The FRC:
"It is time to build a new house"

by Michael Kavanagh

The UK Financial Reporting Council (FRC) is a multi-faceted organisation that many of us in Ireland are familiar with. Its tasks include setting the UK's Corporate Governance Code, financial reporting standards, auditing standards, being the UK's financial reporting enforcer, and audit quality inspector.

From the Irish perspective, we use FRC accounting standards (UK/Irish GAAP), companies listed on the Main Securities Market of Euronext Dublin are required to comply with the FRC Corporate Governance Code and, up to recently, we used FRC auditing standards for Irish audits. Therefore, it is more than noteworthy that the recent UK government commissioned review of the FRC (the 'Kingman review') is damning in its findings and recommends the abolition of the organisation.

Before going into some of the detail of the findings contained in the 76-page review which contains 83 recommendations, let me declare an interest. The FRC is an organisation that I knew very well. For 12 years, I was the Irish observer at the meetings of its Corporate Reporting Council which sets the financial reporting standards for the UK and Ireland (for those not using IFRS). This included giving the Irish perspective and input when the new standards were introduced in 2015. I attended, for one year, their Audit and Assurance Council which produced auditing standards for the UK and Ireland and also worked closely with their financial reporting enforcement and audit quality division as part of European initiatives. As CEO of IAASA, I negotiated the transition from the FRC, being the auditing standard setter for Ireland, to IAASA taking over that function in 2016. In fact I was so familiar with their HQ in London that they gave me an access card normally provided to staff and council members! In light of that, I don't feel it is appropriate for me to comment on the inner workings of the FRC but suffice to say that I found FRC staff and councils to be of the highest quality. However, to paraphrase a song title - they did it their way - and tended to conduct their business differently to how others in Europe did. While the extremely blunt and almost cutting language used in the Kingman review came as a surprise to me, the overall nature of the recommendations did not.

Abolition of the FRC

The main recommendation is that the FRC be replaced as soon as possible with a new independent regulator which has clear statutory powers and objectives. The language used in describing the FRC is forthright and unambiguous. The FRC is a 'hangover from a different era'. It is, according to Kingman, a 'ramshackle house cobbled together with all sorts of extensions over time'. Using the same analogy the Review continues, 'the house is just serviceable up to a point but it leaks and creaks sometimes badly. The inhabitants in the house sort of patch and mend but in the end the house is built on weak foundations and we need to build a new house.'

Compared to other regulatory bodies, the FRC is seen as unusual. Indeed, Kingman even finds its name strange in that it is still titled a 'Council', not an 'Authority' or 'Regulator' like European counterparts. He therefore recommends that the new organisation should be named the Audit, Reporting and Governance Authority (ARGA). This new organisation should have new leadership, a new mission, new powers and new funding.

Interestingly Kingman also strongly criticised the FRC's propensity for media leaks, which have led to several of its decisions appearing in the press ahead of their official announcement.

Funding and remit of the new body

The Review finds that the FRC has 'no meaningful statutory basis' which is extremely unusual for a regulator. For most of its history it has been a private company and not a public regulator and it has taken 'an excessively consensual approach to its work'. The new regulator should have an overarching duty to promote the interests of consumers of financial information, not producers. It should also have a duty to promote competition, a duty to promote innovation, and a duty to apply proportionality to all its work. Kingman called for the new body to maintain its remit around improving corporate reporting, but said it needed to have an expanded role in addressing and discussing audit quality, and said current arrangements which give the FRC oversight of the actuarial profession should cease.

Kingman also found the fact that it is funded partly through a voluntary levy from audit firms 'a very odd thing' and could reduce its willingness to 'bite the hand that feeds'.

Audit regulation

Kingman described the FRC as 'almost powerless' to take action against audit firms as opposed to actions against individual partners and auditors. Currently, if the FRC become concerned that problems of quality or compliance exist throughout an audit firm or its associated local offices, it cannot formally intervene, require improvement, or mandate changes at the firm but can, and has, reported on such matters publicly. The review says that the new regulator should work towards a position where individual audit quality inspection reports, including gradings, are published in full upon completion of Audit Quality Reviews (AQRs). The approval and registration of certain audit firms should shift from accountancy bodies ('their trade association') to the new body.

Kingman also says that the UK government should introduce a 'duty of alert' for auditors to report concerns about a company's viability or other serious matters similar to the system in place in France.

Interestingly he suggests that the new body could be given more power of oversight on public audits conducted by the National Audit Office. The equivalent here is the Office of the Comptroller & Auditor General which, up to now, has managed to avoid the regulatory remit of the Irish regulator, IAASA.

New body – new powers

Kingman was supportive of the current fining system which the FRC has in place, noting that there are no limits on the fines it could levy. 'The biggest issue is not the size of the fines but how long some of these enforcement cases have taken' he said. He recommended the new body be given certain expanded powers. For example, the regulator's corporate reporting enforcement remit should be extended from its current limited scope to cover the entire annual report. It should be given stronger powers to require documents and other relevant information in order to conduct that review work. The regulator should be given the power to require restatements promptly (rather than requiring a Court Order). From

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my own involvement in European fora, this is an enforcement power brought in by an EU Directive that all EU financial reporting enforcers are supposed to have in place, but the UK decided not to implement that aspect of the Directive. Kingman also reported that the new regulator should have the power to make recommendations to a company's shareholders that they take action such as cutting dividends or firing senior staff, in 'serious cases' where 'the severity of the facts' merited an intervention.

Criticism of how FRC recruited staff and councils

The Review recommends that the FRC board and staffing needed an overhaul, describing its approach to board and council recruitment as 'surprisingly, and inappropriately, informal'.

Kingman concluded that the FRC was 'often not employing open advertising or using headhunters, and sometimes even relying on the alumni networks of the largest audit firms'. He found that 'of the 21 vacancies in relevant positions between 2016 and 2018 only one role was advertised in the national press, and just six involved external search consultancies'.

He suggested that, though many members of the FRC would transfer to the new body, a new board should be appointed. This should have some, but limited, continuity with the existing board. The new board would be much smaller and should not seek to be representative of stakeholder interests.

Conclusion

In light of persistent criticism of the FRC at political level there is a momentum for change in the UK. Many of Kingman's recommendations could be implemented straight away, such as shifting the FRC's mission and purpose, reshaping the board, and developing a new focus and plan. Others, however, would need primary legislation. This is unlikely to happen in the short term, given the current focus on Brexit.

From an Irish perspective, the Kingman review together with the current UK Competition and Markets Authority (CMA) work in relation to competition in the UK audit market, are being watched with interest. This is understandable given the number of Irish accountants that are members of UK accountancy bodies operating here and historical links to the FRC. However, regardless of which body is producing financial reporting and governance standards in the UK, the appropriateness of, what will be, a non-EU body producing standards for Ireland was always going to come under scrutiny in the future. The abolition of the FRC, as we know it, may hasten that review in Ireland.