



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

16 July 2009

Welcome and introduction

I add my welcome to that of the Chairman. We take very seriously our obligations to be transparent and accountable and I look forward to your comments and questions on our work.

The purpose of today's meeting is to afford an opportunity for public discussion of the FRC's performance in meeting its aim of promoting confidence in corporate reporting and governance. The primary responsibility for confidence in corporate reporting and governance in the UK rests with market participants. The FRC contributes by influencing market participants to do a better job than they would have otherwise done. We exert this influence by setting standards which are, normally, expected to be followed, by drawing attention to current risks and providing guidance, by monitoring the application of standards - which raises awareness that there is a risk that poor practice will be identified - and by our investigation and enforcement activities, which further increase the incentives for good performance.

My remarks will focus on our main achievements in 2008/09 and our priorities for 2009/10. I will also make a few personal remarks about a key philosophical debate which could have major implications for the future of corporate reporting.

Achievements and current priorities

Our annual report provides a full account of our work, including our assessment of the extent to which we judge that our overall aim and each of the six outcomes in our strategic framework are being achieved. We made significant progress on all of our major planned projects and activities but we also had to respond to the deteriorating economic conditions.

Responding to tougher economic conditions

Our 2008/09 Plan, published in April 2008, noted that "the recent credit market conditions meant that the risks to confidence in corporate reporting and governance were higher than they have been for some years." The deepening of the credit crisis and its extension to the non-financial sectors of the economy meant that the risks intensified during the year.

During the autumn of 2008, we published a number of documents to assist market participants in considering the heightened risks, including a note on the challenges for audit committees. We also sought to influence the public policy debate on the corporate reporting and governance aspects of the crisis, making statements about the importance of the independence of accounting standard-setters and testifying before the Treasury Select Committee.

The tougher economic conditions also influenced our monitoring activities. We continued the practice of thematic reviews of particular measurement or disclosure topics across a number of companies, looking at goodwill impairment disclosures. In a regulatory innovation, the Panel followed up this review by letting 30 companies know in advance that the impairment disclosures in their 2008 financial statements would be subject to particular scrutiny. The Panel has recently reported the results, noting that 22 of the 30 companies improved the overall quality of their impairment information. We get more satisfaction from encouraging people to meet standards than we do from pointing out where they have failed to do so.

One of the areas of highest priority for the Audit Inspection Unit was looking at the way in which the audit firms responded to the challenges of auditing in the tougher economic conditions. We shall report later this year on the results of those inspections in accordance with the revised procedures for reporting on individual firms which we introduced for the first time in 2008/09.

Our overall assessment is that preparers of financial statements, audit committees and auditors have recognised the heightened risks and have reacted accordingly. The results of the IPSOS Mori survey of stakeholders' opinions, which are included in our Annual Report, show that there has been, unsurprisingly, a decline from the very high levels of confidence in corporate reporting and governance which we have reported in previous years, but the decline is modest in the context of the severity of the tougher economic conditions.

Governance, reporting and auditing scandals tend to be lagging indicators and so it is still too early to be certain that the risks presented by the crisis have been successfully mitigated but it is noteworthy how few scandals have emerged to date. I would like to believe that the FRC has made a modest contribution to this relatively good outcome. We have even received a few words of thanks from stakeholders for our efforts!

We hope that 2009 year-end reporting season will be less difficult than last year but there is no room for complacency. There are still a number of difficult-to-manage risks and experience suggests that cash-flow difficulties can emerge as the economy moves from recession to upturn. Our warning of heightened risks to confidence in corporate reporting and governance remains in place.

Other issues not driven primarily by tougher economic conditions

A substantial proportion of our work was not driven by the economic crisis but is intended to increase or sustain confidence in corporate reporting and governance over the longer term.

Corporate governance

One of our most significant projects, which will be a major feature of our work this year, is our review of the effectiveness of the Combined Code. The review has been conducted in co-operation with Sir David Walker's Review of the governance of banks and other financial institutions, although the scope of our review is not limited to the financial services sector. We welcome the publication today of Sir David's progress report and we shall be considering to what extent his recommendations are applicable for some or all listed companies in other sectors. The Board of the FRC discussed the progress of our review at its meeting this morning and we shall be publishing our own progress report before the end of this month.

The UK system of corporate governance is well-respected but our sense is that application of the "comply or explain" approach which underpins it needs to be strengthened. The continued viability of the "comply or explain" approach depends on the willingness of a sufficient number of institutional investors to play an active role in monitoring the corporate governance practices of the companies in which they invest.

Corporate reporting

We have been following closely the work of the International Accounting Standards Board. We continue to believe that it is important that the EU keeps "adopted IFRS" aligned with the standards issued by the IASB. Having said that, we have concerns about the future direction of IFRS. We believe that the IASB's objective should be to improve IFRS and should not include reference to convergence with particular national standards. It is not clear to us that convergence between IFRS and US GAAP is the best strategy for improving IFRS.

One of the ways in which we believe IFRS could be improved is for it to be simplified. For instance, is it desirable that IFRS should contain 23 different probability thresholds such as probable, more likely than not, reasonably certain? This example of an opportunity to improve IFRS is one of several contained in our discussion paper, "Louder than Words", which we hope will stimulate change on the part of all of those who influence the preparation of corporate reports.

The FRRP continued its core work of reviewing a sample of annual reports of both publicly traded and private companies. The Panel concluded that the overall

standard of corporate reporting in the UK remains good, although some individual cases of poor practice were identified and there are areas for improvement.

Efficient targeting of our work remains a challenge and so I repeat my invitation to anyone who has suggestions as to particular financial statements that we should look at to let us know. The anonymity of our sources is assured!

Auditing

We continued our work on choice in the UK audit market, focussing on 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. The sudden collapse during 2008 of organisations with long histories of success reminds us that this risk cannot lightly be dismissed.

Although there has been some good progress in the past year on the implementation of the 15 recommendations of the Market Participants Group, we believe that the risks posed by the current structure of the market will remain significant for many years to come. The FRC does not have the authority to make all of the changes which might be needed: changes in legislation will be required. We look forward to the announcement by the European Commission of the next steps following its consultation on the ownership rules for audit firms.

We continued to devote considerable attention to implementing the EU Statutory Audit Directive. Although the EU transitional measures have helped defer some of the implementation challenges these measures expire during 2010 and considerable difficulties, including conflicts of EU and third country laws, can be expected.

We have been influential in the International Auditing and Assurance Standards Board's "Clarity" project to improve international auditing standards, which is now complete. The APB has proposed that the new standards should be adopted in the UK from 2010 and we are encouraged by recent signs of willingness of the EU to adopt these new standards.

Despite the publication by us of market-based guidance on the implementation of auditor liability limitation agreements, the take-up of these agreements has been disappointing. To some extent this is due to concerns on the part of the US Securities and Exchange Commission about the interaction between these agreements and their rules on auditor independence. Any further changes in the law which may be needed to stimulate greater use of these agreements are a matter for the government.

One of the Treasury Select Committee's reports on the banking crisis has recommended that we consult on proposals to further restrict the extent to which auditors can provide non-audit services to their clients. This is a controversial

topic and we shall be giving further consideration over the summer as to how best to respond to the Committee's recommendation.

We played an important role in promoting international co-operation between audit regulators. I was honoured to have been Chairman of the International Forum of Independent Audit Regulators throughout the year. IFIAR is now established as an international body and its membership has grown from just 12 at its creation in September 2006 to 31 today and there are further increases in prospect.

It is clear that some of the important decisions related to the quality of audit work performed by national audit firms are made at a regional or global level. It seems to me that there are some significant gaps in the current system of audit regulation. These gaps include the absence of oversight of the firms which co-ordinate the international audit networks, the absence of formal arrangements for collaboration between national regulators comparable to the "colleges of supervisors" which are being established for the major cross-border financial groups and the absence of a formal mandate to consider the systemic issues facing the audit market.

Actuarial practice

The combination within the FRC of responsibility for actuarial standards as well as accounting and auditing standards is, we believe, unique. The BAS is the world's first actuarial standard setter to operate independently of the profession. We are already benefitting from the synergies between the different parts of the FRC. For example, in preparing its conceptual framework for the setting of actuarial standards BAS has drawn on the APB's extensive experience.

The BAS is on track to have completed a complete overhaul of the suite of actuarial standards during 2010/11, although there remains a lot of work to be done by the Board and by respondents to its numerous consultation papers. We believe that the new standards will make an important contribution to increasing the reliance which users of actuarial information can place on its relevance, transparency of assumptions and comprehensibility.

Professionalism of accountants and actuaries

Our work on the professionalism of accountants and actuaries includes oversight by the POB of the way in which the accountancy and actuarial professional bodies discharge their regulatory responsibilities. The POB has concluded that the professional bodies take their regulatory responsibilities seriously, although it has also identified areas for improvement, and it has demonstrated a willingness to speak out publicly about matters in which it judges that there is a serious risk of shortcomings in the work of the bodies.

Our work also includes the operation by the AADB of an independent investigation and disciplinary scheme for the two professions. The AADB's

caseload has continued to increase, including the commencement of the first actuarial case, relating to Equitable Life. One case was successfully concluded during the year. A number of other investigations are very close to completion and we can expect the outcomes to be reported later this year. Of course, there are certain cases where we are awaiting the outcome of investigations, including criminal investigations, by other bodies.

It is frustrating that we have been unable to complete our review of the accountancy scheme due to the need to secure the consent of the accountancy professional bodies to any changes to the scheme. I hope that this matter can now be swiftly concluded.

The scheme review process and our experience of the operation of the scheme have raised some important questions about the effectiveness of the framework for professional discipline and the enforcement of standards, including the FRC's role within that framework. We shall begin to consider these questions later in this financial year.

Effectiveness of the FRC

The sixth outcome in our strategic framework relates to the effectiveness of the FRC - an enabler which contributes to each of the other five outcomes. It is an outcome which we take seriously.

During the past year we have taken a number of steps to improve the effectiveness of the FRC. In response to the announcement by the Government of their intention to reduce substantially their funding for the FRC we consulted on revised funding arrangements which we are putting into effect this year. The main changes are to share the costs of the FRC over a wider group of organisations which fall within the scope of our activities. The FRC's funding has operated successfully on a flexible, non-statutory basis since it was established in 1990 because of the wide support amongst market participants for our work. We hope that will continue.

I believe that we are very cost-effective when our costs are considered against the range and significance of our responsibilities. Our core operating costs were, once again, close to budget. We have responded to the financial crisis without arguing for a significant increase in our budget, although we have included a higher than normal contingency to allow us to respond to previously unidentified risks which emerge during the year.

A key philosophical debate which needs to be settled

I would like to offer some personal reflections on a key philosophical debate which could have major implications for the future of corporate reporting.

The financial crisis has generated a philosophical debate about the role of accounting, notably the extent to which accounting is pro-cyclical, exacerbating booms and busts.

It is clear that the financial sector has been badly damaged by the crisis and the risks of similar costs to the public purse occurring again should be minimised. However, it is not clear that accounting has the potential to be a public policy tool to reduce pro-cyclicality, nor that it would be appropriate to use it in this way.

An equally, or perhaps even more, dangerous argument now gaining currency is that accounting should be given an explicit role in promoting financial stability, rather than its traditional role of providing information useful to investors in their decision-making. The implication of this view is that accounting measures that show volatility should be adjusted to create an impression of stability.

Accounting is a measurement system that presents the financial performance and position of a company in as neutral a way as possible. It is not surprising that banks report substantial profits when the economy is doing well and reduced profits, or even losses, when the economy is doing badly. This is accounting reflecting the economic cycle, which is a good characteristic of a financial measurement system.

Can this reflection of the economic cycle become too much of a good thing, and pro-cyclical? To answer this, it is worth considering the dangers of altering other measurement systems to make them less pro-cyclical. It could be argued, for example, that unemployment statistics have damaging pro-cyclical effects. Low unemployment numbers make consumers feel confident, thus encouraging them to borrow and spend at levels which might prove unsustainable. High unemployment numbers make consumers worried, causing them to reduce their spending and pay off debts, with the undesirable consequence of even greater unemployment. Yet no-one seriously argues that it would be in the public interest for the unemployment statistics to be adjusted in the interests of financial stability.

One could also argue that house price statistics are pro-cyclical; reports of rising prices encourage consumers to make more purchases at higher values, thereby driving up prices further. Reports of falling prices have the opposite effect. I have not heard pleas that the national statistics agencies should intervene to prevent these seditious numbers being disclosed to a public who cannot be trusted to react in a way consistent with financial stability.

If there were to be an intervention to adjust the reported economic numbers then the monetary authorities, and perhaps a small number of other people in influential positions who could be trusted to respond appropriately, would have to be permitted to see the true figures. Most people would regard this as a deeply unattractive prospect with Orwellian implications. It is for this reason that calls to adjust accounting measures to make them less pro-cyclical should be treated with suspicion.

The way in which consumers or investors will react to statistical or accounting information is not easy to determine in advance, as it will be influenced by a large number of variables. It is, therefore, not reasonable to expect that national statistics agencies or accounting standard setters should be asked to predict those reactions, far less take a view as to whether those reactions are “good”, in making their measurement choices.

Those who argue that accounting should be amended to make it less pro-cyclical must believe investors are not to be trusted to react appropriately to unadjusted numbers. Once again, however, there would be certain people, including prudential regulators, who would have to be trusted to see the raw figures.

It would, though, be hard, perhaps impossible, to persuade investors to fund financial institutions without showing them the true, unadjusted numbers. This is not to say that current accounting standards need no improvement. But the merits of proposed “improvements” need to be assessed against a clear understanding of the purposes of accounting.

It may well be appropriate to attempt to reduce the volatility of economic cycles, but there are more appropriate tools than accounting to achieve this.

Concluding remarks

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 in our Strategic Framework. This level of market participant participation in our work is one of the FRC’s distinctive features. I would like to thank them and the staff of the FRC for their important contribution to our work.

This is the last time that I will address the FRC’s Annual Open Meeting as Chief Executive. It has been a privilege to have had the opportunity to make a contribution to making the FRC an effective and credible organisation. The main privilege has been the opportunity to work with and to interact with a large number of very talented and experienced people. I have learned a great deal from them.

Paul Boyle