

Mr Ed Davey
Minister of State
Department of Business, Innovation and Skills
1 Victoria Street
London, SW1H 0ET

19th January 2012

BIS/FRC proposal on restructuring the FRC

As you know from our previous meeting the Forum represents the interests of 55 public sector pension fund members, which have combined assets of approximately £100 billion. Its mission is to protect their and their beneficiaries' long-term investment interests, by promoting the highest standards of corporate governance and corporate responsibility amongst the companies in which they invest.

This consultation was issued jointly by BIS and the FRC, although the consultation requested responses to the FRC, that seems inappropriate if there are substantive criticisms about the FRC itself resulting from this consultation and proposal. LAPFF is therefore replying to yourself rather than the FRC.

In particular LAPFF does not understand how the statutory and quasi judicial powers vested in the existing operating bodies which have themselves been constituted under statute or Royal Charter, can be transferred by a process of merely secondary legislation to the FRC. The FRC as a body has itself had no legislative legitimacy or scrutiny. And in LAPFF's opinion it has an inadequate governance record.

The objections of LAPFF are:-

- using secondary legislation instead of primary legislation to confer statutory and quasi judicial powers to the FRC which at the moment has no legal status other than being a limited company.

- inadequate governance of the FRC.

- the FRC promoting an accurate or misleading "Core Mission" in which it is asserting that it has a secondary market confidence function - which is actually a second order protection function, currently vested in the Listing Authority. Given

that the FRC has already failed to acquire the functions of the Listing Authority in the review of quangos, it is difficult to understand why it is claiming that it has a core mission like that of the Listing Authority. The attributes attached to regulated accounting functions which, as they are covered by Company Law, are actually for first order corporate protection, including solvency, one, in our view, more tangible than the nebulous “market confidence” objective.

In looking at the differences in auditor responsibility for second order versus first order function of accounts, LAPFF can only conclude that the FRC is operating in line with a mission statement that is itself evidence of prior capture by elements of the accounting profession. Essentially the FRC has taken on a nebulous objective to downplay the actual responsibility of the auditors for first order corporate protection.

Inappropriate governance of the FRC itself

In the opinion of LAPFF, the FRC itself (the main FRC board and the related functions) has inadequate governance – this proposal does not address that. LAPFF cannot therefore have confidence that collapsing the existing technical operating boards and disciplinary boards into two new structures under the tighter control of the existing FRC board is going to be an improvement over the existing arrangements.

Given that a part of the FRC’s responsibility is maintaining the UK Corporate Governance Code for setting standards of corporate governance in listed companies, LAPFF questions whether the existing FRC arrangements comply with the principles from the Committee on Standards in Public Life:-

- one current ex-officio FRC board member (APB Chairman) has served on a subsidiary technical board for more than 25 years (the APB), including as chairman, whilst acting in his day-job as adviser to large accounting firms in a defence capacity. He cannot be regarded by LAPFF as independent by tenure, or due to the financial links with particular accounting firms.

- the FRC has made senior appointments - including an entirely new post - without external advertising. This reflects the broader problem for the FRC in having no statement about potential conflicts of interest and how these are handled.

- It is LAPFF’s understanding that the FRC, without consultation, wound up the subsidiary technical boards as statutory companies two to three years ago. This appears to have effectively pre-empted the restructuring suggested by this proposal, but creates a lack of clarity on disclosure of pay of subsidiary board executives as the information is not available in the FRC accounts, or separate operating board statutory accounts or statements.

- the structure of the FRC board itself is too heavily weighted towards corporate representation. This proposal seems to merely transfer existing conflicts of interest to another constituency.

Lack of objectives legally consistent with the law

What the FRC claims to be its “Core Mission” in this proposal does not actually cover the statutory requirements of accounts and audits in Company Law. In the Forum’s view the FRC is incorrectly assuming for itself a market confidence function, which actually rests with the Listing Regime, not the FRC (or even BIS).

The functions of the FRC operating boards, not least as they include unlisted incorporated entities, and unlisted subsidiaries of listed entities, actually relate to the requirements of Company Law irrespective of the status of listing, which goes further than the indistinct and **second order** “markets confidence” function (share trading) and is about **first order** corporate protection (accountability, including capital disclosure and protection).

The banking crisis (undercapitalised and insolvent banks) was a first order corporate protection issue. The Bank of England has confirmed that the banking crisis was not a “liquidity crisis”, but a capitalisation crisis. By LAPFF’s analysis it has been a collapse in the efficacy of the statutory company law based capital maintenance regime - due to faulty accounting standards - that caused the breakdown of both financial governance and then the regulatory capital maintenance regime.

Furthermore, the FRC seems to have developed the habit of making tangential assertions about the scope of statutory accounts - and the audit thereof – which does not actually accord to statute or judicial interpretation.

An example:-

*“Audit developed in the nineteenth century to address a very different corporate and economic environment. **It provided assurance about ‘the numbers’**. The companies being audited were mainly simple and predictable. They did not have complex financial instruments in their balance sheets.*

*As companies have changed, so have the interests of investors and, indeed, of regulators. **Once the focus was the reliability of dividends**. Now it is with the strategy of the business and its risks.”*

Speech by the FRC Chief Executive, European Conference on Financial Reporting and Auditing, 10th February 2011. (Source, FRC website)

However, Section 836 Companies Act 2006 says this:-

Whether a distribution [i.e. a dividend] may be made by a company without contravening this Part is determined by reference to the following items as stated in the relevant accounts—

- (a) profits, losses, assets and liabilities;**
- (b) provisions of the following kinds—**

- (i) where the relevant accounts are Companies Act accounts, provisions of a kind specified for the purposes of this subsection by regulations under section 396;***
- (ii) where the relevant accounts are IAS accounts, provisions of any kind;***
- (c) share capital and reserves (including undistributable reserves).***

The FRC Chief Executive's speech – in **downplaying the reliability of numbers in the accounts** and the reliability of dividends as a thing of the past - is in fact incorrect. The current legislation confirms that the relevance of accounts is their mathematical accuracy for the purpose of reliable dividends (distributions). Incumbent in that is robust asset values, full business control (including the lack of material fraud) and a stable business and funding model. If any or all of these three things are not reliable, then capital and reserves may be overstated, or the business is inherently unstable, and the operation of Section 836 and 837 fails.

Despite what the FRC CEO is claiming is the investor interest in the above speech, it is difficult to envisage how investors (the shareholders) could be more interested in something other than the stability of their investment, not least as illegal dividends may have to be reclaimed.

That something is systemically amiss with the FRC on the fundamentals is demonstrated in another speech, which again uses a "thing of the past" approach.

The audit was designed over 150 years ago to address particular issues in a wholly different environment. Companies were small – not global or international. Computers did not exist, so mathematical accuracy mattered.

Speech by the Chairman of the Auditing Practices Board to an FRC Company Stewardship Roundtable on 29th June 2011. (Source, FRC website)

Not only is Section 836 directly connecting the audited accounts, to the mathematical reliability of the numbers for a lawful dividend, but the subsequent Section 837 is particularly clear regarding the function of the auditor in policing Section 836, even if his opinion is qualified:-

Unless the company is exempt from audit and the directors take advantage of that exemption, the auditor must have made his report on the accounts.

(4) If that report was qualified—

(a) the auditor must have stated in writing (either at the time of his report or subsequently) whether in his opinion the matters in respect of which his report is qualified are material for determining whether a distribution would contravene this Part,

What the FRC is saying is not merely inaccurate by reference to the law, it is prejudicial to the interests of long-term shareholders and creditors. It is creating a false presumption that accounts can be signed off in accordance with standards, that are in fact mathematically deficient by reference to the practical dividend/corporate stability test required by the law.

LAPFF believes that Auditing Standards have been consistently underplaying the statutory test of accounting materiality (and hence audit reliability) to the extent of ignoring this function of accounts, and Accounting Standards have also fallen short or become absolutely defective against this test of accounting (and hence corporate) reliability.

The consultation asks for comments about cost reduction. LAPFF notes that the FRC board alone creates an overhead of approximately £1m.

It may well be the case that in the case of a regulator that has lost direction due to having unclear and unsatisfactory objectives, that winding it up and substituting it with a more effective Companies Regulator instead would be beneficial in terms of direct cost and even more beneficial in terms of cost/benefit.

Warm Regards,



Cllr Ian Greenwood
Chairman

CC Mr Richard Carter, BIS
Steve Baker MP

Cllr Ian Greenwood
Chair of LAPFF
c/o PIRC Ltd.
9 Prescott Street
London E1 8AZ

LAPFF Contact Person
Ms Ashley Hamilton
PIRC (research and engagement partner to LAPFF)
Tel: 0207 247 2323 x 241
Email: ashleyh@pirc.co.uk

APPENDIX

The core proposal

The FRC should remain well connected to and informed by market participants - but it needs to be more streamlined and efficient. It is therefore proposed that:

- *statutory powers should be delegated direct to the FRC Board, and not to its individual operating bodies as at present, to enable the FRC to take decisions at the right level **within a streamlined structure**;*

LAPFF Comment: The issue is not “being well connected to and informed by market participants”. The issue is being properly connected to the law that exists to protect the public interest.

There is no safeguard that this is not merely transferring conflicts of interest from the operating bodies to the FRC board. Further, there is no safeguard that the FRC has the competences to be responsible for these functions.

- *the FRC should report annually to the Secretary of State and Parliament on the exercise of its powers and those delegated to it;*

LAPFF Comment: This in principle should apply to any quango. The issue is that the FRC has an insufficiently defined objective that does not actually accord with the legal framework that has been set down by Parliament. This proposal is not giving Parliament the opportunity to define the appropriate governance structure for the FRC, and is not aligned with the law set out by Parliament .

- *in future the FRC Board should be supported by two Board Committees – one to focus on Codes and Standards, the other on Conduct. This arrangement will replace the existing seven operating bodies.*

LAPFF Comment: Rather than dealing clearly with the conflicts of interest which are peculiar to the functions of each particular board:-

Accounting Standards Board - capture by companies and or auditors

Auditing Standards Board - capture by auditors

Board for Actuarial Standards -

This proposal seems to throw all functions to two sub-committees, increasing the scope for conflicts in practice.