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IoD Response to the Independent Review of the Financial Reporting Council

Thank you for giving the Institute of Directors (IoD) the opportunity to respond to the Independent Review of the Financial Reporting Council.

About the IoD

The IoD was founded in 1903 and obtained a Royal Charter in 1906. It is an independent, non-party political organisation of approximately 32,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. 49% of FTSE 100 companies and 45% of FTSE 350 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises (SMEs), ranging from long-established businesses to start-up companies. IoD members' organisations are entrepreneurial and growth-orientated, and more than half (61%) export goods and services internationally.

The IoD has long been an advocate of high standards of corporate governance. According to our Royal Charter, one of the IoD's key objectives is "to promote the study, research and development of the law and practice of corporate governance, and to share findings." We strongly believe that an effective system of corporate governance is a key underpinning of UK economic performance and business legitimacy.

Our view

Statutory audit

The current scrutiny of the FRC has largely arisen due to the increasing mismatch between what investors and the wider public expect from a statutory audit, and what an audit delivers in practice. The recent collapse of Carillion and other entities have highlighted the need for a fundamental review of the purpose of the statutory audit and how it is overseen by regulators, the application of various accounting standards, and the promotion of competition in the audit market.

In our view, these are legitimate areas of concern, with implications for the credibility of UK corporate governance. However, we are not yet persuaded that an immediate restructuring of the FRC, or a merger of its activities into other regulatory bodies, would necessarily take us forward to any significant extent in addressing these fundamental issues. They are issues that will have to be addressed by policy makers and regulators regardless of any reforms to the FRC, and we do not see how urgent changes to the current configuration of regulatory bodies will facilitate this process.

However, we would agree that the FRC should be given more power/resources to investigate audit firms, as a means of rebuilding confidence in the external audit process. Furthermore, it should be more proactive in that role, which may require some changes to its internal culture and regulatory powers.

Corporate governance and investor stewardship

Our main area of engagement with the FRC is on matters of corporate governance – in particular, with regard to the UK Corporate Governance Code and, more recently, in the development of the Wates Principles of Corporate Governance for Large Private Companies. As a result, we will focus on these elements of the FRC's remit in our response.

Over the years, the IoD has found the FRC corporate governance team to be a constructive and competent partner. Broadly speaking, we believe the FRC does a good job in the corporate governance space - the UK Corporate Governance Code is internationally respected and is often used by other jurisdictions when developing their own governance frameworks. Our perception is that the FRC achieves a good deal with relatively limited resources. Both the latest iteration of the UK Corporate Governance Code and the recent Wates Corporate Governance Principles for Large Private Companies, which the FRC helped to coordinate, are positive developments for corporate governance in the UK.

However, we are not convinced that the 2012 restructuring of the FRC committee structure, which replaced multiple subject specific boards with a single decision-making body (i.e. the overall board of the FRC), has been a positive development in terms of encouraging accountability, transparency and stakeholder involvement. In our view, the earlier structure, with a specific committee with designated responsibility for the UK Corporate Governance Code, provided a clearer framework regarding the evolution of the Code.

The relatively opaque process by which the FRC makes changes to the Code was highlighted in the run up to the most recent edition of the Code, published in July 2018. The changes to this edition were the most substantial for many years. In the past, such a significant re-shaping of the Code might well have been undertaken by a Commission involving a broad spectrum of relevant stakeholders and experts (e.g. analogous to those led by Sir Adrian Cadbury in 1992 and Sir Derek Higgs in 2003). However, the latest revisions to the Code emerged as a result of a relatively opaque process from within the FRC. Although a consultation process was conducted, this appeared to have a limited impact on the final outcome.

As a result, we would like to see more transparency in the policy making process in respect of the UK Corporate Governance Code and related guidance. At the current time, we find it difficult to understand the relative roles and influence of various parties within the FRC. Although the FRC's board may claim to take ultimate responsibility, we believe that responsibility should be vested in a body that is more directly focused on the Code, and whose attention and accountability is not spread across a range of other areas.

We would not support the merging of the FRC's corporate governance functions into other regulatory bodies, such as the FCA, UKLA or a UK government department. It is important that the soft law codes (like the UK Corporate Governance Code, the Stewardship Code and the Wates Principles) are administered by an independent body with close links to business and investors.

If the codes were placed under the ambit of a conventional regulator, business would fear that this heralded a more legalistic approach which would undermine our much admired 'comply or explain'

governance framework. One of the inherent benefits of the UK corporate governance system is its avoidance of a regulatory-driven “one size fits all” approach. By allowing companies to adapt recommendations to fit the specific nature of their organisation, the Code in its current form allows for beneficial diversity in the governance of premium listed companies.

Proposal for a Corporate Governance Commission

We have for some time felt that locating the UK’s main corporate governance oversight body within the organisational structure of an accounting and actuarial regulator is not an ideal situation. The shaping of voluntary best practice for boards of directors, and the setting and enforcement of accounting standards are very different activities. Also, the current structure creates an unhelpful perception that UK corporate governance is simply an adjunct of the accountancy profession. In fact, if anything, the reverse is true – the accounting profession in its delivery of statutory audit is only one aspect of the broader UK corporate governance framework.

Something that might be considered in the medium term is locating corporate governance and investor stewardship activities within a self-standing Corporate Governance Commission, as in Germany. This might provide a better framework through which to ensure focus, transparency, accountability and wider stakeholder engagement on corporate governance issues. Accounting regulation would then take place in a separate regulatory body.

The German model of a corporate governance commission involves managing and supervisory board representatives of German listed companies and their stakeholders, i.e. institutional and retail investors, academics (economics, jurisprudence), auditors and a trade union federation. The members of the Commission are appointed by the German Federal Minister of Justice and for Consumer Protection. The Commission can submit recommendations for new members.

The Chairman of the Commission is appointed by the German Federal Minister of Justice and for Consumer Protection, too. He represents the Commission externally and coordinates the work internally. The Commission shapes standards of good corporate governance in the German Corporate Governance Code, which it reviews on an annual basis. The Commission develops the standards not only by internal discussions, but in dialogue with economy, politics and the general public.

IoD proposal: a professional framework for directors

Although not directly related to the remit of the FRC, we would also like to highlight a proposal that we have recently made to the BEIS and work and pensions committee report into the collapse of Carillion.

In this proposal, we argue for an industry led professional standards board tasked with upholding high standards of director competence and continuing professional development. In our view, this would be a more effective and proportionate way of enhancing director accountability in comparison with an option mentioned in your consultation document – namely, empowering the FRC to initiate direct legal action against directors for failing to fulfil their legal duties.

According to our proposal, an industry-led body would define a Code of Conduct applying to boards and board members of significant corporate entities, i.e. companies exceeding a certain size threshold or level of importance for stakeholders and the wider UK economy.

All persons joining the board of directors of a significant corporate entity would be required to sign up to the Code of Conduct. In cases where the conduct of an individual director (or board of directors) failed to live up to the standards prescribed in the Code of Conduct, the case would be reviewed by a panel of experienced business practitioners.

Based on the findings of the review, a public statement of censure or reproach could be issued in relation to the conduct of the director or the board. The possibility of such a reproach would serve to increase board-level responsibility and accountability due to its implications for the reputation and standing of affected persons.

In the most significant cases, the panel could recommend to BEIS that a director should no longer be permitted to serve as a board member of a significant corporate entity or that legal proceedings should commence which might lead to that person being disqualified as a director. In effect, the consequence of the bad behaviour would be that a person is “struck off” from serving in a similar role in the future.

In addition, directors that signed-up to such a professional framework would also be required to undertake a targeted programme of continuing professional development (CPD). We believe that this could exert a positive impact on the capacity of boards to make better decisions and enable them to better internalise the requirements of an increasingly complex business and regulatory environment.

Overall, we believe that such a professional framework of Conduct and Competency for directors could play a significant role in increasing the responsibility and accountability of boards of directors, both to their peers and society as a whole.

Furthermore, the new framework would represent significant progress in shifting the role of director (particularly that of non-executive director) away from that of “gifted amateur”, and more in the direction of competent professional with a practical understanding of fiduciary duties and responsibilities.

We hope that you have found our comments useful.

With kind regards

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