The stamp of authority

__Jane Fuller__ assesses the recommendations of a review into the Financial Reporting Council's supervisory role and says they amount to evolution rather than revolution

One change of a word sums up the message of Sir John Kingman's Independent Review of the Financial Reporting Council (FRC), the UK regulator whose reputation has been fatally damaged by corporate failures such as Carillion. It is that its replacement should be called an "authority" – and act like one in every sense of the word.

The word "council", which smacks of a talking shop, is to be swept away along with what Kingman describes as a tendency to be "excessively consensual" in its supervisory work. His recommended replacement for the FRC, the Audit, Reporting and Governance Authority, or Arga, will have the following strategic objective: "To protect the interests of investors and the wider public interest by setting high standards of corporate governance, corporate reporting and statutory audit, and by holding to account the companies and professional advisers responsible for meeting those standards."

Bearing in mind the political pressure and public criticism of the FRC, it was bound to be replaced. Yet the proposed changes – set out in 83 recommendations – amount to accelerated evolution rather than revolution. Once in place, they will complete a transformation from self-regulation by professional bodies to statutory independent oversight by a regulator accountable to parliament. Many people do not realise, for instance, that it was only in 2016 – thanks to an EU directive – that the FRC formally became the "competent authority" for overseeing audit.

Even now, while action can be taken against auditors – individuals and firms – for failed audits, the FRC has no direct "purchase" on the firms, as Kingman puts it, via their registration and a statutory power to monitor them. This review at last sounds the death knell for the delegation of audit firm supervision to the professional bodies.

Directors held to account

It also tackles the most popular complaint of respondents (of which I was one), that "the current position is inadequate in holding 'non-member' [non-accountant] directors to account for any part they have played in a serious reporting or audit-related failure". It proposes "an effective enforcement regime" for directors in exercising their duties to prepare true and fair accounts – and to deal "honestly with auditors". This is a welcome reminder that it is a company's board that bears primary responsibility for producing the information on which users of accounts rely.

Other proposed powers include the ability to order the prompt restatement of accounts, and to commission an inspection ("skilled person review") where there are serious concerns about a company's accounting, governance or viability.

More subtle than new powers is Kingman's desire to "shift the balance of authority between the regulator and the preparers of accounts, enhancing the regulator's credibility and status and giving it 'teeth'". This signals an end to hand-holding and a greater willingness to wield the stick. It might be put like this: "what part of 'fair, balanced and understandable' don't you understand, Mr Director, when reporting to shareholders?"

The FRC has been a champion of "best practice" guidance – from the Corporate Governance Code to the worthy output of the Financial Reporting Lab. The theory is that if you bring preparers and users of accounts and auditors together, they will reach a consensus on what can be of most help to investors and analysts without costing the company too much, and without prescribing a one-size-fits-all approach to entities with diverse business models.

> *The review sounds the death knell for the delegation of audit firm supervision to the professional bodies*

More ruthless and more clout

It is unlikely that the culture of encouraging improvement by highlighting good examples will be thrown out with the bathwater, but a more ruthless approach will be welcome – and not just in enforcement. Two examples of this are: first, viability statements, which have not proved effective in warning of existential threats to companies; and second, the Stewardship Code, to which institutional investors sign up to demonstrate their intention to be responsible owners. Kingman reckons that if these initiatives do not produce effective outcomes, they should be abolished.

Behind the cold hard look at the Stewardship Code is another important point about the revamped regulator having more clout. "It needs to engage at more senior level in a much wider and deeper dialogue with UK investors, both fund managers and representatives of end-investors." Too often it is the ESG (environmental, social and governance) specialists who volunteer for duty on FRC committees, not those at the coalface of using corporate information to allocate savers' capital efficiently.

Some would say that Kingman has not smelt the coffee here and point to a link between managing ESG factors and creating, or at least protecting, sustainable value in a business. But his overall argument about engaging with investment decision-makers at the most senior levels rings true. This is not just in the hands of the regulator. Fund managers, asset owners and financial analysts should become more involved in ensuring that it delivers what they need.

Competition and Markets Authority: statutory audit services market study

Update paper 18 December, 2018

These are its main proposed remedies:

- Regulatory scrutiny of audit committees: during the tender process and via reporting requirements thereafter.
- Joint audit: of FTSE 350 companies, with one of the pair being a "challenger", ie ex Big Four. An alternative would be a cap on market share.
- Full structural or operational split between audit and non-audit services: to apply at least to the Big Four, including separate governance and budgets.
- Peer review: an additional independent check by a reviewer appointed by the regulator, eg in higher-risk cases.

In addition, the government has appointed Sir Donald Brydon to lead an independent review of audit standards in the UK; and, in parliament, the Business, Energy and Industrial Strategy Committee is holding an inquiry into the future of audit.

Who should appoint the auditor?

A litmus test of this lies in audit. In a perfect world, the owners of the business or their representatives would appoint the auditors. Kingman was asked to consider whether there was a case for a fundamental change in who makes this appointment. He is inclined to say "yes" and outlines what would be a "world-first experiment". Auditors would be appointed by an independent body under the umbrella of Arga, but with its own governance in which investors would be heavily involved. Board audit committees would continue to manage the company's relationship with the auditor, engaging with the regulator. But Kingman ruefully notes that investors are opposed to such a major change, undermining the case since they are supposed to be the ones who would benefit.

His view is clear that as long as auditors see the company as their client, rather than external users of accounts, "incentives are, at best, blunted". Between his suggestions and those of the Competition and Markets Authority (see box), the regulator is going to be more involved in auditor appointments, whether by approving them or by stepping in when there are specific problems.

Short of radical change, there are proposals that should encourage auditors to be more sceptical and to exercise independent challenge of management. A key recommendation is that they should have "a duty of alert" to report serious concerns to the regulator. Another is that the auditor's report (in the company's annual report), which has already been extended to identify the main risks of misstated numbers, should include "graduated" findings. KPMG pioneered disclosure of its judgments on management calculations, using words such as optimistic or cautious, but few boards would agree to it. Kingman recommends that the new regulator should require it. Add in a "robust market intelligence function" and closer attention to the audit market, and Arga will need significantly more staff for its core functions. Responsibility for oversight of actuarial work is set to shift to the Prudential Regulation Authority and for local and other public audits to a resuscitated audit commission. Nevertheless, the regulator's annual budget of about £36m looks set to rise – and there will be a statutory levy to pay for it.

As a member of the audit and assurance council, I welcome the proposal to simplify the committee structure to focus on purpose, eg audit quality, and to create direct links between committees and a slimmed down board. This goes with the message of focusing on outcomes rather than process.

Beyond structure, the key question is who will lead Arga, replacing Stephen Haddrill as chief executive, and, presumably, Sir Win Bischoff as chairman. Both were exemplars of the consensual approach. It will be fascinating to see not only whether someone more fierce can be found, but also whether he or she might actually hail from the constituency Kingman wants Arga to focus on: the "consumers of financial information, not producers". ■

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