DRAFT

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LAPFF Response to The Financial Reporting Council 'FRC ARGA Consultation'

Background

- The Local Authority Pension Fund Forum (LAPFF) is a voluntary association of 85 local authority pension funds and six LGPS pools, with combined assets of over £350 billion. It exists to promote the investment interests of member funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest.

Response

Background

LAPFF welcomes the transition of the FRC to the Auditing Reporting and Governance Authority (ARGA). LAPFF was the first shareholder organisation to identify that the FRC had been designated a public body in the 1990's[1], by the Office of National Statistics by virtue of the Chair being appointed by the Secretary of State. That status was affirmed again on the 2004 reorganisation when the FRC picked up additional functions from accounting institutes.

Therefore, the Kingman Review should never have been needed. The FRC's problems always flowed from its own poor governance. Its status was clear, but the FRC Board, and department for Business, Energy and Industrial Strategy (BEIS) officials[2] had knowingly operated the FRC as a private body, despite its designation by the Office of National Statistics for three decades as a public body.

In February 2018, prior to the announcement of the Kingman Review in April 2018, LAPFF said

"The Financial Reporting Council (FRC) has requested comments regarding its consultation on a Revised Corporate Governance Code issued in November 2017. It's not appropriate to respond to the consultation without referring to the FRC's own governance problems, not least in view of the emphasis being placed on culture and diversity by the FRC. LAPFF is on public record in response to the consultation from the Department of Business in 2016 (Green Paper for Corporate Governance Reform) that the FRC needs to be disbanded – and a replacement body reconstituted under primary legislation.

However, that was before the recent discovery through answers to Parliamentary questions that the FRC has been designated a public body since 2004 but has avoided

[1] https://lapfforum.org/wp-content/uploads/2020/07/201802_LAPFF_Response_to_FRC_Code.pdf
[2] Parliamentary Question UIN HL 4991

the obligations that stem from that status. More detailed information released by the Office of National Statistics (ONS) has revealed the FRC stating itself to be a collaboration between the Confederation of British Industry (CBI) and the CCAB (the Accounting Institutes' umbrella body) with seats on the FRC board to those parties as the result for funding it. LAPFF cannot think of clearer evidence of regulatory capture.

LAPFF considers that the positions of the FRC Chair and the Chief Executive are untenable and considers that the FRC should be put into special measures, to be run by commissioners until a new body is set up under primary legislation".

LAPFF therefore welcomed the conclusions of Sir John Kingman's subsequent report. One conclusion was that the FRC, in trying to balance various sectional interests, wasn't serving the public interest.

There has also been a consistent problem of having to fact check statements the FRC has made.

Legacy issues outstanding

There are several legacy issues from the period before the Kingman Review which remain outstanding. LAPFF continues to pursue these. The FRC didn't just have a bad board and bad structure, it has undertaken actions that are still having a deleterious effect. These include: -

- issuing the profession's own audit standards (under the alias of 'international standards of auditing' (ISA)) without any public consultation.
- that FRC inspections take place by following ISA, not the requirements of company law. And the focus is on the group accounts, not parent company accounts, the entity which shareholders actually own, and which pays and receives dividends.
- the decision to permit international accounting standards (IAS/IFRS) in **company accounts** – when the EU only mandated them for **group accounts** of listed companies.

The basis of this consultation runs contrary to the Kingman Review.

This consultation from the FRC has the effect of moving ARGA from representing the public interest to narrow sectional interests. This consultation says: -

- *"Views are sought from **all groups with an interest** in ARGA's operations. This consultation will be of particular interest to the entities falling within the proposed funding groups and their professional advisers, including: Users and preparers of accounts Companies, including listed and large private companies Investors, including institutional investors, and those who advise them Others who rely on audited accounts Insurers, pension schemes, pension scheme sponsors and funeral plan trusts who rely on actuarial information Auditors, including auditors of public interest entities; accountants and actuaries; and audit and accountancy firms Regulatory and professional bodies."*

But The Kingman Review said:

- *"The Review is concerned by what appears to be a widespread assumption that the FRC's board should in some sense be "representative" of the many stakeholders affected by its work." "This approach would also, however, be wrong in principle. Other regulators have not adopted a representative approach. The*

> *FCA, for example, has if anything a much wider group of stakeholders, but a smaller board. This reflects the purpose of a regulator's board, which is **not to represent all the multiplicity of views of relevant vested interests and somehow reconcile them in discussion, but rather to ensure that the regulator is doing a highly effective job in protecting and promoting the public interest**."*

The FRC is therefore following a sectional interest approach and is not dealing with the full nature of the public interest; for example, the pensioners of BHS, the creditors and workers of Carillion and the parties that had construction projects affected by the collapse of Carillion. LAPFF presented to a joint committee of both houses of the Irish Parliament and the impact of Carillion's collapse on Irish public sector projects was raised.

Related to that is the anomalous status of the UK Accounting Standards Endorsement Board (UKEB); which includes: having a board based on the sectional interest approach which Sir John had rightly criticised, and whose Chair has not only been appointed without the proper competitive process for public appointments, but the process used wasn't given the necessary waiver by the Commissioner for Public Appointments[3]. That is made worse by the fact that the Chair has then made all of the other board appointments themselves, many of whom are appointments from prior FRC boards.

One problem with the FRC operating as a private sector body was that staff were not recruited properly in accordance with public appointment rules. We are therefore unclear why all FRC staff that were not properly appointed haven't been required to reapply, with those posts open to open competition. The recently announced move of the FRC/ARGA to Birmingham may help facilitate this necessary action.

In this context, LAPFF strongly supports legislation to establish a statutory basis for fees but considers it essential that there is proper Parliamentary scrutiny of all new legislation setting up ARGA itself. But there is no reference to Parliament anywhere in this Consultation, despite that fact that the authority of Parliament is needed.

The budget for standard setting – including that for the UKEB – is excessive. Some of the objectives set out for ARGA are different to the legal basis for audits and accounts. Without dealing with that, ARGA (as well as BEIS) will be tinkering with remedies that are tangential to the actual problems.

The Report of the Brydon Review has diluted the conclusions of more rigorous inquiries

The Brydon Review hasn't dealt with problems. That is best illustrated by this quote from its final report which uses several rhetorical devices to avoid dealing with the issues that various Parliamentary Committees, including the BEIS Select Committee raised, which were, IFRS, prudence and the false construct of an 'expectations gap'.

> *"I found, in the words of Professor Chris Humphrey, a member of the Review's Advisory Board, that the debate so far "encourages a form of analysis where incremental change is probably the most likely recommendation and outcome, where old 'hobby horses' (such as the expectations gaps or the value of IFRS and the case for prudence) frequently get resurrected, where people seek to dominate a collective discussion with their singular perspectives, and quite*

[3] https://publicappointmentscommissioner.independent.gov.uk/regulating-appointments/exceptional-appointments-made-without-competition/

quickly we end up in a discussion that we seemed to have had many times over; a debate which is notable only for its familiarity and circularity – and, if any radicalism does emerge, it tends to come in the form of speculative proposals that antagonise rather than resolve, and which, ironically, reinforce or ground analysis in what we have come to accept and understand as audit (with a frequent refrain to proposed extensions in the audit being dismissed as ‘not audit’).”

The reason things are “going round in circles” is because issues aren’t being dealt with.

We note that the Secretary to the Brydon Review has been a participant in the PwC Corporate Reporting Users Forum (CRUF) see below.

The above quote also says, “*people seek to dominate a collective discussion*” That is rather an irony given the dominance of PwC in this. The Review cites in several places a) another accounting academic commissioned by PwC, b) PwC’s agenda setting paper “The Future of audit”.

This is in contrast to one reference to the BEIS Select Committee and only then in a paragraph which only obfuscates the issue of ‘expectations gap’ which the BEIS Select Committee said was actually a delivery gap, partly as the law was not being followed.

The Brydon Review Report is in effect a series of rhetorical devices to avoid the issues, and the concept of a ‘collective discussion’ without ‘singular perspectives’ would be a recipe for group think.

“Making up Users”

We also note a problem with the notion of “users”. Indeed, a paper from Joni Young of the University of Albuquerque is called “Making up Users”[4]. This paper posits that accounting standard setters have created the concept of “users” to sit with their agendas.

We note that the FRC standard setting process has been heavily populated by so called “users” who were or have been member of a PwC run club called ‘CRUF’ (the Corporate Reporting Users Forum).

The presence of the CRUF giving the appearance of investor support should not be part of a public interest function. We have yet to see one member from the “users” group involved in standard setting who has the credentials to be representing the public interest, or asset owners. We note to that the judge in the Royal Bank of Scotland prospectus case threw out an application for a sell-side equity analyst to act as an expert witness. The judgment states that sell-side skills aren’t the requisite skills for deciding what is a legal test.

The judgement also says of sell-side analysts:

> “*their expertise is in bringing to bear detailed research and subjective assessments at least in part based on information and analysis not generally available to the public in the evaluation of such opportunities. Their selling point, as it were, is that they may be able to provide those employing or instructing them with an “information edge over their competitors”*
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> *“As presently advised, it does not seem to me that either this body of expertise or the particular skills of equity analysts are likely to provide a standard or litmus*

[4] Joni J. Young * Anderson Schools of Management, MSC 05 3090, 1 University of New Mexico, Albuquerque, NM 87131Accounting, Organizations and Society 31 (2006) 579–600,

test by reference to which safely to assess whether the statutory requirement has been satisfied".

We note that the CRUF in June 2019 responded to the Brydon Review call for evidence as if the concept of a gap between what is required of auditors and what is expected of them, the so called "expectations gap" was a reality[5]. However, the BEIS Select Committee had in March 2019 revealed that to be a fiction – not least as a definitive case settled in the middle of the enquiry - and concluded that the problem was a delivery gap, which included not following the law[6]. The CRUF letter is evidence of 1) poor research and 2) being taken in.

That contrasts to a demonstrably competent investor, Charlie Munger, CIO of Berkshire Hathaway. In an eight minute video he described the accountants in the context of setting standards "the sewer", later on he then corrects himself to "the sewage[7]". In that video he refers to "idiot bubbles driven by the accounting" and "phoney accounting".

The fact that the FRC was tapping into less than impressive "users" of accounts came to the fore in the case of Carillion (see below).

Any sense that the CRUF was a genuine investor led group was betrayed when PwC circulated a pre-written "round robin" letter to the CRUF membership to lobby against Competition Commission proposals to deal with auditor independence[16]

We are not aware of any member of CRUF who has run public money as a fiduciary investor. Nor would we want them to based on CRUF outputs. The concept of fiduciary duty is important as it requires absolute loyalty to the principal (the owners of the capital invested) not some other agenda to gain attention and status within standard setting. And it most certainly does not entail being taken in or subservient to a group run by PwC.

The accounting standards are a bug in the system

The mismatch between the (arbitrary) accounting standards and the (sensible) law has resulted in a 'bug' in the system, that has gone unfixed. We have clear evidence that this goes beyond having closed ears. Poor excuses and inconsistent answers don't come from not hearing.

We note from what is unfolding with the Post Office Horizon scandal that the propensity for parties within and under the control of BEIS to be unwilling to accept such basic facts may be cultural.

As a result of this, material parts of FRC (and now ARGA) expenditure will be misdirected.

Example 1

We note for example the recent FRC case against PwC regarding the fraud in an Italian subsidiary of BT. PwC was fined a seven-figure sum.

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[5] https://cruf.com/wp-content/uploads/2019/07/CRUF-letter-to-Brydon-Call-for-Views-18-June-2019.pdf
[6] https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/1718.pdf
[7] https://www.youtube.com/watch?v=M69Wdw1m2IE

But there is no evidence that the accounting for the fraud **after the event** caused loss or harm to BT investors[8]. What caused harm was the fraud for which **the loss was the consequence.** That is where the attention should be placed. Instead, the case leading to the PwC fine was about auditing the **apportionment** of the loss in the consolidated accounts between two types of IFRS adjustments. That issue is consequentially irrelevant.

Losses occur in the holding company or the subsidiaries.

There are problems in general with the way IFRS accounts for a fraud that has occurred. In the case of the Kerviel fraud at Societe Generale, the French authorities had to intervene to use the "true and fair override" to ensure that the fraud was accounted for in the period in which the fraudulent trading began. Whereas with the IFRS "market to market" approach, the IFRS treatment required a profit at the year-end on the open trading positions and regarded the loss in closing these positions as an event for the following year. That treatment would create an illusion of capital.

Example 2

We see other issues of superficiality with the way the FRC dealt with Carillion.

The Financial Reporting Lab of the FRC applauded the accounts of Carillion in its report of December 2016 on the basis it was an example of best practice for dividend **disclosure**. Carillion then collapsed months later. Carillion is now being pursued in the Courts by the Official Receiver for unlawful distributions and trading whilst insolvent as far back as 2013.

Carillion was carrying large amounts of goodwill for bad acquisitions and hadn't impaired the cost of those subsidiaries in its holding company accounts (thus enabling reserves to be stated that weren't there, hence enabling dividend **capacity** to be overstated).

In addition to that, Carillion was using "reverse credit factoring" which resulted in a misclassification of debt and creditors.

The Chair of the FRC Sir Win Bischoff was asked by Frank Field MP, Chair of the Department of Work and Pensions Select Committee and Rachel Reeves MP, Chair of the BEIS Select Committee in joint committee about accounting standards and such reverse factoring.

The response from the FRC Chair begs more questions[9]. It doesn't conclude whether the treatment is right or wrong and relies on citing parts of IFRS. It also reveals that the FRC's financial reporting inspection team passed Carillion's 2015 accounts.

However, it shouldn't be difficult to differentiate right from wrong.

A feature of reverse factoring is that the amount of trade creditors that would arise with payment on normal 30-day terms, goes up two or three times, whereas the substance of the arrangement is that there is hidden bank debt. With reverse factoring, the actual creditor is paid within 30 days by a bank, and that is the provider of credit, not the creditors

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[8] The case revolved around how the loss should be classified between two types of treatment, as an accounting adjustment or a prior year adjustment.
[9] https://www.parliament.uk/globalassets/documents/commons-committees/work-and-pensions/Carillion-report/Letter-from-FRC-to-Chairs-21-March-2018.pdf

However IFRS classifies this as a trade creditor not a bank debt, hiding where the funding is actually coming from.

Subsequent papers from the International Accounting Standards Board reveal that the Carillion approach is sanctioned by IFRS. The state of play there is that rather than deal with the distorted defective accounting, more “**disclosure**” is their solution. What is needed is the absence of a clear misrepresentation.

Disclosure rather than action leads to clutter

That approach is superficial (not dealing with the numbers being wrong) and creates clutter and more lengthy annual reports despite Secretaries of State at BEIS calling for more brevity.

It will also be the case that such irrational accounting standards are downgrading the auditing profession, as applying basic common sense carries no value with the IFRS system.

Discounting liabilities in a time of inflation

IFRS allows the discounting of liabilities at the risk rate. However, the original basis for discounting liabilities was insurance on the basis and condition that 1) assets were ringfenced to meet liabilities and 2) where those assets were gilts then the return was essentially guaranteed, hence discounting at the risk-free rate.

However, IFRS now has a hotchpotch of approaches to discounting, including where there are no ring-fenced assets. Such an approach is unlikely to result in sensible results where 1) there is inflation 2) interest rates are being raised to deal with inflation.

“Garbage in garbage out” – the distraction of auditors from the basics by “standards” and bureaucracy

The former President of the Institute of Chartered Accountants in England and Wales (ICAEW) Martyn Jones presented at the 2021 LAPFF conference. He has also published papers recently on the subject. His presentation was refreshing as he not only accepts auditor duties per the law, including detection of material fraud, he set out examples of actively seeking it out.

He is also concerned that both accounting standards and auditing standards and the administration and bureaucracy of undertaking audits is crowding out intelligent thinking and standing back to review. We agree. If it now takes third party analysts to spot problems in accounts and business models (a going concern issue) the advantage of auditors having the privilege of proximity to the company is lost.

Martyn Jones is the former head of auditing technical at Deloitte UK. A firm that over the years had had considerably less FRC fines than the most fined firm, KPMG.

The pre-Kingman Review FRC made great play of ‘tone at the top’ in corporate culture. But the Kingman Review then identified the culture problem at the FRC. The FRC has, in the last two decades, been over-populated with alumni of KPMG and PwC, as well as over representation from Grant Thornton. One advantage we could see in having KPMG people working at the FRC is at least they weren’t doing audits of public companies. However, the utility of those alumni in inspecting the audits of companies is questionable - Carillion and the Co-op Bank -both passed inspections in the year before the companies failed.

Overall conclusion

This consultation does not provide a basis to create a new ARGA distant from the problems of the FRC.

A major defect of the consultation is that there is no reference to Parliament anywhere in the document. As public bodies receive public money under the authority of Parliament that is a serious omission.

Given that the FRC (which has no statutory basis) will not exist with the transition to a body with a statutory basis it would seem that any consultation on a fee base should have been done by BEIS and the Treasury.

QUESTIONS and RESPONSES

Question 1

Do you have any comments on the proposed guiding principles for ARGA's overall funding arrangements?

Yes. The basis of this consultation runs contrary to the Kingman Review. There needs to be more than the transition of the FRC to ARGA than a change of brand.

Question 2

Do you have any comments on the proposals for setting ARGA's annual funding requirement?

Yes. This consultation makes no reference to Parliament anywhere in the document. Given that both the FRC and now ARGA are public bodies that is a significant deficiency.

Question 3

Do you have any comments on the proposed approach to setting ARGA's annual levies?

Pre-2000 virtually all the costs of standard setting and enforcement fell to the accounting institutes. Shareholders - via the company - already pay for the audit fee. So any levy on UK companies and UK investors would amount to paying for bad audits twice.

As the main costs of ARGA to be funded relate to standards and enforcement – it is only fair that the lion's share should fall on the auditing institutes and firms. That is a particularly important principle given that the problems the auditing profession are self-inflicted. Those include:-

- auditing firms having business models with the conflicts of interest from consulting and other non-audit services embedded in them
- the largest firms having initiated complex and obfuscatory auditing and accounting standards which do not sit with the purpose of accounts and audits as set out in company law, including the definite 'Caparo'[10] decision.

Question 4

Do you have any comments on the proposed approach to setting ARGA's annual levies for its responsibilities in relation to audit? arrangements

See above. That lack of quality in audit represents a market failure and the costs should fall to the accounting firms and their institutes. The firms are announcing record partner profits. The institutes have a public interest purpose under their Royal Charters which carried the promise of effective self-regulation.

Question 5

Do you have any comments on our proposals for funding ARGA's responsibilities in relation to accountants and their professional bodies?

See Answer 4 above.

[10] ***Caparo*** Industries plc ***v Dickman*** [1990] 2 AC 605 House of Lord

Question 6

Do you have any comments on the proposed approach to setting ARGA's annual levies for its responsibilities in relation to corporate reporting?

We have described in the foregoing that the framework of company law is not being followed by the accounting standards.

We also add that the cost of the UK Endorsement Board at over £4m is excessive. Further, the Board has been set up in a way which is contrary to the approach the Kingman Review recommended for the FRC. This was:-

"A new board should be appointed. This should have some, but limited, continuity with the existing board. It should be significantly smaller than the FRC's. It should not seek to be "representative" of stakeholder interests. The board should cease to be self-perpetuating. All appointments to the new board should be public appointments. All appointments to both the board and committees of the new regulator should be advertised, and head-hunters should be used."

However, the UKEB has significant continuity with prior FRC boards and sub-boards (at least six of the 11 members) and has been set-up with sectional interests.

Question 7 Do you have any comments on the proposed approach to setting ARGA's annual levies for its responsibilities in relation to corporate governance?

ANY COMMENT?

Question 8

Do you have any comments on the proposed approach to setting ARGA's annual levies for its responsibilities in relation to investor stewardship?

We see a risk of ARGA's approach not merely being subjective in these areas of responsibility, but wrong.

The Law Commission's Report in the wake of the 2013 Kay Review pointed out that there was confusion between fiduciary duties, stewardship and other contractual duties. Paragraph 1.18 of the law Commission report says:-

"As the Government acknowledged in its response to the Kay Review, the term "fiduciary duty" is used in different ways by different people.

*"Even for lawyers, the term "fiduciary duties" is used in different ways. In the past, it has been used in a broad sense to encompass all the various duties owed by fiduciaries to their principals, including duties of care and duties which arise from the exercise of a power. As we discuss in Chapter 2, the courts have issued stern warnings against using the term in this broad, loose sense. Instead the courts have emphasised that the core of fiduciary duty is "**the obligation of loyalty", so that breach "connotes disloyalty or infidelity"**. Mere incompetence is not enough. Fiduciaries often also owe duties not to be negligent, but these are distinct from fiduciary duties*."

There is therefore a risk that stewardship activity is serviced and/or delegated on the wrong basis, by loose or inaccurate use of the word. It would seem from the above that the strict legal meaning of fiduciary duty - absolute loyalty (avoiding a conflict of interest) to the principal - cannot be delegated away.

However, of stewardship, The Law Commission Report at Para 5.97 says.

"Our conclusion is that, at present, there is no duty on pension trustees or other investors to undertake stewardship activities. Nor is there a direct duty on investment managers, provided that they explain why they are not complying with the Stewardship Code. If the Government wished to go beyond the "comply or explain" approach of the Stewardship Code, this would require a change in the law."

With ARGA being given a statutory footing it is difficult to see how ARGA can creditably set a levy for activity that includes 'stewardship' when there is not actually a duty to do it. The relevance here is that one the biggest problems in the investment chain is conflicts of interest that **run counter to properly defined fiduciary duties**, and that some purported 'stewardship' products are ersatz and money for old rope.

For example, we have seen claims that 'stewardship products' can cover bond and equities. However, given that there can be significant conflicts of interest between holding bonds and equities (for example if debt is poised to take control of a company, wiping out the equity) we struggle to see how they can be delegated together where there is any risk of a breach of loyalty to the principal.

This is another area where it is essential that Parliament is involved. It is incongruous to have a statutory levy for something there isn't a legal duty to have, but which carries the risk of eclipsing the real duty of a fiduciary.

LAPFF fully supports the concept of stewardship, in its proper context. With the FRC having got into a muddle over legal matters on accounting and audit, which flow from campaigns to eclipse auditor duties, it is relevant that there may also be an interest for some asset managers to eclipse some of their duties by downplaying fiduciary duties and relying on a diluted form of 'stewardship' instead.

Question 9

Do you have any comments on the proposed approach to setting ARGA's annual levies for its responsibilities in relation to public interest actuarial work?

Question 10

Do you have any initial comments on the metrics that should be applied to determine the appropriate share of the costs of actuarial regulation between the proposed funding groups?

This is outside the scope of LAPFF's interest. However, some of the problems with setting statutory levies for activities without a statutory basis for what those activities are, is also a problem here.

