



# Association of Accounting Technicians (AAT) response to the “Independent Review of the Financial Reporting Council: Call for evidence”

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## 1. Introduction

- 1.1. The Association of Accounting Technicians (AAT) is pleased to have the opportunity to respond to the “Independent Review of the Financial Reporting Council (FRC): Call for evidence,” published on 6 June 2018.
- 1.2. AAT is submitting this response on behalf of our membership and for the wider public benefit of having a vibrant economy that encourages sustainable economic growth, technological development, social mobility and high levels of employment.
- 1.3. Although AAT is not a professional body for auditors, we do have an external audit exam and a significant number of our membership base work for audit firms. Additionally, AAT regularly responds to FRC consultations, is represented on the FRC’s UK GAAP Technical Advisory Group and has FRC membership on its own Financial Reporting Panel.

## 2. Executive Summary

- 2.1. **The FRC has presided over a catalogue of audit failure that has brought its own existence into question.** It failed to investigate the audits of most of the UK banks that played a role in the 2007-8 financial crisis and in September 2017 the FRC closed its investigation into the auditing of HBOS by stating that KPMG’s performance, “...*did not fall significantly short of the standards reasonably to be expected.*” It has been widely criticised for its performance in dealing with the collapse of both BHS and Carillion and on Corporate Governance its changes to tackle excessive executive pay are said by the FRC to be “world leading” but are entirely lacking in effectiveness.
- 2.2. **Looking to the rest of the world will be unlikely to provide a very effective solution to the challenges faced here in the UK.** For example, Norway, having failed to implement EU legislation on audit, is listed as having the world’s second-best auditing standards according to the influential World Economic Forum Global Competitiveness Report (2017-18)<sup>1</sup>
- 2.3. **If the FRC is unable to evolve and change its culture then its primary function of regulating accountants, auditors and actuaries could be transferred.** This function could go to another department such as BEIS, an expanded FCA or even to the relevant professional bodies.
- 2.4. **If the FRC were to mirror the FCA approach to prioritising its work based on the potential for consumer harm this could avoid harm.** For example, taking into account issues such as public funding, the number of employees, importance to the British economy etc.
- 2.5. **The FRC should do whatever it can to promote competition.** Ofgem, Ofwat, the FCA and PRA all have clearly stated objectives to promote competition. Promoting competition is unlikely to cause any harm whilst it could achieve much.

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<sup>1</sup> WEF 2017-18:

<http://www3.weforum.org/docs/GCR2017-2018/05FullReport/TheGlobalCompetitivenessReport2017-2018.pdf>

- 2.6. **The FRC should consider adopting the FCA model of seeking to identify emerging trends and risks before they materialise.** This could be done by undertaking forward looking market studies and data analysis and reacting accordingly. By doing so, the risk of major corporate failure, whilst not eliminated, could probably be reduced.
- 2.7. **The recent appointments of Julia Unwin CBE and Jenny Watson CBE (April 2018) are welcome.** They bring much needed broader experience as well as doubling the number of women on what was previously a very male dominated board. These appointments should not be the end of the process but the beginning and the FRC may wish to look at how it operates at grades below board level too.
- 2.8. **Along with various other stakeholders, AAT has consistently stated that any extra powers the FRC receives, any change in FRC structures or accountability or status, may well prove inadequate without a change in culture, mindset and outlook.**

### 3. AAT response to the review

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

- 3.1. AAT acknowledges that the FRC mission statement was updated only last year but its mission statement and objectives would benefit from some minor changes that could achieve major improvements.
- 3.2. The FRC objectives should include an objective to promote competition as further detailed in response to question 5 below.
- 3.3. With reference to the mission statement, the first sentence should refer to social responsibility in recognition of the increasing importance of this area, it's interrelationship with corporate governance and its importance to employees, stakeholders and investors.
- 3.4. For example, *"Our mission is to promote transparency, integrity **"and social responsibility"** in business."*
- 3.5. Next, the statement, *"We encourage well-run companies and high-quality work by auditors, accountants and actuaries"* should be strengthened to *"We seek to **ensure...**"* because *"encourage"* appears to suggest its activities are voluntary, optional, or to persuade rather than insist.
- 3.6. The FRC values of being effective, fair, independent and influential appear reasonable but the wealth of evidence of action to the contrary – i.e. a failure to act in relation to the financial crises, its performance in relation to BHS and most recently Carillion - would suggest these values are not sufficiently embedded within the organisation.

#### **Q2: Does the FRC's name remain, right?**

- 3.7. The name is already unreflective of much of its work and substantive change in the future would increase the suitability of a name change. That said, the costs of doing so must be considered and the existing level of awareness of the FRC brand considered. A change in name may also serve as a psychological tool to encourage cultural change within the organisation.
- 3.8. The experience of the FCA (Financial Conduct Authority) previously the Financial Services Authority (FSA) would be worth exploring before deciding on what course of action to take.

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

- 3.9. The functions of the FRC may need to change if it is to take more robust regulatory action against auditors.
- 3.10. If the FRC is unable to evolve and change its culture then its primary function of regulating accountants, auditors and actuaries could be transferred to another department such as BEIS, an expanded FCA or even to the relevant professional bodies.
- 3.11. There have been suggestions from some parts of the investor community<sup>2</sup> for the introduction of *"an independent public body (and ideally two bodies-one responsible for standard setting and the other responsible for enforcement)"*.
- 3.12. On the issue of 'independence' the FRC's Board structure was simplified in 2012 to ensure an appropriate separation of functions and to maintain independence, the Board delegated certain responsibilities to its Codes & Standards Committee and Conduct Committee. However, if the FRC is to take a more prudential approach to regulation, as discussed in question 29 and 35 below, then it may be appropriate to have a separate independent body that is responsible for standard setting.

**Q4: What lessons can be learned from other countries' regulatory systems? Which ones?**

- 3.13. There have been concerns about audit quality in many countries, for many years. For example, the 29 IFIAR<sup>3</sup> member countries around the world reported inspection findings in 2014 from 948 public company audits and found deficiencies in 47 percent. It would appear that the UK is far from alone in having deficiencies with audit and with its regulation.
- 3.14. It is also worth noting that at the beginning of the year a state of play report from Accountancy Europe found that Norway, Iceland, Croatia, Slovenia and Liechtenstein had not even begun to implement the most recent EU audit legislation, whereas others such as the UK had fully implemented it already.<sup>4</sup>
- 3.15. However, Norway, having failed to implement EU legislation on audit, is listed as having the world's second-best auditing standards according to the influential World Economic Forum Global Competitiveness Report (2017-18)<sup>5</sup> which lists Finland as having the best standards.
- 3.16. In short, looking to the rest of the world will be unlikely to provide a very effective solution to the challenges faced in the UK.

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<sup>2</sup> Sarasin & Partners, October 2017:

<https://www.docdroid.net/g076F21/letter-morgan-oct-2017-final.pdf#page=2>

<sup>3</sup> International Forum of Independent Audit Regulators:

<https://www.ifiar.org/>

<sup>4</sup> State of Play Report:

<http://www.8cld.eu/Pages/Index.aspx>

<sup>5</sup> WEF 2017-18:

<http://www3.weforum.org/docs/GCR2017-2018/05FullReport/TheGlobalCompetitivenessReport2017-2018.pdf>

**Q5: How effective has the FRC been in influencing wider debates that affect its ability to deliver its objectives – for example, around audit competition, or its legal powers?**

- 3.17. The FRC undertook a “*Consultation on the future role of the Financial Reporting Council*”<sup>6</sup> in July 2012 and more recently (Tuesday 6 February 2018) held its annual Priorities Meeting at which these issues were discussed. This would suggest the FRC is engaged in such debates.
- 3.18. In response to the issue of audit competition being raised in the Select Committee report on Carillion, the FRC raised the issue of “audit competition”<sup>7</sup> where it stated that, “...*competition between providers should place upwards pressure on the quality of services and downwards pressure on the price*”. This appears to have been largely ineffective.
- 3.19. Earlier this month it was reported that the Bank of England’s Prudential Regulation Authority is examining whether or not Goldman Sachs can appoint an accountancy firm outside the Big Four as its British auditor.
- 3.20. Goldman Sachs has held discussions with Grant Thornton, the fifth largest audit firm by fee income in Britain. Given the clamour for greater competition from the media, politicians, and rivals it was expected such a development would prove welcome. Instead, the Bank has raised concerns about Grant Thornton’s resources and will likely block the move unless the recent correspondence from the Chairs of the Treasury, BEIS and Work & Pensions Committees<sup>8</sup> prompts a change of approach.
- 3.21. If the FRC had a clear objective to promote competition it could intervene in such matters with real authority.

**Q6: Is the current balance between cross-cutting reviews and firm-specific investigations most effective?**

- 3.22. The FRC’s monitoring comprises<sup>9</sup> inspections of a sample of audits and related procedures supporting audit quality (firm-wide procedures) at individual audit firms. In addition, it periodically undertakes thematic inspections that focus on aspects of audit across a sample of audits and firms. It is reasonable, given this is a more efficient use of the FRC’s resources, to have these two different approaches. The firm-wide procedure identifies recurring issues and then the thematic review could raise that issue with a wider group of audit firms.
- 3.23. It is an operational decision and for the FRC to decide whether or not the current balance between the two types of review is most effective, as the balance would depend on whether the firm-wide procedures is identifying enough issues that can be fed into the thematic reviews.

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

- 3.24. The Financial Reporting Council (FRC), has failed to investigate the audits of most of the UK banks that played a role in the 2007-8 financial crisis, the auditors of those that had been examined were cleared and in September 2017 the FRC closed its investigation into the auditing of HBOS by stating that KPMG’s performance, “...*did not fall significantly short of the standards reasonably to be expected.*”
- 3.25. Consider the bare facts, the annual report and accounts issued in February 2008 stated a £5.5bn profit, eight months later the bank was bust with an £11bn loss and a £12bn impairment charge. This was one of the biggest failures in British banking history. By most objective measures that would fall short of what is reasonably expected.

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<sup>6</sup> Consultation on future role of FRC, 02 July 2012:

<https://www.frc.org.uk/consultation-list/2011/consultation-on-the-future-role-of-the-financial-r>

<sup>7</sup> Guardian, March 2018:

<https://www.theguardian.com/business/2018/mar/16/frc-inquiry-big-four-accountancy-kpmg-deloitte-pwc-ey>

<sup>8</sup> Select Committees correspondence to PRA, 13 July 2018:

<https://www.parliament.uk/documents/commons-committees/work-and-pensions/Correspondence/180712-PRA-to-Chairs-audit-Goldman-Sachs.pdf>

<sup>9</sup> Audit Quality Review

<https://www.frc.org.uk/auditors/audit-quality-review>

- 3.26. Following these apparent failings came a failure to act on BHS and a roundly criticised approach to Carillion.
- 3.27. These numerous examples indicate a need for reform at the FRC. Whilst AAT notes many have called for the body to be scrapped, meaningful reform would better serve the interests of British businesses, investors, the economy and consumers. But the emphasis must be on “meaningful”.
- 3.28. There was some reform at the FRC in 2012 but none of those changes appear to have resulted in proactive challenge or to taking proportionate action against obvious wrong-doing or to any improvement in the perception of the FRC as being timid.
- 3.29. Any extra powers the FRC receives as a result of the current review may well prove inadequate without a change in both culture and outlook – something the Parliamentary report into Carillion was at pains to highlight too.
- 3.30. Of course, the FRC’s work extends beyond audit but it appears willing to do little more than the bare minimum in tackling important Corporate Governance issues such as excessive executive pay. However, not all responsibility for this can be put at the FRC’s doorstep, Government should shoulder much of the blame here too.
- 3.31. There is a wealth of evidence to suggest executive pay reporting requirements are inadequate, that the “world first” pay votes register is an ineffective gimmick and that steps to make remuneration committees more accountable have failed.
- 3.32. Perhaps the range of public policy responses AAT has proposed to deal with these challenges will become more attractive if progress in these areas continues at its current glacial pace.<sup>10</sup>

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

- 3.33. AAT agrees with the general sentiment and certainly believes that a change in culture, outlook and approach would be beneficial. Evidence to inform this view is listed above at 3.24 to 3.31 which details the list of “weaknesses” demonstrated in recent years.

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

- 3.34. AAT has made a number of recommendations for change throughout this response which it believes can help achieve the vision set out by government.

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

- 3.35. Yes, arrangements for financial reporting, audit and corporate governance are critical elements and there are no substantive elements missing.

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

- 3.36. It is important to note that improvements in audit quality, even the best audits in the world, are not necessarily going to result in fewer corporate failures. If a company is going to collapse it will do so, although a solid, effective audit should ensure this happens in a much more orderly fashion.

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<sup>10</sup> AAT response to Business, Energy and Industrial Strategy (BEIS) Committee inquiry into Corporate Governance: Delivering on Fair Pay (Executive Pay), published on 23 March 2018: <https://www.aat.org.uk/prod/s3fs-public/assets/BEIS-Committee-Executive-Pay-25.4.18.pdf>

- 3.37. Similarly, additional caution can sometimes lead to unintended consequences. For example, a 'qualified audit' may cause a company's bank to withdraw its overdraft facility, which in turn could lead to the collapse of the company.
- 3.38. The FRC does actively promote quality improvements in auditing by monitoring audit firms and publishing the results of the reviews for the purposes of providing feedback so that they can adopt best practice and avoid pitfalls. Additionally, in 2017 the FRC published "Promoting Audit Quality"<sup>11</sup> and "Audit Quality Thematic Review: The Use of Data Analytics in the Audit of Financial Statements"<sup>12</sup> to assist auditors.
- 3.39. The FRC has also recently begun publicly criticising the audit quality of the Big Four, most noticeably KPMG<sup>13</sup> which has gained considerable media and political attention and has focused the minds of these companies. Arguably this should have been done much sooner.
- 3.40. AAT would like to see FRC continue in this vein as this type of transparency can prove a very useful incentive for firms to improve their performance.

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

- 3.41. Historically this may not have been the case but it is worthy of note that FRC fines have been increasingly effective given the substantial increase in the level of such fines.
- 3.42. In 2016 the record imposed was £4m, it was £5m in 2017 and following the introduction of new rules on June 1<sup>st</sup>, 2018 this doubled to £10m last month.
- 3.43. As well as being a significant cost to the firm, the reputational damage these fines can cause is of just as much value, if not more.
- 3.44. Similarly, the fines for individuals has increased and will doubtless concentrate minds, as will the imposition of five, 10-15 year bans from audit work. The FRC could go further and introduce a senior manager regime, like that recently introduced at the FCA, as a means of further focussing on personal accountability.
- 3.45. AAT welcomes these sanctions and believes that whilst not a panacea, they will have a significant impact and deterrent effect.
- 3.46. AAT also supports the Select Committee recommendation that there should be, "*...changes to ensure that all directors who exert influence over financial statements can be investigated and punished as part of the same investigation, not just those with accounting qualifications.*" This recommendation would allow the FRC to hold accountable all the directors that are responsible for the financial statements. This too would further concentrate the minds of those who were previously outside the remit of the FRC.

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

- 3.47. There are valid concerns about the closeness of the FRC to the big four, not least because its senior ranks are comprised of several former employees of the big four.
- 3.48. AAT therefore welcomes the FRC's recent steps to bring in new board members with broader experience. Likewise, the recent establishment of a conflict of interests register for all FRC board members, committees and councils is welcome, although this could be extended to all FRC staff.

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<sup>11</sup> Promoting Audit Quality

<https://www.frc.org.uk/auditors/audit-assurance/promoting-audit-quality>

<sup>12</sup> Audit Quality Thematic Review

[https://www.frc.org.uk/getattachment/4fd19a18-1beb-4959-8737-ae2dca80af67/AQTR\\_Audit-Data-Analytics-Jan-2017.pdf](https://www.frc.org.uk/getattachment/4fd19a18-1beb-4959-8737-ae2dca80af67/AQTR_Audit-Data-Analytics-Jan-2017.pdf)

<sup>13</sup> BBC, 18 June 2018:

<https://www.bbc.co.uk/news/business-44526486>

- 3.49. Some of this closeness may well be cause for concern, some may be mere perception but whether real or perceived, action is clearly needed.
- 3.50. With regard to the failure of one or more of the big four, AAT believes that this is unlikely but should nevertheless be considered as matter of prudence. AAT understands that this is something that the FRC has met with the Competition & Markets Authority (CMA) to discuss on several occasions this year which could be taken as being “too concerned” or equally as “prudent”. There are other individuals and organisations who are probably better placed than AAT to form a conclusion.

**Q14: Are investigations of audit work effective, transparent, satisfactorily concluded and unfettered?**

- 3.51. Whilst some investigations may be very effective, others are clearly far from being so and certainly not satisfactorily concluded as indicated by the HBOS and BHS cases, to say nothing of Carillion.
- 3.52. The FRC provides feedback on its investigations of audit work which suggests it is reasonably transparent. AAT understands the legal problems with publication in contested cases such as the Taveta Investments (BHS) case but would urge the Government to examine how such problems may be avoided in the future.

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

- 3.53. Yes. If the FRC were to mirror the FCA approach to prioritising its work based on the potential for consumer harm this could avoid harm. For example, taking into account issues such as public funding, the number of employees, importance to the British economy etc.
- 3.54. The impact of different regulatory strategies or tactics will also need to consider the potential harm upon the company and in turn its stakeholders including employees and investors. For example, qualifying the audit report may precipitate the premature collapse of an organisation.

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

- 3.55. Yes. The FRC should do whatever it can to promote competition in this area.
- 3.56. Other regulators do this with varying degrees of success. It is certainly unlikely to cause any harm whilst it could achieve much. For example, the very first listed objective of water regulator Ofwat is to “*further the consumer objective to protect the interests of consumers, wherever appropriate by promoting effective competition*”<sup>14</sup> and similarly Ofgem, the FCA and PRA all have clearly stated objectives to promote competition.
- 3.57. The Competition Commission looked at this issue some years ago and imposed a requirement for FTSE 350 companies to put their audit out to tender every ten years. It was obvious to any objective observer that this would not lead to increased competition and indeed that has proved to be the case.
- 3.58. If genuine competition is required then a range of more radical approaches should be considered. These should include changes such as whether or not to impose a cap on the total number of listed firms one of the big four is allowed to audit or as the FRC has previously floated, splitting audit work from the rest of the organisations non-audit work to end the current multi-disciplinary approach (this does not necessarily require a full split).

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<sup>14</sup> Ofwat objectives:  
<https://www.ofwat.gov.uk/about-us/our-duties/>

- 3.59. As stated above at 3.19 and 3.20 the very recent example of the Bank of England intervening to prevent competition (Goldman Sachs & Grant Thornton) is an area where the FRC could play a role too.

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

- 3.60. Yes, please refer to the response given to question 3 above.

**Q18: Has the FRC been effective in influencing the development of accounting standards internationally as well as accountable and effective in setting UK GAAP?**

- 3.61. The FRC appears to engage very well with the International Accounting Standards Board (IASB)<sup>15</sup> for example, in relation to exposure drafts of accounting standards, as well as Consultation Papers and Discussion Papers.

**Q19: How else could the FRC improve the quality of financial reporting with a view to ensuring investor confidence?**

- 3.62. Financial reporting does not deal with absolutes, for example whether a business is a going concern or not. It could be improved by more qualitative reporting on the director's statement regarding 'going concern'.

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

- 3.63. To meet the information needs of investors it would be desirable for auditors to report to shareholders on a more frequent basis. However, from the company's perspective there will be management time and costs to consider.

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

- 3.64. If the professional bodies and the audit firms are providing the information that the FRC requires on a voluntary basis, and this appears to be the case<sup>16</sup>, then this combination of statutory and voluntary methods would be appropriate. However, if the method of oversight is to be entirely statutory then consideration will have to be given to whether or not the information provided on a voluntary basis is absolutely necessary as the professional bodies and audit firms will incur costs in collecting and presenting this information.

- 3.65. AAT is not formally part of the FRC's supervisory oversight, and to that extent is not as well placed as those bodies that are, to comment on this question. Nonetheless, AAT does voluntarily provide details for the Key Facts And Trends in the Accountancy Profession (KFAT) publication in order to ensure that a more comprehensive overview of the profession is captured.

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

- 3.66. From the perspective of the FRC, compliance with the UK Corporate Governance Code is voluntary, however, the Listing Rules require companies to report on their compliance with the UK Corporate Governance Code.
- 3.67. AAT recommends that the FRC's monitoring work includes the corporate governance statement of listed public limited companies as this is a key area that is not currently monitored.

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<sup>15</sup> FRC list of open IASB and EFRAG projects

<https://www.frc.org.uk/accountants/accounting-and-reporting-policy/international-standards/ifrs-influencing/current-projects>

<sup>16</sup> FRC Professional Oversight Board, Key Facts and Trends in the Accountancy Profession, June 2016:

<https://www.frc.org.uk/getattachment/cd51413b-df19-4ca5-8a58-e51a9a735772/2016-KFAT.pdf>

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

- 3.68. This is not an area that AAT has previously engaged with and it would therefore be inappropriate to comment.

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

- 3.69. The HBOS case demonstrates that speed is probably not one of the FRC's greatest strengths. That said, the FRC would likely counter that it may be reluctant to speed up investigations where doing so would undermine the thoroughness of the investigation.<sup>17</sup> The Review team can doubtless look at the case history of the FRC and reach a more informed view on this issue.

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

- 3.70. An audit firm, individual auditor or Finance Director has a legal right to have an appropriate amount of time to consider and respond to questions put to them in an investigation. The firm or individual may receive fines, suffer reputational damage and may be barred from practicing their profession so the FRC so in certain circumstances the length of time it takes may be appropriate.
- 3.71. In other circumstances, the lack of speed may be due to more practical issues such as a lack of resources.
- 3.72. Legal obstacles, as demonstrated by the current Teva Investments case, are likely to require legislative changes but would obviously need to be very carefully considered.

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

- 3.73. Given that more than a decade has passed, it would make sense to review whether or not the changes brought about by the Morris Review<sup>18</sup> remain fit for purpose. AAT also notes that last month, the Institute & Faculty of Actuaries (IFoA) launched a consultation on "*Proposals for an enhanced system to promote the quality of actuarial work*"<sup>19</sup> the findings of which should also be taken into account.

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

- 3.74. Yes. The FRC should certainly do more.
- 3.75. It must first be recognised that the success or failure of a company may be due to factors ranging from the management attitude to risk and reward, cash flow problems, trade-offs between different economic activities, an economic downturn or changing consumer tastes to disruptive technologies and under or over-trading. The FRC clearly has little or no control over those factors.

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<sup>17</sup> Investigation into the audit of the financial statements of Carillion plc, 29 January 2018  
[https://www.frc.org.uk/news/january-2018-\(1\)/investigation-into-the-audit-of-the-financial-stat](https://www.frc.org.uk/news/january-2018-(1)/investigation-into-the-audit-of-the-financial-stat)

<sup>18</sup> Morris Review  
<https://www.frc.org.uk/actuarial/oversight-of-the-actuarial-profession/morris-review>

<sup>19</sup> IFoA consultation, 29 June 2018:  
<https://www.actuaries.org.uk/upholding-standards/regulatory-communications-and-consultations/current-consultations/monitoring-project-consultation>

- 3.76. However, lessons could be learned from other regulators, most notably the FCA who now seek to identify emerging trends and risks before they materialise - by undertaking forward looking market studies and data analysis - and react accordingly. If the FRC were to adopt such a model then the risk of major corporate failure, whilst not eliminated, could probably be reduced.

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

- 3.77. The FRC can act on the 'warning signs' in terms of reviewing the audit and auditors. In the case of Carillion, the Independent auditor's report to the members of Carillion in the Annual Report 2016<sup>20</sup> (page 86) contained a large section covering "Our assessment of risks of material misstatement"<sup>21</sup> which covered the issues of Goodwill and the recognition of contract revenue. The Annual Report 2015 raised the same issues.
- 3.78. There was an estimated total of 17,243 companies that entered insolvency in 2017<sup>22</sup> and probably thousands more with 'warning signs' that may enter insolvency in the future if corrective action is not taken. While the focus is on the smaller number of listed PLCs there will still be hundreds of companies with 'warning signs'. In summary, it may be reasonable for the FRC to monitor the warning signs of listed PLCs but it may not be reasonable or appropriate for the FRC to act on all corporate insolvencies.

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

- 3.79. It may be appropriate for the FRC to take a more prudential approach similar to that of the FCA whereby the role of the FRC is not to prevent firms from failing but to minimise detrimental 'domino' effects on customers, counterparties or market stability.
- 3.80. The FRC would need to monitor all the companies in scope to ensure that they are solvent for the short-term.
- 3.81. Given that there are millions of companies on the Register and the FRC clearly does not have the resources to monitor them all, a reasonable approach would be to include only listed companies. In which case, the FRC might ask these companies to provide a quarterly solvency report. This would result in some additional costs but it is likely that these large listed companies will already be producing monthly management accounts (sales forecast, cash budget and detailed P&L) from which an assessment of solvency could be made.

**Q30: The introduction of the viability statement was an important development, but could it be made more effective?**

- 3.82. The introduction of the viability statement was deeply unpopular with investors. The likes of Legal & General, Threadneedle Investments, the Universities Superannuation Scheme and the London Pension Funds amongst others expressed concerns that this is a basic assessment of whether or not the main foreseeable risks would damage the business, rather than a commitment on behalf of the company that it would be a going concern for the foreseeable future.
- 3.83. AAT has been concerned that these statements are mere boiler plate notices and indeed, an analysis by *Gather* of 91 annual reports from across the FTSE 350 when they first came into effect, found that most merely provided boiler plate notices.<sup>23</sup>

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<sup>20</sup> Companies House, Carillion PLC filing history

<sup>21</sup> Filed at Companies House, 12 May 2017:

<https://beta.companieshouse.gov.uk/company/03782379/filing-history>

<sup>22</sup> Insolvency Statistics – October to December 2017 (Q4 2017)

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/675931/Insolvency\\_Statistics\\_-\\_web.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/675931/Insolvency_Statistics_-_web.pdf)

<sup>23</sup> The Viability Statement, Did it work? 2016:

[http://gather.london/wp-content/uploads/2016/05/8.1.7\\_White-Paper-Viability\\_Statement\\_Did-it-work\\_v2.pdf](http://gather.london/wp-content/uploads/2016/05/8.1.7_White-Paper-Viability_Statement_Did-it-work_v2.pdf)

3.84. However, there were also many that provided much more than a boiler plate and they should be commended for doing so. Furthermore, AAT agrees with the findings of *Gather* that, “...the advent of the Viability Statement is important not so much for the final words printed on the page of the annual report but for the robustness of the process that precedes it.”<sup>24</sup>

3.85. As a result, AAT believes that the Viability Statement is an important development but that the FRC should take action where a boiler plate approach is taken to ensure it is not repeated.

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

3.86. The Review (in paragraph 30) states that the FRC has raised some issues in relation to its powers. The FRC asserts that, “it does not have powers to test and seek change to some aspects of a company’s annual report, including its statements on governance”.

3.87. AAT agrees with the FRC that it should be given the powers to test and seek change on **all** aspects of a company’s annual report, including its statements on governance. Failing to do so means it is much harder, in some cases impossible, for the FRC to meet its own mission statement and objectives.

3.88. The FRC also highlighted that, “...confidentiality requirements in the Companies Act prevent the FRC from making public concerns it has about poor audit work in relation to individual companies without the auditor’s and company’s permission. Does this need to be reconsidered against shifting public expectations on transparency?”

3.89. If the FRC believes that ‘poor audit work’ has resulted in an Annual Report that does not give a true and fair view of the company’s financial position then it would be perfectly reasonable to raise its concerns publicly provided it had given the auditors and the company an opportunity to address the FRC’s concerns or amend the Annual Report.

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

3.90. The powers are similar but as outlined above there are some shortcomings.

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

3.91. As outlined above at 3.44 and 3.45, AAT welcomes the new FRC sanctions regime and believes that whilst not a panacea, they will have a significant impact and deterrent effect.

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

3.92. Placing the FRC on a statutory footing with consolidated legislation setting out its remit, powers and functions may be helpful but as repeatedly stated above, a change in both culture and outlook – something the Parliamentary report into Carillion was at pains to highlight – is of greater importance than whether or not the FRC is placed on a statutory footing.

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

3.93. If the FRC is to become a prudential regulator then a statutory footing would be required and this would likely prove the best structure for the FRC to fulfil its enforcement remit.

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<sup>24</sup> **The Viability Statement, Did it work? 2016:**  
[http://gather.london/wp-content/uploads/2016/05/8.1.7\\_White-Paper-Viability\\_Statement\\_Did-it-work\\_v2.pdf](http://gather.london/wp-content/uploads/2016/05/8.1.7_White-Paper-Viability_Statement_Did-it-work_v2.pdf)

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

- 3.94. Greater transparency is always helpful, not just in terms of the public interest but in ensuring appropriate performance and accountability. However, it should also be recognised that this can often be limited by legal constraints and that a balance must be struck between the need to disclose the details of enforcement action and rights to confidentiality and privacy as well as sensitivity to the potential for reputational damage to either individuals or companies where those individuals and/or organisations may not have had sufficient opportunity to state their case.

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

- 3.95. The Select Committee on Work & Pensions and the Select Committee on BEIS stated in the joint report on Carillion;
- 3.96. *"The FRC was far too passive in relation to Carillion's financial reporting. It should have followed up its identification of several failings in Carillion's 2015 accounts with subsequent monitoring. Its limited intervention in July 2017 clearly failed to deter the company in persisting with its over-optimistic presentation of financial information. The FRC was instead happy to walk away after securing box-ticking disclosures of information. It was timid in challenging Carillion on the inadequate and questionable nature of the financial information it provided and wholly ineffective in taking to task the auditors who had responsibility for ensuring their veracity."*
- 3.97. These findings are not indicative of effective leadership at the FRC.
- 3.98. Stephen Haddrill's numerous recent media comments<sup>25</sup> suggest a belated willingness to take appropriate action and in the FRC response to the joint select committee's report on Carillion, Haddrill highlights that the FRC lacks powers of intervention, both in the audit market and in response to warning signs that companies might be beginning to fail. This indicates both an awareness of shortcomings and a willingness to change.
- 3.99. Sir Win Bischoff has a number of outstanding questions to answer in relation to his time at Lloyds, not least in respect of his conduct around dealing with the HBOS fraud<sup>26</sup>. These issues alone make his continued tenure at the FRC questionable. AAT has also discussed issues relating to Corporate Governance directly with Sir Win and his very begrudging approach to curbing executive pay and limited support for action to encourage greater gender diversity also raise serious questions about his suitability to Chair a regulator that has responsibility for upholding good Corporate Governance and stewardship.

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

- 3.100. The recent appointments of Julia Unwin CBE and Jenny Watson CBE (April 2018) are welcome given they bring much needed broader experience as well as doubling the number of women on what was previously a very male dominated board. Continued steps in this direction, as and when vacancies arise, would be most welcome.
- 3.101. Whether the FRC Board is the right size is a very subjective issue but it certainly doesn't appear unreasonable at present.

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<sup>25</sup> The Times, 7 July 2018:

<https://www.thetimes.co.uk/article/frc-the-watchdog-that-barked-too-late-qln3xg7zh>

FT, 11 July 2018:

<https://www.ft.com/content/9dac7e24-8530-11e8-96dd-fa565ec55929>

FRC News release, 20 July 2018:

<https://www.frc.org.uk/news/july-2018/speech-by-stephen-haddrill-corporate-governance>

<sup>26</sup> This is Money, December 2017:

<https://www.frc.org.uk/news/july-2018/speech-by-stephen-haddrill-corporate-governance>

**Q39: Is the balance of decision-making between the Board, its Committees and the Executive described in paragraphs 34-36 above right, given relevant legal constraints?**

3.102. The simplification of the Board structure in 2012 - moving from a multiple Board structure to a single decision-making Board that is supported by a Codes and Standards Committee, Conduct Committee; and several Councils, subordinate Committees, and Panels, appears to be appropriate.

**Q40: Is the Board's structure appropriate, including given the FRC's roles on standard setting, assessment and enforcement? Does the Board's accountability appropriately reflect its role and functions? Are its decisions appropriately transparent, bearing in mind the need to balance public interest and confidentiality?**

3.103. It does seem somewhat odd that the FRC Board is not responsible for any decisions to open an enforcement investigation (taken by the Conduct Committee) nor is it responsible for any decisions on whether to proceed from an investigation to a Formal Complaint (Tribunal) (taken by the FRC's Executive Counsel).

3.104. As the Call for Evidence highlights, this means that, "...the FRC board has no involvement in many of the most high-profile and contentious decisions for which the FRC is generally held publicly responsible."

3.105. This problem could be partially alleviated by ensuring that the Board is made aware of any such decisions when they are being considered and conversely that the Board is given the capability to make recommendations to those separate parts of the FRC where it has reasonable grounds for concern.

3.106. The transparency of its decision making is certainly open to question given its performance in relation to BHS although AAT acknowledges delays caused by Taveta Investments application for an injunction to prevent publication.

3.107. AAT strongly agrees with the comments of the judge in the Taveta investments case who last month stated, "*The importance of regulators operating with transparency and openness hardly needs stating. It inspires confidence both in those who are regulated and in the wider public, and it allows areas of concern or weakness to be identified. When a regulator sanctions one of its regulated community, publicity for the sanction (and the reasons for it) promotes the maintenance of standards and protects the public from those whose standards fall below the required level*"<sup>27</sup>

3.108. AAT has consistently stated throughout this response, a change in outlook and mindset is essential to ensuring greater transparency and it is pleasing to note that at the Governance Institute conference earlier this month, Stephen Hadrill acknowledged that the FRC must be more transparent in the future.

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

3.109. As a minimum, the FRC should be following their own Guidance on Board Effectiveness (The Guidance) that they seek to impose on UK companies.

3.110. As the FRC's sponsoring department, BEIS has a clear responsibility here too. BEIS should be responsible for undertaking regular assessment of the organisation, publishing an annual assessment and ensuring it operates as effectively as possible at all times.

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<sup>27</sup> **Taveta Investments v FRC, 29 June 2018:**  
<https://www.judiciary.uk/wp-content/uploads/2018/06/taveta-v-frc-judgment.pdf>

**Q42: Who should fund the FRC, and how? What are the impacts of current funding arrangements, including of having a partially voluntary funded regime?**

- 3.111. To cover the costs of monitoring auditing, the fees should come from audit firms (either directly or through their professional bodies) or from the firms being audited. There is an argument that the costs could be split between the two which as well as spreading the costs would arguably raise levels of engagement with the FRC amongst both parties.
- 3.112. A partially voluntary funded regime does not seem appropriate as this presents an unnecessary risk that those paying voluntarily may choose not to do so at some future point in time.

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

- 3.113. Auditing skills are essential (and AAT notes that the vast majority of its staff have such skills) but so too are broader skills in dealing effectively with complaints, in issues relating to gender and diversity and in better understanding the wider public interest. Therefore, the recent appointment of a member of the Independent Complaints Panel at the Portman Group and a non-executive director at the Financial Ombudsman Service (Jenny Watson CBE) and someone who has written extensively about Corporate Governance (Jenny Unwin CBE) are very much welcome.

**Q44: Are there conflicts of interest in the FRC's structure, processes, or culture? Are there deficiencies in the FRC's approach to managing conflicts of interests?**

- 3.114. There have been a number of reported conflicts in the recent past which are cause for concern, not least the fact that the Director responsible for the FRC at BEIS is married to FRC Chief Executive Stephen Haddrill. Irrespective of whether conflict here is merely perceived or real, the fact both claimed this is not a conflict of interest shows a lack of awareness as to how much damage such incidences cause the FRC reputationally.
- 3.115. The FRC needs to address both perceptions of conflict and any actual conflicts of interest. As already stated in response to question 13 above, the new conflict of interests register for all FRC board members, committees and councils is a welcome step towards addressing this issue but more work on culture in this area is clearly needed.

**Q45: Are there any other issues relevant to the terms of reference that respondents would like to raise?**

- 3.116. AAT has no further comment to make here.

**4. About AAT**

- 4.1. AAT is a professional accountancy body with approximately 50,000 full and fellow members and over 90,000 student and affiliate members worldwide. Of the full and fellow members, there are more than 4,250 licensed accountants who provide accountancy and taxation services to over 400,000 British businesses.
- 4.2. AAT is a registered charity whose objectives are to advance public education and promote the study of the practice, theory and techniques of accountancy and the prevention of crime and promotion of the sound administration of the law.

**5. Further information**

If you have any queries, require any further information or would like to discuss any of the above points in more detail, please contact Phil Hall, AAT Head of Public Affairs & Public Policy, at:

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