Financial Reporting Council (FRC)
FRC Priorities Meeting 2018/19
6 February 2018

FRC Strategy, Plan and Budget

Melanie McLaren

Executive Director, Audit & Actuarial Regulation, FRC

You are all very welcome at this FRC Annual Priorities meeting. I am Melanie McLaren, Executive Director of Audit and Actuarial Regulation at the FRC. I am a board member and a member of the executive committee. Stephen Haddrill was hoping to lead today's event but, unfortunately, he has lost his voice, so he sends his apologies and has given the opportunity to his executive committee colleagues to demonstrate our depths, strengths and diversity. I hope it will not be too diverse an afternoon for you, but we do, as you will see in our Corporate Governance Code consultation, take diversity of input very seriously at the FRC.

The opportunity today is for you to be able to scrutinise our strategic plan for 2018-2021 and to look in a little bit of depth at our immediate plans for 2018/19. There will be an opportunity after Paul and I have spoken to ask questions, and we will do our best to answer. We will be looking at a longer-term horizon with a panel.

1. Mission Review

We thought we should explain the context of our strategy for 2018-2021. Those of you who follow our activities quite closely might recollect that we had a strategy period of 2016-2019, so why have we now developed a different synchronisation for our work? It was, quite simply, prompted by the post-Brexit debate that we have been having as a society about trust in business. When you are an organisation whose mission at that stage was to promote high quality corporate governance and reporting to foster investment, and there is a debate raging about whether there is, in fact, high-quality corporate governance, whether business can be trusted and, therefore, whether its transparency and integrity is appropriate, it causes one to pause for thought.

2. Trust

The FRC had a review and looked at our mission, and worked out whether we thought we were sufficiently aligned with the public-interest aspects of our role. From that work, which was led by our board but involved a lot of bottom-up discussions with our people, we developed a new mission very firmly rooted in trust. Our mission, which we gave exposure to last year, is promoting transparency and integrity in business. The words ‘transparency’ and ‘integrity’, we feel, are absolutely crucial to trust. There is a trust equation which is based on there being reliability and credibility – words that relate to integrity – and also on there being familiarity and proximity, and there being no conflicts of interest. Transparency, we feel, really contributes to that.

With this mission around trust in business, what we hope to do is to provide investor confidence and effective capital markets, to ensure that there is information which is sound and, therefore, enables business decisions to be made, and to more broadly serve the wider public interest. We will be coming back particularly to that public interest point as we go through and explain our strategy in a little bit more detail.

3. Technology

The other context that we wish to set is that we do feel that there are opportunities that we need to seize in this mission period. Technology is affecting all walks of life, and that pertains also to reporting in particular and to audit, but it also means that business models are changing. Therefore, stakeholder expectations are changing, so the FRC feels that there is an opportunity for us to review that quite thoughtfully and to develop thought leadership around the corporate governance, reporting and assurance model that that leads to. That may mean that we need to reform some of the frameworks that we work to in order to meet expectations, so there is a technology input from that, but also this public interest expectation that seems to be changing shape and size in the UK is something that we would like to take the opportunity to review.

4. Brexit

I am probably now about five minutes in and I have not mentioned Brexit, which is probably a record in the FRC at the moment. Clearly, having exited the EU, we will need to ensure that we continue to exert appropriate influence both in the EU and beyond the EU. We have long tried to espouse global standards that provide high quality and international coherence, and we will continue to do that. The fact of exiting the EU provides an opportunity to seize that.

5. Public Scrutiny

Finally, we are under increasing public scrutiny. We have recently been confirmed as a public body, which means that there are consequences for our own transparency and accountability, so we want to make the most of the opportunities that that confirmed public body status affords us, and to make sure that we do our best job to act in a way that is, of itself, transparent and has integrity. We are, then, operating in quite a broad context.

Within that broad context, we have set out, in our strategy and plan consultation, a number of strategic outcomes. What we would like to do for the next few minutes is to explore each strategic outcome in a little bit more detail, setting out what our immediate plans are, what we might do in the medium-term, and then what is further ahead on the horizon. My colleague, Paul George, is going to talk about corporate governance and reporting, I will pick up on the audit and enforcement matters, and we hope to take your questions after that.

The Future of Governance, Stewardship, Auditing and Reporting

Paul George

Executive Director, Corporate Governance & Reporting, FRC

Thank you, Melanie, and good afternoon, everybody. As Melanie has said, I am going to look at two of our strategic outcomes: first, world-class corporate governance; and second, true and fair corporate reporting. I am not going to do those as separate items. I am going to look at them, first of all, in terms of what business-as-usual activities are planned for 2018/19. Second, I am going to look at some of the ad hoc projects that we will be undertaking during that period and, as Melanie has suggested, then look slightly further ahead in terms of some of our longer-term aspirations.

1. Reviews of Annual Reports and Accounts

In terms of our business-as-usual activity, I would highlight two in particular, the first one being our annual cycle of reviews of annual reports and accounts. We will continue to undertake a programme of reviews probably in order of slightly over 200 sets of accounts. That will pick up some of our thematic work as well, which I will come on to in due course. We have highlighted some particular sectors that we have set and already published as our priority sectors, and these priority sectors are relevant not only to our Corporate Reporting Review (CRR) activity but also to our Audit Quality Review activity.

What it does not mean is that, if you are a director of a company that operates in a segment that is not listed, your accounts or your reports will not be selected, so you can still look forward to the prospect of some correspondence with the FRC. What it does mean, however, is that there is a higher chance that your accounts or your audit will be selected for review. We will then summarise the findings from that work and our other activities across the FRC in respect of corporate reporting in our annual report of developments in corporate reporting, which we plan to publish around about October this year.

2. Future Development of International Financial Reporting Standards (IFRS)

a. IFRS 17

The second business-as-usual activity – and I hesitate to suggest that this might be a business-as-usual activity in the current climate – is to influence the future development of IFRS. I would highlight two particular aspects of that: first, a new standard which is in the process of going through endorsement – IFRS 17, the accounting standard for insurance contracts, which is a particularly significant change of accounting for insurance companies – and we will be spending a significant amount of our time and effort helping, both at a European Financial Reporting Advisory Group (EFRAG) level but also as a contingency at the UK level, in terms of how and whether we should endorse that standard into European requirements and, thereafter, into UK requirements.

b. Post-Brexit accounting framework

The second aspect is that we will be liaising with the Department for Business, Energy and Industrial Strategy (BEIS) and we anticipate a fairly high level consultation later in the year around the accounting framework for the UK post-Brexit, and the extent to which the UK has an endorsement process, the extent to which we adopt IFRS, and what the processes and parties involved in those processes are.

3. Corporate Governance Code Consultation

In terms of ad hoc projects, the first and very significant project, which has been running throughout 2017, is on our consultation on changes to the Corporate Governance Code. The consultation closes at the end of February. We are doing significant outreach at the moment and we will continue to do that outreach beyond the closure of the consultation period as we test out how we need to reflect the changes that we are proposing and reflect on the consultation responses on the code that we have issued for consultation.

I do urge you to participate in that consultation and in the various outreach events that are taking place, and, most significantly, to respond to that consultation. We do not expect everybody to answer all of the 30 or so questions that we pose; if there is a particular issue that you wish to respond on, that is perfectly fine as well. Please do not just highlight the things that you do not like; if there are things that you do like, please report back on those, because we want to make sure that, when we finalise the Code, we have a fair reflection on the good and where improvements are required.

You will have noticed that, in that consultation, we are asking some fairly high level questions as part of our initial outreach on a significant update of the Stewardship Code. Our plan is, shortly after we publish the final Corporate Governance Code in June this year, to issue a consultation on the Stewardship Code thereafter with a view to finalising that towards the end of the year or early next year.

4. Guidance on the Strategic Report Consultation

The consultation period has closed on our Guidance on the Strategic Report. The Guidance on the Strategic Report that we are consulting on has sought to address several issues: first, it is timely to reflect on how well the original guidance has landed; second, to implement the Non-Financial Reporting (NFR) Directive, which was brought into UK legislation in 2017; and third, to push forward the agenda of directors' duties around Section 172. We have not finalised that consultation, even though the period has closed, because we are waiting for BEIS to issue some secondary legislation, which may influence how we finalise that guidance. We expect to finalise that over the summer period.

5. Governance Framework for Large Private Companies

We have also, as many of you will have seen, just started work on the governance framework for large private companies. BEIS has appointed James Wates as the chair of the working group, and we are acting as the secretariat. We had an initial meeting before the chair was appointed and we have now had the first meeting with the chair in place and are beginning to get to work on that in earnest. Again, we hope to issue a consultation during the second half of 2018.

6. CRR

I have talked a little bit about the normal annual CRR cycle. We are also planning three thematic reviews. The good news here for many of you is that we have pre-informed all of the companies whose accounts we are planning to review as part of those thematic reviews. What we have found from our previous CRR thematic reviews is that pre-informing companies that we are focusing in on a particular aspect of their reporting has shown to result in significant improvements in those particular areas. Companies have responded very positively to the fact that we are looking at a particular aspect of their annual report and accounts, and that has been a good way of driving targeted improvements.

7. Lab Projects

We have two significant Lab projects planned, the first of which is underway on performance measures. The first part of that is to get some investor views around what they are looking for in performance measures, and we will roll that on into ideas of how companies might best be able to meet investor wishes. We will continue on our work on the digital futures project. We have recently published a report on XBRL (eXtensible Business Reporting Language). The next part of that will be a report on blockchain and how it might affect corporate reporting going forward. We are then going to move on to a further project on artificial intelligence. Those projects will build on an earlier report where we looked at the characteristics that users were looking for in digital reporting.

8. Longer-Term Initiatives

a. Corporate-governance reporting

In terms of longer-term initiatives – by which I mean the three-year timeframe of our strategic plan – we must, first of all, assess how well and how effectively the changes to the Corporate Governance and Stewardship Codes land. That will be a significant part of our work. We asked Government for some additional powers around our ability to monitor corporate-governance reporting by companies. That is not forthcoming in the short term and, therefore, we are developing proposals to do that on a voluntary basis.

b. Companies Act Section 172

All of you will be very familiar with the level of discussion around Section 172 of the Companies Act and efforts that the FRC and many others have been pushing for better reporting of how directors have discharged their duty under Section 172. During that latter part of our strategy period, we will be doing a deep dive into how practice has changed and whether more work is required.

c. Role of annual report and accounts

Perhaps the more significant ad hoc project in the longer term that we plan to initiate is to really have a drains-up on corporate reporting more generally and, in particular, the role of the annual report and accounts. This will probably be an 18-month-to-two-year project. We are at the very early stages of developing a project plan. It will examine issues around the tension between the length of the annual report and who the annual report is designed to provide information to – whether it is purely to shareholders, which is how the legislation is drafted, or whether reporting to wider stakeholders should be done through the annual report and accounts. If it is extending the annual report and accounts, how can we make use of digital technology to make that effective? Does that overburden the annual report and accounts and the original purpose? Do we need to think about other mechanisms of wider stakeholder reporting?

As part of that, we will explore what wider stakeholders want and what shareholders want. Very often, those two things are closely aligned. A challenge to the length of reports is the materiality filter. What goes in an annual report and accounts, and what perhaps is reported elsewhere. Clearly, one of the things we want to address there is whether we have overburdened the annual report and accounts and whether we need to look more radically at solutions to corporate reporting. That will be quite a significant initiative and we will be looking for input from a variety of different sources.

I will now hand back to Melanie, who will revert to her day job, rather than Stephen's job, and deal with audit and actuarial regulation.

The Future of Audit and Actuarial Regulation

Melanie McLaren

Our second strategic outcome is to promote consistently high quality audit. Of course, in recent days, there has been quite a lot in the press on exactly that: what is the quality of audit in the UK? In our strategy document, we highlighted three particular strategic initiatives. I am going to explain in a little more detail what we have in mind for audit firms and the approach that we take to their regulation. I am also going to, rather as Paul has just done, give some insight into perhaps a more radical review of the future of audit that we want to kick-start during the strategy period.

9. Strong International Auditing Standards

First, I will perhaps say a couple of words about strong international auditing standards. As I said a few moments ago, the FRC, in all of its work, seeks to promote high quality global standards. The UK capital market has lots of global investors, and UK companies have a very large, strong global footprint. Therefore, we think it is very important that we are a world leader and promote a rise in global standards.

In connection with auditing, we continue to support the work of the International Auditing and Assurance Standards Board (IAASB), which sets the technical standards, and the International Ethics Standards Board for Accountants (IESBA). However, we feel that much work needs to be done to future-proof the standard-setting process, and we have been supporting a review by the Monitoring Group of regulators that oversees that standard-setting process.

There is currently an open consultation, which closes on 9 February. If you have not had a look at that, I would encourage you to take a look. If you have some comments, please feel free to make a response. In particular, there is a focus on whether the standards are being developed in a sufficiently independent way – independent from the profession. That is one of the key aspects that is being addressed. Particularly for those investors in the room, what does it take for you to trust in the standards, and does the way that the standards are being developed meet your needs in that regard?

Turning to UK matters, the FRC, in June 2016, about a week before the Brexit vote, became the UK's competent authority for audit through the implementation of a European directive. As the competent authority for statutory audit, we have a wide range of responsibilities. One such responsibility is to monitor risks to the public interest entity (PIE) audit market. Public interest entities are those that are listed on the regulated market, unlisted banks and unlisted insurers. We have a responsibility to look at risks there: risks to quality as well as to capacity. The law says that we should consider things that might give rise to the demise of an audit firm and what impact that may have.

Of course, the UK capital market is very significant – it is the second largest capital market in the world – and we have a very rich and diverse financial services market. We also have a very concentrated audit market in that large capital and financial services market, where much of the audit activity is concentrated on six firms. We think that we need to have an understanding not just about the quality of the audits of those firms but the broader firm and what the risks might be to the viability and sustainability of those firms. That is a new responsibility. Previously, the FRC's role has been to oversee the accountancy profession and to focus on the audit quality of those firms. That is one driver.

Another driver is that we have been looking at audit quality through the lens of individual audit engagements for over a decade, and we are told that we have driven up standards of quality. Through the innovative use of things like the Corporate Governance Code, we have introduced retendering, which has promoted competition on the grounds of quality. We have put drivers for audit quality in place; nonetheless, too often in our routine engagement work, we see poor quality audit and we would like to look more at what the root cause for that is. Often, the root cause is about the culture of the firm and how it supports quality, the leadership of the firm and whether they are providing sufficient leadership and resources, and the governance of the firm and whether there is enough external challenge going in.

Taking these new responsibilities for risk and an impetus to drive more consistent audit quality, we have stepped back and said that we should think about introducing an audit firm monitoring approach, and there are some explanations of this in the strategy and plan consultation, which is still open. What we want to do is to look at audit quality, as we always have, but also at other pillars that contribute to a safer and sounder audit market in the UK.

That means that we would like to look at aspects of leadership and governance, values and behaviour, business model and financial soundness, and risk management and control. In some of these areas, whilst we are given the responsibility, we are not given the tools and the powers to be able to take very much action, so we will need the collaboration and the support of the firms to be able to go in and get the information we need and to ensure transparency and integrity within the audit firms. We are consulting with the firms and all stakeholders on this at the moment, and I have to say our conversations to date are that the firms are supportive of us taking this necessary step in order to provide more confidence to the audit market. That is a key aspect that I would like to highlight. That is an immediate thing that we want to kick-start in 2018/19.

Another thing that we would like to make a start on in 2018/19 is perhaps a more radical review of the future of audit. I have been involved with the audit profession for 30 years. There was an expectation gap when I started 30 years ago; in our analysis, there is a widening expectation gap now. We can try to address that expectation gap in two ways: we can try to explain that those who have the expectation are incorrect; or we can try to broaden what audit does and take a proper look at whether it really is serving the right needs of the public.

In 2018, we hope to be able to begin to address what audit should do in the future and how it can best serve the public interest. That is quite a radical and bold thing to do, and it is also not appropriate that we, as regulators, should be in the lead from that point of view. If the world was designed by regulators, it may not be the most effective world. What we hope to do is to provide some resource and some impetus to a coalition, rather like the coalition that we used to look at the future of corporate governance and culture in the boardroom.

We would like that coalition to be led by an independent chair, who we would support with some resource, and who would do a thoughtful piece of work bringing a wide range of stakeholders together in order to look at what the expectations are in the public interest and how audit and assurance can meet future needs. We think that that will lead us to needing to look at the impact of technology in corporate reporting as well as in insurance, and hopefully to arriving at a new set of principles as to what audit and assurance has as an objective. We are very early days and we are currently engaging with a broad range of stakeholders to form that coalition. There is a search underway for an independent chair, so let us see how that model goes.

Another strategic outcome is effective enforcement. We said in our plan last year that we wanted to progress and conclude enforcement cases more quickly. We published a key indicator for that. We are tracking progress on that and I think you will have seen that we are bringing cases more swiftly to an investigation stage and then to a conclusion stage thereafter. We will continue to push on that. As part of that, we want to give increased transparency. We published a report in autumn last year on the lessons that we had learned from our investigations of the audits of HBOS. Increased transparency about our own processes, being clearer about what we can and cannot do, how we have gone about doing it, and how we have safeguarded against conflicts of interest and managed any conflicts were key lessons that we have learned. We have put those under the banner of increased transparency and we intend to live up to those lessons and to the commitments that we have made there.

Also last year, we had an independent review of our sanctions regime, led by an independent judge. A number of recommendations were made. One key outcome for this year is to take those recommendations, give effect to them and implement them, and we are working that through. Quite crucially, the recommendation was that not only should there be fines but that we should also look at a wider range of non-financial sanctions available, and we will be working that through.

Last but not least is the work that we do on a non-statutory basis for the actuarial profession. We oversee the actuarial profession, and actuarial work of a high quality is absolutely key to the public interest. I checked before I came out, for example, that, annually, 25 million statutory money purchase illustrations are issued each year. Those illustrations use an FRC standard as their basis. In fact, our actuarial work probably touches more individuals in UK society than some of the work that we do on annual reporting.

We have been talking with the Institute and Faculty of Actuaries (IFoA) about the fact that high quality actuarial work does matter, yet we do not have very much evidence about the quality of actuarial work. The IFoA is developing plans to implement a regime to monitor actuarial quality and to ensure that standards are maintained and raised. We will be overseeing the implementation and development of those plans. We develop technical actuarial standards. A new suite of standards and framework was switched on in the middle of last year. As we come towards the end of this strategy period, we will need to do a post-implementation review as to the effectiveness.

It is perhaps in the area of pensions and pensions disclosure where we feel that there are some risks and some issues that we want to explore, so we will continue to engage with Government and work through matters such as the Pensions Dashboard and the actuarial work that may need to support that. There are some quite gritty problems that we want to be engaged in, in order to make sure that the role of professionals is both safeguarded and developed in that context.

That was quite a whirlwind tour through what the key business matters are that we are looking at in terms of policy, but none of that can be achieved unless we have an organisation that is fit for purpose, with the right culture and the right resources. We have set out in our plan how we are taking some of the corporate governance aspects that we are consulting on to heart ourselves. The Spanish have a phrase that blacksmiths' children always eat with wooden spoons, but not at the FRC, so we will be doing some thoughtful work on our own culture.

We have to be effective and efficient, so we look very hard each year at our budgeting. Tracy, who is here to answer your questions, is a very hard taskmaster. We have to justify anything that is in addition and, of course, we consult annually on the levies that are raised. We are conscious that, outside of audit, those levies are set on a voluntary basis, so they have to be fit for purpose and support the corporate activity that is the lifeblood of the UK.

In 2018/19, there is an increase in our costs of 3%. That recognises a lot of additional activity and some efficiency. The audit firm monitoring approach that I outlined will be funded by the audit profession. It is a requirement in statute that they provide the funding for our competent authority work. We will be very thoughtful about the additional resources and skills that we bring in to carry out that work. Taking all of that together, what we have decided to do for the next year is that there will be no increase in those voluntary levies in 2018/19. We have tried to make savings and efficiencies throughout the organisation in order to be able to deliver high quality without increased costs.

In doing that, we have taken quite a lot of input in terms of you, our stakeholders, and what you think of us. During last year, we carried out quite an extensive quantitative and qualitative stakeholder survey, and we have very transparently issued the full survey on our website. If you would like to look at that, you can see where we feel we have actions to take. Very many people in this room will have responded to that survey, so I would like to thank you. We have developed a stakeholder panel to give us input as we take our strategic priorities forward, and we get very good input from that.

We are always open to consultation. Particularly in terms of the 2018-2021 strategy and the 2018/19 plan, you have until the very last day of the month to give us your feedback. However, if you have points and observations or questions that you would like to make today, now is your opportunity.

Questions and Answers

Ben Yeoh, Royal Bank of Canada Global Asset Management

I am a global investor. There is a current line of thinking that the majority of many companies' values today are in intangibles and matters that are quite hard to account for. Investors are increasingly interested in these extra-financial factors – some are financial and some are non-financial, however you want to describe them. I am interested in what the FRC is thinking about this. This is probably in the longer-term initiatives. There is some work at the Global Reporting Initiative (GRI) and now, increasingly, the Sustainability Accounting Standards Board (SASB) thinking about that. Is this something that the FRC wants to input into? What is the line of thinking on these, which do not necessarily meet core report and accounts but are often in the slide decks of the companies that we are interested in?

Paul George

It is not only part of a longer-term initiative; we have already touched on a number of those issues in our consultation on the strategic report, very much looking at the drivers of value that perhaps are not necessarily recorded or do not meet, the recognition criteria for a traditional set of financial statements. I am quite convinced that our Lab project on performance measures will pick up issues of that nature and, as you say, our project looking at the future of corporate reporting more generally, we will pick that up. It is a very good point but it is not just a long-term report – it is a here and now issue.

Bryan Foss, FRC Audit & Assurance Council and Independent Non-Executive Director

I was very interested to take part in the initiative which brings together investors and audit chairs. I would quite like to understand where you see that going ahead and what deliverables might come out of it. Does it fit within the future of audit and how might you manage the other sub-projects within the future of audit? I see that as a really interesting initiative.

Melanie McLaren

Bryan is talking about our Audit and Assurance Lab pilot project. We are very proud and think that the Financial Reporting Lab has been very influential in developing good financial reporting practice. We are trying to see if we can use that Lab idea to promote improvements in audit quality. Audit quality depends not just on auditors but also on audit committees and companies all working together to support high quality reporting and audit.

There was a project report in the first phase of this in December last year, which, as Bryan said, he contributed to. It looked at what investors make of audit committee reporting and whether it is meeting their needs: can they relate to the messaging? Does it make sense? What more would they like to see? Phase two of the report will be to look at what auditors report to audit committees and how the auditor reporting supports the audit committees in carrying out their role. We hope to begin the work in that second phase in earnest in April, and to issue a report quite quickly thereafter, so certainly by the end of the summer. It may be a long summer this year, but we hope to issue that report.

Once we have done that, we will look at whether it is having an impact and what the feedback is. If people think that this is a helpful initiative, we would hope to build an Audit and Assurance Lab as a standing concept within the FRC and use it to develop matters where investors, audit committees, companies and auditors feel that that safe environment to be able to experiment, collaborate and have a constructive debate can be taken forward.

Sallie Pilot, Black Sun

In terms of reporting from a corporate perspective, there are quite a lot of initiatives around mandatory and voluntary reporting, with different frameworks and different initiatives taking place. There seems to be one popping up its head every week. It would be great to know what the FRC is doing more to move forward in order to promote greater collaboration and to understand the plans for that and provide clearer direction for UK plc.

Paul George

We are engaged with a number of different bodies that are producing different ideas, whether through a legislative framework or on a voluntary basis, so we are engaged in that. In terms of our idea of a more significant project looking at the role of the annual report we need to challenge, the default that all new reporting requirements should be through the annual report. This is a natural position to take largely because of the assurance value that is associated with the internal control process within the company and the auditors work not only on the financial statements but their obligations more broadly. We are getting to the stage where the annual report is creaking at the seams and we need to have a good look at that. There are lots of different demands from stakeholders for different types of reporting and, as part of that, we need to do some work to develop some consensus of what the UK requires, to see what best practice is internationally, and to try to bring that together. It is not an easy project and it will take some time, but your question is very much in the thinking of this initiative that I outlined earlier.

Carlos Tornero, *Responsible Investor*

Is Carillion going to change any of the FRC priorities or reviews in the future? It seems that this case embodies a lot of failures: a failure of stewardship and a failure of the auditors, arguably. I know that you are already looking into what happened with the auditor. It can also be argued whether the shareholders were asking questions of the board. Another dimension to Carillion is that only short sellers saw it coming, so you can also ask whether, being one of the most shorted stocks, the FRC should look into securities lending as well. If shareholders are not asking questions, it is perhaps because they are lending their own shares to short sellers. It is a sad but important case, and I wonder if this will change any priorities in the FRC agenda.

Melanie McLaren

The first thing I would say is that our utmost priority is that we carry out appropriate and thorough investigations of Carillion within our remit. Our priority in enforcement is that this is a priority investigation and a priority case, and we need to make sure that we gather the right evidence and reach appropriate conclusions effectively and efficiently, but with the full wealth of evidence. You are absolutely right to highlight that Carillion has to be a priority for the organisation.

When we have found that evidence and carried out the investigation, and we have the benefit of parliamentary inquiries and what other regulators might be doing, there will need to be lessons learned to step back and reflect on how we can improve in the future. It is too early, however, to reach any conclusion now as to what those lessons will be.

I am going to draw that Q&A to a close now and hand over to Tracy and her panel, who are going to try to lift our sights to some future challenges. Some of your questions looked at these ideas, and I am sure that there will be a lot that resonates in the panel discussion in that regard.

Panel Discussion: Future Challenges and the Need for Reform

Participants:

Tracy Vegro, Executive Director, Strategy & Resources, FRC (Chair)

Sue Almond, Partner and Head of Assurance, Grant Thornton

Jo Causon, Chief Executive, Institute of Customer Service

Paul Druckman, Board Member and Chair of the Corporate Reporting Council, FRC

Deborah Gilshan, Governance and Stewardship Director, Standard Life Investments

Tracy Vegro

We are very lucky to have the experienced group we do as our panel. As Melanie touched on earlier, wider stakeholder involvement is something that we are keen to explore from all aspects and angles. I am going to introduce the individual panel members very quickly and then ask each of them to give us five minutes on a theme that might fit with the discussion so far and some of the questions that have already been raised. I want to say first of all though a particular thanks to everybody for agreeing to do this. Some have agreed at quite short notice, so thank you very much. I am going to kick off with Paul Druckman, who is a member of the FRC board. In his time with the FRC, he has probably seen us go through quite a lot of changes in the organisation, and a lot of the issues around corporate reporting and expectations of timeliness and so on are probably themes that we will touch on in the wider discussion.

Paul Druckman

Thank you very much, Tracy. An appropriate place to start is to quote Sir Win Bischoff, our chairman, who said: ‘Trustworthy information isn’t enough – trustworthy behaviour in a company is equally as important.’ That really reflects why I and many others in the space have always been interested in reporting. Reporting does influence behaviour, and that is a really important point that we need to acknowledge; otherwise, we lead simply to a compliance routine.

Melanie went through the FRC’s mission and some of the strategic themes that we are following. In my own language, in the future we are thinking that a company’s health, not shareholders’ wealth, should be the priority for management.

We really must understand where reporting fits? I like to think about there being four lines of sight - we are in danger of only ever thinking about hindsight and oversight, and not using foresight and insight as part of our lexicon and part of what we are trying to do with reporting.

I was going to highlight three things today of which Paul Geoge alluded to some of these already. Part of what the future of corporate reporting needs to deal with is to make sure that we have excellent financial reporting standards. That does not go away in the discussions that we have about wider or broader reporting, and it is something that we must stay focused on, whether it be IFRS 17 on insurance contracts or whether it be the new standards that are being implemented at the moment here in the UK and elsewhere.

The second area that I wanted to talk about in terms of looking into the future is the flow that corporate information which is witnessing a sea change. The fact is that the wide, global digital trends are transforming the flows of corporate information, and I want to reiterate that point about flows of information rather than just one directional information. It is really important to recognise that, both now and as we go forward, it is not just the company that is providing information about its performance and its strategy, but the whole universe of information that is now available. Whether it be lakes or oceans, or big data, or whatever you want to call it, it is making significant change.

It is that change that we have in creating, sharing and consuming information that we really need to think through in terms of how it is going to affect what we do in corporate reporting. We are seeing democratisation of data; multiplication of data; transparency of data; and intelligibility of data - all of these things interact and are being enabled in a disruptive way by technology.

That leads on to broader reporting for multiple stakeholders, which is not necessarily, as Paul said, part of an annual report but is necessary in the corporate reporting regime that we need to think through. That third area I wanted to highlight is what I call wider reporting to the capital markets with an audience of what I call dedicated stakeholders, whether they be employees, customers, suppliers or others connected to the market. The work that we did at the International Integrated Reporting Council around the six capitals highlighted this area. In fact, to the point from the gentleman from the Royal Bank of Canada Global Asset Management, it is not just GRI and SASB that are coming up with this sort of understanding; it is also things such as intellectual property and human capital. It may be flippant to say it – and I am sure I can be challenged – but pencils are worth more on the balance sheet than brains? We have to think about what goes onto the balance sheet – which, in my opinion, is not necessarily the place – and how we make more of where value is created.

We need to have a clear understanding of planetary boundaries and inequality, and the role of capital markets and business more generally. I noticed that Sallie Pilot from Black Sun asked a question earlier. Black Sun’s December 2017 report contained this statement: ‘As businesses around the globe respond to demonstrate their contribution to inclusive, long-term value creation for all society, change is in the air.’ How do they do that and how is it going to be done? It is not just Section 172 that we should and perhaps will focus on in the future, but the Sustainable Development Goals, the Financial Stability Board’s Taskforce on Climate Change and social impact investing. All of these things are in the mix. It may seem bewildering but it is not and simply needs to be brought together.

I will leave it there but all I would say is that it is very exciting: change is in the air in corporate reporting.

Tracy Vegro

You have definitely left us very interested and excited to discuss things further. Paul and his team are going to be very busy and there is a lot to go at, but it leads very nicely into my introduction to Deborah from Aberdeen Standard Investments and her role in stewardship: what it means and what you require to make sure that investors and owners of the companies get a say.

Deborah Gilshan

Thanks, Tracy, and thank you to the FRC for inviting me to speak today. I have had the privilege of being in shareholder stewardship for over 17 years. It is a privilege because we are, ultimately, acting on behalf of other people. We are stewarding other people's capital and looking after people's pensions and savings. We forget that at our peril when we engage on their behalf and when we invest.

I started my career at the Co-operative Insurance Society, whose assets are now owned by Royal London Asset Management. I then spent nine years with the Railways Pension Fund as an asset owner, really utilising the power we had in the investment chain to not only engage directly but also to encourage our asset managers who were acting on our behalf and on our clients' behalf – the railway workers of the UK – to engage for better long-term returns as well. Now I work for Aberdeen Standard Investments, which is one of the largest UK fund houses.

There has been a huge amount of change in stewardship in the last 17 years. The Cadbury Code talked about the importance of vigilant shareholders as a key safeguard to reduce risks. He talked about the power of the annual general meeting and the power of shareholders to call directors to account. Even more, especially with the current debate in the marketplace, the role of institutional shareholders as stewards is vitally important and remains so, and I cannot imagine that that is going to change.

However, stewardship is shared. We have a board of directors who we elect to act on our behalf. We are not in the boardroom, nor should we be. The concept of governance and stewardship in many capital markets is based on the fact that shareholders do not micromanage companies. We appoint a board and we ask them to appoint – and fire, occasionally – management teams, including CEOs, if they are not acting, investing and have a long-term strategy that is in our long-term interests as ultimate providers of capital.

There is a huge need to rebuild trust in the financial system and we have a role as asset managers and asset owners to demonstrate our role and make a more coherent case for our contribution to the real economy. Rebuilding trust matters not only from a hypothetical perspective; there is a huge amount of evidence from both a micro and a macro level that rebuilding trust does increase value creation. We do not just talk about this, and it is really important for the delivery of long-term sustainable returns.

We have moved from being vigilant shareholders to what we talk about at Standard Life Aberdeen as visible stewardship. I am a huge proponent of utilising the power of the annual general meeting. Last year, I went to the AGM of Vodafone. I have been to the AGM of WPP for a number of years to raise issues around succession planning as well as executive pay. We are leading a group of shareholders who are collaborating on diversity. I co-lead the work of the 30% Club with Legal & General Investment

Management. We are seeing real desire, both from investors and from companies, to really engage on these issues of long-term management of human capital and try to reduce group-think in our boardrooms.

We must also remember that the ownership of UK plc in the 25 years that the Cadbury Code has been in place has change quite dramatically. In the 1990s, the majority of UK plc was owned by UK insurance and pension funds. Statistics from the Office of National Statistics show that, in the early 1990s, we owned about 56% of UK corporate plc; by 2014, it had reduced to less than 10%. There has been an increase in overseas investors as well as ownership by asset managers. That demonstrates the increased relative importance of UK asset managers to act as stewards and to demonstrate that that is part of the value that we deliver.

I wanted to pick up the point about Carillion, because it has been well trailed that Standard Life Aberdeen have been invited to provide evidence by the BEIS Select Committee on what we were doing on stewardship. We submitted our evidence on Friday and I cannot say very much yet because I do not want to influence the outcomes of the committee, but it is well-known that we had a very large position and that there were a number of red flags at Carillion that worried our investment managers. We began to divest at the end of 2015 and we did not hold anything at all in the stock by July of last year because, ultimately, our role is to act in the best interests of our clients and, as an active fund manager, once you have tried to engage – and we did worry about the board's reluctance to change the strategic direction of the company – then the ultimate sanction we have is to divest and reinvest that capital elsewhere, acting in the interests of our clients.

When these issues come to the fore, there is always the question of 'Where were the shareholders?' but when stewardship is shared, it is also about what boards of directors are doing. It is a really healthy debate that we are having about Section 172 as well as the other duties of directors that we have had in this country since the Companies Act was introduced in 2006. All of this debate will, hopefully, help us move to a much more sustainable financial capital system.

Tracy Vegro

Deborah, thank you. Again, you are picking up some very big issues, which we saw the Business Department highlight in their recent green paper. There is an awful lot around stewardship, and that is something that we links with the broader reporting requirements. Sue, I would like to pass to you now. Sue Almond is a partner and Head of Assurance at Grant Thornton.

Sue Almond

I am going to pick up on a few of the comments around looking at the future of audit. Perhaps just taking a step back and thinking about the role of audit as well, the FRC's strategic objective is promoting justifiable confidence in UK audit. If we look at the role of audit and its contribution to confidence in the market, it is quite an important part.

A few years ago, we did some research jointly with the Association of Chartered Certified Accountants (ACCA) into the future of audit, and we did that on a global basis. As we sit here in a very mature market, that is really important because you get quite different feedback and views of audit as you look in different marketplaces. The feedback in the UK and other mature markets was very much about audit as it is currently defined as being a hygiene factor, and the discussion was all around broader assurance on the front-end of accounts or preliminary announcements.

If you move away from the more mature markets, however, audit, as it is currently designed, holds tremendous value. In places like eastern Europe and Africa, the real trust that was being placed in the work that was being done to check the financials was really quite substantial. As we move into this review process, it is really important that we do not lose sight of where we have come from and why it is important, as we seek, in our marketplace, to improve.

If I think about the UK in particular, it is great that we are talking about doing work in the UK. As Melanie referenced, we have had a leadership position in the audit market for a long time. We have done some great thought work, and our work on audit reports has really set the way, so it is fantastic that we talk about taking a longer-term look. I would probably just throw in a note of caution that, as Brits, we can be fantastic at being what I might call sceptical and what my overseas colleagues might term cynical. We are great at talking ourselves down, and the language that we use sometimes can be quite challenging. From that global perspective, there are an awful lot of people who look at what we do and take the words that we say absolutely at face value. If we have a debate about audit being broken, that will be reported worldwide.

What is really important for us is that we look absolutely at what we need to change, but also what we achieve and what we contribute. I am sure that there are FRC and audit committee chairs and members who will see a lot of what audit contributes through improving the quality of financial reporting, like Deborah, sometimes changing management, and the feedback on systems. Let us keep the messaging positive at this really critical time for the UK economy, because it is important that we create and maintain that trust.

Finally, on the review of audit itself, it is absolutely fantastic that we are talking about what Paul referred to as a drains-up exercise. It is well due for the work. Paul referenced the change that has happened in data and financial reporting, and that is absolutely the same in audit. When audit was invented, you could pretty much touch and see things, the recording was pretty straightforward, and you did not have all the external information that you have now that is available both to business and to the audit profession. We really need to look at how that plays into the audit of the future.

I would love to have a really honest debate about where the expectations are. I thought Melanie captured it brilliantly: ‘Either I am wrong or you are wrong.’ I do not think that that is how life is, so let us have a conversation about what people are looking for. If it is around deep dives into going concern or fraud, let us talk about how that might be achieved, and it might be completely different. That is particularly important. We can look at what audit could evolve to be and what needs to be true for us to get there and, hopefully, engage with everybody, because I have a feeling that probably most people in the room will be thinking that the current position is not ideal. Let us all feed into that. Like Paul, I am excited.

Tracy Vegro

Thank you very much, Sue. I have been struck by the lack of understanding of what an audit currently covers - lots of people have different understandings. If nothing else, having the debate about what is and is not currently covered and making sure we understand what the expectation gap is, and how we might fix it is probably a more honest approach to it. It is very easy to take positions and always be blaming somebody else.

The final panel member is Jo Causon, Chief Executive of the Institute of Customer Service. We are very lucky that Jo agreed to join our stakeholder panel, which is a new development for the FRC, and we are very interested to hear you talk about what the end-user and what the customer expects, and how you define that.

Jo Causon

I would like to start by saying that it is absolutely fantastic to be here, because so often customer metrics are too low level and transactional and we frequently put the wrong emphasis on what we measure Often, organisations talk about the importance of the customer but there is a real opportunity to grab this and drive this forward. My immediate point would be rather than calling this ‘future challenges’, I think ‘future opportunities’ might be a way of looking at this, because we are living in a world of huge opportunity.

Just to let you know where I come from –the purpose of the Institute of Customer Service is to help organisations get better at customer experience and customer service, not just because it is the right thing to do but because there is an economic imperative to this. I have had the privilege of running the Institute now for nearly nine years, and one of my desires has been about proving that link between the financial performance of organisations and the customer experience that they create. At the end of last year, I was delighted to be able to publish a piece of research from the Institute that proves that link. It proves that those organisations – and there are lots of outliers – that have focused consistently on achieving great customer experiences have, on average, over a five-to-eight-year period, almost a 10% higher EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation), and a 5% higher average gross margin.

For me, the link between the customer experience and the end financial performance of the organisation is really clear to see, in three areas: profitability; productivity, which we need to have a wider debate around in terms of what drives productivity in the UK; and revenue generation.

The other side of this – and I used to be a marketing director, so I think I am allowed to say this – is that, in the history of my life, marketing directors and communications teams often transmit information so we send out messages and communications. The world has so fundamentally changed now that we are no longer transmitting; customers are telling. In terms of the balance of power – and we see this all the time – the knowledge and the information that is available and out there, and the desire from customers to be involved, either through social media or other means as well, is increasing. We are moving from a world of what I would call transmission or monologue to one of dialogue, and customers are making their views, as we know, very well known.

This link to the customer experience is not just about customer service; it is about trust. Those organisations, again looking at my own data, that have higher levels of customer experience and better customer satisfaction, where they are scoring nines and 10s, will have nearly a 50% higher trust rating. There is a really important time now to think about what we are reporting on from a customer point of view and the importance of the customer as part of this, because there is quite a lot of economic data that supports that. There is also an obligation in terms of us understanding.

I came here today having spoken at another conference and I asked who in the audience worked in customer service. About a quarter of the audience put their hands up, (and they were executives and directors). I asked how many of them served somebody who might be in customer service, and we got a few more. I then asked who pays our wages and, and my point is ultimately, it is the customer and of course the employee who ensures we remain in business.

For me, it is really great to be here and to be involved in this debate. I hope, in some small way, that the Institute and I can add value to that, because there are some really important things that we can share and learn. It is about opportunity. The more we focus on involving, collaboration and co-creation, the better the outcomes will be for the UK and our position, quite frankly, in the wider world.

Tracy Vegro

Thank you, and thanks, everybody. In true *Question Time* style, we are now going to take some questions from the floor.

Bryan Foss

I would particularly like to follow Jo’s thinking there and ask about vulnerable customers. Your mum could be one of them; my mum is. They get treated very badly and there is a complete lack of trust between, certainly, me and the companies that serve vulnerable customers. What can we do here not just in customer service but for everything that has been talked about today to look after vulnerable customers?

Jo Causon

One of the biggest challenges that organisations have – and I recognise this – is what we mean by ‘vulnerable customers’ and the fact that, today, I am not a vulnerable customer but, tomorrow, I could be. That is one of the challenges. In a way it is about having a focus on the customer all the time whether vulnerable or not, this is a mindset. Paul, you talked right at the beginning about measuring the right things and influencing behaviour. Having a mindset on the customer and doing the right thing as a business absolutely helps with it.

Organisations are getting better – and we have seen this particularly in some of the more regulated sectors – at sharing information, which comes back to data and our ability to trust the data that we are sharing. There needs to be a greater focus, however, on the wider customer, but also thinking about that in terms of protecting or safeguarding those who perhaps cannot protect or safeguard themselves.

Paul Druckman

I just wanted to pick up something that might be quite contentious, Deborah, so stand prepared! You said, and it is relevant to what you talked about: that we live in a culture where the role is to act on behalf of and in the best interests of our clients. I am not sure I agree with that. That is something that one should do, but there is also something more intrinsic there about acting in the public interest. I wonder where that sits in the thinking?

Deborah Gilshan

I do not think these things are mutually exclusive. Acting in the best interests of your clients is also about a visibility to that stewardship work, like going to an annual general meeting or escalating your stewardship concerns through a variety of mechanisms underneath the Stewardship Code. There is a lot of private dialogue goes on, but stewardship has to be more than just private dialogue because the Stewardship Code gives a range of ways, including shareholder collaboration.

We talk about stakeholders as well. The customer is the saver, the current pensioner, the future pensioner and the employee. These things are not discrete and are not mutually exclusive. We need to start thinking much more holistically, so that a shareholder acting in the interests of its clients is not seen as either/or, or seen as unique in a system, but rather that it has positive, wider ramifications. There is much more recognition that the societal expectations on us as stewards of capital are being debated, and we are being, quite rightly, held to account.

Melanie McLaren

I would add the breadth of the debate. There is the whole public-policy debate around what business is here for and how you get the system to work better for everybody. It is a big issue.

Deborah Gilshan

There are lots of really great companies out there that have great governance systems, that we invest in for the long term and that we have great relationships with. Perhaps there is no visibility of that relationship. We were large investors in Sports Direct, and we engaged and sold down our holding, but there is a lot of engagement that goes on that is not visible to the marketplace. In our eyes, visible stewardship has to be positive as well. When I went to the annual general meeting of Vodafone last year, that was about issues around conflicts of interest with PwC as Vodafone's auditor, and the board of Vodafone were supportive and shared our concerns, so it was us working together with the company that we were investing in to challenge conflicts of interest. We have huge issues and concerns around lack of choice in the audit market, and the perception gap of what the audit is, because we, as users of financial accounts, rely hugely on the audit market and auditors, and really want to re-emphasise the audit process and that everything else – other non-audit services – really need to come second place as part of rebuilding trust in the financial system.

Sue Almond

My reflection, certainly as Deborah was speaking, is about taking ourselves away from the box of one particular role. There are a lot of multiple roles there and there is probably an awful lot of stuff that goes on behind the scenes about how you can meet some of the broader needs and requirements in the public interest in the widest sense. It is about how we can work more transparently to allow some of that to be visible.

Tracy Vegro

The hard thing for the FRC as a public body is when we are in front of a Select Committee explaining how we operate in the public interest. Of course, we do a variety of things, and I do not think that people's understanding of the totality of what the FRC does and the different times and points one could intervene on something. For us, it is a massive issue in terms of how you get a debate going in a way that is not defensive but rather looks like we want to do the better, bigger thing and move things on, while still doing core activities and meeting the particular needs of different stakeholders. It is not an easy formula.

Neville Wells, Bridgewell

I just heard a phrase there that really woke me up: 'What is business here for?' This is a question for Paul as well as the rest of the panel. If you accept that the annual report is for more than shareholders, and that it is for stakeholders, then surely more than quoted companies should be reporting to the same level of rigour as quoted companies. We beat up the FTSE 350 on a regular basis for their reporting, when there are huge companies – some of them in this room at the moment – who perhaps should be reporting to the same standards.

Paul Druckman

The Strategic Report does cover all companies and we do have a pretty stringent reporting regime through Financial Reporting Standard (FRS) 102 – the UK Generally Accepted Accounting Practice (GAAP). It is something that we are looking at and will look at, especially in terms of corporate governance there is momentum. It will be interesting to see where that comes out.

Participant

You mentioned a narrow section. Surely, everybody should be doing strategic reporting and governance reporting to the same standard as quoted companies, if all stakeholders are interested.

Paul Druckman

I did not say 'all stakeholders'; I talked about 'dedicated' stakeholders, but that is quibbling.

Tracy Vegro

He is not on the panel, but Deborah is also keen to say something.

Deborah Gilshan

We should change the nomenclature, because I am tired of hearing 'the burden of corporate reporting.' This is an opportunity, regardless of whether you are a private or a public company, to tell your story. The purpose of business is to provide services for us to be able to invest on behalf of pensioners and savers, for a company to access that capital and provide services. The last time I looked, that was what it is about. Public accountability is public or private, because the public does not make a difference between BHS and Sports Direct. It is just poor corporate behaviour and poor corporate acting. We need to turn this around and make this about a positive 'tell your story and what you are doing.' The gender-pay-gap reporting is really interesting because it is public/private companies: 9,000 companies in this country will have to report. The narrative, apparently, is voluntary, but this is an opportunity to maybe take some of these issues on the chin and move forward.

Tracy Vegro

Also public bodies. It is a much more level playing field in terms of reporting.

Sue Almond

I was going to come to the public sector. I agree that there is an awful lot there when we are talking about what is systemically important to us. I started my career in a local town, and businesses that might not have hit some of those thresholds were massive employers. When one went bust, it was a really big deal, so there are broader expectations.

Also, playing into the reporting and trust debate, with the availability of information, a lot of what you are talking about is widely available, and businesses will choose to publish it, albeit perhaps in a different way than through corporate reporting. It maybe circles us back to the trust debate because I have the same debate about what I do with my parents and nieces. It is often around trust. You come back and challenge, and ask, 'How do you know that that is true? How do you know that this is ethically sourced?' That is where some of the challenges come and where you maybe link it into a more formal structure.

Tracy Vegro

It will be interesting in the private companies initiative under James Wates.

Jo Causon

All I would add is that the points that Deborah made are really well made. At the end of the day, this should be an opportunity to be open and transparent about what has been done and what has been achieved. I am a small, not-for-profit organisation. I produce a report and accounts. In that and at my AGM, I am always very happy for anybody to ask us about what we have been doing. I am very clear that, ultimately, as long as we are clear about our purpose, about why we are relevant and about the impact that we are looking to create, that should go a long way in terms of answering whichever shareholder, stakeholder, customer or employee who I am trying to serve as a chief executive of my own organisation. Sometimes forget our purpose, what we are here to do and why we are reporting in the way that we are.

Carlos Tornero

I forgot that Aberdeen was not holding Carillion, so I would like to know, Deborah, what red flags you saw that others did not. Was it Carillion's corporate reporting and anything that you observed there, or possibly not the going concern of the auditor KPMG? What were the red flags?

Deborah Gilshan

Just to clarify: I did not say that there were red flags that others did not see; I said we saw red flags, including the company's financial management, what we had learned from engaging on governance issues, the board's unwillingness to think about changing the strategic direction of the company and addressing our concerns, the overall strategy, and the pension deficit. That is active management, when you are able to act. There are passive holdings as well.

Carlos Tornero

The audits of the company [inaudible].

Deborah Gilshan

As I said, we are worried about audit in general and the lack of competition in the audit market.

Tracy Vegro

We have to wrap up. I want to say a massive thank you to everyone on the panel, not just for today but for all the help that you are giving us in all sorts of ways. Thank you.

Closing Comments

Paul George

I would also like to add my thanks to the panel. That was a really interesting discussion. I am absolutely sure that that could have gone on for at least another half hour. The good news is that I am sure the panellists will be next door, where I have the pleasure of inviting you for refreshments. I would like to thank you all for your questions. Some really good issues were raised. Most importantly, what was really good was the level of enthusiasm that was coming through from the panel on the opportunities that lie ahead. There are some big issues here, and the panel gave enthusiasm to us all collectively trying to tackle that. With that, thank you all for your participation.