



Rt Hon Frank Field MP  
Rachel Reeves MP  
Work and Pensions Committee  
Business, Energy and Industrial Strategy Committee  
House of Commons  
London  
SW1A 0AA

3 July 2018

Dear Mr Field

Thank you for your letter of May 2nd, with your additional questions following our evidence to your joint hearings on Carillion.

### **FRC Investigation**

FRC welcomes your comprehensive report into the collapse of Carillion. I can assure you that our own investigation into the audit of the company and the conduct of two of its accountants who fall within the scope of our remit will be very thorough. It will focus on whether audit standards were breached by KPMG, and whether there was misconduct by the two accountants in order to determine if we should take enforcement action. The work of your joint Committees is very helpful to our consideration.

These investigations are large and complex. They entail obtaining and reviewing a vast set of documents including four years of audit files, KPMG's and Carillion's emails, extensive company documents, as well as interviewing KPMG and Carillion employees. As part of the investigation we will instruct an independent expert witness to consider the key accounting and audit issues and to prepare a detailed report that will be relied on at any subsequent tribunal proceedings.

Once the investigations are complete, the FRC Executive Counsel will determine whether the legal threshold is met to bring disciplinary proceedings. As matters stand it should be expected that if proceedings are commenced, they will be contested. In those circumstances we cannot set a final date for the conclusion of enforcement action, not least because the proceedings take place before an independent tribunal, and it is the tribunal that will set the timetable. However, we are committing resources to complete the investigative work as fast as possible. We have provided a recent update on the progress of the investigations and, in light of the exceptional level of public interest in Carillion, will continue to keep you and others informed of progress.

### **Disclosure of dividends**

Your letter asks whether we provided mixed messages by commenting positively on the quality of Carillion's dividend disclosures in the Financial Reporting Lab report. The views expressed in the report reflected input from investors but nevertheless it would have been better not to reference Carillion. We need to be clearer about what we are endorsing and on what basis.

For clarification, there is no requirement for a company to disclose the level of their distributable reserves, but many investors had said that more information about dividend policies would be helpful. The report suggested best practice on meeting that investor wish. Subsequent implementation studies in 2016 and 2017 found that a significant number of companies had provided more information drawing on the Lab report.

### **Regulatory reviews of Carillion**

Your report makes a number of observations about our review of Carillion's report and accounts for 2015.

We raised a number of questions about disclosures in the 2015 report as part of our Corporate Reporting Review (CRR). We followed up with a review of the 2016 accounts. It is our policy to check that the required improvements have been made in subsequent accounts. These inquiries informed our review of the 2016 audit which we started following the July profits warning. An audit quality review is our most effective tool to ascertain whether any of those losses should have been recognised earlier in the accounts as it gives us access to the auditors' records. The review showed that the case for enforcement action should be considered. At the point the company failed, this consideration was well advanced and we were quickly able to announce our investigation. The points the Committee has raised about the accounting treatment of goodwill, reverse factoring and other matters will form part of the investigation.

### **Stewardship**

We welcome your observations on investor stewardship. These will inform our work on the Stewardship Code which will start after the Corporate Governance Code review is completed shortly. We plan to consult on stewardship later in the year. We intend to look at the effectiveness of the Code but also consider other ways in which effective engagement between companies and investors can be achieved and the role of intermediaries such as proxy agents.

### **Audit Market Competition**

We share many of the concerns expressed by the Committee about concentration in the audit market and, in particular, the dominance of the Big 4. The failure of a firm could have serious implications for confidence in the capital markets. It is also worth noting that at present the loss of an audit contract gives a firm an opportunity to pick up better remunerated consulting work. The market does not therefore fully incentivise high quality performance. We have a responsibility to monitor these risks but do not have powers to intervene. We have therefore raised the issue with the CMA who are considering the matter. Working with the CMA we will consider whether any of the audit regulations could be changed to reduce concentration in tandem with competition measures.

### **Lessons Learned / Powers**

Through our work in reviewing the quality of corporate reports and audits we secure improvement to individual companies' reports and to their audit work. We are committed to identifying and calling out poor performance and have done so in our most recent reports on the major audit firms after finding a reversal in the last year of a previously improving trend.

However, in the light of Carillion we have reviewed whether our supervisory work should be strengthened further and whether we should do more to signal our concerns to investors.

The objective of the powers granted to the FRC in relation to audit is to enhance overall audit quality. We have therefore focused on and published our assessments of the overall performance of the audit firms. It was not envisaged when the regulatory framework was put in place that these powers should or would prevent failure by individual companies. Indeed, because of the confidentiality requirements in the Companies Act, we are not able to publish our views on individual company audits.

We now intend to enhance our focus on the audits of companies which appear to be in danger and should like this to be combined with an ability to call out what we find. Companies will still fail. Not every impending failure can be stopped, especially through the backward-looking lens of audit. However, we do feel it would be valuable to investors if we could do more to signal concerns, if before problems become terminal.

Carillion has also shown the importance of a Board's awareness of its own effectiveness and willingness to enhance its own performance. Statements by companies in the Annual Report about their governance can fail to provide real insight and investors can find them hard to challenge. The FRC has no power to challenge these parts of the Annual Report. We believe this should be addressed by extending the scope of our corporate reporting review powers, combined with a power to undertake or commission a report into the quality of governance akin to the powers of the FCA. The role of investors in governance must not be undermined but we believe they would benefit from regulatory support.

In relation to audit the Statutory Audit and Third Country Audit Regulation 2016 went a long way to strengthening our monitoring regime. However, there are gaps in that regime, such as in relation to the performance of leadership, the suitability of those being appointed to senior audit positions and the strength of the business. The firms have recently agreed to work with us in these areas on a voluntary basis and so far this is working satisfactorily. However, we believe that in view of the systemic importance of the major firms and the variation in audit quality within each firm, a statutory basis for scrutiny and challenge of leadership roles in protecting the sustainability of the business and driving consistency in quality is especially important.

On enforcement, as we informed the BEIS Select Committee in 2016 we have no powers to pursue directors who are not accountants. The Committee supported action to correct this. Such powers are held by the FCA and INSS. Nevertheless we believe it would be more efficient for the FRC to have limited concurrent powers to enable a better, more efficient and holistic regulatory framework.

It is also important to recognise that our enforcement action on Carillion is taking place under two separate procedures. The case against the auditor is pursued under the Audit Enforcement Procedure ("the AEP"). This procedure does not apply to the accountants in business who we investigate under The Accountancy Scheme ("the Scheme"), a contractual arrangement with the profession. The AEP requires us to establish that there has been a breach of relevant requirements. The Scheme test is misconduct. This is a much higher test, which tribunals have defined as poor conduct more serious than negligence. We believe that the Scheme should be replaced with a new statutory regime and its tests should be aligned with and similar to those in the AEP.



We hope this provides sufficient detail in response to your letter. There are other legislative issues, such as our overall statutory basis which we believe Sir John Kingman will consider; the above points are those which we believe of most relevance to learning from Carillion.

We are happy to follow up on any points in further detail should you wish.

Yours sincerely,

Stephen

**Stephen Haddrill**  
**Chief Executive**