

Chief Executive's Remarks to the Financial Reporting Council's Annual Open Meeting

17 July 2008

Welcome and introduction

I would like to add my welcome to that of the Chairman.

Some of you will already be aware of this morning's announcement by the government that it has invited Christopher to extend the term of his chairmanship by one year to the end of 2009. The good news is that he has accepted the invitation. Christopher has quietly but skillfully navigated the FRC through significant changes to its governance in the past two years. These changes will prove to be a great source of strength and stability for the FRC for many years to come. I have very much enjoyed working with him and I am very pleased that we will have the benefit of his leadership for an additional year.

My remarks will focus on our main achievements in 2007/08 and our priorities for 2008/09 in relation to each of our six strategic outcomes. However, I will also start with a few words about our aim and regulatory approach as we believe that it is helpful to our stakeholders – and to the FRC itself – if we are open in explaining what we are trying to do and how we do it.

The FRC's aim and regulatory approach

I believe that it is essential for every organisation to be clear about its purpose and the ways in which it can add value to its stakeholders, particularly organisations such as the FRC which spend other people's money. I feel comfortable that the FRC has been transparent about its purpose and regulatory approach.

However, our remit is unusually wide in its scope - covering both technical and behavioural issues relating to company directors, accountants and actuaries - and our powers are unusually diverse, ranging from full statutory authority to set and enforce standards through to non-statutory recommendations which market participants have the choice to follow or not. Our regulatory approach to navigating our way through a complex and rapidly-changing environment is, we believe, both multi-faceted and distinctive.

For these reasons the narrative of our purpose and approach requires some effort to master. The details are set out in our Regulatory Strategy which has at its heart our Strategic Framework and the way in which we apply the principles of good regulation. From the Strategy I would highlight two key sentences.

“Our overall aim is to promote confidence in corporate reporting and governance.”

This sets out the FRC’s core purpose. We do not regard regulation as an end in itself. We believe in wealth creation. We observe that loss of confidence in corporate reporting and governance is usually associated with wealth destruction.

Our Strategic Framework sets out, in progressively detailed levels, the outcomes which we seek in relation to each of the six areas of our responsibilities which contribute to confidence in corporate reporting and governance. The Framework recognises that the most important determinant of confidence in corporate reporting and governance in the UK is not the work of the FRC but the skills and behaviour of the large number of market participants who are responsible for it.

“[We ...] work on the basis that a well-informed market is the best regulator ...”

Most of our work on standards, codes and guidance is devoted to improving the relevance or reliability of information which organisations are required or encouraged to disclose. Our work on monitoring and enforcement is intended to increase the incentives for organisations to meet those requirements or expectations.

The FRC operates in the public interest. Our Regulatory Strategy helps to define the context in which we judge what is in the public interest. In making those judgements we attempt to strike an appropriate – and independent – balance between the interests of our many stakeholders, whilst also meeting the statutory and non-statutory responsibilities which have been entrusted to us.

Achievements and current priorities

Turning now to our achievements and priorities, our Annual Report provides a full account of our work and, for the first time this year, includes our assessment of the extent to which we judge that our overall aim and each of the six strategic outcomes are being achieved at present. Today I will refer to some of the matters which I personally believe are of the greatest significance.

Our work in 2007/08 was devoted largely to the implementation of our Plan for the year, which we finalised after a public consultation. We made significant progress on all of our major planned projects and activities but we also had to respond to unplanned events, most notably the implications for corporate reporting and governance of the turbulence in the credit markets.

Corporate governance

Our most visible work on corporate governance during the year has been the completion of our review of the impact of the Combined Code. The responses to our consultation provided robust support for our conclusion that the Code is

working reasonably well and there is no need for major changes at present. However, we have recently made two relatively small amendments to the Code.

Our assessment is that the Combined Code is presently satisfactory but both companies and investors need to work on engagement to ensure that the Code continues to operate satisfactorily. We are planning no major projects in relation to corporate governance in the current year.

Corporate reporting

Our work on corporate reporting has two main elements. The first is setting (or influencing) the legislative and regulatory framework for corporate reporting, including accounting standards. The second is influencing the way in which that framework is implemented by companies.

As regards the legislative and regulatory framework, I hope that our statement and leading counsel's opinion on the continuing centrality of the concept of "true and fair" in corporate reporting in the UK, even for those companies which apply international accounting standards, will prove to be of significance for many years.

We have been following closely the work of the International Accounting Standards Board. From a rather tentative basis when it commenced operations in 2001 the IASB has made remarkable progress in securing support for its standards being the most widely accepted in the global capital markets. We at the FRC have been strong supporters of the IASB. We wrote to the SEC to support its proposals to allow foreign issuers in the US to present their financial statements using IFRS without reconciliation to US GAAP. We also believe that the development of international accounting standards would be strengthened if the SEC was to allow US companies the option of using IFRS. At an operational level the UK has been one of the first countries to move its share of the funding of the IASB to a broad and transparent basis through the FRC's levy on publicly-traded companies. We believe that these developments, and others, put the IASB in a position of considerable strength – but also of considerable responsibility – as it considers its future work programme.

We continue to believe that it is important that the EU keeps "adopted IFRS" aligned closely with the standards issued by the IASB. On the other hand, we believe that there are some risks that IFRS will develop inappropriately and we shall continue to be active in seeking to influence the IASB.

However, mandatory adoption of IFRS by all companies and organisations that currently use UK GAAP would be a considerable challenge. The ASB's deliberations on how best to proceed on this issue are continuing.

A further highlight of our work on the framework for corporate reporting in the past year was the joint publication by the ASB and the European Financial Reporting Advisory Group on the "Financial Reporting of Pensions". Following that publication there has been another round of comment to the effect that

accounting standards being responsible for the demise of final salary pension schemes. Of course, you would expect me to agree that accounting standards are important and have real-world effects, but we need to retain a sense of proportion: there are other factors (not least the Pensions Act 2004, which made pension deficits legally binding obligations) which have been much more significant in persuading companies that they do not wish to continue to be exposed to the very considerable financial risks associated with sponsoring final salary pension schemes, particularly as such schemes are no longer essential to their ability to attract and retain high calibre staff. My personal view is that the risks are very much on the downside, ie we are likely to discover that pensions obligations prove to be more burdensome for sponsoring companies than the accounting numbers suggest. Poor accounting also has behavioural consequences.

We have made a start on our work to review the complexity and relevance of corporate reports and our advisory group met for the first time earlier this week.

The main focus of our review of annual and interim accounts was the first-time implementation of IFRS by listed companies. The FRRP found a good level of compliance but identified issues which companies should consider in preparing future reports. The Panel also gave increased attention to AIM companies, many of whom were implementing IFRS for the first time.

Our current priority is to review financial statements issued in the first half of 2008. About 8 months ago the FRRP announced what are to be our priority sectors for this year (banking, retail, travel and leisure, commercial property, house builders). In the light of developments since then this still seems to be a good choice of sectors to focus on. Given the well-publicised stresses which have affected the banking sector and the increasing evidence that this is transmitting stresses into the non-financial sectors of the economy, I expect that we shall be kept pretty busy dealing with our priority sectors. However, we are always on the look-out for particular sets of financial statements which might warrant our attention and so if you have any suggestions we will be delighted to hear from you. The anonymity of our sources is assured!

Much as I am sure that you would like to hear what we are doing on specific cases I am sure that you will understand why I am going to adhere to our published policy of not commenting on cases unless and until the Panel has concluded that a public statement about the need for changes to a company's financial statements is required.

Our assessment is that our strategic outcome in relation to corporate reporting is largely being achieved at present, although there are a number of potentially significant risks which we will work on in the current year.

Auditing

Our work on auditing has the same two main elements: regulatory requirements and implementation.

An important project has been the continuation of our work on choice in the UK audit market. There are many aspects to this issue but the most critical one is the risks to the continued availability of high quality independent auditing if one or more of the Big Four audit firms were to leave the market. We know from a variety of sources, most notably the points which the firms themselves make in pressing their case for reform of the auditor liability regime, that the risk is serious.

Our Market Participants Group considered the responses to its Interim Report and issued an unanimous Final Report containing 15 recommendations. The responsibility for implementing those recommendations lies with a variety of organisations, including the FRC. We issued a report in May 2008 which noted good progress and we will issue a further progress report in October. There is increased awareness internationally of our work on this issue. The work on our project on Choice in the UK audit market will continue.

We finalised our framework of the drivers of audit quality. We think that the framework is of value to purchasers and suppliers of audit services and to those who rely on audited financial information. We will keep this under review in the light of experience of its use in practice.

We devoted considerable attention to planning for the implementation of the EU Statutory Audit Directive, which has now come into force. As we note in our Plan for 2008/09 implementing those parts of the Directive relating to foreign auditors is likely to prove to be challenging. Although the EU has concluded that a substantial number of foreign countries will benefit from transitional measures which will delay the full impact of the provisions of the Statutory Audit Directive, not all countries will be covered by those measures. We shall be working to ensure satisfactory implementation of the new regulatory requirements for the relevant foreign audit firms.

We have been influential in the development of the International Auditing and Assurance Standards Board's "Clarity" project to improve international auditing standards. As the "Clarity" project nears completion the APB shall be reviewing the timing and extent of the adoption of the new standards in the UK. We shall continue to encourage the EU to adopt these new standards.

In response to calls for greater transparency and more information to be made available to audit committees, significant changes have been made to make the Audit Inspection Unit reporting more transparent. As a result later this year the first public reports on individual audit firms will be published by the Oversight Board, and we have already issued the first reports on the conduct of individual audits designed to be shared by auditors with their clients.

One of the areas of highest priority for our audit inspection unit is looking at the way in which the audit firms within our scope have responded to the challenges of auditing in the recent period of credit market turbulence. We shall report in due course on the results of those inspections in accordance with our revised procedures.

We sometimes detect that the audit firms are not wholly enthusiastic about the work of our Audit Inspection Unit. On the other hand, they have had considerably more enthusiasm for the work which we have done, through a broadly-based group of market participants led by Sir Anthony Coleman, in producing guidance on the implementation of the newly-permissible auditor liability limitation agreements. We believe that this is a good example of the way in which the FRC can add value for all of its stakeholders and we look forward to seeing how market practice now develops. Our discussions with the US Securities and Exchange Commission on the interaction between these new provisions and their rules on the independence of auditors are continuing.

We played an important role in the development of international auditing regulation. I was honoured to have been appointed Chair of the International Forum of Independent Audit Regulators in September of last year.

Our assessment is that our strategic outcome in relation to auditing is largely being achieved at present, although we believe that the high level of concentration in the market continues to present some significant risks and potentially long-duration risks.

Actuarial practice

The pace of our work on actuarial standards increased during the year. We took a number of steps towards a conceptual framework for actuarial standards, culminating in the publication of an exposure draft. We also published a discussion paper on mortality assumptions. We also worked on papers on an Exposure Draft of a Reporting Standard and a consultation paper on the Structure of the new actuarial standards which were published in April.

Our current priorities include the finalisation of the conceptual framework for actuarial standards and the development of specific standards.

We have continued to benefit from the advice of our Stakeholder Group and we published a survey which it had commissioned into the needs of principal users of actuarial services.

Our assessment is that there are still significant concerns about the achievement of our strategic outcome in relation to actuarial practice, although we are now confident that plans are in place to make the necessary progress. Those of you to whom these matters are important can take comfort from the fact that there will be

a steady stream of papers emerging from the Board for Actuarial Standards in the remainder of the year.

Professionalism of accountants and actuaries

Our independent accountancy investigation and discipline scheme continued its work in relation to the cases brought forward from 2007/08 and added one new case.

We have completed our review of the accountancy scheme and have consulted on proposals for change. We are continuing to assess the responses to that consultation and expect to bring forward formal amendments to the scheme later this year.

The Professional Oversight Board's oversight of the work of the accountancy professional bodies continued during the year and the POB published papers on the arrangements for monitoring of actuarial work and on the drivers of actuarial quality. Later this year we shall make final recommendations for the monitoring of actuarial work taking into account the responses to our consultation. The POB has also commented on the actuarial profession's proposed Actuaries' Code.

Our assessment is that our strategic outcome in relation to the professionalism of accountants and actuaries is largely being achieved at present, although we believe that there are significant risks to the continued achievement of this outcome.

Effectiveness of the FRC

My responsibilities have given me opportunities to learn about the regulatory arrangements for corporate reporting and governance in other countries. I believe that the breadth of the FRC's responsibilities is unique and that it adds to our capabilities to add value to our stakeholders. I have never returned from one of my overseas trips and said to Christopher "I wish that we had the structure and approach that they are fortunate to have in that jurisdiction."

During the past year we have taken a number of steps to improve the effectiveness of the FRC. Christopher referred in his remarks to the changes to the governance of the FRC and to the appointment of a new Board. I have been very grateful to the new Directors for the insights and assistance which they have been able to give us in their first six months and I look forward to their input in the year ahead.

We have also strengthened the senior management of the FRC and I am delighted that we have also been able to recruit other talented and experienced staff.

We believe that our work makes an important contribution to sustaining confidence in corporate reporting and governance in the UK. The results of the IPSOS Mori survey of stakeholders' opinions, which is included in our Annual

Report, suggests that there is some independent support for this proposition. We welcome today's opportunity to get further feedback from our stakeholders.

I believe that we are also a very cost-effective organisation when our costs are considered against the range and significance of our responsibilities. Our core operating costs for our responsibilities for accounting, auditing and corporate governance were £10.7m, compared to a budget of £10.9m. The budget for 2007/08 was less than the budget originally proposed for 2004/05. Our core operating costs for actuarial regulation were close to budget at £1.8m.

Our assessment is that the FRC has operated effectively in the past year but the Government's decision to withdraw its share of the FRC's funding presents risks to our continued effectiveness. We have published proposals to replace the loss of the Government's contribution and we hope that our stakeholders will respond positively.

Concluding remarks

In December of last year we issued a statement noting that the risks to confidence in corporate reporting and governance were higher than they had been for some years and that this needed to be matched by additional diligence on the part of preparers of accounts, audit committees and auditors. Eight months on our warning remains in place and the text of our statement and the key questions which we suggested that audit committees should consider is worth re-reading.

The wide range of organisations and individuals who contribute to our work, either by participating in our Operating Bodies and their committees or by commenting on our proposals, play a key role in ensuring that we can successfully promote the outcomes set out in our Strategic Framework. In fact this level of market participant participation in our work is one of the distinctive features of the FRC. I would like to conclude my remarks by thanking them and the staff of the FRC for their vital contribution to our work.

I look forward to hearing your comments and questions on any aspect of our work.

Paul Boyle