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Mr Mark Holmes
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Department for Business, Energy &
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11 June 2019

Dear Mark,

Independent review of the Financial Reporting Council - initial consultation on the recommendations

I am writing on behalf of KPMG LLP (KPMG), the UK member firm of the KPMG International network, in response to the Department for Business, Energy and Industrial Strategy's (BEIS) initial consultation (BEIS Consultation) on the recommendations made following the Independent Review of the Financial Reporting Council (FRC Review).

The recommendations made by the FRC Review are significant and provide the opportunity to establish greater clarity in relation to corporate oversight and rationalise the regulatory landscape for corporate Britain to reflect the changing nature and complexity of business and stakeholder interests. We appreciate the opportunity to comment on this important initiative.

We are generally supportive of (a) the recommendations of the FRC Review and (b) the proposals in relation to it set out in the BEIS Consultation (the Proposals).

In our response to the FRC Review's Call for Evidence, we set out four qualities that a strong and effective corporate regulator should demonstrate being (i) clarity of purpose; (ii) independence; (iii) ability to enforce; and (iv) authority and capability. We believe that the Proposals go a long way to achieving this. As BEIS considers the extent to which, and how, the Proposals might best be implemented, there are a series of considerations which we believe are critical. We address each of these in turn.

Balancing effective regulation and stimulating growth and investment

Firstly, new regulation must balance the protection of shareholders and others with a valid interest in company success whilst not stifling innovation, growth or the attractiveness of the UK for inward investment and as a destination for companies seeking to access the international capital markets. The UK regulatory regime needs to be seen as one which ensures confidence in the governance of and reporting by companies, but does not result in unnecessary expense or burden which puts the UK out of line with other jurisdictions if there is no obvious benefit. This should be an overarching consideration for BEIS when assessing the Proposals and how they are implemented.

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One particular aspect of this will be the consideration of whether, and if so how, to extend the definition of a Public Interest Entity (and the consequential implications of being classified as such). For example, the extent to which private companies are brought within this definition has potentially far reaching consequences.

Accountability for the success of corporate Britain

We consider that there are many parties with important roles to play in the success of corporate Britain - in particular the management and boards of companies, investors, auditors and regulators and there needs to be a fair division of responsibility and legal accountability between them.

At present there is an asymmetry in the respective responsibilities between these parties with the role and authority of the auditor often overstated, while the roles of the executive management and board are widely understated in the current framework. The FRC Review recognises this with proposals to expand the powers of the new regulator to individuals based on their roles, rather than simply whether or not they are members of professional bodies and we believe this is an important development.

Clear standards as a basis for assessing performance and holding to account

In order to ensure high standards of corporate governance and stewardship the standards against which performance will be judged need to be clear. This is the case at present with accounting and audit, but less so with governance and stewardship which are at present addressed largely through principles-based codes. It is important that there is clarity over the aspects of performance the new regulator is responsible for overseeing and then setting the standards that will apply with sufficient granularity to enable individuals to be held to account. The FRC Review recommendations fall short of proposing that a Sarbanes-Oxley type regime should be introduced but we believe that ultimately such a regime, reflecting the different context of the UK market, is important and should therefore be taken forward. Similarly whether other individuals, in addition to directors, should be subject to a regime along the lines of the Senior Managers & Certification Regime in financial services might be considered although such a regime sitting alongside a UK equivalent of Sarbanes-Oxley would be a significant change which would need careful implementation. We support the proposal to consider the need for and implementation of such regimes in more detail in particular taking account of the need for proportionality.

Proportionality is critical

At the same time the oversight and enforcement regime needs to be proportionate, focussing on protecting those who rely on company performance and reporting and seeking continuous improvement, rather than having an undue focus on punishment. We are advocates of the new regulator being an improvement regulator which we do not consider means that the regulator needs to be, nor should be seen to be, a “soft” regulator.

This proportionality is critical not just to ensure the appropriate balance between effective regulation and the continued attractiveness of the UK as referred to above, but also to ensure that individuals of a high calibre are encouraged to take on senior management, director or audit roles, rather than be deterred by consequences that are perceived to be disproportionate or unfair when there are issues.

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The FRC Review is only part of the picture

Alongside the FRC Review are a number of other important initiatives - namely the FRC's review of the future of corporate reporting; the BEIS Select Committee and the CMA's recommendations in relation to the audit market; and Sir Donald Brydon's Independent Review into the Quality and Effectiveness of Audit. Each of these is an important component in ensuring the success of corporate Britain and the Proposals cannot be considered in isolation. We consider that it is important that initiatives arising from each of these reviews are considered together to ensure that they are implemented in a consistent and complementary fashion. In deciding on which of the Proposals to take forward and how quickly this should be done, the immediate focus should be on those where implementation is independent of other initiatives which might be taken as a result of the other reviews.

International considerations

Particular consideration needs to be given to two international considerations. Firstly, the extent to which the regulator's powers (and the underlying requirements for companies, directors, auditors, etc) apply to overseas companies which are UK Public Interest Entities (for example, by virtue of being traded on the UK Stock Exchange). Exclusion of such entities may place UK companies at a disadvantage in terms of the additional burden that the FRC Review recommendations will impose, but on the other hand inclusion of such companies is likely to require specific implementation challenges which will need to be addressed.

Secondly, to the extent practicable, reforms should not position the UK as anything other than best practice. Care should be taken, for example, to ensure that UK accounting and auditing standards do not diverge from international versions to such an extent that they are not regarded as equivalent in other jurisdictions. This is particularly important at a time when the UK may be exiting the EU and the benefits that this brings in terms of mutual recognition.

The new regulator must be set up to succeed

We have some detailed observations on the proposed strategic objective (set out in response to Question 1 in the Appendix) but on any formulation it is clearly a very broad one which arguably covers every aspect of a company's operation. In that sense it will be a difficult one to fulfil with the danger that the ARGA falls short of public expectations. For example, it is unlikely that its market intelligence function and other activities identify all areas where intervention is desirable or necessary - one such area being the ARGA's role in preventing company failure. As the FRC Review notes, "*[t]he Review does not believe it would be practical or desirable to task a regulator with a general responsibility to ensure that even major companies are well-run and that failure could not occur*". We would not suggest that the ambition behind the objective should be diluted, but stakeholders - including BEIS and parliamentarians - need to understand and acknowledge the limitations of any regime if confidence in the ARGA is not to be undermined.

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Throughout this response we refer to the existing FRC, the FRC in transition or the Audit, Reporting and Governance Authority as the ARGA, notwithstanding our comments on the naming of the new regulator in response to Recommendation 3 in the Appendix (paragraph 4.3). References to the Financial Reporting Council (FRC) are to the historic activities of the FRC.

We have set out in the Appendix our responses to the detailed Questions included in the BEIS Consultation.

Please do not hesitate to contact me should you have any questions in relation to our response.

Yours sincerely

Bill Michael
UK Chairman and Senior Partner

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Appendix – Detailed Responses

CHAPTER 1 - FRC STRUCTURE AND PURPOSE

1 What comments do you have on the proposed objective set out in Recommendation 4?

1.1 We are very supportive of the ARGA as a body established by statute with a clearly defined statutory remit and powers, leading to an active, effective regulator that commands respect. Its strategic objective is a foundation stone of that. However, we believe that the draft strategic objective set out in Recommendation 4 is not yet clear enough to achieve that.

1.2 The strategic objective, as proposed, is "*To protect the interests of users of financial information and the wider public interest by setting high standards of statutory audit, corporate reporting and corporate governance, and by holding to account the companies and professional advisers responsible for meeting those standards*".

1.3 We have two key observations on this objective, firstly in relation to those who ARGA is seeking to protect and secondly in relation to the basis on which those who might be held to account, as well as a number of more detailed suggestions. We address these in turn in the following paragraphs.

ARGA's remit to protect

1.4 We note that the ARGA's remit to protect is focussed on "users of financial information": whilst this may encompass the ARGA's role in relation to company reporting and audit, it does not address its role in the context of promoting good corporate governance or responsible stewardship.

1.5 It may be that the FRC Review's intent is to emphasise that, as at present, shareholders are to be regarded as the primary users of financial information. This intent is suggested since "users of financial information" appears as "investors" in the version of the recommendation published in the summary on page 11 of the FRC Review. If this is the intent, which we support, we would favour the articulation of the objective by reference to "investors" since "users of financial information" places undue emphasis on "financial" rather than "non-financial" information which is likely to also be of importance to investors and which Recommendation 29 would bring within ARGA's remit. Whilst this may appear to be a "narrow" responsibility, the subsequent reference to "public interest" or similar term (see paragraph 1.12.1 below) addresses this.

1.6 Alternatively, it may be that the responsibility is intended, logically, to be based on the existing requirements in company law - namely that those to be protected are the members of the company as a whole, but having regard to other matters as set out in s172 of the Companies Act 2006. Even if this might be difficult to

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encapsulate in a single statement, if this is the intention it should be clear from the broader articulation of the ARGA's functions and duties.

1.7 If some other responsibility is intended, then this needs to be clear, but consideration would also need to be given to any changes to company law (the fundamental duty and accountability of companies to their owners) to achieve this. In turn this would have additional considerations as to the questions of who the intended beneficiaries were and the responsibilities of the company and its directors / management to those parties. This would be a much broader question and require much wider debate to precede any fundamental change in law.

Holding to account

1.8 In order for the ARGA to "hold to account", the standards against which performance or behaviour will be judged must be clear and sufficient.

1.9 In relation to clarity, the correct place to start may be to identify the specific laws and regulations in point and to draft the objectives for the ARGA around that (accepting that an objective will always be drafted in broad rather than precise terms). In certain areas this may already be clear - for example in relation to corporate reporting and auditing where there is a statutory requirement for true and fair accounts and for an audit to give an opinion on those accounts. However, in other areas further clarity would be required. For example, it may be that the ARGA's corporate governance object would flow from the proposition that it would regulate compliance with the law on directors' duties. If this is the intention then the ARGA would be taking on the role of developing interpretations of that law or alternatively to make rules to implement the duties at a more detailed level. Clarity is therefore required on whether the ARGA is to be regarded as, in effect, making law or simply setting standards to enable the implementation of law.

1.10 In relation to sufficiency, key areas which the ARGA has responsibility for are currently addressed via codes - specifically the Stewardship Code and the UK Corporate Governance Code. In these areas, the principles-based nature of the codes nature makes it more difficult to hold organisations and individuals to account other than for the most egregious breaches and moving from "comply-or-explain" to "comply" would be a major cultural shift. On the other hand, it would be possible to bolster elements of these codes with more detailed standards (for

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example in relation to internal controls, as we comment on in paragraph 8.18 below).

1.11 Whilst it is important that the ARGA should have adequate powers to hold all individuals with defined responsibilities to account, we also believe that it should focus on seeking improvement, as we explain in paragraph 7.22 below.

Other observations on the strategic objective

1.12 In terms of our more detailed, but nevertheless we believe important, observations:

1.12.1 The term "public interest", although in commonplace use, is neither defined nor widely understood and means different things in different contexts. We note that the consultation on the Stewardship Code refers to "the economy and society"[1] and the UK Corporate Governance Code refers to "contributing to wider society"[2]. We would suggest that the latter is preferable.

1.12.2 The objective omits any reference to investors. Given the critical role they play, and the responsibility of the ARGA for the Stewardship Code and its ownership, we believe this should be referenced explicitly.

1.12.3 We would re-order the activities for which high standards are to be set to reflect the sequence and order of responsibilities - therefore with corporate governance before corporate reporting and finally audit.

1.12.4 Whilst companies are referenced as being accountable, there is no reference to the driving force behind companies - ie management and directors. Given that the FRC Review is elsewhere clear that there should be an ability to hold all individuals to account regardless of whether or not they are members of a professional body, we consider that they should be explicitly referenced to emphasise individual and collective responsibilities.

1.12.5 The objective contains no reference to auditors. We assume that the inclusion of "professional advisors" was intended to capture auditors, but auditors are not professional advisers in the context of their relationships with audited entities, and this should be made clear.

1.12.6 Whether reference to "professional advisers" remains within the strategic objective depends whether BEIS considers that there are others (be they tax advisors, lawyers, corporate finance advisors, actuaries, etc) who the ARGA should be able to hold to account. At present, advisers cannot be held to account for the company's compliance with requirements applicable to the company, as drafted, but only for requirements applicable to their giving of advice to the

[1] Introduction to *Proposed Revision to the UK Stewardship Code Annex A - Revised UK Stewardship Code.*
[2] Principle A of the *UK Corporate Governance Code 2018*.

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company. Therefore, whilst these advisors are important for companies and their management, bringing them within the range of activities for which the ARGA is responsible would require specific responsibilities to be defined in law (or through regulation) and standards by which their performance would be assessed to be established and further increase the scope of the ARGA's responsibilities and work.

Our suggestion for the strategic objective

1.13 Our suggestion would therefore be that the strategic objective should be: "*To protect the interests of investors ~~users of financial information~~ and to contribute to wider society ~~the wider public interest~~ by setting high standards of corporate governance, corporate reporting, stewardship and statutory audit, ~~corporate reporting and corporate governance,~~ and by holding to account the companies (and their management / directors), auditors, investors and professional advisers responsible for meeting those standards*".

2 What comments do you have on the duties and functions set out in Recommendations 5 & 6?

2.1 We agree that the functions and duties of the ARGA should be defined.

2.2 In so far as the functions of the ARGA in Recommendation 6 are concerned, it would appear to us that these could be streamlined: the "functions" of the ARGA are, in each of the areas of stewardship, corporate governance, accounting and reporting and audit, to (i) set codes and standards, (ii) monitor compliance with them; (iii) take appropriate enforcement action when necessary and (iv) report on its activities and the success thereof in achieving its strategic objective. As currently articulated in Recommendation 6, we would suggest that:

- it is not clear on the difference between the first bullet (setting high standards) and the third bullet (maintaining and promoting codes);
- the third bullet (maintaining wide and deep relationships with investors) is more in line with the "duties" set out in Recommendation 5 rather than the "functions" of the regulator; and
- some of the functions (eg the fifth and sixth bullets) are somewhat selective in the aspects of the ARGA's proposed operations, arguably giving undue prominence to these specific activities and / or diminishing the importance of those not highlighted here.

2.3 In so far as the "duties" set out in Recommendation 5 are concerned, these are a combination of "modes of operation" (eg to be forward looking, proportionate, etc) and "intended outcomes" (promoting competition in audit, promoting brevity, comprehensibility and usefulness in corporate reporting, etc). Whilst we do not disagree with any of the points listed, we note that there is no reference to promoting responsible stewardship which we consider should be included. In

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addition, further consideration might be given to whether some form of sub-categorisation is appropriate. We have commented on certain of the individual "duties" in our responses to other questions below in the remainder of this Appendix.

3 How do other regulators mitigate the potential for conflict between their standard setting roles and enforcement roles as set out in Recommendation 14?

3.1 We agree with the FRC Review that there are "*valuable synergies in the same regulator developing and enforcing standards*"[3].

3.2 We have not undertaken a review of other regulatory regimes to understand how, currently, other regulators mitigate the potential for conflict although we make some observations in the following paragraph.

3.3 The separation of (i) standard setting, (ii) oversight and monitoring and (iii) enforcement activities in the detailed architecture of the ARGA should help avoid the risk of a single body being "judge and jury". However, conversely there is a risk that this is undermined by the recommendation of the FRC Review that the board of the ARGA should launch investigations, not just in the launching of the investigation but, potentially, in resulting in a pre-disposition for the enforcement team to "find issue" with the subject matter and pursue an enforcement action beyond where it would otherwise have done. The criteria and process for launching investigations is currently defined and it is not clear why the board of the ARGA should have a right to direct a course of action if following the normal apparatus for determining that an investigation should be launched has concluded that it should not be. That should not stop the Board exercising appropriate oversight, for example understanding the rationale behind a decision not to launch an investigation and ensuring that all relevant considerations have been taken into account.

3.4 We agree that the Board should receive regular reports from the enforcement team and provide challenge where it considers that investigations are taking too long.

3.5 Finally, we note the recommendation refers to the board to take decisions in relation to "audit" investigations: it is not clear why the board's intervention should only be in relation to audit matters rather than any other enforcement activities of the ARGA and we would suggest that this could be rectified by deleting "audit" or

[3] FRC review paragraph 1.32.

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otherwise making clear of the board's responsibility in relation to investigations more generally.

4 Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

Establishing a new regulator - Recommendations 1 (Category 3), 2 (Category 1) and 3 (Category 2)

4.1 In our response to the FRC Review's Call for Evidence we expressed the view that "*the regulator should be put on a statutory footing with statutory independence, accountable to Parliament*" and we therefore agree that the FRC should be replaced by a new independent regulator with clear statutory powers and objectives (Recommendation 1).

4.2 In principle, we accept that a remit letter from Government, at least once during the lifetime of each Parliament (Recommendation 2), may be appropriate. However, we note that the recommendation of the FRC Review is that the remit letter should set out "*those aspects of economic policy that the regulator should have regard to when advancing its objectives and discharging its duties*". Arguably this carries some risk that the ARGA loses independence in fulfilling its strategic objective which is subjugated to the pursuit of Government policy. For example, an economic policy initiative to increase choice in the audit market may be to the detriment of audit quality; or an initiative to reduce the cost of regulation to business may result in lower standards being applied by participants in the capital markets more generally. It would therefore be sensible to make explicit in the drafting of any requirement that to "have regard" to economic policy does not require the ARGA to pursue initiatives which are inconsistent with its strategic objective.

4.3 We would suggest that BEIS reconsiders the name of the new regulator. The recommendation of the "Audit, Reporting and Governance Authority" (Recommendation 3) gives undue prominence to "Audit" and does not reflect the sequential nature of activities (audit being the "third line of defence") for which the new regulator would have responsibility. We would suggest that the order therefore be reversed with the name being the "Governance, Reporting and Audit Authority". For completeness, "stewardship" might also be included (ie the "Governance, Reporting, Audit and Stewardship Authority") to recognise the important role of investors.

Board of the new regulator - Recommendations 7-10 (Category 1)

4.4 We agree with the recommendations (Recommendations 7-9) relating to the skills, capabilities and experience requirements for members of a new board of

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the ARGA with extended responsibilities and powers, the need for strong leadership and for board appointments to be approved by the Secretary of State.

4.5 In relation to Recommendation 10, we consider that appointments to the Board should be regarded as public appointments and therefore subject to the Governance Code on Public Appointments and oversight by the Commissioner for Public Appointments. In terms of approval by the Secretary of State for BEIS as recommended by the FRC Review, consideration might be given as to whether one or more non-executive appointments should be subject to joint (or separate) approval with HM Treasury given the far reaching responsibilities of the ARGA (including, for example, a role in relation to economic policy as discussed in paragraph 4.2 above). Such a model of joint approval applies to certain roles at the Financial Conduct Authority[4].

4.6 We note that Recommendation 12 is that the appointments of the Chair of the Board of the ARGA and its CEO should be subject to confirmation hearings with the BEIS Select Committee (we assume the intent being to require application of the Cabinet Office Guidance on pre-appointment scrutiny[5] to these roles). Whilst this would be appropriate for the Chair of the ARGA, we consider that pre-appointment scrutiny of the the CEO should be considered further. In that context, we also note that paragraph 9 of that guidance states that "In most instance, such posts will be the chair of the board of an organisation or individual office….." and that Annex D to the guidance lists only a single role any individual organisations as being subject to pre-appointment scrutiny. We agree with BEIS' approach of seeking to appoint the new Chair, Deputy-Chair and CEO of the ARGA at an early date to enable more significant recommendations to proceed in advance of the formal establishment of it.

4.7 However, it is not clear whether detailed consideration has been given to the time commitment expected of board members in order to be able to discharge their responsibilities diligently and whether this time commitment would be compatible with holding (one or more) other, possibly significant, roles. In our submission to the FRC Review's Call for Evidence, we suggested that consideration be given to the appointment of a small number of full time commissioners, similar to the structure adopted for the US' Securities and Exchange Commission. Aside from ensuring that the relevant individuals had sufficient time available, this would also ensure that any perception that individuals might have a conflict (by virtue of holding executive or non-executive roles with companies subject to regulation by

[4] Section 2(2)(d) of Schedule 1ZA to FSMA2000 provides that 2 members of the governing body of the FCA must be appointed jointly by the Secretary of State and the Treasury.
[5] *Cabinet Office Guidance: pre-appointment scrutiny by House of Commons select committees* (January 2019)

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the ARGA) would be avoided. We recommend that BEIS give further consideration to this model.

Board appointments, structures and roles - Recommendations 11 and 14 (Category 2) and 12-13 (Category 1)

4.8 We have commented on Recommendation 14 in response to Question 3 above and Recommendation 12 in paragraph 4.5 above.

4.9 We support the other recommendations, but consider that it would be sensible to consult on the detail of how certain of these will be implemented. For example the simplification of the architecture envisaged in Recommendation 13 depends in part on the full range of responsibilities ultimately ascribed to the ARGA and, therefore, it may not be appropriate to define the underpinning architecture until these questions have been resolved.

4.10 As a small point of detail, it is not altogether clear to us why Recommendation 11 falls into a different category to Recommendations 7-10 and 12-13.

CHAPTER 2 - FRC EFFECTIVENESS OF CORE FUNCTIONS

5 How will the change in focus of CRR [Corporate Reporting Review] work to PIEs [Public Interest Entities] affect corporate reporting for non-PIE entities?

Corporate Reporting Reviews - Recommendations 24 (Category 1), 25-26 (Category 3) and 27 (Category 2)

5.1 We agree that the Corporate Reporting Review activity should be increased (Recommendation 24) on a risk assessed basis, potentially being informed by the ARGA's market intelligence function to assess risk. Whilst companies for review might be selected on a risk basis, there should be a frequency within which each PIE must be reviewed: that frequency will depend on an assessment of the cost / benefit, but we consider that the five yearly frequency is sufficient where there are no heightened risk factors identified. The thematic activity is useful and should continue, being informed by the ARGA's market intelligence activity (see paragraph 8.3 below) to ensure that the output of thematic reviews is available on the most timely basis.

5.2 We also agree that the ARGA should have the power to direct changes to accounts (Recommendation 25) but we would suggest there needs to be a mechanism for companies to appeal the decision of CRR if it disagrees, possibly by reference to an expert panel (for example the existing FRC Financial Reporting Review Panel, assuming that panel had not been involved in the initial decision, or a separate tribunal). We anticipate that companies would only take such a

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course of action rarely and if they - and presumably the auditor - considered the direction by the ARGA to be unreasonable.

5.3 Two further practical considerations arise. Firstly, at present both the FRC in relation to PIEs and the Secretary of State (under administrative law Companies House exercises his power) have the power to apply to court for an order to revise the accounts (the FRC and the Secretary of State having agreed that the FRC will confine itself to PIEs and certain other companies and the Secretary of State will cover the rest). By extension, if the ARGA has the power to direct such a change without reference to the court, consideration should be given as to whether the Secretary of State should have similar powers in relation to other companies. At the same time, this would raise the question as to whether Companies House would have the requisite expertise on accounting matters to direct such a change (albeit one solution would be for Companies House to request the ARGA to look into a specified set of accounts).

5.4 Secondly, at present the basis for directing a change to the accounts is that the accounts do not comply with the Companies Act 2006 (CA2006) (s456). Since the preparation of defective accounts is currently a criminal office (under s414(4) CA2006), consideration may therefore need to be given to de-criminalising the act of preparing defective accounts, as it seems unreasonable for a civil regulator to be making *de facto* judgments as to criminal offences.

5.5 In relation to the publication of "full correspondence following all CRR reviews" (Recommendation 26), whilst in favour of transparency we would suggest that it would be more appropriate for the ARGA to publish a summary of the issue and its resolution rather than the "full correspondence" which may well be extensive. We consider that a summary (i) is likely to be of greater use than the detailed correspondence, (ii) reduces the potential for individual elements of the correspondence to be taken in isolation / out of context and (iii) allows for considerations relating to price sensitive or otherwise commercially confidential information to be dealt with appropriately. We would not see that the preparation of such a summary should result in any undue delays in its publication.

5.6 As BEIS identifies, the recommendation that the ARGA's CRR activity be limited to PIEs (Recommendation 27) potentially creates a gap in oversight for non-PIEs. Recent experience has shown that there is a valid interest in the corporate reporting of companies which are not currently within the definition of a PIE - for example Patisserie Valerie (an AIM-listed company) and BHS (unlisted). The extent and significance of any gap would depend on any revisions to the definition of a PIE pursuant to Recommendation 18 of the FRC Review (see paragraphs 7.8 - 7.9 below).

5.7 In addition to taking account of any changed definition of a PIE, when considering whether or not to exclude non-PIEs from the scope of the ARGA's CRR activity,

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BEIS should take into account the views of shareholders in non-PIEs and being conscious of what it would be leaving out of any such regime.

5.8 One alternative would be to give another body the power to look into non-PIE accounts, although it is not obvious which body would take on such a responsibility and, if it no such body was identified leaving the only alternative to be establishing a new body specifically for that purpose, then leaving the responsibility with the ARGA would appear to be the sensible option.

5.9 If excluding non-PIEs is the eventual decision, then, in addition, we consider that the Secretary of State should have the right to require the CRR to look into a specified set of accounts etc (see our comment on Recommendation 25 at paragraph 5.3 above).

6 What are your views on how the pre-clearance of accounts proposed in Recommendation 28 could work?

6.1 We agree with the FRC Review that more can be done to help companies which want assistance in relation to accounting treatments, presentation and disclosure and we therefore support the introduction of a pre-clearance process. The challenge will be how to achieve this in a way that (a) does not undermine primary accountability for accounting and disclosure judgements or result in excessive use of a pre-clearance process "to be on the safe side" and (b) ensures the avoidance of delays in release of information by the company, which might unsettle shareholders. Other regulators, such as the US Securities and Exchange Commission, already have such regimes which actively encourage companies and their auditors to consult with the Office of the Chief Accountant (OCA) on accounting, financial reporting, and auditing concerns or questions[6].

6.2 As a practical matter, the ARGA will need to set out how the process will operate. We believe that any pre-clearance request should be accompanied by detailed documentation from the company setting out the facts, the analysis of the issue and alternatives considered and why the proposed course of action is the preferred one. It may also be sensible to have a published policy for the typical timescales for a review leading to pre-clearance, albeit acknowledging that the timescales for any particular case would be dependent on its particular circumstances. Whilst we would expect companies to approach the ARGA at an early stage, the process should allow, on an exceptional basis, for requests late in a company's reporting timetable so that the issue can be dealt with wherever possible without delays in planned publication dates.

6.3 As the FRC Review acknowledges, any pre-clearance process requires access to expertise and sufficient capacity. On the former, it seems unlikely that the ARGA would be able to secure expert resource in-house to cover every possible subject area. It follows that this resource may or will need to be provided

[6] See https://www.sec.gov/page/communicating-oca.

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externally from a panel of experts (potentially the existing FRC Financial Reporting Review Panel).

6.4 A further consideration relates to the involvement of the auditor in any pre-clearance process and whether the company's assessment of the matter (see previous paragraph) should include the views of the auditor. Clearly these views should be relevant and we believe that the auditor should therefore be involved in the pre-clearance process. This will also reduce the possibility that the auditor disagrees with the outcome of the pre-clearance process. However, it should be clear that the inclusion of the views of the auditor (assuming that they coincide with the company's, as discussed in the following paragraph) does not amount to advocacy by the auditor on behalf of the company's proposed treatment.

6.5 In practice, it seems likely that a company might approach the ARGA in two scenarios: firstly, where the company and its auditor are in agreement, but where they share the view that the course of action proposed is unclear by reference to accounting standards or other requirements and secondly where the auditor has questioned the company's proposed treatment (suggesting that an alternative is more appropriate) and the company disagrees with the auditor's view. In the latter case, involvement of the auditor will ensure that the FRC has been made aware not only of the auditor's disagreement but also of all the facts known to the auditor and therefore that professional requirements on second opinions (presumably applicable to relevant individuals at the ARGA) are followed.

6.6 In forming its view, the ARGA should be required to take account of any international interpretations which may be relevant. For PIEs, the relevant standards (IFRS) are set by an international body (the IASB) and are interpreted by it too. We consider that it would not be in the interest of shareholders – remembering that shareholders in UK companies invest around the world – if different national interpretations of IFRS develop. In addition, if the UK takes the step of establishing regulator-backed UK interpretations of IFRS then other national regulators may follow, giving rise to an increasing divergence of practice and undermining the benefits of global consistency.

6.7 Consideration should also be given as to whether any correspondence in relation to pre-clearance should be regarded as confidential. We consider that it should be.

6.8 On the question of whether any pre-clearance service should be subject to a fee, if the fee is intended to discourage over-use of the pre-clearance procedure, we would hope that this would be unnecessary. More importantly, we consider that this introduces a commercial element to the process which may be unhelpful or, over time, result in an actual or perceived conflict of interest for the ARGA. Our view is that there should not be a fee for this service.

6.9 Finally, we would suggest that a pre-clearance regime could be progressed as a Category 1 matter. The question of legislation would appear to be one of whether

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a view provided in the pre-clearance process has a status in law, but we have not identified any reason as to why the ARGA might not express its view on a proposed treatment in advance of any decision relating to legislation.

7 Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

Audit regulation - Recommendations 15-16 (Category 2) and 19 (Category 3)

7.1 We consider that the consequences of reclaiming the approval and registration of audit firms conducting PIE audits from the RSBs need to be fully thought through before taking a decision on whether to proceed with this recommendation (Recommendation 15), particularly as it is not clear that any of the RSBs has not taken account of the FRC's views when approving or registering the relevant firms. There are two more obvious points to address here.

7.2 Firstly, if this power is only in relation to audit firms conducting PIE audits, then those firms are likely to have to seek approval by and registration with more than one body for the same activity (audit) which is unlikely to be efficient (since we assume a separate approval / registration would also be required as an auditor of entities other than PIEs).

7.3 Secondly, any dual registration requirement might deter some firms, at the margin, from participating in PIE audits which would potentially reduce choice of audit firms at a time when the extent of choice is a key concern of certain stakeholders. This might be exacerbated as a result of any extension in the definition of a PIE (which will potentially extend the number of audit firms which the ARGA would be required to consider the approval and registration of).

7.4 An alternative to reclaiming these activities might simply be to give the ARGA a power to require the RSBs to impose conditions on the relevant audit firms (which might include a condition that such firm could not undertake audits of PIEs) when considering approval / registrations of such firms. However, this alternative would not be without issue for example, as the RSBs would presumably then be faced with the prospect of defending any legal challenges by an audit firm to any denial of registration / conditions imposed when this was outside of the RSBs control: the question of funding the costs of defending such challenges would then arise.

7.5 Similarly, whilst we agree that the approval and registration process should not be a simple "yes or no" question, and therefore other sanctions (or, rather, conditions of approval / registration) should be available (Recommendation 16), the process by which such conditions are established need to be both transparent and fair. We would suggest that it would not be equitable for conditions, which might be equivalent to non-financial sanctions imposed as a result of an action under the Audit Enforcement Procedure, to be imposed without the agreement of

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the relevant firm if it has not had the same opportunity to put its case as it would have had under the enforcement regime.

7.6 In relation to Recommendation 19, whilst we agree that the AFMAS approach might be put onto a statutory basis, we would note that we are unaware of any instance where a request by the FRC has been resisted. We agree that, as with all of the work undertaken by the ARGA, the monitoring activity should be undertaken by individuals with the appropriate skills and experience.

Audit expectations and the public interest - Recommendations 17 (Category 1) and 18 (Category 3)

7.7 We are very supportive of the Recommendation (17) to explore the issues arising from the audit expectation gap. We consider that this is the moment to revisit the purpose of audit so that it better meets the needs of those who use it today. We welcome Sir Donald Brydon's review which is, *inter alia*, considering this and we have submitted a detailed response to his Call for Views. In that response we suggest there are areas where (provided there is demand from users) the scope of audit, the assurance it can offer, and corporate reporting more widely could be expanded. But this would need a proportionate and workable approach to liability, to ensure a fair division of responsibility and legal accountability between various parties in the corporate reporting ecosystem: companies and their management/directors, investors and auditors. We have also highlighted a number of areas where auditing standards need to be enhanced, for example to reflect the impact of technology on the audit process. In addition, a number of ISAs can be difficult to apply to a consistently high quality and we believe that the ARGA should, as a priority, make changes and / or influence the IAASB to make changes that will support enhanced audit quality.

7.8 We welcome the recommendation that the definition of a PIE should be reviewed (Recommendation 18). The starting point should be considering what characteristics are important, and why. At present categorisation as a PIE is largely a consequence of a company's shares being traded on an EU regulated market (recognising that the potential for the interests of management of a company to diverge from those of its shareholders and this risk being greatest when share ownership is widely dispersed)[7]. However, this creates anomalies - for example in the treatment of entities whose securities are listed on unregulated markets (such as the Alternative Investment Market) where there may also be wide share ownership. At the same time, whilst the focus on listing status and widespread share ownership reflects the focus on financial statements as a tool for shareholders, it does not necessarily reflect the significance of a company to others or to whom the directors of a company may need (under s172 of the Companies Act 2006) to have regard - be they employees, customers, suppliers or other stakeholders. On the other hand, it might be argued that some companies which are listed are too small to be of significant public interest and we would

[7] Certain credit and insurance undertakings are also PIEs.

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expect the size of the company, particularly when considering widening the definition, to be one of those criteria, to ensure proportionality. Being clear on these criteria is essential, and an entity should not just be regarded as a PIE because it is "a household name" to the public.

7.9 The consequences of widening the definition of a PIE need to be thought through fully. The FRC Review notes (at paragraph 2.41) that the "*scope of the FRC's corporate reporting review work and its separate audit quality review regime is not aligned……The Review does not believe that this difference makes sense: either there is a public interest in an entity's accounts and its audit or there is not*". We would agree with this sentiment but also recognise that extending the definition of a PIE will increase not only the number of companies which might be subject to oversight from a governance and corporate reporting perspective, but also increase the population of audits and audit firms that may be subject to review with corresponding implications for the ARGA's skills and resource requirements.

Audit Quality Reviews - Recommendations 20 (Category 3) and 21-22 (Category 1)

7.10 We are supportive of increased transparency around the outcomes of the inspections (Recommendation 20). We support the immediate step of providing anonymised (and probably summarised) reports, although again the ARGA will need to give very careful consideration to the form of these reports and the language used to prevent unintended reactions. We also consider that there would be merit in ARGA being explicit about whether any deficiencies identified in the audit call into question either the audit opinion or the accuracy of the financial statements and being explicit where this is not the case. However, we are more cautious about the publication of un-anonymised reports which, as far as we are aware, is a practice not adopted by other audit regulators around the world. Whilst this might increase transparency, before implementing such a regime careful consideration should be given to the form of reporting which would need to take into account (i) the need for audit committees of audited entities to be fully aware of the details of the inspections' findings, (ii) genuine concerns in relation to the price sensitivity of confidential information and (iii) the needs of a wide range of potential readers and commentators. Developing a summary suitable for public consumption and a fuller version for audit committees might be a workable solution.

7.11 In relation to how the ARGA considers the quality of audit work conducted in relation to overseas components by non-UK audit firms (Recommendation 21) we consider that, wherever possible, inspection of component audit work conducted overseas is carried out in conjunction with and/or through a mechanism of mutual recognition by the local regulator and that the primary evidence should consist of inspection of the work undertaken by the UK based group audit team in using the overseas audit work to support its opinion on the Group accounts. However, the

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ARGA should have the power to conduct additional work where it considers that the work of the overseas regulator has been insufficient.

7.12 We are supportive of the AQR inspection regime as a contributor to audit quality in the UK and believe that this would be strengthened by including more experienced inspection staff as outlined in Recommendation 22. We are pleased that this is proposed as a Category 1 recommendation and therefore a high priority for the ARGA as we consider that it will most quickly make a significant difference.

Wider role on corporate reporting - Recommendations 23, 29 and 31 (Category 1) and 30 (Category 2)

7.13 We agree that it is desirable for accounts and annual reports to be both concise and comprehensible (Recommendation 23). We do however question how easy this will be to achieve in practice given that the length and complexity of annual reports and accounts remains a concern notwithstanding the FRC's previous work in this area[8].

7.14 We also agree that the ARGA should provide a periodic report to BEIS on the extent to which the statutory reporting framework is serving the interests of users of company reports and make recommendations for improvement. A pre-requisite of this is clarity on which "users" are required to be satisfied by the content of such reports, recognising that it is unlikely that all needs can be satisfied: it is difficult to be all things to all people whilst seeking to achieve objectives of conciseness and comprehensibility.

7.15 The above objective may be assisted if the ARGA has responsibility for all areas of corporate reporting recognising that at present, as the FRC Review identifies, the areas subject to the FRC's control are limited in relation to aspects of the UK Corporate Governance Code (in the main it is the Listing Rules' requirement to disclose how and whether the company has complied etc). The strategic report, directors' report, directors' remuneration report and IFRS disclosure requirements are all outside of the FRC's control.

7.16 We agree that it is unsatisfactory that the whole of the annual report is not subject to regulatory oversight and that any new responsibility in this area that would naturally fall to the ARGA. We are therefore supportive of extending ARGA's responsibilities to cover the entire annual report (Recommendation 29) albeit there are two implementation issues to address.

7.17 First, whether regulation means not only enforcement but also rule-making, and this may vary between different statutory components of the annual report. For example, the existing case with accounts is that rule-making is in IFRS (for listed

[8] For example, *Guidance on the strategic report* (July 2018); *Clear and concise: developments in narrative reporting* (December 2015); *Clear and concise: the journey to high quality corporate reporting* (January 2015); *Cutting clutter* (April 2011).

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companies), outside of the ARGA's remit, but monitoring does fall to the ARGA; and we do not suggest changing this. However, each statutory component of the annual report needs to be considered and decided upon, eg would BEIS wish the ARGA to make rules about the content of directors' remuneration reports as well as enforce the rules, or not?

7.18 The second issue concerns the non-statutory components of the annual report, the content of which are not the product of any legal requirement. Thus in order to be regulated they need to be subject to some requirement. Our assumption is that this would have to be some form of negative requirement or restriction, eg that they do not contain anything false or misleading in a material particular. However, there may well be some existing requirement to that effect in financial markets regulation, which the FCA is charged with enforcing. If so, a decision is required as to whether that stays with the FCA, and be more actively enforced, or move to the ARGA; but regulatory overlap should be avoided.

7.19 Similarly we are supportive that the ARGA's oversight should extend to certain wider communications beyond the annual report (Recommendation 30). On this, we consider that the question is more about which communications should subject be to regulatory oversight rather than whether ARGA's role should be extended. A key consideration will be ensuring the avoidance of duplication with the FCA, but it would not appear to be sensible to have different communications which may contain similar information to be subject to scrutiny and, potentially, enforcement actions by different bodies.

7.20 We agree that guidance and discussion documents should only be produced and issued if useful to relevant stakeholders (Recommendation 31) - but that is not to say that every document would or should be useful to all stakeholders. Different stakeholders may have different needs. For example certain material may be published in detail (for example Audit Quality Review reports for individual audit firms) and summarised in the annual Developments in Audit publication. In addition, given the significant changes which might result from current changes - whether from the FRC Review itself, changes in the Stewardship Code, potential revisions in relation to a company's consideration of risk management, control and viability reporting and changes in the audit market - more, rather than less, guidance may be necessary to help ensure a consistently high standard in the areas covered by those changes, at least in the short term. This may be an area where the board of the ARGA can play a role - standing back from the detail - in challenging whether planned publications (and the underlying work) will be genuinely valuable, with regular feedback from stakeholders being obtained to inform such views. Of course, anything that can be done to ensure that such

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documents are only as long as they need to be would be welcomed by all stakeholders.

Enforcement - Recommendations 32-33 (Category 1) and 34-38 (Category 3)

7.21 We agree that it is important that auditors, accountants and directors should be held to account where necessary. Related to this is the question of whether other individuals in senior roles in companies, such as senior management not holding the position of director, should also be required to comply with particular standards equivalent to those which apply to senior managers in the financial services' sector[9]. In this case, care would be needed to ensure that individuals were not subject to multiple, potentially duplicative or contradictory, requirements defined and applied by different regulators. However, enforcement needs to be fair and proportionate and not create an environment where individuals become unwilling to take on responsibilities, or companies are deterred from investing or listing in the UK, because of an overly hostile enforcement regime. We note that, in so far as auditors are concerned, "the primary purpose of imposing sanctions for breaches of the Relevant Requirements is not to punish, but to protect the public and the wider public interest"[10]. Such a principle should apply to all enforcement activity undertaken by the ARGA.

7.22 A key element of protecting the public interest is ensuring that lessons from issues are learned and not repeated. We therefore welcome the FRC Review's agreement that the ARGA should be an improvement regulator and agree that this does not mean it should be a soft regulator[11]. The FRC Review highlights that analogies have been made with the CAA as an improvement regulator but asserts that there are strong commercial incentives "*not to allow aeroplanes to fall out of the sky*" but that the "*commercial pressures on auditors to pursue stringent, challenging and high-quality auditors are much weaker than this*". This is clearly a matter of judgement, but we would observe that the financial consequences of any sanctions and reputational damage are borne by the owners of the business - shareholders in the case of airlines or aeroplane manufacturers and partners in audit firms. We would suggest that the ownership interest of the partners in audit firms (who also manage those firms) provides a stronger commercial incentive to ensure audit quality than the FRC Review gives credit for.

7.23 The FRC Review highlights the views of respondents to its Call for Evidence of a "*significant and positive shift in the FRC's approach*" (since the introduction of the Audit Enforcement Procedure (AEP)) without commenting on either whether there has, in fact, been a shift in approach and, if there has, whether it is a positive one. The FRC Review notes that it has "*been struck …… by the apparent respect of the major audit firms for the tougher approach of the PCAOB and the benefits this*

[9] Senior Managers & Certification regime pursuant to the Financial Services (Banking Reform) Act 2013.
[10] FRC Sanctions Policy (Audit Enforcement Procedure), para 12.
[11] Page 22

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has brought"[12]. At the same time it highlights the very marked difference between the numbers and significance of sanctions for audit failures imposed by the FRC and the PCAOB[13], notwithstanding that there is no evidence that there are significant differences between audit quality in the UK and the US. Given that the level of public confidence in audit appears lower in the UK than in the US, it might be questioned whether the enforcement approach in the UK is appropriately focussed.

7.24 We therefore agree that the ARGA's board and the Government should monitor enforcement performance, that this should be reported on in the ARGA's Annual Report and that the ARGA should be held accountable by Parliament (Recommendation 32). This should be a key principle behind all enforcement and the board of the ARGA should have a role in ensuring that its enforcement activities reflect this purpose in practice. This should include consideration of whether the enforcement actions of the ARGA are both sufficient and proportionate but in line with the strategic objective rather than for punishment and in the pursuit of improvements as we set out above.

7.25 In relation to publication (Recommendation 33), we suggest that the publication policy in relation to matters which do not result in adverse findings or tribunal proceedings should be aligned with that in relation to that of the annual inspection results, namely that sufficient details of the issue should be provided but that these should not be linked to a particular company or named individual.

7.26 We commented in paragraph 7.11 above that, in our view, the ARGA should have the power to conduct additional work where it considers that the work of the overseas regulator has been insufficient and we agree that the ARGA should have the powers to conduct enforcement action against overseas auditors (Recommendation 34) where appropriate.

7.27 As the FRC Review recognises, the current system is unbalanced in that the mechanism for holding to account is limited for individuals who are not accountants, and that even for accountants there is not a level playing field with the threshold for sanction being the "breach of a relevant requirement" for auditors of PIEs under the AEP and for "misconduct" for accountants under the Accountancy Scheme.

7.28 Recommendations 35-37 propose:

- the alignment of the Accountancy Scheme with the AEP and that the revised arrangements should be on a statutory basis;
- the development of an enforcement regime to hold the chair, CEO, CFO and Audit Committee chair of PIEs to account for their duties to prepare true and

[12] Page 22
[13] Figure 7, page 40

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fair accounts, compliant corporate reports and to deal openly and honestly with the auditor; and

- the regime for non-member directors to follow the principles of the AEP and that the ARGA should set out the "relevant requirements" that directors are individually accountable for.

We are supportive of a single regime, or regimes which are based on common principles (and established on a statutory basis), but would suggest that for non-member directors this should not be limited to the chair, CEO, CFO and Audit Committee chair but should rather apply to all directors and others in senior executive positions. Establishing the relevant requirements for directors (and potentially other senior managers - see paragraph 7.21 above) should take into account consideration of the requirements in relation to governance and internal control discussed in response to Recommendation 51 at paragraphs 8.13-8.18 below.

7.29 The FRC Review also recommends that the action relating to director disqualification applications should rest with the Insolvency Service (Recommendation 38). We would suggest that the ARGA should be given this power within the range of sanctions available to it. Firstly, there may be occasions when disqualification may be appropriate when the Insolvency Service (or indeed any other party entitled to apply for a disqualification order[14]) is not involved and secondly this power would be equivalent to the power to exclude an individual from membership of one of the RSBs.

Oversight of the accountancy profession - Recommendations 39 and 41 (Category 1) and 40 (Category 3)

7.30 Whilst we don't have visibility of the ARGA's current work programme, we agree with the recommendation that it should be "*sufficiently wide and expert to identify any emerging concerns of public interest*" (Recommendation 39).

7.31 We note paragraph 2.77 of the FRC Review which states that "*Until 2010, the FRC conducted oversight thematic reviews of the accountancy profession. The FRC has told the Review that securing action to meet its recommendations was not always easy to achieve, not least when the recommendations were unwelcome*" and that, as a result, the FRC took a different approach. We do not have information on the specific matters that the FRC refers to, but we would expect RSBs to accept and implement reasonable recommendations, particularly when these are in the public interest. At the same time, it is important that there is a mechanism for professional bodies - or any regulated individual or organisation - to have an alternative view to ARGA. Therefore, whilst we agree that the Government should have a backstop power to require, at the request of the ARGA, action to be taken by a professional body (Recommendation 40),

[14] The Company Directors Disqualification Act 2006 enables other parties (for example the Competition and Markets Authority) to make such applications in specified circumstances.

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activation of that power should only be following representations by the relevant professional body. We would expect it to be unusual that use of such a power by the Government would be required.

7.32 We agree that the exchange of letters should be replaced with formal memoranda of understanding (Recommendation 41).

Stewardship and investor relations - Recommendations 42 (Category 2) and 43 (Category 1)

7.33 We consider that effective stewardship is an important element of the overall corporate governance framework, with investors having a key role to play through challenging on material issues and thereby influencing decision making to improve the effectiveness of capital allocation in the economy.

7.34 The suggestion set out in Recommendation 42 of abolishing the Stewardship Code because "*it remains simply a driver of boilerplate reporting*" cannot, in our view, be the right answer. To the extent the Stewardship Code is not considered to be effective, we are therefore in favour of strengthening it and the oversight of compliance with it.

7.35 We are generally supportive of the revisions to the Stewardship Code recently proposed by the FRC and we provided a detailed response to its consultation. In summary, we consider that:

- There is further scope for enhancing engagement between (i) investors and companies, (ii) investors and auditors and (iii) investors and the ARGA (with the latter focussing on senior management and decision makers within investor organisations as well as governance specialists).
- Assessment and oversight of the effectiveness of stewardship needs to move from a desk based approach to one which assesses the extent and quality of the underlying activities.
- Given the increasing proportion of ownership of UK assets by overseas investors, the benefits of the Stewardship Code are diluted, as well as resulting in an uneven playing field for UK based institutions. We therefore welcome the joint FCA / FRC Discussion Paper[15] which sought views on whether there is more that should be done to incentivise international investors to exercise stewardship in a form consistent with the revised Stewardship Code.

[15] *Building a regulatory framework for effective stewardship*.

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7.36 Further consideration might be given to the range of measures that the ARGA might have when those voluntarily complying, or required to comply, with the Stewardship Code have fallen short of their responsibilities.

7.37 We agree that the ARGA's interaction with investors should be extend beyond ESG specialists at more senior levels in wider and deeper dialogue with UK investors (Recommendation 43) but recognise the challenges that the FRC has faced in this regard. Aspects of the changes the FRC is proposing to the Stewardship Code may help address this but it might be further helped if investors subject to the this code were required to report (in the Annual Activities and Outcomes report) how they had sought to engage at a senior level with the ARGA (and, where appropriate, other relevant regulators).

CHAPTER 3 - CORPORATE FAILURE

8 Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

8.1 Our submission to the FRC Review's Call for Evidence suggested more proactive monitoring by the FRC and intervention where necessary, as well as a corporate governance code enshrined in law, underpinned by more detailed standards and a proportionate enforcement regime. We therefore agree with both the FRC Review and BEIS that there is more that could be achieved in this area and also with the direction of the recommendations of the FRC Review. We also agree with BEIS' that the vision is a challenging one where options for implementation need careful consideration.

8.2 Importantly, the limitations of what is possible need to be recognised and market participants aware of these. As the FRC Review points out, seeking to design a regulatory regime which ensures that companies are well run and that failure cannot occur is impractical where the costs are likely to outweigh the benefits: market participants and stakeholders need to understand and acknowledge this.

Risk awareness - Recommendations 44 (Category 1) and 45 (Category 3)

8.3 We support the development of a market intelligence function (Recommendation 44), but note the inherent danger that this creates an unrealistic expectation about the ability of the ARGA to identify issues and to intervene effectively. Such interventions assume clarity of the standards or requirements against which the relevant company will be assessed.

8.4 We also suggest that this should be regarded as a Category 2 initiative to allow consultation on how such a function should be designed after considering the potential range of stakeholders and sources of information which might contribute to such a function, in advance of implementation - for example, to what extent should investors contribute information which might be valuable to this activity?

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Further consultation as to how such a regime might work would also mean that the new board of the ARGA would likely be in place and be able to take responsibility for the design and implementation of this new activity.

8.5 In relation to the introduction of a duty of alert by the auditors (Recommendation 45), provisions already exist for reporting of certain matters[16]. However, there would be benefit in further consideration of and clarity with regard to (a) to whom such matters should be reported (this might simply be that all relevant matters should be reported to ARGA who would liaise with other regulators, if appropriate); (b) the range of matters which should be reported; and (c) the timing of such reports.

8.6 We note that both Recommendations 44 and 45 are made in the context of corporate failure. This may be an unnecessarily narrow context, and in design of both the market intelligence function and the duty of alert arrangements consideration should be given as to the range of issues that any arrangements might seek to identify.

Powers of ARGA in cases of serious concern - Recommendations 46-50 (Category 3)

8.7 We support the objective for swift regulatory action where potentially serious problems are indicated and the recommendations for the ARGA to have powers to require explanations (Recommendation 46) and, where appropriate, undertake a skilled persons' review (Recommendation 47) and to publicise the results when in the public interest to do so Recommendation 48). On the latter, we consider that it is important that there is clarity on the "public interest" test which will determine whether or not publication is to be made and should avoid precipitating a crisis that the regime may be attempting to address.

8.8 The FRC Review identifies (at para 3.16) circumstances justifying a skilled persons review (inspection). We do not disagree with any of these (although would suggest that "audit" should be deleted form the first bullet, so that it reads "*where there are concerns about the accounting treatment of key areas of ~~audit~~ judgement*"), but consider that ultimately the ARGA should have power to commission such a review in any circumstance where it considers it appropriate in the context of its strategic objective.

8.9 Such a power might be modelled on something like either s165 of the Financial Services and Markets Act 2000 (FSMA) or s434 Companies Act 1985 (CA85) concerning the production of documents and information to the PRA / FCA and to inspectors respectively. Note that those powers are tied to specific triggers allowing such requests. In the case of FSMA the trigger is that the documents and information that could be reasonably required by PRA or FCA in connection with the exercise of their functions. In the case of CA85 the triggers include circumstances suggesting fraud, misconduct towards the company or its

[16] Article 12(1)(b) of the EU Audit Regulation.

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members or that the members have not been given all information that they might reasonably expect. The trigger for the ARGA would thus need to be based on its function, ie on those aspects of law that it is its function to implement or enforce.

8.10 The FRC Review also recommends (Recommendation 49) a number of powers that the ARGA should be given to enable follow up as a result of an inspection. We agree that the ARGA should have additional powers, but further consideration is needed as to the nature of those powers rather than limiting them simply to those listed in the recommendation. In particular, we consider that the powers given to the ARGA should follow on from a fuller consideration of which aspects of company law and other regulation the ARGA is charged with enforcing and then giving it the powers to do so. For that reason we do not comment in detail on the four particular powers suggested (although we do not object to them), as we believe that the powers generally need more fundamental consideration.

8.11 Having said that, we note that the suggested power of the ARGA to order the removal of the auditor is at odds with the FRC Review's conclusion on directors' removal (in Recommendation 50) that "*Decision-making should rest, as now, with Boards and shareholders*". To be consistent, it would follow that if the ARGA was of the view that the auditor should be replaced or the audit retendered, this view should be communicated to shareholders for a decision where the board of the relevant company had not already taken steps to effect such a change.

8.12 More generally in relation to the trigger for use of any additional powers conferred on the ARGA, we consider that these should not be limited in their application to the follow-up of an inspection but should be available more widely. For example, the explanations to the concerns of and questions from the ARGA envisaged by Recommendation 46 might be sufficient for such powers to be triggered.

Internal company controls - Recommendation 51 (Category 3)

8.13 In our response to the FRC Review's Call for Evidence we recommended that regimes such as the Sarbanes-Oxley regime in the US should be considered and we therefore support the FRC Review's recommendation for further consideration of a strengthened framework around internal controls and company reporting and

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we are supportive of such a regime being introduced taking account of the UK context.

8.14 Some care needs to be taken when comparing the relative merits of the relevant elements of the Sarbanes-Oxley regime[17] in the US and the existing FRC Guidance[18] as there are significant differences in both approach and scope.

8.15 The existing UK framework is principles based (as epitomised by 'comply or explain' and the UK Corporate Governance Code) whereas the US approach is characterised as being 'rules based'. A key challenge in implementing a more prescriptive approach will be to preserve the substantive assessment and management of risk which is the focus and one of the main strengths of the UK model, avoiding a mindset which is may be driven overly by procedural compliance considerations alone. Consideration would also need to be given as to how such a regime would sit alongside the requirements of Sarbanes-Oxley for UK companies that are already required to comply with the provisions of that regime (by virtue of having securities registered in the US).

8.16 In addition, the FRC Guidance addresses all internal controls, whereas the relevant elements of Sarbanes-Oxley are focussed on internal controls over financial reporting and the content of the annual report. To the extent that the UK adopts the more prescriptive requirements of Sarbanes-Oxley, it would be a retrograde step to lose the focus which the FRC Guidance provides on the broader range of controls. A half-and-half model with different reporting requirements for financial reporting controls and other controls may be an alternative, but at the risk of creating a new expectation gap.

8.17 At the same time, the limitations of even this more rigorous approach need to be recognised as is demonstrated by the US' experience, where the existence of the Sarbanes-Oxley regime did not prevent the 2008 financial crisis or corporate governance 'scandals' at various financial institutions – many of which, at least in part, had some element of a breakdown in internal controls.

8.18 We consider there would be clear benefits to revising the existing regime to provide additional focus on internal financial controls and the preparation of the annual report, accounts, and other important company documents, but that the current focus on a broader control set should not be lost. Clear standards will be necessary, as well as clarity on those to whom such requirements apply. We have commented in paragraph 7.21 above in relation to the potential for certain senior

[17] Whilst the Sarbanes-Oxley Act of 2002 covers many areas, the relevant elements for risk management and internal control are sections 302, dealing with dealing with Corporate Responsibility for Financial Reports, and section 404, dealing with Management Assessment of Internal Controls.
[18] Guidance on Risk Management, Internal Control and Related Financial and Business Reporting (September 2014).

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managers, as well as directors, of an entity to be subject to regulatory oversight and this would be one such area where that might be appropriate.

Viability statements - Recommendation 52 (Category 1)

8.19 We agree that the approach to the viability statement needs to be refreshed.

8.20 We expressed concerns during the development of the current regime in relation to the reporting requirement, for example saying that "*more transparency as to the actual assessment of long term viability is better than binary confirmations about the outcome*"[19]. What has happened, as the FRC Review notes (paragraph 3.23), is that too much of the reporting is focused on the binary confirmation statement and too little on explaining what stresses, particular to the company, have been considered in making the assessment. Our 2014 comment letter made proposals for how the UK Corporate Governance Code might be framed to lead to better reporting.

8.21 In our view there is an appetite for more information about business resilience. This is at the heart of the viability statement and also at the heart of question about the role of going concern in reporting. We have expressed this view, together with suggestions for enhancing the corporate reporting requirements around this in our responses to both the Brydon Review and to the FRC in its consultation on proposed revisions to International Standard on Auditing (ISA) (UK) 570 *Going Concern* where the FRC has undertaken to share responses with the Brydon Review team. We look forward to participating further in this crucial debate.

Enhanced grading of inspected audits - Recommendation 53 (Category 3)

8.22 Having pioneered graduated audit findings in certain audit opinions issued by our firm, we are very supportive of making this a requirement for all audit reports on large companies. Our view is that this would be an effective and proportionate way to help close the expectation gap, strengthen the quality of audit and thus increase stakeholder and public confidence in the audit profession. We would like to see graduated findings evolve into a narrative report with greater description of the audit work, consideration of challenge and judgements made in arriving at the conclusion. In order for this to be consistently applied and effective, it would need to be mandated within a regulatory framework. We consider that such a requirement could be introduced by ISAs (applicable in the UK) without the need

[19] KPMG comment letter to the FRC dated 27 June 2014.

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for primary legislation (and therefore could be dealt with as a Category 2 initiative).

CHAPTER 4 - THE NEW REGULATOR: OVERSIGHT AND ACCOUNTABILITY

9 Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

Governance and accountability - Recommendations 54-56 and 62 (Category1)

9.1 We agree with Recommendations 54-56 and their categorisation.

9.2 In relation to applying the Freedom of Information (FOI) provisions in full to ARGA's functions (Recommendation 62), we agree that all of the statutory functions of the ARGA should be covered by FOI provisions. However, we note that some other regulators (for example the FCA) are subject to restrictions on the disclosure of Confidential Information (in the case of the FCA, by virtue of s348 of the Financial Services and Markets Act 2000). We believe the same criteria applicable to the FCA should apply to the ARGA. In that context, to the extent that legislation may be required to introduce equivalent provisions for the FRC, implementation as a Category 1 matter would not be appropriate.

Conflicts of interest - Recommendations 57-58 (Category1)

9.3 We acknowledge the public concern regarding individuals formerly with a Big-4 firm working at the FRC and note the observation in the FRC Review that this is inevitable and not inappropriate. We agree that it is important that there are appropriate procedures in place for managing the risk of conflict: stakeholders need to be satisfied that there is no conflict or the risks are adequately mitigated and BEIS, in particular, once satisfied needs to support the ARGA in its defence of such arrangements in the face of criticism.

9.4 That said, we accept that the thrust of Recommendation 57 (ie a more restrictive approach) should be applied for a period - which we think should be a defined one rather than for the (undefined) "*foreseeable future*". However, we do question whether implementation of this recommendation as envisaged by the FRC Review will be detrimental to the ability of the ARGA to be effective at a time when it is looking to enhance its capability, since it would appear to preclude *any* former employee of an audit firm which audits PIEs (however PIE is ultimately defined) from holding a supervisory role at ARGA. We would therefore suggest that any temporary restriction should only apply to "direct" oversight roles and that where a former employee of a relevant audit firm is employed at a level or seniority which involves oversight of all audit firms that ARGA is transparent about the mitigations it is putting in place, for example an appropriate cooling-off period. In due course, once the time-bound restriction envisaged by Recommendation 57 is lifted, a

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similar approach (ie the use of a cooling-off period rather than a prohibition) might also be appropriate for those with direct oversight roles.

9.5 We agree with the second element of Recommendation 57 (that written declarations for all staff members' conflicts of interest and financial interests should include proposed mitigations, and record any exercise of management discretion in relation to work undertaken relating to a former employer) and Recommendation 58 (that ARGA should have a transparent procurement policy that adheres to public contracting regulations).

Complaints handling - Recommendations 59-61 (Category1)

9.6 We do not have visibility of the detail of the FRC's complaints handling procedure and, therefore, any enhancements which might be desirable.

9.7 However, transparency on the trend, nature and outcome of complaints (Recommendation 59), triaging and ensuring appropriate action in relation to complaints (Recommendation 61) and ensuring that it is satisfied with the complaints handling processes of the RSBs (Recommendation 60) appear to be sensible recommendations. The ARGA's regular reporting to Parliament would be one mechanism by which transparency in this area might be enhanced.

Confidentiality - Recommendation 63 (Category1)

9.8 We share the concerns of the FRC Review in relation to the leaking of confidential information illustrated by the examples set out therein (and note that there have been further leaks subsequent to its publication) which has the potential to undermine trust in both the ARGA and those regulated by it. At the same time, we recognise that information which has been leaked will also have been

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available to individuals and organisations outside the FRC who may be the source of such leaks.

9.9 We do not have knowledge of the details of the processes the FRC has in place to ensure confidentiality, but agree that these should be of the highest standards.

CHAPTER 5 - STAFFING AND RESOURCE

10 Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

Funding - Recommendations 64-66 (Category 2)

10.1 We agree that the ARGA should be funded on a statutory basis (Recommendation 64), albeit that we are not aware of any difficulties that have arisen from the existing funding arrangements.

10.2 We also agree that BEIS should agree a new budget working with the ARGA after consulting stakeholders (Recommendation 65) and thereafter agree the budget annually (Recommendation 66). On the latter, we consider that the annual budget setting should also involve stakeholder consultation and in both cases the results of that consultation, and its impact on the final budget, should be made public.

10.3 In relation to the question of the proportions of the levy funding the ARGA that apply to different parties, we note that at present the FRC is (largely) funded by organisations undertaking audits (indirectly via the RSBs) and companies. In future, we suggest that this could and should be limited to companies.

10.4 Regulation is for the benefit of shareholders and it is therefore appropriate that its costs are met out of the shareholders' funds of their companies.

10.5 If some element were to fall on audit firms, then they should recover any costs of regulation from the companies they audit, particularly given the current emphasis on the operational separation of audit and non-audit businesses within audit firms and the need to fully recover the costs of operation out of the revenues from audit alone.

10.6 We would suggest that to drive simplicity and avoid issues with auditors being unable to recover the costs from the entities that they audit that the costs of the ARGA should be met in full by a levy on companies given that ultimately they should bear these costs.

10.7 To the extent that this approach is not adopted then it would appear logical that others subject to regulatory oversight should also bear part of the cost of funding the regulator. For example, under the current model asset owners and managers who comply with the Stewardship Code and are therefore subject to the

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associated regulatory oversight bear none of the cost of the regulator directly yet are significant beneficiaries of the regulation of companies and auditors (although indirectly bear an element of the cost by virtue of distributions by, and capital appreciation in the value of, accounts preparers - ie the companies in which they invest).

Skills, resourcing and remuneration - Recommendations 67-69 (Category 1) and 70 (Category 3)

10.8 We strongly agree that the ARGA needs to have the skills and resources to be able to discharge its responsibilities effectively and efficiently, and it should be prepared to pay accordingly. We therefore welcome the views of the FRC Review set out in paragraphs 5.6-5.14 and support the related recommendations.

10.9 In terms of the categorisation of these recommendations, whilst we agree that they should be pursued as soon as possible, we consider it important that they reflect detailed consideration of the requirements of the new regulator rather than be pre-empted based on an assumption of what those requirements might be. It is therefore important that implementation of these recommendations follows on from the appointment of senior leadership of the new regulator.

CHAPTER 6 - Other matters

11 Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

Competition role - Recommendations 71-73 (Category 3)

11.1 We have commented in our submissions to the CMA's Market Study that we believe there is strong competition in the large audit market, although we have also acknowledged the desirability of greater choice - which is not the same as competition.

11.2 We agree that actions taken by the ARGA, including some of those activities referred to by the FRC Review[20], may encourage (or deter) new entrants (and therefore impact on the level of concentration and choice) and / or impact on competition.

11.3 However, we believe that high standards and delivery of audit quality must remain the overriding objective for the ARGA in relation to its regulatory responsibility for audit and that other objectives - whether in terms of promotion of choice and / or competition (or indeed any other matters) - should be subordinate to this objective. Consideration might be given as to how any "stronger form" of responsibility in relation to competition, etc might result in more beneficial

[20] Paragraph 6.5.

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outcomes than would be achieved with the responsibility being limited, as recommended by the Competition Commission in 2013, to "having regard to" competition, etc. Clearly one step might be to require the ARGA to articulate *how* it had regard to these aspects when undertaking its work.

11.4 We also consider that any requirement for the ARGA to report regularly on market and competition developments (Recommendation 72) needs to reflect the fact that the ARGA is unlikely to have expertise in competition policy and therefore we suggest that formal reviews should be left to the CMA itself. In this regard we note that the CMA has proposed a review after five years "following full implementation" of any remedies.

Actuarial oversight - Recommendations 74-75 (Category 3)

11.5 In our response to the FRC Review's Call for Evidence, we expressed no strong view on actuarial oversight. In assessing whether responsibility should be assumed by another body (Recommendation 75), it needs to be clear that another body would be better placed to do so and that this would outweigh any benefits that would be lost by separating oversight from that of stewardship, governance, corporate reporting and audit that would remain with the ARGA.

11.6 It appears to us that Recommendation 74 (assessing what powers are required to effectively oversee regulation of the actuarial profession) is a useful starting point. Being clear on this may provide greater clarity on the body best placed to assume oversight responsibility.

Local audit arrangements - Recommendations 76-78 and 82 (Category 3)

11.7 We agree that the current arrangements are fragmented and would benefit from re-consideration.

11.8 However, we are not convinced that regulation and oversight should be separated from the FRC. Such local public body audits are all undertaken in accordance with a Code of Audit Practice based on International Standards on Auditing. A consistent application of those standards is unlikely to be achieved by having oversight distributed amongst more than one body. On this basis, it would be sensible for the ARGA to assume responsibility for such audits and for the Code of Practice.

11.9 We also note that the FRC Review identifies (in paragraph 6.20) a number of differences between local authority and private sector audits which may be summarised:

a) the scope of audits of local public bodies being wider than for companies;

b) the audits being undertaken on behalf of the public (rather than shareholders) with lower awareness and challenge of auditors' work in the public sector;

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c) differences in enforcement powers in relation to local public body audits, with a "narrower" test being applied than for companies; and

d) auditor rotation requirements for audits of local public bodies only applying in certain circumstances.

Whilst these differences exist at present it is arguable as to whether all but the first are sensible. Rather, we would suggest, audits ought to be undertaken to the same standard, with a common test for holding auditors to account and similar independence requirements where entities subject to audit have similar public significance. On the remaining "difference" we note that Sir Donald Brydon is currently reviewing the scope and purpose of audits which may result it being changed. This would also appear to support a common regulator of audit, namely the ARGA.

11.10 Regardless of our views on responsibility for oversight of audit, as with audit more generally it is important that the responsibilities of auditors are balanced appropriately with others, notably the management and boards of the relevant local public bodies. The FRC Review recognises that this is imbalanced for the audit of companies, and any changes in the requirements for oversight of local public body audits should be considered in the context of oversight of the local public bodies themselves.

Independent supervision of the National Audit Office - Recommendations 79-81 (Category 3)

11.11 We agree that all audits undertaken by the National Audit Office (NAO) should be within the scope of the ARGA's monitoring and that the public disclosure of the results of this work should be aligned with that for audits undertaken by audit firms.

11.12 For the reasons set out in 11.9-11.10 above, we believe that oversight of the NAO's work should remain with the ARGA rather than being transferred to a new body.

11.13 We agree that responsibility for the Code of Practice should be aligned with that of oversight of the NAO.

CHAPTER 7 - INTERIM STEPS (Category 1)

12 Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

12.1 We agree with the FRC Review and BEIS' desire to move forward as swiftly as possible. We welcome BEIS' categorisation of the recommendations setting out how it intends to proceed and have included comments or suggestions above

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where we consider the categorisation set out in the Proposals requires further consideration.

12.2 Our comments in this section are therefore limited to those relating to the "immediate actions" described in Figure 16 of the FRC Review where we believe care is required.

12.3 In particular, the FRC should not take steps which pre-empt matters where it has been identified that further consultation is necessary or require other activities to be completed in advance.

12.4 On the former, there are a number of actions specified as "immediate" where BEIS' has classified these as Category 2 and therefore requiring further consultation (of which this initial consultation may form a part) and which cannot therefore be implemented "immediately". For example, the FRC Review recommends that the FRC should amend its articles to align with its recommendations in respect of strategic objective, duties and functions all of which are regarded as Category 2 recommendations. It is not clear as to how the FRC would amend its Articles of Association (Articles) "immediately" without the process of further consultation implicit in a Category 2 item would be possible, unless the proposal to amend its Articles is in the context of recognising that a further change might be required following the consultation and legislation.

12.5 Similarly, Figure 16 states that its recommendations in relation to the size and composition of the Board should be implemented immediately, but the composition and the skills required is dependent on a various other considerations depending on the final scope, remit and design of the ARGA.

12.6 The following "immediate" steps also appear to be related to Category 2 (or 3) recommendations or require other steps to be completed in advance of the "immediate" action where further consideration of the proposed immediate action would be merited:

- Exercise stronger ownership of the FRC's enforcement functions - Recommendation 14 (Category 2).
- Revise the current delegation letter from Secretary of State along with the eligibility criteria and guidance set by the FRC in relation to its RSBs and finalise new delegation agreements with the RSBs to clarify that their role no longer includes registration and approval of PIE audit firms - Recommendations 15 & 16 (Category 2).
- BEIS should prepare secondary legislation to activate the existing Companies Act provisions to put in place a statutory levy - Recommendation 64 (Category 2).

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CONCLUSIONS

13 What evidence or information do you have on the costs and benefits of these reforms?

13.1 We have no specific information or evidence on the costs and benefits of these reforms. We would, however, make the following points.

13.2 The benefits and costs arising from the implementation of the recommendations from the FRC Review cannot be considered in isolation of other changes being contemplated by other initiatives - including recommendations of the BEIS Select Committee and the CMA; proposed changes to the Stewardship Code; potential recommendations which may follow on from Sir Donald Brydon's review; etc.

13.3 We consider that the benefits may be substantial but may be inherently difficult to quantify. For example, the benefits which flow from consistently better governance across corporate Britain, the possibility of early intervention which prevents a company from failing or simply from increased public confidence, etc would be significant.

13.4 On the other hand, the costs are also likely to be substantial and ultimately the majority of these will fall on companies, either because of the costs they incur to comply with measures that impact on them directly or because the costs that are borne initially by other parties will need to be recovered from companies through levies (for example from the ARGA whose source of income is limited to those that it regulates) and fees from third parties (for example from audit firms which will need to recharge incremental costs in order to remain profitable).

13.5 A further question for BEIS will be not only assessing the extent of the above costs but considering the potential for further "costs" which may arise if the overall package of changes stifles UK growth or deters overseas investment or the attractiveness of the UK as a destination for companies seeking to raise capital on UK public markets.

14 What further comments do you wish to make?

14.1 We have no comments other than those in response to Questions 1-12 in this Appendix and the letter to which it is appended.

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