The Financial Reporting Council: a watchdog that doesn’t bite

After a report posed serious questions about the FRC, we look at where the greatest concerns appear to lie

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Critics says the Financial Reporting Council, far from baring its teeth, is much more likely to shut its eyes to questionable practices and roll over to have its tummy tickled Getty Images

It’s the watchdog at the heart of capitalism. It has the power to investigate, rebuke, fine and ban accountants for life.

It ought to have the audit profession in its thrall. It ought to be playing a potent deterrent effect in keeping auditors straight and prudent and so preventing future financial scandals and frauds.

Yet, according to its critics, the Financial Reporting Council, far from baring its teeth, is much more likely to shut its eyes to questionable practices and roll over to have its tummy tickled.

In June it cleared PWC over the Tesco accounting scandal. The supermarket group lost £326 million over the affair, but its auditor was found to have done nothing wrong.

In August it cleared KPMG over its audit of HBOS during the financial crisis. KPMG had given the bank a clean bill of health in February 2008, only eight months before it collapsed and had to be rescued with £20 billion of taxpayers' cash.

And last month it cleared PWC over its checks on Barclays. The lender had already been fined £38 million for improperly mixing up client assets with its own money, yet PWC, which repeatedly had signed off on official reports saying that Barclays was complying with client asset rules, was declared innocent.

Some investors say that the exonerations are part of a pattern that goes back years. The Financial Reporting Council, they argue, has been "captured" by the profession it is supposed to regulate. Its people, its governance, its funding arrangements, its legal status and its processes and culture are all said to conspire to prevent it properly policing the nation's accountants.

MPs have demanded an explanation over the HBOS decision and the FRC has promised a response this month. However, Sir Win Bischoff, its chairman, has already defended it, saying that decisions have to be taken based on available evidence, not "on political considerations or public clamour".

Natasha Landell-Mills, head of stewardship at Sarasin & Partners, a fund manager, has drawn up a highly critical position paper, which was sent to MPs last week and is now circulating in the City. The Local Authority Pension Fund Forum and the UK Shareholders' Association are backing it.

She argues that British capitalism is being weakened: "The regulator should be playing a critical role in underpinning market confidence in audits and enforcing company law. As it is currently structured and governed, the FRC is simply unable to fulfill that role. The damage done to the public interest and shareholders is insidious."

Toothless

Company, auditor at time	Audit period investigated	Years from audit to end of investigation	Fine (exc. costs)	Auditor remuneration for period
MG Rover Group Deloitte	2003	12	**£3m**	£300k
HBOS KPMG	2007	10	**None**	£11.4m
Cattles PwC	2007	9	**£2.3m**	£1.3m
Aero Inventory Deloitte	2006 - 08	8	**£4m**	£1.46m
Connaught Pwc	2009	8	**£5m**	£600k
Asset Co Grant Thornton	2009 - 10	7	**£2.3m**	£500k
European Home Retail EY	2005 - 06	7	**£750k**	£271k
BAE Systems Group KPMG	1997 - 07	6	**None**	N/A
RSM Tenon Group PwC	2010 - 11	6	**£5.1m**	£1m
Pendragon KPMG	2010 - 11	4	**£162.5k**	£2.16m
Tesco PwC	2012 - 14	3	**None**	£39.5m
Manchester Building Society Grant Thornton	2012	3	**£975k**	£91k
Berkeley Group PwC	2012	2	**None**	N/A

Sources: FRC, Times research

People
The most glaring potential for regulatory capture lies in the sheer number of accountants, both retired and still practising, that dominate its senior ranks. “It’s been infiltrated — there’s no other word for it,” according to one critic. At least 34 present or former Big Four partners sit on its main board or on senior committees overseeing areas such as misconduct and corporate reporting.

When the latest PWC decision was taken, three out of 15 directors on the main Financial Reporting Council board were former PWC partners. Another seven sat on other FRC committees. At the time of the KPMG decision, five past partners and five present ones sat on the council’s committees.

The FRC says that it has systems in place to manage potential conflicts and that enforcement decisions are taken solely by its executive counsel, a lawyer. Yet even here the revolving door is spinnning. Gareth Rees, QC, the executive counsel, is in the process of leaving for a job at King & Spalding, the American law firm that acts for PWC over allegations of negligent audit.

The FRC also argues that it needs the in-house accounting expertise to grapple with issues that are complex. But the sheer weight of accountants in every corner of the watchdog inevitably means that it has an at best favourable mindset towards the profession.

Take banking. In spite of the gargantuan losses and economic pain thrown up by the banking crisis, not a single accountant has been held accountable in any way.

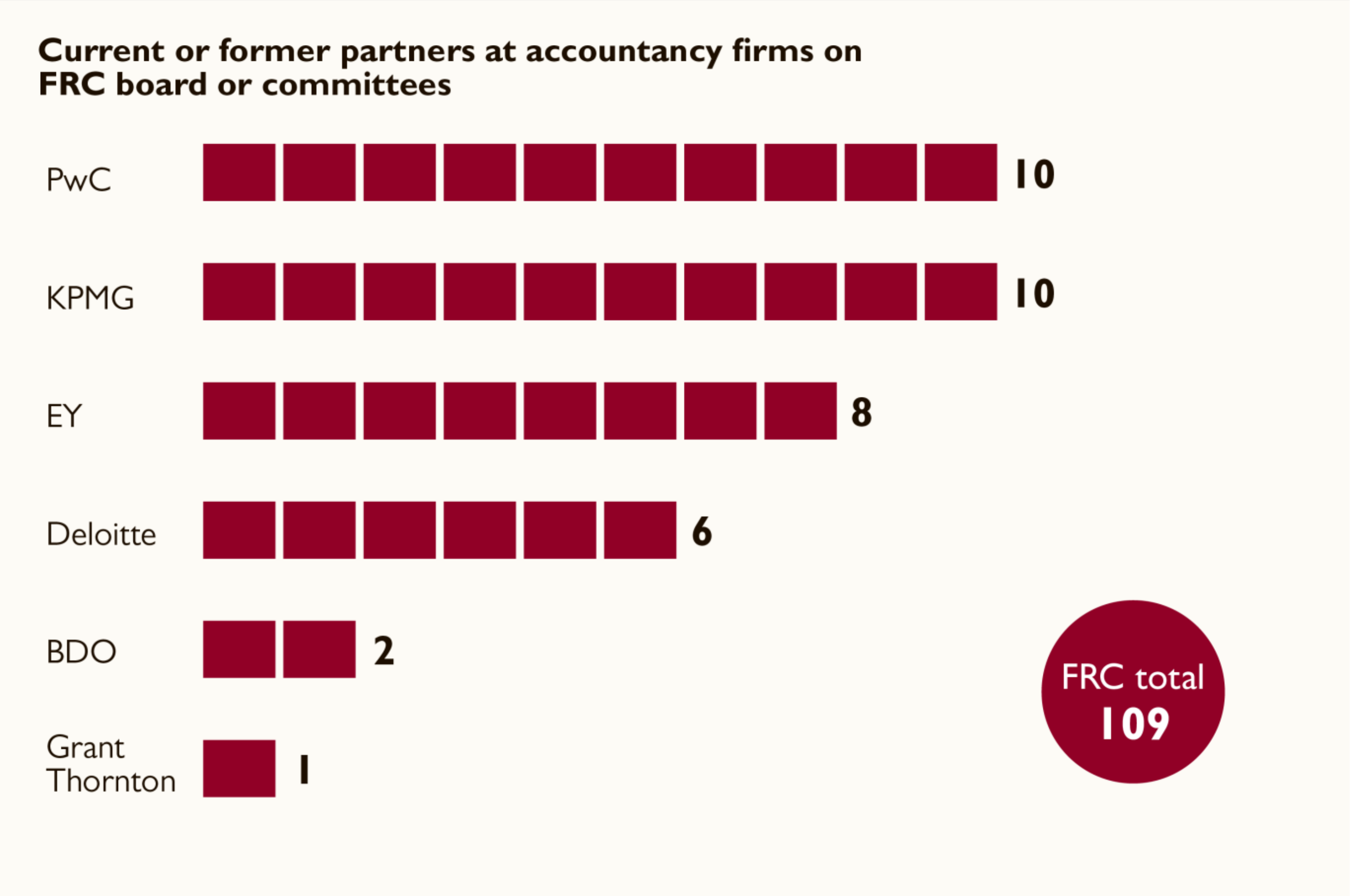
And the FRC is particularly well-stocked with former bank auditors in powerful positions. Brendan Nelson is a former head of banking audit for KPMG, ultimately responsible for the audits of not only HBOS but also Bradford & Bingley, which similarly failed, and the Co-operative Bank, which came very close. He now sits on the FRC’s financial reporting review panel, the powerful committee to which investors are directed to make complaints about company reporting.

His verdict on bank auditors? They “discharged their responsibilities diligently in the context of what the statutory audit responsibilty represents”, he has said.

Another former bank auditor now advising the FRC is John Hitchens, former head of audit at PWC. As such, he was responsible for the audit of Northern Rock, as well as of Lloyds TSB and Barclays. PWC was criticised by the House of Lords economic affairs committee, which said that it was “astonished that PWC appeared not to recognise an amber light that flashed so brightly”. He is now deputy chairman of the financial reporting review panel. He is also chairman of the banking committee at the Institute of Chartered Accountants of England and Wales.

It isn’t only banking where the arrangements can look too cosy, critics argue. Jimmy Daboo sat on the financial reporting review panel for ten years until 2015. A partner at KPMG, Mr Daboo was responsible for auditing Rolls-Royce. Those audits are now being investigated by the FRC’s conduct committee.

The council says that work on publishing a register of conflicts is “nearing completion”



Processes
The process by which the Financial Reporting Council decides to conduct an investigation into misconduct can be opaque, long-winded, bureaucratic and riddled with more potential conflicts of interest. MPs on the Treasury select committee said that its original decision in 2013 not to investigate the auditing of HBOS was "a serious mistake", adding: "The process by which it reached its decision suggests a lack of curiosity and diligence."

When investigations are launched, they tend to be very narrowly framed. The belated inquiry into the HBOS audit focused purely on the 2007 audit year, despite the fact that the seeds of the bank's destruction, as the Banking Commission made plain, went back many years. MPs criticised the reporting council over the narrowness of its inquiry into PWC's audit of BHS, which is still continuing.

In the case of the Co-op Bank and its disastrous implosion, the FRC is investigating the wrong year, according to Tim Bush, head of corporate governance at Pirc, the shareholder consultancy, another signatory to the Sarasin position paper.

First, after routine spot checks, it passed KPMG's 2011 audit of the bank despite the fact that, as the later Kelly Review made plain, it had failed to examine loans in the bank's "good book" that subsequently went wrong. Instead, it launched an investigation into the 2012 audit only.

"How odd, to have passed an audit shortly before the bank failed, and how convenient to now investigate another year instead." Mr Bush remarked.

Investigations also go on for a very long time. Sometimes audit firms are censured or fined up to ten years after the events to which they relate. The MG Rover case took 12 years. The delay can be very helpful for any accounting firm found at fault, as a seven-year statute of limitations often applies, preventing investors or consumers from suing.

The FRC says that it now has a target of completing investigations of newer cases within two years and that it is investing more of its budget in enforcement.

The way in which inquiries are conducted is also highly opaque, critics claim. Few if any details are published at the end of an investigation. The FRC has promised an explanation by the end of this month of its exoneration in the HBOS case, but this was only because of pressure from MPs.

The FRC often hires external firms of lawyers or accountants to advise on cases, but invariably it refuses to divulge their names, hardly giving the impression that due process has been followed. The suspicion is that firms give each other an easy ride because next time the roles could be reversed.

Another big issue is that the council's test for what it regards as misconduct seems to be very demanding — and increasingly so. In 2013 it changed the definition. Accountants had to "fall significantly short of standards" to justify enforcement action. Prior to that, they merely had to "fall short of standards".

Nicky Morgan, chairwoman of the Treasury select committee, said that the change was "concerning", although the FRC claims that the removal of "significantly" merely brought it into line with the test already used by the tribunal, where cases go when challenged. Sanctions can be relatively modest. Fines generally are smaller than the audit fees the firm tends to have racked up in the years or decades before a scandal is exposed. The danger is that the occasional rebuke or fine from the regulator is seen merely as the cost of doing business.

The FRC rejects this. According to a spokesman: "This year PWC has been fined the two largest amounts in FRC history, £5 million in the Connaught case after a tribunal hearing and £5.1 million in relation to RSM Tenon after they agreed to settle the case. We expect to report shortly on another settlement and fine imposed on an audit firm.

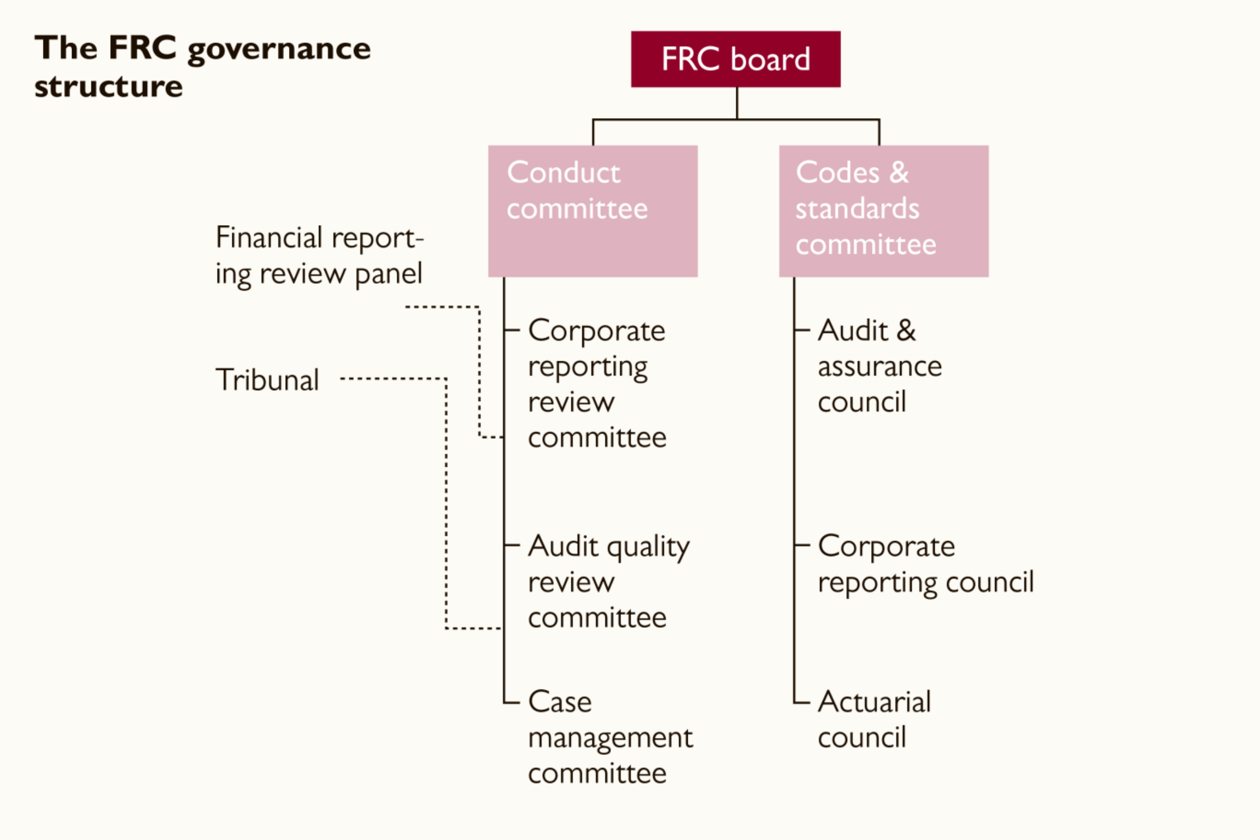
"We do accept, however, that there is a body of opinion that fines need to be higher in order to act as a more effective deterrent." It has commissioned an independent review, led by Sir Christopher Clarke, a retired Court of Appeal judge.

Governance and politics

The FRC's apparent weaknesses are exacerbated by its curious structure. Unlike other regulators, which have been established by a clear act of parliament, its legal backing is more opaque.

It is an independent company limited by guarantee that derives its functions and powers partly by delegation from the Department for Business, Energy and Industrial Strategy, partly from private arrangements with other departments, partly through convention and voluntary arrangements with other stakeholders, including the audit profession, and partly through its own constitution.

It reports to the business department, from which its chief executive Stephen Haddrill hails. Mr Haddrill was paid £486,000 last year, including a £67,000 bonus. The FRC articles and code of conduct appear to say that directors are responsible for holding themselves to account.



It also claims that it is not subject to the same Freedom of Information requirements of other regulators.

The business secretary appoints the chairman and deputy, Sir Win Bischoff and Gay Huey Evans, who in February 2017 were reconfirmed in their jobs for three and two years, respectively.

Of 16 board members, only two are clearly representative of the investment industry — Keith Skeoch, co-chief executive of Aberdeen Standard Life, and Mark Zinkula, who runs Legal & General's investment side. Five are former Big Four partners.

The profession that pays for its own policing

Unlike a regulator that works fully at arm's length, the Financial Reporting Council is dependent on the accounting firms it polices for about half of its annual £36 million income (Patrick Hosking writes). Listed companies, actuaries and pension funds also pay levies because of the FRC's responsibility for corporate governance rules and for regulating the actuarial profession. Only 1 per cent of its funding comes from the government.

Yet the situation is worse than that, reformers claim. Any specific enforcement action requires additional funding that has to be sanctioned by the auditors.

“The FRC’s hands are tied in determining what it decides to pursue and how well resourced its enforcement actions are,” Natasha Landell-Mills, at Sarasin & Partners, says. “It is not hard to see how the FRC’s hands are potentially tied in determining what it decides to pursue.”

Moreover, the deterrent effect of fines is seriously reduced because some of the revenue from fines is then passed on to accountancy bodies.

Critics want to see a more robust, US-style system, or at the very least mandatory fees that remove the discretionary element.

The FRC argues: “Funding by the audit profession follows the well-known principle of the regulated paying for the regulator. The audit professional bodies pay for the FRC’s funding, rather than individual firms paying directly.”