

Gonzalo Ramos
Secretary General
Public Interest Oversight Board
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Spain

25 November 2016

Dear Secretary General,

2017-2019 PIOB STRATEGY

The Financial Reporting Council welcomes the opportunity to respond to the PIOB's consultation on its strategy for the period 2017-19. The FRC is the UK's Competent Authority for Audit, and regulates in the public interest. We are responsible for setting auditing and ethical standards in the UK, undertaking audit oversight and monitoring and taking enforcement action where necessary. Through our work, we seek to underpin public confidence in the value of audit in the UK, and to support the auditing profession in the delivery of high quality audit.

The FRC is strongly supportive of the objective of the PIOB to ensure that the public interest is properly reflected in the standard setting process, and the public confidence that this engenders. Our responses to the questions asked in the strategy are reflective of this. We understand through our own engagement and research, the premium that stakeholders, particularly investors, attach to auditor independence, and ensuring that the auditing, ethical and educational standards that auditors apply underpin this outcome by properly reflecting public interest considerations both in the standards themselves and in the way by which they are developed. For stakeholders to have confidence that standards will deliver high quality audit, it is important they have confidence that standards are set by independent Boards that have a majority of independent members with a mandate to represent the public interest. The current model, whereby the Boards sit within IFAC and rely heavily on volunteer resource, often sponsored either by an audit firm or a professional body is not the best way to support user confidence. Standards should also be developed in a way that takes account of a diversity of views to support greater global take-up and alignment.

The PIOB's role as currently designed primarily focuses on the proper application of due process in the standard setting process. If the PIOB is to be able to play its role fully, it may need to secure a broader mandate which focuses on outcomes as well as due process. In order to determine just what might be included within that mandate, the discussions between IFAC and the Monitoring Group, referred to in the consultation document need to conclude on:

- The optimal future model for independent standard setting and oversight in the public interest;

- How that structure might be funded (including the contribution the auditing profession might make), and what governance structures might be necessary to provide credible and independent oversight; and
- The necessary technical staff resources that might be necessary to support a new model to develop high quality standards in the public interest and respond more quickly to user needs.

We appreciate that these questions are not part of this consultation, however, they do need to be addressed if the PIOB is best able to exercise its role representing the public interest. Part of that wider consideration should also determine whether it is possible to make the current governance framework operating over the standard setting boards less complicated, and thereby contributing to greater transparency.

Our responses to each of the questions are set out below.

Q1: Do you think that the process currently in place to identify risks to the public interest is appropriate? Can you suggest any improvements?

The standard setting boards (SSBs) have in place longstanding arrangements to identify risks to the public interest through stakeholder engagement. However, whether these arrangements are successful in capturing a sufficiently broad diversity of views to feed into the standard setting process is a matter of some debate. For instance, investors are under-represented on the Boards, as are other public stakeholders, which is of increasing importance given the growing broader interest in audit. The CAGs include a number of represented member organisations, but membership could be amended to better incorporate the views of a more diverse range of participants including chief financial officers (as preparers), non-executive directors, audit committee chairs, a broader range of national and international regulators, and investors and analysts. Our own experience leads us to conclude that there is merit in having a separate focus on users of financial statements.

Making greater use of virtual meetings might also help to supplement the CAG process with a more diverse and regular means of engagement which could strengthen the mechanism through which risks to the public interest are identified and addressed. This would also help to overcome the barriers of travel costs to certain stakeholders joining in CAG meetings. Although there is a trade-off, as meetings made through conference call are rarely as effective as in-person meetings.

We also question whether the Boards currently devote sufficient time and focus to the development of strategy. They currently rely on outreach by members, including significant engagement by the respective Chairs and by the staff that support the Boards. The Boards do engage through the CAGs, and for individual projects, round tables may be held to gain a broader perspective, but this is not routine and sometimes dependent on volunteer organisations. The PIOB should encourage the Boards to take a longer term strategic view of what the likely demands are to be from their users. This needs to focus on the following key stages:

- More focus on outreach by the Boards to develop a strategy for each Board, which link together in the support of shared objectives and outcomes;
- Greater oversight of this by the PIOB, which, for instance could have a role in ensuring that the Board's strategic thinking is well aligned both between them, and with other key players (e.g. the IASB); and
- Ensuring that strategy and forward thinking is carried out to identify in plenty of time what needs to be done by when. A five year strategy period would be better than three, given the time that it typically takes to develop a new standard, however, the Board's

should also consider the likely workload needed to address stakeholder needs in the medium and long term and well as the short – being able to respond quickly to user needs is likely to become increasingly important and the current model does not lend itself well to doing so.

There is also value, in our view, in the PIOB considering whether there should be more frequent formal touch points through the development phase of a standard, which include an opportunity to obtain wider engagement and insight from stakeholders, to ensure that the development process continues to reflect the public interest. Continuing to apply robust due process to ensure that the public interest is being represented throughout is of fundamental importance. However, this means that the PIOB will need to consider how it resources the demand that this will create – for instance, does all of that work that needs to be undertaken need to be done by the PIOB itself, or can the PIOB closely coordinate with other parts of the standard setting framework to ensure that risks are properly identified and addressed, and focused on accordingly.

Q2: In addition to investors and regulators, are there any other stakeholders that you think need further representation in the standard setting process?

Please see our response to Question 1 which identifies a number of other stakeholder groups that we believe should be brought into the standard setting process, and with which we consult when developing standards and guidance for use in the UK.

There is also extensive public debate in the UK on the need for audit to also serve the needs of a broader group of civil society stakeholders, who are also users of the auditor's report on the financial statements. Increasingly we have found that different stakeholder groups tend to respond to different aspects of ethical and auditing standards, and therefore, calling for stakeholder participation to support the consultation process for individual standards may help identify groups who should also be represented. This may also assist the SSBs in seeking to gain a more diverse, more representative membership balance not only on the Boards themselves, but also in the consultative and advisory forums that exist, or are developed to assist engagement with the standard setting process. Gaining this balance appears to be an ongoing challenge, and may pose a limitation to the standard setting process. We acknowledge that this is a challenge for national standard setters, and is likely to be even more difficult at the international level. However, we recommend that the PIOB considers this in finalising its forward strategy.

Q3: Do you see any benefit in the introduction of a public member Chair of the Nominating Committee for the selection of SSB members and Chairs?

The SSBs are independent Boards responsible for the setting of standards. However, we question whether stakeholders would consider those Boards to be truly independent, because the members and Chairs are nominated for those posts by the Nominating Committee of IFAC which is representative body for the professional accountancy bodies. However diligent and public-spirited its members may be, this will in our view always be a limiting factor in engendering confidence that the selection of members is in the public interest.

An independent, public member Chair for the Nominating Committee when appointing members to the SSBs would help address actual or perceived risks to independence. Currently the appointment process may appear to be supportive of vested interests (i.e. the auditing profession maintaining control over the standard setting process for the standards they use). Work in the UK and the EU to end self-regulation for the audit profession has been well received by stakeholders, and this proposal in the consultation paper can only be a positive development in that respect.

Do you see a benefit in an entirely separate Nominating Committee constituted by public members for that purpose?

Yes – although the proposal set out in Question 3 is a positive development, we believe that a separate Nominating Committee comprising only public members, under the auspices of the PIOB would much more effectively address concerns or perceptions over independence and the risks posed by self-regulation which are well known, and which can impact on stakeholder confidence. Whilst that Committee might draw on external support to address any technical issues relating to the appointment process, an independent Nominating Committee will reinforce the independence of the SSBs, and better address the needs of stakeholders.

Q4: Do you believe that Public Members bring perspectives on the public interest different from those of the accounting profession?

Yes - we strongly believe that Public Members offer a different perspective to the standard setting process compared to that offered by members of the profession who are, or who have recently been in practice as auditors or employed by a professional body, and we strongly believe that the public perception generally reflects this view. The FRC underwent a reform exercise in 2012, whereby standards in the UK are now set by a process that includes a Board and a Board Committee comprising only members who are not currently, nor have recently been in practice¹. Technical input in to the process is provided by FRC executive staff responsible for technical drafting, consultation and outreach work. This is supported by practitioner and other stakeholder input provided through an Advisory Council mechanism which includes practitioner members, but who do not represent a majority on that Council. The Council is chaired by a member of the FRC Board who is not a practitioner. The FRC Board has committed publicly that where it does not take account of the Council's advice it will explain why it has not done so.

Public members bring a wider user perspective to the standard setting process, and are able to provide valuable strategic level challenge to new standards and guidance. Although they may not have detailed technical knowledge, they are able to provide a critical strategic challenge on whether standards will be able to address the user perspective and user needs for a given subject area. This can help counter a prevailing approach from practitioners which focuses on the practical application of standards and guidance at the expense of the end-user need. For instance, an investor or audit committee chair will be able to offer greater insight over how to best satisfy user need from an auditor's report when compared with a professional accountant. As the technical drafting is undertaken by FRC staff, non- practitioner members of the FRC Board, Committees and Councils play a full part in the development of our standards and guidance.

The FRC's own research has found that public members can better reflect the needs of users', for instance, in our work on auditor reporting, users' value clear and unambiguous language and the sharing of insight arising from the auditor's findings as a result of their work, which continues to drive innovation in UK audit reports. In a similar vein, public members may also be better able to provide a practical challenge of how the SSBs can address fast-paced change in the audit market, for instance, that resulting from developments in IT and data analytics.

¹ In the FRC context a cooling off period of three years applies before a practitioner can be a member of the FRC Board, or a Board Committee.

Q5: Do you think that Public Members should receive modest remuneration for their contribution to standard setting in the absence of a sponsoring organisation? If so, who should pay?

We believe that support should be available for Public Members who do not have a sponsor organisation that is willing or able to meet their costs. Providing a modest remuneration may also assist the SSBs in their objective of seeking a greater diversity of views and a better diversity balance around the Board table than has previously been achieved, although the challenge of identifying individuals who would be willing to be involved in the process, and be able to add value should not be under-estimated. We believe that this has the potential to help address the challenge set by the PIOB in Question 1 of the consultation. If public members are to be remunerated, over the medium and longer term this raises questions about the way in which the standard setting process is funded.

The source of such funding will no doubt be a matter of discussion. The FRC strongly believes that: (i) there should be no link or perceived link between funding and influence over the standard setting process; and (ii) those who benefit from or use audit (and thereby standards) should contribute to those costs – this would not preclude audit firms, as a principal users of standards, from making a significant contribution, as long as the mechanism to collect and apply that funding addressed the risk or perceived risk that funding brings with it influence. In the example provided by the IASB, funding is provided by audit firms and national contributing authorities, which in the UK context is funded through a levy on users which is collected by the FRC. The FRC, as UK standard setter, is itself funded through a series of levies on different stakeholder groups, and a levy on the audit profession collected from the professional bodies.

Subject to a funding mechanism being designed in a way that addresses the two points set out in the previous paragraph, the FRC believes that this could be used to address the issue of providing funding in a way that does not impact on the independence or perceived independence of the SSBs.

Q6: Did you come across cases where auditing, ethics and education standards did not adequately respond to your public interest concerns?

Standard setting is about striking the right balance, and in reaching that balance there will always be stakeholders who wanted a different outcome to that achieved. We believe that in this model, transparency is an important way of ensuring that standards adequately respond to public interest concerns. For instance, late changes to a standard in the development process, might give stakeholders grounds for concern, so they need to be able to understand the process and deliberations that a SSB has undergone – the current model does not always provide such transparency.

We have two examples, where we consider the development of standards did not adequately respond to our public interest concerns:

- On auditor reporting, the IAASB, in revising ISA 700 decided not to adopt an enhanced going concern disclosure, which would have better responded to user needs, and in our view done more to underpin user confidence. The FRC's view is that explicit auditor reporting related to the going concern basis of accounting is in the public interest and is valuable to investors. The FRC introduced a requirement into ISA (UK) 570 (Revised), in addition to the recent enhancements made by the IAASB, for the auditor to report by exception on management's use of the going concern basis of accounting and on the disclosure of material uncertainties;
- We have repeatedly raised our concerns with IESBA, in successive consultations, the risks to independence that can be posed by the provision of certain non-audit services

by auditors – the Board has not adequately taken account of those views in making revisions to the Code of Ethics.

One further area where the current standard setting model may not adequately respond to public interest concerns relates to the timeliness with which the SSBs develop and adopt standards for use. The FRC shares the PIOB's concerns about the timeliness of the standard setting process, which can make it appear that the Boards are unable to respond quickly to emerging needs, or developments in the market place and in so doing protect the public interest. We strongly believe that this issue will pose an increasing challenge to the Boards looking forward. One way of addressing this might be through considering an annual update project for standards, which provides a mechanism to address urgent issues that emerge from inspection work, or from a dynamic and developing market. This model is currently used by the IASB. Although this is not in the gift of the PIOB, the PIOB should engage with the SSBs to determine whether such a process can be developed to better respond to public interest issues.

Q7: Technical work on a standard under development is in the first instance undertaken by working groups or task forces. Do you see any benefit in the PIOB being involved at an earlier stage by overseeing working groups and/ or task forces?

The development of standards under the existing model means that early technical and developmental work is undertaken by working groups, but executive decision making remains with the Board itself, which needs to consider and ultimately approve the way in which a standards will be developed. The merits of the PIOB being involved in working groups or task forces and providing oversight, depends on the extent to which more executive work is taken forward by working groups or task forces in future. Working groups and task forces provide an integral part of the standard setting process, and also represents that part of the process where the need for professional technical input is greatest. It allows the Boards to leverage the expertise of their members and of high quality and experienced Technical Advisors and others to drive forward the standard setting process. As this developmental work can be influential in supporting a boards thinking, without adequate oversight, either from a SSB, or from the PIOB, there may be a risk that the public interest might not be adequately taken account of, and standards being developed in a way that lacks consideration of a broad and sufficient diversity of views.

Whilst participating in a series of largely technical meetings might not be the best use of the PIOB's scarce resources, being consulted on whether a working group has been constituted in a way that might address those questions of public interest and diversity of views might be of greater value.

Given that the current standard setting model is reliant on a significant amount of volunteer resource, supplemented by resource from the small IAASB staff team. PIOB oversight involvement covering working groups and task forces would need to be proportionate and driven by a risk assessment so that it did not add further to the standard setting timetable. Given the PIOB's comments about the timeliness of standard setting, it might be helpful to set out how this process could work, once the PIOB has had chance to consider the responses to this consultation.

Q8: Where do you see the gaps in the PIOB's oversight?

The PIOB's mandate, to oversee the SSBs and ensure that the public interest is represented, is a clear and helpful one. However, the focus on due process alone can be distracting, and can fail to fully reflect the wider value that the PIOB's oversight brings. This focus can mean that the PIOB does not, for instance, consider whether the outcomes a new or revised standard is intended to deliver will properly represent the public interest. Certain stakeholders may

already consider the PIOB's involvement is the standard setting process to be broader than in fact it is.

PIOB members have access to the meetings of the SSBs and also have the opportunity to speak at those meetings. Over time the PIOB needs to build the insight offered by the participation of members in the meetings of the SSBs, and the articulation of their views into a persuasive narrative on how the public interest is best addressed. This process might also include providing the SSBs with routine feedback as part of the standard setting process to allow them to respond to particular issues as they emerge.

Although the PIOB has a clear oversight mechanism, it has little in the way of power to hold to account Boards where they fail to adequately reflect the public interest. All the PIOB can currently do is fail to approve a standard – and whilst this is a strong power, it is not one that lends itself well to influencing the development of a standard. A more graded range of responses, for instance, requiring additional consultation on an issue of public interest that is not adequately addressed, or requiring PIOB approval of project proposals would be ways of developing greater accountability. Although the PIOB is responsible for approving the terms of reference of the SSBs, it does not appear to have any direct influence over the decision to carry out a review.

Q9: Do you think the length of time take in standard development should be shortened in the public interest? If so how can the need for public consultation and respect for due process be balanced?

The FRC shares the PIOB's concern that reducing the time taken to develop standards should not be at the expense of informed engagement and proper consultation from a diverse range of interested stakeholders, representing key user groups. We believe that it is possible for the Boards to undertake more outreach activity before the process of developing a standard begins to ensure that it will properly address user needs and protect the public interest. Obtaining a clear understanding at the outset of user concerns and needs could help shorten the overall project timeframe as unforeseen issues are less likely to arise at later stages. We do, however, continue to support the use of a three month public consultation period for revised materials – it is important to be able to get a broad range of responses from stakeholders.

However, if the Boards are to accelerate the timetable for the delivery of standards, the professional staff resource within each Board, available to support the development of standards needs to be enhanced. For instance, The IAASB's current project to revise ISA 540, is comparatively lightly resourced by IAASB staff, who are thinly stretched to support the Board's ongoing projects. Despite this being a priority delivery for the Board to allow it to respond to demands from the auditing profession and from the financial services sector, the current resourcing model is clearly inadequate to support the number and technical complexity of current projects. Whilst recognising this is not a question in this consultation, it needs to be answered in order to determine how standard development can be achieved in a shorter timeframe.

We have also set out, in our response to Question 6, whether the SSB's could establish an abbreviated procedure to deal with urgent issues, or smaller amendments which could be addressed without fully revising a whole standard. This would allow the Boards to better respond to the needs of the market and the needs of users, and address risks transparently through a transparent process which does not require the level of consultation and process that revising a full standard or standards quite properly requires. PIOB involvement in that process offers a way of providing confidence to stakeholders that such amendments have been made to address issues which are in themselves of public interest should they not be addressed on a timely basis.

Q10: What topics would you consider – from a public interest perspective – essential additions to the present education curricula?

The FRC responded to the IAESB's public consultation on its future strategy. In that letter², we sought to identify areas where the Board could develop its work in the public interest. We still consider that those issues are worthy of further consideration and should be used by the Board to determine potential additions to the present education criteria.

In developing any criteria, the FRC considers it important that the three SSBs properly co-ordinate their efforts, given that those issues identified in our letter are as relevant to the IAASB and IESBA as they are to the IAESB. This indicates the importance of the SSBs having shared objectives to support them in developing or revising standards in the public interest.

Q11: Can you suggest how the PIOB might enhance its understanding of the public interest issues relevant to international accounting education standard-setting, and to accounting education practices and processes?

The PIOB has already demonstrated the value offered by the seminars it has run on the public interest. The PIOB may wish to consider whether a seminar might offer an opportunity for the PIOB to enhance its understanding of the issues, and engage with a broader range of stakeholders.

Based on our own oversight work, and in common with the SSBs, technology is becoming an ever more important issue and it drives developments in the marketplace. Whether, and how, this is addressed through the educational standard setting process would be an important issue to address.

Q12: In your opinion, what else could the PIOB do to encourage adoption and implementation of international standards (ISAs, the Code of Ethics and the IESs)?

The PIOB has expanded its outreach activity, and should use this activity to provide a clearer articulation to stakeholders of what has been achieved in the public interest as a result of PIOB oversight of the standard setting process, and thereby support confidence in the standards. We understand that there is a proposal that the SSBs should state on their standards, that they have been approved by the PIOB which confirms that due process has been followed to properly reflect the public interest, and we see value in making this disclosure.

The FRC shares the PIOB's support for high quality audit underpinned by internationally adopted, globally consistent standards. However, although standards issued by the SSBs are required to be adopted globally by IFAC member organisations under their membership obligations, the way in which standards are adopted in each jurisdiction are not always consistent. We believe, in the interests of the user community, that jurisdictions adopting standards issued by the SSBs should demonstrate that their standards do not in any respect fall below the requirements contained in standards issued by the SSBs. Whether or not the needs to be some sort of monitoring process to ensure that this is the case is an issue that the PIOB might want to consider as a means of supporting confidence in standards by stakeholders.

² <https://www.frc.org.uk/Our-Work/Publications/FRC-Board/FRC-response-to-International-Accounting-Education.pdf>

Q13: Do you find the PIOB Quarterly Updates useful?

The quarterly updates produced by the PIOB provide transparency over the PIOB's activities and a record of decisions taken. They do not, however, provide stakeholders with any indication of the actions undertaken by the PIOB to safeguard the public interest, other than showing its participation in the due process of standard setting, and providing confirmation that due process has been followed. In order to help build stakeholder awareness of public interest issues, it would be helpful to provide a richer picture of the sort of issues that the PIOB has engaged with the SSBs over, and in doing so, how it has sought to address user needs.

The record of conclusions from the PIOB public interest seminars is a further valuable stakeholder resource, and we welcome the PIOB's appetite to build the dialogue between the accounting profession, the user community and international regulatory bodies.

Q14: Is there anything the PIOB could do to improve the understanding of its role as a defender of the public interest?

The FRC welcomes the PIOB's programme of outreach work, and supports continued investment in this activity to improve understanding of the PIOB's role as a defender of the public interest. For this to work effectively, the PIOB should continue its outreach and look for ways to bring together the stakeholder groups that we have referred to throughout this letter. Setting standards can be seen through two lenses – the high quality technical input to deliver a standard that will achieve the objectives that the SSB determines that it should address, and also a strategic consideration of what the standards should be seeking to achieve and how. First and foremost this is about supporting high quality professional work, but it is also ensuring that standards remain relevant and useful, properly represent the user perspective and keep apace of the needs of a changing and dynamic marketplace that delivers professional services.

Q15: What would you think should be the role of the PIOB in the longer run given the set of reforms currently contemplated?

We reiterate the point made in our response to Question 12 – namely that the PIOB should be an integral part of the standard setting framework. That said, if the PIOB is to be part of an integrated process, it needs to consider how it works with and enhances the existing governance processes within the SSBs to ensure that they take account of the public interest in their standard setting. The role of the PIOB should not, in our view, be about setting a further set of expectations for each standard set, but rather how it ensures that the processes to identify Board members, and to then set standards are designed in a way that will underpin stakeholder confidence in those standards, and the work that is carried out when using them.

We think that it would also be helpful to clearly articulate the difference between the role of the PIOB and the role of the Monitoring Group, both in the oversight of the standard setting process, and the appointment of members of the boards. In some of our discussions with stakeholders, there is a perception that the respective roles overlap, and it would be useful to provide greater clarity of the relationships between the PIOB and the Monitoring Group, and the SSBs and the Monitoring Group.

Should the PIOB wish to discuss any of the responses in this letter in more detail, then in the first instance please contact Mark Babington, the FRC's Deputy Director of Audit Policy on m.babington@frc.org.uk or on +44-207-492-2323. I am also happy to be party to any further discussions on our response to your strategy if you would find that helpful.

Yours sincerely,

A handwritten signature in blue ink that reads "M McLaren". The signature is written in a cursive style and is underlined.

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