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Response to the Independent Review of the Financial Reporting Council – Initial consultation on the recommendations

Background

The Local Authority Pension Fund Forum was set up in 1991 and is a voluntary association of 80 local authority pension funds and six LGPS pools, based in the UK with combined assets of approximately £230 billion. It exists to promote the investment interests of the funds, and to maximize their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest. LAPFF has had concerns about accounting and audit practices since the banking crisis

Response

LAPFF is pleased to comment on the independent review. LAPFF has stated for some time that there was leadership failure with the Financial Reporting Council (FRC) that the FRC needed to be disbanded and replaced, that the position of standard setting and enforcement should be separated, and that the new body should be constituted by statute and accountable to Parliament.

LAPFF further stated that the FRC itself should be placed in special measures, so the replacement with the Auditing, Reporting and Governance Authority (ARGA) is welcomed.

We were also pleased to note that the Call for Views for the Brydon Review was well researched and asks pertinent questions, correctly citing from the statute and case law. LAPFF concluded some time ago that the FRC wasn't interpreting the law properly – nor even referring to it correctly – and on issues of fundamental importance was writing the legislation down wrongly.

According to the FRC, some 27% of audits are below standard. Rachel Reeves MP, Chair of the BEIS Select Committee pointed out. "What other industry would survive with this level of quality? A school would be put into special measures straight away; a supermarket would see customers flocking somewhere else immediately".

The questions posed by the Brydon Review included the issue of 'producer led standards'. What has occurred is that global auditing firms have influenced



global standards with disconnection from the proper purpose set out in Company Law applicable to limited liability companies, which is to deal with the risk to creditors and the public that limited liability status creates. We therefore focus less on the detail inspection and enforcement as elements of failure are baked into aspects of the standards, the worst offender being the International Financial Reporting Standards (IFRS) system.

The recent AssetCo case demonstrates very clearly what the statutory objectives of an audit are, and we note at last that there is agreement, even from the International Accounting Standards Board itself, that its system does not deal with the requirements of company law. Given that company law in the UK is essentially reflecting the economic reality of limited liability companies regarding their profits and capital, the mismatch is very serious. That fact that IFRS doesn't deliver sensible and fundamental statutory objectives is an indictment of the IFRS system.

Part of the reason why the FRC has failed as a regulator is that it was not only championing the IFRS system, but denying in public that there was any problem with IFRS's compatibility with company law – including to Parliament – whilst having written in private in April 2005 stating that there were problems¹. It was inevitable that from the point that the FRC wrote the letter, but did nothing about it, that the FRC was creating a public and moral hazard.

Rather than serving the public interest, key elements of the FRC's strategy and budget appeared to be an adjunct to the Big Four accounting firms marketing and expansion plans. We also note that questions about defining 'public interest entities' flow from the FRC having adopted an approach similar to the International Federation of Accountants (i.e. the trade association of the Big Four globally) which is essentially a model of public interest that has been decided by the accountancy firms themselves, and, like the approach to accounts and audit, is disconnected from the statutory basis.

'Users and usefulness'

LAPFF notes that the concept of 'users' – which underpins the IFRS system - does not reflect the statutory purpose of audits and audited accounts given that the law is clear on who the **protected parties** are and for what purpose, which is a public interest test. Indeed in the Royal Bank of Scotland prospectus

¹ Xx ASB letter.



case,² the judge refuses to take a sell-side analyst as a ‘user’ as an expert witness. In that case the judgment also refers to such analysts drowning out or muffling the views of the actual parties protected. But the IFRS system has been justified with precisely such contributions. IFRS is a key contributor to the ‘Delivery Gap’ which is being passed off as an ‘Expectation Gap’. We set out in the response where the ‘Expectation Gap’ risks being added to by proposals rather than deconstructed.

A significant number of people involved in UK, EU and International standard setting to purportedly represent ‘users’ were members of the PwC led ‘Corporate Reporting Users Forum’ (CRUF) which was ostensibly to give input to the production of accounting standards. However, the agenda of PwC was clear when the EU was attempting to deal with auditor independence issues. At this time CRUF members were asked to sign a letter written by PwC lobbying against the proposals, even though audit (as opposed to accounting) wasn’t ostensibly in the remit of CRUF. Furthermore unless these CRUF members looked elsewhere, the view of auditor responsibility which does relate to the expected output of accounting standards would be of the model that avoided capital maintenance and would be closer to the ‘expectation gap’ model of accounting and audit that the BEIS Select Committee concluded was actually a delivery gap.

We were unable to find any members of CRUF that were trained in accountancy and were FCA/FSA regulated fund managers. Many appear to be neither. One was a director of Farepak, which then collapsed. One told a House of Lords Committee that his background was “in investment”, when he actually worked for an investment bank which had had to be bailed out. One is a financial journalist with no financial qualifications that we could find, whose entry in to financial journalism was relatively late in life having worked as a staff reporter for Horse and Hound. One rather than working for the public part of a fund manager actually works for the family office of the largest shareholder of that fund manager, something that we would regard as a conflict of interest.

² RBS Rights Issue Litigation 2015 EWHC 3433 (Ch)

Answers to questions

Chapter 1 – FRC structure and purpose

Q1. What comments do you have on the proposed objective set out in Recommendation 4?

The proposed objective is ‘To protect the interests of users of financial information and the wider public interest by setting high standards of statutory audit, corporate reporting and corporate governance, and by holding to account the companies and professional advisers responsible for meeting those standards.’

There is a significant problem with putting the emphasis on ‘users’ – which overlaps with the ‘decision usefulness concept’ of IFRS (‘useful for users’) when the law recognises tangible protection for **protected parties** (shareholders, creditors and the public) not the indiscriminate, woolly and vague term ‘users’. The statutory purpose is not merely ‘useful’ it is essential, indeed s837 CA 2006 makes it impossible to make a distribution without an auditor report or (where qualified) an auditor statement.

In a recent RBS case³ the judge was correctly critical of analysts as users. Given that the objectives of ARGA are going to be in statute, then those objectives should stand up to legislative standards of consistency with the law. The judge, which in that case was a prospectus case, refers clearly to the ‘**protected interest**’ for which the information serves.

We suggest that the objectives are along these lines:

‘To serve **the protected interests** in audited accounts, the public interest and then users of financial information by setting high standards of statutory audit, corporate reporting and corporate governance, and by holding to account the companies and professional advisers responsible for meeting those standards.’

An objective expressed that way is capable of dealing with the protected parties for annual accounts, and where annual accounts form part of prospectus, those too. We also refer in Q5 to the problem that a non-statutory definition of ‘public interest’ flows from the accounting profession’s view of what public interest is.

³ *ibid*



Q2. What comments do you have on the duties and functions set out in Recommendations 5 & 6?

On this, we set out the recommendations verbatim, and then our comments.

Recommendations 5

The full set of duties that the Review proposes be placed on the new regulator are below, requiring that it should act in a way which:

- Is forward-looking, seeking to anticipate and where possible act on emerging corporate governance, reporting or audit risks, both in the short and the longer term;
- Promotes competition in the market for statutory audit services;
- Advances innovation and quality improvements;
- Promotes brevity, comprehensibility and usefulness in corporate reporting;
- Is proportionate, having regard to the size and resources of those being regulated and balancing the costs and benefits of regulatory action;
- Is collaborative, working closely with other regulators both in the UK and internationally; and
- Prioritises regulatory activity on the basis of risk, having regard to the Regulators' Code.

Comment

There is a significant problem with the term 'usefulness' as set out in Q1. It does not adequately cover the fact that statutory accounts serve a protective purpose.

The word 'collaborative' is unfortunate as the FRC's collaborative approach was rightly criticised by the Kingman Review.

Recommendations 6

The Review recommends that the new regulator's duties will guide the new regulator in carrying out its core functions on audit and corporate reporting. The Review proposes that its functions should also include:

- To set and apply high corporate governance, reporting and audit standards;
- To regulate and be responsible for the registration of the audit profession;



- To maintain and promote the UK Corporate Governance Code and the UK Stewardship Code, reporting annually on compliance with the Codes;
- To maintain wide and deep relationships with investors and other users of financial information;
- To monitor and report on developments in the audit market, including trends in audit pricing, the extent of any cross-subsidy from non-audit work and the implications for the quality of audit; and
- To appoint inspectors to investigate a company's affairs where there are public interest concerns about any matter that falls within the Authority's statutory competence.

Comment

LAPFF has expressed concern about mixing up 'comply or explain' governance codes with 'comply or else' law and standards. The concept of 'wide and deep relationships' is very troubling for a regulator, and then there's the added problem again of 'users'. See also our response to Q4.

Q3. How do other regulators mitigate the potential for conflict between their standard setting roles and enforcement roles as set out in Recommendation 14?

We are not sure that there are good examples of those that do. The Financial Conduct Authority does that and has had recent problems with London Capital and Finance. However, the closer that ARGA sets standards for company law that actually align with company law, then the problem may be mitigated with proper legal scrutiny of ARGA's standards outputs.

Q4. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

LAPFF considers that the independence of the Competition and Markets Authority is the model to strive to replicate. It is clear that key staff are essentially 'firewalled' with demonstrable operational independence. A problem that ARGA will face with the maintaining of responsibility of a collaborative 'comply or explain' corporate governance code, is that such operational independence may be difficult to operate.



In basic terms 'are too many people coming into the building'. See also our response to Q2.

Chapter 2 – FRC: Effectiveness of core functions

Q5. How will the change in focus of CRR [Corporate Reporting Review] work to PIEs [Public Interest Entities] affect corporate reporting for non-PIE entities?

We believe that the fact that the FRC was not dealing properly with a **company law** based system of accounting, auditing and reporting has confused matters. The public policy intent of accounting and audit for limited liability companies is to protect the public interest due to the hazard of limited liability. It is the attempt to define PIEs by reference to some other model that creates difficulty. This model has come from the International Federation of Accountants (IFAC)⁴ and it represents yet another facet of the delivery gap passing off as an expectations gap.

This is the IFAC policy statement; 'A hallmark of the accountancy profession is its obligation to act in the public interest. But it is not always apparent what this means, and how accountants can determine whether they are meeting this expectation. IFAC, by developing this position paper, is seeking to advance its understanding of this important issue. The paper, which presents **a practical definition** of the public interest, was developed in the context of IFAC's mission, **to enable IFAC to assess the extent to which its actions** and decisions are made in the public interest.'

Given that ARGA is going to be given a statutory basis, then the work of ARGAs must stand up to legislative standards of scrutiny. The IFAC statement does not, it merely indicates that the accountancy profession would prefer to make it up as it goes along in the way that suits it.

Q6. What are your views on how the pre-clearance of accounts proposed in Recommendation 28 could work?

The Dearing Review of 1987 recommended the setting up of the Urgent Issues Task Force, which was capable of delivering the policy objective being sought again here.

⁴ <https://www.ifac.org/publications-resources/definition-public-interest>



Q7. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

See our responses to Q5 and Q6. The recommendations in this chapter are confused as a result of adopting the existing accountancy profession defined model of 'public interest' rather than the ones set out in legislation.

Chapter 3 – Corporate failure

Q8. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

This chapter raises very important issues well. However, there are so many complex factors here, that perhaps this can be better dealt with by separate consultation after the new regulator is functioning. The civil liability regime does place significant sanctions on auditors of companies that fail. Despite that there are several obstacles to that route being applied in practice transparently. First, if the company has failed, then there may not be enough funds to pursue the auditor, given that the company is the rightful plaintiff. We note that in cases that have come to the court, Barings and AssetCo, there was pressure to litigate from specific creditors where they had the financial incentive to ensure that the case was funded. Second, case law is sufficiently established so we believe that for cases to be settled out of court, risks a loss of transparency.

One model that may be worth pursuing is treating large corporate failures in a way that is similar to air accidents. The Air Accidents Branch is independent given that the aircraft manufacturer or airline or both, may be at fault. With the pervasive presence of the Big Four accounting firms in the insolvency process, then there is clear risk of a lack of independence in the insolvency process. We note also that the FSA's report into the failure of Royal Bank of Scotland (a Deloitte audit) was written by PwC. Given that they too were operating the same defective standards, then it's difficult to see how that exercise could be demonstrably independent.



Chapter 4 – The new regulator: oversight and accountability

Q9. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

Given that ARGA will have several functions, then to be properly accountable to Parliament there should be separate reporting on each of the separate functions to Parliament. One feature of the FRC was that it would tend to talk up its activities on e.g. governance and ‘culture’ whenever it was under-pressure on auditing and accounting issues.

The new body must be subject to the Freedom of Information Act as these proposals suggest.

On ARGA staff and links with their former firm, this may be a more pervasive risk than in other industries given that many staff will still be members of the accounting institutes that the Big Four firms are also members of, hence they may still have loyalty to the firms in general as well as their own specific firms that they are alumni of. Another risk is not merely the firms whose staff have worked for in the past, but those who staff may wish to work for in the future.

Chapter 5 – Staffing and resources

Q10. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

The accounting standards system is costly and people intensive, with most ‘consultations’ of dubious merit, and at the end of the process, producing harmful outcomes. It would therefore seem that standards could be improved by a considerable reduction in the budget for consultations, and resources put into properly dealing with issues of conduct and enforcement.

Chapter 6 – Other matters

Q11. Are there specific considerations you think should be borne in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

On the basis that this relates to the subject of how LAPFF members are audited, that fall outside of the scope of LAPFFs work.



On actuarial regulation, LAPFF agrees that the FRC is not the right place for that regulation.

Chapter 7 – Interim steps

Q12. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

LAPFF believes that legislation should be rapidly implemented. That said, some of the work of the Brydon Review seems to be getting to grips with issues in a way that will solve some of the problems referred to in other questions, and hence those findings will need to affect outcomes. LAPFF also notes that there has been effective cross party consensus in both the House of Lords and House of Commons on this area, including the recent position of the BEIS Select Committee. Given the large vested interests at stake, the role of Parliamentary Committees in getting the legislation right should be an opportunity for clear public interest regulation, in much the same way that they were in ring fencing of banks.

Conclusions Q13. What evidence or information do you have on the costs and benefits of these reforms?

On the basis that the FRC has grown its budget significantly since 2005, but audit quality has got worse, the problem is inherent confusion on the product rather than a lack of resources in regulation. The benefits are potentially very large given the size of investment losses arising from large preventable audit failures.

Q14. What further comments do you wish to make?

A key point is that an effective regulator needs an effective purpose. The fact that the Brydon Review aims to 'reset' the delivery of audits, which LAPFF believes is only achieved by reconnecting with the law, should also drive the model for the setting up and development of ARGAs.