



FINANCIAL REPORTING COUNCIL

**CONSULTATION PAPER ON THE GOVERNANCE
STRUCTURE OF THE FRC**

MARCH 2007

Purpose

1. The purpose of this paper is to invite views on proposed changes to the structure of the Financial Reporting Council (FRC) in order to enhance its independence, transparency and efficiency.
2. The FRC's initiative in issuing these proposals for consultation is supported by the Government and by the FRC's Council. The consultation period will close on Friday, 1st June, which will allow the results of the consultation to be discussed with Council at its next meeting on 5th June.

Evolution of the FRC

3. Following some significant and disturbing company collapses in the late 1980s, the Government commissioned a review of the arrangements for the setting and enforcing of accounting standards in the UK. This review led to the establishment in 1990 of the Accounting Standards Board and the Financial Reporting Review Panel; and the FRC was created to be their parent, responsible for raising their funding and ensuring their independence. The FRC subsequently joined with the accountancy profession and the London Stock Exchange in setting up the Cadbury Committee which issued in 1992 its report on the Financial Aspects of Corporate Governance, including the first version of the Combined Code (the Code).
4. In the 1990s, the scope of the Code was enlarged by the Greenbury and Hampel Committees. There was also a progressive move away from entirely self-regulation of auditing by the accountancy profession. This resulted in the transfer of certain key regulatory activities, including the setting of auditing standards and ethical standards, to an independent regulator, the Accountancy Foundation, which began operating in 2000.
5. The UK regulatory regime covering financial reporting, auditing and corporate governance had thus developed considerably by the time of the major corporate scandals in the US and the collapse of Andersen. The Government, in reviewing the whole regime at that time, took this into account in deciding in 2003 to widen and deepen significantly the role of the FRC and to make it the UK's independent and unified regulator for corporate reporting and governance.
6. As a result, the FRC took over the functions of the Accountancy Foundation and thus became the parent of the Auditing Practices Board in addition to its existing subsidiaries, the Accounting Standards Board and the Financial Reporting Review Panel. A new Professional Oversight Board, with powers delegated from the Secretary of State and a new Audit Inspection Unit, was created and put under the FRC. The FRC was also charged with bringing into operation the Investigation and Discipline Board for hearing significant public interest disciplinary cases. To these five Boards was subsequently added a sixth, the Board for Actuarial Standards, following the Morris Review of the Actuarial Profession. The FRC's corporate governance responsibilities are handled as described in paragraph 13 below.

7. The Boards are collectively referred to within the FRC and in this paper as the Operating Bodies (OBs). The FRC's experience has shown that there are strong connections between the issues of corporate reporting, auditing, actuarial work, corporate governance and oversight of the accounting and actuarial professions. It therefore believes the broadening of its remit to cover all these functions has enhanced its effectiveness.
8. Full information on the FRC's remit, organisation and other matters was set out in its booklet "Regulatory Strategy" published in May 2006, complemented by the Annual Report for 2005/06 published in the same month. An updated picture, published in December 2006, and also available on the FRC's website, is the "Draft Updated Regulatory Strategy and Plan & Budget 2007/08". A revised version of the latter, which will take account of much helpful and substantially supportive feedback, will be published by the end of April.
9. The FRC has always been a market-led regulator. It has throughout its life believed in the value of thorough consultation and research as the best way to secure the application of high standards in practice. It has therefore paid close and continuous attention to the views of practitioners, particularly investors, businesses and the professions. It recognises the central role of the professions in formulating and applying accounting, auditing and actuarial standards.
10. The FRC is committed to the Better Regulation Commission's principles of proportionality, targeting, consistency, transparency and accountability. It seeks to make effective use of Regulatory Impact Assessments. It has always had particular regard to the impact of regulation on small enterprises.

The reasons for proposing changes

11. Since the April 2004 enlargement of the FRC's remit, great progress has been made in developing the running of the FRC so as to exploit effectively the strong interconnections between the work of the OBs without infringing the degree of autonomy appropriate to each. Attention has subsequently focussed on whether the governance of the FRC itself is as effective as it could be.
12. From its inception, the Council of the FRC has been composed of a broad selection of representatives – at least thirty in number – from the commercial, financial, and professional communities at the most senior levels. This was especially important when the FRC's formal powers were extremely limited and its funding was raised on an entirely voluntary basis; and the widely representative nature of Council gave stakeholders confidence that their views could be heard.

13. The Council's role and future were fully debated before the establishment in 2004 of the greatly enlarged FRC. There was concern then that the Council would be too unwieldy to oversee the organisation and provide accountability. However, it was decided to retain it in an advisory role, having regard to its weight of calibre and experience and to its potential as a recognised channel for stakeholders to express views. It was also decided that it should be a function of Council, through a Corporate Governance Committee, to determine the FRC's general policy in relation to corporate governance.
14. The FRC's governing body became a very small Board of five, to which the Chief Executive was added as a sixth in 2005. Overlap between the advisory Council and the FRC's operations is secured by all the members of the Board and all the Chairs of the OBs being ex officio members of Council.
15. Sir Christopher Hogg, after taking over the Chair of the FRC on 1st January 2006, undertook one-to-one familiarisation interviews with members of the Board and the Council. From these discussions three concerns emerged: the unwieldiness of the Council; uncertainty about its impact, except in relation to corporate governance; and whether the FRC's governance was as compliant as it should be with those of the Code's principles which could be judged relevant and applicable.
16. These concerns were put to Council and debated. There was general agreement that a proper advisory role for Council was frustrated by its size, its relative infrequency of meeting, and the consequent impracticability of briefing it adequately to obtain appropriate challenge and advice with regard to strategy. But many also stressed the value obtained in the past from the support of such a weighty representative body and the reassurance it provided to stakeholders. It was also generally accepted that the Board was too small to perform adequately all the functions ideally required of the FRC's governing body and could be perceived, on the criteria for its membership, to be insufficiently independent of stakeholders.
17. The Board, having reflected on Council's comments and undertaken further consultations, decided that the right course was for the Board and the Council to be merged to form a single FRC governing body. This decision was put to Council, which supported it. The way was then open to explore and prepare for all the implications of such a change.

Key features of the changes now proposed

18. Revised Articles will provide for the Board of the FRC to have a maximum of up to twenty members but the expectation is that the Board will not exceed sixteen Directors, comprising a Chair and Deputy Chair, both appointed by Government; the Chief Executive and the Chairs of the OBs; and non-executive Directors (NEDs) who, in conjunction with the Chair and Deputy Chair, will be a majority of the Board.

19. As in the board of a public company operating under the Code, appointments (other than those of the Chair and Deputy Chair) will be handled by a Nominations Committee of the Board making recommendations to be endorsed by the Board as a whole. The Nominations Committee will be comprised of NEDs chaired by the FRC Chair. It will apply the principles set by the Office of the Commissioner for Public Appointments (OCPA) of openness, fairness and diversity and will be guided by a template of the range of skills and experience required for the Board as a whole and for individual appointments.
20. With regard to the Committees of the new Board, the Audit and Remuneration Committees will operate generally as at present and with regard to the principles of the Code. Operations will be covered by a Chairs Committee, substantially as at present. The Board will have a Corporate Governance Committee (CGC), as the Council does at present, and may well decide, if circumstances require it, to include amongst the CGC's membership, temporarily or permanently, people who are not members of the new Board.
21. The FRC is a small organisation with less than eighty staff in total serving the Board, the Council, the OBs and their committees which between them comprise more than double that number of part-time practitioners. To keep costs to a minimum, the FRC has to judge priorities accurately and ensure it has the quantum and quality of resources to deal with them. The subjects of the FRC's remit are complex and very demanding to understand as they should be understood for purposes of strategic discussion.
22. The template of the skills and experience ideally required for the new Board as a whole is a subject on which the FRC would welcome the views of the recipients of this paper. It is certainly a matter which the Temporary Nominations Committee (see below) and the ultimate Nominations Committee will have to debate and decide upon as soon as they have been formed and bear in mind throughout their work. If the new Board is to have an appropriate influence on the FRC's strategy and priorities it will require high quality briefing papers from the FRC's executive and will have to bring to the Board table a very wide practical experience in reporting and governance, as well as adequate intra-professional understanding, international knowledge and experience, and diversity.
23. A single governing body, meeting not less than six times a year, will enable strategy to be better communicated, challenged and supported than at present; and the whole of the FRC's operations can be better focussed, with less duplication and a lot of meeting time saved. Furthermore, the simplification of the FRC's structure will over time give it a clearer profile in its work both in the UK and internationally.

24. The FRC takes relations with its stakeholders very seriously. It will establish a schedule of regular high level meetings with representatives of the accountancy and actuarial professional bodies. It will also discuss with representative organisations of business and investors whether they would like similar, regular meetings. Stakeholder formal meeting arrangements, in conjunction with the high stakeholder involvement in the OBs and the intensity of the FRC's contacts with its stakeholders in its daily business, should suffice more than adequately over time to replace the communication channels afforded by the present Council.
25. The selection of the directors of the new Board by a Nominations Committee operating in accordance with the Code and with OCPA principles will better enable the FRC to strike the right balance between close working relationships with the professions on the one hand and, on the other, the charge that the regulator is too close to those being regulated.

Transitional Arrangements

26. These will be made so as to ensure a clean break between the public sector controlled appointments to the existing Board and appointments to the new Board. The core task is that of choosing the seven NEDs according to OCPA principles and in line with an appropriate template.
27. This task will be performed by a Temporary Nominations Committee (TNC) which Sir Christopher will chair. The members of the TNC, apart from the Chair, will be between six and ten in number and will be senior representatives of private sector stakeholders in the work of the FRC. They will be selected by an appointing group comprising the members of Council other than the present Board and Chairs of the OBs. The TNC may include people who are currently on the Council (provided the appointing group agree) but only if all such people have themselves been appointed to Council originally by recommendation from a stakeholder representative body such as the CBI or the CCAB.
28. When the NEDs of the new Board have been appointed, the TNC will wind up and the new Board will come into being. The new Board, which at that stage will comprise the Chair, the Deputy Chair and the NEDs, will appoint the Chief Executive as a Board member and agree on the Nominations Committee. The Nominations Committee will then deal with the appointment or reappointment of the Chairs of the OBs all of whom, as noted above, will also be members of the new Board.
29. The transitional arrangements will, even on an optimistic view, take several months to complete. While they are being expedited, current members of Council, including the present Board and the Chairs of the OBs, will continue, with their appointments if necessary being adjusted as required. It is hoped that the FRC in its new form will be fully operational by the end of 2007.

Questions

1. Do you have any points to make about the likely effectiveness or otherwise of the changes proposed?
2. Do you have any points to make about the template of skills and experience required within the new Board?
3. Will you support the transitional arrangements and do you have any comments thereon?
4. Do you believe, on the basis of your experience of it, that the FRC is, and will continue to be, a market-led regulator accountable to its stakeholders?

Comments on the Consultation Paper should be sent by 1st June 2007 to:

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