detail around the content, convey the impression of a rushed set of proposals which risk being poorly drafted, impractical to implement and add to business overload and cost rather than reducing it.

RESPONSE SUMMARY

Implications for BIS and growth:

6. The paper does not deal with all the issues that both BIS and FRC should be considering in a major overhaul of FRC governance. The consultation process is not being managed in a way that will achieve the best outcomes. The limited timeframe for feedback means that the business community, for example, which is ultimately most affected by these changes will not have had an opportunity to properly engage with this process and give substantive comment.
7. The consultation process is based on a document that lacks significant amounts of detail and which overlaps with proposals for changes to statutory audit currently under consideration by the European Parliament and the Council of Ministers. Changes to UK legislation are proposed to be in place within three months of the close of consultation. As well as calling in to question the genuineness of the consultation process, there is a high risk to BIS that resultant changes will be neither practical, effective nor sustainable.
8. The paper is limited in its terms of reference, not taking the opportunity for example to consider the current accountability of the FRC itself to BIS, how the FRC's scope is determined and how appointments will be made to the main and subsidiary boards. (Paragraph reference 35a, 72, 86)
9. The accountability of the FRC in relation to the setting and determination of its own budget is not examined. The Legal Services Board (LSB), for example, is accountable to the Ministry of Justice, but that relationship is not exemplified in the BIS/FRC governance arrangements, nor is it considered in this paper. (50)
10. Proposals are put forward for an investment focus that have the merit of addressing concerns of the capital markets, but fail to address how the remaining parts of the market (not part of that focus) would be overseen. These remaining parts account for a significant percentage of the UK economy and BIS risks being seen as being interested solely in big business to the exclusion of small business. (53)
11. The impact assessment focuses largely on the financial implications for the FRC and ignores qualitative considerations and the assessment of impact on businesses, other stakeholders and BIS itself. (46)
12. The paper does not consider that aspects of the proposals for changes to disciplinary and regulatory matters may impact on natural justice and could potentially require BIS itself to operate as an appellate body. (76, 85, 91)

13. The paper undervalues the existing strength of the FRC brand and the contribution to that brand of its constituent boards, particularly the ASB and the APB, through which the UK is able to make a significant impact on global standard setting and international reporting practices that directly impact many UK companies. The proposals would in our view weaken the standing and capability of these boards and as a consequence BIS/FRC's ability to make its case in Europe (for example with the European Securities and Markets Authority (ESMA) and the European Financial Advisory Reporting Group (EFRAG)) and elsewhere, affording less protection for UK business. (40 - 43)
14. The underlying business case is not persuasive. It does not clearly articulate or evidence 'perceived' weaknesses and fails to consider compensating controls and safeguards within existing processes. The BIS concept of 'earned recognition' and the government supported concept of co-regulation (intended to limit additional layers of cost and regulation) are not explored. (45, 48)

Investment focus

15. The paper asks whether the scope of the FRC's work should be refocused on the corporate sector with a primary focus given to publicly traded and the largest private companies. ICAEW's opinion is that the primary focus should be on publicly traded companies, and perhaps narrowed even further to the FTSE250 or the FTSE100 where the systemic risk to the UK capital market is highest. The current EU Statutory Audit Directive limits the definition of public interest entities (PIEs) for audit monitoring purposes to entities listed on a 'regulated market' (as defined). However the EC proposals extend far beyond this and the scope can only be sensibly determined when the proposals are enacted.(52 - 54)
16. Subject to the EC proposals a proportionate but rigorous regulatory regime aimed at this narrower segment will arguably provide more confidence to investors at less overall regulatory cost, particularly if the focus is on addressing the risk of systemic failure. In this context, the recently announced extension of FRC's remit into UK Local Government is considered a dilution rather than strengthening of focus. (52 - 54)
17. Any extension beyond the narrower base favoured by ICAEW should be subject to a rigorous justification exercise by BIS, rather than leaving the decision to the FRC itself. (52)
18. It follows that ICAEW favours a focus of the FRC's disciplinary and audit inspection remits on the same narrower market segment. Responsibility for the areas that fall outside the revised FRC scope should fall to the RSBs under an oversight (as distinct from a direct regulatory) role exercised by the FRC. This will also help resolve the conflict of interest that ICAEW perceives in several areas of the FRC's current role, whereby the mix of FRC's regulatory and oversight roles compromise its effectiveness. (60)

Governance and structure

19. While there is merit in some streamlining of the FRC structure, efficiency of structure should not be at the expense of effectiveness of outcomes. The quality and expertise that have earned the FRC a good reputation with respect to its technical and standards work have been largely achieved by the quality of members of the constituent operating boards, for example the ASB and the APB. Over-streamlining of these activities could result in either technical decisions being taken at an unaccountable staff level, or pushed too far up the governance structure where board members lack the necessary technical expertise. (40 - 42)
20. The ASB has a strong international reputation which allows the UK to play a significant role in European and international standard setting that directly impacts on standards developed for UK businesses. Reorganisation may weaken that reputation and influence and thereby damage the long term interests of UK business and investors and the growth agenda. (43)

21. Savings if any from this exercise will depend on what comes in its place. The inherent functions of the different parts still need to be carried out and alternative structures if not properly thought out will add to rather than reduce cost. The paper does not provide the detail as to how the reorganisation would reposition responsibilities, eliminate overlap, and capture items not currently addressed by any of the existing bodies. The bottom up approach also means there is no measure of proportionality between cost of the revised model and the ensuing benefit to the market as a whole. (45)
22. Currently there is only a notional separation between the Professional Oversight Board (POB) and the Audit Inspection Unit (AIU). There is no effective oversight of the AIU's activities at an operational or substantive technical level to ensure the delivery of the necessary level of quality and public protection. ICAEW is concerned that under the proposed Conduct Board even the notional element of oversight will disappear. (64)

Reinforced independence

23. The proposals in the consultation document concerning independence are based on conjecture, rather than on an evidence-based approach which the FRC should be adopting as an 'evidence based regulator'. It is instructive that none of the issues that the proposals seek to address with respect to independence have ever been included in successive FRC annual reports to the Secretary of State from 2005 onwards. Indeed, they have not even been included in the POB's annual inspection reports to ICAEW following rigorous review work by POB staff. (34b, 88)
24. For example, professed concerns around the composition and effectiveness of ICAEW's Audit Registration Committee (ARC) were first aired informally by the POB in summer 2011, with no supporting evidence. In fact, ICAEW can demonstrate that in no case has the ARC thwarted the will of the AIU with respect to regulatory recommendations made by the AIU. In fact, the ARC has imposed stricter sanctions beyond AIU recommendations in over a quarter of the 32 cases considered in the past two years. (39a)
25. Indeed, it is instructive to note that the ARC has full regulatory powers (which it must discharge independently of any external influence) under the Companies Act 2006 with respect to audit firms registered with ICAEW. However, the POB/AIU has never requested the ARC to take any significant regulatory action against a major audit firm, including any of the Big 4. So we question what the FRC intends to do with the enhanced powers it now seeks, that it could not achieve under the current system. (73)
26. With respect to the FRC's desire to make its own rules for independent disciplinary arrangements, ICAEW is on public record before the House of Lords Economic Affairs Committee with its concerns over the ineffectiveness of the Accountancy and Actuarial Disciplinary Board (AADB) in investigating and determining public interest cases. (36)
27. The inference in the consultation paper is that the blockage in progressing AADB cases has been caused by interference in the disciplinary scheme by the professional bodies. ICAEW believes that this is at best disingenuous of the FRC, which has had ample scope, time and financial resources since 2005 to have made a significant impact and contribution in maintaining the good reputation of the vast majority of the accountancy and audit profession. In our view the AADB has failed to operate to its own full potential and therefore the proposed way forward is neither evidence based nor realistic. (36, 60)
28. The steps then proposed to deal with the perceived lack of independence bring with them additional problems and in our view are counter-intuitive in light of the FRC's own objectives, and the current direction of government policy. The Minister for Business and Enterprise has himself said regulators are required to recognise business activities that support compliance and reduce intervention. Making itself more remote from the profession weakens the FRC's technical understanding of the industry it oversees and its ability to challenge effectively. (35b, 70, 74)

29. Other options to strengthen independence have not been considered, in particular addressing the membership of the FRC Board itself, that of its constituent committees and possibly within the RSBs themselves. Considered lay membership may strengthen perceptions of independence as well as bringing a wider perspective to the regulation of the industry. (86)

Proportionate regulation

30. The proposals for the FRC to take powers to impose proportionate sanctions against RSBs and RQBs are symptomatic of the FRC's confusion between its role as an oversight body and its seeming desire to extend its regulatory scope beyond that which is given in the Companies Act 2006. That onus is on the RSBs and RQBs, not the FRC, to exercise functions under the Act with respect to, among other things, auditor education, registration and regulation. (34c, 89)

31. The Act also provides for the POB to provide oversight of the RSBs and RQBs in the way that they discharge these functions. If the POB believes that any RSB or RQB is failing to discharge their statutory duties, the power to withdraw status already exists. Fining and enforcement powers are the remit of regulators, not oversight bodies. (90)

32. With respect to the FRC wishing to take disciplinary action against professional accountants or firms (presumably only in relation to statutory audit matters) without a public tribunal hearing, ICAEW believes this to be difficult territory. Firstly, there is more than a hint that this is designed as a convenient way of remedying the backlog of cases that the AADB has built up over the past six years. Second, the fact that these are public interest cases means that the public will feel short changed as 'deals are done' behind closed doors. (97 – 102)

33. If the FRC wishes to pursue this route it must be made abundantly clear how the public interest will be served and indeed whether 'no fault' deals will be entertained. Recent cases in the UK (HMRC and Vodafone) and in the USA (SEC and Citigroup) indicate that some judges, the general public and MPs have strong concerns about these kinds of settlements. The FRC champions transparency in the financial markets. It should uphold that principle in its own workings. (102)

ANSWERS TO SPECIFIC QUESTIONS

The case for FRC reform

Q1: Do you have any comments on the case for FRC reform as set out in this paper?

34. In reviewing the business case for change we believe there are a number of conflicting drivers and unsubstantiated assumptions which make the proposed actions and outcomes less tenable and deliver less value to the market. The drivers for change set out in paragraph 1.5 of the paper are illustrative of this.

- a. **Current scope of activity is ill-defined and the structure is overly-complex;** the historical establishment and bringing together of these organisations has brought with it a degree of overlap. However there is no evidence that the structure is over-complex and not fit for purpose. Clarification of roles and responsibilities in a more logical framework could equally be achieved within the existing structure.

- b. **The FRC is not sufficiently independent**; we do not believe that the business case shows hard evidence that this is a problem that needs addressing. The illustrations provided give theoretical limitations where the FRC might be deemed to be compromised, but our own experience to date has indicated if anything the approach taken by the RSBs has more than met the enforcement guidelines the FRC would seek to apply itself. None of the issues which the proposals seek to address have been brought to the attention of ICAEW at any stage and the FRC has not raised these matters with the Secretary of State. Therefore there has been no opportunity to discuss and remedy any perceived deficiencies. In addition we believe that in pursuit of further independence from the profession, the FRC and its sub-boards are at risk of losing their engagement with the profession on those aspects of its role where individual expertise and knowledge can bring enormous benefits and value.
 - c. **The FRC does not have a proportionate range of sanctions**; we consider there would be a conflict in the FRC having additional powers, and requiring proportionality to exercise them effectively. In our view this introduces self-review into what is supposed to be an independent oversight body and weakens its independence. In addition, in order to exercise proportionality there would need to be a skilled decision support unit which would add to rather than reduce cost for the FRC.
35. In our view, the business case should be more focused on the regulatory approach objectives set out in paragraph 1.2, so that a better directed series of reforms might be proposed. In particular:
- a. Independence is a thread that should be applied across the full regulatory landscape, not just in the relationship between oversight body and the profession. The paper should include in its remit the representation on the FRC and its committees, and perhaps the RSBs themselves. For example, it is difficult to see how the proposals can be truly independent when, with the exception of only two individuals, the FRC Board will be responsible for appointing its own members, the members of the two Board Committees and the advisory councils and panels.
 - b. The paper should set out as a preamble specific instances of failure in the existing structure which justify change. The lack of these suggests that the proposals are a response to regulatory problems in other professions which have not been experienced to date in the accounting environment. Indeed some consideration should be made as to why the absence of example is the case, including the identification of compensating safeguards obviating the need for added regulation – a point made recently by the Minister for Business & Enterprise who has referred to the need for greater reliance on earned recognition reducing the need for central intervention.
 - c. The FRC aims inter alia to support the leadership of the professional bodies.....ensuring that its own work does not detract from their responsibilities. Proposed steps to take up additional powers are prima facie a detraction from the RSBs' responsibility, but this paradox is not addressed in the business case.
 - d. The financial saving seems to be the prime driver in both the paper and the Impact Assessment, an objective that does not sit easily (though understandably) in an effective regulatory environment. It appears to us that for some financial saving to be achieved, a common infrastructure support can be placed under the seven major functions. However this model needs to be reconciled with the roles of those units and the need for independence between a number of them; addressing those points in turn may dissipate some of the initially perceived savings.

36. Our views on the FRC's desire for more powers are on the public record and are set out in ICAEW's letter to the House of Lords' enquiry in November 2010, rebutting the FRC claim that it needs more powers. A copy is attached to this submission (Appendix One) and at this link: <http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/10101908.htm>.
37. Finally we are concerned that the timing of the implementation may result in further changes needing to be made almost immediately afterwards, as a result of the impending FSA reorganisation and the European Commission audit proposals.

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

38. The proposed restructuring of the FRC and its component bodies could bring some financial and operational benefits, provided the safeguards we have referred to in earlier paragraphs are taken into account. However a clear definition of roles and responsibilities within the current structure, could equally improve communication and responsiveness as well as enabling a leaner support structure.
39. We disagree, however, that increased powers would achieve the aim of stronger independence, and, indeed, we believe the proposals could be counter productive and damaging to the FRC's credibility. Concerns we have in this area are set out below:
- a. The proposals will not achieve true independence as there is no external oversight of the regulatory proposals for the revised FRC. The consultation paper mentions a range of proportionate sanctions and procedures but there is no evidence in either the paper or within ICAEW that any sanction requested by the AIU has been refused or reduced by the ICAEW ARC. In fact the opposite is true in a number of cases – the ARC has imposed stricter sanctions than those suggested by the AIU in over a quarter of 32 cases in the past 2 years.
 - b. The exercise of disciplinary powers would mean that the FRC would be acting as both judge and jury and compromising its oversight responsibilities.
 - c. As a general point, the proposals do not go into detail about how the new organisation and general interaction with other bodies and advisors would operate on a day to day basis. In particular the vagueness of the proposals makes it difficult to understand what is being proposed particularly with regard to the structure on the standard setting side. No one set of people can be expected to have expertise in all of the areas for which the FRC sets standards, so the consultation and approval arrangements are vital.
 - d. The proposals make little reference to the oversight of the actuarial profession – this is an important element of the FRC's work.
 - e. We do accept that FRC has a concern over the regulator being too close to the body that it regulates. However we think it important that the risks/benefits here are carefully weighted. Open channels of communication between POB and ICAEW has helped ICAEW (and we think POB too) considerably in recent years. It has helped to forge effective working relationships between each body's staff. It has also helped to define and clarify policy for students, members and firms and recommendations and follow-up measures for ICAEW. It would be a great shame if in a desire to create greater space between the FRC and those it regulates these channels of communication were damaged.
 - f. The professional bodies have responsibility to other stakeholders including overseas regulators, and recommendations, for example from the POB, at times can be in conflict with those responsibilities. The current status quo facilitates a challenge and monitoring process which works well to enable the POB to reinforce best practice without compromising the profession and the market as a whole. Compulsory powers could put this fine balance at risk.

- g. The business case and the Impact Assessment are both weakened by the lack of specific examples of current problems or indications of where future problems might arise. The absence of examples of deficiency means there are limited performance indicators to establish whether any benefits would be delivered under the paper's proposals.
- 40.** The FRC currently has an internationally respected leadership role in a number of areas of standard setting and regulation, and as a powerful, independent advocate of UK perspectives on good financial reporting. The consultation paper believes the new structure will enhance this. However, in our view merging expert boards into generic standard setting and conduct boards, and the inevitable diversion of time into the restructuring, risk the appearance of downgrading existing expertise and the FRC's reputation for leadership at a key time for professional regulation. There is a very real risk that the UK voice will be diminished in future if the ASB and APB are merged into a less familiar and accessible organisational architecture, without the sort of high calibre individuals it currently attracts, and one which in governance terms would not meet the criteria of an independent national standard setter.
- 41.** Decision-making powers for standard setting should lie, as now, with an appropriately-constituted standard-setting body with a high level of relevant expertise, adequate technical capacity and a clear technical focus. That body should be (as it is currently) subject directly to the rigours of due process, consulting widely with constituents whilst enjoying institutional protection from undue political intervention.
- 42.** It seems unlikely that the new regime will continue to attract individuals of the same calibre and expertise as are found on the ASB and APB. In any case, the proposed new governance structure envisages a separation of decision making from these essential elements of high-quality, principles-based standard setting, and does not explain how technical independence and the current high quality of UK accounting standards will be maintained. Indeed, the bases given on which recommendations on standards may be overturned by the FRC Board are so wide as to allow almost complete latitude by a body that has not been subject to that rigorous due process and which does not have the relevant technical expertise.
- 43.** We understand that the above concerns are shared by many key stakeholders at both European and international level. There is, in particular, a concern that the complex interplay between the different accounting bodies at European level, and their relative influence, will be materially affected by the potential advent of a less influential UK body. The ASB is one of the three major national standard setters within the EFRAG, and is a major contributor to the EFRAG thought leadership programme. A shift in the current balance of views in Europe may be one of many unintended consequence of the FRC proposals, and may damage the long-term interests of UK business and investors.
- 44.** The proposals would be enhanced if they included considerations and conclusions on:
- a. aspects of regulatory activities of other comparable bodies, for example the FSA and the FRC's equivalent bodies in Australia and the US, that are considered to have been successful or otherwise;
 - b. implementing some of the good regulatory activities that the FRC suggests for others - for example applying the corporate governance code, or having its own activities monitored.

Q3 Do you have any comments on the consultation stage Impact Assessment?

- 45.** The Impact Assessment reiterates many of the assumptions which we have challenged in the paragraphs above. In particular the absence of specific behaviours that the FRC is seeking to address makes a financial assessment of benefit in those areas difficult to identify. In short we see the commercial merit in rationalisation of structures and scope, but do not see the realisation of benefits through the adoption of additional powers.
- 46.** The impact analysis appears to be solely concentrated on financial considerations. This in itself is not enough to enable a proper consideration of the points addressing efficiency, 'non monetised cost' and costs which are more difficult to forecast. In our view, for the FRC to sustain its credibility, quality needs to be the driver of the changes it seeks. There should be proper measurement (now and estimations for the future) of the suggested benefits to improved independence, speed of handling and all other areas cited as the reasons for change through financial and non-financial key performance indicators. Examples of non-financial measures include perception/opinion scoring by key stakeholders.
- 47.** The FRCs Impact Assessment sets out three options, which are presented in a way which leads the reader to the FRC answer. In other words, Option 1 (streamlining the FRC's governance structure and reforming its powers) is shared with a positive statement. Options 2 (do nothing), and 3 (additional licensing arrangements), are shared with negative statements. This gives the impression that Options 2 and 3 were added as after thoughts and not given full weight of consideration; indeed Option 3 seems to add to complexity which is counter-intuitive to the perceived drivers for change. This weakens the standing of the Assessment. In addition the options have been aggregated rather than set out as separate components which would allow assessment of the impact of individual proposals, so for example the impact of reorganisation is not separately set out apart from the introduction of new powers.
- 48.** Savings of £280k associated with the narrowing of powers as set out on page 20 appear to be rather simplistic. In our view the overall saving to the regulated community is likely to be nil. This is because any work not done by the FRC as they withdraw to core operations must be done elsewhere. If the firms pay for this work now, either through the FRC levy or AIU charges, they will need to pay for it in another way in future, eg, if the RSB picks up the work previously done by the FRC. The risk outlined in a subsequent paragraph gives the impression that the work does not need to be done at all or that the RSBs would perform the task without additional costs. The savings identified would only be confined to government and that overall regulatory oversight costs would only reduce slightly if it was intended that comprehensive inspection coverage be sustained between the AIU and RSBs.
- 49.** On page 29 the risk associated with the tribunal savings of £750k is dismissed in our view without proper weighting. Audit firms and professional bodies fund the full case costs and a significant proportion of the AADB's operational costs including external legal costs so there is some opportunity for saving here. For those firms that do not end up paying a fine there could be some savings through a reduced levy. But based on the limited success of the AADB to date, we are not sure there is sufficient incentive for a firm to settle. The AADB will have even further reduced its resources, and may have in most cases failed to secure a fine. There is a big risk that if firms don't buy into the settlement arrangement, the FRC will very quickly have to reinstate the previous levy funding levels, negating any savings and causing funding from the firms and RSBs to be raised.
- 50.** On page 9 is a statement that the FRC consults annually on its budget and funding arrangements. However it is not made clear with whom that consultation takes place, and the content that is discussed. As far as ICAEW is concerned, we may be advised as to the FRC's intentions, but we are not asked to challenge the basis of the budget, details of which are only disclosed at a summary level. We do not believe that, in itself, constitutes a consultation, though the concept under the transparency objectives of the FRC would be welcomed as a proposed reform.

51. Page 3 of the Impact Assessment refers to a number of qualitative areas where there is assessed to be no impact. This is referred to in page 34 of the paper for more detail, but page 34 merely reiterates the content of page 3 and provides no detail to support the conclusions.

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?

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

52. We agree in principle that the primary focus as it relates to monitoring and enforcement should be across the spectrum of corporates broadly as defined. We believe, however, that BIS should set the FRC's scope and not the FRC itself. Nevertheless if the FRC is looking to balance effectiveness with limited resource, the scope could be narrowed further to say the FTSE250 or even the FTSE100. We would add to the terms of reference for this primary focus the need to address the key areas of risk including systemic failure and those corporates that are vulnerable in this area.
53. There is implicit in the proposals that there would also be a secondary focus, but the remit for this is not defined. We believe there needs to be care in how this two tier focus is expressed as the FRC is in danger of appearing to wish to remove its responsibility for serving the generality of the public interest, in favour of only paying attention to 'public interest entities', such that 'primary focus' becomes sole focus. Statements of focus need to ensure that non-Public Interest Entities are covered through the monitoring work of the RSBs.
54. However we question the timeliness of changing the focus at this time in the light of the draft amendment to the EU Statutory Audit Directive issued at the end of November 2011. The current Directive itself limits the definition of public interest entities for monitoring purposes to the audits of entities listed on a regulated market (as defined). On the other hand the draft EC proposals embrace a definition well beyond the current scope of the FRC. Given the uncertainty around the FRC's role under the new Directive proposals we fail to see how a sensible focus profile can be achieved at this point.
55. Subject to EC proposals, it would seem to us that in keeping with the UK government's approach to decentralised regulation, rebasing the FRC scope to that required under the Directive would maintain (or in some areas improve) a proportionate but rigorous regulatory regime. It would also be more consistent with that operated by other EU member states, while reducing the regulatory cost burden on audit firms. We believe the proposed public interest definition in paragraph 2.5 would be difficult to apply as:
- a. many of the 1000 AIM companies (as per the Impact Assessment) currently in AIU scope have a different investor profile to larger listed entities (often being financed by a small number of informed investors). Adopting a standard but somewhat arbitrary £500m turnover limit ignores this or any other reference to risk (for example in terms of company activity).
 - b. AIU's current coverage of such entities is in practice limited. AIU coverage understandably concentrates on the largest listed companies, particularly at the largest firms. This means AIM companies in AIU scope often receive proportionately less coverage. By contrast, these AIM companies would be the most significant entities in a RSB's remit with coverage to match.
 - c. returning all AIM companies to RSB scope avoids issues of companies around the £500m limit moving from RSB to AIU and back again over a few years. It also reduces the regulatory cost burden on firms (the cost of RSB monitoring being somewhat less than the cost of AIU monitoring).

- 56.** The Impact Assessment does not make any specific reference to financial institutions. These remain high public interest entities and all financial institutions should remain within AIU scope. If the FRC chooses to move out of this area, the suggested savings might be dissipated by the Bank of England and/or FSA (or the successor arrangements) stepping in to replace what it may see as a dilution of oversight.
- 57.** We do not believe the financial test of £500m turnover is itself sufficient definition for bringing into scrutiny the larger entities. For example some large financial entities (such as Insurance companies) have minimal turnover levels but significant amounts of capital under management, which would be overlooked under a £500m turnover test. We believe that a higher turnover cut off should be applied coupled with other measures. We have indicated above our concerns re AIM companies, but were this area still to be pursued, then one key area when deciding on which private companies to include within scope is the investment profile (for instance how much is publicly owned / in the hands of employees etc.). Refining the criteria in this way would enable the AIU to target individual companies for review based on more transparent public interest risks rather than including in its scope a much wider population solely using a fixed monetary value.
- 58.** Finally in setting the scope for the FRC's own focus, it is unclear to what extent the regulatory oversight of the activities of the professional accountancy bodies will be restricted to their own work in respect of publicly traded companies and large private companies only. Such a restriction would be unlikely to conserve resource as the bodies operate similar regulatory and disciplinary arrangements regardless of the nature of the ultimate client, and could risk concern from other interested regulators that the profession's regulatory and disciplinary activities are no longer subject to comprehensive oversight. It would be very much better for oversight of the full range of activities that are in practice going to be considered, to be explicitly recognised by the FRC and taken into account in assessing its procedures and oversight, rather than being omitted from its objectives.

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?

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

- 59.** We found it difficult to answer these questions directly without consideration of other strategic factors affecting the FRC, for example where the work for other external parties such as the National Audit Office (NAO) feature in the FRC's future plans, the FSA reorganisation, and the draft amendment to the EU Statutory Audit Directive. The NAO changes are referred to but not commented upon in the consultation and require further explanation. For instance, it needs to be made clear how the type of audit clients falling within the scope of such third party work compare with and are consistent with the planned revisions to the FRC's core operations. It should be added that ICAEW believes that the recently announced extension of the FRC's remit into the local public audit sector will prove a significant distraction from its core focus.
- 60.** Subject to the previous observation we find these proposals to be consistent with the aim to move to a risks and outcomes approach. We share the FRC's view that attention should be focused on the higher risk to the capital markets, and the narrowing of disciplinary arrangements we believe is a sensible move consistent with that. However in our experience the AADB has a tendency to move outside its current remit, and some clear guidelines are necessary to ensure that the RSBs perform the core disciplinary activities and the work of the AADB is confined to the new area of remit.

A streamlined structure

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

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

- 61.** It is difficult to make an objective assessment when full detail of the restructure has not been articulated, nor a matrix offered of the roles and responsibilities of the existing structure and how they should map into a proposed new structure, identifying the specific removals of overlap and covering of gaps.
- 62.** Whilst we agree that some rationalisation is required in the bodies the FRC currently coordinates, this needs to be effected with due regard to;
- a. The independence of the individual functions within its structure.
 - b. The efficiency of operation of those units and their specific objectives.
 - c. The sustaining of the quality and expertise of the legacy bodies.
 - d. The membership of the panels or committees that may oversee the function of the units, as well as the membership of the board itself.

These four factors are explored further below.

Independence

- 63.** The proposed structure appears to move a large amount of power, including ultimate decision making, up to the main FRC board, compared with current arrangements. However, it then sets out some largely administrative criteria for its relations with the committees it is proposing to set up. It is, however, unclear whether the FRC board intends to exercise its ultimate decision making power as direct involvement in the output of those committees, or as more of a detached oversight mechanism.
- 64.** Currently, there is a notional separation between POB and AIU, although there is clearly no effective 'oversight' in terms of independent review of files, methodology and cyclical/risk-based visit plans (to which the RSBs are subjected). We are concerned that streamlining the AIU and POB under the same Board Committee may remove the notional separation in the current system and could lead to what might be seen as an unacceptable lack of oversight by POB over the regulatory monitoring conducted by the AIU. This seems to be at odds with the statement in paragraph 1.2 that the FRC is independent from those that it oversees/regulates. Clearly in defining more closely the new structure this arms' length relationship needs to be sustained and reinforced rather than compromised.
- 65.** It is important that the standard setting and regulatory arrangements are largely independent of each other. Where they are under common influence – which would appear to be much greater than under the current arrangements, there is a risk of a dilution of input into the standard setting arrangements. People and organisations will be reluctant to object to standard setting proposals even on public interest grounds, if they risk offending relationships with their own regulators.

Efficiency

- 66.** The consultation paper implies that there are savings to be made in the infrastructure support platform for these regulatory bodies over and above that currently achieved, for example in IT, HR, finance and communications. However the role of that platform and its interactions with the bodies as they are at present should be clearly articulated to ensure some measure of independence is sustained between the bodies, particularly where they may have oversight responsibilities.

67. We equally recognise that the leadership of the individual bodies does not necessarily require the full competency make up of a chief executive or a board with back office operational responsibilities. However the leadership of those units still needs individuals with the technical skills, background and gravitas to make these bodies effective. It is not clear from the paper how those roles will be dealt with. Assumptions around savings in remuneration costs associated with unit leadership may be premature at this stage.

Quality and expertise

68. Linked to the last point is the question of decision making and which bodies would be making the decisions. Were the structure of the FRC to be over-streamlined, there is a higher risk that that key activity/decision-making processes may be pushed down to a non-accountable body or staff or too far up to those without expertise. This is particularly relevant given the size of the FRC Board and the number of areas it will be responsible for (standard setting, policing and monitoring) – which means that in practical terms it would only make decisions on very high level subject matters. The proposed model appears to us to present a serious risk of over-delegation which can lead to slow, cumbersome and sub-optimal decision making. It would be a shame if the current inefficiencies were to be replaced with inefficiencies of over-centralisation. The details provided in the paper do not appear to articulate sufficient safeguards against this.

69. In particular the advisory bodies seem side-lined and there is no indication of their constitution, representation or designation. The APB and ASB are very important standard setting bodies who lobby and influence international standard setting bodies. The APB and ASB should not be side-lined and their members need to be drawn from those with greatest experience, knowledge and skills in their respective areas. There is a clear risk that quasi-governmental and unelected bodies/directors will appoint quasi-governmental and unrepresentative members. We believe that the FRC could suffer a loss of credibility and standing in this area as a consequence of this apparent dilution of their importance within the structure.

70. In seeking independence, FRC should be careful not to deprive itself of the very expertise that they need to regulate effectively. Feedback from those being regulated (firms, directors, professional bodies) is as important as that from the investor community. It may be treated differently, but it should not be precluded or disregarded. We are not convinced that the models proposed ensure that the industry knowledge is captured and sustained in the same fashion as under the current boards.

Membership of Boards

71. In defining the new board structures we are surprised that the FRC does not appear to have addressed governance developments in other areas of regulation, for example by the FSA and the LSB. An emerging feature of these is the visible measures of independence demonstrated by the member appointment process and the number of lay members on the board. These aspects are not mentioned in the paper. Indeed in some respects we believe the proposed appointment structure is inconsistent with the FRC's Corporate Governance Code. We recommend that the FRC Board should be appointed by a panel of key stakeholders and this selection process be extended to appointments to the underlying Board Committees and Advisory Councils.

72. It appears to us that a critical part of the proposed structure will be the Executive, as the efficiency and functionality is likely to be highly dependent on the coordination and infrastructure presumably overseen by this body. However the paper does not explain who the 'Executive' are, how they are selected and appointed and to whom they are accountable, let alone what functions they might carry out. These aspects need to be clearly articulated in order for stakeholders to have confidence in the new structure.

Independent supervisory and disciplinary arrangements

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

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

- 73.** We have severe reservations about this proposal. We have set out above our concerns around the underlying business case for this proposal, to which we would add at this juncture the question as to why the FRC is asking for extra powers when it has not indicated at any time hitherto that it wished to use the existing powers available to it, nor has it indicated in the annual reports to the Secretary of State any issue with the existing powers available to it.
- 74.** The proposals contrast with other Government initiatives; both the Government's growth review and the consultation on transforming regulatory enforcement suggest strengthening the role of professional bodies, not weakening it. A recent speech by the Business and Enterprise Minister identified that where existing systems deliver essential protections under the concept of earned recognition then further regulatory interference is not justified. Inconsistency with clearly set out Government policy needs a strong public interest justification.
- 75.** We believe that as drafted this proposal is based on a misunderstanding of the roles and responsibilities of the RSBs and the oversight body under the Companies Act 2006 and as a consequence it compromises the structure and standing of the FRC, particularly in its role as an oversight body. The FRC should have and does have the power to require responses to its recommendations, but if it does take on some of the implementation role (through for example direct disciplinary power), then it compromises its own independence, as it would potentially be part of a problem, rather than simply be responsible for ensuring it gets dealt with.
- 76.** The proposals also bring with them some serious challenges around the principles of natural justice. Circumvention of powers of appeal potentially brings into conflict the requirements of the European Convention on Human Rights which is enshrined in UK law, and could be challenged by a number of affected parties in court. The writing of the rules and the determination of cases by the same body would also lead the FRC vulnerable to judicial review with all the associated costs. We would not consider this an effective use of the FRC's time, nor would it enhance its credibility as an oversight regulator.
- 77.** In our view the FRC has correctly identified independence as an issue in its functionality, but the core issues with independence are not so much as between it and the underlying profession, as to the way it is itself structured. The FRC's progressive acquisition of an increasing number of operational responsibilities is in direct conflict with its responsibility to oversee these activities. This conflict (or 'self-review' threat) already exists with AIU and the AADB – and considerably more effort should be made to segregate these functions from oversight rather than perpetuate or worsen the current situation.
- 78.** In criticising the arrangements of the ARC the paper argues (paragraph 1.12) that these are deficient because the chairman of the committee is an audit partner, some other committee members are auditors and there is no lay majority. The ARC is composed as it is because it is essential for it to have the necessary technical competence to deal with all types of audit issues. Removing audit partners would seriously damage the ability of the committee to carry out effective informed challenges and reach the right conclusions on cases. Whilst we approve the concept of lay membership, this has to be balanced with the need for quality and understanding of content. For example in technical areas such as those dealt with by the ARC, lay majorities would be a retrograde step in underpinning the principles of quality and the raising of standards which are seen as key elements of the FRC's own approach. We would nevertheless be open to further discussion on this approach should the FRC wish to examine it further.

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?

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

- 79.** We reiterate our concern that the FRC in seeking these powers is compromising its ability to function properly as an effective oversight body. This is against a backdrop where no events to date have occurred which would evidence the need for this change to be made. Moreover taking on these powers would appear to bring additional cost into the FRC's structure, and to dilute the powers of the underlying RSBs. Both actions are in clear conflict with the aims and objectives of the FRC as set out in paragraph 1.2 of the paper.
- 80.** The current AADB scheme is approved by the Councils of all the participating professional bodies. The current rules are well understood. People entering a profession are entitled to know in advance what the rules are to which they will be subject. The disciplinary rules are enshrined in the disciplinary bye-laws which are subject to approval by members in general meeting and Privy Council approval. In order to ensure that any changes to the AADB scheme may be made expeditiously the general body of members has delegated to the Council of ICAEW (and to the Councils of other participating professional bodies) the right to determine the terms of the scheme. These arrangements permit changes to be made promptly if necessary.
- 81.** There is no evidence that the present arrangements have proved deficient in any respect. It is right that from time to time that AADB has consulted in relation to changes to the scheme but the RSBs have always responded promptly and strictly in accordance with a timetable laid down by AADB in making any observations on proposals. If AADB were to be left to establish a scheme without the need for consultation, history demonstrates that this would be likely to result in a seriously flawed scheme. It is noteworthy that in 2008, AADB embarked on a major review of the scheme. It did not consult with the profession during the extensive period within which it drew up its proposals. It then deposited the proposals with a very brief period for response. The RSBs with the benefit of advice from Queen's Counsel demonstrated that there were serious flaws in the proposals, a position which AADB accepted.
- 82.** Further, it is important to bear in mind that the AADB Scheme has the potential to deal with all failures in the accountancy profession, not just those which arise from audit cases. In the event that the AADB scheme is to be one which is imposed rather than agreed the profession would need to consider carefully whether it wished to withdraw from the scheme other than in respect of audit matters. This would be a retrograde step. In short, the proposals are not founded on evidence of any practical problem and if implemented they may well result in the remit of the AADB being substantially curtailed. In particular there is no evidence that the 'speed and quality of the responses of the recognised bodies to recommendations' need to be sharpened (paragraph 1.16 of the paper).
- 83.** We have made it clear in at least one recent response that independence is not the same as being distant and disengaged, and that independence without engagement is inefficient. The mark of a mature regulator is the ability to reap the benefits of engagement without capture. It is therefore disappointing that the list of consultees for the proposed Codes and Standards Committee in paragraph 3.6 (box, bullet 5), does not include the regulated bodies.
- 84.** An effective accountability mechanism would go some way to ensuring that the FRC is both seen to be and is discharging its powers appropriately. Clear lines of accountability are desirable for upholding the public interest. If the FRC wants increased disciplinary powers this should be accompanied with a clearer statement of how these powers will be used. We recommend that there is no increase in powers without an increase in accountability. This could, for example, take the form of an annual appearance in front of the BIS Select Committee.

- 85.** The above point is particularly important with reference to the current financial model that underpins the disciplinary arrangements, the economic consequences of which are not mentioned in the paper. The current process of regulation is funded through the RSBs by their regulated firms and thence to business through the audit fees. An unfettered power for disciplinary arrangements, quite apart from issues of natural justice, risks building new costs and penalties that then cascade down to business to fund that cost. BIS would need to put in place an alternative oversight process that ensured the business model was not disrupted by unbalanced decisions by the FRC, which would have its own cost implications.
- 86.** In paragraphs 71 and 72 above we have drawn attention to the need for the membership of the Board and its respective committees and bodies to be open to good governance principles in line with the FRC's own code and that of its peer bodies. The FRC needs to consider improving the transparency and rigour of the selection and appointment of key officers and staff to the Board and its various subsidiary but vitally important organs (such as the APB and ASB or their successor bodies). Essential skills, knowledge, experience and aptitude should also be valued alongside political acumen and the ability/willingness to robustly challenge the status quo. In our view the FRC's mission should be 'continuous improvement' not 'destroy and replace'. We believe greater attention to this area would be a far more effective demonstration of independence by the FRC.

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:

- a) Issue an enforcement order, requiring the body to take specified actions by a specified date, without the need for a court order?
 - b) Impose conditions on continued recognition as an RSB or RQB?
 - c) RSB or RQB and if so, at what level?
- 87.** In principle, we are in favour of the FRC seeking to strengthen its existing options, but not to widen them. We do have a series of concerns around the proposals in the paper, in particular;
- a. The business case for these changes.
 - b. The implementation structure.
 - c. The financial model underpinning this.
 - d. The override of leadership.

Business case

- 88.** It is not clear which business issues these proposals are seeking to address. The Impact Assessment paper mentions only two issues – completion of a certain number of visits within a given period, and carrying out an external moderation by a specified date, which do not appear to be major issues in their own right. The use of the word 'perception' in paragraph 5.3 suggests that the main thrust for these particular proposals is driven by speculative scenarios without taking sufficient credit for existing controls and safeguards within the FRC itself and the RSBs, and that the perception risk could be equally addressed by better communication of the existing powers and their effectiveness rather than extension of them.
- 89.** We are not sure these powers are in line with the powers conferred by Parliament on the FRC and the RSBs. For example, under the Companies Act 2006 the ICAEW is 'recognised' by the Secretary of State as a 'Supervisory Body'. In short the responsibility for regulation of audit firms registered by ICAEW rests with it. In accordance with the Act, inspection of firms auditing

major entities has to be done by an independent body i.e. independent of it but subject to oversight. The Act does not impose any obligation on an RSB to follow recommendations that may be made by inspectors.

The implementation structure

90. In exercising its responsibilities as an RSB, ICAEW is exercising a public function. Although the regime introduced under the Legal Services Act 2007 adopts a different approach, bodies exercising public functions are not traditionally subject to penalties and fines in respect of alleged failures.
91. If, however, the FRC is to take on disciplinary powers, there needs to be a proper process, adjudication and an appellate structure in order for natural justice to be seen to be done. The right of appeal should be considered as very important. It is not clear from the paper or the Impact Assessment who bodies could appeal to. If the powers were adopted we believe the most logical appellant body would be BIS, but we are not convinced this is a role it would wish to adopt.
92. The proposed application of disciplinary powers against RSBs for failure presumably would also extend to the AADB and the AIU. The proposals for the reorganisation and the enhanced powers do not address this particular paradox in the proposed roles and responsibilities.
93. There is a presumption throughout the paper that 'proportionate powers' are a good thing and the nuclear option is not appropriate. However other parts of the British constitution work very effectively under this dynamic, particularly in oversight roles. The nuclear option has the effect of letting the regulatory bodies themselves get on with their work, but has them always looking back over their shoulder to make sure they do not stray too far from the required path. This maintains an effective independence as well as being inexpensive to operate. In this context the appropriate action if an RSB fails is not to seek to impose penalties but to remove its RSB status, and we still believe this is the right measured penalty.

The financial model

94. In paragraph 85 above we have referred to the financial model that currently underpins the regulatory framework and the long term economic impact of the proposals. However, there are also short term impacts which are detrimental. If the FRC itself were to levy fines these could prove to be counter-productive as most RSBs would only have the option to pass the costs on to members and in the interim severe fines could restrict a body's financial capability to take appropriate action to address the underlying problems. The FRC needs to consider and explain the strategic purpose of any fines.

The override of leadership

95. The FRC has laid out in paragraph 1.2 the principles it seeks to operate by, and these include 'supporting the leadership of the professional bodies...ensuring that its own work does not detract from their responsibilities'. In our view the imposition of fines and penalties would undermine the standing of the professional bodies and weaken the high level of quality supervision that those bodies currently exert. In short the proposals appear to run counter to the FRC's own objectives.

Possible areas for strengthening

96. Where we believe some effective changes might be made are in the proposed oversight powers and the tuning of the nuclear options themselves. These could include:
 - a. Applying restrictions as well as conditions – these would provide powerful incentives.
 - b. Issuing clear guidelines – for example covering starting points for action for various categories of offence, mitigating/aggravating features and whether to publicise. ICAEW has sentencing guidelines to enable a fair, proportionate and consistent approach which might be a useful point of reference.

- c. Having a range of sanctions, with transparent guidelines as to what type of action would be taken for various categories of offence.
- d. Operating a series of relevant key performance indicators to demonstrate improvement or sustainability in the current process, and to provide a basis for challenge where they weaken.

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?

- 97.** We fully support enhancements to the mechanism to expedite a satisfactory course of justice. The process is presently slow and expensive and ICAEW is on public record as stating that the AADB does not serve the profession or the public interest well particularly due to this slow progress of cases through the AADB.
- 98.** However we need to see more detail on how this would operate in practice and that the criteria would not be contrary to the public interest. Further, we would consider that it goes against the public interest if the outcomes, in terms of names, fines and decisions, of these disciplinary processes are not fully transparent and published, regardless of how and when settlement was reached. Publicity is core to protecting the public interest in terms of transparency of justice, awareness and also aiding a fuller understanding of the underlying issues. This is the process followed by the regulators of financial services, for example. An acknowledged and clear admission of fault, as well as a full admission of liability, where appropriate, is also essential to a robust process.
- 99.** Ever since 1980, when the Joint Disciplinary Scheme (JDS) was introduced by the professional bodies, it has been felt appropriate that where public interest cases are concerned there should be full and public accountability. Where proceedings are not to be initiated following an investigation there should be a report which is publicly available explaining why. Where audit failures result in complaints which require sanction, the need for public accountability and transparency means that they should go before a tribunal at a public hearing.
- 100.** It is absolutely correct (as stated in paragraph 1.17) that the current disciplinary arrangements take too long to conclude. Nevertheless there is no evidence that where parties agree that there has been misconduct and have agreed on an appropriate penalty, there has been delay in imposing this. Where there is such agreement, the delay in having a matter referred to an independent tribunal will only be marginal in relation to the length of time taken in investigation.
- 101.** It is wrong to assert that there is no process for ensuring that where misconduct is admitted and agreement reached as to disciplinary sanction there is no means for dealing with the issue without a full hearing of all the matters before a tribunal. Under both the JDS and the AADB in such situations 'Carecraft' arrangements have been adopted. These parallel the arrangements for company director disqualifications where there has been agreement both as to failure and period of disqualification but the proposals have to be considered by the Court. In the same way the need for accountability means that both AADB and the member/firm should have the proposals approved by an independent tribunal. Further, it should be open to such a tribunal where it feels that AADB has been lenient to reject a proposal.
- 102.** Finally on this point we make reference to the FRC's credibility and the potential damage that could be made to it by a settlement behind closed doors. The recent example of HMRC and Vodafone has demonstrated that no matter how well intentioned and thought through an approach by both sides, its settlement as a 'deal' and the fact it was concluded in camera make a British public highly uncomfortable, as well as leave the FRC and BIS itself open to scrutiny by MPs. The confidentiality is also counter to the FRC's own principles (paragraph 1.2) of transparency.

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?

- 103.** We make the point at the outset that under the current powers, this process already happens in practice by the calling in of cases. So we are unclear why there should be added changes needed at this stage.
- 104.** The model proposed appears to resemble the Public Company Accounting Oversight Board (PCAOB) model, but the FRC also appears to want to develop a role as a market regulator and to appropriate some of the powers which in the US are held by the SEC. For example paragraph 5.10 on supervisory enquiries refers to 'issuing general guidance to the market'. The FRC appears to be confusing its role in the regulation of companies, with the regulation of markets. Its role is to regulate companies and auditors. It should be noted that the Financial Reporting Review Panel (FRRP) writing to all chief executives is not the same as 'issuing general guidance to the market'.
- 105.** Having said the above, we agree with the concept of supervisory enquiries. However the proposal as framed is too widely drafted and could be open to abuse as this would add to further concentration of power and executive responsibility within one organisation. Therefore it is important that there are effective checks and balances.
- 106.** As there would be general concern and suspicion that such powers could be used for a fishing expedition, the specific scope and criteria for each inquiry should be carefully set out and justified. We suggest each inquiry should be approved by BIS on a case by case basis, and RSBs should be consulted to ensure a joined-up approach and avoidance of duplicated effort or confusion of roles/responsibilities/activities and the mechanism and time-frame need to be made clear.
- 107.** The exercise of supervisory enquiries would bring with it additional costs. It is not clear from the impact paper how these costs would be funded. It is recognised that the lack of scope and terms of reference at this stage make this something of a moving target, but in principle the FRC should explain how these activities would be funded.

Appendix One: ICAEW's Letter to the HOL enquiry, November 2010

Appendix One: ICAEW's letter to the House of Lords' enquiry in November 2010

Further supplementary memorandum by Mr Vernon Soare, Executive Director, Professional Standards, ICAEW (ADT 9)

I would like to comment on a number of the points that were made during the Committee hearing on Tuesday 9 November at which representatives of the supervisory community, including the Financial Reporting Council (FRC), gave evidence. As a Recognised Supervisory Body (RSB) for statutory audit under the Companies Act 2006, the ICAEW has a useful perspective to offer on the matters raised.

BACKGROUND

As the Committee may be aware the current arrangements for audit supervision in the UK arose out of a 2002-03 Government Review commissioned by the then Secretary of State for Trade and Industry (*Review of the Regulatory Regime of the Accountancy Profession*). This Review concluded that the arrangements established under the Companies Act 1989 were fundamentally sound but that the system could be strengthened.

This led to the introduction of a revised supervisory framework (now part of the Companies Act 2006) whereby Recognised Supervisory Bodies (RSBs) such as ICAEW are subject to the oversight of the Professional Oversight Board (POB) and are also required to participate in independent arrangements for the monitoring of public interest audits and the investigation, for disciplinary purposes, of public interest cases. The latter arrangements are operated with ICAEW's agreement via the Accountancy and Actuarial Discipline Board (AADB), the former via the Audit Inspection Unit (AIU), who along with POB are part of the FRC.

It should be noted that auditing standards, effectively the "rules" on how to conduct an audit, sit under the control of the Auditing Practices Board, also part of the FRC.

These arrangements are now mirrored to a very large extent in the EU's Statutory Audit Directive. While in many respects the UK has led the way in the development of robust arrangements for the supervision of auditors, for good reason the EU Directive draws a clear distinction between those responsible for the day-to-day regulation of audit firms and those who provide oversight of this process. In our view placing regulatory functions within the remit of the FRC blurs the separation between regulation and oversight. It is with this in mind that we write to the Committee.

9 NOVEMBER EVIDENCE SESSION

In their evidence session on 9 November the FRC noted that, as they do not register/licence the audit firms which the AIU inspects, they only have the "nuclear" option of recommending to a RSB the removal of a firm's registration/licence. This is because under the terms of the Companies Act the AIU provides independent inspection which the RSBs then act upon. Under the Act, RSBs have a wide range of powers to take action against firms including removal of registration. All RSBs can fine a firm, place restrictions on the type of audit clients it can have, place conditions on how audit work is conducted and remove the right of individuals within the firm from being involved in audit.

With respect to reports made by the AIU to the Audit Registration Committee (ARC) of the ICAEW, these are closely reviewed and appropriate sanctions applied in accordance with the circumstances of each case. The AIU has never recommended that a firm's registration be removed, or that an individual be prevented from undertaking audit work although it has made other recommendations for regulatory action. In all cases these have been taken up by the ARC and action taken against the firm or individual in question. In some cases the ARC has taken additional action to that requested by the AIU, such as restricting a firm from taking on new audit

appointments, until the underlying matters have been dealt with—this may also require the firm to submit to an additional AIU inspection.

In passing it is worth noting that despite the most recent round of AIU reports on large firm audits raising issues requiring "significant improvement" and an increase in auditor scepticism, no request was made by the AIU to the ICAEW's ARC to take any regulatory action against either a large firm or any individual auditor.

As we have stressed to the Committee in our previous submissions, it is important that recommendations on the future of audit regulation are evidence based. The AIU and POB are made aware of the ARC's decisions that are based on AIU reports and they have never commented adversely on the decisions or the process used to reach them.

As far as ICAEW is concerned, nothing presented by the FRC to date suggests that the Companies Act 2006 provisions are not working effectively. However, we recognise that the continuing success of the regime depends on clear lines of reporting between the AIU and the ARC.

With reference to the AADB, it is able to use any disciplinary sanction open to the ICAEW, including the power to impose unlimited fines and exclude from membership. This arrangement continues the powers enjoyed by the AADB's predecessor body, the Joint Disciplinary Scheme (JDS). Like the JDS, the AADB independently investigates public interest cases against audit firms registered with the ICAEW and is designed to play a key role in maintaining confidence in the UK audit profession. However, despite accumulating a substantial caseload the AADB shows no evidence of an ability to meet the promises concerning speed and thoroughness of investigation made at its outset. Indeed, according to its website, since announcing its first investigation in 2005, the AADB has brought only two cases to a tribunal hearing. An independent review of the effectiveness of its work may now be timely.

During their evidence session the FRC also commented that it needed a wider range of sanctions against RSBs. Again we would advocate an evidence based approach here. The POB undertakes annual reviews of each RSB. Inevitably matters are discussed and recommendations made. As far as we are aware, all matters raised have been resolved to the satisfaction of the POB as evidenced by successive annual reports by the POB to the Secretary of State.

As the Committee is aware the European Commission is currently consulting on a number of these issues at a pan-European level including the possibility of an EU-wide audit licence, which would have a major impact on current licensing arrangements for audit firms carrying out audits of public interest entities. This has been a global crisis and reform proposals must be capable of implementation across international markets.

I would be happy to brief you further on any or all of these matters.

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