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Dear Policy and Planning Manager

Draft plan and budget 2009/10

INTRODUCTION

1. Ernst & Young LLP welcomes the opportunity to comment on *Draft Plan 2009/10, Proposed Updates to the Strategic Framework and 2009/10 Levy Proposals, including supporting information* ("the Plan") issued by the Financial Reporting Council ("FRC").
2. We applaud the FRC for undertaking this consultation, which demonstrates a commendable level of transparency and willingness to engage the market on its aims and responsibilities. We believe this is consistent with the FRC's overall approach towards regulation and oversight, and its pragmatic and timely response to issues created by the current crisis (e.g., introduction of guidance on going concern) was particularly well received by the profession and markets.
3. We have a few overall observations to make that we outline below before commenting on the FRC's specific questions.

OVERALL OBSERVATIONS

Funding

4. We are pleased the FRC has proposed to extend its levies to large private companies and public sector organisations. We believe that all beneficiaries of the FRC's work, which helps to preserve the good reputation of the UK's markets, should make an appropriate financial contribution. This should also help to reinforce the perceived independence of the FRC by ensuring its source of funding is transparently diverse.
5. We regard these arrangements as a welcome precedent for the future, but it would be helpful if the FRC could outline in more detail the rationale behind them. In particular, it is



unclear how the level of discounts offered to contributors are set, and to what extent they are fixed in the short to medium term. We say this because when the government withdraws completely from its commitment to make a financial contribution, a shortfall in funding will need to be covered. In our view a potential means to cover this could be a reduction in these discounts.

6. We believe this would also provide a greater parity of financial contribution, between the different categories of company that benefit from the work of the FRC. In our view all companies listed here (UK and foreign) and private entities benefit from the FRC's guardianship of standards (reporting, auditing and actuarial), corporate governance and the FRRP's oversight.

Strategic framework

7. Our views on the strategic framework focus on its scope. We believe it is very ambitious because it seeks to identify and assess the projected outcomes rather than outputs of the FRC's work. While outcomes are important and need to be monitored, the complex interplay between the FRC's stakeholders and influencers makes it difficult to isolate, assess and cost the FRC's contribution to these outcomes. Therefore we encourage the FRC to also highlight its specific activities and outputs, so there can be no doubt amongst its financial contributors how, when and where their funding will be spent.

Regulatory budgets and impact assessments

8. In the spirit of this openness we also encourage the FRC to apply the proposed principles of regulatory budgets, as outlined by BERR in the autumn of 2008. This should complement the use of Impact Assessments and provide added assurance for the FRC's stakeholders that regulation is only introduced or modified when it is absolutely necessary and subject to a cost-benefit analysis. The FRC might also wish to consider assessing the net regulatory benefit of its activities in instances where it might be able to simplify, if not reduce, its overall regulatory footprint in the UK – another aspect of the BERR proposal.

RESPONSES TO SPECIFIC QUESTIONS

Q1. Do you agree with our proposed updates to our Strategic Framework?

We agree with the proposed updates, to the extent that they define in more detail the strategic outcomes outlined by the FRC. For example, by sub-dividing and redefining various categories (i.e., "auditing" and "related services") the FRC should help to clarify further the role and contribution auditors can make. In addition, this should help to illustrate the value of "related services" in enhancing audit quality. We believe it would be helpful if the FRC could provide a more detailed explanation of its position on this matter.

However, in our view most of the outcomes in the framework are inter-dependent and mutually supportive. This makes the task of distinguishing between them difficult. For this reason it might be useful to include outputs in the framework as well, to help clarify the activities of the FRC and how it intends to fund them with its budget.

Q2. Do you agree that the major risks we have identified in the draft Plan 2009/10 are significant in relation to confidence in corporate reporting and governance in the UK? Are there major risks which we have not identified? Do you agree with our draft risks assessments in section B?

We agree that the risks identified in the Plan and assessed in Section B are significant. However, some may be more significant than others; some may be more widely drawn and overlap, making it difficult to distinguish between them; and others may have been overlooked altogether.

For example, strategic outcome one refers to the Combined Code and the loss of credibility in the 'comply or explain' approach, resulting in a loss of confidence in corporate governance. In our view this lack of confidence can arise from other significant risks as well, including but not limited to those shown in the Plan. Another example is outcome three, where the potential cost and risk of a big firm leaving the market is attributed to the 'high level of concentration in the audit market.' In our view another causal risk which has the potential to be more significant is the UK's "opt in" liability limitation regime. This has the effect of reducing a firm's protection against unlimited liability, with a corresponding increase in the risk of it having to leave the market unnecessarily in the event of a catastrophic claim.

Some of the perceived risks outlined by the FRC could also change rapidly and become less significant during the shelf-life of the Plan. For example, it is suggested that IFRS might develop into a more rules-based set of standards in an attempt to converge with US GAAP. However, at the time of writing this reply, press reports suggest that the SEC executive may be less enthusiastic about accepting IFRS, because of concerns about the potential cost and distraction of IFRS transition during the current economic crisis. That said, we continue to believe that global acceptance of IFRS is the ultimate goal.

Other risks not mentioned in the Plan, which are nonetheless significant, include the possibility of the FRC and other regulators becoming distracted under the current financial crisis, with the continuation or onset of divergent operations and standards as a consequence. The key implications arising from these risks are listed below and most but not all have been covered in the Plan, in one form or another:

- continued complexity of ISAs;
- continued existence of divergent ethical standards (IFAC and APB);
- slow and complex third-country auditor registrations, undermining investor confidence in third-country companies with EU listings;
- unresolved issues related to multiple inspections and/or the transfer of audit working papers, undermining the effectiveness of international regulation and oversight; and a
- continued threat of catastrophic litigation due to a lack of auditor liability regimes, or disparate regimes operating without caps or statutory force.

Q3. Do you have any comments on the scope and relevance of the proposed major activities and projects included in the draft Plan 2009/10? Are there any additional major activities or projects which should be included in the Plan? Do you agree with our draft work programme 2009/10 in section B?

In our view the scope and relevance of the activities seem to address the risks highlighted by the FRC, and to that extent we agree with the work programme in Section B. However, two of the additional risks identified in our response to Q2 (co-existence of IFAC and APB ethical standards and slow/complex third-country registrations) do not appear to be addressed (directly or indirectly) with specific FRC activities or projects. For this reason we encourage the FRC to review these risks and consider whether any additional work might be required to mitigate them.

Q4. Do you believe there are any other significant risks which may emerge, beyond the 2009/10 horizon, which may be relevant to our future planning?

We believe there are other significant risks which may emerge beyond 2009/10. These include the following, which could adversely affect the market's perception of auditors, namely:

- growing emergence of fraud;
- impact of the financial crisis on "going concern";
- widening expectations gap between auditors and investors; and
- increasingly restrictive independence rules, with the potential to prevent and undermine the delivery of audit-related services and quality respectively.

Q5. Do you have any comments on our draft budget for 2009/10?

Considering the depth and breadth of the FRC's work, and recognising its influence on other regulators in support of closer convergence, we believe its estimated budget for 2009/10 seems proportionate. In particular, its headcount of less than 100 has remained relatively low compared with a significant increase in scope. We note in particular the development of standards and a quality framework for actuaries, and the addition of third-country registrations and oversight.

Q6. Do you have any comments on our draft funding projections for 2009/10?

We are pleased the FRC decided to extend its levies to large private companies and public sector organisations. We regard this as a welcome precedent for future funding. Also, the market capitalisation bands used to determine the amounts payable by listed and private companies are acceptable to us, especially as they are aligned to those implemented by the FSA for its UKLA fees.

However, the FRC has not explained how it formulated the 50% discount on levies charged to large private companies and foreign companies listed on the LSE, combined with a 75% discount for public sector organisations. We encourage the FRC to be more transparent about this and to consider whether some of these discounts could be used to cover the

shortfall in funding (13% based on the 2009/10 budget) when the government contribution disappears altogether.

In our view the FRC contributes significantly to the strong reputation of the UK's capital markets, and all companies listed here (UK and foreign) benefit from this. Similarly, all companies - public and private - benefit from the FRC's guardianship of standards (reporting, auditing and actuarial), corporate governance and the FRRP's oversight. Therefore, greater parity of financial contribution between these categories of company seems equitable, especially if there is a commensurate rise in the overall levy to offset the impending government shortfall.

Q7. Do you have any comments on our proposed preparers' levy rates for 2009/10? Do you have any comments on our proposed insurance and pension levy rates for 2009/10?

We have no specific comments to make on the proposed insurance and pension levy rates, nor do we have any further views on the other levies (see our response to Q6). However, we ask that the FRC continues to consult in the same way it has done for its 2009/10 Plan. This should help to ensure that future levy rates remain transparent and, as far as possible, proportionate and appropriate for the market.

CONCLUSION

We believe the size of the FRC's budget, relative to the scale of its operations, is appropriate and we applaud the FRC's work in making the structure of its funding more transparent. The extension of levies to other entities is particularly welcome, although we expect new contributors will be interested in understanding how their funding will be spent, so there may be more scope to explain outputs as well as outcomes in the strategic framework.

We are grateful to the FRC for publishing this consultation and we hope you have found our comments helpful. If you would find it useful, colleagues in our firm are available to discuss further any of the points we have raised.

We wish you every success with the rest of the consultation process and encourage you to publish all non-confidential responses shortly after the closing date. We look forward to reading the results.

Yours sincerely



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