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31 May 2008

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Dear Policy and Planning Manager

FRC regulation cost-effectiveness

INTRODUCTION

1. Ernst & Young LLP welcomes the opportunity to comment on *Cost-Effectiveness of FRC Regulation Discussion Paper, March 2008* ("the Discussion Paper") issued by the Financial Reporting Council ("the FRC").
2. Our response is formed from three perspectives: i) an entity regulated by the FRC; ii) professionals who work alongside the FRC's various boards and engage in their consultations; and iii) a business whose clients are subject to FRC standards and reviews. We also take into consideration the FRC Discussion Paper relative to the *Principles of Good Regulation*¹, such as: proportionality; accountability; consistency; transparency; and targeting.

OVERALL OBSERVATION

3. With so many regulatory initiatives in consultative or embryonic form, the overall assessment of "regulatory cost-effectiveness" of any initiative or single regulatory entity is challenged. In addition, most of the FRC's "strategic outcomes" (as defined in its Strategic Framework and Plan) are long-term and not always directly attributable to the FRC. Consequently, many of these outcomes are inter-dependent and mutually supportive, which makes the task of distinguishing between them and assessing their cost effectiveness highly subjective, especially in the absence of front-end Regulatory Impact Assessments. Our responses to specific questions should be considered in the context of this subjectivity.

¹ *Principles of Good Regulation* was published in 2007 by the Better Regulation Executive.



RESPONSES TO SPECIFIC QUESTIONS

Q1. Do you have any comments on our approach to improving the cost-effectiveness of FRC regulation whilst preserving confidence in corporate reporting and governance?

It is important to remember that the first line of defence in preserving confidence lies with management, followed by the board and its independent directors. In that context, the FRC's stated aim to remove, simplify and/or restrict regulatory requirements on companies is one we fully support.

We also acknowledge that a high proportion of FRC regulation, and some of the costs associated with it, is driven by the UK government, European Commission and various international standard setters. Accordingly, the challenge of improving the cost effectiveness of this regulation is difficult. For this reason we encourage the FRC to narrow and deepen its approach. This should lead to fewer initiatives with a higher proportion managed through to completion or closure.

Q2. Do you agree that the actions we have already implemented to improve the cost-effectiveness of FRC regulation have been helpful? Are there any aspects of those actions which are particularly relevant to the development of further proposals?

We agree, for the most part, that the actions taken by the FRC to improve the cost effectiveness of its regulation have been helpful. However, we encourage the FRC to improve further certain types of action, specifically:

- Conduct robust Impact Assessments on new or proposed changes to regulation, to assess whether these proposals are worth developing from the outset. This should help to lower the risk of launching ineffectual or unnecessary regulation, accompanied by needless and wasteful consultations.
- Use analytical weighting techniques when assessing responses to consultations, to avoid decision-making based on disproportionate and unrepresentative public viewpoints.
- Be more mindful of the auditing calendar and other parties' consultations, before issuing consultations or calling public meetings.
- Publish minutes of public meetings and responses to consultations in a more timely and comprehensive way. This should help to expedite a return on the public's investment in the ongoing regulatory dialogue.
- Seek more opportunities to harmonise regulation with overseas regulators, to improve the continuity of regulation across jurisdictions.

- **Ensure that the FRC's international regulatory initiatives (meetings, consultations, agreements etc) are aligned with its strategy, governance and board.**

Listed below are various regulatory initiatives - in progress or recently completed - where some changes may be more helpful than others in decreasing market cost and increasing effectiveness, depending on whether you are a preparer, investor or auditor. We discuss seven examples as follows.

Corporate governance

We support the FRC's commitment to maintain a principles-based corporate governance regime, through a relatively "unaltered" Combined Code. In particular, the decision to allow individuals to chair more than one FTSE100 company, and allow chairmen from non-FTSE350 companies to join their respective audit committees, should help to make the Code more cost effective without significant compromise.

Corporate reporting

Most would agree that the introduction of the FRSSE was, in principle, the right thing to do in the interest of smaller companies. However, making the standard optional and in some respects more complicated by including elements from other standards seems inconsistent with the object of the exercise: to simplify and ease the cost of financial reporting for smaller companies.

Auditing

Our work, as a global network serving global clients, indicates that there is considerable scope for the FRC to operate with and alongside regulators in other jurisdictions. The Auditing Practices Board (APB) and IFAC, in the context of setting ethical standards, is a good example.

The co-existence of two sets of ethical standards (APB and IFAC), where updates to one set causes discontinuity and a requirement to update the other, creates added complexity and cost. This could be avoided if the international and more widely used set of standards were allowed to take precedence in the UK. We understand however that the APB is unlikely to repeal its Ethical Standards in favour of IFAC's Code.

Another example is the implementation of the SAD provisions for Transparency Reports. There is scope for different regulators to work together and minimise jurisdictional discrepancies in areas such as: timing of annual report publication; minimum duration of report availability; and definition of Public Interest Entity. In this regard we were surprised that POB had decided to expand some of the requirements of Article 40.

Monitoring and audit quality

The new reporting requirements of the AIU, which were introduced to meet increased expectations for more transparent inspections, have not been put to the test yet. For this reason we believe it is far too soon to assess the cost effectiveness of this change, especially since it is unclear if and how greater public access to certain types of AIU reports will positively affect the regulatory regime.

Actuarial practice

We note that HM Treasury asked the FRC to take responsibility for introducing and overseeing the application of actuarial standards. So the effectiveness or otherwise of introducing standards in this area, regardless of cost, will be an appropriate question for the government. However, the newness of this responsibility for the FRC makes any attempt to assess its cost effectiveness premature.

Accountancy and Actuarial Discipline Board – Accountancy Scheme

This scheme, with the inclusion of actuaries, should be clarified and efforts made to ensure it is fair and not prone to a disproportionate regulatory response. In our view the current scheme is indistinct when compared with the available recourse to other “disciplinary arrangements” in the UK, which leads us to assume that this scheme could overlap with others (for example, the RSBs, AIU, civil and criminal law). Therefore, its cost effectiveness may be in doubt unless or until matters are clarified.

Q3. Do you agree that the further proposals we have identified can potentially further improve the cost-effectiveness of those aspects of the regulatory regime for which the FRC is responsible whilst preserving confidence in corporate reporting and governance?

Without more detail and closer inspection, it is not possible to say with any degree of certainty whether the FRC’s proposals for future change can potentially improve the cost effectiveness of its regulatory regime. However, some of the proposed initiatives give us cause for concern.

For example, we noted the FRC’s intention to seek ways to simplify or remove reporting standards with a series of consultation projects, while admitting in the Discussion Paper that it had a ‘limited chance of making any significant improvements’. Therefore we question the cost effectiveness of the FRC undertaking these projects, especially when the IASB and others are already looking at the same issue.

Of equal concern is the FRC’s plan to get more closely involved with the provision of “improved” training for auditors. We believe the RSBs and other training agencies, in addition to the in-house training provided by the audit networks, is well funded and more experienced in this area. Therefore we question the merits of the FRC committing its time and resource to this type of subject, especially when the cost-effectiveness of other

matters with a closer proximity to the FRC (for example, third-country oversight) will probably deserve closer attention.

On a similar theme, we see opportunities and concerns associated with the review of the Accountancy Scheme. For example, if the proposed "preliminary enquiries" are used appropriately and effectively to dispose of cases which might otherwise escalate to a full-blown Tribunal, there are potential costs savings to be made. Likewise, if the proposed "Disciplinary Decisions Committee" robustly challenges the findings of the Executive Counsel, by paring-down widely-drawn complaints or rejecting unmeritorious cases, there is another prospect of making real costs savings. However, the proposed definition of "relevant conduct" is less clear than the current definition, which could increase the potential for disagreement between the Board and respondents, off-setting these savings and making the overall Scheme more costly.

Q4. Are there any additional aspects of FRC regulation where you believe there are opportunities to improve the cost-effectiveness of those aspects of the regulatory regime for which the FRC is responsible?

One aspect of FRC regulation is the governance of audit committees, which could change under current proposals and, as a consequence, undermine the FRC's objective of regulatory cost effectiveness. This involves Market Participant Group proposals to amend the Smith Guidance, with the effect of increasing audit committee responsibility for engaging shareholders in the "audit firm relationship."

This is currently under review in a separate FRC consultation. We highlight two examples where the proposed changes could have a disproportionate impact on cost, for little or no regulatory gain.

Firstly, the proposal requiring audit committees to inform shareholders of their recommendations to appoint, re-appoint or remove an auditor (to include details on the incumbent auditor's length of service and the last time the audit was subject to tender) could be an unwelcome distraction for company boards. They may be coerced into putting the audit out to tender at set frequencies, regardless of whether they consider it to be in the company's best interest to change their auditor.

A higher frequency of tenders, over an extended period of time, could increase costs significantly for companies, without any commensurate benefit in terms of audit quality or choice. Of course, if this results in companies changing their auditors more frequently, costs will be increased even further. This is because companies will have to spend a considerable amount of extra time and effort to undertake the bid process, and then support the incoming auditor to help it get familiarised with the business. Conversely, the knowledge and experience which is lost every time the outgoing auditor leaves can often erode the overall quality and effectiveness of the audit.

Secondly, the proposal that companies should develop contingency plans to deal with the possibility of their auditor leaving the market, will in effect require boards to "appoint" another audit firm as their "standby". This means that companies may decide to disengage altogether from using non-audit services from these "standby" firms. This could inhibit

competition and restrict overall choice in the audit market. As a consequence, a smaller number of firms are likely to experience a bigger demand for their non-audit services, enabling them to increase their fees accordingly and inadvertently increase company overheads.

Q5. Do you have any comments from the perspective of smaller enterprises subject to FRC regulatory requirements?

The FRC has actively engaged in a dialogue with the SME community, which we fully support. In our view it is important to consult with SMEs to identify reasonable and commercial exemptions, if particular regulations or standards are unsuitable or simply unworkable for this type of entity. We believe that a one-size-fits-all approach to reporting and ethical standards can create unnecessary costs and uncertainties for the type of entity that can least afford it.

For example, the introduction of IFRS for SMEs is a welcome initiative, but the roll-out needs to be timetabled and communicated well in advance of the effective date, to minimise the cost and disruption of the adoption process.

CONCLUSION

In conclusion we recognise the best endeavours of the FRC, but the validity and reliability of an assessment of regulatory cost-effectiveness in "one hit" such as this is unlikely to be meaningful, given the extensive agenda that the FRC drives. We therefore question whether the FRC's attempt to do this is the most cost-effective use of its time and resource.

We suggest that assessments of cost-effectiveness should be focused on specific Impact Assessments, relative to discrete proposals and initiatives. We believe that the FRC's current application of these types of assessments; the duration and timing of its consultation periods; and the timeliness of its public responses could often be more aligned to the government's *Principles of Good Regulation*. Therefore we hope this consultation does not prove to be a case in point, and the FRC heeds the opinions and views it has so expertly sought.

We hope our response is helpful and respectfully ask the FRC to publish it alongside other responses shortly after the consultation closes. If the FRC would like further clarification on the points raised by Ernst & Young, please contact me at your convenience.

Yours sincerely



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