

FRC Review Secretariat
Department for Business, Energy and Industrial Strategy
1 Victoria Street
London
SW1H 0ET

Management and Investment Resources

Roliscon Limited
PO Box 62
Chislehurst
Kent, BR7 5YB, UK

Tel: 020-8295-0378
Int: +44-20-8295-0378
Web: www.roliscon.com

Via Email: FRCReview@BEIS.gov.uk

02 August 2018

Submitted Evidence to the Review of the Financial Reporting Council (FRC)

Dear Mr Kingman,

As an individual investor with a large stock market portfolio, I have a great interest in the regulation of the audit profession and in good corporate governance in public companies. The foreword to your review document spells out what I consider to be the failings in the FRC. Namely:

- It is “chronically passive” and requires “culture change”.
- It is too slow to act and insufficiently “proactive”.
- It seems to act more in the interests of audit firms, and in the interests of public companies and their directors, rather than the investors in such companies.

The FRC is very ineffective in ensuring that high quality accounts are issued by public companies, and when problems arise their investigatory and disciplinary activities are poor. Whether that is simply because they do not have sufficient resources to do their job adequately you will need to determine. But it does appear to me that there are “cultural” problems in the organisation when one examines the details of how it operates when complaints are made. I give specific details below of my experience of dealing with the FCA in the Globo case – see Appendix B.

But as a general comment, in respect of the audit profession there have been just too many issues with listed company accounts in recent years. The latest is an investigation announced by the FRC into the audit of Conviviality but there have been lots of other problem cases in both large and small companies – Carillion, Interserve, BHS, BT, Rolls-Royce, Mitie, RSM Tenon, Connaught, Autonomy, Quindell, Globo and Blancco Technology are just a few not to mention those in the financial crisis a few years back such as HBOS, RBS, Northern Rock et al. There are simply too many such examples but whenever I go to meetings run by auditors or the FRC I get the distinct impression of complacency. They all think they are doing a great job and the bad apples are exceptions.

I have answered the detail questions in your review in Appendix A to this letter.

In summary I suggest that the FRC needs substantial reform in its structure, management, operations and funding if it is to more effective.

I would be happy to answer questions on this submission if you have any.

Yours sincerely

Roger W. Lawson
Managing Director

Appendix A – Answers to Detailed Questions

Q1: What should the FRC’s objective(s) be? Is its present mission statement the right one?

Answer: I have no concerns with FRC’s objectives, more about how it operationally implements its policies.

Q2: Does the FRC’s name remain right?

Answer: No because it does not summarise the existing activities of the FRC.

Q3: Are the functions and structure of the FRC still relevant and appropriate, or is there a case for any structural change? Should any of the FRC’s functions move to other regulators?

Answer: There is considerable confusion at present between the responsibilities of the FRC, the FCA and the BEIS Department. In addition the FRC claims to be an independent body effectively responsible to nobody (although the Chairman is appointed by the Secretary of State for the BEIS Department). This is confusing to say the least and one needs to have considerable knowledge of the role of each of these bodies to figure out who to complain to on particular issues. I suggest there should be a single regulator for all the activities of companies, i.e. a single “securities regulator” as part of the BEIS Department.

Q4: What lessons can be learned from other countries’ regulatory systems? Which ones?

Answer: The USA seems to have a much more effective regulator. The SEC has a better structure and governance with a more embracing manifesto and is much more effective at vigorously pursuing wrongdoing. A good example is the case of Autonomy which I describe in a blog post here: <https://roliscon.blog/2018/05/02/they-do-things-differently-in-the-usa/> .

Q5: How effective has the FRC been in influencing wider debates that affect its ability to deliver its objectives – for example, around audit competition, or its legal powers?

Answer: No comment.

Q6: Is the current balance between cross-cutting reviews and firm-specific investigations most effective?

Answer: Thematic reviews may be helpful, but firm-specific investigations should always be progressed if there is clear evidence of failures. The former should never prejudice the latter because of limited resources.

Q7: What are the FRC’s strengths and weaknesses?

Answer: See introductory comments re weaknesses. As regards strengths it has developed good corporate governance standards that have been more widely adopted in one form or another. But these standards often appear to be designed for the benefit of companies and their directors rather than for shareholders and the wider community (i.e. other stakeholders). For example, the standards as regards remuneration have not prevented the rapid escalation of management pay in public companies. There is too much desire to obtain a consensus rather than provide firm leadership.

Q8: The recent joint report on Carillion from the Business, Energy and Industrial Strategy and the Work and Pensions Select considered the FRC to be characterised by “febleness and timidity” and recommended that a change of culture and outlook is needed. Do you agree? If so, please cite relevant evidence which informs your view.

Answer: Yes I agree. The FRC is too slow and not aggressive enough in taking up complaints and pursuing them. Too many complaints re audit work and the accounts of companies seem to disappear into a black hole with no action ever resulting and no feedback to the complainants. Even when investigations are commenced, the process takes too long. To be effective justice must be both effective and quick.

Q9: Are there changes respondents would like to see to achieve the vision set out in the Review’s terms of reference?

Answer: The structure of the FRC and its management needs to be changed so that there is a cultural change in how the FRC operates.

Q10: Are arrangements for financial reporting, audit and corporate governance the critical elements for effective delivery of FRC’s mission, or are elements missing?

Answer: I do not believe there are any significant elements missing. It’s just a question of executing the mission more effectively.

Q11: How effective is the FRC at driving quality improvements in audit? What further improvements would respondents like to see?

Answer: Bearing in mind the frequent occurrence of problems in audits in recent years, it hardly appears that the FRC have been effective in improving the quality of audits. I would like to see such events as being extraordinarily rare, particularly those where fraud by directors of a company or gross negligence is subsequently apparent.

There are two ways to improve performance of anyone: the carrot or the stick. Tougher penalties for poor quality audits would be worth considering as they are not a great deterrence at present. Perhaps auditors should be paid more so they can put more time and effort into their audits but company boards might be reluctant to do that. That might be different if auditors were appointed by a shareholder committee rather than by the board of directors. But I suspect that would only help if such a committee had the power to approve expenditure of the company’s money. Certainly one problem at present is that auditors are selected to a large degree on price rather than quality.

Q12: Where quality does fall short, do the FRC’s interventions have sufficient impact and deterrent effect?

Answer: No they do not. The fines imposed on the major audit firms in the UK are not sufficient to have a significant impact on their overall finances, and the fines imposed on individuals are also often fairly trivial. One advantageous change would be to reverse the Caparo legal judgement and make auditors liable to shareholders. At present it’s much too difficult for investors to sue auditors while companies rarely want to do so (the availability of “derivative actions” does not really solve that problem in an adequate way).

Q13: What force is there in the concern of some that the FRC may be too close to the “big 4”? Or that the FRC is too concerned with the risk of failure of one of the “big 4”?

Answer: Certainly one gets the impression that the FRC takes care not to offend audit firms. They appear to be more concerned with obtaining consent than taking a principled stand on certain matters. In other words, they appear to take more interest in serving the audit profession and making life easy for them than correcting problems.

Q14: Are investigations of audit work effective, transparent, satisfactorily concluded and unfettered?

Answer: I would not agree with that statement. In particular they typically take much too long and are too easily abandoned. A good example is the audit of the accounts of HBOS. The report from the Financial Reporting Council (FRC) on the audit of HBOS is a quite tedious and turgid document. To remind you, HBOS was a bank that almost went bust after making imprudent commercial property loans financed by short term debt. When Lehman’s collapsed and debt became difficult to raise, HBOS had to be supported by the Government and then bailed out by a merger with Lloyds TSB. The latter’s shareholders are currently pursuing a claim against the company and its directors over that event.

The reason the audit of HBOS was examined by the FRC was because the company obtained an unqualified audit report suggesting that it was a “going concern” when it soon turned out to be otherwise. These events date back to 2008 – that’s 9 years ago which shows the speed with which the FRC typically operates as the FRC report has only recently been published.

One interesting comment made in the FRC report is that it suggests on page 11 that liquidity support from central banks may be considered “a normal funding source.....and therefore reliance on such support does not mean that the bank is not a going concern.....”. As banks with a positive balance sheet are usually assumed to be eligible for “lending of last resort” from the Bank of England that might mean that HBOS would be considered to be a going concern even if it ran out of cash (which is the reason most banks go bust, not because of defective balance sheets – Northern Rock is a good example).

The report also refers on page 29 to “market expectations” at the time. They say market participants did not expect the financial crisis to get worse which affected the auditor’s views. So now we know why the FRC let the auditors of HBOS (KPMG) off the hook! But that is a weak excuse from the FRC when investors in the property sector considered HBOS was a sucker for dubious propositions and was taking excessive risks.

Q15: Could a different regulatory strategy or tactics result in greater avoidance of harm?

Answer: A tougher and more aggressive regulatory approach would be more successful in improving audit quality.

Q16: Could or should the FRC’s work promote competition and a well-functioning audit market? Does the FRC’s work undermine competition or a well-functioning audit market in any way?

Answer: I am not convinced that lack of competition in the audit market is a serious problem.

Q17: Can questions regarding the effectiveness of the FRC be separated from the wider question on whether change is needed to audit arrangements to take account of shifting expectations?

Answer: I am not convinced that expectations have shifted. Rather it seems that the quality of accounts have fallen because of lowered standards in both the behaviour of public company directors and in the audit profession.

Q18: Has the FRC been effective in influencing the development of accounting standards internationally as well as accountable and effective in setting UK GAAP?

Answer: I believe it has.

Q19: How else could the FRC improve the quality of financial reporting with a view to ensuring investor confidence?

Answer: No additional comments.

Q20: Are there wider issues of financial and other reporting on which a stronger regulatory role would be desirable to better meet the information needs of investors and other stakeholders?

Answer: The information needs of investors are not well served at present. For example, the extensive reporting of “adjusted” figures by companies where there are no standards for those.

Q21: Is the current combination of statutory and voluntary methods of oversight for professional bodies effective, and do they remain fit for the future?

Answer: I take the view that voluntary codes and processes are never effective in ensuring high standards in financial markets.

Q22: In relation to the UK Corporate Governance Code, are there issues relevant to the Review’s terms of reference that respondents believe the Review should consider?

Answer: None that come to mind.

Q23: How effective has the Stewardship Code been in driving more and higher quality engagement by institutional investors? If not, why? How might quality of engagement be further strengthened?

Answer: Unable to answer that question as have seen no improvement.

Q24: Do respondents view the FRC as reluctant to undertake investigations or enforcement, or able to do so at speed?

Answer: Absolutely. Too slow to commence investigations and in the case of smaller public companies, reluctant to do anything at all.

Q25: How could the FRC better ensure it is able to take swift, effective and appropriate enforcement action? What practical or legal changes would be needed to achieve this?

Answer: It needs a change of culture to be more aggressive and more willing to take some risks. Perhaps it also needs more financial resources to do its job properly because the current budgets seem low in relation to the number of companies that need monitoring and the frequency of investigations that are required.

Q26: Have the arrangements put in place following the 2005 Morris Review stood the test of time, or is there a need for change? Should actuarial regulation be a focus for the Review's work?

Answer: Dependence on self-regulation should be removed.

Q27: Is there more the FRC could or should do to help reduce the risk of major corporate failure?

Answer: I suggest that the question of when a company is a "going concern" needs to be examined. In many of the recent failures, and those of banks in the financial crisis of 2008, any reasonably skeptical person would have considered that the companies were taking substantial risks. This was not reflected in the audit reports that were published. "Viability statements" seem to have had little impact to date.

Audit reports are too frequently unqualified and it might help to introduce a graded system rather than simple qualified/unqualified. A qualified report is so damaging to a company that auditors are clearly reluctant to give one, hence there are so few.

I am not convinced that enabling more "intervention" by the FRC, or any other body, would assist. Company directors have to take responsibility for the business and should be more aware of any issues than any outside organisation. Increasing bureaucracy would potentially delay decision making and create substantial distractions for management.

Q28: Is the FRC quick and effective enough to act on warning signs arising from its work on accounts and financial reporting, or on evidence of concerns over poor corporate governance?

Answer: Probably not.

Q29: Is there a case for a more "prudential approach"? If so, how could this operate in practice, and to which category of company might such an approach apply?

Answer: This is a complex question with potentially a very long answer. First you would need to define what is meant by "prudential" and how it might relate to the financial ratios or business models of companies. I can see that such an approach might be useful for financial institutions such as banks although their capital asset ratios attempt to cover this to some extent. I think this area would need more research and consideration.

Q30: Introduction of the viability statement was an important development, but could it be made more effective?

Answer: As already mentioned above, it has clearly not been very effective so far. It is worth reading the viability statement for Carillion in their 2016 Annual Report which reads as follows: *"On the basis of both reasonably probable and more extreme downside scenarios, the Directors believe that they have a reasonable expectation that the Company will be able to continue in operation and meet its liabilities as they fall due over the three-year period of their assessment"*. In other words, the Directors consider it Ok so investors reading this would not have had any concerns. Viability statements need to spell out what assumptions have been used if they are to have any meaning.

Q31: Are there gaps in the FRC's powers? Would its effectiveness be improved with further (or different) powers?

Answer: The regulatory environment covered by the FRC and other bodies is confusing and should be simplified. In addition the delegation to professional bodies should cease and the imposition of confidentiality on the FRC should be removed.

Q32: Are the FRC's powers coherent in relation to those of other regulators?

Answer: No.

Q33: Taking account of Sir Christopher Clarke's review of sanctions, and subsequent changes, does the sanctions regime now have the right deterrent effect? Does the FRC make best use of the sanctions at its disposal?

Answer: The sanctions that can be imposed are weak and do not act as a sufficient deterrent.

Q34: Should the Government legislate to put the FRC on a more conventional consolidated statutory footing?

Answer: Yes

Q35: What is the optimal structure for the relationship between the FRC and the Government, best balancing proper accountability with enabling the FRC's effectiveness?

Answer: The FRC should be directly accountable to the Government and report to a Government Minister, e.g. the Secretary of State at the BEIS Dept. I suggest that it should be a Government department and not an independent limited company as at present.

Q36: In terms of the FRC's broader accountability, is there a case for further transparency in its actions or functions?

Answer: Yes there is a good case. The FRC should be subject to the Freedom of Information Act for all its functions in a similar manner to that of the Police (i.e. limited exceptions), and in the case of alleged fraud it should be subject to the "Code of Practice for Victims of Crime" which it is not at present. At present it is far too easy for the FRC to simply not respond to reasonable inquiries about reported complaints.

Q37: How effective is the current leadership and Board of the FRC? Please cite relevant evidence which informs your view.

Answer: Not effective at all in ensuring complaints are progressed promptly and effectively. The Autonomy case and numerous others give evidence of that. I suggest it is down to the "Committee" structure of the organisation which is not one that ensures prompt executive action. It needs executive functions to be delegated to individuals who can provide strong leadership.

Q38: Is the Board's composition appropriate? Is it the right size? Does it have appropriate membership?

Answer: Too many board members (at 15) to be an effective executive body. Boards of that size always result in some members being relatively inactive. Members appear to be typical non-executive directors with lots of other interests and hence limited time commitment.

Q39: Is the balance of decision-making between the Board, its Committees and the Executive described in paragraphs 34-36 above right, given relevant legal constraints?

Answer: The structure looks complex, with numerous “Directors”.

Q40: Is the Board’s structure appropriate, including given the FRC’s roles on standard setting, assessment and enforcement? Does the Board’s accountability appropriately reflect its role and functions? Are its decisions appropriately transparent, bearing in mind the need to balance public interest and confidentiality?

Answer: Difficult to comment without a lot more information on how the Board operates at present, but see comments above.

Q41: How should the Executive’s effectiveness be assessed and ensured?

Answer: Best done by a Government Minister, with Parliamentary supervision by a Select Committee.

Q42: Who should fund the FRC, and how? What are the impacts of current funding arrangements, including of having a partially voluntary funded regime?

Answer: Astonished to read that it is partly funded by voluntary contributions. That’s a recipe for “capture” or at least influence by those contributors. It should be funded by levies and fines or by the public purse (i.e. direct Government funding as it is in everyone’s interests to have good corporate governance and sound accounts in public companies).

Q43: What skills are needed for the FRC to be most effective? Does the FRC have the people, skills and resources it needs, of the quality it needs?

Answer: I do not know but I doubt the people are best employed or motivated by the current structure of the organisation. Otherwise it seems unlikely that the FRC has sufficient financial resources.

Q44: Are there conflicts of interest in the FRC’s structure, processes, or culture? Are there deficiencies in the FRC’s approach to managing conflicts of interests?

Answer: I am not aware of any specific conflicts of interest.

Q45: Are there any other issues relevant to the terms of reference that respondents would like to raise?

Answer: No other comments.

Appendix B – The Globo Case

I was a shareholder in Globo Plc a largish company listed on the AIM market that went into administration in 2015 after it was revealed that the revenue of the company was probably fictitious (see <https://www.sharesoc.org/campaigns/globo/> for details). The report of the administrators made it clear that the cash on the balance sheet of Globo plc seemed to have disappeared, bringing into doubt the preceding audit report on that ground alone let alone the revenue recognition issue.

The FRC announced an investigation in December 2015. What have the FRC been doing, when will the investigation likely conclude, are there any preliminary conclusions, etc, etc? All of these questions were very relevant as the answers might have provided the basis for legal action by shareholders against the auditors and others. After several email exchanges with FRC staff, the only answer I managed to elicit was that the investigation was on-going. It was not even turned into a “Formal Complaint”.

Eventually on the 30th July 2018 the FRC did give some information on the investigation. But the announcement simply said that the FRC was closing the investigation as there was no realistic prospect of a finding of misconduct. It would seem that it was considered that Grant Thornton UK relied on the audits performed by Grant Thornton Greece or other parties and hence it was required under the Tribunal tests to show that their conduct was “more than negligence and must cross the threshold of seriousness”. Bearing in mind that there was public criticism of the accounts of Globo before the last audit was performed, that comment seems unjustified. And why should not simple negligence be sufficient to justify penalties?

The reason more information could not be supplied between 2015 and July 2018 was given as because it might prejudice “the overarching requirement for fairness”. My response was *“I really do suggest that the FRC needs to reconsider its policies in this area. You have too much emphasis on treating those who have been complained about (i.e. auditors) fairly, while those who have complained are treated unfairly. This rather suggests that the FRC is dominated by auditors who are the people it is supposed to be regulating”*.

It is amusing to read in the FRC’s Publication Policy document (para. 3) that “Transparency contributes to public confidence in independent disciplinary arrangements...” but then proceeds to spell out all the restrictions it imposes that thwart it. This is unacceptable in my view.