Supplementary memorandum from FRC Chair Baroness Hogg and CEO Mr Hadrill – November 2010

Legislative change is also needed to enable the FRC to rationalize its current structure and ensure that information can be freely exchanged internally.

In future we believe the FRC should have a greater capacity to be proactive in identifying and responding quickly to problems in capital markets. We currently have powers to monitor the quality of audit, and we review 300 sets of accounts each year. We also conduct investigations into potential misconduct by members of the accountancy and actuarial professions. However, we have limited powers to inquire into the accounting judgements of companies that have failed; our investigations into misconduct cannot compel evidence from, eg, directors who are not accountants and are very time consuming; and our audit inspections are established for the purpose of annual monitoring, and have insufficient powers for exploring urgent issues that fall outside our routine monitoring. This means that we are dependent upon the goodwill of the firms in helping us to understand whether there are any lessons to be learned in other areas, for example from the collapse of a number of companies supplying the public sector.

We believe that additional measures could be taken to strengthen our independence and enhance audit quality:

Information sharing

The FRC believes that better information sharing across our organisation and with fellow regulators, would benefit the market and help to spot and manage risks.

There are currently restrictions on information sharing between some of the FRC's operating boards. For example, under current legislation the Financial Reporting Review Panel (FRRP) is unable to share information on companies whose accounts it may be investigating with the Audit Inspection Unit (AIU). We would ask the Committee to support legislation which will enable effective information sharing across the organisation.

Licensing

The increasing complexity of global business practice and enhanced investor expectations of the auditors of public interest entities require auditors to have a greater degree of expertise and experience to manage adequately the risks involved.

We therefore propose an additional licensing regime for auditors of public interest entities. The need for this is shown by the evidence of the AIU's 2010 Annual Report, published in July 2010, which concluded that "the number of audits assessed as requiring significant improvement at major firms is too high" and among other firms a higher proportion of audits conducted required significant improvement. We believe a new regime for auditors of public interest entities should be provided by the FRC while the professional accountancy bodies should retain responsibility for the oversight of smaller firms.

The ICAEW, in their letter to the Committee of 23 November about the audit inspection and monitoring regime, suggested that the existing regime could achieve our goals. It is correct that the Audit Registration Committee (ARC) has responded to individual reports made by the Audit Inspection Unit (AIU). However, the regime currently operates within very tight parameters. The AIU is restricted in the action it can request the ARC to take; its efforts to broaden the definition of what is a public interest entity have been challenged; as has its wish to undertake non-routine inspection work without seeking the ARC's permission.

Discipline

The current professional disciplinary regime is complicated and is not as independent or effective as it should be. At present the Accountancy and Actuarial Discipline Board (AADB) is required to consult with the relevant professional body before it can begin a disciplinary investigation. It has no statutory powers to obtain evidence.

We believe that the independence of the process is compromised by the requirement placed upon the AADB to consult and seek the agreement of the professional bodies—this is the product of the previous self-regulatory system that we believe should now come to an end.

To address this issue we therefore propose the clarification and streamlining of the AADB's discipline scheme. All disciplinary cases relating to public interest audits should fall to the AADB in the first instance.

Where the market has been misled deliberately it is important that a robust sanctions regime is in place to deal with such behaviour. We are concerned that this does not exist at present and that the sanctions available to the FRC are limited, meaning that the most appropriate remedy is sometimes not available to us. We would therefore like a more tiered sanctions regime to be put in place which, accompanied by other changes outlined in this letter, would strengthen the FRC's independence and contribute to the better operation of the market.

Taken together we believe these measures would significantly improve the accountability of the audit profession, strengthen the FRC's independence and put in place a robust sanctions and company investigations regime in the public interest.

2. FRC GOVERNANCE

The governance structure of the Financial Reporting Council was significantly strengthened three years ago, reducing a large representational council to a Board of 16 members (currently consisting of a non-executive Chairman, the Chief Executive, 6 chairmen of the operating bodies and 8 independent non-executive directors). However, further changes under consideration for the coming year are intended to have the effect of increasing the majority of independent directors on the Board. These are selected to provide a wide range of skills and experience in business, investment institutions, the professions and policy-makers, including those affected by the work of the FRC. However, as the table below shows, there are no practising auditors on the Board, nor on the boards of the bodies responsible for auditor discipline.

BREAKDOWN OF FRC BOARD MEMBERSHIP

6. GOING CONCERN

The FRC meets with market participants regularly to discuss their concerns and identify issues that need to be addressed. This engagement intensified following the collapse of Lehman Brothers in September 2008. During 2008 the FRC held two meetings with market participants, and a further two meetings were held in 2009. Typically, these meetings involved: companies, corporate treasurers, auditors, investors and business organisations. These formal meetings are held in addition to ad hoc meetings held throughout the year.

The FRC issued guidance to the market in 2008 in response to concerns in the market that auditors would find it difficult to sign off the accounts of a large number of companies as going concerns because of the state of the credit markets.

7. EARLY WARNING SIGNALS

In our oral evidence we suggested that the audit process should be capable of providing an early warning signal to the market—something that was not delivered in either 2006-07 or 2007-08. We believe that the market is capable of providing more signals and the creation of a Market Participants' Group comprising regulators, auditors, finance directors and investors would enable warnings to be identified and discussed by the market. These issues could be addressed through market information, guidance or regulatory action. The FRC would be well placed to convene such a group and we would welcome the Committee's support for such a proposal.

8. SCEPTICISM

The FRC believes that company boards have a responsibility to encourage a culture of professional scepticism by auditors. The Committee requested further details on the work the FRC has undertaken to encourage auditors to demonstrate appropriate professional scepticism. We attach as an Appendix a discussion paper which we published in August 2010, along with another paper published jointly with the FSA and which deals with the financial sector specifically. We are currently analysing the responses to these consultations and will announce the outcomes in 2011.

The Audit Inspection Unit's 2010 annual report also called on auditors to exercise greater professional scepticism particularly when reviewing management's judgements relating to fair values and the impairment of goodwill and other intangibles and future cash flows relevant to the consideration of going concern.

We hope this supplementary submission is helpful to the Committee. As we say in our written evidence, we stand ready to play our part in implementing policies that will both enhance competition and quality in the audit market. We look forward to the Committee's analysis and recommendations.

22 December 2010

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45 Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards (the IAS Regulation). Back

46 International Accounting Standards "A Consultation Document on the possible extension of the European Regulation on International Accounting Standards", DTI, dated 30 August 2002. Back

47 SI 2004 No 2947 The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004. Back

48 ICAEW Technical Release-Tech 02/10. Guidance on the determination of realised profits and losses in the context of distribution under the Companies Act 2006. Available at: http://www.icaew.com/index.cfm/route/155791/icaew_ga/en/Technical_and_Business_Topics/Technical_releases/Tech/TECH_series. This guidance is issued following public exposure and independent legal review. Back

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