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Response to FRC Strategy and Draft Budget 2018

We would like to make the following comments in response to the FRC's consultation on its draft strategy and budget for 2018.

1. **Do you have any comments on our strategic priorities – are they in line with your expectations or are there other issues on which the FRC should Focus**

   a) **Promoting Corporate Governance and sound Stewardship**: it is notable that the list of projects and activities on P17 of the strategy document only relates to initiatives that the FRC plans to initiate and do. There are other things going on elsewhere in which the FRC should be seeking a strong and meaningful involvement and it should be endeavouring to influence outcomes.

   For example, it is our understanding that changes in the way in which the beneficial shareholders in the UK are treated is coming. The Shareholder Rights Directive I (SRD) defines 'shareholder' as a natural or legal person who is a shareholder under the law of the registered office of the issuer company. Under the nominee system in the UK, the shareholder is not the final, retail investor but the nominee.

   To enable the communication flow between issuers and the final, retail investor, the Commission is now proposing to introduce an additional definition of "client" in the SRD implementing acts as follows:

   "Client" means the natural or legal person who is not itself recognised under the applicable law as shareholder in an issuer company, but on whose behalf a shareholder acts and who is entitled to the benefits of ownership, including the right to exercise voting rights, even though another party actually has possession and title to the share."

   Under this definition it would become a requirement for the beneficial shareholders (the investor) to be given the same rights as the legal shareholder (nominee). This, if followed through fully, would mean that the beneficial shareholders would be entitled to receive the agenda and other AGM-related documentation, be allowed to vote at the AGM and would be able to enjoy any shareholder benefits offered by the company.

   This definition and the wording surrounding it require further thought and development. There is a need for the FRC, as a matter of urgency, to engage with those responsible for drafting amendments to the SRD both in Europe and within BEIS.

   This is not a Stewardship Code issue. Assuming that this change takes place, it will have fundamental implications for reporting. Few beneficial shareholders have either the time or the inclination to wade through the monumental and seriously flawed document that the annual report has morphed into over many years of uncoordinated change and amendment. This is very much a governance issue which will require reporting to be made more accessible to wider range of investors. This is the only way to begin to ensure their engagement in governance matters – something which the government and regulators are keen to foster. We have commented further on the need for a full review of annual reporting practice below.

b) Promoting True and Fair Reporting:

There are two key issues which should be priorities for the FRC for 2018/19:

- **The annual report**. This is no longer fit for purpose. Fundamental review and revision are long overdue. Apart from developing new reporting models to stakeholders outside the annual report, other reporting priorities for the coming year are based on fine-tuning of detailed aspects of reporting – adding a bit more here and there but rarely, if ever, seeking to delete content that has become superfluous or irrelevant. Something more fundamental is needed – in particular to deal with the mish-mash of content that now constitutes the narrative element of most reports.

  The current format and content of the Annual Report is the product of numerous additions and changes over many years.

  - Remuneration reports now run to thirty or forty pages. Much of the content is impenetrable to most readers. Some of it is incomplete and misleading. Some is misleading even when it is complete (Pay scenarios, for example).
  - Environmental reports are often subverted to become little more than a boiler-plate compliance exercise.
  - Business model reporting remains generally poor despite the fact that the business model sits at the heart of any investor's understanding of the business.
  - The narrative element of the report is stuffed with repetitious, self-congratulatory and sometimes misleading content from the Chairman, the CEO and the CFO. Key information is scattered around in a way that makes it difficult to find or follow. The tone of the content is often vague and patronising – supported by meaningless graphics.
  - There is often a disconnect between the narrative part of the annual report (full of hyperbole and reassuring claims) and the story that the financial statements and the notes to the accounts tell. As one senior FRC employee wryly commented to UKSA members (Lifting the Lid on the FRC 21.11.17), the annual report is often like a pantomime horse where the back and the front are completely out of synch with each other.

In summary, something more like Warren Buffet's annual 'Letter to Investors' would be much more appropriate.

We would like to see the FRC, as a matter of priority, set up a Reporting Lab project to review fundamentally the current structure and content of the Annual Report and recommend how it could be redesigned to make it fit for purpose. This ought to precede the Reporting Lab project on digital reporting. There is no point in digitising something which is so manifestly flawed as the current shape, content and structure of the annual report. The review of the annual report should be carried out with digital reporting in mind and once it is complete there should then be a separate project to consider the technological aspects of how the report can best be presented in digital format.

- **IFRS reporting.** It is hard to tell from the summary on Page 10 what the FRC is really proposing to do in respect of IFRS. There is a need for the Regulator to take responsibility for addressing the current weaknesses of IFRS. The FRC acknowledges that IFRS is a strategic priority; but simply offering to 'assess progress' is not enough. Nor is it appropriate for the FRC simply to applaud from the sidelines by 'supporting the Government as it explores options for the UK's accounting framework….' As discussed above in relation to the SRD, the tone of the strategy document is insular and timid in relation to the outside world. The FRC should be taking an overtly proactive stance in seeking to influence decision-making on matters such as the development of IFRS both in Britain and in Europe. This is particularly important as the Country prepares to leave the EU.

c) Investor engagement:

One activity that is conspicuous by its absence from the strategy document is that of investor engagement. This is something that we find enormously valuable and which we do not take for granted. Nor do we see it a just a by-product of the FRC's project work. It is also something that the FRC does very much better than the other regulatory bodies. The maintenance and development of the FRC's investor engagement approach is something which should be recognised as both an operational and a strategic priority.

2. Do you have any comments on our proposed audit firm monitoring approach?

This is set out in very broad-brush terms. As such we feel that we are not in a position to make meaningful comment on the proposed monitoring approach.

3. Do you have any comments on our key deliverables?

We are unable to comment because it is not clear what the 'key deliverables' are. This is one of the biggest weaknesses of the whole document. There are plenty of lists of:

- Things the FRC is going to consider (pages 9 and 10)

- Things it has already done (p12)
- Things it will test (p12)
- Things to which it will contribute (p13)
- Things it will review (p13)
- Other things such as ‘engaging’, ‘concluding discussions’ and ‘ensuring investigations are progressed’.

There is a table of projects and activities on pages 17 and 18. However, there is no comment on the deliverables or on which of these are seen as being the really important ones – the ‘key deliverables’. Many appear to be business-as-usual activities, many are not time-bound in that they run on into 2020/21 (and possibly beyond) and there is no clarity over what the outputs will be in the period 2018/19 or even at the end of the initiative.

4. Do you have any comments on our draft budget and funding requirements for 2018/19?

There appears to be a significant workload involves in the area of Promoting High Quality Audit and Assurance. You are proposing a thematic review of audit firm culture, a new audit firm supervisory approach and review the relevance of the audit qualification. In addition to this you are take on significant new regulatory responsibility for monitoring the quality of the audit of local public bodies following the government’s decision to disband the Audit Commission.

The budget for audit and assurance regulation is increasing by £1.2m from £13.3m (current forecast) to £14.5m (2018/19 budget. Almost half of this increase relates to new audit firm monitoring (£0.6m). We question whether this budget is achievable given the significant additional responsibilities that the FRC appears to be taking on.

We are concerned that without further funding and more resource the FRC will be unable to deliver the practical oversight of standards of corporate governance, sound reporting practice and high quality audit work that investors expect. Cases like that of Carillion will continue to emerge and will justify detailed investigation – if only so that lessons can be learnt for the future. If these investigations are to be conducted thoroughly and expeditiously they will need an appropriate level of high-quality resource and the funding to pay for it.

5. Do you have any comments on our levy proposals for 2018/ 19?

Why is it that although the FRC is taking on the work of the Audit Commission there appears to be no contribution from government towards the cost of taking on this task? Similarly, if the Regulator is supporting the Government as it explores options for the UK’s accounting framework post-Brexit, the Government ought to be making a contribution towards the cost of this.

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