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A dialogue with Stephen Haddrill

On 2 April 2014, as part of the European Audit Committee Leadership Network (EACLN) meeting in London, members met with Stephen Haddrill,[1] chief executive officer of the Financial Reporting Council (FRC), the UK regulatory body responsible for corporate governance and reporting.[2] For a biography of Mr Haddrill, see Appendix 1, on page 9. For a list of participants, see Appendix 2, on page 10.

Executive summary

Mr Haddrill and the EACLN members discussed the characteristics of the FRC as an organization and its activities in areas of specific interest to audit committees:

- **The FRC and its role** *(Page 1)*

  Mr Haddrill described an organization of 120 people that uses both mandatory regulations and the "comply-or-explain" approach to promote high-quality corporate governance and reporting in the United Kingdom. The FRC is not a statutory regulator, but an independent organization with authority delegated to it by the government through the secretary of state for the Department of Business, Innovation and Skills.[3] In response to members' questions about how the FRC addresses resource challenges, Mr Haddrill explained that the FRC collaborates with a number of other organizations to achieve its goals.

- **Influence in Europe and beyond** *(Page 3)*

  The FRC works closely with other national organizations and international bodies, and its impact extends well beyond the United Kingdom, a legacy of the influential 1992 Cadbury Report on corporate governance. Mr Haddrill pointed to the acceptance of the comply-or-explain approach by the European Union (EU) as an example. He also noted that the FRC tries to persuade other national standards setters to become more engaged in EU legislation.

- **Efforts for less cluttered, more effective reporting** *(Page 4)*

  The FRC's response to the financial crisis has included activity in several areas of interest to audit committees. It is trying to help companies reduce boilerplate and clutter, in part by providing guidance on the new "strategic report" regulations put out by the Department for Business, Innovation and Skills. It is also working on a proposal for improving risk reporting that includes provisions for both boards and auditors, and it has sought to improve audit committee reporting, an effort which EACLN members in the meeting generally supported with the caveat that the board as a whole, and not the audit committee alone, should ultimately be responsible for the report.

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[1] In another session, members discussed cybersecurity with Andrew Archibald, deputy director of the National Cyber Crime Unit of the UK's NCA and Paul C Dwyer, director of strategic solutions at the security firm Mandiant. See European Audit Committee Leadership Network, "Update on cybersecurity" *ViewPoints*, 12 May 2014.

[2] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

[3] Currently the Rt Hon. Dr Vince Cable, MP, a Liberal Democrat.

The FRC and its role

Mr Haddrill described the FRC's aims as follows: *"The mission of the FRC is to promote high-quality corporate governance and reporting to give confidence to investors. Our strategy is to focus on two broad activities. First, information provided to the market must be of high quality and create trust. Second, good behavior must be incentivized through our corporate governance code and through corporate reporting as well. We believe there is a link between what the board reports on and what it will discuss or what it focuses on. Reporting has a bearing on how the board behaves."*

Funding, structure and approach

To pursue its mission, the FRC relies on a staff of 120 people and operational expenditures of around £25 million.[4] Funding comes mostly from accountancy professional bodies and voluntary payments made by publicly traded companies and large private entities.[5] Mr Haddrill elaborated on the funding system and its implications: *"There are several funding streams for the FRC. First, for our supervisory work, the profession is charged. It would be difficult for them to refuse to pay since we have to recognize their professional bodies. Second, there is a levy on the listed market collected by the FCA [Financial Conduct Authority] as a part of their invoice. Keep in mind that under the Trade Descriptions Act, these levies are voluntary. Ninety-nine percent of firms pay, but it is a good discipline on us that they may not pay us in the future."*

The FRC has a board of directors, which establishes "the strategic direction of the organization, approving the plan and budget, and approving changes to codes and standards."[6] The executive committee, chaired by Mr Haddrill, recommends the strategic direction to the board, provides day-to-day oversight of the organization's implementation of the business plan and advises the board on the budget.[7]

Mr Haddrill noted that the FRC has an unusual status: *"We are not a statutory regulator. We are a company. The secretary of state gave his powers to us. We don't exist in law. It's unusual, and some people question if we are sufficiently accountable to Parliament. The secretary of state appoints two of our board members. It is an integrated, balanced power structure."*

The FRC develops codes and standards through an iterative process that solicits input from key stakeholders and the public.[8] It may include an initial consultation document that is circulated to interested parties and, if wider debate is required, released to the public. Exposure drafts of proposals are published for comment by all interested parties, usually for at least three months. Proposals are approved by a two-thirds vote of the board.

Many of the FRC's standards require compliance under various securities or company laws. For major elements of its policymaking, however, the FRC relies on the more flexible approach known as "comply or explain," under which regulated entities must either comply with the standard or explain why they chose not to comply. This approach encourages entities to comply, but it also gives them the option of not complying if they have reasons they believe are acceptable.

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[4] Financial Reporting Council, *Annual Report and Accounts 2012/13* (London: The Financial Reporting Council, 2013), pp 62–63.
[5] Ibid., page 48.
[6] Ibid., page 6.
[7] Ibid.
[8] Financial Reporting Council, "FRC Codes and Standards: procedures," accessed 16 March 2014.

Challenges of regulation

EACLN members mentioned some of the challenges regulators often face, such as inadequate funding, lack of experienced staff and the suspicions and misgivings of the entities they regulate. Several members noted that regulation often expands into overregulation. A member said, *"From the point of view of board members, it becomes so cumbersome going through the statutorily required elements. So you don't look at opportunities, just risk."* Another member noted that the problem is particularly severe in the financial services industry, where one mainland European board had 24 meetings a year just to cover legal requirements.

Mr Haddrill acknowledged these challenges, but said the FRC was addressing them: *"We're a small agency, only 120 people. That's both good and bad. It forces us to work closely with others and to leverage other organizations and their resources. For example, in the area of corporate governance, we talk to organizations such as the ABI [Association of British Insurers], major institutional representatives, IASB [International Accounting Standards Board], and major finance directors such as the 100 Group. We also work with major firms, not on how to supervise them but on standards and regulatory policy questions."*

Mr Haddrill also pointed to certain benefits associated with the FRC's special status as an independent regulator: *"The advantage is that we are not bound by civil-service rules on compensation. We recruit partners of the Big Four firms, not just junior staff. We have a lot of very experienced professionals."*

Influence in Europe and beyond

An EACLN member said in jest, *"From the European point of view, the UK appears to believe that they are the ones that invented football and corporate governance."* With regard to corporate governance, at least, many observers would agree that the United Kingdom has been a leader in the field. The recommendations of the Cadbury Report of 1992 have influenced boards around the world.

As Anne Simpson, senior portfolio manager and director of corporate governance at the California Public Employees' Retirement System, wrote on the 20th anniversary of the Cadbury Report's publication, "[This] code of best practice for Boards has been a catalyst for extraordinary and continuing change in corporate governance across developed and emerging markets. The Cadbury Code's approach has been taken up at national level across Europe, Asia, Latin America, the Caribbean, Africa and the Middle East. The audience and purpose have evolved to reflect local needs, but the core approach has proven resilient."[9]

The FRC works closely with regulatory bodies and even stakeholders in other countries. Mr Haddrill said, *"We operate internationally and work closely with the EU as a leading partner. Until recently, we chaired IFIAR [International Forum of Independent Audit Regulators]. We talk to the European Commission and European Parliament. We organize an annual FRC board meeting in Brussels, and we spend a lot of time in Washington and New York. We recently heard a lot of comments about auditing retendering in the UK – complaints from US companies because of interdependencies. We work in a fact-based but respectful way."*

As an example of the FRC's influence, Mr Haddrill brought up the expanding adoption of the comply-or-explain approach. This approach has been a core element of the regulatory framework for UK corporate governance since the Cadbury Report, and it has become a mainstay in the EU as well, even if its merits

[9] Anne Simpson, "The Power of Example," in *Comply or Explain: 20th Anniversary of the UK Corporate Governance Code* (London: Financial Reporting Council, 2012), page 49.

have been scrutinized and debated.[10] Mr Haddrill reflected, *"We worked with the European Commission to help them understand our process, which led to the creation of a working group. Ultimately, the commission agreed and saw the advantages of comply or explain."*

He also noted that the FRC tries to persuade national standards setters to become more engaged in EU legislation. For example, the FRC will sit on the board of the newly reorganized European Financial Reporting Advisory Group, where it can pursue such advocacy. Mr Haddrill said that one goal of the FRC is to encourage European legislators and regulators to stimulate long-term investment through governance codes, accounting standards and stewardship.

Efforts for less cluttered, more effective reporting

In the years since the financial crisis, a portion of the FRC's activities have been devoted to addressing problems the crisis exposed. At the meeting in London, Mr Haddrill and EACLN members touched on three areas of FRC focus that are especially interesting to audit chairs:

- Reducing clutter and boilerplate in financial reporting
- Improving risk management and reporting
- Improving audit committee reporting

Reducing clutter and boilerplate in financial reporting

A member raised the issue of clearer and more meaningful financial reporting: *"How do we improve the clarity of reporting? More clarity would be welcome, perhaps a digest with the main highlights. There should be a movement to make reporting more friendly and use more common words."* Members saw this imperative as all the more urgent as audit committees and auditors expand their reports and as demands for new types of reporting increase – for example, risk reporting and sustainability reporting, as well as other types of non-financial reporting.

Mr Haddrill explained that the so-called strategic report introduced by the Department for Business, Innovation and Skills in 2013 is an attempt to establish more meaningful reporting.[11] It sets out the company's business model, principle risks and key financials. He added that the strategic report is also compatible with the framework for integrated reporting, which was published by the International Integrated Reporting Council in December 2013: *"When we looked at the UK government's strategic report and compared it to the objectives for integrated reporting, we didn't see any gaps."*

At the same time, implementation of the strategic report does present challenges: *"Some companies can handle it and have created some interesting solutions. But lawyers can get at it and create boilerplate. At the FRC, we focus carefully on cutting clutter because we're responsible to people who are pushing us to put a lot in the financial reports. So we have to think about how to implement the strategic report versus good and effective reporting … We don't want people to fall into a 'safety first' approach and put in everything."*

Mr Haddrill explained that the FRC wants to work with companies to develop an effective report: *"We are looking for volunteers to see how company reports can be slimmed down. We are looking for six or seven*

[10] RiskMetrics Group, BusinessEurope, ecoDA and Landwell & Associates, *Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States* (Brussels: European Commission, 2009).

[11] Department for Business Innovation and Skills, "Better and Simpler Company Reporting," press release, 12 June 2013.

more companies to help us think about different ways to do it. It's part of the Financial Reporting Lab.[12] *It's no good complaining about reports; we have to help [improve] them. One of the obstacles companies face is that they are not sure how regulators or investors will accept these reports. The Lab represents a safe harbor to discuss the report."*

An EACLN member noted that targeting specific audiences with information relevant to them might solve some issues of clutter: *"There needs to be financial documentation for sophisticated investors that is not in the annual report. We created a bullet point front page that small shareholders could understand. And the remuneration report, we referred to our website. Sustainability is targeted at a completely different audience than financial reporting."* Mr Haddrill agreed that more information could be put on the website.

Improving risk management and reporting

The first stage of the FRC's multiyear effort to improve risk management and reporting in the wake of the financial crisis included a report on boards and risk, published in 2011, and an inquiry led by Lord Sharman (an alumnus of the EACLN), which produced a set of recommendations in June 2012. The FRC then issued an initial proposal for consultation in January 2013, which was followed by a revised proposal in November.

The proposal includes draft guidance and changes to the UK Corporate Governance Code that are directed at both boards and auditors, which the FRC summarized as follows:[13]

- **Boards.** "The draft guidance sets out boards' responsibilities for setting the company's risk appetite, ensuring there is an appropriate risk culture throughout the organization, and assessing and managing the principal risks facing the company, including risks to its solvency and liquidity. As now, boards should summarize the process applied in reviewing the effectiveness of the system of risk management and internal control. There is a new encouragement to explain what actions have been or are being taken to remedy any significant failings or weaknesses identified from that review."
- **Auditors.** "Under the proposals, auditors will be required, in meeting their current requirement to consider whether reporting is fair, balanced and understandable, to consider and report if they are aware of any material matter in connection with the disclosure of principal risks that should be disclosed."

The FRC also explained its new approach to going concern: "[The proposed changes and guidance] establish the need for a robust assessment by companies of how they manage or mitigate their principal risks, including risks to solvency and liquidity [emphasis in original], and to explain which if any of those risks have also given rise to material uncertainties for the purposes of reporting on the company's going concern basis of accounting. The FRC is, therefore, proposing to remove the current Code provision requiring listed companies to make a 'going concern' statement. That statement is focused on the narrow meaning of assessing the going concern basis of accounting, and so detracts from the broader integrated assessment and description of solvency and liquidity risks envisaged by Lord Sharman."[14]

The consultation on the revised proposal closed on 24 January 2014, and the FRC plans to finalize the guidance and changes to the governance code in mid-2014. Mr Haddrill commented, *"We hope to*

[12] The Financial Reporting Lab was set up by the FRC in 2011 to allow the FRC, companies, investors and analysts to collaborate on improving reporting.

[13] Financial Reporting Council, "FRC Raises the Bar for Risk Management," news release, 6 November 2013.

[14] Ibid.

implement recommendations from the Sharman report in September, especially the concept of going concern – not in a pure accounting sense, but directors giving an assessment about the viability of the company's future."

He acknowledged some of the difficulties involved, however: *"Directors should give a longer view, but it's harder to make assertions about the long term. For example, in the nuclear power industry, directors might look at a much longer time horizon because of the nature of the assets. Or should directors look at a five-year horizon because regulators set rates in that time period? What's important is whatever makes sense to the board members and that directors provide assurances of viability over that period. What are the reasonable expectations over that period?"*

EACLN members underscored the importance of better reporting on risk.[15] One member said, *"Today, financial reporting expresses reward, but not necessarily risk. Financial reporting should involve integrated reporting, including risk."*

Improving audit committee reporting

The FRC expects companies from 2013 to include more information in the annual report about the work of the audit committee. Mr Haddrill called the audit committee's report *"a platform for talking to investors."* In a November 2013 speech, he said, "Audit committees should now disclose significant issues considered in relation to the financial statements and how they were addressed; how they went about assessing the effectiveness of the audit; and their approach both to appointing the auditor and ensuring auditor independence, for example in relation to any non-audit service the external audit firm provides."[16] In the United States, *Enhancing the Audit Committee Report: A Call to Action,* a paper issued by a consortium of corporate governance organizations, including Tapestry Networks, has also called for audit committees to strengthen their public disclosures.[17]

By directing audit committees to discuss significant audit issues involving the financial statements, the FRC is taking a different tack than the International Auditing and Assurance Standards Board and the Public Company Accounting Oversight Board in the United States, which are considering an expanded report from the auditor. Mr Haddrill noted, *"Directors say that they are the stewards of the business and any shareholders' report … should come from [the board]."* He added that *"reporting by the external auditor should be by exception – are they aware of anything else? Do they have concerns? It's less about reporting and more about empowering the external auditor if they have any concerns about the audit."*

EACLN members discussed whether reporting about audit committee activities should come from the audit committee or the entire board. One member said, *"Why shouldn't the whole board report out on the audit committee? Otherwise, you expose the audit committee members. We want all board members to be responsible."* Other members agreed: *"The board must be single entity. To give special responsibilities to the audit committee and audit committee chairs is the wrong route."*

Mr Haddrill commented, *"This is an issue that we've debated. Should the report be signed by just the audit committee? Here in the UK, the board signs off on the audit committee report. But it is a separate audit*

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[15] The EACLN discussed risk oversight and risk appetite in November 2012. See European Audit Committee Leadership Network, *Strategy, Risk Appetite and the Board*, ViewPoints (Waltham, MA: Tapestry Networks, 2013).

[16] Stephen Haddrill, Speech at the PCAOB's International Auditor Regulatory Institute, Washington, DC, 19 November 2013.

[17] Center for Audit Quality, "Governance Leaders Issue 'Call to Action' to Enhance the Audit Committee Report," news release, 20 November 2013.

committee report. Investors want separate visibility, and the ability to engage with both the remuneration committee and the audit committee."

Potentially adding even more reporting for the audit committee, the UK Competition Commission last year proposed increasing the number of inspections that the Audit Quality Review Team conducts, which would make possible better and more comparable assessments of each firm, and then arranging for the audit committee to publicize the resulting grade and explain how the committee has used the review to assess the auditor.[18] Mr Haddrill said in a speech last November that the proposal had strong potential and that the FRC would want to consult on it.[19] In the United Kingdom, unlike other jurisdictions, audit committees receive the audit quality report directly from the regulator.

However, Mr Haddrill raised several issues that need to be resolved. For example, the reporting of the grade would have to be done in a way that does not mislead investors about the financial statements. Also, given the timing of inspections, it is unclear if the audit committee would have sufficient time to discuss how it used the results. Mr Haddrill commented, *"It might make sense if audit committees published a report every few years. We want to understand audit quality. But publishing a report every few years is not the view of the Competition Commission."* He also noted that a Competition Commission proposal to have shareholders vote at the annual general meeting on whether the audit committee report is satisfactory was unlikely to move ahead.

The UK Corporate Governance Code going forward

Mr Haddrill said that the Higgs review of corporate governance, commissioned by the government and conducted in 2002, was a "watershed for the Corporate Governance Code."[20] By affirming the crucial role of non-executive directors but identifying key issues that needed to be addressed, the Higgs review set the stage for important reforms. Reflecting on how corporate governance has evolved and will continue to evolve, Mr Haddrill mentioned several points:

- **Comply or explain reduces resistance to reforms.** The flexibility allowed by comply or explain helps companies adjust to change: *"Companies can take it at their own pace – there's been less resistance in the UK versus continental Europe because of this flexibility."*
- **Implementing the Sharman recommendations is a key priority.** The Sharman recommendations encompass not only risk reporting but risk management, including setting a company's risk appetite and ensuring an appropriate risk culture. They are an ambitious effort to improve how risk is handled by boards and companies.
- **Succession planning is an emerging concern.** Mr Haddrill said that the UK government has raised the issue of planning for executive succession, reflecting a concern that long-term planning is insufficient at many companies. The FRC has started gathering evidence on the issue.

A member remarked that the FRC seems to be entering a quieter period of implementation and consolidation rather than radical innovation.

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[18] Competition Commission, *Statutory Audit Services for Large Companies Market Investigation* (London: Competition Commission, 2013), page 281.

[19] Stephen Haddrill, Speech at the PCAOB's International Auditor Regulatory Institute.

[20] See Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (London: Department of Trade and Industry, 2003).

Conclusion

Mr Haddrill and the EACLN members discussed a range of issues relating to regulation and improving financial reporting. Reflecting on the FRC's role, Mr Haddrill described an approach to regulation that is collaborative and accountable to stakeholders, relying on both voluntary compliance as well as mandatory elements. He noted that the FRC works closely with its overseas counterparts and international organizations. Though he acknowledged that the comply-or-explain approach has its flaws and recognized that companies do not always adhere to its spirit, he argued that its flexibility is an important strength now recognized by other regulators. In addressing how to make reporting more effective, Mr Haddrill and the members explored the challenge of adding useful information while keeping the clutter and boilerplate to a minimum. Mr Haddrill noted that good reporting not only conveys information effectively, it also influences how boards and companies behave.

About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of management and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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Appendix 1: Biography of Stephen Haddrill

Stephen Haddrill became chief executive officer of the Financial Reporting Council in November 2009. Previously he was director general of the Association of British Insurers (ABI) from May 2005. In December 2008, Mr Haddrill was appointed as a member of the Financial Crisis Advisory Group (FCAG), the high-level advisory group set up by the International Accounting Standards Board and the Financial Accounting Standards Board to consider financial reporting issues arising from the global financial crisis. From October 2007 to 2011, Mr Haddrill also served vice president and chair of the board of the Institute for Employment Studies, the United Kingdom's leading employment and human resources experts.

Mr Haddrill was the director general of the Fair Markets Group at the Department of Trade and Industry (DTI), where he was responsible for the development of the framework within which the business operates, including the competition and consumer framework, employment relations, company law, women and equality issues, and also trade and European issues. He held this position from January 2002. Prior to this, from 1998 until Spring 2002, he held other positions within the DTI, including director of employment relations and consumer affairs.

From 1994 to 1998 Mr Haddrill was a director of the DTI's competitiveness unit, a central policy team reporting directly to the secretary of state. From 1990 to 1994 he worked for the government of Hong Kong as a member of the governor's central policy unit.

Mr Haddrill studied history and economics at Oxford University and began his civil-service career in 1978, working for the Department of Energy, where he held a number of posts, principally on nuclear issues and as principal private secretary to the secretary of state for energy.

Appendix 2: Participants

Members participating in all or parts of the meeting sit on the boards of 25 large-, mid- and small-capitalization public companies:

- Mr Aldo Cardoso, Audit Committee Chair, GDF SUEZ
- Mr Ángel Durández Audit Committee Chair, Repsol
- Mr Phil Hodkinson, Board Member, BT (alumnus)
- Mr Lou Hughes, Audit Committee Chair, ABB
- Dame DeAnne Julius, Audit Committee Chair, Roche
- Dr Maurizio Lauri, Audit Committee Chair, UniCredit
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Ms Guylaine Saucier, Audit Committee Chair, AREVA
- Mr Jack Tai, Audit Committee Chair, Royal Philips

EY was represented in all or parts of the meeting by Mr Christian Mouillon, Global Risk Management Leader.